

OBSERVATION

TD Economics



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CANADIAN SMALL BUSINESS: TAKING STOCK OF TODAY, LOOKING TO TOMORROW

Highlights

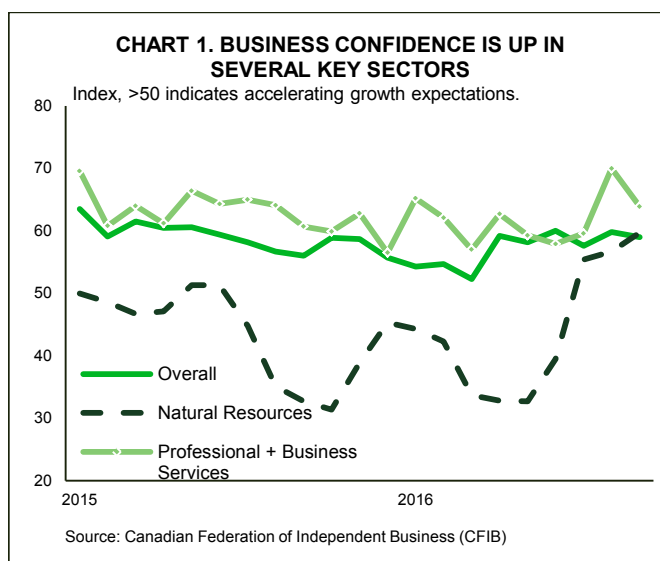
- Small and medium enterprises (SMEs; firms with less than 500 employees) are an important backbone to the Canadian economy, responsible for roughly 9 of every 10 private sector jobs and roughly 30% of overall economic output. These firms are active in nearly every industry, and in every province and territory.
- After falling through most of last year, business confidence has recovered, with businesses in Alberta leading the way. The biggest recovery of confidence has been among natural resource firms, but confidence remains high for those providing a variety of professional and business services.
- Looking to the future, an expected return to steady growth bodes well for Canada's SMEs. Further supporting SME activity is a return to growth across most of Canada's regions led by the SME-prevalent service side of the economy.

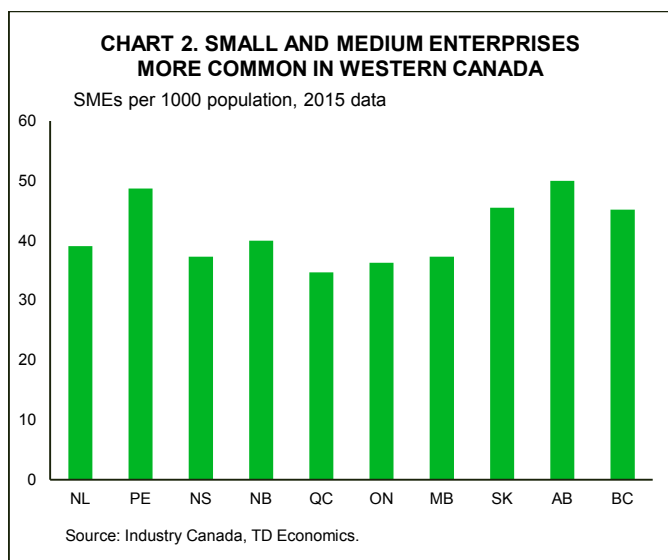
October is small business month, a perfect opportunity to examine the state of Canada's small and medium-sized enterprises (those with 499 or fewer employees). These firms remain a backbone of the Canadian economy, responsible for a significant majority of both Canada's businesses and employment. Confidence (as measured by the Canadian Federation of Independent Business) has been on a downtrend since early 2015 (Chart 1). This is largely a story of the natural resource sector, and recent months have seen a recovery in confidence both in natural resources and other industries. Rising confidence appears well-founded, as TD Economics' forecasts of a return to steady growth, led by the service-producing side of the economy bodes well for small and medium sized firms.

The importance of SMEs

Small and medium sized enterprises (SMEs) are an integral part of the Canadian economy. Accounting for 99.7% of Canadian businesses (97.9% if only small businesses – those with 99 or fewer employees – are included), slightly more than 9 of every 10 Canadians working in the private sector works for an SME. It is clearly difficult to understate the importance of SMEs in Canadians' daily lives.

Where are the SMEs located? While they exist in all provinces and territories, on a per-capita basis, Western Canada tends to have the highest concentration (Chart 2). At 50 SMEs per 1000 citizens, Alberta leads the way, with British Columbia and Saskatchewan close behind. Perhaps unsurprisingly, the provinces with the highest relative concentrations of SMEs also tend to have a higher concentration of small businesses, with P.E.I, Saskatchewan, and





Alberta containing the highest concentration of businesses with less than 100 employees.

