ECONOMICS

# Canadian SMEs — The Cycle and Beyond

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Small and medium-sized enterprises (SMEs) were the pioneers of the economic recovery, able to generate jobs at a pace faster than managed by larger corporations. But the cycle is maturing, and SMEs are showing some signs of fatigue. Overall, SME confidence has softened recently, and for the first time in nine years, larger corporations are outpacing them in job creation. External shocks such as higher interest rates, a stronger Canadian dollar, rising minimum wages and potential tax policy changes will further test the durability of this critical segment of the Canadian economy. Are they up to the task?

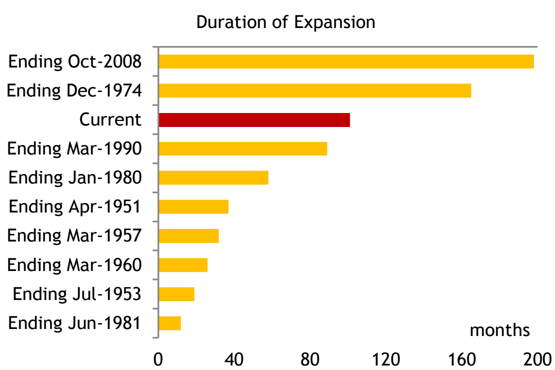
## The Cycle is Getting Old

The current expansion is 100 months old—the third longest expansion in the post-war era (Chart 1). And as opposed to the other two, this one is not benefiting from a life-prolonging productivity boom. Nobody is talking about a recession any time soon, but it is reasonable to suggest that we are closer to the next recession than to the previous one.

For its part, corporate Canada projects a secure image with no major red flags. But a closer look reveals early signs of fragility. Profit margins, at just under 7%, are consistent with what we have seen in the second half of the past two expansions. But, this time those margins are helped by a clear downward trajectory in unit labour costs (Chart 2), reflecting, in part, wages that are remaining tame for deeper into the cycle than textbook models predict.

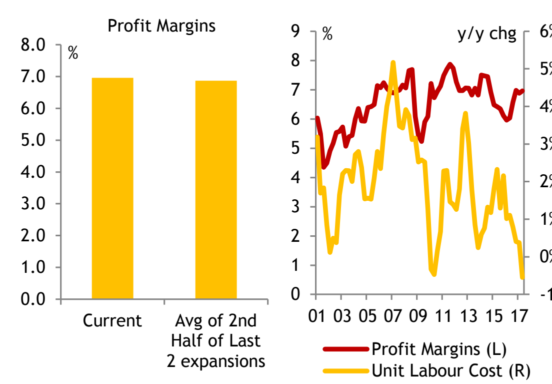
Business investment is finally in positive territory, and while the improvement here is not as broadly based as the Bank of Canada would like you to think, it nevertheless represents an important milestone in the trajectory of the current expansion. This improvement, however, is not financed by the so-called "dead money" accumulated

