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Introduction

Canada's small and medium-sized enterprises (SMEs) are a vital part of the Canadian economy. And for over 60 years, as Canada's development bank, BDC has been contributing to their prosperity. By providing financing, investment and consulting services, BDC helps entrepreneurs create, grow and sustain their businesses.

BDC has the pulse of Canadian entrepreneurship at its fingertips. Our relationship with over 27,000 clients allows us to have a keen understanding of the competitive environment as well as the key challenges faced by entrepreneurs and SMEs. Our client portfolio gives us insight on their performance as well as their evolving needs.

In this light, we are pleased to introduce *Entrepreneurial Insight*, a newsletter about Canadian entrepreneurship and the SME sector. This first issue aims to simply set the stage by presenting a synopsis of facts and figures on Canadian SMEs and provide some insight based on BDC's experience. You will learn what they are, their economic contribution, how they start up and grow, their key success factors and their challenges. We are planning to supplement this edition with subsequent shorter issues that will cover specific topics.

1. Small and medium-size enterprises – what are they?

Definition of an “SME”

Currently, there is no solid consensus as to the definition of a micro, small or medium-sized firm – among OECD countries, Canadian governmental institutions or the academic/research institutions that study SMEs and entrepreneurship. There are also differing opinions as to how best approach such a definition - from the perspective of the number of employees or in relation to revenues/sales; the former approach tends to be adopted more frequently because this information is more accessible.

What’s more, some experts believe that the definition should vary according to the industry in which a firm operates, since the fundamental characteristics of each industry differs (e.g. manufacturing firms are generally larger than service firms). For instance, Industry Canada, in its bi-annual *Key Small Business Statistics* report, uses an SME definition that is based on the number of employees and varies according to whether the firm produces goods or services. In the service sector, a medium-sized firm would typically have more than 50 employees, while in the manufacturing sector, a firm would have more than 100 employees in order to be considered medium-sized.

BDC does not segment the SME market according to the industry but by the number of employees. For us, SMEs are firms that have from 1 to 499 employees. Companies with no employees or that have more than 500 employees are traditionally outside of our market.

The following three categories provide the most common and useful way to look at the SME market:

- 1) **micro firms** with 1 to 4 employees;
- 2) **small firms** with 5 to 99 employees; and;
- 3) **medium-sized firms** with 100 to 499 employees.

SMEs by size

Using this segmentation, we see that the vast majority of Canadian enterprises are in fact SMEs. In fact, close to 60% of employer businesses in Canada are micro firms with less than 5 employees.

	Size of firm (# of employees)	# of firms	% of firms	
99.7% Micro, Small & Medium	Micro	1-4	618,555	58.0%
	Small	5-99	422,404	39.5%
	Medium	100-499	23,021	2.2%
	Large	500+	3,149	0.3%
	TOTAL		1,067,129	100%

Source: Statistics Canada, Business Register, December 2006. Excludes enterprises without employees.

BDC’s portfolio is in line with the SME market with most clients being in the “micro” and “small” categories. We know from first hand experience that SME challenges and needs vary according to their size.

Let’s illustrate this with micro firms, which have different characteristics in terms of resources, level of management experience and stage of development. For example, micro firms have limited resources and are more likely to be in their start-up phase. This means that affordable advice and financing are of equal importance in building their companies.

In addition, based on our loan performance indicators, we see that companies reaching 100 employees go through a transition period where they experience more difficulties. This could be attributed to the fact that in order to continue operating and expanding, these companies may require a more complex management structure, which leads to a period of adjustment. Another possible explanation could be that costs rise more rapidly than sales when a firm is in a hiring mode phase. These observations highlight the importance of properly segmenting the SME population when developing financing and consulting solutions.

SMEs by industry

As illustrated in the following table, SMEs are active across virtually all sectors of the Canadian economy.

SME distribution by industry	%
Manufacturing	4.2%
Wholesale trade	5.1%
Transportation and warehousing	5.4%
Construction	11.5%
Professional, scientific and technical services	13.9%
Retail trade	9.3%
Agriculture, forestry, fishing and hunting	8.3%
Real estate and rental and leasing	8.3%
Other services	7.6%
Finance and insurance	4.8%
Administrative and support, waste management and remediation services	4.7%
Accommodation and food services	4.5%
Health care and social assistance	4.3%
Management of companies and enterprises	3.0%
Arts and entertainment	1.9%
Information and cultural industries	1.4%
Educational services	1.0%
Mining and oil and gas extraction	0.8%
Total	100.0%

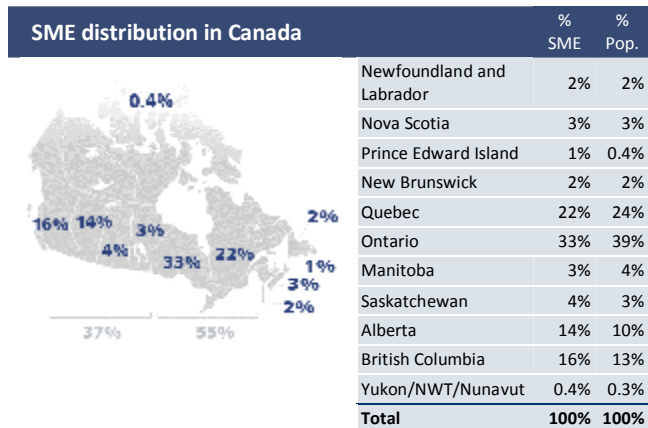
Source: Statistics Canada, *Business Register*, January 2007 (1-499 employees firms).

