TD Bank Financial Group

Special Report

October 13, 2010

TD Economics
www.td.com/economics

HIGHLIGHTS

- Economic conditions are improving for small and medium-sized business (SMEs), but a competitive and challenging environment will persist.
- For entrepreneurs willing to rise to the challenge, SME business opportunities can be found in all regions and all sectors of the Canadian economy.
- Surveys suggest that the core capabilities needed for all SMEs include: strong management skills, skilled labour, good marketing, high-quality customer service, flexibility to customer needs and product quality.
- However, truly successful firms that experience strong growth not only perform well in the areas above, but they go further. Specifically, SMEs that excel tend to be more productive and innovative. They do more R&D, access new markets, adapt new technologies, control costs and are more innovative with new products.
- While there are economies of scale, being small does not prevent being highly productive and innovative. Indeed, more than one-third of small businesses are more productive than their large counterparts.

Craig Alexander, SVP and Chief Economist
416-982-8064
mailto:craig.alexander@td.com

SECRET TO SUCCESS: AN ECONOMIC PERSPECTIVE FOR SMALL BUSINESS

Canada's economic prospects are only as good as the fortunes of its small and medium-sized (SMEs) businesses, as they represent a core part of all provincial and territorial economies. While the last couple of years were extremely hard, the highly uncertain economic recovery has proven challenging for many SMEs. Looking ahead, the outlook is for modest to moderate economic growth, continued low inflation, only slightly higher interest rates and a strong Canadian dollar. Growth in input costs will likely remain constrained, as slack in the labour market will persist and commodity prices will rise only modestly. This backdrop should create increased opportunities for SMEs and entrepreneurs. However, competition will remain fierce both from foreign imports and from domestic firms.

The above is a typical macroeconomic outlook perspective. However, with the approach of Small Business Week from October 17 to 23, it is perhaps a good opportunity to dig a bit deeper. A more fundamental question is what are the key determinants of success for small businesses? Economic cycles are inevitable. Recessions are followed by recoveries and then expansions, but ultimately the seeds are laid for the next recession. SMEs must find ways of coping with the economic volatility. What we are looking for are the characteristics that have fostered survival and growth of modest-sized firms with less than 500 employees in good times and bad.

This report draws heavily on the high quality work done by the Micro-Economic and Analysis Division at Statistics Canada. The primary sources are two particularly illuminating studies: "Innovation: The Key To Success In Small Business" and "Failing Concerns: Business Bankruptcy in Canada". These studies are complemented by findings from other Industry Canada research and some additional academic and non-academic sources.

Several key themes can be drawn about the qualities and characteristics that lead to success. The first theme is that profitable opportunities for SMEs can be found in all regions of Canada and in all sectors. The second theme is that good management and financial skills, as well as marketing capacity, are essential for enterprises to remain viable. These capabilities are a necessary, but not sufficient, condition for success. Firms also need to have skilled labour, access to markets and capital at a reasonable cost. To be competitive, businesses must be proficient at customer service, show flexibility to customer requirements, offer quality products over a range of goods or services, have competitive pricing and employ adequately skilled workers. These competencies generally help to avoid failure (i.e. bankruptcy) and aid in fostering growth. However, the most successful enterprises go beyond these traits. While they are masters of the above, they are also highly innovative and productive firms that tend to be more inclined than average towards investment in research and development and new capital. They are also willing to access new markets and find competitive advantage through product and process innovation.

Opportunities abound

Small and medium-sized enterprises are a core part of the Canadian economy. In 2003, they constituted 99% of all firms, employed more than 60% of all workers and accounted for approximately 45% of the country's economic output. SMEs are found in virtually every industry and are spread across the country. They form the entrepreneurial foundation of Canada.

There is enormous turnover in SMEs. Less than 1-in-5 new firms last ten years. New firms tend to be smaller in scale and more than half of them fail in their first two years of life. Roughly half of the job creation by all firms arises from the net entering and exiting of firms, which makes SMEs a powerful engine for job creation since they make up a high proportion of new firms. This heavy churn is what economists refer to as the creative destruction of capitalism. Less productive companies leave the market, while new and more productive or innovative start-ups are launched.

