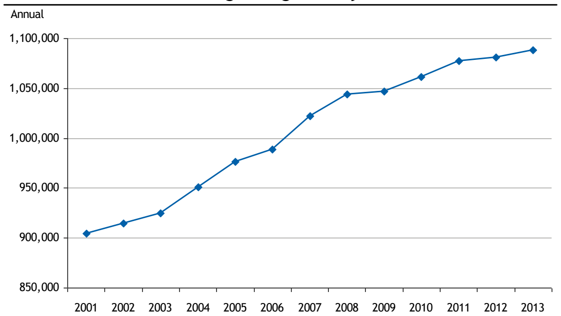
CURRENT ANALYSIS
October 2015

Doors open for Canada's SME exporters

- SME exporters are a key feature of Canada's business landscape and make a significant contribution to exports and the overall economy.
- Exporter numbers have trended lower in recent years and may be hindering Canada's export recovery.
- The tendency of SME exporters to be large and fast-growing highlights the potential of exporting as a growth avenue for small businesses.
- A weaker Canadian dollar, lower energy prices, and stronger growth in key export markets are creating opportunities for SMEs to boost their export activities.

After stalling during the recession, Canada's small- and medium-sized enterprises (SMEs) grew steadily in subsequent years (Chart 1). Firm numbers increased by 4% between 2009 and 2013 and since the recession, SMEs have created two-thirds of net new jobs. The increase in the number of SMEs occurred even as exporters faced weak U.S. demand, high energy prices, and a strong Canadian dollar and many responded by reorienting themselves toward the domestic market or closing altogether. Recently however, the headwinds facing SME exporters have begun to abate. After a slow start to 2015, the United States is expected to show solid growth over the remainder of this year and through 2016, energy prices have fallen, and a significantly weaker Canadian dollar is aiding export competitiveness. A revival of export activity by SMEs will underpin stronger growth for the Canadian economy as a whole.

Chart 1: SME numbers are growing steadily

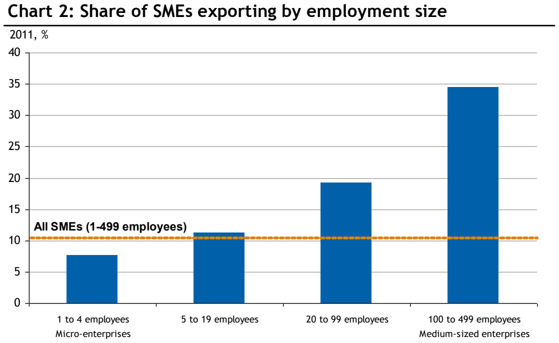


Source: Statistics Canada, RBC Economics Research

SME exporters are critical to Canada's economy

Canada's 1.1 million SMEs are well recognized for their contributions to economic growth, innovation and new job creation. Defined as enterprises with fewer than 500 employees, 99.8% of Canada's employer establishments are SMEs and they account for a majority of private-sector payrolls and generate approximately 40% of Canada's GDP[1]. While only an estimated 10% of Canada's SMEs are exporters[2], they accounted for 25% of total merchandise exports in 2013. SME exporters are on average larger and faster-growing than SMEs as a whole, a fact which is reflected in rising export propensity by firm size (Chart 2). Whereas only 8% of micro-enterprises (1-4 employees) are exporters, that share rises to 34% among medium-sized firms (100-499 employees).

