TD Bank Financial Group

Special Report

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HIGHLIGHTS

- The economic recovery is underway, and this will improve conditions for small businesses in virtually all sectors and across all provinces.
- This report highlights the prospects in the seven industries with the greatest concentration of small and medium-sized companies (SMEs).
- The main conclusion is that sectors hit the hardest by the recession will tend to post the strongest rebound, but the recovery will take some time. Export-oriented businesses in particular will be challenged by the strong Canadian dollar. Domestically-oriented firms will benefit from rising demand.
- While the economic recovery is good news, now is not the time for complacency. Pricing power will be limited and demand growth moderate. Competition will remain fierce and a firm eye must remain on controlling expense growth. Given this tough environment, businesses must constantly strive to improve efficiency and profitability.

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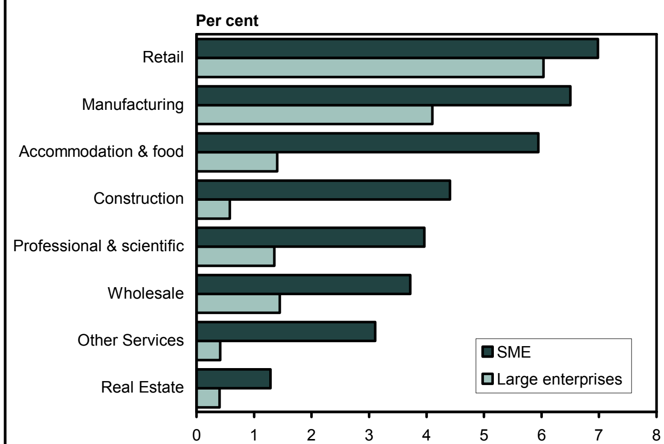
ECONOMIC RECOVERY TO KICK START SMALL BUSINESSES

Next week is Small Business Week in Canada, making it an ideal time to delve into economic issues that matter for these business owners. In particular, the question on everyone's mind is no longer when the recession will end; but rather, what the economic recovery will look like. As indicated in our latest Quarterly Economic Forecast, we foresee a moderately paced economic recovery in Canada – similar to that after the early 1990s recession, but much slower than the rebound after the early 1970s and early 1980s recessions. In general, small and medium-sized (SMEs) companies should benefit from the economic improvement, which will lift all boats. However, some industries and businesses will benefit disproportionately from the re-emergence of economic growth. More than two-thirds of all employment within the SME sector is concentrated in seven industries – retail, manufacturing, accommodation, health care, construction, professional/scientific services and wholesale. So, we'll investigate the prospects for these industries in the coming year.

SHARE OF CANADIAN TOTAL EMPLOYMENT



Source: Statistics Canada

The "good"s side of the story

For the purpose of this report, small-sized businesses refers to companies that employ less than 100 workers, while medium-sized firms employ anywhere from 100-499 workers. When compared to large firms with more than 500 employees, SMEs tend to have a disproportionate share of workers in construction, manufacturing and wholesale trade. Within these three sectors, 15% of all Canadian workers derive a paycheck from an SME; more than double the share of large firms. Looking at the data in another way, 88% of all construction workers in Canada are associated with an SME, particularly a small-sized company. For manufacturing and wholesale, that ratio is 61% and 72% respectively.

This makes the case that SMEs have a lot at stake when it comes to the fortunes of manufacturing and construction, two major goods-producing sectors that behave very differently during economic recoveries.

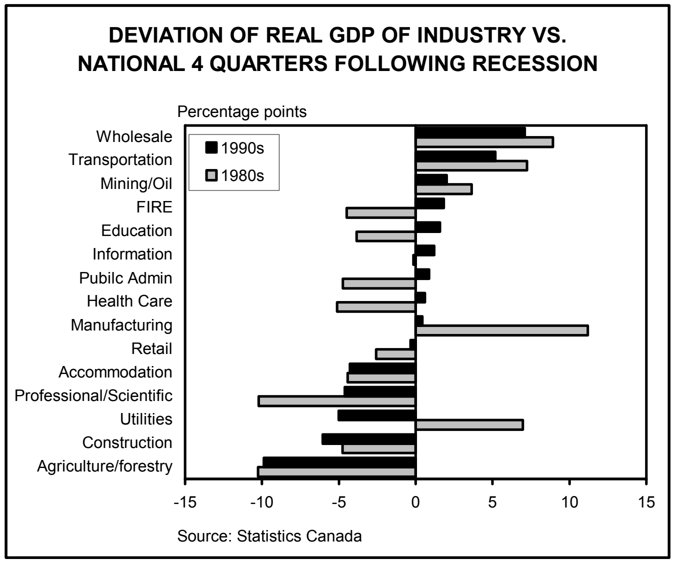
The future long/slow recovery in manufacturing

