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# SPECIAL REPORT

## TD Economics



October 13, 2011

## NIMBLE AND ARMED WITH REALISTIC EXPECTATIONS, SMALL BUSINESSES LOOK TO THE FUTURE

### Highlights

- Survey data confirm that during the 2008-09 recession, small- and medium-sized enterprises (SMEs) displayed great resilience, flexibility, agility and resourcefulness to weather the economic storm. This performance has contributed to Canada's impressive economic growth and job creation showing relative to that of other advanced economies.
- After a series of shocks on the global economic stage in the past few months, consumer and business confidence has edged noticeably lower. All signs point to SME readings being in line with national sentiment.
- Embracing the economic climate and being cognizant of the challenging times ahead gives SMEs realistic future expectations. Still, the modest national growth picture will have important implications for SMEs including their profitability, growth strategies and business prospects.
- In addition to economic turbulence and heightened volatility, new SME survey data suggest that many medium- to long-term challenges continue to serve as barriers to success.

Economic storm clouds are once again emerging; however, recent survey data from the 2008-09 recession suggests that small- and medium-sized enterprises (SMEs) are well positioned to weather these headwinds. First, SMEs have an inherent nimbleness and resourcefulness which are on their best display when times get tough. Second, expectations, sentiment and confidence levels among SMEs seem to be well grounded in the event of economic turbulence. Third, most SME businesses are oriented toward the domestic economy and, as a result, are shielded in part from the volatile nature of the global recovery. While SMEs are rooted in resilience, we take note of a recent TD poll that finds that many of the same barriers to business success continue to persist. The good news, though, is that progress in overcoming these obstacles looks promising over the coming years.

### How SMEs fared during the 2008-09 recession

In survey results released last month, the Canadian Federation of Independent Business (CFIB) presented a high-level overview of how SMEs fared during the 2008-09 recession<sup>1</sup>. For the purposes of this report and within this CFIB study, small- and medium-sized enterprises are classified as those businesses having less than 499 employees. As part of this survey, CFIB polled slightly more than 6,100 of their members from October to November 2010. Results indicate that the most popular choices of action for SME owners when confronted with the recession were to work longer hours, expand business within the local community, introduce new products or services, and/or cut personal salary.

The fifth most cited change in owner/operator behaviour was to shed employees, with 42% of respondents saying the action was performed. While job cuts were likely a means of last resort, data from

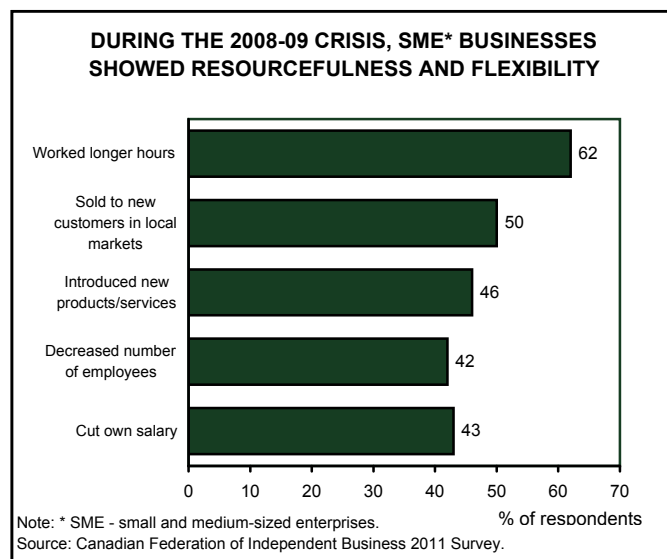
Statistics Canada’s Survey of Employment, Payrolls and Hours suggest that SMEs were hit hard on the job front during the recession. Using Industry Canada’s seasonally adjusted measure of this data series<sup>2</sup>, small businesses lost 171,000 jobs and medium-sized businesses cut 99,000 positions, both over three quarters. As a share of all of the job losses incurred in Canada during the recession, SMEs carry the majority of the burden with 63%. However, this is the same share of national employees typically housed within small- and medium-sized enterprises<sup>3</sup>. In turn, it appears that SMEs were neither hit harder nor softer than other firms. Still, given their smaller work force, the job cuts within SMEs may have had a greater impact on operating strategy than was the case for large firms.