Chart 2: Share of SMEs exporting by employment size



Source: Statistics Canada, RBC Economics Research

Given the contribution to Canada's economy made by SME exporters, it is worrying that data suggests their numbers have declined in recent years. After peaking in 2005, the number of exporting enterprises of all sizes (97% of which are SMEs) declined by 15% through 2010 and provisional estimates suggest their numbers have not recovered in the years since[3]. The 2008-09

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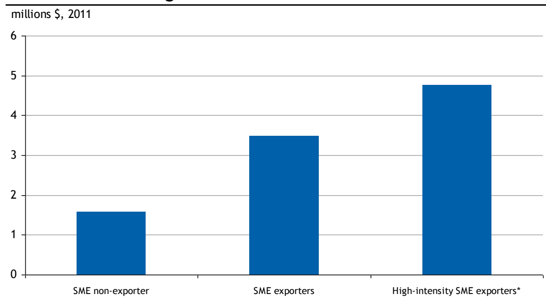
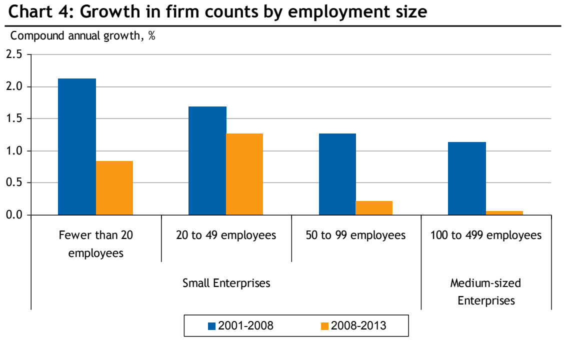
Chart 3: SME average revenues



* Greater than 50% of total revenues from exports

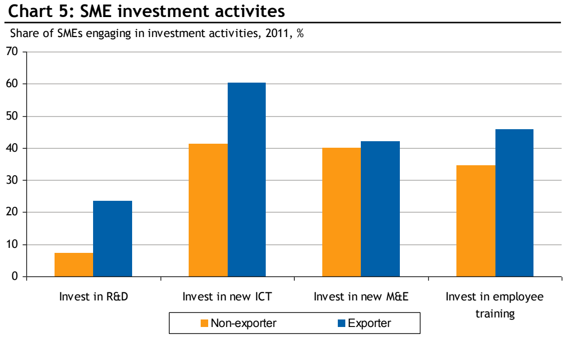
Source: Statistics Canada, RBC Economics Research

Chart 4: Growth in firm counts by employment size



Source: Statistics Canada, RBC Economics Research

Chart 5: SME investment activites



Source: Industry Canada, RBC Economics Research

recession, the relatively strong Canadian dollar which prevailed in the recession's aftermath, and high energy prices likely impeded the return of firms to the export market. Further, the declining number of exporters may help explain the sluggish recovery of exports following the recession. As exporters closed or reoriented themselves toward the domestic market, export capacity may have been lost.

SME exporters remain large and fast growing

Despite their diminished numbers, SME exporters remain larger and faster growing on average than non-exporting SMEs. Led by high-intensity exporters (i.e. firms generating over 50% of revenues from exports), SME exporters generate twice as much revenue on average than other SMEs (Chart 3). A 2011 survey revealed that 10% of SME exporters were 'high-growth' firms which had grown their revenues by at least 20% per year over the previous three years.

The growth performance of SME exporters suggests a potential solution to a longstanding challenge for Canadian small businesses: moving up the size scale. While Canada has added small businesses steadily in recent years, growth in firm numbers has been slower in larger size categories, especially since the recession (Chart 4). As a result, Canada has a relatively large number of small businesses which tend to have lower productivity than medium-sized and large enterprises partly because they are less capital intensive and make fewer investments in technology and innovation[4]. This has been linked to Canada's persistent productivity gap with the United States where the economic contribution made by large firms is greater[5]. The growth experience of SME exporters offers a template to other SMEs which may grow faster by expanding exports.

What drives SME exporters' success?

