



## Economics

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## Times Are A Changin' for SMEs

Benjamin Tal and Royce Mendes

Canada's small- and medium-sized enterprises (SMEs) have been an island of stability since the global financial crisis, not only demonstrating resiliency during the recession but also leading the way during the recovery. This has been a departure from the highly cyclical tendencies of past decades.

To be sure, in absolute terms over the latest volatile business cycle, SME's economic activity was hardly a boon. But, relative to large corporations, it was a pleasant surprise: The small business sector has unequivocally kept Canada's economy from sinking into deeper water. Their comparatively low export orientation and high dependency on the Canadian consumer shielded SMEs from the headwinds of the past cycle, namely anemic global demand and the loonie's unrelenting appreciation. Nevertheless, SMEs are entering a new reality, one that will force them to look to innovate and enter new markets to sustain growth.

While small business activity has been driving Canada's economy, this piston of growth is in for tough times if it doesn't start to focus on innovation and export markets. Canada's hot housing market and debt-fueled consumption buttressed them, driving growth and insulating them from external headwinds. But, Canadians are just about maxed out on debt and our flirtation with a parity exchange rate is now a thing of the past.

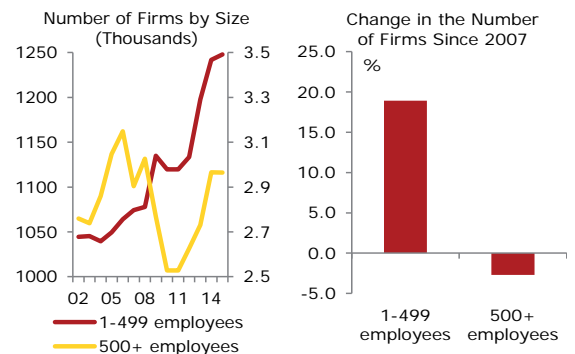
To maintain and build on their performance of the past cycle, SMEs will have to change their business models by both raising their propensity to export and increasing investment in research and development. Fortunately, those tasks are not mutually exclusive, as SMEs with higher export orientation also happen to be more innovative.

### Performing Through the Cycle

Prior to the financial crisis, the Canadian economy was benefiting from both an exchange rate not far from the levels seen today and increasing demand for our nation's resources from emerging markets. That confluence of events proved beneficial for Canadian manufacturers and exporters, many of which were large firms with more than 500 employees.

However, when the crisis hit, it was SMEs that stepped up to the plate. That was

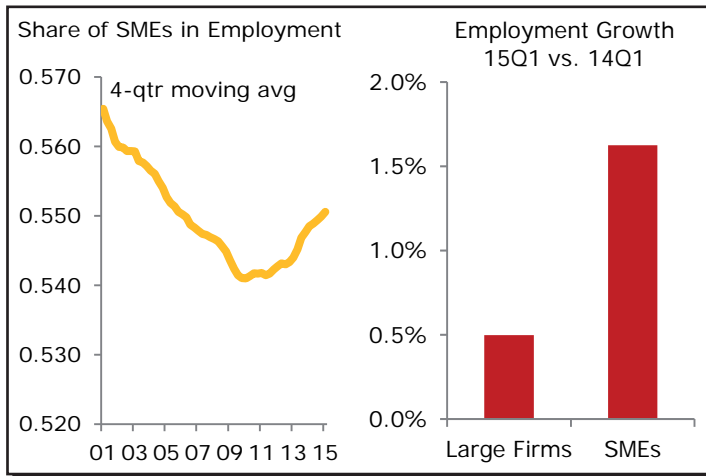
Chart 1  
**SME Business Formation Rising Faster**



<http://research.cibcwm.com/res/Eco/EcoResearch.html>

Chart 2

**SMEs are Also Hiring More Workers Than Larger Firms**



Source: Statistics Canada, CIBC

significant, given that historically it was these firms that led the overall economy into recession and, in the process, suffered a disproportionate amount of hardship compared to larger firms. But for the first time in the post-war era, small business activity actually outpaced the rest of the economy during the recent slowdown.

SMEs were also quick to capitalize on the acceleration in economic activity following the Great Recession, with the number of SMEs growing faster than the number of large corporations through the last cycle (Chart 1).

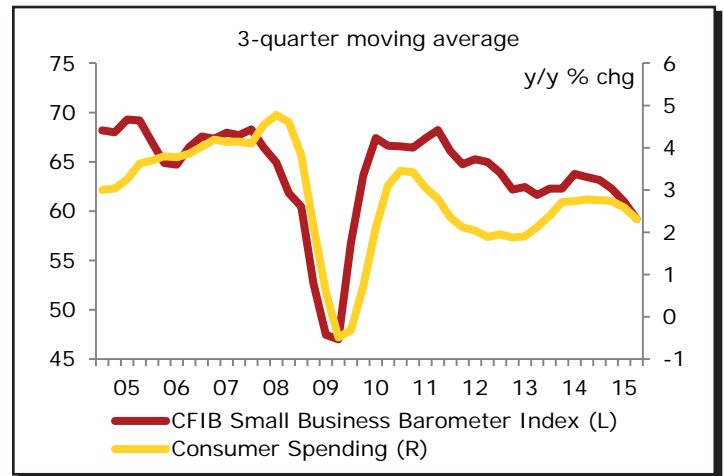
Ditto for hiring during the recovery. Following decades of steady decline, the share of SME employment began increasing in the aftermath of the recession (Chart 2, left). In the past year alone, SME employment has risen three times faster than that of large corporations (Chart 2, right). This growth has accounted for no less than 80% of all private sector jobs created in the economy.