The good news for entrepreneurs willing to take the risk of launching a start-up is that rapid growth enterprises can be found across Canada. Indeed, Industry Canada found that between 1993 and 2002, hyper-growth firms (those with 150% or greater employment growth over a four year period) and strong-growth firms (between 50% and 150% employment growth) represented a remarkably stable 16% to 18% of continuing businesses in every region of Canada. Moreover, hyper- and strong-growth firms were found in every major industrial classification and the distribution was assessed as being relatively even across sectors. In other words, there are profitable and growth opportunities to be had for entrepreneurs everywhere.

The key, then, is to launch and run a firm that will prove viable at the start and then grow the business over time. Of course, this is very easy to say, but extremely hard to do.

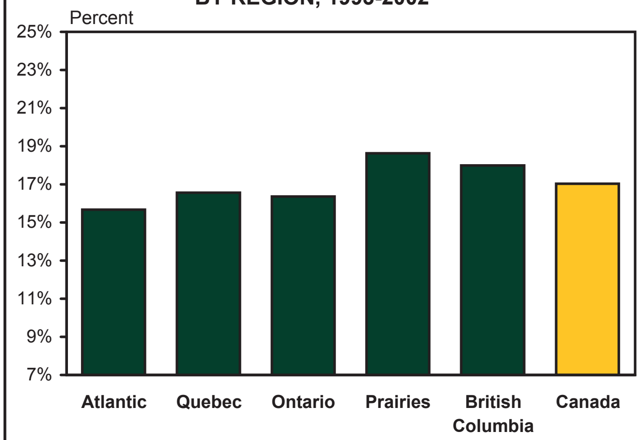
Guidance from successful SMEs

To help improve the odds of success, one might ask SME operators who have succeeded or failed what skills or traits were the biggest contributors to their business outcomes. Statistics Canada surveyed growing SMEs in all sectors except public administration, health and education between 1984 and 1988. Growing firms were asked to self evaluate the factors key to their success. Although dated, the findings of the report "Innovation: The Key To Success In Small Firms" is still very relevant today.

The survey results were surprisingly similar across sectors. The three leading determinants of growth as reported by SMEs were management skills (by a significant margin) followed by skilled labour and then marketing capacity. Other responses included access to markets, access to capital and cost of capital.

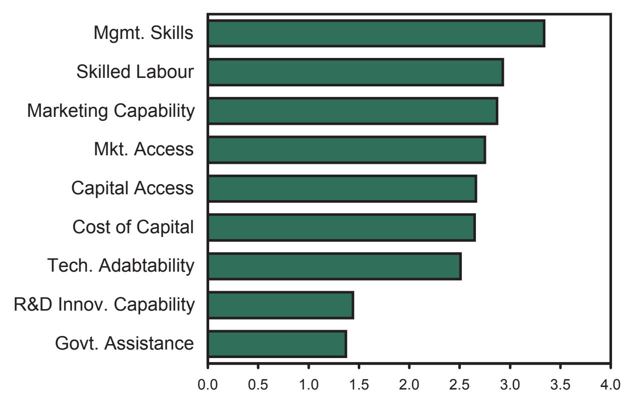
On the subject of competitiveness, the leading three factors were customer service, followed closely by flexibility

SHARE OF HYPER AND STRONG GROWTH FIRMS BY REGION, 1993-2002



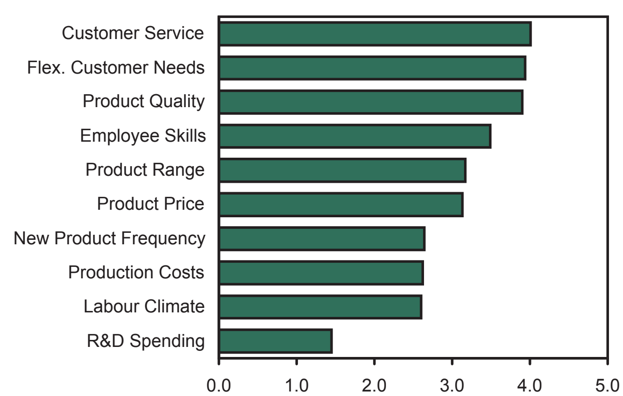
Source: Parsley and Halabisky, 2008; Industry Canada