*Chart 1*
***The Current Expansion is Old***



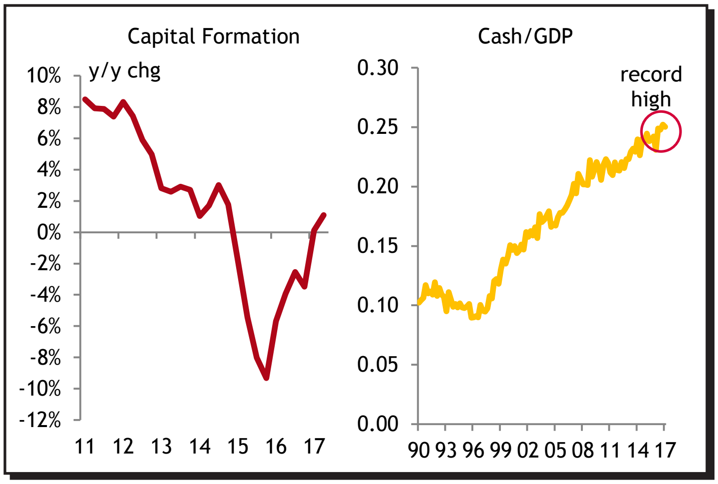

*Source: C.D. Howe Institute, CIBC*

*Chart 2*
***Healthy Profit Margins Helped By Lower Labour Cost***



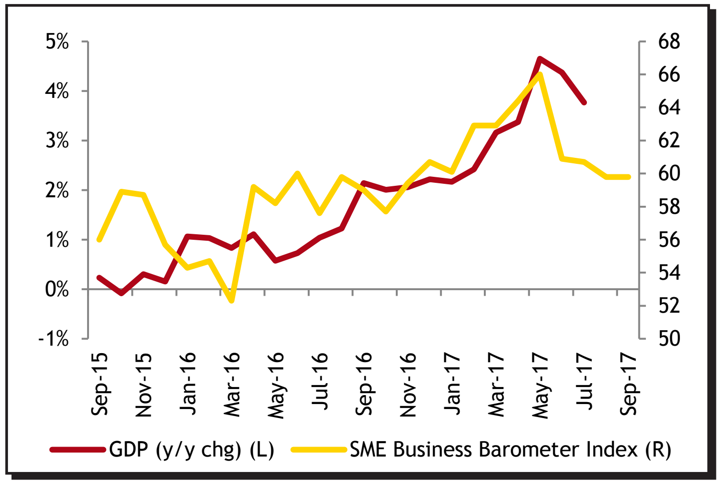

*Source: Statistics Canada, CIBC*

Chart 3
***Rebound in Capital Spending Not Financed by Lower Cash Position***




*Source: Statistics Canada, CIBC*

Chart 5
***SMEs Signaling Slowing Ahead***

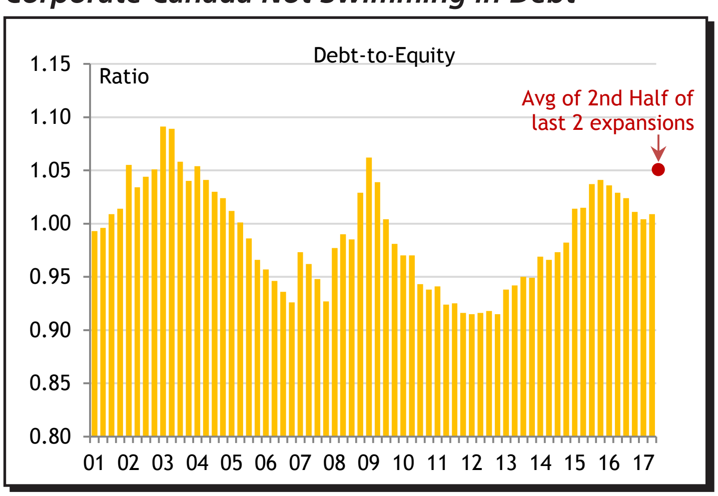



*Source: CFIB, Statistics Canada, CIBC*

by Canadian firms over the years, as cash positions (as a share of assets and GDP) continue to break new records (Chart 3). We have argued in the past that that money is not really dead—it simply needed to pave corporate Canada's way to the credit market. Therefore, we do not expect any material softening in cash positions to finance future improvements in capital expenditures.

Healthy profit margins and elevated cash positions indeed allowed corporations to tap the credit market, but many have elected to avoid the temptation, with business loans outstanding rising by just over 5% over the year ending July 2017—the slowest pace in six years. Consequently, the debt-to-equity ratio today is now lower than the average seen in the mid-to-late stage of previous expansions (Chart 4).

