

SPECIAL REPORT

TD Economics



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CANADA'S SMALL AND MEDIUM-SIZED BUSINESS OWNERS: DIVERSE SOCIETY IN A MICROCOSM

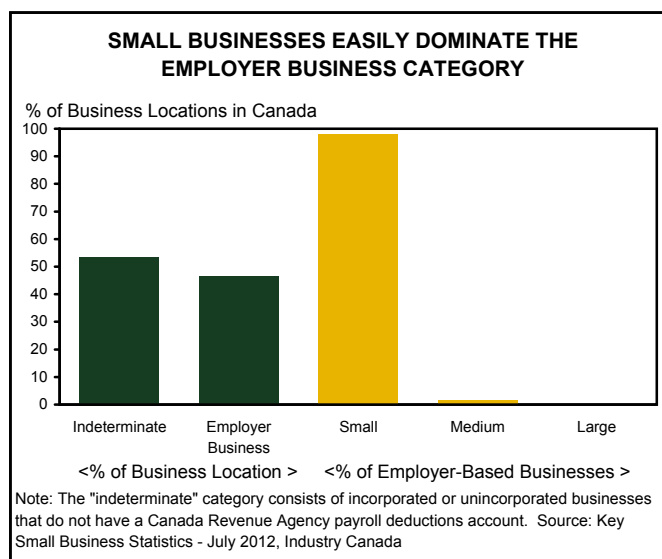
Highlights

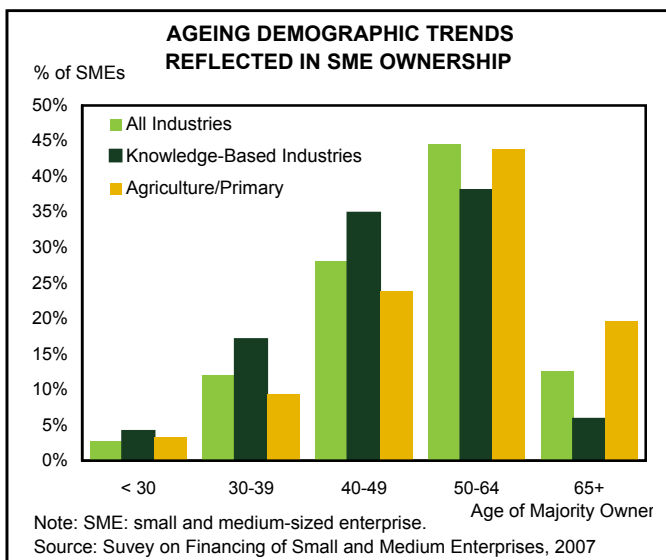
- In this annual publication, we use the opportunity to paint a picture of small and medium-sized enterprise owners (SMEs) to better understand who is driving the economic growth train.
- SME owners are a microcosm of Canada's diverse and multicultural society. In turn, they cannot be painted with a single brush. Their firms are situated in all industries, with a greater presence in some like agriculture. They are not immune from ageing population trends, as nearly 60% of owners are aged 50 and above. Women either partly- or wholly-own 47% of all SMEs, a touch smaller than their population share.
- Interesting facts surrounding SMEs go far beyond demographic characteristics. The vast majority of these firms do not invest in research and development and only 53% of firms survive for more than five years. Export concentration also differs across the country, with greater representation of exporting SMEs in central and eastern Canada.
- The diverse nature of small business owners and their firms translate into a heterogeneous mix of challenges. These obstacles are dependent on the nature of the business, but also where the company is situated along its maturation cycle. For instance, one of the biggest challenges for a start-up venture is access to capital. By contrast, for a company that is 3-5 years old, owners cite that their biggest difficulty is attracting and retaining staff.

In this version of our annual small business publication, we use the opportunity to paint a picture of small and medium-sized enterprise owners (SMEs) to better understand who is driving the economic growth train. In doing so, we see that they are a microcosm of Canada's diverse society. In light of this assortment, SMEs cannot be painted with a single brush. Instead, each enterprise is unique in its own right. Barriers to success for these firms also vary. High regulatory burden and difficulty attracting high-skilled labour are some of the more common obstacles cited. We also see that the challenges faced by SMEs depend on where the firm is situated along its maturation cycle. The cycle includes the following five stages: striving for existence, surviving comfortably, achieving success, taking-off, and resource maturity.

SMEs are a diverse group

Enterprises are typically categorized and identified by size. In the U.S. for instance, a business is put into small, medium and large buckets depending upon its annual, before-tax revenues. Industry Canada takes a different approach, as the income information by firm size is not publicly and regularly available on this side of the





border. The Canadian government agency uses the number of employees to segment enterprise size, a practice which we adopt throughout this report. A business is ‘small’ if it has 99 employees or less. A firm is labelled ‘medium’ if it has between 100-499 employees and ‘large’ if it has 500 or more staff.

