



Economics & Strategy

Braving the Storm

by Benjamin Tal

Jeffrey Rubin (416) 594-7357 jeff.rubin@cibc.ca

Avery Shenfeld (416) 594-7356 avery.shenfeld@cibc.ca

Benjamin Tal (416) 956-3698 benjamin.tal@cibc.ca

Peter Buchanan (416) 594-7354 peter.buchanan@cibc.ca

Meny Grauman (416) 956-6527 meny.grauman@cibc.ca

Krishen Rangasamy (416) 956-3219 krishen.rangasamy@cibc.ca

“...over the coming five years the average annual growth in the number of small and mid-size businesses formed will exceed 2%, leading to the creation of no less than 260,000 new businesses by 2013.”

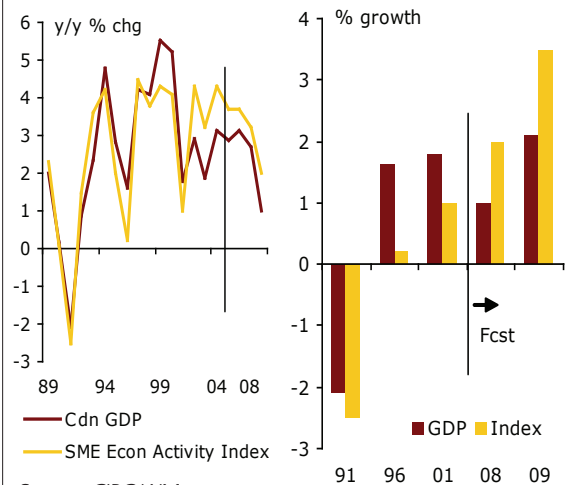
The Canadian economy saw the start-up of an additional 33,000 new small and mid-size firms in 2007, bringing the cumulative number of net small and mid-size business formations since the beginning of the decade to more than 300,000<sup>1</sup>. Irreversible forces such as the changing demographic landscape of the Canadian society, rising immigration and the growing sophistication and rapid change in consumer tastes suggest that the coming years will see even more impressive growth in the size of the Small and Medium-Size Enterprise (SME)<sup>2</sup> market in the Canadian economy. We expect that over the coming five years the average annual growth in the number of small and mid-size businesses formed will exceed 2%, leading to the creation of no less than 260,000 new businesses by 2013.

The Cycle

For the first time in more than two decades, SME economic activity will outpace the rest of the economy during a period of economic slowdown. This is significant given that historically, SMEs led the overall economy into periods of slowdowns and, in the process, suffered disproportionate hardship compared to larger firms.

Small businesses were quick to capitalize on the acceleration in economic activity between 2005 and 2007, outpacing the overall economy by a full percentage point (Chart 1, left). While the current economic slowdown did not spare the Canadian SME

Chart 1 SME Economic Activity



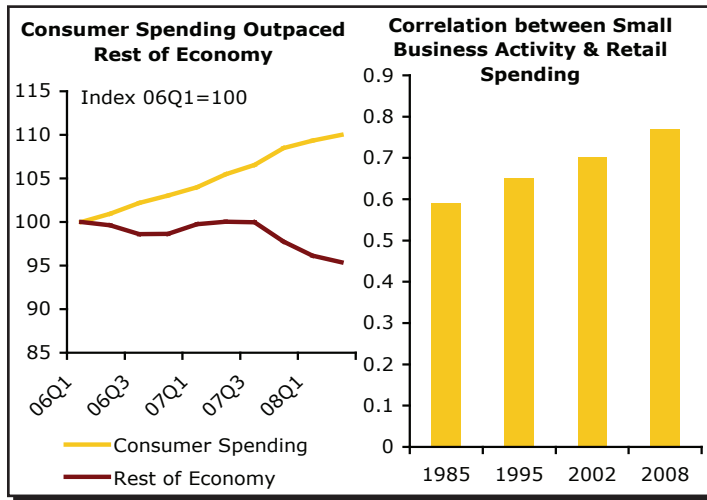
Source: CIBC WM

sector, our index of SME economic activity<sup>3</sup> reveals that in comparison to the overall economy, the sector in fact outperformed. And by next year, as the economy begins to recover, SMEs in aggregate appear to be well positioned to resume their traditional role as the pioneers of the economic cycle (Chart 1, right).