MEAN SCORES OF FACTORS CONTRIBUTING TO GROWTH



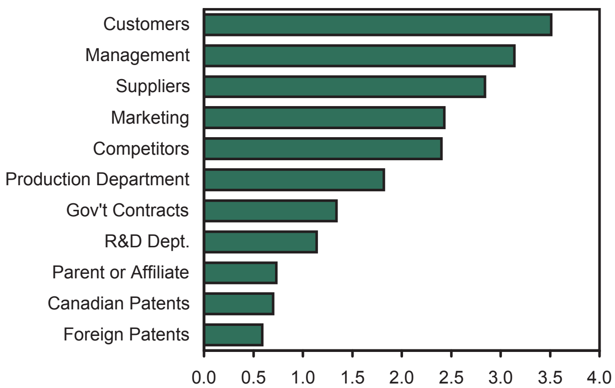
Source: Baldwin and Gellatly (2003), Statistics Canada

MEAN SCORES OF COMPETITIVENESS ASSESSMENT



Source: Baldwin and Gellatly (2003), Statistics Canada

MEAN SCORES OF SOURCES OF INNOVATION



Source: Baldwin and Gellatly (2003), Statistics Canada

to customer needs and quality of products. Next came employee skills, range of products, and price of products.

It is interesting to note that innovative activities such as research & development (R&D) and the adoption of new technologies did not rank high on firms' list of determinants of growth. Similarly, new products, production costs, and R&D spending did not rank near the top of the competitiveness factors. When it came to the source of the firm's innovative activities, respondents felt that the key drivers were customers, followed by management and then suppliers. The R&D department was in eighth position.

Economic drivers of viability

The natural issue over self-evaluation is whether the perception of respondents meets the reality of business outcomes. In order to make this comparison, one can look at a 1997 Statistics Canada report entitled "Failing Concerns: Business Bankruptcy In Canada" that provided an in-depth look at the characteristics of firms that experienced bankruptcy. The findings showed significant overlap between the odds of insolvency and an absence of the self identified required skills for success.

Firms fail because of either external factors or internal factors, and the survey results suggest that the cause of bankruptcy is split almost evenly between these two sources. The negative external force most often identified is an economic downturn. Other key external forces are greater competition and customer difficulties. However, the external and internal factors are inherently related: it is how businesses internally respond to external shocks that often makes the difference for survival. In some cases, no amount of talent and capability will be adequate, but in many cases internal traits can help weather the storm. With respect to internal factors, more than 70% of firms that went bankrupt had deficiencies in general or financial management, while close to 50% had weak marketing capabilities.

Rather than harp on about the negatives, it is perhaps more constructive to outline what the survey suggests would have helped firms to avoid bankruptcy. Managers need to have broad and deep knowledge to coordinate finance, marketing and operations effectively. They need vision, should be prepared to use outside advisers and should be capable of providing good supervision of staff.

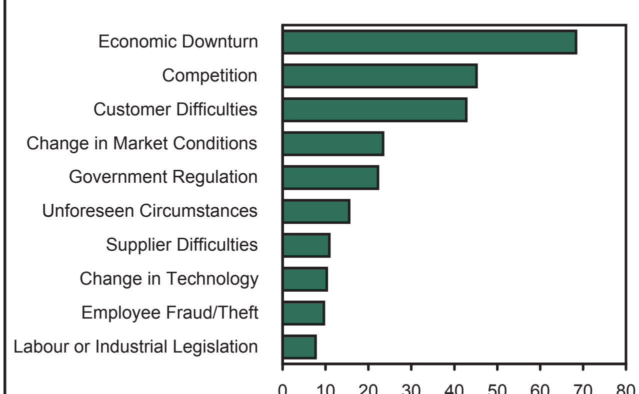
Firms also need adequate financial management. This means ensuring that the firm is adequately capitalized, that working capital is managed effectively and that the capital structure is properly balanced (i.e. avoid excessive debt). Although there may be external barriers to accessing capital, financial management is essential for properly assessing the options for raising capital and handling capital.