These categorizations help us to identify trends for small and medium-sized businesses, while comparing and contrasting them to trends of large businesses. At the same time, there is a tendency to think that all enterprises within each bucket are roughly the same. This could not be further from the truth. Small and medium-sized businesses come in a variety of forms. Their owners also represent a diverse population. Industry Canada only infrequently collects data on SME owner demographics: the last detailed analysis was done in 2007. The 2011 Census also does not shed much light on the characteristics of the average business owner, or at least it has not thus far. Data limitations noted, we have compiled statistics from a variety of sources which allow us to describe the average business owner.

SME owners are greying

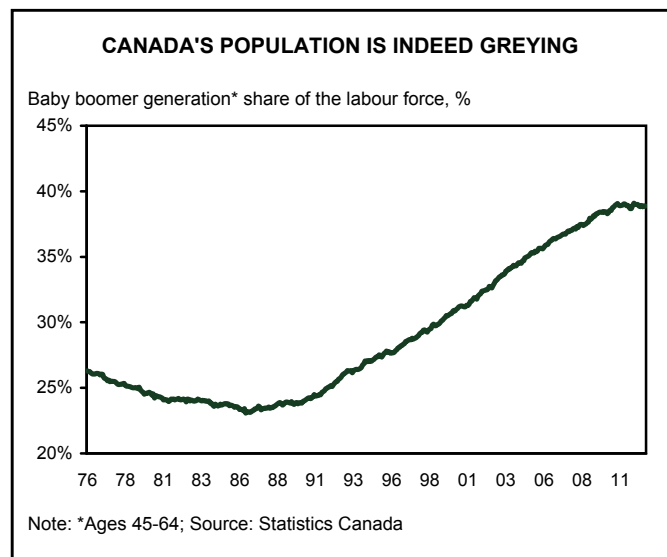
SME owners are experiencing the same greying phenomenon as much of the advanced world. The latest data we have on ownership age are based on 2007 survey results. At the time, 45% of SME majority owners were between the ages of 50-64. An additional 13% of majority owners were 65 of older. They also have experience owning and managing a business, with 75% of owners have at least ten or more years at the helm of their company.

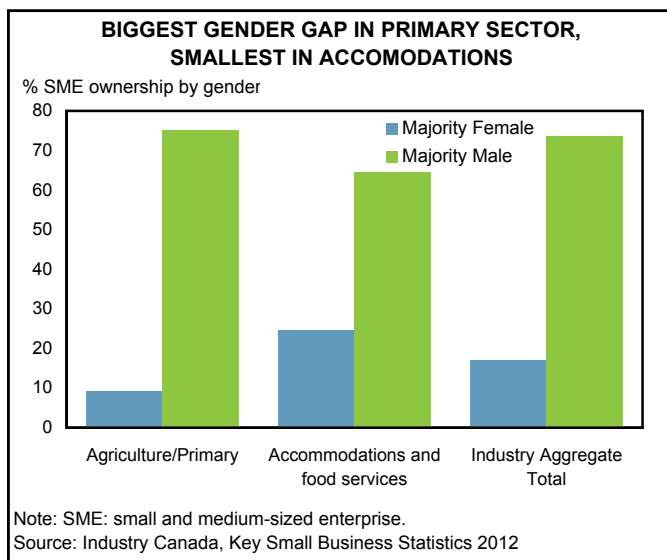
From 2007-2012 and given recent population trends, one would expect that a higher share of SME owners would

fall into the 50-plus age category. One projection estimates that 29% of entrepreneurs will retire by 2020.¹ Such a high share begs the need for succession planning to ensure there is no impact on business performance when the business leadership change does occur.

A TD Canada Trust survey released earlier this week signals that another trend may also be contributing to an older SME demographic. The results indicate that more than half of baby boomers have started (15%) or are considering starting (39%) a small business prior to retirement. The ventures under deliberation include freelance consulting, opening a franchise, or starting a speciality business. Survey respondents indicated that they were attracted to entrepreneurship due to the prospect of being their own boss, the opportunity to make more money, and for personal achievement reasons. The relative affordability of technology such as internet and cell phones also permits seniors to work as entrepreneurs from their homes. Given their age and work experience, they can also tap into their business networks and Rolodexes to help the business get off the ground.