Chart 4
***Corporate Canada Not Swimming in Debt***




*Source: Statistics Canada, CIBC*

## SMEs Starting to Show Some Signs of Fatigue

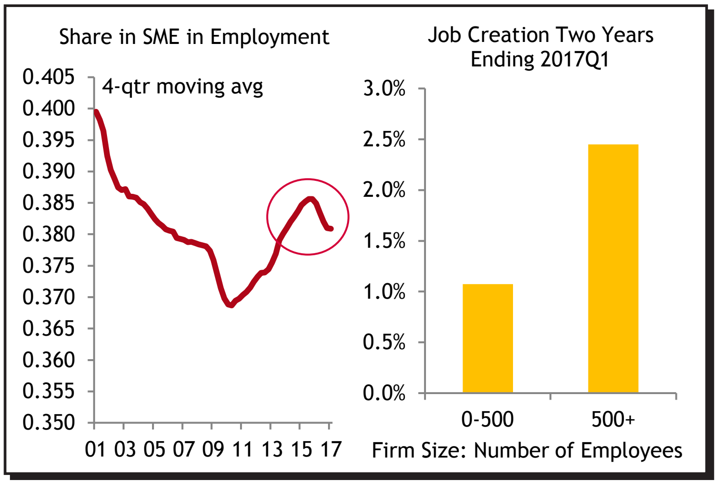
But not all is rosy. Corporate Canada is a tale of two entities; large corporations, defined here as those with more than 500 employees, account for more than 70% of overall economic activity, and SMEs with fewer than 500 employees, account for more than 99% of the number of all firms. And here is where we often get a sense of what's coming. The recently euphoric 4%+ GDP growth is of course not going to last, and SMEs are already telling us that. As Chart 5 illustrates, SMEs' confidence took a nosedive in the past few months, paving the way to a much softer economic reading in the second half of the year.

And that reduced confidence is also visible in the hiring momentum in the SME space. After outpacing large companies in job creation during the recovery, SME hiring is slowing down, seeing its share in employment falling (Chart 6). Over the past two years the pace of job creation by SMEs was half of that seen among large corporations.

## Challenges Ahead

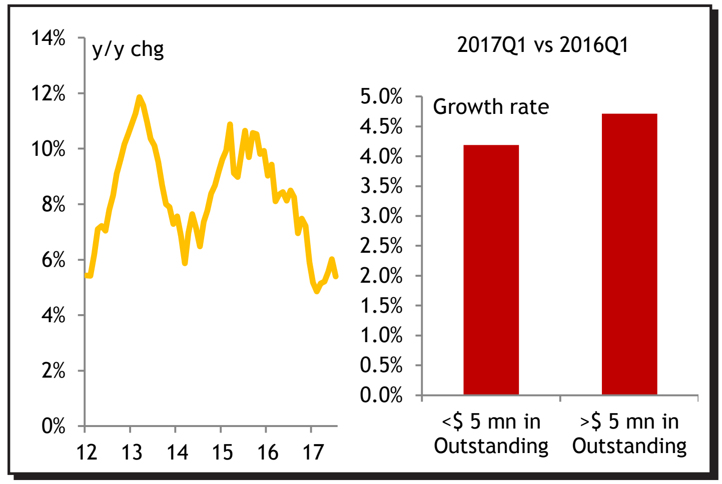
In addition to those cyclical forces, many SMEs will have to cope with additional near-term developments such as this year's appreciation in the value of the Canadian dollar, rising interest rates, higher minimum wages and potential tax changes.