Another interesting finding from the CFIB report was the fact nearly 20% of respondents found ways to increase the number of employees, expand to new markets in other provinces or set their sights on other countries. While manufacturing, wholesale and retail had the majority of these enterprises, success stories could be found in nearly every major industry. The sizeable percentage going against the national trend speaks to the inherent nimbleness of these firms.

**Global confidence teetering**

Small- and medium-sized enterprises will need to demonstrate these same characteristics to combat the chill-winds currently blowing across the global financial and economic landscape.

Businesses, including SMEs, raring to go and consumers ready and able to shell out their wallets, helped propel

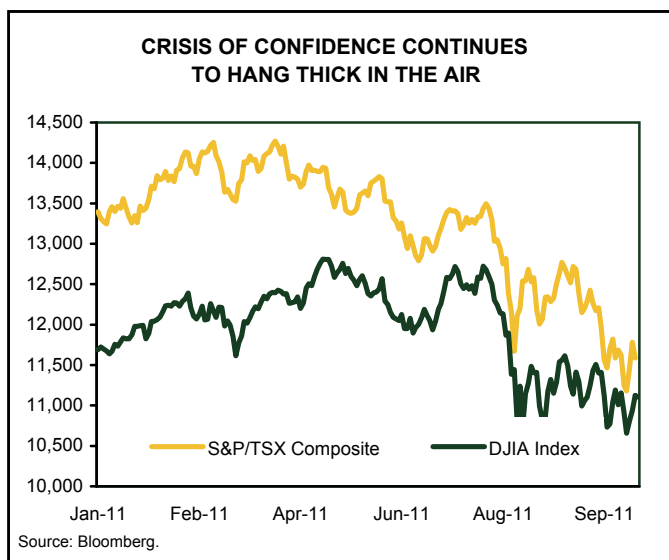


the Canadian economy into the first phase of the recovery. Statistics Canada estimates that small- and medium-sized enterprises contribute approximately 55% to national GDP every year<sup>4</sup>. As a share of employment, SMEs employees make up about 63% of the total pot. These statistics help support the notion that SMEs played an important role in Canada’s impressive showing on the global stage. In fact, in a recent Forbes poll<sup>5</sup>, Canada now ranks as the number one country in which to do business.

Armed with a variety of economic indicators including job creation, we get a good sense as to how much progress the Canadian economy has made in a relatively short period of time. What’s more, employment growth has not been limited to large-sized firms. According to Statistics Canada and Industry Canada data<sup>6</sup>, SMEs have re-staffed about half of all positions lost during the downturn, as of the first quarter of 2011.

As we embark on the next recovery phase, we see that international risks stemming from the U.S. and the euro zone have been permeating equity markets and consumer psyches in recent months. With the dust still settling from this unrest, we are left to deal with a crisis of confidence surrounding the overall health of the global economy.

While this volatility and uncertainty has definitely returned with a vengeance, the underlying reasons for concern among financial markets and investors are not new. For instance, long identified structural challenges – employment and the housing market – should keep U.S. GDP growth subdued over the next few years. Second, the European debt crisis continues to reignite every now and again until policymakers douse the flame. However, the carrying vessel



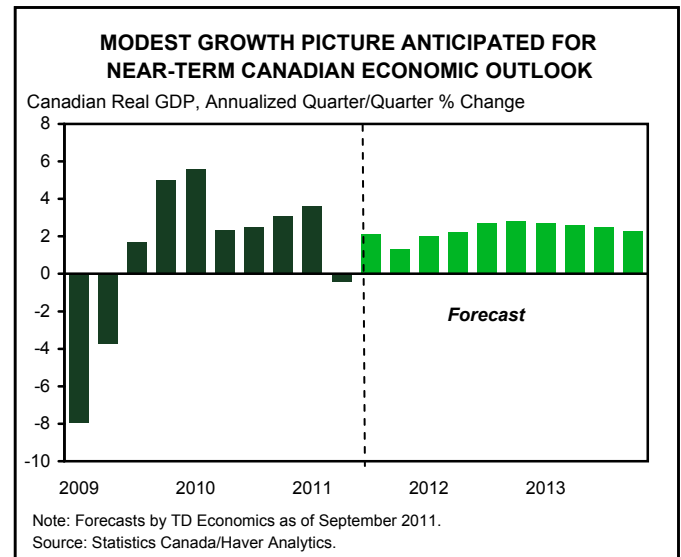
of the water used so far has been a mug, rather than a water bomber. Accordingly, there remains a risk that fires could frequently flare up until permanent solutions are put in place.