It is interesting to note that not all sectors have the same age breakdown and structure. For instance, owners in the knowledge-based sector (research, innovation, communications and technology) are younger than the all-industry average. The age structure difference might be because younger individuals are, on average, more technologically savvy than their older counterparts. In turn, they explore opportunities to service clients that perhaps older individuals are not aware of or simply do not see. Approximately 44% of SME owners tied to the knowledge sector are 50 or older. By contrast, the age structure in the SMEs linked to agricultural and primary industries like farming, forestry





and fishing tend to be older. Roughly 70% of all SMEs in this sector had an owner who was 50 or older.

Other demographic trends in entrepreneurship

Much like the Canadian populace, the demographic mix of entrepreneurs has diversified over the past two decades. Women, young entrepreneurs, visible minorities, recent immigrants, and Aboriginals are just some of the different groups who are increasingly being represented in the SME community. The recent trends among each of these demographic groups are explored next.

Women entrepreneurs:

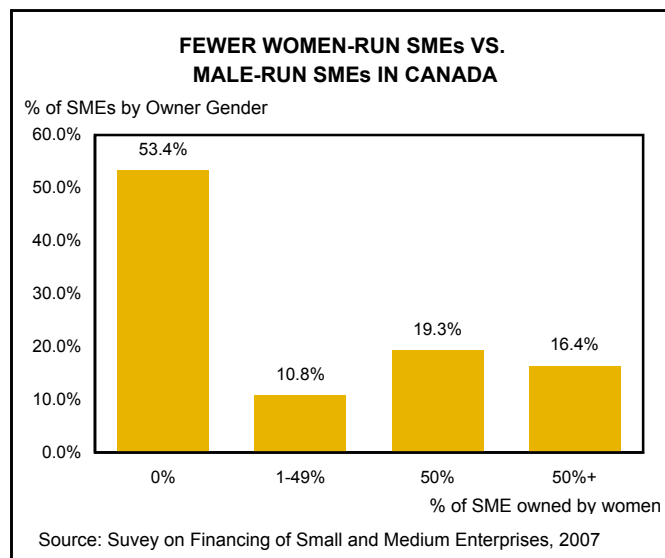
Approximately 47% of SMEs were entirely- or partly-owned by women, a touch lower than their population share.² If we look at just wholly-owned, the share drops to 16%. These numbers and proportions have increased over the past few decades as women have increasingly made their mark on the business world. This is because women have been growing their labour force participation rate since the 1970s, which is reflected in rising paid and self-employment numbers. In a discussion of demographics among SMEs, we compare women-owned businesses with their male counterparts, and comment on any noteworthy trends³:

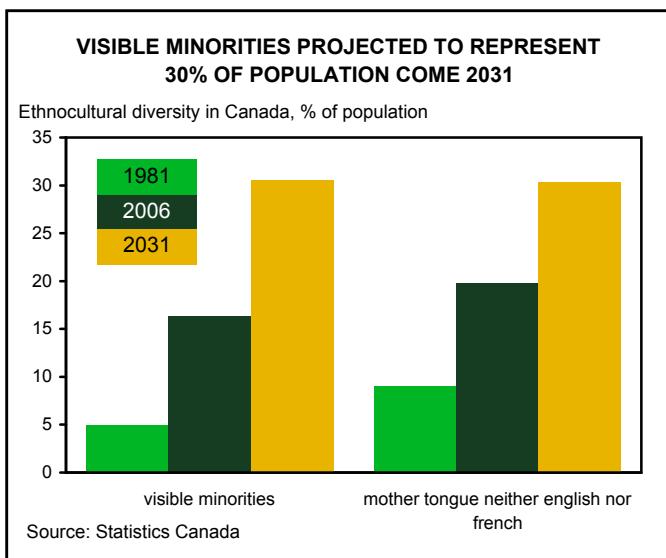
- Majority women-owned SMEs are smaller (with more than 99% having fewer than 20 employees) than male-owned firms. The differences in size may reflect industry choice, but also could signal varied tolerance levels for risk across genders. However, when a woman does decide to start a business, she tends to stay in business longer. In other words, their survival rates are higher.

- Women owners have, on average, less years of work experience under their belt: 50% have less than 10 years of experience. This may reflect a looser labour force and/or business attachment for women in their child rearing years. They also seek out business-related financing to a lesser extent: approximately 18% of these firms request financing. When the financing is approved, women owners tend to receive a lesser dollar amount. Differing degrees of risk aversion towards debt may also help explain why fewer women entrepreneurs request financing.
- A greater concentration of women-run SMEs is present in certain sectors such as professional services and accommodation and food services. Keeping with this theme, male-owned businesses have a greater tendency to export their goods and services, even after controlling for traits such as sector, firm and owner traits. The export focus often serves to enhance the firm's revenue growth potential.⁴ Yet, the proportion of women-owned businesses that plan to expand their business is generally higher than men.

