U.S. SMALL BUSINESS RECOVERY READY TO ENTER A NEW PHASE

Highlights

• Small and medium-sized businesses are important engines of job creation. Businesses with fewer than 500 employees account for 49% of total employment nationally and account for an even larger share of gross hiring and firing.

• Regionally, states exhibit a considerable degree of variation in the prevalence and diversity of small and medium companies. A higher degree of small business diversification improves flexibility and dynamics of the labor market, and is positively related to the post-recession employment recovery.

• While challenges continue to exist, the outlook for small and medium businesses is brightening across the TD Footprint. States that have a combination of strong housing fundamentals and more diversified industry base are likely to emerge as regional leaders.

• Smaller companies, which dominate the construction, leisure & hospitality, and professional & technical services industries, will benefit from the rebound in the housing market and ongoing improvements in household finances.

The economic recovery is into its fourth year and it hasn’t been a picnic. The normalization of the unemployment rate and growth in consumer spending has been the slowest in post-war history. Meanwhile, small and medium sized businesses (SMBs) have also been hit by policy uncertainty over healthcare reform and government spending cuts.

The combination of these forces has weighed on business confidence. The lack of small business optimism is reflected in muted expansion intentions and soft demand for credit, even as small business lending standards on commercial and industrial loans continue to ease. While the number of small business loans (those less than $1 million) was up 5.6% from a year-earlier in the fourth quarter of 2012, the average loan amount was down 7.2%. This is an indication that more businesses are applying for credit, but their expansion plans are less ambitious. Moreover, the creation of new establishments remains 8% below the 2007 level.

Despite downbeat sentiment and a challenging economic environment, SMBs have soldiered on. According to the ADP employment report, 48% of the jobs created so far this year were in businesses with fewer than 50 employees and another 32% were among businesses with 50 to 500 employees. Small businesses in particular have outshined their larger counterparts. While employment at medium- and large-sized firms remains 3%
below its pre-recession level, small businesses (with fewer than 50 employees) have recovered all of the jobs lost during the recession.

Going forward, the concentration of SMBs in a number of industries that are expected to be growth leaders in 2013 and 2014 should become a game changer on momentum. Companies with fewer than 500 employees account for 84% of construction employment. Moreover, 93% of all construction firms are very small businesses with less than 20 employees. This sector is likely to add around 0.5 percentage points to real GDP growth and over 40k jobs a month over the next two years. In turn, benefits from the revival in construction will spill over to related real estate and leasing industries, which are also predominantly made up of small and medium sized businesses.

Ongoing improvement in household finances will also contribute to greater household spending, especially within services and household goods. The high concentration of SMBs in leisure & hospitality, professional, scientific and technical services and wholesale trade will benefit from the improvement in spending.

From a regional perspective, the distribution of SMBs across industries is an important driver of employment growth. The greater the industry diversity among SMBs within a state, the greater the likelihood of stronger job creation relative to the nation. And, at this point in the business cycle, those at the top of the leader board will have the potent combination of a strong housing rebound and a diversified industry base –Massachusetts, Florida and Georgia.

All told, the outlook for SMBs is better than it has been in several years. While challenges will continue to exist they will be made easier by the upturn in underlying demand.

**SMBs are active across the country, but differ in composition and diversification**

In every part of the country, small and medium-sized businesses (SMBs) account for a significant share of total employment – from 42% in Nevada to 68% in Montana. In states where TD Bank operates, companies with less than 500 employees represent 48% of total employment. States with the largest SMB footprint are Maine, Vermont, Rhode Island and West Virginia (55-60%), but even in states with the smallest share – Florida and Georgia – employment in SMBs represents 45% of the total.
Regions with the largest share of small businesses tend to have a concentration in only a handful of industries; namely: retail, health care & social assistance, and accommodation & food services. Georgia, Florida and Massachusetts, on the other hand, have a relatively smaller prevalence of SMBs, but a highly diversified industry base. New York and New Jersey stand out from the pack, since in these states SMBs account for a fairly large fraction of total employment and are also highly diversified.

**Diversification boosts employment recovery**

The diversity of small businesses helps to explain differences in labor market performances across states, both during and after the recession. Portfolio managers are well familiar with the notion of diversification and the role it plays in minimizing volatility and limiting assets exposure to risk. Likewise, diversification benefits regional economic performance.

We find evidence that states with more diversity in small business employment experienced better labor market dynamics both during the recession and the recovery. In particular, their employment declined somewhat less during the economic downturn and grew faster during the recovery. This is true all across the United States, but especially in our footprint where labor diversification explains 23% of cross-state variation in post-recessionary employment growth. Taking this into the account, it becomes less surprising that New York and Massachusetts – two of the most diversified states in TD’s footprint – were the first to recover all the jobs lost during the recession.

