OBSERVATION

TD Economics

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SMALL BUSINESS RESILIENT EVEN IN TURBULENT WATERS

Highlights

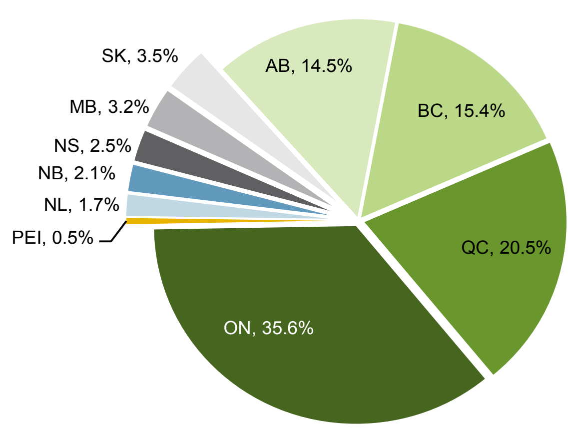
- Small business is an important part of the Canadian economy. Despite economic turbulence, the small business sector has remained resilient, even becoming a key source of employment growth.
- Some key small-business sectors such as professional services and real estate tend to be more resilient to economic headwinds, likely due to the specialized qualifications these sectors require.
- Reflecting the challenges that have faced the Canadian economy this year, many small business owners are concerned about the outlook for their firms. In commodity-producing regions, growth will be slow to return. However, in other parts of the country, the outlook is more positive.
- Businesses that can take advantage of current conditions, particularly the weak loonie, are likely to outperform. These industries include transportation and warehousing, tourism, and professional services.

Small and medium-sized businesses are a driving force of the Canadian economy. In addition to their large number, they historically account for around 40% of Canada's GDP not to mention their important contribution to the labour market. Their large share of the economy in both size and scope means that small business are just as exposed, if not more, to swings in the business cycle. Recent history provided another test of small businesses, as the economy experienced back to back quarterly contractions – a so called "technical recession"

'Traditional' thinking would tell us that small business should underperform in a downturn, as they tend to be less diversified than larger firms, and have smaller (relative) cash buffers. However, in this year's downturn, small (and medium) firms actually outperformed their larger counterparts, at least in terms of employment. While the heavy concentration of the weakness in mining and manufacturing industries (which tend to be skewed towards larger enterprises) explains part of this relative resilience, we don't believe it tells the whole story. A closer look shows that small businesses are increasingly showing less cyclicality over time in response to a greater service orientation.

That said, we must also recognize that small businesses are much less confident about the prospects for the Canadian economy than they were a year ago. The good news however is that the pressures on the economy are expected to ease over the coming quarters, giving them reasons to feel more optimistic. At the same time, the dynamic domestic market will remain supportive of services-producing industries (well known for their concen-

CHART 1. PROVINCIAL DISTRIBUTION OF SMALL BUSINESSES



Source: Statistics Canada, TD Economics. As of June 2015.

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tration of small businesses), while export growth should translate into new opportunities for small businesses along the supply chain.

Small business adds up to a big part of the economy

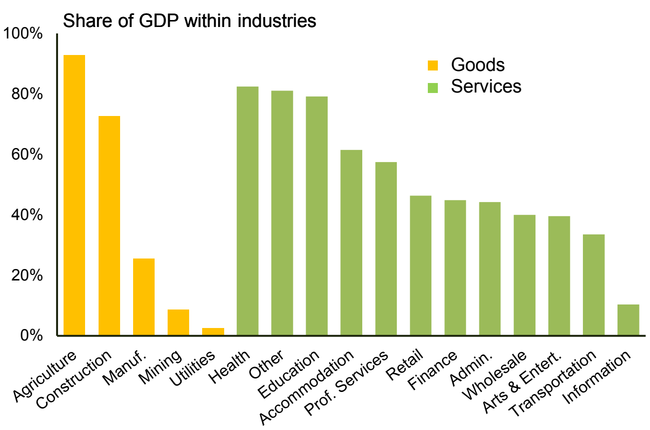
In June 2015, there were a little over 1.2 million small businesses (firms with 99 employees or less) in Canada, which is equivalent to 98% of all employer businesses. As shown in Chart 1, these companies were mainly located in Ontario (36%) and Quebec (21%), followed by British Columbia and Alberta, each hosting 15% of Canadian small businesses.