The secret behind the unprecedented ability of small businesses to overcome the softening in overall economic conditions over the past year is their increased reliance on the health of the Canadian consumer. It is well documented that consumers, by keeping their wallets open, were able to sustain the economy, and almost single-handedly kept it above water (Chart 2).

http://research.cibcwm.com/res/Eco/EcoResearch.html

Chart 2  
**Strong Consumers Sustained SME Activity**



The strong housing market, another beneficiary of the low interest rate environment, also played a significant role behind the supremacy of consumers and the SME sector. Not only has the real estate boom of recent years seen housing starts and resale activity rise to levels not witnessed in 20 years, but it has also given birth to an estimated 700,000 new jobs, accounting for one-quarter of the labour market strength since the beginning of the decade. With SMEs employing close to 70% of workers in the construction and real estate sectors, the benefit to the sector is obvious. Furthermore, with each housing sale generating an estimated \$20,000 in additional consumer spending, the real estate boom provided consumers and SMEs with an additional boost. Clearly the leveling-off in housing activity in Canada will hurt the momentum in overall SME activity, but the level of activity will remain at historic highs.

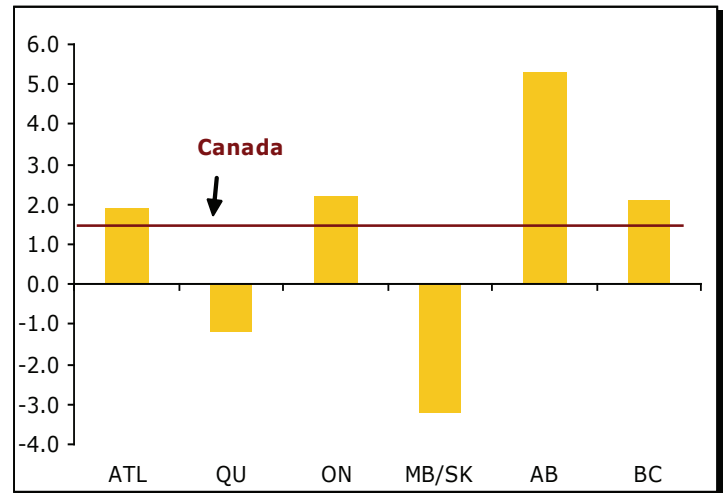
**Business Formation**

The number of firms with less than fifty employees rose by 1.6% in 2007. But this figure masks two opposing trends; continued decline in the number of micro-firms (less than 5 employees) and an acceleration in the pace of growth in the number of larger firms. This trend is consistent with the nature of the current economic cycle. Many owners of micro-businesses were attracted by the increased paid-employment opportunities given the recent strength of the labour market. At the same time, larger firms within the SME sector were able to take advantage of continued outsourcing activity by large corporations and still very

strong consumer demand. Interestingly, note that since 2000, the share of incorporated self-employed workers has been increasing by an average annual rate of 3.7% vs only 0.2% for unincorporated self-employed workers.