BDC's loan portfolio is heavily concentrated in the manufacturing industry. While manufacturing accounts for only 4.2% of Canadian SMEs, it represents 26% of BDC's clients and 34% of our financing portfolio value (\$3.7 billion as at December 31, 2007¹).

SMEs by region

The distribution of SMEs across the country is largely in line with the population distribution, with the largest proportion (55%) found in Ontario and Quebec. The next largest concentration is in the four western provinces, with 37% of SMEs, while 9% of Canadian SMEs are located in remaining areas.

¹ Including BDC Sub-Financing clients, excluding BDC Venture Capital clients.



Source: Statistics Canada, *Business Register*, December 2006 and Census 2006.

SME exporters

Exporters are of particular interest to BDC because of their significant and positive impact on economic growth and job creation. Micro and small firms represent the vast majority of Canadian exporters, with 85% with fewer than 100 employees. However, micro and small exporters are responsible for only 20% of the total value of Canadian exports. If you consider that medium-sized firms (from 100 to 499 employees) account for only an additional 15% of exports, it is clear that large firms (500+ employees) account for the bulk of the value of all Canadian exports (65%).²

Other key features of exporters are:³

- 4 The propensity to export is higher among SMEs in the manufacturing and knowledge-based sectors.
- 4 Taking into account the overall SME population in Canada (instead of the exporter population), only 8% of SMEs export goods or services outside of Canada's borders.

² Halabisky et al., *Small Business Exporters: A Canadian Profile*, Industry Canada, 2005.

³ Industry Canada, *Financing Profiles: Exporter SMEs*, September 2006.

Composition of Exporters by Size		
Employees	#	%
Less than 50 employees	32,607	73%
50 to 99 employees	5,816	13%
100 to 199 employees	3,736	8%
200 and over employees	2,810	6%
TOTAL Exporters⁴	44,969	100%

Source: Statistics Canada, *A Profile of Canadian Exporters: 1993 to 2004*, November 2006.

At BDC, we can see the real impact of the global economy on our exporting clients, many of whom are seeking niche markets. Today, the most pressing financing need for small exporters is working capital to help them bridge the gap between the Canadian market in which they operate and their targeted international market. Working capital helps SMEs to better manage their own cash flow and meet their day-to-day operating needs. Financing expansion in external markets is often more problematic for small firms because they have insufficient funding and lack loan collateral.

BDC draws from its own experience to provide the following insight on this segment.

- CE BDC's exporting clients generate an average of 33% of their sales from exporting activities.
 - 4 In fact, the vast majority of BDC clients export to the U.S. (93%), with 60% exporting exclusively to the U.S.
- Not surprisingly, the propensity to export is highest amongst manufacturing clients.
 - 4 Manufacturing accounts for 65% of BDC's portfolio of exporters, with 27% having exports accounting for more than 40% of total sales. The largest exporters are metal producers, wood producers, food processors, and equipment producers.
- Ž In the context of the rapid increase of the Canadian dollar against its U.S. counterpart:
 - 4 BDC's experience shows that company failure increases when exports sales rise over 40% of a company's total sales. While this trend is seen in manufacturing, wholesale and business services, it is by far more prominent in the manufacturing segment.
 - 4 Manufacturers that produce in Canada but sell in the U.S. have been impacted the most. This is because revenues, which are often paid in U.S. dollars, have decreased due to the lower value of the "greenback", and input costs, paid in Canadian dollars, have become more expensive.
 - 4 The impact on manufacturers is clear when you consider the make-up of BDC's impaired loans portfolio: 45% of impaired loans are to manufacturers. 68% of these impaired loans are to manufacturing exporters and 80%

are to those where U.S. exports account for 40% or more of their sales. It appears that SMEs have embraced exporting in recent years, but have overly relied on our close proximity to and ease of trade with the U.S. With lower productivity than the U.S., a stronger Canadian dollar, and increasing global competition, SME exporters who have focused on the American market are now feeling the consequences.

- There are further indications that the rapid rise in the Canadian dollar is having a significant impact.
 - 4 Among non-manufacturing clients, BDC is seeing a lower concentration of exporters than in previous years (76.3% currently do not export vs. historical levels of 72% to 73%).
 - 4 BDC is seeing changes in loan purpose for its exporting clients. In terms of exporters to the U.S., equipment financing is up approximately 20% since last fiscal year (indicating firms may finally be investing in productivity enhancing machinery), and loans for working capital are up 10%.

Also, changes in ownership have doubled historical levels, indicating that there may be some degree of consolidation amongst exporting SMEs, or more entrepreneurs seeking exit opportunities.

