TD Bank Financial Group

TD Economics

Special Report

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SMALL BUSINESSES TO BENEFIT FROM SOLID DOMESTIC DEMAND, BUT CHALLENGES CALL FOR INNOVATIVE THINKING

October 14 to 20 is small business week, so it is timely to inquire about what might be in store for Canadian small- and medium-sized enterprises (SMEs) in the year ahead. We'll focus on five key external factors that tend to impact the fortunes of small-scale businesses: the prospects for sales, competition, labour markets, non-labour costs and the climate for investment.

The overall assessment is that 2008 should be a decent year for small business. Specifically, 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. In contrast, 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.

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. Competition in local and foreign markets will remain fierce. Labour markets will remain extremely tight and wage pressures will moderate only slightly. Energy and other input costs will also remain elevated.

Given this backdrop, businesses will need to be nimble, changing with the times and constantly striving to improve efficiency and profitability. This calls for innovative strategies to attract and retain high skilled workers and to reduce costs wherever possible. Adopting new processes and investment in labour-saving and productivity-enhancing machinery and equipment could also enhance profitability.

HIGHLIGHTS

- **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 U.S. or businesses that are adversely affected by a strong currency will experience a tough sales environment.**
- **Firms will face a number of key challenges:**
  - **Fierce competition in both local and foreign markets**
  - **Tight labour markets across the country**
  - **Elevated energy and non-labour costs**
- **Small businesses cannot be complacent and must be innovative in developing strategies to address the challenges.**

Sales to be supported by strong domestic demand

Let's start with the good news. 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. In this regard, SMEs are less vulnerable to the appreciation in the Canadian dollar and the U.S. economic slowdown, the latter of which is likely to continue over the course of 2008.

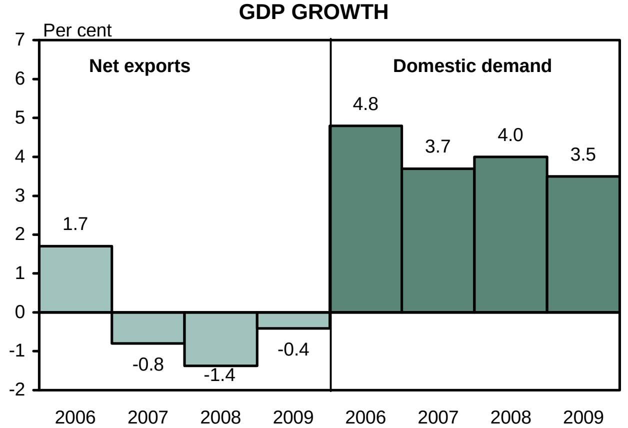
In contrast to the weakness south of the border, Canadian consumers will keep their wallets open in 2008, supported by continued low unemployment, rising personal income, healthy real estate markets, and moderate interest rates. That said, the volume of personal expenditure growth (i.e. purchases after removing the impact of inflation) is likely to moderate from an unsustainably rapid 4% pace in 2007 to a still robust 3.1% in 2008. This will partly reflect a cooling in residential real estate markets, with the pace of construction and home sales moderating across the country – but particularly in the west. This will dampen spending on furniture, appliances, and other housing-related items. It will also impact small businesses that are tied to the construction industry. However, one must stress that the level of housing activity will remain strong. Overall, this backdrop suggests that the dollar value of small business sales to households should rise at around 5% next year.

Purchases by corporations and governments should prove similarly robust. After adjusting for inflation, total government expenditure is expected to rise 3.6% next year, reflecting healthy fiscal balances at both the provincial and federal levels. Business capital outlays are projected to increase by a strong 6.2%, but the strength may come in the second half of next year as firms take advantage of a federal budget measure that allows for increased depreciation allowances for machinery and equipment bought by manufacturers before the end of 2008. Again, this is good news for domestic-focused SMEs.