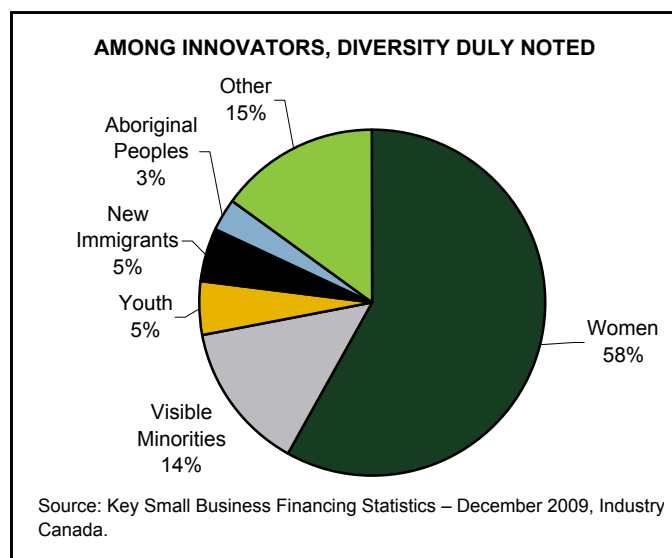
Young entrepreneurs (those younger than thirty):

With the greying trends seen among SME owners, who might be present to spur small business growth in the future? The SMEs may be given to family members once the owner decides to retire, a likely possibility given that family-owned SMEs represent the dominate business ownership structure.² Alternatively, it may be up to the next generation to start their own firms. The next few observations relate to today's young entrepreneurs, or those individuals younger than thirty.





- Given the age of the owner, young entrepreneurs tend to have newer and smaller firms. They also might be perceived to be slightly riskier given the owner’s short (or lack of) credit history. Risk, on average, tends to accompany reward and this holds true here. Firms led by young entrepreneurs typically record higher growth rates versus all SMEs. This is the case even though the owners have fewer years of work experience (91% of owners have less than ten years of work experience).
- The firms themselves tend to be more concentrated in certain sectors such as knowledge-based industries. Earlier in this report, we speculated that this may be because today’s youth are more comfortable with technological advancements. They also may have better insight as to how to exploit technology in a business setting.

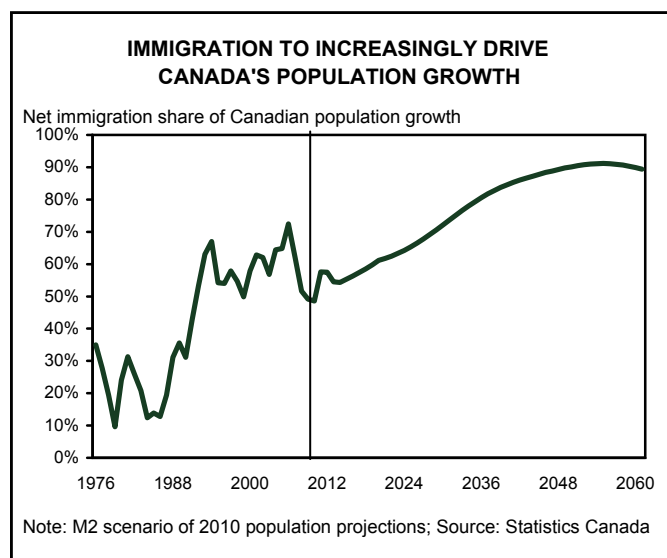


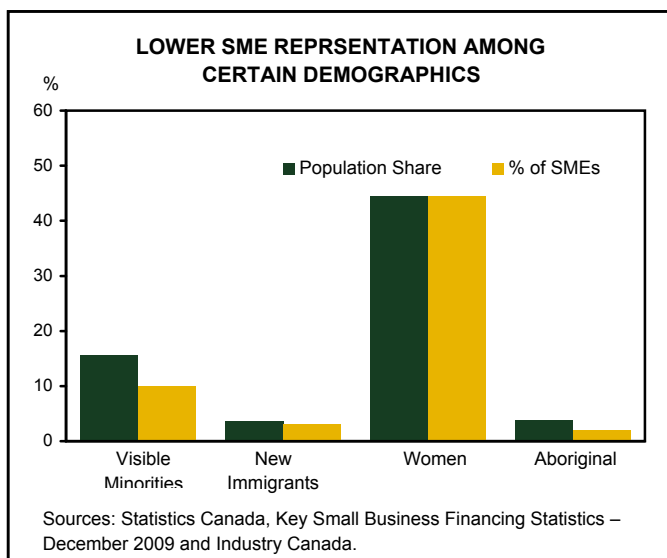
- The Financing Statistics database compiled by Industry Canada reveals that firms led by young entrepreneurs have lower net values on average. However, this may simply be a signal that these firms are simply less mature and in their infancy on the business growth cycle. It may also reflect the fact that youth-owned SMEs have difficulty getting capital. In turn, owners tend to use informal financing methods such as personal savings and loans from friends and family.²