One factor driving the success of SME exporters is that large and high productivity firms are drawn to exporting because they have the most to gain from access to larger markets and are best suited to meet the challenges of international competition[6]. Further, firms which take up exporting tend to see better performance and higher productivity growth in subsequent years. Studies by Statistics Canada using plant-level data suggest that new exporters are 'learning by exporting' as they expand into new markets: improving their management techniques, exploiting economies of scale, and using new technologies to stay competitive[7]. Furthermore, international competition and access to larger markets prompts exporters to boost investment. SME exporters are more likely to make new investments and spend more when they do so. A larger share of SME exporters made investments in machinery and equipment, research and development (R&D), employee training, and information and communications technology than non-exporters in 2011 (Chart 5). Among firms undertaking investments in these categories, SME exporters spent approximately twice as much as the average SME[8]. The difference is largest in R&D spending where 91% of SME exporters which invest in innovation report positive results (Chart 6).

Exporting suitable for some, but not for all

The strong performance of SME exporters suggests the economy would benefit from increased participation in export activities. However, it should be noted that not all SMEs are in a position to become exporters. In the first quarter of 2015, nearly half (48%) of Canada's 1.1 million SMEs were in domestically-oriented industries in which becoming an exporter is particularly difficult, including construction, real estate, and accommodation and food services. Nevertheless, compared with other advanced economies, Canadian SMEs' share of overall exports is low suggesting there is scope for expansion[9].

SME exporters are clustered in a few industries, especially manufacturing

SME exporters are unevenly distributed across industries both in terms of number of firms and share of exports (Chart 7). In 2013, SME merchandise exporters were concentrated in manufacturing (38%), the wholesale and retail trades (30%) and business services (9%). Within industries, SMEs' contribution to Canadian exports tends to align with their contribution to overall output. For example, SMEs engaged in retail trade accounted for 46% of output and 44% of merchandise exports. Similarly, the shares in mining, oil and gas extraction in those years were 9% and 8% respectively[10]. SME export intensity – the average percentage of SME revenues derived from exports – also varies widely across industries. According to a 2011 survey, export intensity is highest in knowledge-based industries where the internet facilitates high export intensity by improving logistics and making it simpler for firms to export the services in which they specialize[11]. By contrast, in domestically-oriented industries like accommodation, food services, and construction, exports generate less than 1% of SME revenues.

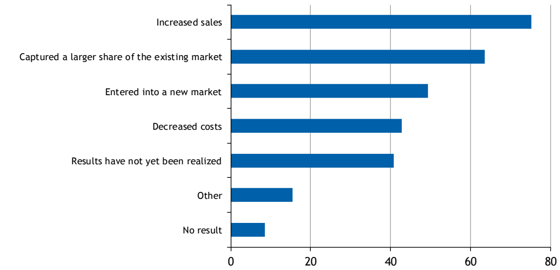
Canada's SME exporters are particularly concentrated in manufacturing which may partly explain why declining exporter numbers in recent years has coincided with weakness in the manufacturing sector. 30% of manufacturing SMEs report exporting goods or services – the highest share of any industry – and in 2013, manufacturing accounted for a majority (53%) of total SME merchandise exports by value. Furthermore, these figures likely understate the importance of exports for manufacturing SMEs. Many of Canada's manufacturing SMEs are engaged in 'indirect exporting' – supplying intermediate manufactured goods to other firms, which in turn export finished products[12]. For example, in transportation equipment manufacturing, SMEs account for only 6% of total exports, but over one-third of SMEs in that sector reported selling inputs to another enterprise for use in producing exports[13].

SME exporters are tapping diverse markets at home and abroad

Not only do SME exporters diversify their sales internationally, they are also more likely to seek broader internal markets. SME exporters generate 66% of their revenues outside their local area compared to only 16% for non-exporters (Chart 8).