Oddly enough, the analysis does not suggest that having a well-developed business plan is essential, as roughly the same number of firms with one succeed as go bankrupt. Perhaps the difference is in the execution of the plan. One would expect that having a plan would aid in terms of turning a vision into a strategy.

In contrast, marketing skills do appear essential for SMEs, as almost half of bankrupt firms fell short in this area. Marketing is needed to establish a market niche, to affect pricing, and for location and customer service purposes. When one considers that SMEs are often niche players, it is unsurprising that marketing comes immediately after management and financial skills in terms of importance.

One particularly interesting dimension of the Statistics

EXTERNAL FACTORS CONTRIBUTING TO BANKRUPTCY (%)



Source: Statistics Canada

Canada research was the actions that help to avoid bankruptcy when business problems arise. First, firms that raised additional capital or sought new sources of financing early during financial difficulty had greater scope to ride out the storm. Second, getting input or perspective from outside sources was helpful to avoid insolvency. This suggests that bringing in a different and often unemotional perspective can led to new management, financial and marketing responses to the difficulty. Third, reengineering operations was often needed. Fourth, renegotiation of the terms of commitments with debt holders or suppliers was a useful response.

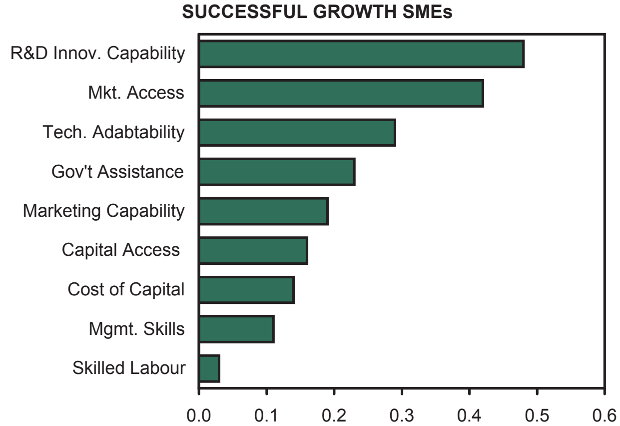
Lessons from the most successful

The bankruptcy analysis provides some good guidance on the skills necessary for running a viable firm. But, what sets some SMEs apart from their counterparts? No one wants to launch a business just to survive. That sets the bar too low. The real goal is to succeed. In the Statistics Canada paper "Innovation: The Key to Success in Small Firms" successful firms are defined as those that are profitable and gain market share over time. The analysis evaluated the characteristics of firms that grew more strongly relative to those that grew more slowly.

The survey results suggest that key sources for growth outperformance are R&D innovative capacity and access to markets. These factors are followed, in order, by technological adaptability, government assistance, marketing, access to capital, cost of capital, management skills and labour skills. This is a remarkable ranking, as it is almost the inverse of the self-identified sources of growth mentioned earlier – where management and skilled labour were at the top of the list.

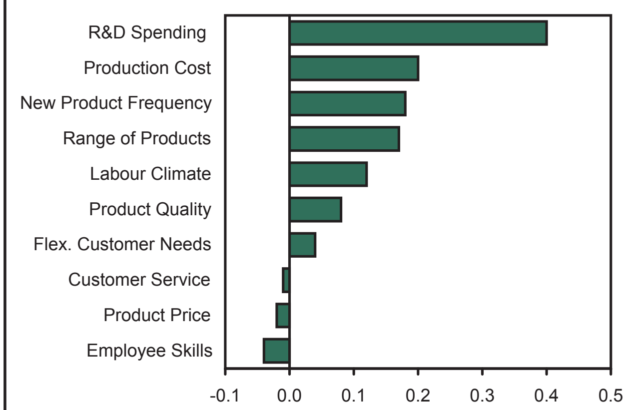
The key factor leading to competitive outperformance is R&D spending. This is trailed by production costs, frequency of new products, and product range. Further lower in ranking is labour climate, product quality and flexibility with customers. Again the ranking is at odds with the self evaluation. Customer service did not rank positively, yet it was the number one self-identified source of competitive strength.