Weaker confidence levels are percolating down to Canadians as well. To demonstrate, the Conference Board of Canada's index of consumer confidence has inched down for five out of the past seven months. Trends in CFIB's business barometer are also in line with the national mindset. Readings of this latter measure have dropped to levels not seen since the recovery got underway in 2009. The pessimism in the air suggests that Canadian SMEs are aware both of current developments in the global economy and the increasing likelihood of bumpy times ahead. Nevertheless, it is important to recognize that sentiment can change at a moment's notice based on emotional reactions to world events.

### Moderate national growth picture

Foreign and domestic risks aside, multiple factors led to the Canadian economy contracting in the second quarter of 2011. Examples of latter influences include disappointing economic indicators coming from south of the border, the surge in oil and gasoline prices this past spring, disruptions to the global supply chain as a result of the March earthquake in Japan, and weather-related disruptions in some provinces.

Looking out to the near-term, we expect that the Canadian economy will avoid a technical recession, by posting positive economic growth in the third quarter of this year. Even so, global headwinds should restrain national economic growth to a modest pace. More precisely, we anticipate that real GDP growth will be 2% in 2011 and 2012, nearly one percentage point below our forecast from just three months ago.



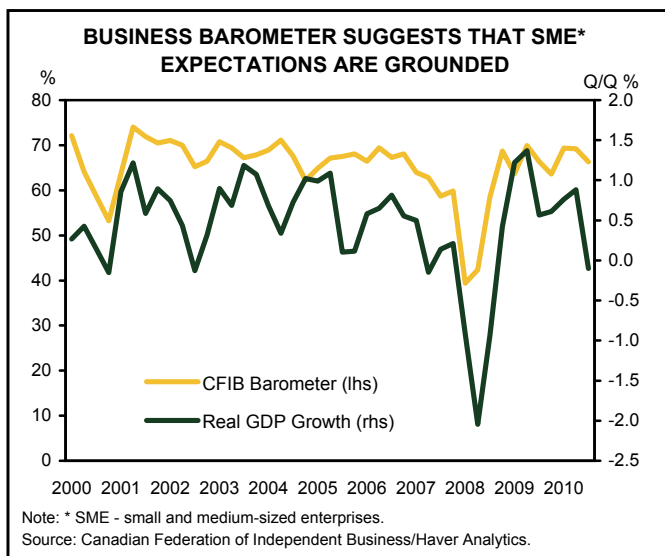
### Implications of growth climate for SMEs

The downgrade to the near-term picture for the Canadian economic outlook will be felt by nearly all small- and medium-sized enterprises. This is by no means surprising, given how important a contributor these firms are to overall national growth as well as the broad spectrum of industries in which SMEs participate. Due to the fact that not all enterprises are the same, we expand the breadth and depth of our analysis over the next few sections.

*Commodity prices will remain off their highs, but should stay relatively elevated*

While small- and medium-sized enterprises are not heavily concentrated to the oil and gas sector (roughly 1% of total SME employment), many firms have cited rising energy and non-energy commodity prices as a key challenge to business survival and overall growth. This is because many of these inputs feed into production processes and often, top line margins are too slim to absorb noticeable hikes to variable costs.

To better ascertain global demand, we look to the commodity hungry regions in China, India and other rapidly growing emerging markets. After many of these economies posted almost double digit growth numbers at the onset of the recovery, the road ahead looks much more moderate. At the same time, however, GDP growth and demand are poised to keep commodity prices relatively firm over the 2011-13 period. Ultimately, we expect prices to remain well within their five-year ranges. This outcome should have two implications: (1) input costs are not going to substantially increase for SMEs; and (2) revenues of resource-based