⁴ These figures, derived from the Exporter Register, present statistics on exporting establishments for the year 2004. Reconciliation with data from the SME Financing Survey, indicating that 8% of SMEs export, is not possible considering that data sources and methodologies differ.

SMEs by stage of development

For BDC, looking at the stage of development of SMEs helps us better understand the context in which they evolve. In turn, this enables us to tailor our services accordingly. Market data shows that start-ups represent approximately 5% of the SME population in Canada. Another SME segment that is of particular interest to BDC involves fast-growing businesses, which make up an estimated 13% of the SME population.⁵ These growth-oriented firms are key to economic growth and contribute disproportionately to job creation. However, they also tend to be riskier ventures with a greater probability of failure.

As shown in the following table entitled “Perceived Stage of Development – BDC Versus Marketplace”, BDC found that when comparing client responses to those of the SMEs in general (using the same methodology as in the Trois-Rivières study), we see more than twice as many clients who perceive themselves in the start-up and almost twice as many clients who perceive themselves in fast growth stage. This is not surprising since BDC attracts clients in underserved markets. For most financial institutions, start-up projects are considered extremely high-risk and there is very limited appetite to finance them if the entrepreneur lacks collateral. High-growth and innovative SMEs also face serious difficulties in securing financing for their growth plans. As these enterprises often have more intangible than tangible assets, they have difficulty securing financing from traditional financing sources. As such, they require larger amounts of unsecured financing.

Perceived Stage of Development – BDC versus Marketplace		
	SMEs*	BDC clients**
Slow or moderate	52%	44%
Fast	13%	23%
Start-up	5%	10%
Don't know/refused	0%	2%
Maturity	21%	18%
Winding down	9%	3%

Sources:

* Industry Canada, *SME Financing in Canada 2002* and independent report by l'Université du Québec à Trois-Rivières, based on SME perceived stage of development.

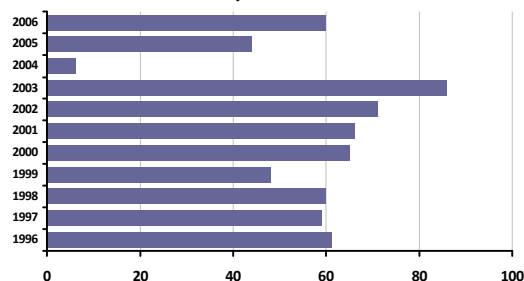
** *BDC Client Satisfaction Survey 2007*, based on client's own perception of stage of development.

⁵ The Research Institute for SMEs, Université du Québec à Trois-Rivières, *Financing SMEs: Satisfaction, Access, Knowledge and Needs*, 2002.

2. What is the contribution of SMEs to the Canadian economy?

Share of employment & job creation

Contribution of SMEs to the net creation of jobs in the private sector



Source: Statistics Canada, *Survey on Employment, Payrolls and Hours*, April 2007.

SMEs represent the largest share of businesses established in Canada and employ 64% of private sector employees, or 6.8 million people across the country.⁶ In 2006 (the last full year for which data is available), SMEs were responsible for 60% of jobs created. Generally, new firms entering the market are responsible for half of new jobs created.⁷

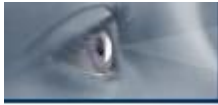
Contribution to GDP is significant

Since gross domestic product (GDP) is not available by firm size, it is very difficult to measure the true added value of SMEs in terms of net economic output (and avoid double counting). BC Stats, the government of British Columbia's statistical service, has developed a methodology to determine the small business contribution to GDP by province. Based on this methodology, 22% of Canadian GDP in 2005 was attributed to businesses with fewer than 50 employees. This highlights the fact that the contribution of SMEs to the national economy is not proportional to their share of the business population.

Statistics Canada is expected to release data on the GDP contribution by firm size in March 2008. We will then have a better sense of the added value produced by firms that have from 1 to 499 employees.

⁶ Statistics Canada, *Survey of Employment, Payrolls and Hours*, April 2007.

⁷ D. Halabisky, *The Growth Process: Job Creation by Firm Age*, Industry Canada, April 2007.



Economic impact of "high growth SMEs"

While the overall contribution of SMEs to economic growth and employment is evident, a small group of SMEs contribute disproportionately to Canadian economic growth.⁸ These high performers, often referred to as high-growth small and medium-sized enterprises⁹, create a disproportionate number of new jobs (1 million of the 1.8 million net jobs created in Canada from 1985 to 1999). They are also major contributors to innovation (mostly in IT and life sciences). However, research demonstrates that although high-growth SMEs have greater profit potential, they also represent more financial risk.¹⁰

Less than one-fifth (17%)¹¹ of Canadian SMEs are considered to be high-growth. The characteristics of these firms are:¹²

- 4 They tend to be concentrated in Ontario (38%) and Quebec (24%);
- 4 22% are medium-sized (100-299 employees¹³);
- 4 They are concentrated in the manufacturing, professional services and knowledge-based industries;
- 4 They are more likely to invest in R&D (34% compared to 25% for all SMEs); and
- 4 They are more inclined to apply for financing (31% compared to 19% for all SMEs).