According to Statistics Canada,[1] small businesses alone were responsible for 41% of Canada's private sector Gross Domestic Product (GDP) in 2008. In fact, in some sectors such as agriculture and health services, small businesses accounted for almost the entire industry's output (93% and 82%, respectively).

It is also worth mentioning that although small businesses have historically been distributed across most major economic sectors (Chart 2), they now mostly operate in the services sector (close to 80% of small businesses were active in the services sector in June 2015).

This distribution of small businesses across sectors could help to explain their resilience during the first half of 2015. Indeed, real GDP contracted by 2.8% in goods-producing industries during that period, while that of services industries increased by a moderate 0.7%. This strength was also reflected in the labour market, where small business employment grew by more than 43,000 positions, or nearly half of the job gains. Indeed, growth in the sector remains strong

CHART 2. SMALL BUSINESSES' CONTRIBUTION TO CANADA'S GDP



Source: Industry Canada, *Key Small Business Statistics*, Aug. 2013.

CHART 3. SMALL BUSINESS HIRING REMAINED STRONG THROUGH THIS YEAR'S DOWNTURN

Source: Statistics Canada, TD Economics

along other measures as well, with (for instance) around 44,000 new businesses created since June 2014.

Employment in downturns a sign of resiliency

Resiliency refers to the ability to weather unexpected storms and come out unscathed, or perhaps even stronger. For small business, swings in the business cycle are often the biggest test of resilience. A cyclical downturn can, to borrow an analogy from Warren Buffet, be much like a receding tide: once the water is gone, everyone can see who has been swimming without a bathing suit.

One simple 'bathing suit test' is to look at trends in employment during economic downturns. In general, small business performs roughly in line with larger firms when it comes to employment, with swings of roughly the same size in both the 2001 growth slow-down, and the 2008/2009 recession (unfortunately, data limitations prevent us from looking at earlier periods). There are signs that the resiliency of small business employment is growing. Breaking from past cycles, during this year's mild recession, employment continued to expand (albeit at a slower pace), with significant growth occurring among small and medium businesses (Chart 3).

What the employment data show is that far from being laggards, in the most recent period in particular small businesses have provided a backstop to Canadian employment, with robust hiring in the face of a weak economic climate. There is no doubt that the mild nature of this year's recession translated to a less challenging operating environment than past downturns. At the same time, SMEs have become more service-centric over time alongside the economy more broadly, as service industries now represent approximately 60% of SME employment, up from 55% just 10 years ago. Service industries tend to be less volatile, dampening swings in employment.

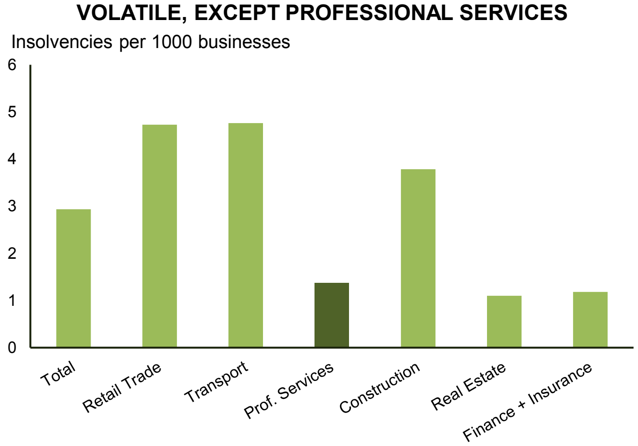
It is also worth noting that small *and* medium sized firms saw the strongest growth in the most recent period. In addition to the 43,000 positions created by small business, medium sized firms (100 to 499 employees) added an additional 13,000 jobs. Removing the very smallest firms (those with less than 5 employees), SME employment still rose by 33,000 in the first half of the year. This strong performance demonstrates that it is not just sole proprietorships being created that drove employment growth (which can be considered a negative sign as it often reflects individuals that have been laid off bridging the space between jobs). Rather, the evidence points to existing small and medium businesses continuing to create jobs. However, as will be discussed in a subsequent section, confidence has declined significantly among small business, typically associated with a slowdown (or contraction) in employment. It remains to be seen if the relatively strong performance seen to date will continue.

Professional services firms tend to be survivors

Business involves taking risks which may not always pay off. Year after year firms wind up operations, and new firms arise to take their place. This natural churn gives us another avenue to explore resiliency. Perhaps the best test of business in recent memory was the 2008/2009 recession. To capture this, we look at insolvency data for 2009 (data for the current downturn are not yet available).