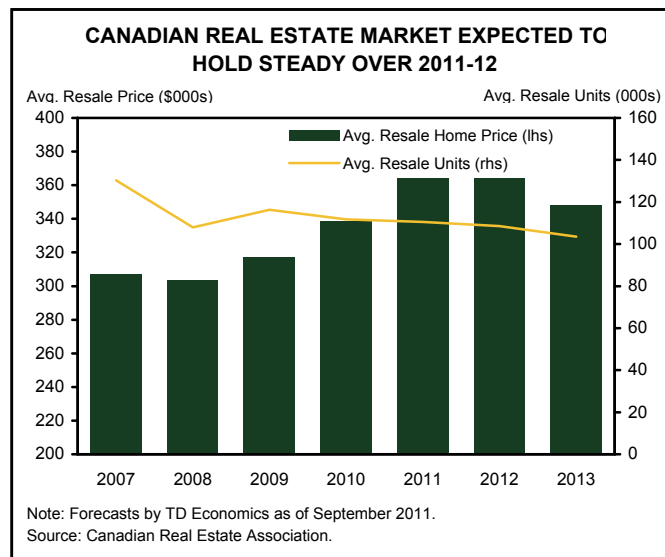
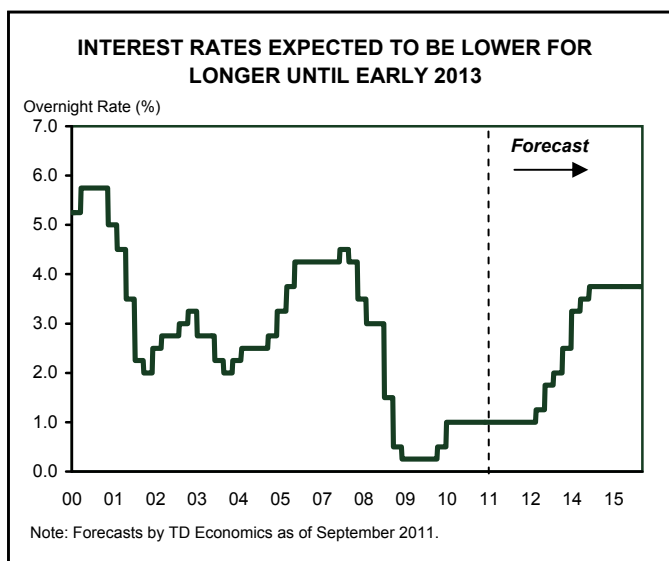


SMEs should hold steady. In summary though, sizeable price swings in these goods will likely pose a challenge for business planning.

The Canadian dollar tends to track commodity prices and, thus, help to cushion the elevated price outlook described. Similar to commodities, the Canadian dollar will remain under bouts of downward pressure in the near term, as global investors remain on edge about economic and financial prospects. Next year, we expect a rebound in the loonie (relative to the greenback) as some of the fears dissipate. Few SMEs will benefit from the large trading range, making forecasting difficult for those SMEs that purchase imports and/or export goods. Roughly 30% of respondents in a TD small business survey stated this was already the case. However, the bulk of SMEs (roughly 60-70%) conduct their operations within Canada, so for these firms, the currency trading volatility might have a lesser day-to-day impact.

*Low interest rate profile to keep resale housing market and consumer spending steady*

With the economic recovery proceeding at a gradual pace, the Bank of Canada will not start increasing its overnight rate until 2013. As a result, operating loans tied to the prime business lending rate, and commercial and residential mortgages are expected to remain low in the interim. With this backdrop, the residential housing market, in terms of prices and sales, will hold relatively steady in 2011-12. However, a downward adjustment looks to be in store in 2013 once interest rate increases kick in. Putting everything into perspective, for those small- and medium-sized enterprises linked to movements in the housing market, this



near-term outlook of things holding steady is supportive, as the level of activity should be high.

For those SMEs tied to the retail side of the market, business growth prospects are expected to be constrained. This is because income and wage growth will likely be muted. Still, the low interest rate conditions should prop up consumer buying levels to the extent that the pace of spending exceeds that of income. In turn, household debt levels are expected to inch up to a record 150% debt-to-income ratio next year. With wallets growing increasingly thin and consumers generally becoming fatigued, small- and medium-sized enterprises attached to retail activity may need to exert additional effort to boost sales.

*SMEs tied to manufacturing and construction on different growth paths*

SMEs exert a noticeable presence in manufacturing; as a share of total employment, Statistics Canada puts small- and medium-sized enterprises tied to manufacturing at a sizeable 62%. Looking ahead, manufacturing should be bogged down a high Canadian dollar relative to the greenback. In essence, the high Canadian dollar and its projected volatility serve as a double edged sword for those SMEs tied to manufacturing. The third headwind for this particular sector is lacklustre demand coming from south of the border; 73% of Canada's exports have this destination on their shipping labels. Downward pressure from all of these sources will serve to limit the upside potential realized by manufacturing SMEs over the near term.