Chart 6
***SMEs Losing Ground in Job Creation***




*Source: Statistics Canada, CIBC*

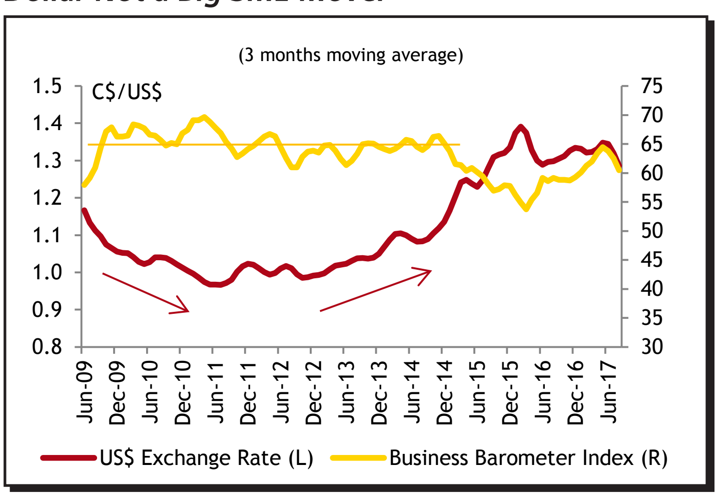
Chart 8
***Business Loans***




*Source: CBA, Bank of Canada, CIBC*

We do not view the fluctuations in the value of the loonie as a major macro factor impacting SMEs. Clearly the 10% of SMEs that are export-oriented will feel the pain as will those that rely on orders from large Canadian exporters. Vulnerability to increased import penetration and reduced tourism are also important negatives for the SMEs. At the same time, the stronger dollar means cheaper imports—a clear positive for SMEs that import raw materials and finished goods. Overall, as illustrated in Chart 7, in aggregate, SME confidence was relatively flat during past periods of wild fluctuations in the value of the currency, reflecting those offsetting forces and the fact that an estimated 75% of SMEs experience little-to-no currency sensitivity.

Chart 7
***Dollar Not a Big SME Mover***



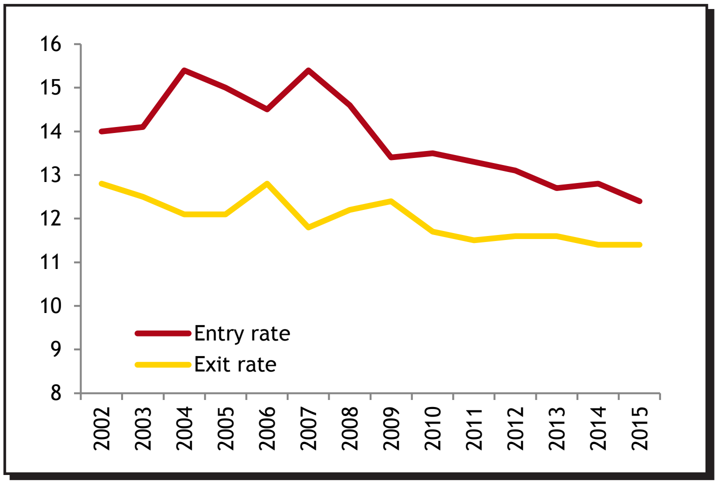

*Source: Bank of Canada, CFIB, CIBC*

While that might be the case, SMEs apparently are not immune to trade issues. In fact, just under 60% of SMEs fear that NAFTA renegotiations could have negative impacts on their business, and almost 50% suggest that the uncertainty over NAFTA is already affecting their business[1].

While the dollar is not a major factor, that cannot be said for the impact of higher interest rates on SMEs. Like large corporations, SMEs did not accumulate debt at an alarming rate (Chart 8). In fact, the pace of SME credit growth over the past year was in line with that seen among large corporations. Higher rates, however, impact SMEs indirectly through rising consumer sensitivity to higher interest rates (see our report *"Assessing Household Debt's Sensitivity to Higher Interest Rates"*). The projected increase in interest rates in the coming twelve months will no doubt lessen consumer enthusiasm and therefore SME economic growth, directly via higher debt-service payments, and indirectly through slowing housing market activity. Fortunately, our assessment that the Bank of Canada will raise rates gradually and moderately implies that the damage will be manageable.

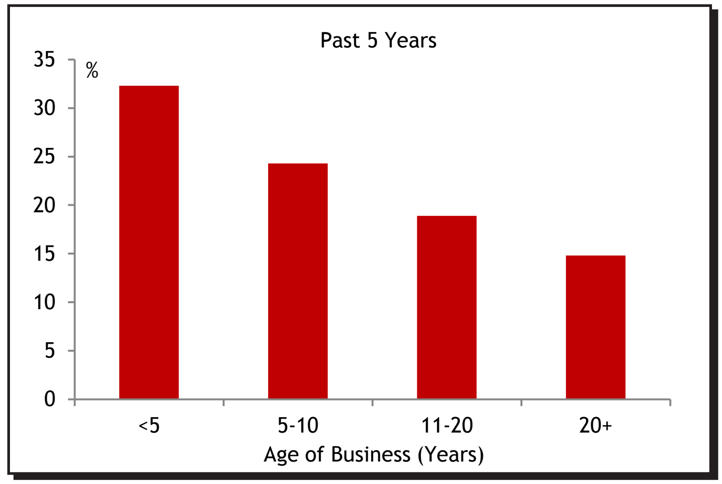
As for the impact of recent (and proposed) policy changes, we will resist the temptation to dig deeply into it in this analysis. But from an economic perspective it is reasonable to assume that the speed at which minimum wages will be increasing, and the potential impact on the rest of the wage spectrum, will act as a headwind on overall SME activity in the coming years. The same can be said for proposed tax changes, but overall we