Chart 6: Results of innovation activity by SME exporters

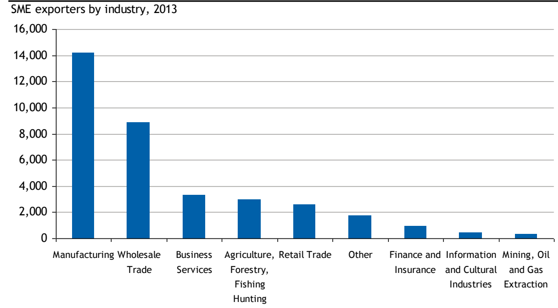
Share of SME exporters reporting the following as results of innovation in the last three years, 2011, %



Source: Statistics Canada, RBC Economics Research

Chart 7: SME merchandise exporters by industry

SME exporters by industry, 2013

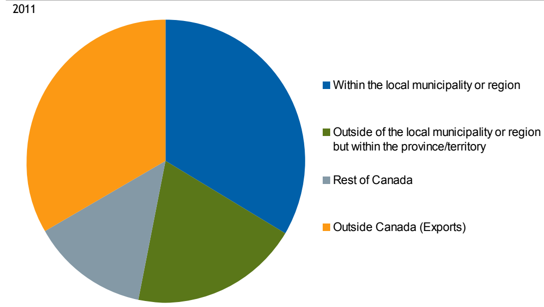


Excludes utilities, construction, and transportation and warehousing

Source: Statistics Canada, RBC Economics Research

Chart 8: SME exporter sales by geography

2011

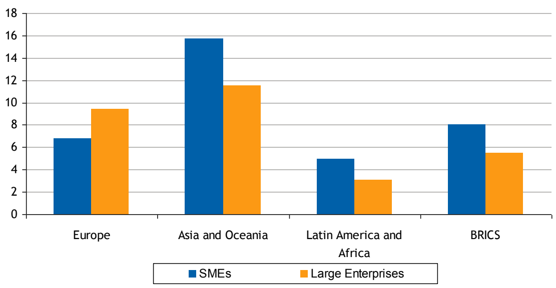


Source: Statistics Canada, RBC Economics Research

While the United States remains the primary export market for both SME exporters and large exporters, SMEs exporters are less focused on the U.S. than their larger counterparts and send a greater proportion of their exports to emerging markets (Chart 9). In 2013, 8% of SME merchandise exports were destined for Brazil, Russia, India, China or South Africa (the BRICS) compared with 5% for large exporters. A relatively high level of immigrant ownership may be contributing to the linkages that SMEs have formed with non-U.S. markets. In 2011, 27% of SME exporters were immigrant owned (compared with 22% of SMEs overall) and these firms may benefit from their owners' international networks and knowledge of foreign markets.

Chart 9: Share of total SME and large enterprise exports to selected markets

Share of total merchandise exports by firm size to selected markets, 2013, %



Source: Statistics Canada, RBC Economics Research

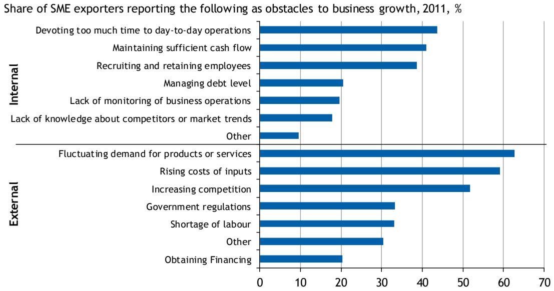
Obstacles, resources and opportunities

Becoming an exporter can unlock many opportunities for a small business, but also requires overcoming new challenges. Compared with non-exporters, SME exporters are more likely to report fluctuating demand, rising input costs and increased competition as obstacles to their growth reflecting a challenging external environment (Chart 10).

Part of the reason SME exporters are likely to report difficulty managing the challenges of international operations is because they often lack the resources and expertise available to larger firms. To help close this gap, public-sector institutions including *Export Development Canada* (EDC) and the *Business Development Bank of Canada* (BDC) among others offer education, export incentives and financial services to SME exporters, and firms' usage of these services is on the rise[14]. While government was the main provider of external financing for 9% of SME exporters in 2011, the chief source of external financing for SME exporters are domestic chartered banks. Banks are the principal providers of external financing for over half of SME exporters and approval rates for their debt financing requests exceed 90%. The upshot is that while 29% of SME exporters reported obtaining financing as a stumbling block to growth in 2004, by 2011 only 20% reported that same obstacle.