Visible minority entrepreneurs:

The Canadian population is diverse in ethnicities and languages as a result of a steady flow of immigrants – this multicultural society is an important component of Canada’s unique identity. Visible minorities who have a majority stake in SMEs represent about 10% of all such firms in Canada – a much smaller proportion relative to the share of visible minorities in the overall population. This share is expected to increase as ageing demographic trends kick in and more of Canada’s population growth stems from multi-national immigration.

- Visible minority SMEs are concentrated to certain sectors such as accommodation and food services (11%) and knowledge-based industries (10%). In comparison, there is less representation in certain sectors like agriculture and the primary sector (3%) or in rural areas (2%).³ New immigrants tend to settle in urban areas, where these latter sectors are less dominant. Second, the training that the minorities receive in their country of origin may translate better to certain sectors versus others.
- Firms owned by visible minority businesses are typically





smaller than the all-industry average: only 0.2% have more than 100 employees. In spite of their size, these firms may have greater export appetite if the owners still have ties and/or business connections with their country of origin. This is likely as more than two-thirds of immigrants arrive in Canada as adults.

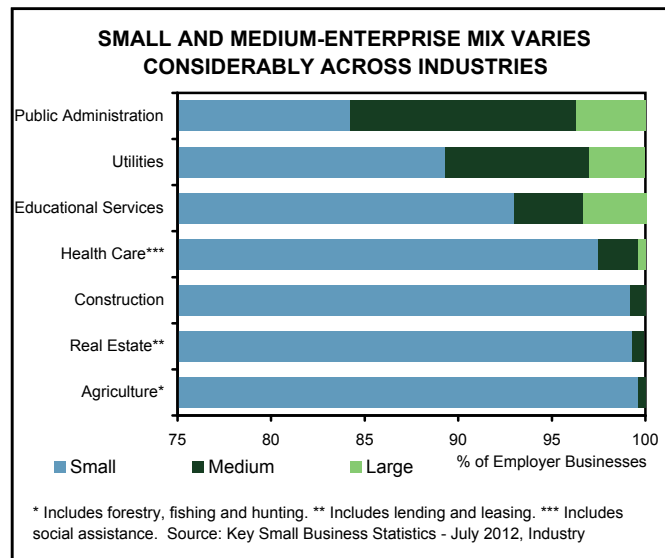
- The visible minority owners themselves also tend to be younger than the average business owner. Industry Canada estimates that 15% of visible minority business owners are under the age of thirty.

New immigrant entrepreneurs (those entrepreneurs residing in Canada for less than five years):

These entrepreneurs share many similarities with visible minority owners, except that new immigrant entrepreneurs have been in Canada for a shorter period of time. SME firms owned by new immigrants represent approximately 3% of the national total. They tend to have a similar preference towards the knowledge-based sectors and are younger than the national average. There is a greater regional presence in Ontario and British Columbia, which is no surprise given that these two provinces attract the majority of all new immigrants to Canada every year. The data on research and development expenditures by SME owners reveals an interesting conclusion for new immigrant entrepreneurs: their firms comprise 5% of innovative businesses (those firms that spend more than 20% on research and development each year), even though they only represent 3% of all SMEs.

Aboriginal entrepreneurs:

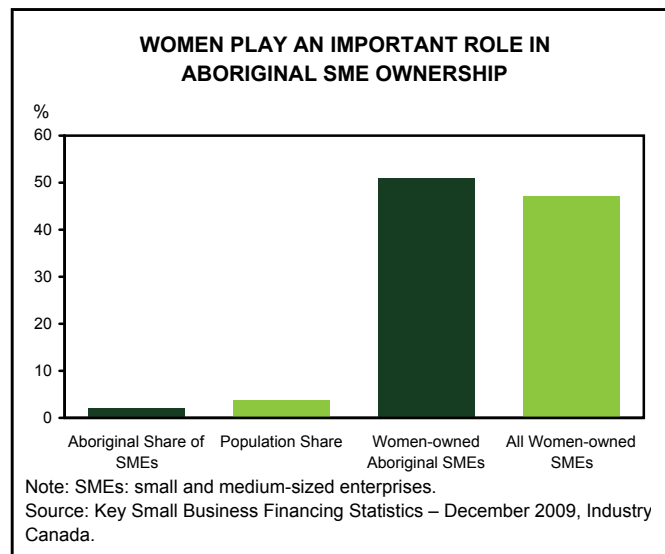
In previous reports, we have analyzed the trends noted