High-flying loonie and weakness in U.S. will be a hurdle for some

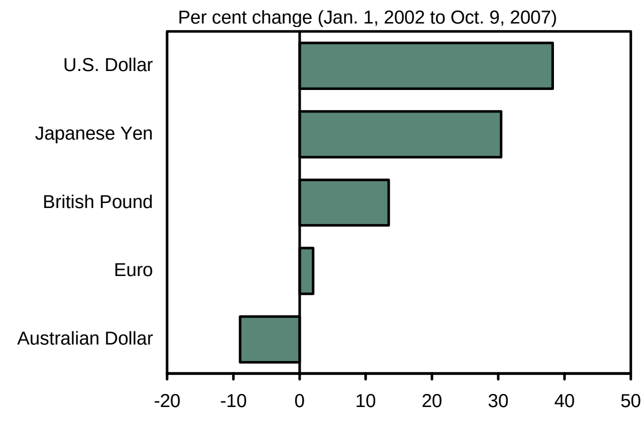
The weak spot in the sales outlook is on the export front. The U.S. housing-led economic slump will persist throughout next year. A recession is expected to be avoided, but U.S.-export oriented small businesses will struggle with weak U.S. demand until well into 2009. Similarly, small businesses that are plugged into the production chain of large Canadian firms that export Stateside will be adversely affected.

PER CENT CONTRIBUTION TO CANADIAN REAL GDP GROWTH



Source: Statistics Canada/Haver Analytics; Forecast by TD Economics as at September 2007

CANADIAN DOLLAR PERFORMACE AGAINST MAJOR CURRENCIES



Source: Bloomberg

Strength in the Canadian dollar will also be a hurdle for many exporters, and it will prove a challenge for a number of other areas, like tourism and hospitality businesses that are affected by foreign visitors. The average value of the Canadian dollar is expected to remain at close to, or modestly above, parity in the first half of 2008, and then dip towards 95 U.S. cents in the final six months of the year. In other words, the strong Canadian dollar is here to stay.

It should be noted that small businesses that export overseas will face a somewhat better environment. Although the Canadian dollar has risen against most major currencies, the extent of the gain has been more moderate. Whereas the loonie in early October 2007 had strengthened by 38% relative to the greenback since the end of 2001, it appreciated by 30% relative to the Japanese yen, 13% to the U.K. pound and only 2% compared to the euro. Moreover, demand for Canadian exports in Asia, and to a much lesser extent Europe, is also expected to remain strong. So, prospects depend on where companies are exporting and the movements in the relative exchange rates.

Competitive pressures will not abate

However, the sales perspective only tells half of the story for profitability; the other half relates to pricing and costs. On these fronts, businesses should be prepared to face a number of challenges.

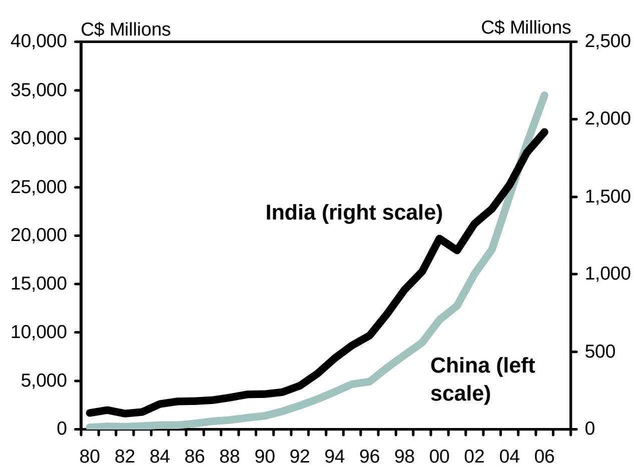
Competitive pressures will remain fierce in both domestic and foreign markets. Businesses are likely to find it difficult to pass along rising costs to consumers, particularly at a time when domestic and foreign demand growth is moderating. Canadians are also likely to put greater pressure on firms to pass along savings from the appreciation in the Canadian dollar, as media attention on this issue has increased significantly in recent months. The strength in the Canadian dollar will also make imports more competitive in domestic markets. Moreover, import competition from low-cost labour centres, like China and India, will continue to increase. Products from China climbed from 2.7% of Canadian imports in 1999 to 8.5% in 2006, while products from India have gone from 4.1% to 5.9%. There is no evidence that this trend will abate in the years ahead. Indeed, globalization is creating competitive pressures in areas that had previously been insulated, like many service industries. Finally, firms will continue to vie for market share and price competition from big box stores will remain a challenge for some small scale retailers.

The implication is that firms cannot be complacent. Those that are struggling with the strong dollar and weak U.S. demand have no choice but to adapt. However, those that are domestically-oriented must also strive to move up the value added chain, producing more sophisticated goods and services. Product differentiation and the client experience are becoming ever more important. Identifying niche markets or under-serviced areas can also provide good opportunities, and branding has grown to be critical in attracting business.