Diversification also increases the flexibility and dynamics of the labor market. In more diverse economies, displaced workers in one industry can be accommodated in others. Arguably, this channel was particularly important during the Great Recession and its aftermath, when the housing crisis impeded labor mobility. As a result of the collapse of housing prices, many households found themselves in a negative home equity trap: “stuck” with their houses and unable to move to regions with better employment prospects.

**Construction recovery helps boost SMBs in the Lower South Atlantic**

Given the vital role that small and medium businesses play in terms of job creation, differences in their prevalence and, especially, composition contributes to the divergence in regional labor markets. States in the Lower South Atlantic – Florida, Georgia, and South Carolina – were among the hardest hit during the recession. However, aided by a recovery in small business hiring, they have since moved into the ranks of outperformers. Led by Florida and Georgia, the region outshined the national economy last year, and the strong momentum has carried over into 2013.

Although, there remains considerable room for further improvement, Florida’s unemployment rate is decreasing at an astounding pace. Its jobless rate fell 1.7 percentage points (pp) over the past year to 7.2% as of April. This is now 0.3 pp below the national level. Georgia’s unemployment rate remains above the national average; however, it too has shown marked improvement, edging down by 0.9 pp.

Much of the turnaround is related to the recovery in
construction and tourism/hospitality sectors, both of which are dominated by SMBs. Some support for Florida’s construction firms may come from a record budget in fiscal 2014, which earmarked an 11% rise in transportation-related infrastructure spending; however the bulk of the job creation will be on the residential side. The pace of activity in the housing sector picked up in the first quarter of 2013, with 3-month average housing starts up 61% in Florida and 46% in Georgia, relative to the first quarter of 2012. The latest payrolls report further re-affirm a comeback of Florida’s home-building, with half of all April’s jobs created in the construction industry. The pick-up in housing construction is trickling over to other SMB-dense industries, such as real estate, rental and leasing and professional & technical services, where year-over-year employment is up by 4.1% and 2.6%, respectively.

We also see SMBs in accommodation and food and arts and entertainment industries benefitting from an improvement in households finances, which is boosting demand for domestic travel. These industries are among the few where employment has surpassed its pre-recession level – a reflection of strengthening consumer spending on discretionary items. According to state tourism officials, 26 million people visited the Sunshine State in the first quarter of 2013 which represents a 4.7% increase relative to last year and the best quarterly result in the state’s history.3

Professional services a bright spot in New England

The outlook for SMBs in New England is a story of contrast between Connecticut and Massachusetts. Massachusetts has a relatively diverse SMB backdrop and a strong track record in new firm creation. This should help the state outperform both the region and the country this year and next.

The latest data on venture capital investment suggests that Massachusetts continues to be a hotbed of entrepreneurial activity.4 Three of Massachusetts’ venture firms, which back high-tech and life sciences start-ups, have collectively raised $1.6 billion in the first quarter of the year, accounting for 40% of the nationally raised capital.

Access to ample venture capital is good news for prospective entrepreneurs and for the region’s well-educated workforce. Since most of the new businesses require accounting, marketing, and legal help, the benefits of brisk firm-creation will also spill-over to local professional and business services firms, where employment is 4.8% higher than a year ago.

Connecticut, on the other hand, will underperform the nation. Connecticut has a fairly high concentration of its SMB employment in manufacturing, one area where New England has underperformed relative to the nation and has yet to see an improvement in hiring. Set against the backdrop of the economic downturn in Europe, external demand for manufactured goods will likely remain soft for at least another year. At the same time, reduced federal defense procurement spending as a result of sequestration will pose another challenge for the state, which has the second-highest share of defense procurement contracts relative to its GDP.

On the bright side, rising activity in residential construction will help to offset some of the fiscal drag. Connecticut’s three-month average housing starts were up by an impressive 86% in the first quarter of this year relative to the same period last year. Hiring is also on the mend, with 4.9k new construction jobs added to payrolls over the past two months, representing more than half of all new jobs in the state.

Sequester weighs on Upper South Atlantic

Economic growth in the Upper South Atlantic States (Virginia, North Carolina, Maryland, Delaware, West Virginia, and District of Columbia) will hit a speed bump this year, as a result of its high exposure to sequestration. Federal spending on wages and procurement accounts for 20% of the combined economies of Maryland, DC and Virginia.