Chart 10: Obstacles to growth for SME exporters

Share of SME exporters reporting the following as obstacles to business growth, 2011, %



Source: Statistics Canada, RBC Economics Research

Government negotiated free trade agreements are also opening up new opportunities for SME exporters. The recently concluded *Comprehensive Economic and Trade Agreement* (CETA) with the European Union – Canada's second-largest trading partner – may offer new opportunities to SMEs as tariff and non-tariff barriers come down. Agreements now in force with the United States, Mexico, Peru, Colombia, and South Korea among others are also giving exporters, including SME exporters, improved access to international markets[15]. Looking ahead, the *Trans-Pacific Partnership* may present further upside for SME exporters. The agreement contains a chapter dedicated to SMEs with provisions to enhance access to markets in the Asia-Pacific region, simplify the clearance of goods through customs, and improve the information on local markets and regulations available to SMEs. These measures, among others, are designed to help SME exporters take full advantage of the opportunities created by the agreement[16].

Conclusion

Exports are expected to be a key growth driver in the near term as the U.S. economy heats up and a weakened Canadian dollar and lower energy prices provide a tailwind to exporters. The current environment is presenting SMEs a golden opportunity to build up their exporting activities. Given that SMEs which successfully become exporters tend to grow faster and invest more than their non-exporting counterparts, the more export-oriented Canada's SMEs become, the larger the upside for overall economic growth.

End Notes

1. Business counts from the longitudinal employment analysis program, payrolls from the survey of employment, payrolls and hours, and GDP shares from Industry Canada's "Key Small Business Statistics" Small Business Branch (2013)
2. According to the 2011 Survey on Financing and Growth of Small and Medium Enterprises (SFGSME). The survey considered enterprises with between 1 and 499 employees and which generated an annual gross revenue of between $30,000 and $50 million. An exporter is a firm which reported exporting goods and/or services in 2011
3. 2013 firm counts from the Trade by Enterprise Characteristics. Previous figures from: Moeller, Dylan (2012) "Canada's Trade Performance: an examination of 8 indicators" EDC Corporate Research Branch
4. Leung, D., Meh, C., Terajima, Y. (2008) "Productivity in Canada: Does Firm Size Matter?" Bank of Canada Review, Autumn 2008
5. Tang, J. (2014) "Are Small or Large Producers Driving the Canada-U.S. Labour Productivity Gap? Recent Evidence from Manufacturing" Industry Canada Working Paper
   Baldwin, J., Leung, D., Rispoli, L. (2014). "Canada-United States Labour Productivity Gap Across Firm Size Classes". Statistics Canada. The Canadian Productivity Review
6. Melitz, M. (2003) "The Impact of Trade on Intra-Industry Reallocations and Aggregate Industry Productivity" Econometrica, Vol. 71, No. 6, pp. 1695-1725
   Baldwin, J. and Gu, W. (2004) "Trade Liberalization: Export-market Participation, Productivity Growth and Innovation" Statistics Canada, Economic Analysis Research Paper Series
7. Ibid.
8. Survey on Financing and Growth of Small and Medium Enterprises (2011)
9. OECD trade by enterprise characteristics
10. While the most recent estimates of SME contributions to GDP date to 2008, they are still instructive for establishing magnitudes.
11. Seens, D. (2015) "SME profiles: Canadian exporters" Industry Canada
12. "Canadian Small Business Exporters" (2011) Industry Canada Small Business Branch
13. Manufactured goods sold to another enterprise and used as an intermediate input in final goods and exported.
14. The share of SME exporters taking up export incentives and services from all levels of government nearly tripled from the 2007-2009 period to 2010-2012.
15. Foreign Affairs, Trade and Development Canada
16. Trans-Pacific Partnership (TPP) technical summary.