SMEs tied to the construction sector should experience a different fate in 2011. Both new and resale housing demand

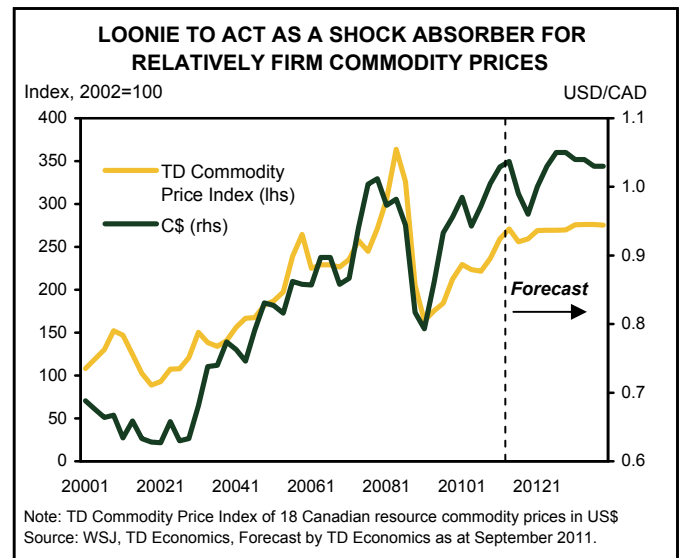
has come in stronger than originally expected, helped in large part by a prolonged period of low interest rates. The same can be said for non-residential construction. Looking to next year, softer numbers are expected, as new projects begin to track milder economic conditions and subdued demand. Still, with 87% of Canada's construction workers tied to a small or medium sized enterprise as of the second quarter of 2011, the near-term strength should help buoy in year business performance.

*Labour market conditions not expected to change materially*

It was just this past July when the Bank of Canada's Business Outlook survey released the statistic that 57% of Canadian firms were expecting to hire additional workers. This number represents the highest reading measured since the survey began in 1998. While this survey has not been updated after the summer's developments, we suspect that hiring intentions among Canadian businesses have decreased from these record highs.

While revised survey data are not available for Canadian businesses as a whole, updated statistics have been released at the SME level. According to the September 2011 CFIB barometer, 13% of survey respondents plan to hire full-time staff in the next three or four months. The percentage is down when compared to just a few months ago. Conversely, 14% of respondents are looking to cut back on employment. However, on a year-over-year basis, this second result is little changed.

The recent hit to confidence readings, combined with lower hiring intentions are suggestive of only slight changes

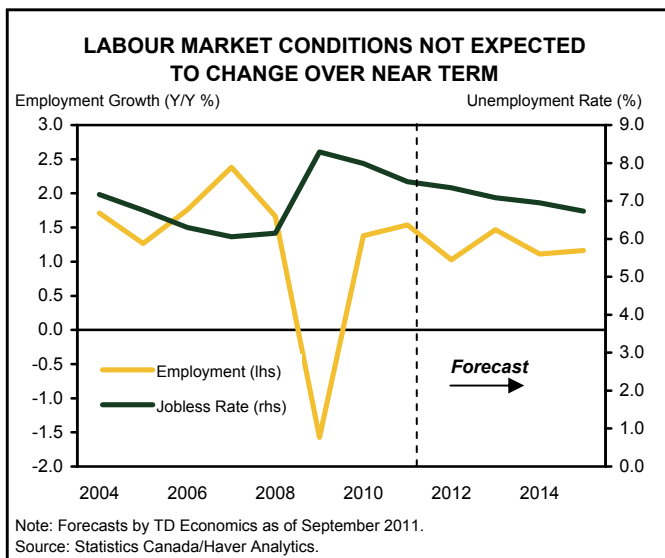


to overall national employment. With roughly equal labour force growth, unemployment rates, at both the national and provincial level, should not face much downward momentum. We have the national jobless rate hovering near 7.1% at the end of 2013. Generally looser labour market conditions may actually be a positive for small- and medium-sized enterprises. This is because SMEs often cite a shortage of skilled and unskilled labour as a barrier to success and business growth. We delve into this particular challenge later on in this report.

**Many of the same challenges to success persist**

The previous section outlined the near-term challenges for small- and medium-sized enterprises in light of the economic climate. These underlying factors are important for immediate business decisions of whether to hire or not, where to focus the business growth strategy, or perhaps how firms might want to hedge against currency volatility.