By industry, SMEs tend to be best represented (on an employment basis) in the services side of the economy. In accommodation and food services, SMEs provide 98.0% of private sector employment – while for wholesale and retail trade, the figure is 97.1%. On the goods-producing side of the coin, SMEs are relatively less represented – although they are still responsible for more than 87% of private sector employment. Notably, nearly 99% of private agricultural employment is attributable to SMEs, and 96% of construction jobs.

The importance of SMEs for Canadian employment is not just one of size, but all of dynamics: since 2009, SMEs have been responsible for the vast majority of private job growth in every year, with the bulk of the impact generally coming from small businesses. SMEs also tend to be dynamic, with many new firms appearing each year while others discontinue operations. While the data is only available with a significant time lag, the most dynamic sectors for SMEs in terms of firm creation and destruction are construction and professional services – both of which tend to be contract driven.

Who runs SMEs? Statistics Canada provides some insight in their 2014 survey of SMEs. They found that SMEs tend to be male controlled (Chart 3). Roughly 1/5 of SMEs were found to have an equal ownership share by gender, while just under 16% were majority female controlled. Although the share of female-controlled SMEs remains low, it continues to rise, up nearly 20% since 2013.

Breaking ownership down by industry, the most male-

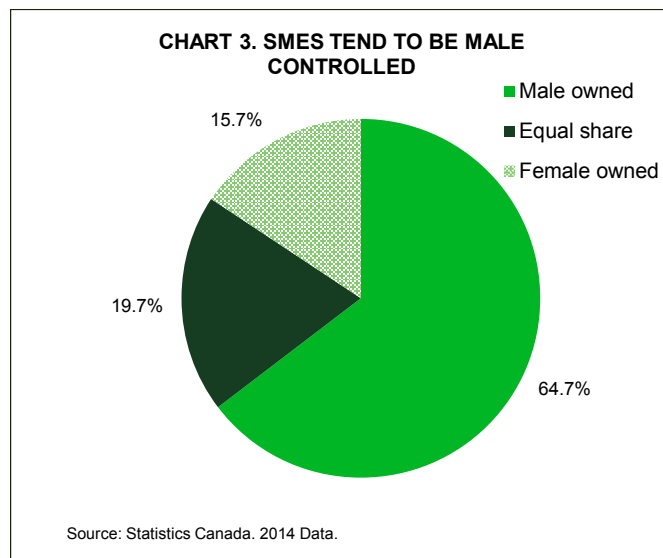
dominated was construction (78% male owned; 5.1% female owned), followed by wholesale trade (73.9% male owned; 8.8% female). While no major industry category saw a majority of SMEs run by women, information, waste management, healthcare and recreation had the highest concentration of female-controlled SMEs, at 24.1% of firms (with 59.1% of firms male-controlled). Relatively higher female ownership rates were also seen for other services (23%), retail trade (22.1%), and accommodation and food services (21.4%).

That women are underrepresented among SME owners may be discouraging, but it does match broader trends in employment by gender. Females tend to be over-represented within the public sector, and somewhat under-represented within overall private employment. So, although the male-female disparity in SME ownership is slightly larger than what overall labour market patterns would suggest, it is not out of line with these broader trends.

Economic activity and SMEs

SMEs may be responsible for the bulk of employment in Canada, but when it comes to economic output, the contribution is much more modest. The most recent estimates suggest that in 2014, Small businesses were responsible for about 30% of Canadian GDP – well below the level their employment and firm count shares would suggest. The largest contributions at the provincial level were again seen in the west, with SMEs in Quebec also performing well (the sheer size of Ontario means that it dominates at the national level).

One potential explanation for the relatively small share



of output may be the well-documented reluctance of SMEs to export their goods and services. The most recent data shows that only 11.5% of small businesses export, while 28% of medium sized firms do (Chart 4). Though not directly comparable, in both cases these proportions fall below the share of exports in the overall economy, although the share among medium sized firms is much closer to the economy-wide share of exports.