Manufacturing is a highly pro-cyclical sector that fares poorly in recessions, but order books among manufacturers tend to rebound quickly during the recovery. For those manufacturers that were able to survive the worst global recession in post war history – which resulted in extreme competitive pricing pressures and restructuring – they will see a bounce in profitability as global and domestic demand improves. However, it will not be business as usual. Manufacturing activity has been on a structural decline since 2006, and by the time of the economic trough, production will have contracted by a total of 20%. So, although we expect a 4% rise in real manufacturing output in 2010 (Q4/Q4), it will only be a drop in the bucket in recapturing lost production. It will likely be many years (3 or more) before manufacturing activity returns to levels seen in 2006. For instance, following the 1990 recession, it took 13 quarters for manufacturing output to return to pre-recession levels. Given the unique restructuring challenges surrounding this recession, it seems reasonable to assume the time frame could be even longer this time around.

One challenge that doesn't seem likely to go away is the high value of the Canadian dollar. Even as domestic and global demand recovers, the currency will likely hold near parity against the U.S. dollar through the first half of 2010, before easing to 93 U.S. cents by the end of 2010. Gone are the days of the 65-70 U.S. cent currency that helped boost competitiveness and manufacturing output. The higher level of the loonie during this economic recovery cycle will limit profit growth for those manufacturers who are export oriented. But, the impact disproportionately affects larger firms rather than small business owners, due to the former's greater export concentration.

Recovery under construction

SME's have a particularly high stake in the construction sector; but unfortunately, it tends to be a sector that underperforms national economic growth during the recovery phase. However, the construction and renovation sector hasn't been hit too badly. From the peak, activity in the sector contracted by 7% compared with an economy-wide real GDP (at basic prices) decline of 4%. This is a far cry from the large gap that appeared in the manufacturing sector and certainly better than the construction sectors' performance during the previous two recessions (-20% in the 1990s and -10% during the 1980s). Furthermore, the high Canadian dollar is beneficial to this industry since sales are virtually all domestic and about 11% of its inputs are priced in U.S. dollars.[1] So, small-sized construction businesses this time around will fare comparatively better than previous recession and recovery cycles, especially since the resale housing market has come back to life with a vengeance, which should eventually lift new home construction. In addition, construction workers and their businesses should see the benefits from government rebate programs, such as the Federal government's Renovation Tax Credit that expires in February 1, 2010. There is one note of caution, however. Once the government rebates expire and interest rates start to rise in late 2010, renovation business owners are likely in for an extended lull period.



Servicing the recovery

The focus thus far has been on the link between SMEs and goods producing industries. However, there is also a strong link to a handful of service-producing industries. Many SMEs are found in wholesale trade, which is a highly pro-cyclical industry. In particular, four quarters after the end of the last two recessions, real output for the wholesale industry outpaced real GDP growth by a cumulative 7-9 percentage points – the strongest performer of any industry. Of course, the industry was also the worst performer during the recessions, thus providing the foundation for a stronger bounce-back once economic conditions improved. Nonetheless, the post-recession pattern bodes well for wholesale SMEs as the broader Canadian economy embarks on a recovery this year, and especially as growth pick-ups speed in 2010. It's no coincidence that in our industrial outlook, real GDP for the wholesale industry is expected to run at the fastest pace in 2010 relative to all the other major industry categories within Canada.