The secret behind the unprecedented ability of small businesses to overcome the weakness in economic conditions over the past cycle has been their exposure to the Canadian consumer (Chart 3). It's well documented that consumers, by opening their wallets, were able to sustain the economy and almost single-handedly move Canada back into the growth column.

Low borrowing rates have been a large contributor in allowing consumers to continue spending, but the strength of Canada's housing market also played a

Chart 3

**SME Performance is Closely Tied to the Consumer**



Source: CFIB, Statistics Canada, CIBC

significant role by making consumers feel more wealthy. Furthermore, the increase in activity directly produced more consumer spending since each housing sale generates an estimated \$20,000 in additional consumer spending.

But the gains from the real estate boom don't end there. With housing starts and resale activity rising to levels not seen in decades, the construction and real estate industries have created more than 200,000 new jobs, accounting for 17% of the labour market strength since the beginning of 2010. With SMEs employing close to 70% of workers in these two sectors, the benefits from the pick-up in the housing sector has been obvious.

SME's focus on the domestic consumer also meant that they were less exposed to the international slowdown which followed the financial crisis. Despite increased trade activity and freer trade around the world, only 10% of Canadian SMEs engage in exporting—around the same level seen in 2000. And even this number probably overstates their real international exposure since it includes companies that only export sporadically and certainly do not rely on exports as an integral part of their business model.

Similarly, by focusing on the domestic market, SMEs were also more insulated from the strengthening Canadian dollar. While larger companies especially in the manufacturing industry were hurt by the loonie's appreciation, only about one in five Canadian SMEs are

Table 1  
Share of Small Firms in Each Sector Relative to Total Small Business

	%
<b>Export and Import Penetration</b>	
Furniture and related product manufacturing	0.31
Computer and electronic product manufacturing	0.14
Electrical equipment, appliance and component mfg	0.09
	0.53
<b>Export Penetration</b>	
Forestry and logging	0.35
Mining and quarrying (except oil and gas)	0.09
Wood product manufacturing	0.28
Paper manufacturing	0.05
Primary metal manufacturing	0.05
Machinery manufacturing	0.38
Transportation equipment manufacturing	0.15
Chemical manufacturing	0.16
Miscellaneous manufacturing	0.44
Transportation and warehousing	4.98
Motor vehicle and motor vehicle parts and accessories	0.33
Building material and supplies	0.83
Machinery, equipment and supplies	1.31
	9.40
<b>Import Penetration</b>	
Food manufacturing	0.45
Beverage manufacturing	0.07
Tobacco manufacturing	0.00
Textile product mills	0.05
Clothing manufacturing	0.11
Printing and related support activities	0.30
Fabricated metal product manufacturing	0.62
	1.61
<b>Tourism</b>	
Accommodation services	0.84
Food services and drinking places	5.48
Amusement, gambling and recreation industries	0.81
	7.13

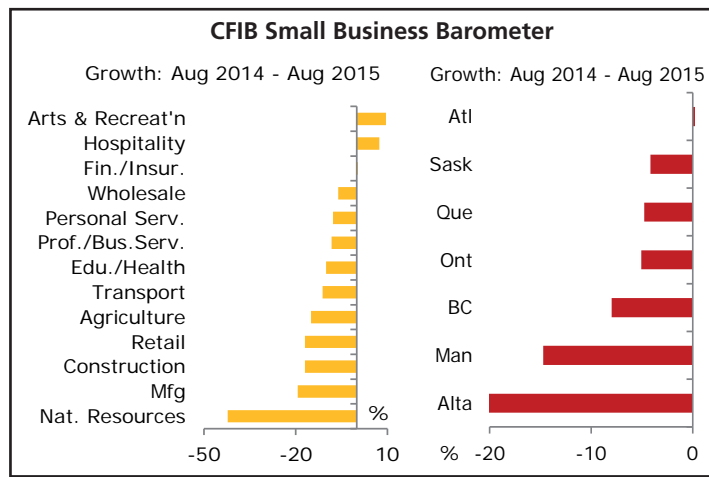
Source: Statistics Canada, CIBC

in sectors directly impacted by a stronger dollar (Table 1). Goods exporters certainly make up the lion's share of SMEs impacted by changes in the exchange rate, while tourism is second. Even together, though, they don't add up to a significant fraction of overall SMEs operating in Canada and the amount of revenues they generate from abroad is even less.