Tight labour markets to persist

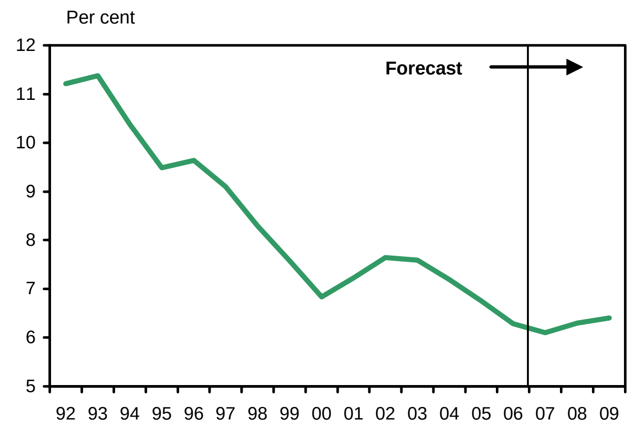
Another serious challenge is the tight labour markets in

CANADIAN IMPORTS BY COUNTRY OF ORIGIN



Source: Statistics Canada, Haver Analytics

CANADIAN UNEMPLOYMENT RATE



Forecast by TD Economics as at September 2007; Source: Haver Analytics, Statistics Canada

Canada. Small businesses regularly respond to surveys that they are having difficulty hiring and retaining high skilled workers. They are also often concerned about rising wage bills, which is natural since labour outlays are usually the single biggest cost for firms.

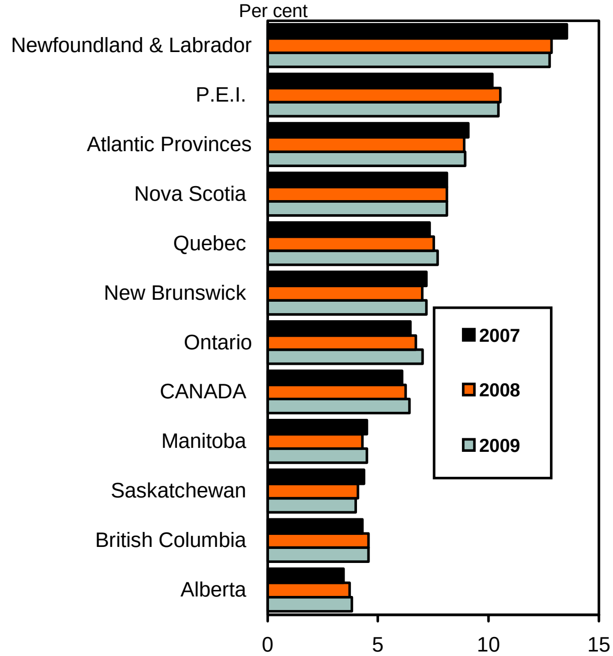
The recent labour concerns by entrepreneurs should not be surprising, given that the national unemployment rate is at a 33-year low. This tightness has created increased competition for workers and has translated to upward pressure on wages and salaries. And, this is not just a story in the west. While labour shortages are most acute in Western Canada, the strength of the labour market is evident across the country. Even in provinces that are not blessed by commodities with high-flying prices, unemployment rates are still quite low. This is readily apparent from the many help wanted signs that can be found in most cities from coast to coast.

Looking forward, the pace of employment growth is expected to slow. In the first nine months of 2007, the economy generated 282,000 net new jobs, which pushed the unemployment rate down to 5.9%. This rate of hiring is not sustainable and it is inconsistent with an economy that is expected to growth at a pace of close to 2.3%. In late 2007 and over 2008, the average monthly gain in employment is forecast to slip from the recent 31,000 to between 13,000 and15,000. This will not absorb all of the available workers, leading the unemployment rate to gradually edge up to 6.3%.

However, even with this moderation, businesses will still find staffing problematic and wage pressures will remain present. Wages, salaries and supplementary income is expected to rise at a 4.7% pace in 2008, which is roughly 2.5 percentage points faster than the rate of inflation and approximately in line with business revenue growth. In addition to market wage pressures, minimum wages rates are slated to rise in several jurisdictions.