While these pressing concerns are important when discussing the small business economic outlook, medium-term challenges that often serve as a barrier to success should not be pushed to the back burner. Recognizing the importance of these latter obstacles, we now bring them into the scope of our analysis. A recent TD Small Business Satisfaction Poll conducted earlier this year gives us insight as to the challenges related to long-term business prosperity. Through these results, we see that the top five barriers to success are those that have been frequently stated in past polls and in other surveys. Over the next few paragraphs, we review three of the issues on this list, while bringing some discussion to the table and/or commenting on recent developments.

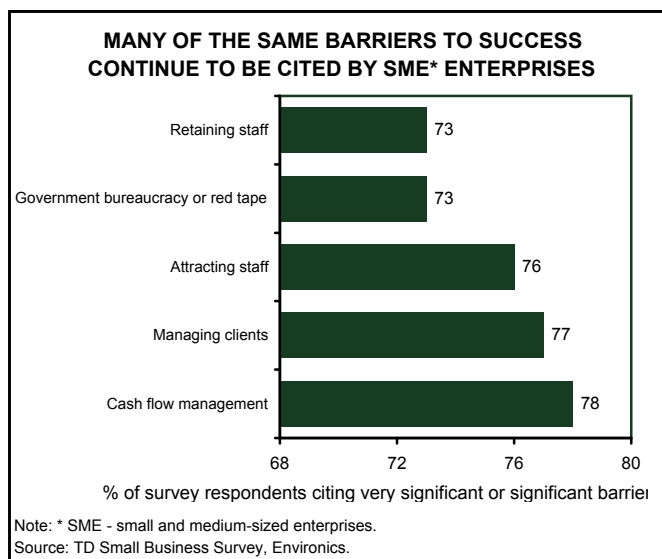


### Cash flow management and credit conditions

According to the 2011 TD Survey, cash flow management and credit conditions top the list for SMEs in terms of limiting their chances for success. The Survey of Suppliers of Business Financing<sup>7</sup> corroborates the tightened lending practices - outstanding debt to business decreased by roughly 10% between 2008 and 2009. A reversal to the downward trend was noted last year, as outstanding balances inched up year-over-year by 1.5%. For SMEs, balances have remained fairly stable from 2000 to 2010. We suspect that credit conditions were indeed tightened given the downturn. Alternatively, some SMEs may have elected to work down their debt given the economic uncertainty hanging thick in the air. Both theories concern either the supply side or the demand side of the same coin.

As the recovery carries on, access to commercial loans and demand for funds are expected to improve. We are already seeing this noted within the TD poll. In 2010, 52% of respondents cited cash flow management as a very significant obstacle of success; in 2011, the survey estimates the same figure to be much lower at 41%. The Bank of Canada's Senior Loan Officer Survey for the second quarter of this year also points to improved conditions for SME borrowers. The balance of opinion for commercial and small business borrowers had the greatest degree of consensus since the survey began.

Cash flow appears to be a critical planning element for SMEs. In the 2009 TD survey, roughly 21% of respondents said that they wished they had raised more capital before starting their business venture. To improve cash flow management, we look to the TD Business Planner<sup>8</sup> that outlines



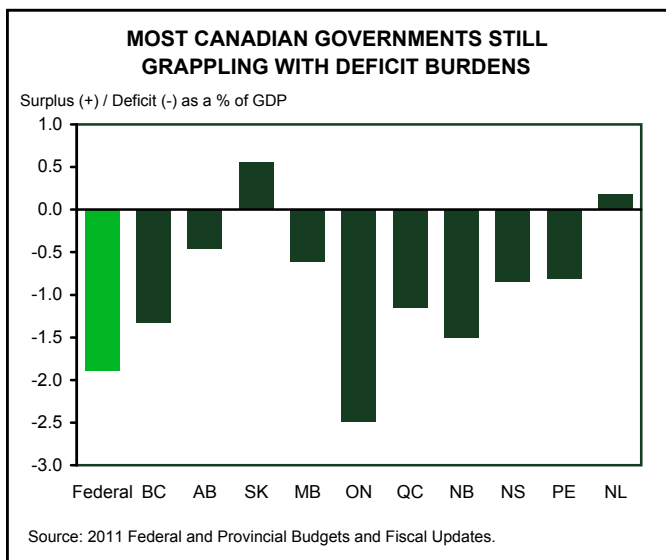
some of the key secrets to successfully overcome this obstacle. Examples of some of the advice given include better management of invoices, and the need to obtain a line of credit before it becomes a means of last resort.

