

Q&A on the State of SMEs in Canada

- Overall, SMEs weathered the last recession well — largely owing to the resilience of small firms.
- The recession was a setback for medium-sized enterprises reversing a previous trend toward ‘bulking up’.
- Startup rates show signs of recovery and are highest in construction; professional, cultural and technical industries; food and accommodation; and knowledge-based industries.
- After falling sharply during the recession, the number of high-growth firms is recovering.
- While SMEs report facing substantial challenges, concerns about financing are relatively low.

Canada’s economy relies on small- and medium-sized enterprises (SMEs). Defined as firms with fewer than 500 employees, SMEs employ 8 million Canadians representing 54% of payrolls¹. SMEs also generate a large share of Canadian research and development and exports.

Medium-sized firms were hard hit during the recession. Small firms (those with 1-99 employees) have increased steadily while medium-sized firms (employing 100-499) have retraced some of their losses. Overall, SME numbers reached an all-time high in 2012 despite a subdued pace of firm creation. Further employment gains in 2013 suggest this trend persisted.

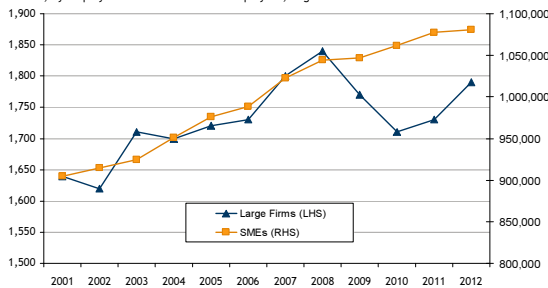
Q1: How have SMEs fared since the recession?

A: SMEs, and especially medium-sized firms, were hard hit during the recession but are now recovering. A 2008 study by RBC Economics² found that following a spate of startups in the 1980s and early 1990s, Canadian small business began to mature as firms expanded their payrolls. The mid 2000s saw growth in firm size slow, and during the recession, reverse. In 2009 growth in small enterprise numbers was the slowest in a decade and the number of medium-sized firms plunged. After the recession new firm entries consistently outpaced exits and SME numbers rose steadily.

The decline in the number of medium-sized firms during the recession is striking, especially given smaller firm numbers held up. Driving this divergence were medium-sized manufacturing firm numbers, which tumbled 40% from 2006 to 2010³. On a provincial basis, declining medium-sized firm numbers hit Ontario hardest given the prominence of manufacturing in the province. Partially offsetting declines in manufacturing, medium-sized firm numbers in services industries have grown, particularly in retail and accommodation and food services. By 2012, manufacturing firm entry rates had ticked up with positive implications for the industry going forward.

Chart 1: Number of SMEs

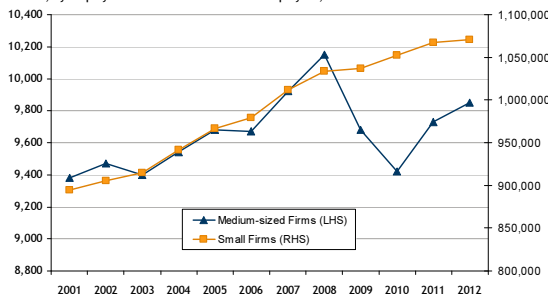
Annual, by employment size. SMEs: 1-499 employees, large firms: 500+



Source: Statistics Canada, RBC Economics Research

Chart 2: Small vs. Medium-sized Firm Numbers

Annual, by employment size. Small firms: 1-99 employees, medium-sized firms: 100-499



Source: Statistics Canada, RBC Economics Research

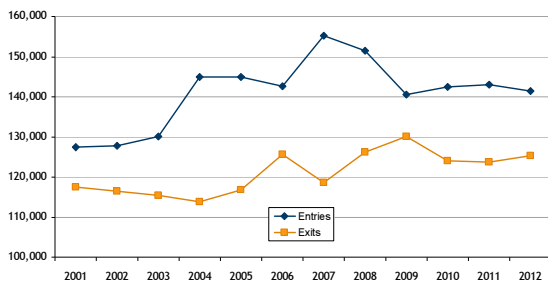
Gerard Walsh

Economist

(416) 974-6525

gerard.walsh@rbc.com

Chart 3: SME entries and exits



Source: Statistics Canada, RBC Economics Research

Chart 4: Startups as a Percentage of Total Firms

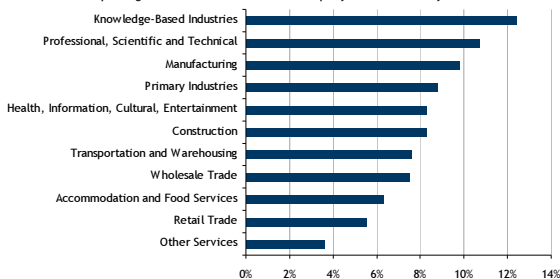
Share of firms by industry younger than 2 years old, 2011



Source: Industry Canada

Chart 5: High Growth Firms

Share of firms expanding revenues or sales faster than 20% per year for at least 3 years



Source: Industry Canada

Q2: What is happening with firm entries and exits?