### The Tide is Turning

While the lack of export orientation contributed to the resiliency in SMEs during the last cycle, that may not be the case moving forward. With debt-to-income ratios just under 165% and house prices looking stretched in many pockets of the country, consumers can't be relied

Chart 4  
Overall SME Sentiment Has Taken a Hit From Consumer Related Industries



Source: CFIB, Statistics Canada, CIBC

on to provide the type of growth seen in the recent past. In fact, consumer spending is already showing signs of decelerating this year.

The weakness in consumption is also beginning to show up in newly released SME data. The CFIB Small Business Barometer Index has followed consumer spending data in turning lower recently. While that is in large part due to weakness in natural resource companies, retail trade and construction—which are more closely related to the consumer—are at the bottom of the list as well (Chart 4).

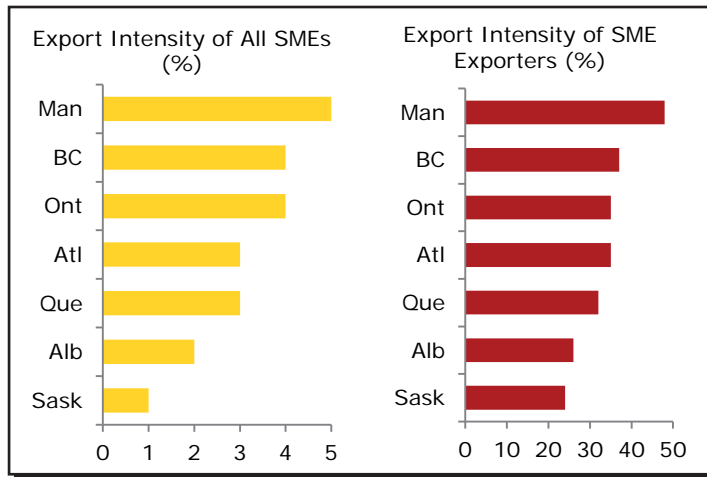
### Looking Abroad

With the slowdown in consumption in mind, it makes sense for SMEs to review their options with regard to exporting. That's especially true since the near-parity loonie, which caused great pain in the export and manufacturing sectors, is now a thing of the past. The renewed weakness in the loonie should be seen as an opportunity for SMEs to gain exposure to the strengthening external environment, in particular the US and Europe.

SMEs in Alberta, which will be the hardest hit by the drop in commodity prices, have the most room to add export capacity. Overall, SMEs in Alberta generate far less revenue from exports than their peers in other provinces (Chart 5). Moreover, revenues of firms that do export in those two provinces fall far short of those in other parts of the country.

Chart 5

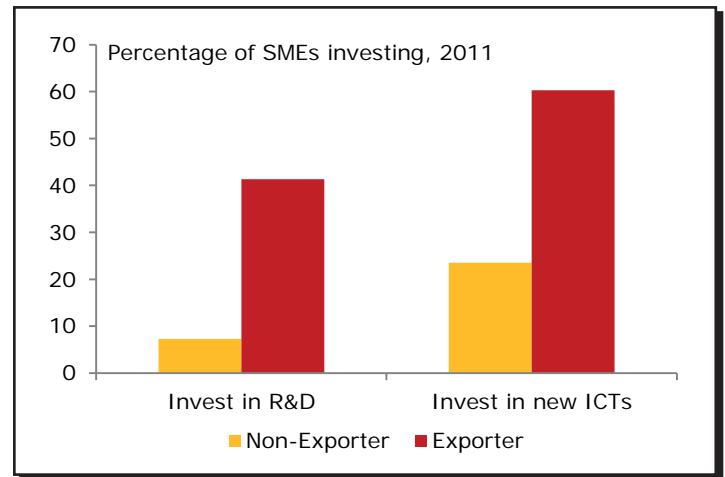
**Alberta and Saskatchewan Lag Others In Terms of SME Export Intensity**



Source: Statistics Canada, CIBC

Chart 6

**SME Exporters Are More Likely To Spend on R&D**



Source: CIBC

**Innovation is the Key**

It's true that many SMEs have preferred to focus on the domestic market to avoid competing with larger exporters. But, there's now an added incentive for SMEs to reorient or add capacity to exporting goods and services.

Historically, when large exporting and manufacturing companies have been shielded from foreign competition by a weak exchange rate, their propensity to invest in research and development has fallen and their future productivity growth has languished.

Looking ahead, that means SMEs could gain a competitive advantage by investing in innovation. SMEs in the export sector are actually starting from a place of strength. They have long been more likely to invest in innovation than those not tied to the sector (Chart 6). Therefore, as long as spending doesn't slow down, they can gain ground on their larger peers by reaping the benefits of better productivity growth.

Given Canada's weak productivity track record of late, any support from SMEs will be a boon for the country too. SMEs generate about half of the private sector's investment in R&D, so their continued spending at a time when larger companies are pulling back, remains an important goal for the country as well.

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