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Current Analysis

The new challenges facing Canada's small businesses

Post-COVID concerns include debt and digital disruption

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The majority of Canadian small businesses survived the pandemic, but their journey to a full recovery is far from complete. To put the crisis behind them, they'll have to contend with its after-effects: added debt loads, supply-chain disruptions and labour shortages—not to mention the spectre of further COVID waves. They'll also have to compete with new entrants and larger rivals, and adapt to changes in the way we do almost everything, from shopping and exercising to business meetings. And they'll need to do all of this as unprecedented government support is phased out.

Amid these challenges, Canada's small businesses will also find opportunities: in the efficiencies and expanded market access that accompanied a pandemic-driven jump to digital commerce, and in a rising consumer preference for "buying local." An RBC survey found three-quarters of Canadians plan to spend more at local businesses as the economy reopens. Six in 10 have sought out or will seek out businesses with BIPOC owners, and half wanted to support those with 2SLGBTQ+ ownership.

Canada's small businesses have already proven their resilience. To seize on the opportunities this historic crisis created, they'll need to call on that spirit again. Building on our 2020 report, Small Business, Big Pivot, we've identified four major challenges likely to confront them in the months ahead. With small firms accounting for more than 40% of Canada's private sector GDP, their success in overcoming them will be the country's success.

1. The debt overhang

The pandemic choked the flow of cash to many small businesses, forcing them to borrow to stay afloat. According to a recent survey from the Canadian Federation of Independent Business, seven in 10 small businesses took on debt due to the crisis, with additional borrowing hitting an average $170,000. One third of businesses thought it would take more than two years to repay that debt and another 13% were concerned about their ability to ever repay. Half of respondents said debt repayment was one of their biggest challenges.

Consumer-facing businesses that bore the brunt of COVID restrictions were more likely to have accumulated debt, with average borrowing in the hospitality sector twice as high as in other industries. Even accounting for the forgivable portion of CEBA loans (up to $20,000 if repaid by the end of 2022) and an aggregate increase in business deposits that suggests some firms have cash to spare, many continue to carry a daunting debt load. Though government programs and payment deferrals helped lower the small business default rate in

Small Business, Big Recovery

Then...	...and now
1.5 million jobs lost at small businesses between February and April 2020, twice the rate of medium and large employers	Small business employment was *close to its pre-pandemic level* over the summer, outpacing the jobs recovery at large employers
250,000 businesses closed their doors in Q2/20, a 90% increase from a year earlier*	The number of active employer businesses *recovered to its pre-pandemic level* in May and June.

*Business closures are not necessarily permanent—they represent firms with one or more employees in the previous month and zero in the current month. Business closures are for all firm sizes though small businesses account for 98% of employer businesses, and Statistics Canada found most job losses associated with business closures were attributable to small firms.

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the second half of 2020, some companies will nevertheless face financial challenges as support is phased out.

Debt overhang will drag on small business owners in other ways. A March 2021 CFIB survey found half of business owners that borrowed to get through the crisis will have to reduce their salaries to manage debt payments—a tough pill to swallow for those who tapped into personal resources to support their businesses. And it likely hindered their growth plans— in a recent Statistics Canada survey, larger businesses were nearly 50% more likely to be planning expansion or acquisitions in the next year.

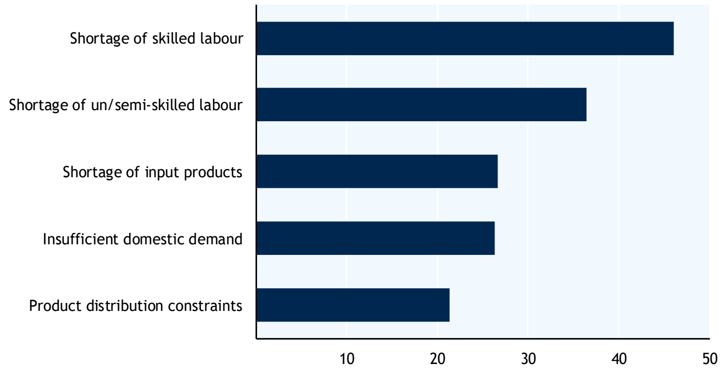
2. Supply-chain snarls and labour crunches

Supply-chain disruptions and labour shortages are key headwinds to the recovery, and both issues are taking a heavy toll on small businesses. Rising input costs topped the list of near-term obstacles for smaller firms in Statistics Canada's third-quarter business conditions survey, followed by labour shortages, recruiting challenges, transportation costs and difficulty acquiring inputs. Labour and input shortages likely contributed to an increase in unfilled orders—which a record one in three businesses said were above normal, according to the CFIB.