*Chart 9*
***Falling Entry and Exit Rates Suggest Reduced SMEs Dynamism***




*Source: Statistics Canada, CIBC*

*Chart 10*
***Growth in Revenue by Age of Business***




*Source: CIBC Survey, CIBC*

expect Canadian businesses will continue to face a relatively favourable tax regime when compared to other developed nations[2].

## Value-Builders vs. Lifestylers

The cycle and policy are important, but at the end of the day, the key to success is the business model and the ability to adapt to changing market conditions. And on the latter, it seems that Canadian entrepreneurs are having some success. As illustrated in Chart 9, the exit rate among SMEs has been trending downward, suggesting an increased length of business survival. Increased flexibility must be part of the story here as more than half of SMEs report that the nature of their business has changed over the past five years, with increased export-orientation and growing product or service line playing an important role in that change. This finding suggests that small business owners are able to adjust to an evolving marketplace by shifting products or services.

That's the positive dimension to the story. But take another look at Chart 9 and you will see that alongside the falling exit rate, the entry rate is also on a downward trajectory. This means that, in aggregate, the average age of SMEs is rising. That trajectory also reveals a large portion of SMEs that simply don't want to rock the boat. When focusing on SMEs, we differentiate between "value-builders" and "lifestylers", with the former desiring growth and the latter seeking long-term stability instead of growth—and using the business as a means of generating income that is sufficient to support a certain lifestyle. Almost half of SMEs belong to the "lifestylers" group who are content with their current size[3].

A quick glance at Chart 10 tells the tale. It is hardly a surprise that the younger the business is, the faster it grows. So the rising average age of SMEs is working to reduce the dynamism and growth potential of the entire sector, regardless of where we are in the cycle.

## What Really Works?

But for those who would like to grow, what's the best course of action? We utilize the information in our survey to zoom in on fast-growing SMEs (above-average revenue growth in the past five years) and examine their characteristics in an attempt to discover the secret to success. Here, of course, we focused on businesses that have been in operation for more than six years in order to control for the youth bias.

We found that on average, outsourcing activity leads to comparatively strong growth. Small firms that receive outsourced work from other companies grow their revenues, on average, 45% faster than firms that do not rely on outsourced work. Export orientation was also found to be an important distinguishing factor with export-oriented firms seeing their revenue rising 50% faster than non-exporting firms. Companies that report higher levels of market flexibility due to an increased number of services and products also saw on average stronger revenue growth, and by sector, service-oriented SMEs (business as well as personal) outperformed, including firms in finance, information and recreation.

The gender of SME owners appears not to have had an impact on the revenue growth of small firms, as the growth rate among firms owned by men is rising at approximately the same rate seen among women-owned firms.

Interestingly, we also found no performance difference between SMEs that were created due to negative economic circumstances (entrepreneurs who established their businesses at least in part because they were laid off, downsized, restructured, fired or took early retirement) and companies that were established by the entrepreneur's choice to become self-employed.

*Note:*

[1] *From September 6th to September 15th, 2017 an online survey was conducted among 1,014 randomly selected Canadian adults who are decision makers for a small business (507 with 1-25 employees, 507 with 26-100 employees) and who are Angus Reid Forum or EMI Research Solutions panellists. The margin of error—which measures sampling variability—is +/- 3.1%, 19 times out of 20. Discrepancies in or between totals are due to rounding.*

[2] *CIBC*

[3] *CIBC*