⁸ Parsley and Dreessen, *Growth firms Projects : Key Findings*, Industry Canada, 2004.

⁹ High growth SMEs are defined as firms with cumulative sales increases of 50% or more over a three year period.

¹⁰ Fisher and Reuber, *Support for Rapid Growth Firms: A Comparison of the Views of Founders, Government Policy Makers and Private Sector Resource Providers*, Rotman School of Management, University of Toronto, 2002.

¹¹ There is a discrepancy between this result and figures previously cited. The difference in sources of data and growth criteria among various studies, as well as differing definitions, lead to divergences in findings, such as in the proportion of high growth firms in the SME population. The 17% comes from the 2001 *Survey on Financing of Small and Medium-sized Enterprises* from Statistics Canada. In the previous section on Stage of Development, we referred to 13% of Fast Growth firms. This percentage comes from a University of Québec in Trois-Rivières' Survey that measures the business owner's own perception of the evolution of its firms.

¹² Industry Canada, *High-Growth SMEs: Financing Profiles*, May 2006.

¹³ The definition of a medium-sized firm differs in this study.

3. What is the SME dynamic of creation, survival and growth in Canada?

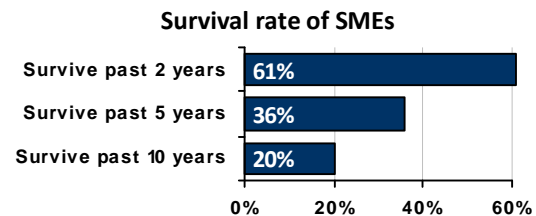
How many firms enter and exit the SME market?

Business creation is important since continued economic growth depends on both firm growth and new entrants. Each year, new SMEs are created and others wind down. Since the last recession in 1991, the number of "entries" on an annual basis ranged from 135,000 to 146,000, while the number of "exits" ranged from 130,000 to 135,000. This means that over the last decade, "net entries" are estimated to be between 10,000 to 15,000 employer businesses per year.

An interesting observation is that "exits" are more influenced by the business cycle than the slightly more stable "entries," which could be a sign of optimism among new SME owners. Furthermore, only a small proportion of firms that exit the marketplace end up filing for bankruptcy; on average, over recent years, there were approximately 12,000 business bankruptcies per year.¹⁴ Most "exits" can then be attributed to reasons such as mergers and acquisitions or businesses winding down.

What is the survival rate of newly created firms?

Running a business successfully is not an easy task. As seen in the following chart, the success rate of new ventures falls off dramatically over time. Research on business survival demonstrates that failure generally correlates to a lower level of management expertise and financial literacy amongst SME owners (in other words, managerial capacity).¹⁵ Later in this document, we will illustrate some of the factors that determine success rates, and provide some of BDC's insight on this matter.



Source: Baldwin et al., *Failure Rates for New Canadian Firms: New Perspectives on Entry and Exit*, Statistics Canada, 2000.

¹⁴ Statistics Canada, *Longitudinal Employment Analysis Program, 1991-2003*.

¹⁵ Baldwin et al., *Innovation Capabilities: The Knowledge Capital Behind the Survival and Growth of Firms*, 2006.

In its role as a development bank, BDC provides a great deal of support to new and aspiring entrepreneurs in Canada. In turn, we have a keen interest in trying to improve the survival rates of our start-up customers. In order to gain a more in-depth understanding of the main characteristics of start-ups, and to identify some key success factors, BDC sponsored an initial study of its start-up portfolio.¹⁶ This research analyzed 7,640 BDC start-up clients who received financing between fiscal years 1999 to 2006.

Key findings included:

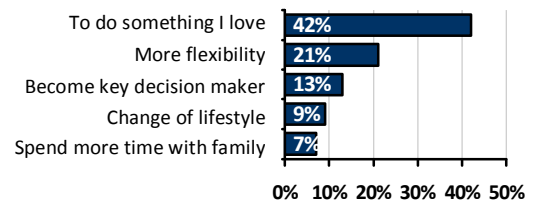
- 4 BDC start-up clients have a very high survival rate. A two-year survival rate of over 95% for our start-up clients compares very favourably with the average survival rate of 61% for Canadian start-ups for the same period.
- 4 BDC start-up clients who export and undertake R&D are 25% more likely to improve their financial performance than other start-up clients in the portfolio. This result is interesting when compared to the findings of the Financing Data Initiative ("FDI") surveys which show that these types of SMEs generally experience greater difficulty in accessing financing. Innovators and exporters are typically higher-risk ventures.
- 4 More than 20% of BDC start-up clients were able to repay their loans ahead of the scheduled repayment term. This was because they had achieved their business objectives early, or they had strengthened their balance sheet to a point where they were able to borrow additional funds from traditional financial institutions.
- 4 Within BDC's start-up portfolio, companies in the manufacturing and the business services sectors were more likely to succeed over time. In contrast, success was less likely for firms in non-business services, retail, tourism and wholesale sectors.

¹⁶ Conducted by the Canadian Innovation Centre (CIC), in conjunction with the University of Waterloo's Survey Research Centre (SRC), in 2007.