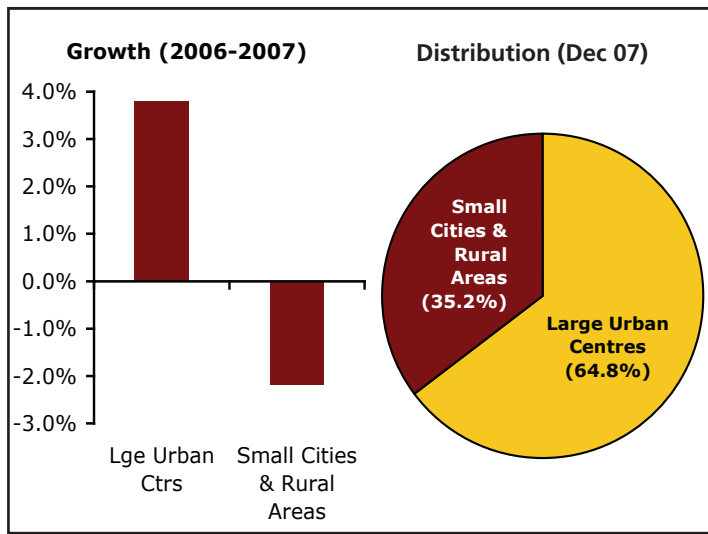
By province, reflecting the cyclical nature of the SME sector, the largest gain in SME business formation in 2007 was in the booming economy of Alberta. Interestingly, business formation in Ontario was also relatively strong, probably reflecting the growing reliance of the province on the service industry as well as some outsourcing activity as large corporations try to cut costs. The decline in the number of SMEs in Manitoba and Saskatchewan in 2007 suggests that the positive economic momentum in the region is yet to be felt by the SME sector. We expect this trend to reverse itself with the region showing one of the largest gains in SME activity in the coming few years (Chart 3).

Chart 3  
**SME Net Business Formation by Province (2006/2007 % Chg)**



The highest proportion of small firms is in Saskatchewan, where over 20% of workers are self-employed. However, when the agriculture sector is excluded, the share of self-employed in Saskatchewan falls to below 15%, somewhat lower than the national average. In British Columbia and Alberta, reflecting the strong growth in self-employment in the past 15 years, the share of self-employment is higher than the national average. The incidence of self-employment in Ontario is in line with the national average while New Brunswick has the lowest incidence of self-employment.

Chart 4  
SME Formation



Note that all the growth in the SME sector in 2007 was in large urban centres which saw a strong 3.8% rise in the number of SMEs. At the same time, the number of SMEs in rural areas fell by more than 2% (Chart 4 & Table 1). This trend is not new and has been observed over the past decade. Currently 65% of Canadian small firms are located in large urban centres with the largest proportion (78%) being in Ontario. The fastest rate of small business formation in 2007 was in Sherbrooke followed by Edmonton and Calgary. Note that the number of SMEs in Toronto rose by a strong 6.1% in 2007 (Chart 5).