Many business owners will lament the continuing labour market challenges, but one should recognize that it is the strength in personal income and the availability of jobs that is supporting consumer spending, which represents almost two-thirds of the Canadian economy. It is desirable to have robust labour markets, the problem is that in some regions the pendulum has swung too far and scarcity of workers has become a significant problem. This is particularly evident in Western Canada, where the unemployment rate is well below 4% in Alberta and below 5% in Manitoba, Saskatchewan and British Columbia.

The issue is that firms cannot simply wait for labour markets to loosen. Businesses must develop strategies to attract and retrain high skilled employees. While offering competitive compensation is necessary, the matter is far more multifaceted. Today's workers are not just attracted by money. 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.



Forecast by TD Economics as at September 2007; Source: Haver Analytics, Statistics Canada

It may also be necessary for firms to adopt a more strategic approach to hiring. It will be difficult to find workers that exactly match the desired skill set, so businesses may need to hire new graduates and be prepared to provide training. Of course, this creates issues around retention. SMEs may also want to come up with innovative ways of recruiting. An example might be hiring workers from abroad and using temporary work permits or the provincial nominee programs; however, it might be necessary to pursue this through a consortium of small and medium-sized businesses to have a scale that would make the regulatory and administrative burden manageable.

Little relief expected for non-labour costs

In addition to labour concerns, businesses often report that input and other non-labour costs have been climbing quite quickly in recent years. At the top of the list is usually complaints about energy prices.

There has been an energy price boom since 2001 and the reality is that high prices will be with us for a long time. The good news is that they should not climb as rapidly in the future. Although crude oil prices climbed to above US$80 a barrel in September, the outlook for supply and demand does not suggest that the recent jump will be sustained. Global economic growth is expected to slow in 2008, leading world oil demand growth to rise by 1.7% next year, while supply is expected to increase gradually with modest gains coming from both OPEC and non-OPEC nations. As a result, and assuming no major unforeseen supply disruptions, crude oil prices are expected to average US$70 a barrel in 2008, marginally above the average US$69 that crude is on-track for in 2007. Based on this outlook, gasoline prices should remain close to current levels, or only rise by a few cents.

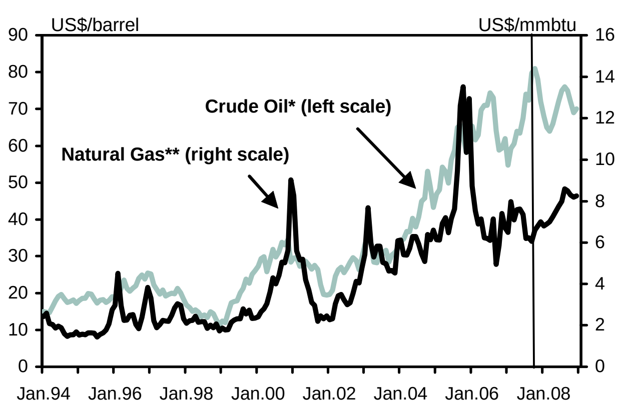
There is greater upside to natural gas prices. Due to high inventory levels and a sharp increase in imports of liquefied natural gas (LNG) into North America, natural gas prices fell from a high of US$8 per MMBtu to about US$5.50-6.00 in the early autumn. However, the move is overdone and driven in part by speculators. Assuming normal weather conditions over the winter, the outlook is for prices to recover towards US$8 in the second half of 2008. This would result in an average price of US$7.80 in 2008, up from an expected US$6.96 in 2007 – an increase of 12%.

Rising natural gas prices and the need to replace aging delivery infrastructure may create some upward pressure on electricity prices. Businesses may wish to budget for a 3 to 4% increase in electricity bills in 2008.

The story is the same for material costs. Base metal prices may dip slightly in response to weaker world demand growth, but any pullback will be limited. Similarly, prices for steel products will not climb in the same way as in past years, but analysts expect some increase in 2008. These trends should limit the upward pressure on products and materials made with these inputs, but little price relief can be expected. There are a couple of exceptions that should be noted. Forest product prices have fallen a long way, reflecting the fallout from the U.S. housing slump, and the recovery in prices should be modest. The strong Canadian dollar may also reduce costs for some businesses that use imported inputs.

