

CHALLENGES FACING SMALL BUSINESSES CALL FOR INNOVATIVE THINKING, SAY TD ECONOMISTS

TORONTO, OCTOBER 11, 2007 — In advance of Small Business Week (October 14 to 20, 2007), TD Economics today released a new report that reviews the outlook for five key external factors impacting the health of Canadian small business: the prospects for sales, competition, labour markets, non-labour costs and the climate for investment. Entitled *Small Businesses to Benefit from Solid Domestic Demand, but Challenges Call for Innovative Thinking*, the report is authored by Craig Alexander, Vice President and Deputy Chief Economist, TD Bank Financial Group and is available in PDF format on TD Economics' homepage at www.td.com/economics.

Executive Summary:

- Small businesses that are domestically focused, benefit from a high-flying loonie or are exporting overseas are expected to post solid sales growth in 2008.
- Exporters to the United States, firms that are part of a supply chain of companies that have a U.S. export focus and those that are adversely affected by a strong currency will face a more difficult sales environment.
- However, the sales outlook only tells part of the story, as small businesses will face a number of key challenges in the year ahead, including:
 - o Fierce competition in both local and foreign markets;
 - o Tight labour markets in urban centres across the country; and
 - o Elevated energy and non-labour costs.

“The overall assessment is that 2008 should be a decent year for small business, but significant challenges will be present,” said Craig Alexander. “Small business owners cannot be complacent and must be innovative in developing strategies to address the challenges.”

Sales outlook is positive

Firms that are focused on selling to domestic markets, benefit from a high flying-loonie, or have overseas trade-ties are likely to experience solid demand for their wares. “The majority of small businesses in Canada are oriented towards selling to the domestic market and the outlook is for healthy domestic demand growth next year,” remarked Alexander.

Conversely, businesses adversely affected by a strong Canadian dollar and those heavily leveraged to trade with the United States (or are part of a production chain with firms that export to the U.S.) will face a difficult environment over the next twelve months, but conditions should improve in late 2008 and throughout 2009.

Small businesses that export overseas will face a somewhat better environment, since the appreciation in the Canadian dollar has been less dramatic and global demand is expected to remain strong.

“However, the sales prospects do not tell the full story, as all small enterprises should be prepared to deal with a number of key challenges,” observed Alexander.

Competition in local and foreign markets will remain fierce

Competitive pressures will not abate. Businesses will have limited pricing power, and Canadian consumers are likely to put greater pressure on firms to pass along savings from the appreciation in the Canadian dollar. The strength in the Canadian dollar has also made imports more competitive in domestic markets and import competition from low-cost labour centres, like China and India, will continue to increase. Globalization is creating competitive pressures in areas that had previously been insulated, like many service industries.

“This is not the time for small business owners to be complacent — they must strive to move up the value added chain by producing more sophisticated goods and services. Product differentiation and the customer experience are becoming ever more important. Identifying niche markets or underserved areas can also provide good opportunities, and branding has grown to be critical in attracting business,” summarized Alexander.

Labour markets will remain extremely tight

Small businesses regularly respond to surveys that they are having difficulty hiring and retaining high skilled workers. Although employment growth is projected to slow in the months ahead, the unemployment rate is only expected to edge up slightly, implying that labour markets would remain tight and wage pressures would persist. This is not just a Western Canada story, as unemployment rates are likely to remain low in most major urban centres across the country.

TD Economics believes small business owners cannot simply wait for labour markets to loosen. Businesses must develop strategies to attract and retrain high skilled employees; they must also be prepared to hire younger staff and provide training to get the workers to meet the needs of the business, which also raises issues around retention.

“While offering competitive compensation is necessary, the matter is far more multifaceted. Today’s workers are not just attracted by money,” remarked Alexander. “Benefits are a crucial part of the equation. The work environment, work-life balance, commute times, flexibility in hours, the possibility of working from home, employer-sponsored training, mentoring programs and a wide array of other factors can also influence the hiring and retention of employees. Even a company’s social and environmental policies and community reputation can have an impact.”

Energy and other input costs will also remain elevated

Non-labour costs are also expected to remain elevated. Although the last surge in crude oil prices to above US\$80 a barrel in September will not be sustained, prices should not drop below US\$70. Based on this outlook, gasoline prices should remain close to current levels, or only rise by a few cents. There is greater upside to natural gas prices. Assuming normal weather conditions over the winter, the outlook is for natural gas prices to rise by 12 percent in 2008. Businesses may also want to budget for modestly higher electricity bills next year. The story is the same with material costs, which are generally expected to advance at a slower pace than in recent years, but remain at relatively high levels.

“In many cases there is little that small businesses can do about high input and material costs, as they are price takers and lack much bargaining power with suppliers. Nevertheless businesses should search high and low for methods to reduce non-labour costs,” concluded Alexander.

Don't wait for governments to respond

The challenges facing small business may provoke a call for government action, but businesses cannot wait or rely on public policy to come to the rescue. "The challenges are here today, but government initiatives take time to formulate, time to pass into legislation, and time to be implemented. Time is not a luxury that small business owners have," remarked Alexander.

Climate for investment to remain supportive

Investing in new technologies is a strategy that for many small businesses might lower costs in the future and boost efficiency. The good news is that the climate for investment is expected to remain positive.

Despite the financial turmoil in August, there is no reason for Canadian financial institutions to significantly cut back on their willingness to lend, for the simple reason that credit conditions were never loosened inappropriately in recent years. Borrowing costs should not prove prohibitive, as interest rates should remain relatively close to current levels. A stronger Canadian dollar has also significantly reduced the cost of imported machinery and equipment.

Creative and innovative responses needed

The central theme of the TD Economics report is that Canada's entrepreneurs will need all of their skills and talents to look for opportunities to overcome the challenges. Business-as-usual strategies won't deliver, and small business owners will need to find ways to attract talented labour and retain their employees, with non-monetary factors becoming particularly important.

Ways of reducing energy and non-labour costs need to be identified, and competing on the basis of price or labour costs is a losing cause. The future is in selling higher quality or more advanced products, exploiting niche markets and ensuring customer satisfaction. Developing scale could lead to cost savings, and exploring new ways to penetrate foreign markets might also prove profitable.

"The bottom line is that creative thinking and flexibility towards new approaches, processes and strategies are called for. Of course, this is easy to say, and extremely hard to deliver," concluded Alexander.

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