Chart 5  
Growth in Business Formation by Major Canadian City

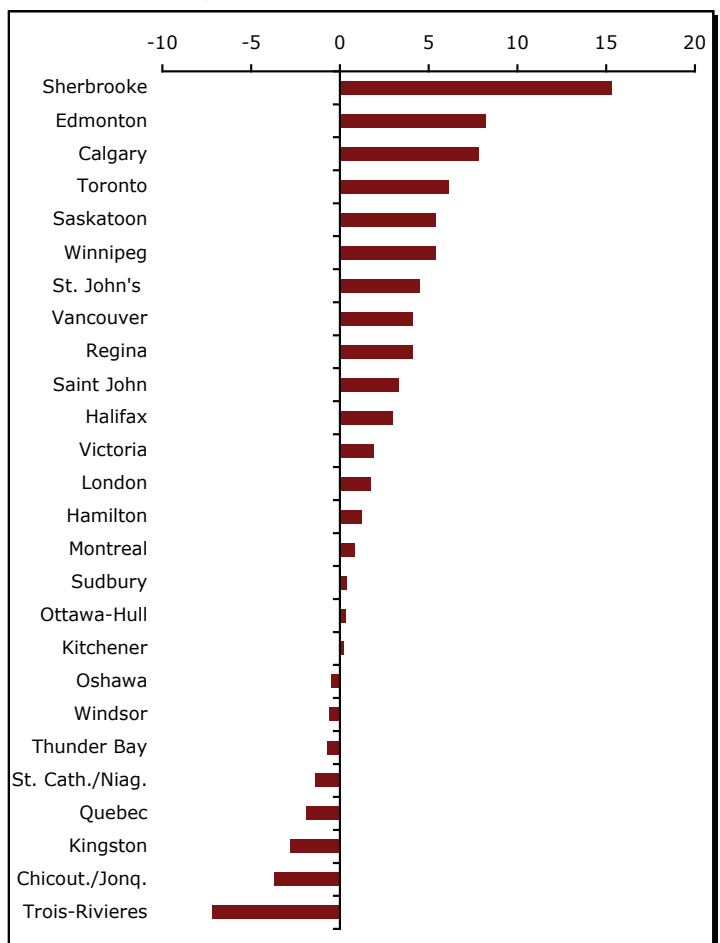


Table 1  
Business Formation by Province  
(Dec 2007, <49 Employees)

	Growth		Share	
	Large Urban Centres	Small Cities & Rural Areas	Large Urban Centres	Small Cities & Rural Areas
<b>Canada</b>	<b>3.8%</b>	<b>-2.2%</b>	<b>64.8%</b>	<b>35.2%</b>
Atlantic	3.4%	1.4%	30.4%	69.6%
Quebec	0.6%	-4.9%	63.5%	36.5%
Ontario	3.9%	-2.5%	78.1%	21.9%
Manitoba	5.4%	-6.9%	53.4%	46.6%
Sask	4.9%	-9.4%	33.8%	66.2%
Alberta	8.0%	2.3%	60.6%	39.4%
BC	3.9%	-0.2%	61.5%	38.5%

SMEs Hiring

Another dimension of the resiliency of the SME sector during the current cycle can be seen in recent developments in the labour market. The Canadian manufacturing sector is in recession and the economy as a whole showed only marginal growth since the beginning of the year. But a glance at the employment situation tells a totally different story. While the pace of overall job creation in Canada is clearly slowing, the economy was able to create an impressive 90,000 jobs during the first eight months of the year—not bad for an economy that is almost in recessionary territory.

How do we reconcile these two conflicting stories? Part of the answer lies in the SME sector of the Canadian economy. During the year ending March 2008, firms with less than 100 employees created 130,000 new jobs, accounting for almost 39% of all jobs created in the economy. This is notably higher than the 28% contribution seen in early 2007 (Chart 6).

Chart 6

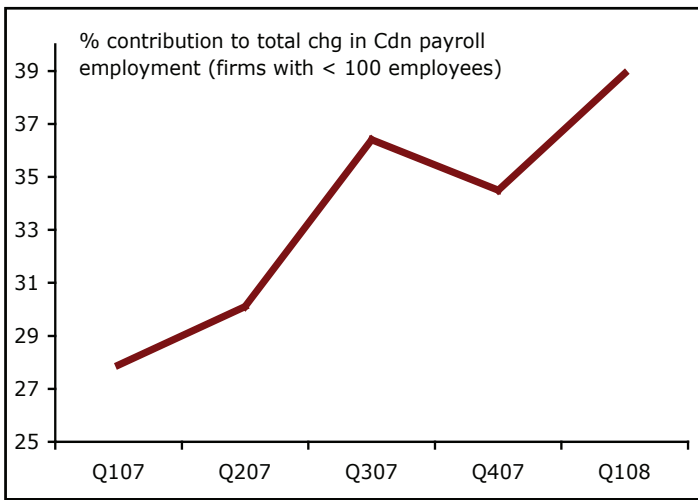
**SMEs Generating Jobs**

Chart 7

**Propensity to Own a Business****The Future**

Rapid change is the SME theme of the future. Some of these changes will be external to the firm, beyond the control of any single SME owner. The following discusses some of the major forces that are likely to shape the nature of the SME sector in the coming decade.