DIFFERENCE IN MEAN SCORES FOR GROWTH STRATEGIES BETWEEN MORE SUCCESSFUL AND LESS SUCCESSFUL GROWTH SMEs



Source: Baldwin and Gellatly (2003), Statistics Canada

DIFFERENCE IN MEAN SCORES FOR COMPETITIVENESS SELF-ASSESSMENT BETWEEN MORE SUCCESSFUL AND LESS SUCCESSFUL GROWTH SMEs

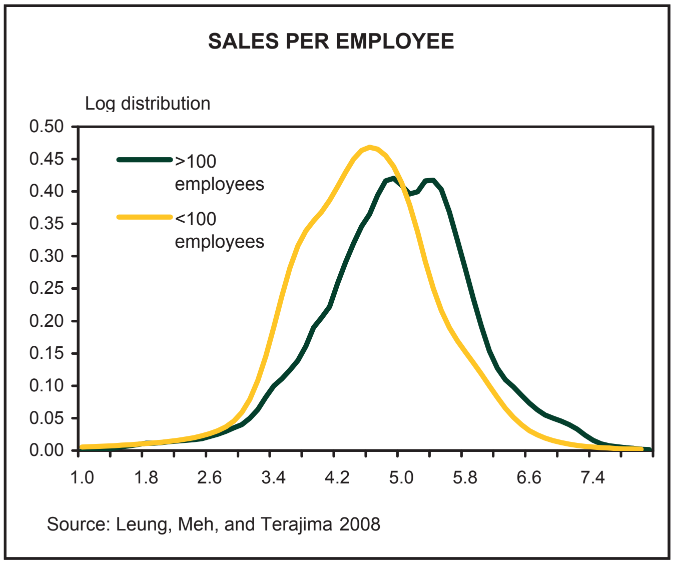


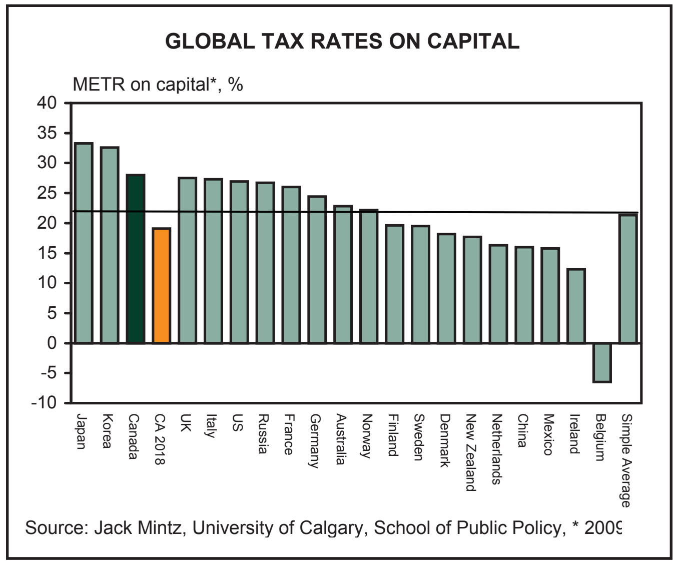
Source: Baldwin and Gellatly (2003), Statistics Canada

How does one reconcile these findings? The simple answer is that the self evaluation was absolutely correct in terms of the core proficiencies and capabilities that every business requires, but the most successful firms meet this bar and then go the next mile. The most successful firms are productive and nimble. They constantly strive to introduce product and process innovations, as well as evolve their business model. They invest in new capital and pursue research into new products, services or methods.