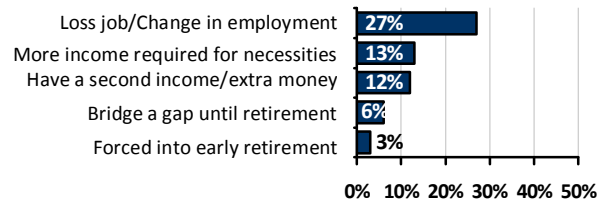
Why do people become entrepreneurs?

Small business owners play a key role in the development of their firms, so understanding what drives entrepreneurship is important to BDC. The survey results that follow show that a desire for autonomy is generally the main motivator for people to become entrepreneurs. Regardless of motivation, research by the Global Entrepreneurship Monitor demonstrates that both "necessity" entrepreneurs (those who started a business out of financial necessity) and "opportunity" entrepreneurs (those who started a business after they had identified a market opportunity) have equal chances of success.

...from a non-financial standpoint:



...from a financial standpoint:



Source: CIBC, *Secrets to Small Business Success*, 2004, 1,829 respondents from 1 to 15 employees.

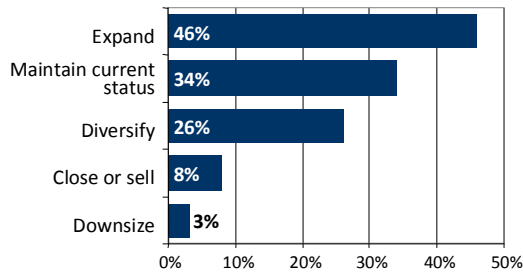
SMEs' growth intentions

Not all business owners plan to expand their businesses; in fact just under half of all entrepreneurs (46%) do. A significant proportion of entrepreneurs (34%) decide to simply "stay the course", while 26% choose to diversify their activities (e.g. add a service component to their manufacturing activities).

Reasons for growth (or for lack of growth) depend on the specific context of each small business and those of its owners. These reasons can generally be grouped in three categories:

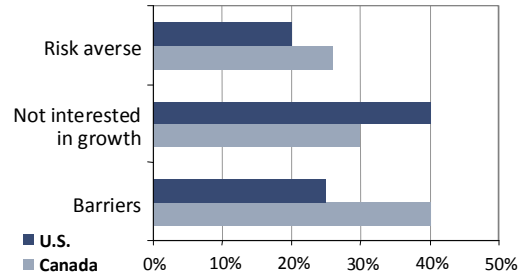
- 1) Barriers prevent the business from expanding (e.g. no market demand, shortage of labour, etc.).
- 2) Management's preferences (e.g. happy with the current size of the business, close to retirement, etc.).
- 3) The level of risk involved is too high to convince an entrepreneur to grow the firm.

Business plans for the next 3 years



Source: CFIB, *Building Business Success: A Survey of SMEs on Productivity*, April 2007, 8,010 respondents.

Reasons for not growing



Source: RBC, CME and CFIB, *The Path to Prosperity*, 2002.

4. Why do only some SMEs succeed?

The fact is, some SMEs fail while others succeed. Earlier, we alluded to the fact that managerial capacity has a great deal to do with the success and/or failure of a firm. Intangible capital such as specialized skills, innovation and technology management often prove to be the make or break factors for a firm's success or failure. Research also indicates that this "knowledge capital" contributes as much as physical capital does to a firm's success.^{17,18}

But what sets successful SMEs apart from their peers? To answer that question, BDC undertook an extensive literature review and validated research findings with its own operational experience; this invaluable knowledge was developed over the years by BDC employees who meet with SMEs every day. In fact, frontline employees at BDC can use these key success factors to help them assess the likelihood of whether or not start-ups firms will succeed.

New entrepreneurs often have little or no track record to rely upon and leverage. Therefore, BDC evaluates the individual's capabilities, the viability of the business project and the owner's commitment to the project, and relies much less on formula-based credit decisions. Furthermore, BDC has observed that most new entrepreneurs need management advice and "know-how" to start their businesses. A combination of lending and advisory services that enable these entrepreneurs to get their businesses started on the right footing is very important.

The key success factors identified by BDC fall into two main areas:

Entrepreneurship profile

- 4 Level of education (degree obtained)
- 4 Level of experience in the industry (number of years)
- 4 Level of business experience (number of years)
- 4 Quality of industry network (knows and works in partnership, with other key players)
- 4 Management team skill set and diversity (the management team is complementary or the owner is relying on key employees)

Project viability

- 4 Level of the initial investment (debt/equity ratio)
- 4 Ability to reinvest in the project (owner's financial capacity to reinvest as required)
- 4 Speed to closing sales (have sales already been made or not)
- 4 Industry type (growing or not)
- 4 Type of product/service (niche, mass or new product)

¹⁷ Baldwin and Gellatly, *Innovation Capabilities: The Knowledge Capital Behind the Survival and Growth of Firms*, Statistics Canada, 2006.

¹⁸ OECD Study Report, "Intellectual Assets & Value Creation", May 2006, and presentation to BDC by Mr. Nobuo Tanaka, then-Director for Science, Technology & Industry, OECD.