A: The recession dampened Canadian startup activity. Firm entries declined by 9% from 2007 to 2009 and have been flat since. Nevertheless, the number of firm entries has consistently exceeded firm exits, boosting SME numbers. Despite a rise in firm exits during the recession, new firm survival rates have held up^{4,5}. As of 2009, 80% of new SMEs survive the first year, and 72% survive the second.

Q3: Where are new firms starting, and in what industries?

A: New businesses, defined as those in existence for less than 2 years, are unevenly distributed across sectors and regions. Statistics Canada's 2011 *Survey on Financing and Growth of Small and Medium Enterprises* provides detailed information on new firms and Canada's small business landscape. Looking geographically, British Columbia has the highest fraction of new firms at 7.1%. At 3.9%, the lowest share is in Ontario. This is related to the prominence of manufacturing in Ontario which has the lowest startup rate among industries. Private services account for the largest share of new firms, nearly 68% in 2010⁶. Within services, new firms are concentrated in accommodation and food services; professional, scientific and technical services; and knowledge-based industries. Among goods-producing industries, construction accounts for the lion's share of new firms. This is related to the large number of firms in the sector and their smaller average size compared with other goods-producing industries.

Q4: Who owns SMEs?

A: The 2011 survey also revealed that female majority-ownership is higher in younger firms. This partly reflects the concentration of women-owned firms in startup-rich sectors including retail trade and accommodation and food services as indicated in a 2013 RBC Economics⁷ report which detailed the steadily rising share of women among business owners. Consistent with Canada's growing foreign-born population, younger businesses are also more likely to be owned by immigrants. The immigrant-owned share of SMEs is higher in Canada's largest cities. In Toronto, where the immigrant-owned share is highest, 40% of SME owners were born abroad.

Q5: How many high-growth firms are there and what sets them apart?

A: Statistics Canada defines a high-growth firm as one which sees sales or revenues grow by more than 20% per year for at least a 3-year period. If that growth takes place in the first 5 years of a business' existence, it is a rapidly growing startup or 'gazelle'. These firms are few in number; between 2009 and 2011 high-growth firms accounted for 7.7% of all firms and gazelles only 1.0%. However, high-growth firms employ one million workers in aggregate, including 200,000 in gazelles⁸. Based on the available data, during the recession high-growth firm numbers fell substantially although have since recovered⁹.

Most SMEs do not grow rapidly, and the owners of slow-growing SMEs typically cite lack of opportunities for expansion as the cause. Among these firms, job creation tends to reflect expanding firm numbers, not existing firm growth¹⁰. Gazelles and high-growth firms are different; they rapidly grow their sales and employment. While high-growth firms are concentrated in knowledge-based industries and professional, scientific and technical ser-

VICES as might be expected, they are present in all sectors.

Q6: What drives the success of high-growth firms?

A: A 2010 OECD study¹¹ found that governments can boost the rate at which exceptional firms form and grow by implementing policies which foster the training of employees and managers, improve access to financing, and promoting SME internationalization. The same study also noted that high-growth firms tend to be innovators. In general, when SMEs seek to innovate they are rewarded for their efforts. In 2011, only 8.7% of firms reported that nothing came of their recent innovation efforts whereas 70% reported a boost in sales. Given its importance, it is worrying that spending on research and development has fallen recently, along with the number of firms that report undertaking innovative activity. According to the *Survey of Innovation and Business Strategy*, 60.1% of medium-sized businesses reported innovative activity between 2010 and 2012, down 16.2% from 2007-2009. Total research and development expenditure fell for both small and medium-sized enterprises over the same period. This decline is striking given both improving economic conditions and the uptake of government incentives¹². The share of enterprises using government tax credits for innovation rose from 20.1% to 40% among small businesses and from 24% to 49% for medium-sized firms.

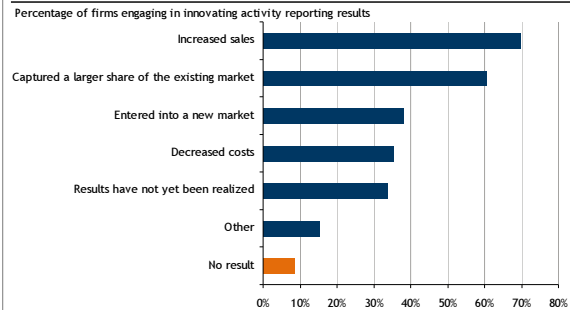
Q7: What challenges do Canadian SMEs face?