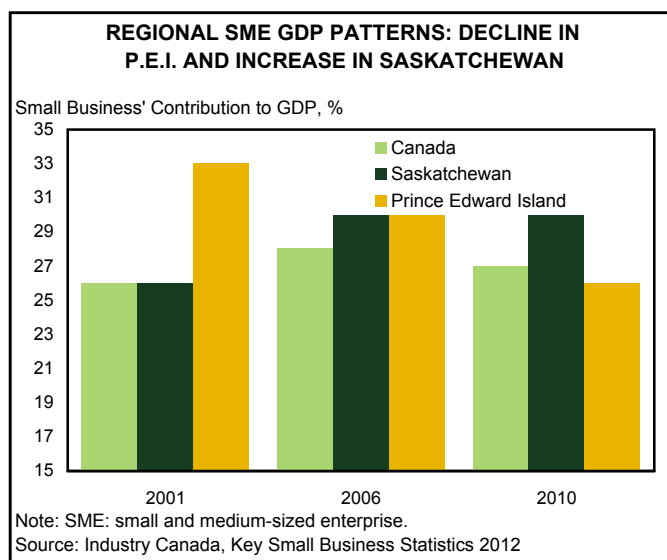
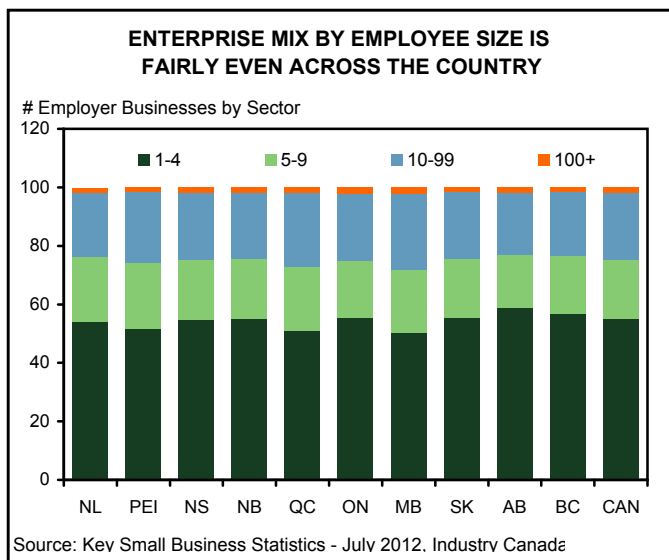


over the past few decades in the Aboriginal business community.^{5,6} At last count, Aboriginal-owned small and medium-sized businesses represented just 2% of all such firms, or about half of their population share. The firms have greater ties to the agriculture and resource sector, which helps explain why Aboriginal-owned SMEs are often located in rural areas. Women play an important role in the businesses. Approximately 51% of Aboriginal-owned SMEs belong partly or wholly to women, well ahead of the Canadian average of 47%. While SME women owners tend to gravitate towards professional services, Aboriginal women business owners buck the trend with greater representation in the goods-producing sectors.

SMEs represented in every region and sector

Approximately 58% of all business locations are present



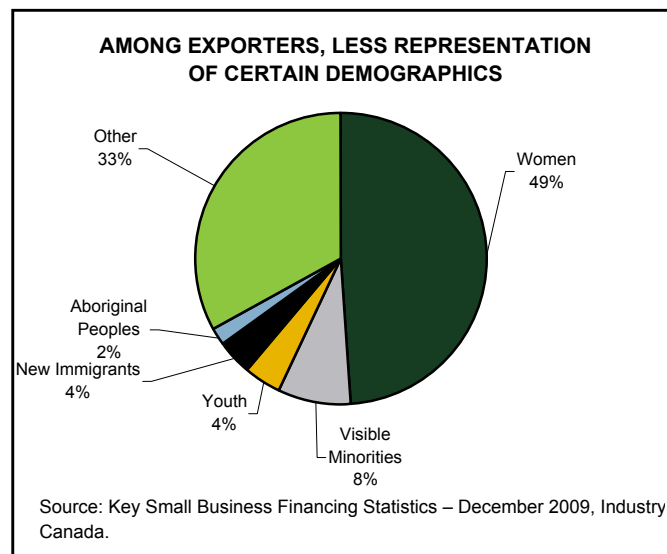


in Ontario and Québec. The rest are scattered across the country: the western provinces house 37% of all SMEs and the Atlantic Provinces carry 5%. These distributions are closely linked to overall population density and concentration. That being said, there is some interesting variation at the provincial level worth noting:^{2,4}