Unfortunately, the data do not let us look at small business directly – rather, we can see only industries (Chart 4). As a result, we can only compare industries typically associated with small business. Many small-business-heavy industries underperformed the average in 2009, with retail trade and transportation both experiencing relatively high insolvency rates compared with the economy-wide total, and indeed with finance and insurance (a sector that tends to have fewer small businesses).

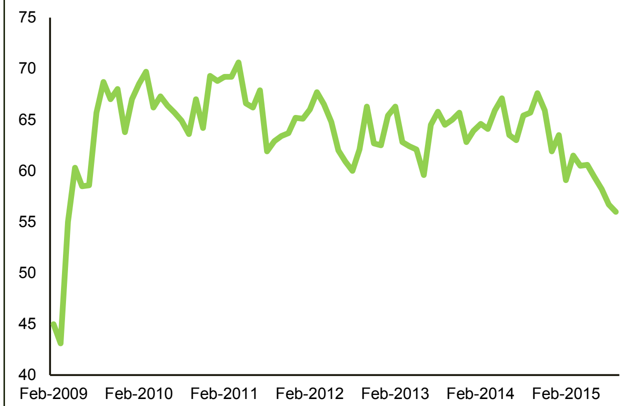
CHART 4. SMALL BUSINESS CAN BE MORE VOLATILE, EXCEPT PROFESSIONAL SERVICES



Source: Industry Canada. 2009 data.

Some key small-business sectors proved to be quite resilient however. Professional services (which includes technical and scientific services), and real estate (including rental and leasing) both saw well below average insolvency rates in 2009. Perhaps unsurprisingly, the data suggests that firms with a clear differentiator (such as the specialized skills needed for the professional service industry) tend to be more resilient.

CHART 5. BUSINESS CONFIDENCE AT ITS LOWEST LEVEL SINCE APRIL 2009



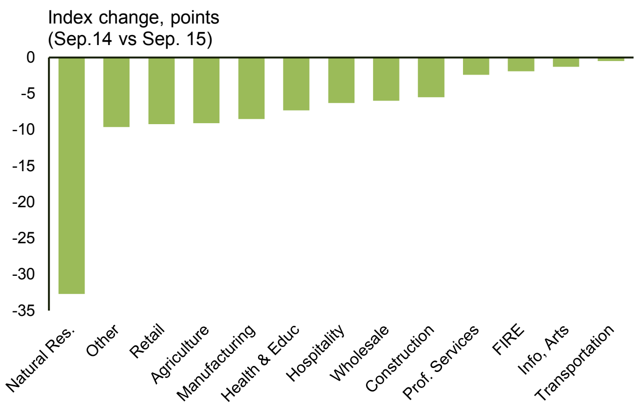
Source: Canadian Federation of Independent Businesses (CFIP)
Last data point September 2015.

Small business confidence trending down

Saying that Canadian small businesses have been resilient despite the contraction in economic activity in H1 2015 does not mean they haven't felt its effects; far from it. As indicated by the Canadian Federation of Independent Business' (CFIB) index, the confidence of small businesses fell to its lowest level in six years in September 2015 (Chart 5).

Despite employment continuing to grow among SMEs, confidence fell across all sectors surveyed (Chart 6), which is quite normal considering the importance of small businesses in the Canadian economy. It is however in the natural resources sector that the deterioration of business sentiment has been the most pronounced, unsurprising given sustained declines in oil prices. Expectedly, the low oil price envi-

CHART 6. NO SECTOR HAS BEEN IMMUNE TO THE LOSS OF CONFIDENCE



Source: Canadian Federation of Independent Businesses (CFIB).

ronment also impacted the optimism of small businesses established in the oil-producing provinces of Alberta, Newfoundland and Saskatchewan. This ultimately translated to lower overall employment growth in H1 2015 (-0.82%) in those regions, compared to those with a less predominant energy sector (0.14%).

Confidence also weakened in non-energy industries, which were otherwise well positioned to benefit from the lower Canadian dollar and energy costs. These include, among others, the manufacturing, transportation and hospitality sectors. Falling confidence was to be expected, given that all those areas saw their real GDP decline in the first half 2015.