5. Are SMEs equipped to succeed?

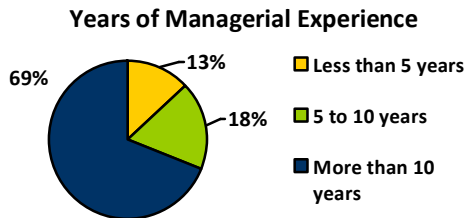
Let's now take a look at the various factors for managerial success, including education and experience, managerial practices, technology adoption rates and level of innovation/R&D.

Education and experience levels

A comparison between education levels of Canadian and U.S. managers demonstrates that Canadian managers have lower levels of education on average than their American counterparts. However, seven out of ten business owners in Canada have more than ten years of managerial experience.

Education	Canada	U.S.
Advanced degree education	11%	16%
Bachelor's degree	21%	32%
Some post secondary	40%	28%
High school	19%	21%
Less than high school	9%	3%

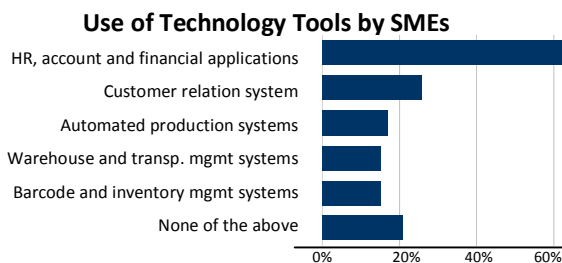
Source: Institute for competitiveness and prosperity (Roger Martin), *Agenda for Canada's Prosperity: Report on Canada 2007, 2007.*



Source: Statistics Canada, *Survey on Financing of Small and Medium Enterprises, 2004.*

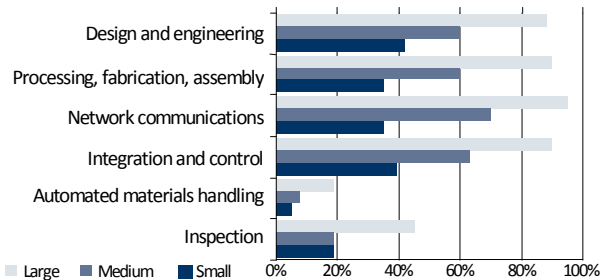
Managerial practices and technology adoption

SMEs, due to their size and more limited resources, tend to use less formal managerial practices than large firms. Often, the business owner takes on most of the responsibility related to HR and even sales. Technology adoption and productivity can also be key determinants in a company's success, and vary according to the size of the firm. Certain types of technology are more prevalent among SMEs and barriers to technology adoption are mainly linked to their more limited resources.



Note: Questions allowed for multiple responses.
Source: CFIB, *Building Business Success: A Survey of SMEs on Productivity*, April 2007, 8,010 respondents.

Technology adoption rates by size of establishment
% of plants using advanced technologies, 1998



Source: *Growth of Advanced Technology Use in Canadian Manufacturing during the 1990s*, John R. Baldwin, Ed Rama, David Sabourin (From: RBC, CME and CFIB, *The Path to Prosperity*, 2002).

Innovation and R&D

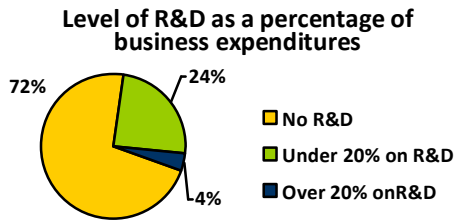
As indicated in the following table, the proportion of R&D expenditures as a percentage of company revenue generally decreases as size increases. While larger companies may contribute a smaller percentage of revenues towards R&D, the nominal amounts are substantial due to their much larger revenue base. Thus, for SMEs, R&D represents a trade-off: investing in R&D is beneficial but much more difficult for them to fund from their own resources. An investment in R&D is an investment in future prosperity, but comes at the expense of working capital that is often needed for day-to-day operations.

More than seven out of ten SMEs do not incur R&D expenditures. This is a concern, given the importance of ongoing product innovation, to a company's ability to remain competitive. One-quarter of manufacturers and exporters report that 25% or more of their total revenues are derived from new products introduced over the past three years.¹⁹

# of Employees	R&D expenditures as % of company revenues
1-49	5.8%
50-99	6.8%
100-199	5.3%
200-499	3.9%
500-999	4.3%
1,000-1,999	2.0%
2,000-4,999	2.0%
5,000+	0.8%
Total	2.1%

Source: Statistics Canada, *Industrial Research and Development*, January 2006.

¹⁹ Canadian Manufacturers & Exporters, "2007-2008 Management Issues Survey", October 2007.



Source: Statistics Canada, *Survey on Financing of Small and Medium Enterprises*, 2004.