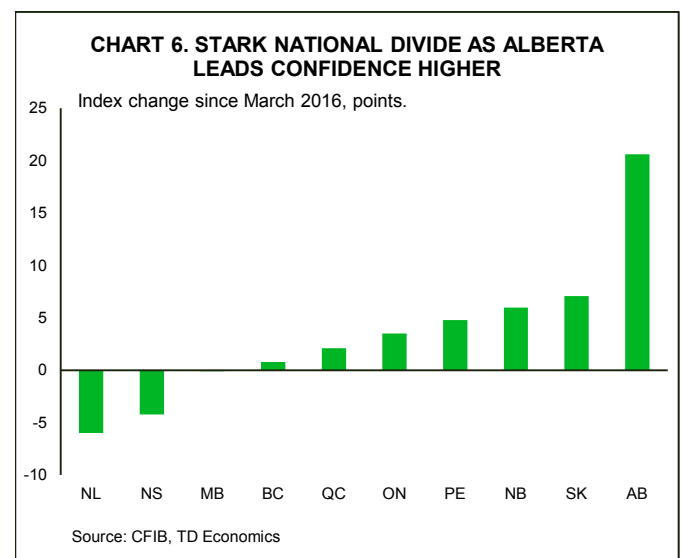
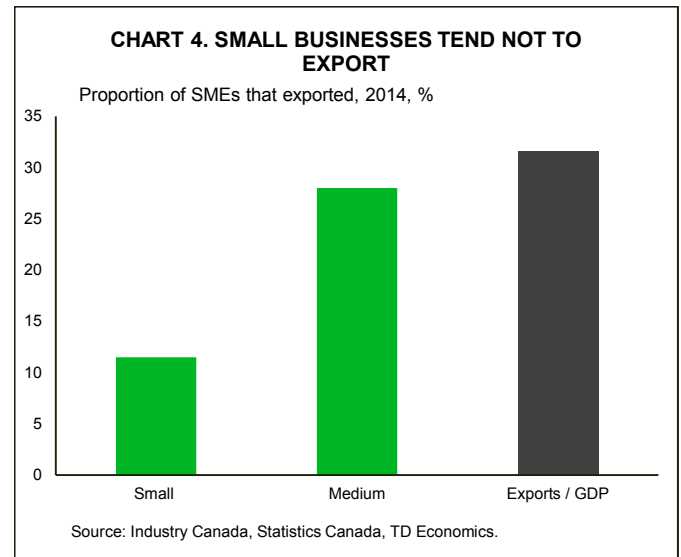
Among those that do export, it should come as no surprise that, in line with the broader economy, the majority of exports are bound for the United States. Roughly 89.2% of SMEs that export send their products to the United States. Europe was the second most common destination (31.3%), followed by Latin America (16.7%). Exports tend to be more geographically diverse among medium sized firms, relative to small ones, likely reflecting the overall scale of business.

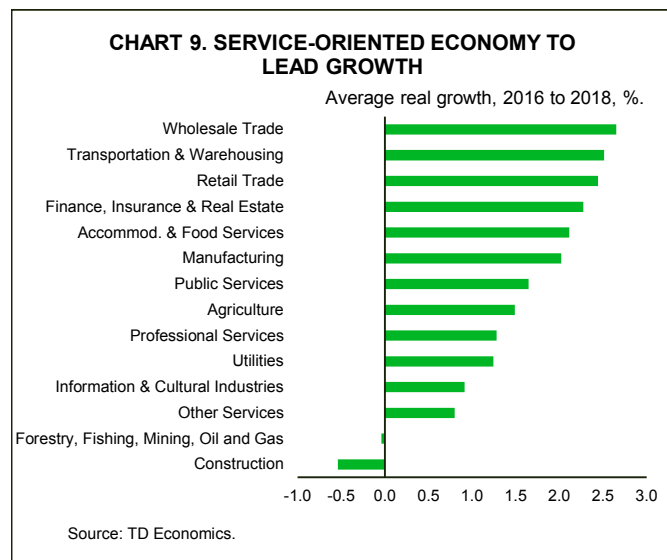
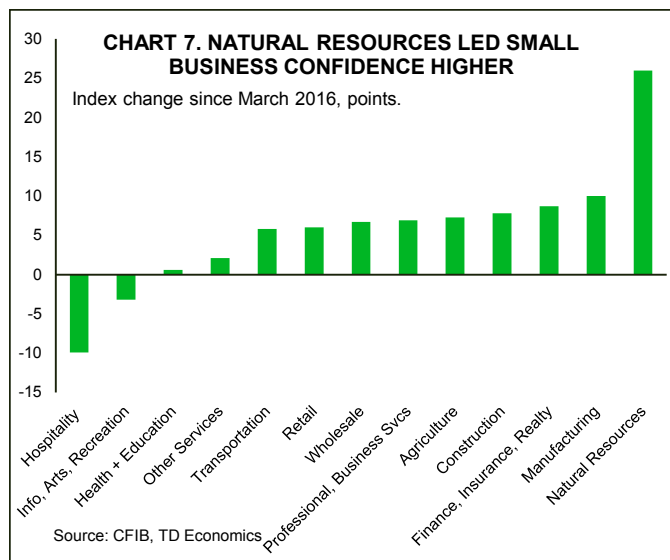
Canadian SMEs feeling increasingly confident