The impact extends beyond order books. Companies are offering higher wages to attract and retain workers. Some are also offering non-wage benefits like hiring bonuses, flexible work schedules and more vacation. And according to an RBC survey, most Canadians think it's important for small businesses to provide wellness and mental-health benefits for employees. Smaller employers will have to keep up with the offerings of larger firms. But higher wages and other costs could cut into profits, particularly in consumer-facing services where labour is a major expense. Rising transportation and input costs are another concern.

Labour and input shortages hinder small business growth

% of businesses identifying factors as limiting ability to increase sales or production, September 2021



Source: CFIB Business Barometer, RBC Economics

3. The leap to digital

Prior to the crisis, digitalization was viewed as one of the factors holding inflation in check, as increased competition from online retailers and digital giants (the so-called "Amazon effect") limited businesses' ability to raise prices. The pandemic only intensified that pressure. E-commerce's share of Canadian retail sales doubled to 7.3% in the first half of 2021 from 3.6% in 2019. Even that figure is an underestimate as it doesn't capture sales by foreign, online-only retailers. Much of the shift toward online sales appears permanent. Eight in 10 Canadians want to continue shopping or connecting online with small businesses even when in-person shopping fully reopens, an RBC survey found.

The shift to virtual platforms holds opportunity for expanded market access, but Canada's small firms will need to tackle longstanding hurdles to take advantage of it. Chronic challenges range from setup and maintenance costs to a lack of expertise—factors likely exacerbated by high debt that eats into investment and training budgets. Though surveys show some progress, smaller firms continue to struggle with technology adoption.

Digitalization is about more than competing for growing online sales. Employees are increasingly demanding flexible work options that small firms are less likely to be able to offer. During the pandemic, employees at large private-sector firms were twice as likely to work from home as those at small businesses. And while industrial composition explains some of that, work from home was more prevalent at larger firms within many industries. Small businesses will need to rethink plans to attract workers in a tight labour market where pay isn't the only consideration. Meantime, Canada's small businesses are facing more demands from customers and governments to reduce their environmental impact. This longer term "leap to green" will require further investments in technology and people.

A silver lining of the crisis is that as some competitors closed permanently, more room opened for surviving firms to expand. But here again, limited capacity to assume debt could make it difficult for incumbents to take advantage. What's more, competition is stiff with the pace of new business entrants up by 7% in the first half of 2021 relative to the same period in 2019.

4. Beyond the fourth wave

Even before the fourth wave, many small firms were in an unsustainable cash flow position. Only half of smaller businesses said they could operate at current revenue and expense levels for a year without laying off staff or considering closure or bankruptcy, Statistics Canada's business conditions survey suggested. By contrast, larger firms were more likely to report they could manage current conditions for a year or more. Similarly, the CFIB's latest small business dashboard shows 76% of businesses are fully open but only 45% are fully staffed and just 40% have returned to normal sales—again, a situation that appears unsustainable long-term.

Canada's fourth wave delayed some provinces' reopening plans while others are reluctantly tightening restrictions again. We expect a high rate of vaccination and vaccine passports to help keep health authorities from reverting to widespread lockdowns. Ongoing restrictions during the fourth wave and any future outbreaks will add to the challenges facing small businesses.

What's next?

With thoughtful support and the ongoing efforts of owners, Canada's small businesses can tackle today's challenges while also positioning themselves for a greener, more digital future. Clear vaccine passport rules could allow for greater re-opening. Targeted extensions of wage and rent subsidies, or extended CEBA loan repayment deadlines, could assist small businesses in sectors facing ongoing restrictions. Government efforts to support digitalization—addressing cost and expertise challenges—and improve rural broadband access are steps in the right direction. But a gap remains on the people side, with small business much less equipped to account and prepare for the employee skills they'll need in the future. Finally, as highlighted in Small Business, Big Pivot, small firms require more than government support. Collaborative models are needed between business, government, industry associations, and educational institutions to help them scale in talent, innovation, and markets, driving growth in the Canadian economy.