Innovation and R&D are crucial for many manufacturers. However, manufacturers are more likely to be process innovators than product innovators. It is also interesting to observe that plants which are integrated into global supply chains are more likely to be innovative than those that are not.²⁰

Productivity

Research and BDC's own experience show that investment in technology and equipment has limited impact on productivity unless it is coupled with an investment in intangible assets. (For example, it is one thing to install a new piece of equipment, but it is of little use if employees are not sufficiently trained to use it productively). Investments in intangible assets include:

- 4 R&D
- 4 Business processes & organization re-design (process re-engineering, technology platform overhauls, etc)
- 4 Technical skills development (specialized competencies, labour force training, etc)
- 4 Management capability & skills development
- 4 Development of external contact networks (including global networks)
- 4 Adoption of industry best practices
- 4 Market development
- 4 Supply chain management & partnerships

Undoubtedly, the aging of the Canadian population will lead to a decline in employment. This means that the main driver of economic growth improvement and our standard of living will rest on our ability to increase our productivity. Lower productivity among

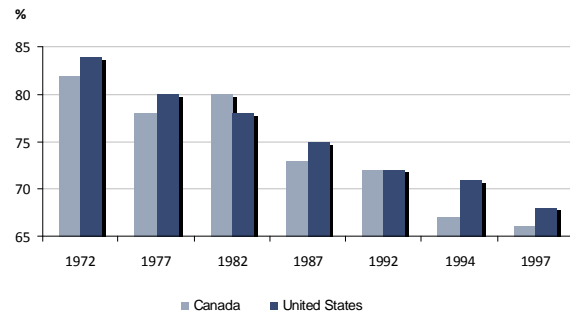
²⁰ Statistics Canada, *Survey of Innovation*, 2005.

Canadian small firms compared to American ones is partly responsible for the productivity gap²¹. However, there is some good news. According to a survey of CFIB members, investment strategies undertaken by SMEs in order to improve their efficiency are based on balanced investments in both capital and human resources.

SMEs need encouragement to improve their productivity in order to compete in a global economy. Upgrading and modernizing facilities, equipment and processes contribute to increased competitiveness. SME manufacturers, in particular, are finally realizing the importance of improved productivity. In turn, BDC provides specialized financing and consulting solutions to help them. At BDC, we are seeing:

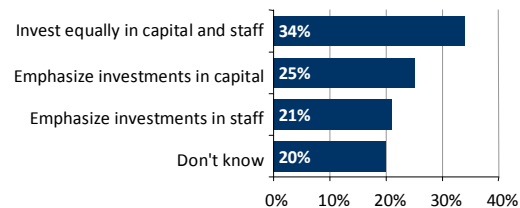
- 4 Increased levels of machinery and equipment financing.
- 4 Increased demand for operational efficiency diagnostics and consulting mandates (e.g. "lean manufacturing").

Small business productivity – Manufacturers
% of industrial average



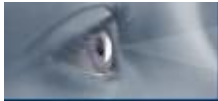
Source: RBC, CME and CFIB, *The Path to Prosperity*, 2002

Investment strategy for the next 3 years



Source: CFIB, *Building Business Success: A Survey of SMEs on Productivity*, April 2007, 8,010 respondents.

²¹ The productivity gap between U.S. and Canadian firms is substantial. Statistics Canada clearly reflects that Canadian firms invest substantially less into productivity enhancing machinery and equipment than their U.S. counterparts. Moreover, it is a lack of investment in information and communications technology (ICT) which accounts for most of this gap (e.g. computers, peripherals, software, automation, etc.).



Canadian SMEs have traditionally relied on an abundance of skilled and relatively cheap labour to fuel productivity improvements over the last years; however, with the rapid increase in the Canadian dollar, a shortage of skilled labour and increasing labour input costs, this is no longer the case. Through our dealings with clients, we see that productivity enhancement is more than just the acquisition and installation of new equipment. To become more productive, SMEs need to:

- 4 Review their business processes & organization.
- 4 Get connected with suppliers and clients to become more agile in production.
- 4 Form strategic partnerships with suppliers – extend reach and achieve economies of scale to become more cost-effective. Use of logistics experts is beneficial.
- 4 Consider having more than one supplier (even if it costs more), if this reduces risk.
- 4 Remember that a weak link in a supply chain can make or break a company trying to compete.

BDC believes that recent economic and global market developments indicate a much higher need for productivity enhancement programs. As well, SMEs have to penetrate new markets and ensure their place in global value chains.

6. What are the challenges confronting SMEs?

Canada's SMEs are operating in the context of a dramatically changing business environment in which they face increased global competition resulting from global restructuring. As SMEs struggle to adapt to this changing environment, they also face challenges where they will require help from professionals. Where there is adversity, there is also opportunity. For those SMEs that can successfully adapt, there will be new market and product/service opportunities.

Main issues facing all SMEs

Regardless of where they operate, all SMEs face certain challenges due to recent economic and market developments, as well as the nature of the Canadian SME market. In the next table, we present a summary of these forces, and in the following sections, we will delve into more detail by examining the results from various survey tools.

Recent economic developments & prospects
4 The pace of economic change is accelerating.
4 Shifting economic trends and the rising influence of emerging economies.
4 A major shift of productive capacity toward the Far East, primarily due to lower labour costs.
4 A strong domestic economic environment, but with growth outlook highly uneven by region and sector.
4 A rapid appreciation in the Canadian dollar.
4 Escalating costs of natural resources and energy.
4 A period of adjustment and uncertainty in the U.S. economy, including a significantly weaker U.S. housing market.
4 An aging national labour force and a shortage of skilled labour across several regions.
4 Lagging productivity trends.