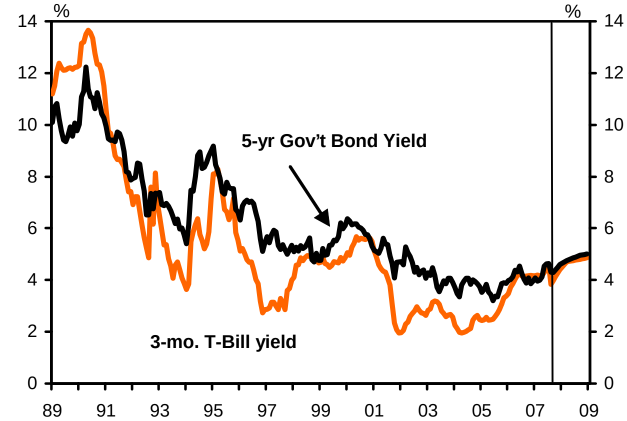
In many cases there is little that small businesses can do about the general high state of input and material costs – as they are price takers and lack much bargaining power with suppliers. They can try to take advantage of the strong Canadian dollar by sourcing from abroad; however, the savings can often be eroded by transportation and other costs. Nevertheless, it goes without saying that businesses should search high and low for any way to reduce non-labour costs.

CRUDE OIL & NATURAL GAS FORECASTS



*West Texas Intermediate; **Henry Hub LA; Forecast by TD Economics as at September 2007; Last plotted: September 2007; Source: Haver Analytics

CANADIAN 3-MONTH T-BILL RATES & 5-YEAR GOVERNMENT BOND YIELDS



Actual data to: September 2007; Forecast by TD Economics as at September 2007; Source: Bank of Canada/Haver Analytics

Climate for investment to remain supportive

One potential response that would fit into a business strategy to address many of the challenges noted above is to invest in new technologies. For some firms, this might lower costs in the future and boost efficiency. For example, more energy-efficient and labour-saving technologies could prove profitable. And, the climate for investment is expected to remain positive.

The direct impact of the financial turmoil in August and the on-going problems in the asset backed commercial paper market should prove minimal for SMEs. Small businesses do not raise financing through commercial paper or at Banker Acceptance (BA) rates, the latter of which have increased in the wake of the recent credit crunch. Medium-size firms also do not issue commercial paper, but they do sometimes raise financing through loans tied to BA rates. This may make borrowing a bit more costly, but the majority of medium-size firms can elect to finance at rates tied to the Prime Lending rate, so liquidity should not be a problem and the impact of the credit crunch should prove extremely limited.

There is also 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 – which was the U.S. experience. Roughly 80% of all Canadian machinery and equipment is imported, and the rise in the Canadian dollar from 62 U.S. cents to parity over the past four years has dramatically reduced the cost of capital investment. For the manufacturing industry, the federal government has provided increased depreciation allowances on machinery and equipment bought before the end of 2008. Borrowing costs should not prove prohibitive, as interest rates should remain relatively close to current levels – although the trend will be higher, with a quarter point increase in short-term rates and roughly a half point increase in long-term rates.

Don't wait for governments to respond

The challenges facing small businesses may provoke a call for government action. And, there are many policies that would be beneficial. In their Advantage Canada platform, the Federal government outlines an intent "to lower business taxes, reduce regulatory and administrative burdens, enhance competition, ensure our capital markets are globally competitive and encourage free trade and foreign investment". Advancement in all of these objectives would be helpful and similar efforts by the provincial governments would be desirable.

However, the reality is that businesses cannot wait or rely on public policy to ride to the rescue. The challenges are here today, but government initiatives would take time to formulate, time to pass into legislation, and time to be implemented. Time is not a luxury that firms have.

Creative and innovative responses needed

To wrap up, the economic and financial outlook suggests that 2008 should prove to be a decent year for domestic and overseas sales, but many key challenges will confront small businesses. The central theme is that Canada's entrepreneurs will need all of their skills and talents to look for opportunities to overcome the hurdles. Business-as-usual strategies won't deliver. Firms will need to find ways to attract talented labour and retain their staffs, and non-monetary factors could be particularly important. Ways of reducing energy and non-labour costs need to be identified. Competing on the basis of price or labour costs is a losing cause. The future is in selling higher quality or more advanced products. Customer satisfaction and exploiting niche markets are key. Developing scale could also be part of cost saving and greater brand-awareness strategies. 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 do.

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