Generally speaking, the softness transpiring from the CFIB index hints that small business still have doubts about their performance in the next three or four months. This feeling is starting to feed through to capital expenditures, as suggested by the increasing share of companies that are not planning any capital expenditure in the near future. Furthermore, due to the depreciation of the Canadian dollar, the acquisition cost of foreign inputs (such as equipment) is becoming a growing concern among businesses; particularly for those importing a large portion of their needs.

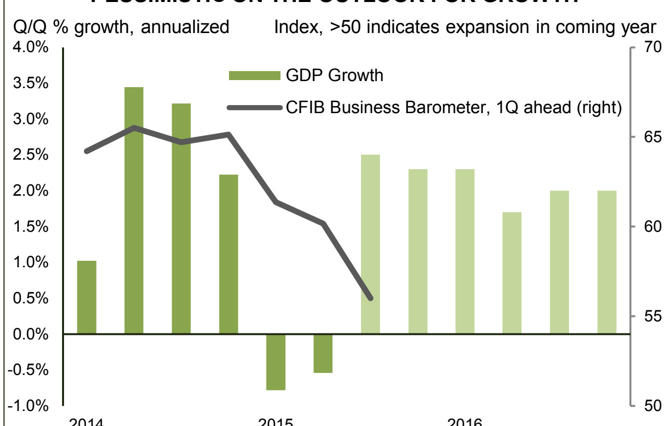
A better road ahead

In many ways, the concerns that many small business owners have expressed in CFIB surveys are a product of broader macroeconomic conditions. Volatile financial markets, falling commodity prices, a slow start to the year in the U.S., and a backdrop of slowing global growth have undoubtedly weighed heavily on the minds of small business owners. Indeed, the Canadian economy as a whole experienced a recession in the first half of the year, and in commodity-producing regions like Alberta, output is likely to continue contracting. Despite regional weakness however, Canada as a whole is poised to return to growth in the second half of the year, with growth expected to average around 2.5% annualized (Chart 7), somewhat higher than implied by the most recent CFIB business barometer survey.

The composition of expected growth also bodes well for small business. Household consumption is expected to remain steady, with the third quarter numbers boosted by the retroactive payment of the government's Universal Childcare Benefit. Exports recovered markedly in June and July, and are expected to remain strong, helped along by the low level of the loonie. While small businesses tend to export internationally somewhat less than larger firms, they should nevertheless benefit from opportunities as export growth makes its way down the supply chain. Finally, housing construction and demand are expected to remain strong over the near term, providing continued opportunities for brokers, lawyers, contractors and countless others involved in the Canadian housing market. Robust housing demand is also associated with growth in retail sales, helping support independent retailers. Beyond growth, interest rates are expected to remain low, resulting in continued favourable financial conditions into 2017.

Moving from the national outlook to the provincial/ industry level provides a more nuanced outlook. Across the country, weakness is expected to persist in Alberta and Saskatchewan, as well Newfoundland and Labrador, as these provinces continue to deal with the effects of weak

CHART 7. SMALL BUSINESSES MAY BE OVERLY PESSIMISTIC ON THE OUTLOOK FOR GROWTH



Source: Statistics Canada, Canadian Federation of Independent Business, TD Economics commodity prices. In contrast, Manitoba, British Columbia, Ontario, and Quebec are all expected to enjoy relatively robust economic growth, supported by the manufacturing industry (itself benefiting from the weak loonie). Manufacturing will not be alone in benefitting from recent currency moves. Transportation and warehousing, and accommodation and food services also stand to benefit, as exports must be shipped, and tourists are attracted by Canada's relative affordability. Professional services are also likely to grow robustly, and have the added benefit that the majority of input costs are priced in Canadian dollars, further increasing their competitiveness. In contrast, industries which rely heavily on imported inputs (such as retail trade) may find the environment more challenging as a result of the weaker loonie.

Bottom line

The recession in the first half of the year created a challenging business environment for small business in Canada. Nevertheless, the resilience which they are known for has helped them maintain a positive performance through it all. Although the sector has held up well to date, recent opinions collected among business owners show that they remain pessimistic about the medium-term prospects for the Canadian economy. It is possible that these business owners are focusing too much on the rear-view mirror, rather than the road ahead. Looking towards the rest of the year, a strong snap-back in growth is expected, which should benefit small businesses and likely reverse some of the recent pessimism. Particular strength is expected for those industries best able to capitalize on the weak loonie and recovery in exports, such as transportation, tourism, and professional services.

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ENDNOTES

1 Key Small Business Statistics, August 2013 edition