- British Columbia is home to the greatest start-up activity in Canada. Alberta comes in a close second. The businesses often start due to spinoffs from the energy and natural resource sectors. When these firms do get off the ground, they tend to stay small for some time: Alberta and British Columbia have the greatest percentage of micro-enterprises (fewer than five employees).
- Alberta's natural-resource economy enables it to have a high GDP per business location and a high number of locations per capita. Typically, there is a negative relationship between the number of businesses present and the income for each. This is because many locations can result in the cannibalization of each location's revenues.
- Contribution to GDP among SMEs has held relatively steady for most provinces. Saskatchewan is a noticeable exception. The strong economic performance displayed by the province over the past decade has meant that SMEs now contribute 30% of GDP, up from 26% seen in 2001. Prince Edward Island has undergone the opposite trend: its SMEs now contribute only 26% towards provincial GDP, down from the 33% seen in 2001.
- Ontario and Québec were hard hit by the recession due to their export-based economies and their out-sized trade

linkages with the U.S. With the economic recovery south of the border still fragile, both provinces should experience only modest economic growth over the near-term. On the plus, small businesses are less trade-oriented than larger firms. However, SMEs tend to get hit harder during recessions and in some cases, recover more slowly.

- Exporters, on average, are more innovative, spending more of their annual budgets on research and development. This effort enables them to be more competitive in the global business arena. They also tend to be more mature (75% of SME exporters have been in business for more than six years) and hold greater growth and expansion intentions.
- Majority ownership of SME firms is typically held among family members. Roughly three-quarters of SMEs in



the Prairie Provinces have this organizational structure, perhaps related to more agricultural-based businesses in the region. Ontario and Québec have the lowest percentage in this country on this metric.

- Size of the SME is also tied to the sector in which the firm operates. Those SMEs tied to agriculture/primary and professional services sectors are typically smaller in nature. This latter category often includes doctors, lawyers and realtors. By contrast, firms in manufacturing, wholesale and retail, and accommodation and food services tend to be larger in scale.

Challenges and barriers to success

Given where Canada is in the economic cycle, it is not surprising that many SMEs are confronted with challenges and barriers to success. The Canadian Federation of Independent Business' (CFIB) small business barometer survey⁷ gives us some clues as to what keeps owners up at night.

There is some concern among the SME community about consumer demand and where it might be headed. It has been difficult to predict the behaviour of Canadian consumers given the uncertain environment we find ourselves in. It is this insecurity that has contributed to a string of months of below-average confidence levels among small and medium-sized enterprises.

The CFIB survey also showed that hiring intentions over the next three to four months are up. Yet, 37% of owners state that a shortage of skilled labour is a business constraint. Demographic trends are set to compound this problem, as the first of the baby boomers retired last year. With more people retiring, businesses will need to boost their efforts

on retaining institutional knowledge among their workforce.

Cash flow management did not make it to CFIB's short list in the October iteration of the survey, but these challenges have been frequently cited as a barrier to success. Statistics Canada reports that many firms fail because they do not have the basic cash management skills and characteristics necessary for success.⁸

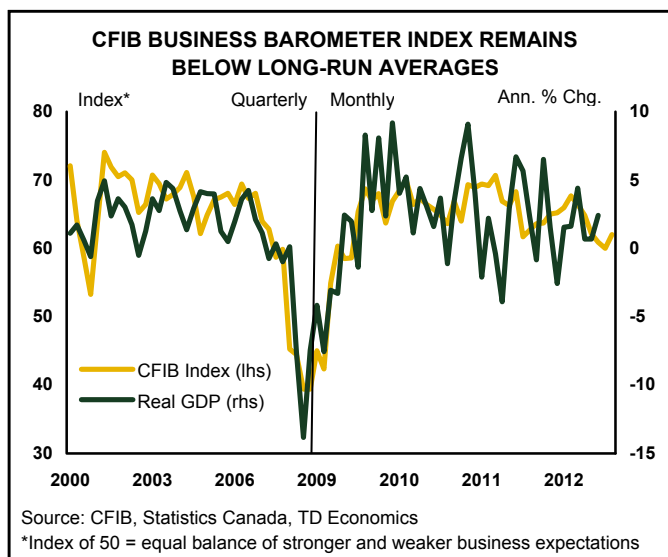
Government bureaucracy and a significant amount of 'red tape' are also commonly cited as challenges for SMEs. This barrier may move down the list in the years to come as the federal government has announced a hundred recommendations to reduce the compliance and regulatory burden.⁹ Many of these policy changes came out of the 2011 Red Tape Reduction Action Plan which was led by Treasury Board President Tony Clement. In an effort to streamline the rules, the federal government has said that it plans to force regulators to eliminate one regulation for every new one added.⁹ At the same time, SMEs encounter red tape from provincial and local governments which the Action Plan did not address.