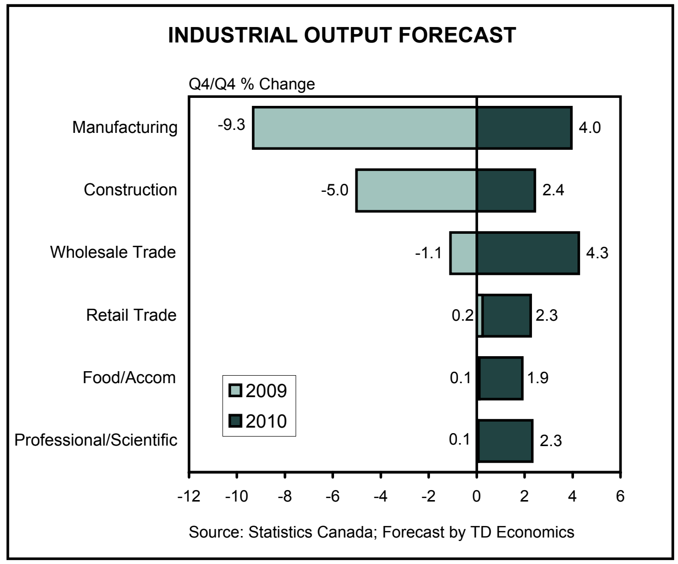
In terms of other SME-heavy service industries, the food/accommodation sector is high on the ranking. Within this sector, 81% of workers are employed by an SME. Just like in construction, the vast majority of these companies employ less than 100 workers, thereby falling specifically into the 'small' business category. As you probably guessed, growth in the accommodation sector lags the national economic pace, since it tends to be the last beneficiary of improved incomes and confidence. In the four quarters following the official end of the last two recessions, output in the sector lagged national real GDP growth by just over 4 percentage points. This recovery cycle brings the extra challenges of an elevated currency relative to past cycles, and a severe deterioration in wealth of our favorite visitors from the south. As such, the recovery in food/accommodation will underperform the nation by nearly a full percentage point in 2010.

Workers are about evenly distributed between SMEs and large-sized firms in the retail sector, with about 53% of all retail workers in Canada attributed to an SME. However, there is a skewed representation if you solely look at all those who are employed by a small enterprise. Nearly 15% of all employees in small-sized firms work in the retail sector, marking the highest representation of employment among the major sectors for these firms. Although consumer spending held up remarkably well during the recession, the retail sector tends to underperform broader economic growth in the initial stages of the recovery cycle, but not by a wide margin. Since we anticipate that the unemployment rate will rise further in the near term and will decline only slowly in 2010, retailers may still need to work hard to attract sales. In addition, a Canadian dollar near parity has been known to put downward pressure on retail prices, which may shrink profit margins. However, the business environment in 2010 should be head and shoulders above the experience of 2009, and it will contrast greatly with the expected still weak performance for retailers in the U.S. next year.

As for the final two categories where SMEs have a high concentration of employment – health care and professional/technical occupations – both proved to be rather recession-resistant and will maintain solid support as the broader economic expansion gains momentum. In general, services are less cyclical than goods-producing industries, so it will be steady-as-she-goes for these industries.

Not the time for complacency

In terms of key messages, small- and medium-sized business owners should take heart that an economic recovery has indeed taken hold. Although there are lingering worries about a double-dip recession, we feel that these fears are unlikely to be realized and economic growth will steadily improve in the coming quarters. This should prove beneficial for virtually all businesses across all provinces, but some firms will be more economically-sensitive than others. The odds are that the strongest rebound will be felt by those sectors that experienced the most pain during the recession and those that have historically responded most acutely to changing economic circumstances.



However, while the economic path forward will be increasingly positive, now is not the time for complacency. Many challenges will persist because the economic recovery will likely be gradual. That means demand for SME-produced goods and services will improve, but for most firms growth will not be booming. If so, firms will find that they have limited pricing power and profit growth may prove moderate. Moreover, in a world with only moderately improving demand, competition will likely remain fierce. That suggests a firm eye must remain on keeping expense growth under control. The good news on this front is that slack labour markets and the legacy of the recent economic downturn have dampened the growth in input costs. For many businesses, now might be an excellent time to strive to build market share while their competitors are struggling or are hampered by uncertainty about economic and financial conditions. Export competitiveness and tourism will be challenged by a strong Canadian dollar – but, the silver lining is that the high-flying currency may make the importation of efficiency boosting machinery & equipment more attractive for businesses in many sectors. And, the slow-paced economic recovery suggests that borrowing costs will remain low for an extended period of time. The bottom line is that the economic tide has turned, but the strategies for business expansion and success have not changed.

ENDNOTES

[1] Loonie tunes: Industry exposure to the rising exchange rate, Statistics Canada, Canadian Economic Observer, March 2008