A: When asked, the obstacles to business growth most cited by SMEs are rising input costs and unstable demand that fuel concerns that cash flows will not be sufficient to allow expansion. Many enterprises report attracting and retaining workers as a major challenge, especially in medium-sized enterprises where demand for qualified employees rises. Over half of medium-sized firms report employee recruitment and retention are stumbling blocks to growth.

Growth obstacles are not uniform across the country and reflect unique regional circumstances. Firms are most likely to report labour shortages and difficulties in attracting and retaining workers in Saskatchewan and Alberta. This reflects tight labour markets in these provinces which forces firms to compete for workers. As the home of Canada's beleaguered manufacturing sector, Ontario firms cite fluctuating demand and increased competition as major obstacles. Overall, manufacturing firms face incessant competitive pressures and 63% of firms in the sector report demand uncertainties. Concerns about input prices, government regulations, and maintaining cash flows are significant nationwide.

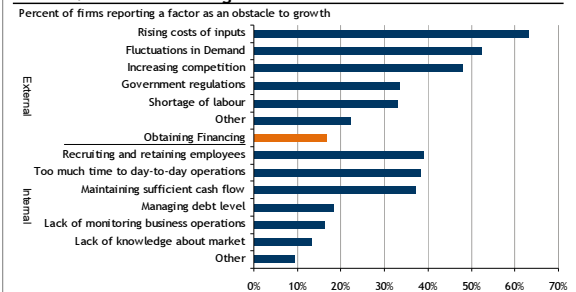
Small business financing is generally available and affordable. In 2011, 26% of SMEs sought external financing and approval rates for new debt exceeded 90%. Since then the availability of credit has continued to improve¹³. Still, 17% of firms report obtaining financing as an impediment to growth, roughly the same share as in 2007¹⁴. This share rises among exporters and new enterprises. In general, these firms find it harder to acquire financing of all types. This results from lenders' concerns about project riskiness, lack of sufficient collateral and stability in cash flows.

Chart 6: Results of Innovation



Source: Industry Canada

Chart 7: Business Challenges



Source: Industry Canada

While the prospects for small business are often highly dependent on the business cycle, their access to funding generally is not. In a 2014 study Industry Canada¹⁵ found that SME access to funding is generally better insulated from the effects of the business cycle than that of larger firms. This effect is attributed partly to the idiosyncratic outlook for individual firms and industries, but also to government programs designed to help small firms. Through Business Development Canada (BDC) and the Canada Small Business Funding Program (CSBFP) at the federal level and additional programs at the provincial level, governments help provide funding to small enterprises through tailored financing, venture capital, consulting services and sharing loan risk with financial institutions. The effect of these programs is estimated to have contributed to the continued availability of credit during the recession.

-
- 1 Survey of Employment Payrolls and Hours (2014) All workers in establishments with 0-499 employees as a share of all workers.
 - 2 RBC Economics (2008) *Small Business and Industries in Canada – Recent Trends*.
 - 3 Business Development Canada (2013) *What's Happened to Canada's Mid-sized firms?*
 - 4 Industry Canada (2011) *Key Small Business Statistics, July 2011*
 - 5 Industry Canada (2013) *Key Small Business Statistics, August 2013*
 - 6 Statistics Canada, Centre for Special Business Projects (2010). Share of businesses entering the service sectors excluding education and health care in 2010.
 - 7 RBC Economics Research (2013) *Canadian Women Grabbing the Baton*.
 - 8 Statistics Canada, Centre for Special Business Projects (2013). *High Growth Enterprises Based on Revenue*.
 - 9 Industry Canada (2013) *The Canadian Provinces. Special Edition: Key Small Business Statistics, September 2013*.
 - 10 Matching employment by firm size from the LFS and business numbers from the LEAP database shows that from 2001-2009 numbers of SMEs and employment therein expanded strongly while employment per business declined.
 - 11 OECD (2010) *High-Growth Enterprises: What Governments Can do to Make a Difference*. Online ISSN: 2078-0990
 - 12 The largest federal program is the *Scientific Research and Experimental Development Program* which distributed \$3.6 billion in 2012 to 23,000 claimants, most of which were small businesses.
 - 13 Bank of Canada Senior Loan Officer Survey, 2014 Q2
 - 14 Statistics Canada (2007) *Survey on Financing and Growth of Small and Medium Enterprises*.
 - 15 Industry Canada (2014). *Cyclicalities of SME Financing in Canada*.

The material contained in this report is the property of Royal Bank of Canada and may not be reproduced in any way, in whole or in part, without express authorization of the copyright holder in writing. The statements and statistics contained herein have been prepared by RBC Economics Research based on information from sources considered to be reliable. We make no representation or warranty, express or implied, as to its accuracy or completeness. This publication is for the information of investors and business persons and does not constitute an offer to sell or a solicitation to buy securities.