**Demographics**

Over the next 5-10 years the large baby boom generation will be moving into their 50s and 60s. The average age of the work force will rise. The labour force will be more experienced and productive. An aging work force may also mean more part-time workers, more job-sharing, and greater work turnover. Replacement for the retiring baby boom generation will be hard to find as labour force growth slows to below 2% annually. This environment will be largely positive for SME economic activity, but it will also introduce some challenges:

*Aging Baby Boomers:* The aging of the Canadian population has direct implications for self-employment as the propensity for self-employment rises with age. For the first time in recent history the age group 45-65 years will be the fastest growing segment of the population. But this is also the age group with the highest propensity to become self-employed (Chart 7). On average, a small to mid-size business owner often had over 13 years of related practical industry experience before launching his/her business. This demographic trend is consistent with an acceleration in the pace of small business formation in the coming decade.

Also note that while Canadians are aging, Canadian entrepreneurs are aging even faster. The number of self-employed who are nearing retirement (ages 55 to 64) has been rising rapidly in recent years, growing by a whopping 7.5% annually since the beginning of the decade. This is double the growth rate seen in the 1990s. In fact, within the coming 15 years, more than half of the country's current small business owners are expected to retire. The economic implications of this accelerated pace of retirement should not be underestimated. The demographic realities of Canada in general, and in the small business sector in particular, suggest that succession planning is becoming an increasingly critical issue.

By 2013, an estimated \$1.3 trillion in business assets is poised to change hands—the largest turnover of economic control in generations. Accordingly, faulty succession planning could have significant economic costs resulting from reduced productivity, job losses, premature sales and increased bankruptcy rates. Yet, only two in five small business owners have a clear plan for exiting their businesses. Moreover, at this stage of the game, a small business principle strength—the reliance on the human capital of the owner in almost every aspect of the business—is also becoming its primary weakness, since it means that adequate succession planning requires time that is often measured in years, not days or months. Still, 60% of entrepreneurs aged 55 to 64 have yet to start discussing their exit plans with their family or business partners<sup>4</sup>.

*Immigration:* The pace of growth in self-employment among immigrants has risen dramatically over the past two decades. Currently close to 20% of self-employed are immigrants, more than double the rate observed in the 1980s. Given that immigration will become an even more significant source of labour market growth, this trend is likely to support small business formation.

*Increased Demand for Personalized Products:* The changing age profile of the population also means growing sophistication and a rapid pace of change in consumer tastes. This is positive for self-employment. By their nature, small-scale operations are flexible enough to support the increased demand for personalized services, given their ability to focus on niche markets.

*Shortage of Skilled Labour:* The shrinking labour force means that small firms will face increased difficulties finding qualified labour. This lack of suitable help can potentially become the chief factor limiting small business growth in the next decade. To overcome this potential difficulty, small firms will have to step up the level of training of their existing labour force to retain employees with technical proficiencies, hire a greater number of older workers and create more family-oriented work policies for married employees. In fact, in some cases, smaller firms will be better equipped to meet the greater need for flexibility in managing this new work force. The main disadvantage facing small firms on this front is lack of economies of scale that larger firms enjoy by managing their own training programs.

## Globalization

For many small and mid-size businesses, exporting is not a dominant strategic objective. The propensity of businesses to export is directly correlated to the size of the operation. For example, only 8.5% of self-employed with no paid help export their products. This ratio rises to 15% for firms with 5-19 employees and to 29% for firms with 20-99 employees.

Having said that, the growing impetus to think and act on a global scale will continue to modify the environment for SMEs. Increasingly, firms are identifying foreign markets and foreign sources of supply as important parts of their strategies for growth and success.

The internet will continue to play an important role in increasing the motivation and ability of small businesses to export their products. There are clear signs that companies using the internet as a business tool have a much higher propensity to export than companies

that are not online. Given the strong likelihood that the internet adoption rate among small firms will rise, this means that the export orientation of the small business sector as a whole should rise as well.