Defense procurement contracts represent 9.6% of Virginia’s GDP – the highest ratio in the country. Therefore, its SMBs in defense-related industries such as manufacturing and professional, scientific & technical services are par-
ticularly vulnerable. Approximately 6% of Virginia’s SMB employment is in manufacturing, but the bulk of its SMB employment falls on firms offering professional, scientific and technical services. The sector accounts for 14% of total SMB employment, the largest share among all industries, and has been a source of strength for the Old Dominion State economy for years. Professional, scientific and technical services employment did not buckle even during the Great Recession; however sequestration is putting its remarkable resilience under pressure. With the onset of 2013, the sector’s employment growth began to falter, and was 1.4% lower in April than at the same time a year ago.

Sequestration will also manifest itself through lower consumer spending as a result of furloughs (unpaid days off) for federal government workers. In addition, statewide increases in the sales tax from 5% to 5.3% (and to 6% in Northern Virginia and Hampton Roads) will further squeeze household finances. The negative income effect from these developments will, in turn, trickle down to local businesses operating in retail trade, arts & entertainment and accommodation & food industries. However, there is one important saving grace for Virginia. It has one of the highest concentrations of SMB employment in the construction industry (10.4%), and like other parts of the country, the upswing in construction activity should help the state mitigate the impact of the fiscal restraint.

### States with the Largest Share of SMB Employment in a Given Industry

<table>
<thead>
<tr>
<th>Industry</th>
<th>State</th>
<th>Share</th>
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</thead>
<tbody>
<tr>
<td>Construction</td>
<td>MD</td>
<td>11%</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>NH, CT, PA</td>
<td>11%</td>
</tr>
<tr>
<td>Wholesale trade</td>
<td>NJ</td>
<td>8%</td>
</tr>
<tr>
<td>Retail trade</td>
<td>VT</td>
<td>15%</td>
</tr>
<tr>
<td>Transportation &amp; warehousing</td>
<td>NJ</td>
<td>4%</td>
</tr>
<tr>
<td>Finance and insurance</td>
<td>CT</td>
<td>5%</td>
</tr>
<tr>
<td>Real estate and leasing</td>
<td>NY</td>
<td>4%</td>
</tr>
<tr>
<td>Professional &amp; technical services</td>
<td>VA</td>
<td>14%</td>
</tr>
<tr>
<td>Administrative &amp; waste mgmt.</td>
<td>FL, MD</td>
<td>8%</td>
</tr>
<tr>
<td>Educational services</td>
<td>VT</td>
<td>6%</td>
</tr>
<tr>
<td>Arts and hospitality</td>
<td>NJ</td>
<td>18%</td>
</tr>
<tr>
<td>Health care</td>
<td>NY, ME</td>
<td>20%</td>
</tr>
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*Source: Census Bureau, Statistics of U.S. Businesses (SUSB) 2010; TD Economics*

The outlook for SMBs in the Middle Atlantic states of Pennsylvania, New York and New Jersey is tempered by a housing recovery that is behind much of the rest of the country. Sandy-related rebuilding efforts will boost growth in New Jersey this year; however this will be offset by weakness in New York.

Thanks in part to a highly diversified base of small and medium businesses, New York was the first state in TD’s footprint to recover all of its recession-related job losses. Although there are signs that the Empire State is running out of steam, much of the weakness is likely to be concentrated in manufacturing and finance and insurance where small businesses are less prevalent. Several European and domestic institutions with large New York City operations announced layoffs earlier this year. Meanwhile, factory payrolls were also 11.7k lower in April relative to a year ago, as Kodak struggles to emerge from bankruptcy and weak international demand for exports take a toll on upstate NY manufacturing. By contrast, hiring remains brisk in accommodation & food and professional, scientific and technical services – two industries dominated by SMBs.

Nonetheless, the recovery in the regional housing market continues to advance at a slower-than-average pace due to a large backlog of distressed inventory and long foreclosure process. As a result, activity in the residential construction and real estate & leasing remains a sore spot, and spillovers to local business will continue to be muted until the revival in the housing sector materializes more broadly.

### Bottom Line

The outlook for small and medium-sized businesses is brightening across the country. While fiscal drag is a near-term challenge, if anything, the economy has surprised by its resiliency in the face of payroll tax hikes and automatic spending cuts.

Much of this resiliency is due to small and medium businesses. As fiscal drag lessens, small and medium-sized businesses are likely to see faster growth. States with higher levels of SMB diversification and those leading in housing market recovery are likely to lead the pack.

Beata Caranci, VP & Deputy Chief Economist  
416-982-8067

James Marple, Senior Economist  
416-982-2557

Ksenia Bushmeneva, Economist  
416-308-7392
Endnotes


2. For examples of empirical studies, which establish a positive relationship between diversification and labor market performance using the so-called portfolio model of employment, see Simon and Nardinelli (1992), and Basile et al. (2012).

3. These results were obtained after excluding RI and DC from the sample.