Diversity trickles down to challenges as well

Throughout this report, we have stated that small- and medium-sized enterprises represent a diverse set of owners, both in terms of their age and ethnicities. The firms themselves are also linked to various industries, each governed by different sets of regulation. SMEs also have another element of distinction: where they are along their maturation cycle. The business' position along this continuous spectrum results in a unique set of challenges. This means that once again, the challenges presented in the previous section, do not apply to everybody under the SME categorization.

To understand where the source of these differences, we refer to a *Harvard Business Review* article that argues that there are five stages of small business growth.¹⁰ As the firm progresses along the growth curve, unique and varied challenges are encountered. Let us first start with summarizing the stages of growth for a small (and later a medium-sized) business:

- **Stage I – Existence:** describes a situation where the business is obtaining customers and delivering product and/or services. The firm has a lean organizational structure with the owner doing much of the day-to-day work. The firm's primary goal is to stay alive.
- **Stage II – Survival:** the business has shown itself to be a workable entity and the main business problem shifts



from existence to managing revenues and expenditures. The organizational structure remains lean, but the firm usually has a few employees in addition to the manager. Quite a lot of firms stay in the survival phase for some time. However, if they can grow in size and/or profitability, the business can graduate to the next level.

- **Stage III – Success:** the company has achieved sufficient size and market share to generate above average profits. The firm can stay indefinitely in this stage if the firm is managed well and there are no external environmental changes (e.g., technological revolution). Cash is typically plentiful, but the owner must be able to successfully manage in up and down times.
- **Stage IV – Take-Off:** the main business problem becomes how to grow rapidly and finance the expansion. The business at this stage is on the cusp of becoming a medium or large enterprise. Alternatively, it can also be sold at a profit if the owner does not want to go down this route. Key challenges include effective delegation and having enough cash on hand to fund the expansion.
- **Stage V – Resource Maturity:** concerns rest in consolidating and managing financial gains due to rapid growth. Also, the firm works to retain the advantage of being small including flexibility of response and nimbleness during tough economic times. It may also suffer from ossification or complacency which is characterized as a lack of decision-making ability or the avoidance of risks.

Along the spectrum of growth, the challenges for the business owner considerably vary. For example, in the early stages, the business owner must be able to prove economic value in the good, service, or the invention they have come up with. The business will not get off the ground without these basics. However, as the business matures, the task for the owner is to delegate financial and management authority to employees. If this does not occur, the owner may become a bottleneck to his/her firm's success.

While effective cash management is necessary throughout the life of a small business, the need for free cash changes as the business grows. A start-up business will need cash as upfront capital even before the good or service is proven viable. However, during the success stage, the business should have enough cash inflow to keep the business afloat.

It should also be nimble enough to survive in the event of a loss of a major customer or supplier. As the business matures and expands in size, cash once again becomes a concern and represents a limiting factor to the pace of growth expansion.

Having good-quality and highly-skilled employees also become increasingly important as the business grows in size and matures. The owner cannot simply do everything and delegation becomes more important. In addition, these staff resources need to put in place ahead of the growth stage to ensure the business functions well.

Last, a recent Deloitte report concludes that many Canadian firms are able to achieve high rates of growth in their first five years of business.¹¹ In fact, Canada has one of the highest rates of new firm entry in the services sector, according to the OECD. However, small businesses have difficulty sustaining that advantage over the longer-term. The research argues that Canadian business leaders are more risk averse than U.S. leaders and more reliant on government assistance to begin new projects.¹¹ These findings suggest that many SMEs get stuck in Stage III of the growth ladder.

Putting everything together

Small business owners represent a diverse set of owners. Different trends have been noted across SME owner age cohorts, gender, among Aboriginals, among visible minorities and recent immigrants. These are just some of the variations reviewed in detail in this report. The SMEs started by each of these groups are also slightly different. The owners are attracted to different types of firms, with some staying in business longer than others. Recognizing the assortment present, we conclude that these small and medium-sized business owners mirror Canada's diverse society in microcosm. The challenges faced by these firms are also quite varied. We reviewed some of the common barriers to success like effective cash management, government bureaucracy, labour scarcity, and worries about consumer demand. However and in line with the diversity theme, we also noted that there are five stages to small business growth. Along this continuous spectrum, the business and the owner encounter different challenges along the way. In light of past performances and their economic clout, SME owners remain well-equipped to meet the obstacles that come in their way.

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