As well, the growing impact of new immigrants on the economy in general, and small SME activity in particular, is another factor that will work to increase the export orientation of small business. More than two-thirds of these immigrants arrived in Canada as adults. This suggests that they still have some potential business connections with their countries of origin.

Increased exports and import orientation also suggest an increased complexity of doing business. Small businesses will have to be increasingly aware of trade, tax and other regulations in the countries with which they trade. Foreign exchange risk is another important factor to consider. It is not clear that small businesses in Canada are totally prepared to fully deal with the impact of globalization.

## Six Keys to Success

Given this prognosis we now turn our attention to what we view as the most important factors that contribute to small business financial success. We examined small business firms that have consistently outperformed their peers in revenue growth and identified the characteristics of these successful businesses<sup>5</sup>. The following are the most important distinguishing characteristics of SMEs with above-average revenue growth:

- **Prior paid-employment** experience was found to be an important factor contributing to strong revenue growth. Those self-employed with such experience enjoyed on average 60% higher revenue growth over the last four years compared to those who opened shop with no paid-employment experience. This finding is not surprising. Industry-specific know-how and a wider network measurably reduce the liability of newness associated with new entrepreneurs. That, in turn, enhances their ability to develop sales, obtain credit and achieve other forms of co-operation. Nine out of ten small business owners in Canada had some sort of prior paid-employment experience.
- **Use of advisors** was another distinguishing factor with firms that, on a regular basis, use the advise of professional advisors such as accountants, bankers and lawyers seeing their revenues rise 75% faster than small firms that don't use such framework. Just over 10% of Canadian small firms use an advisory panel/board as a matter of course.

- **High level of education** played an important role in determining not only the level of revenues, but also the pace at which they grow. Over the past four years small firms run by individuals with a university/college degree enjoyed revenue increases that were more than double the pace of those with less than high school education. Higher education works to increase the ability of the entrepreneur to cope with problems and seize opportunities and submit a clear signal of competency to potential clients. 40% of Canadian small business owners have a university/college diploma.
- **Partnership** also emerged as an important distinguishing factor with partnerships seeing revenues rise by close to 30% faster than sole proprietors. The presence of partners improves the resources and skills base of the venture, enhancing credibility among creditors, and provides ongoing psychological support for one another. Partnership is especially important when the business reaches the maturity stage and is facing new growth challenges.
- **Technology adoption and connectivity** was found to be a significant factor that led to accelerated growth. Small firms that reported a high level of web connectivity saw their revenues rise twice as fast as firms with little or no web connectivity. The rationale here is straightforward. Increased connectivity and the adoption of e-commerce-enabling technologies works to improve and strengthen customer relationships, enhance information availability and exchange, improves the company's image, and in some cases levels the playing field with large corporations. Roughly 38% of small firms in Canada have a website and 7% use the internet as a serious business tool.
- **Market/Exports orientation** is becoming an increasingly important growth-enhancing factor. The growing impetus to think and act on a global scale is starting to modify the environment of small business. While the vast majority of small firms still focus on the domestic market, those that are more export-oriented also grow faster. During the first half of the decade, small businesses that derived revenues from abroad grew 20% faster than companies focussing only on Canada. An even better winning combination was found among small firms that combine high web connectivity and international trade.

<sup>1</sup> Unless indicated otherwise, data sources used in this study are: Statistics Canada (published and unpublished tabulations) and Industry Canada.

<sup>2</sup> The common understanding is that a SME is a firm that is independently owned and managed by its owner or part owner in a personalized fashion, often resulting in greater dependence on outside sources for guidance, and which makes little distinction between business and personal financial goals. Unless indicated otherwise we define SME as a firm with less than 50 employees.

<sup>3</sup> The index is based on real GDP growth modified by allocating different weights to different industries in a way that reflects SME activity more accurately.

<sup>4</sup> Source CIBC small business outlook poll.

<sup>5</sup> Source: CIBC Small Business Polls: various years.

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