Readily available tools such as the TD Business Planner highlight that there are many financing options available to SMEs. This slew of choices and the different instruments available should help these enterprises access working capital and manage these funds over the long-term. Past studies have shown that adequate financial management is vital to overall business prosperity and often can make the difference between ultimate success and crushing failure.

#### Attracting and retaining staff

When discussing the generally loose labour market conditions anticipated out until 2013, we noted that the developments might actually be good news for SMEs. This hypothesis is supported with the results of the TD survey that show that small and medium-sized businesses continue to have difficulty hiring and retaining skilled workers. Muted employment growth in store, and little movement in the national jobless rate are poised to give SMEs the opportunities to secure skilled workers. What's more, modest wage and salary growth should help keep a lid on what typically is the largest variable cost incurred by SMEs.

With small- and medium-sized enterprises well-equipped to compete for labour supply over the near-term, the challenge then translates into retaining staff. Unlike during times of labour tightness, competitive compensation versus those administered by large firms may not be a 'must have' at the bargaining table over the next few years. Still, once



wage pressures begin to heat up again, SMEs must find creative ways to keep staff in their positions. Salary is just one selling feature to any compensation package. Other items that could be added to the pot include flexible work schedules, enhanced pension and health benefits, and telecommuting options.

The performance of Canadian SMEs during the 2008-09 recession gives us a glimpse of how inventive these firms can be during difficult times. These innovative strategies could also be applied to the challenge of hiring and subsequently keeping workers happy and productive.

#### *Government bureaucracy, compliance burden and red tape*

The last area for concern discussed within this report relates to government bureaucracy and red tape. In this year's TD survey, 73% of respondents cited this issue to be a very significant or significant barrier to success. This percentage is up a few notches relative to the 2010 reading. As with the other challenges reviewed, red tape irritants are not new. In 2010, the CFIB estimated that it cost businesses, of all sizes, roughly \$30.5 billion a year to comply with rules and regulations at all three levels of government. Industry Canada also has attempted to measure how much time is spent working through the regulatory burden. In this analysis, the federal department estimates that SMEs spend roughly 30 million hours every year to comply with obligations at all levels of government<sup>9</sup> across only five broad sectors (manufacturing; retail trade; scientific and technical services; accommodation and food services or other service industries).

In light of the enduring nature of this particular barrier to success, the 2011 federal Speech from the Throne committed to cut red tape for SMEs. To accomplish this task, a Red Tape Reduction Commission, now chaired by the Honourable Maxime Bernier, was set up on January 13, 2011. The panel is mandated to review the issues at hand, identify specific irritants among the SME community, and recommend ways to reduce the regulatory burden<sup>10</sup>. Last month, a preliminary report was tabled summarizing what has been heard to date from business leaders. The final report with recommendations is due to be tabled by the end of the year.

While many Red Tape Commissions have been established in years past, the specific mention of red tape in the Conservative election platform, 2011 Speech from the Throne and 2011 June budget suggests that the regulatory burden issue of SMEs has become a national issue for debate. However, it is important to stress that this is not an issue with only federal jurisdiction. Rather, one of the most common irritants by business leaders was that there were silos in place across federal, provincial and municipal boundaries<sup>11</sup>.

#### **Bottom line**

Recent survey data help support the hypothesis that SMEs are inherently more flexible than their large-sized counterparts. Canadians saw these characteristics put into action during the most recent global downturn. What resulted were fewer job losses in Canada than would have ordinarily been the case given the size of the recession. Still, we appear to be at a very vulnerable stage in the recovery process. Sentiment and confidence have retreated and look to be bracing themselves for weaker economic times. While a renewed recession should be avoided, we anticipate modest global growth to reign. SMEs are expected to face headwinds from a high loonie, further bouts of volatility and equity market uncertainty, as well as, elevated commodity prices. For the medium-term outlook, several barriers to success have persisted over the last several years. Progress and improvement look to be in store to help conquer some of these challenges. If these longer term issues are addressed, SMEs should be well-suited to reap the benefits.

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## End Notes

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