You can do it too

There may be some natural resistance to the recommendation that SMEs strive to do more innovation and R&D. Indeed, SMEs get a bad wrap in the productivity literature. It is often said that Canada's poor productivity performance, especially relative to the U.S., is partly a reflection of the fact that a greater share of the Canadian economy is comprised of small businesses. And, small businesses lack the scale to undertake the level of capital investment and R&D of large firms. However, this aggregate picture is far more grey than black and white. Analysis by Industry Canada found that the incidence of R&D (i.e. share of firms doing R&D) by Canadian small and medium-sized firms in 2002 was 1.1% and 10.3%, respectively, compared to 1.0% and 6.1% in the United States. R&D intensity (i.e. the amount of R&D) by Canadian firms was less than their U.S. counterparts, but the greatest differential was for large medium and firms,





not small enterprises. A key issue seems to be that the U.S. has greater numbers of very large enterprises that do more R&D and invest more in capital.

While SMEs do tend to be less productive than large firms, implying that there are economies of scale, this story is skewed by aggregate averages. A Bank of Canada working paper entitled "Firm Size and Productivity" revealed that more than one-third of firms with less than 100 employees are in fact more productive than their large firm counterparts. The conclusion is that while large firms have greater scale, being small is not a barrier to R&D, innovation, productivity or success if management chooses to pursue it.

Innovate today

The best news is that now is an ideal time for SMEs to investment in new capital, pursue new innovations or take on research and development opportunities. Although the economy is likely to deliver only moderate economic growth over the next couple of years, aggregate profits are expected to rise at a 6% to 8% pace per annum and many businesses have good balance sheets. Interest rates may rise, but the level of rates should remain quite low. The effective tax rate on capital has also fallen in recent years, with the elimination of capital taxes by all levels of government, reductions in business income taxes and the introduction of the HST in Ontario and British Columbia. Strong bank balance sheets and diminished financial and regulatory risk also suggest that the supply of credit should be available to meet the future demands of business. The Canadian dollar is also expected to remain close to parity to the U.S. dollar, limiting the cost of imported machinery and equipment. The most positive dimension to this story is that if SMEs were to boost their innovative capacity and capital stock, it would help boost Canada's ailing productivity performance that threatens the country's future standard of living.

Conclusions

So what are the main points to take away? First, SMEs can be successful in every sector and every jurisdiction in Canada. This should be encouraging to current and prospective entrepreneurs across the nation. Second, SMEs are heavily affected by economic conditions and external factors; but, there are internal characteristics that deeply influence the success rate of SMEs. The analysis shows that it takes a lot of different skills and competencies to run a viable business. Self evaluation by SMEs put a spot light on the core characteristics of strong management skills, highly skilled staff, marketing capacity and customer service. But, these are just the top four characteristics from a much more extensive list. The most remarkable finding, however, is that most successful SMEs are those that pursue increased R&D, strive to innovate and invest in new technologies. And the data show that many Canadian small and medium-size businesses do exactly that. Indeed, many SMEs are more productive than large firms. If more SMEs set a similarly high bar and then excel, it opens the door to greater growth and prosperity. It would also be a boon to the Canadian economy overall.

References

Baldwin, John. (1995). "Innovation: The Key to Success in Small Firms" Ottawa: Statistics Canada

Baldwin, John et al. (1997). "Failing Concerns: Business Bankruptcy in Canada" Ottawa: Statistics Canada

Baldwin, John and Guy Gellatly (2006) "Innovation Capabilities: The Knowledge Capital Behind the Survival and Growth of Firms" Ottawa: Statistics Canada

Industry Canada (2008) "Profile of Growth Firms: A Summary of Industry Canada Research" Ottawa: Industry Canada

Industry Canada (2008) "Small Business Quarterly: Business R&D Intensity and Firm Size" Ottawa: Industry Canada

Leung, Danny, Cesaire Meh and Yaz Terajima (2008). "Firm Size and Productivity" Bank of Canada Working Paper 2008-45. Ottawa: Bank of Canada