Given their importance to the economy, and particularly labour markets, just how are SMEs feeling about their prospects? Small and medium businesses have faced a number of challenges in recent years: the downturn in commodity prices, which slowed economic growth, as well as unfavourable tax changes in some provinces (notably Newfoundland and Labrador). This was reflected most clearly in the Canadian Federation of Independent Business (CFIB) Business Barometer (Chart 5). The sharp decline in commodity prices and resulting contraction in economic output in early 2015 appear to have been the trigger for weaker sentiment, with the CFIB survey of sentiment falling throughout 2015. Confidence finally hit a trough earlier this year, reaching a low of 52.6 in March, and has since recovered, although it remains below its historic average.

What has driven the recovery of confidence? Breaking the CFIB survey down further points the way. First, by province, Alberta has seen the largest bounce-back of sentiment since March, albeit from extremely low levels (Chart 6). Indeed, nearly all provinces saw business confidence recovery, with the exception of Nova Scotia and Newfoundland and Labrador. In the case of the latter, confidence has fallen to unprecedented lows, with insufficient domestic demand the predominant factor cited by respondents.

Slicing the confidence data by industry, the most sizeable gains were seen in natural resources, followed by construction and health and education (Chart 7). Thus, while the recovery in small business confidence has been fairly widespread, the recovery in commodity prices appears to be





the key driver, with small businesses regaining confidence in tandem. Although commodities appear to have driven recent improvements, the highest reported level of confidence in September was among manufacturers. Following close behind are those providing professional and business services, and the information, arts, and recreation industry.

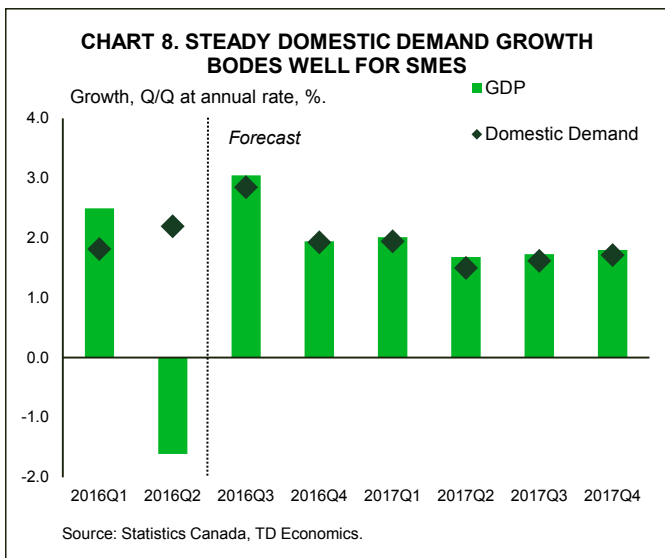
Looking ahead

The recovery of SME confidence likely reflects the stabilizing outlook for the Canadian economy. After a weak start to the year that was made worse by the Fort McMurray wildfires, economic growth is expected to rebound to around 3% before settling around 2%. Beneath the headline numbers lie a number of themes that bode well for Canadian small businesses. First, interest rates are expected to remain low and largely stable, helping to keep debt burdens manageable

and supporting investment. Secondly, growth is expected to be broad-based – although trade will lead the way in the near term, the bulk SMEs that don’t export directly may nevertheless benefit from supply chain effects. Moreover, Canadian domestic demand, which is made of all non-traded economic activity, is expected to remain healthy (Chart 8).

Finally, alongside steadier growth comes a re-convergence of provincial growth. As outlined in our recent Provincial Economic Forecast, the impacts of lower commodity prices on growth in Alberta and Saskatchewan have likely come to an end, and healthier growth is in the cards. SMEs, somewhat over-represented on a relative basis in these provinces, stand to gain from this recovery in growth.

Finally, the industrial composition of growth should also favour SMEs (Chart 9). The service side of the economy is forecast to lead growth, and SMEs are well represented in many of the leading industries, including wholesale trade, transportation & warehousing, and retail trade. If there is one cloud on the horizon, it is the construction sector, which is expected to contract modestly in the coming years. Two opposing factors are playing out: first, an expected adjustment in the real estate market that will lead to lower homebuilding activity. Offsetting this is an improved outlook for business sector construction (such as engineered structures) and government infrastructure spending. Unfortunately, the size of Canada’s residential housing market is such that slowing activity in that area will pull down overall construction activity in coming years.



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