SME challenges
4 Access to financing – innovators, manufacturers & exporters have more difficulty in accessing adequate financing, which impedes their business growth.
4 Access to international markets (awareness, managerial capacity, financial capacity, structural).
4 Regulations that deter trade and labour mobility.
4 Environmental (resource constraints, more stringent standards & regulations, necessary actions to take for the future).
4 Business value - meeting customer and investor expectations (capacity & productivity constraints, operating in a socially & environmentally conscious manner).
4 Workforce demographics (shortage of skilled labour is critical).
4 A divergent economy (differing opportunities & challenges across the country).
4 The escalating value of the Canadian dollar (particularly for manufacturers and exporters).



Issues facing manufacturers

In its annual survey, Canadian Manufacturers & Exporters (CME) monitors the pulse of its members and asks them about the most pressing challenges they are facing. In the current context of high commodity prices and strong Canadian currency, it is not surprising to see that "keeping costs under control" and "responding to dollar appreciation" are at the top of the priority list.

In particular, Canadian manufacturers and exporters have cited that support is needed in the areas of:

- 4 Improvements in operational efficiency
- 4 Skills shortages
- 4 Market development
- 4 Supply chain management

Barriers to exporting

According to the OECD, SMEs have identified the following top 10 barriers to access international markets. BDC finds that most of them are applicable to Canadian SMEs:²²

- ☒ Shortage of working capital to finance exports.
 - Difficulty in identifying foreign business opportunities.
- ☒ Limited information to locate/analyze markets.
 - Inability to contact potential overseas customers.
 - Difficulty in obtaining reliable foreign representation.
- ☒ Lack of managerial time to deal with internationalization.
- ☒ Inadequate quantity of and/or untrained personnel for internationalisation.
- ☒ Difficulty in matching competitors' prices.
- ☒ Lack of home government assistance/incentives.
- Excessive transportation/insurance costs.

Business planning needs



Source: CRA, *SME Needs Assessment Study, 2002*. Conducted with BDC Consulting managers on behalf of BDC.

²² Source: OECD, *Removing Barriers to SME Access to International Markets*, November 2006.

Future business challenges

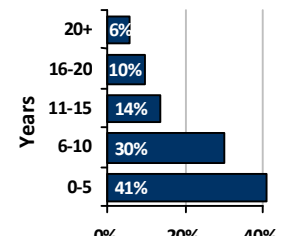


Source: Canadian Manufacturers & Exporters, *2007-2008 Management Issues Survey*, October 2007, 1,014 respondents.

Transition planning

Transition or succession planning is an inevitable question that SME owners will have to plan for and address. This is particularly important considering that most of them will rely on the sale of their businesses to ensure their retirement income. As well, many jobs and the future viability of companies will be at risk if the transition of ownership is not planned carefully.

When do SME owners plan to exit their business?



Source: CFIB, *Succession Can Breed Success*, June 2005.

Unfortunately, surveys point to the fact that most entrepreneurs are not preparing a transition plan. Indeed, according to CFIB, 65% of entrepreneurs have no succession plan, and among those who have one, only 51% have chosen their successor.

The growing number of businesses changing hands for obvious demographic reasons has already had an impact on BDC's portfolio. The level of financing provided to SMEs for change of ownership increased by 39% from December 2006 to December 2007.

Business planning needs

Proper business planning is key to long-term success, and often SME owners need outside professional help to better manage their companies. Based on a survey conducted with experienced BDC Consulting managers, who have carried out hundreds of mandates with clients, SME needs are broad and can be ranked in the order as illustrated in the facing chart.



Access to financing

The type of financing required by SMEs varies according to their short or long-term needs (e.g. acquisition of building or equipment, additional working capital to develop new markets, new equity investment, etc.).

Entrepreneurs often rely on their own personal capital or money from their peers ("love money") when they start a business. For instance, start-up SMEs are more likely to use informal sources of financing such as personal savings (77% for start-ups, compared to 57% for established SMEs). For most SMEs who turn to external financing, their primary source of debt financing comes from their regular financial institution (i.e. where they have developed a relationship based on day-to-day activities in their current account and ongoing use of a credit card or line of credit).

In recent years, and despite current, tighter credit conditions²³, access to debt financing has generally been favourable for SMEs, who experience an overall financing approval rate of approximately 81%.²⁴ However, certain sub-groups of SMEs face substantially more challenges in obtaining the funding they need. BDC focuses its efforts on those groups that have more problems obtaining financing.

SME financing approval rates		
Market segment	%	Reason
Overall – all SMEs	81%	
Exporters	76%	Potential risks associated with exporting
Manufacturers	64%	Structural challenges (strong Canadian dollar, higher cost of commodities, competition from emerging countries, decreasing demand in the U.S.)
Innovative firms (expenditures represent more than 20% in R&D)	56%	Reliance on intangible assets which are given little or no security value by most financial institutions
Younger firms (less than 2 years old)	66%	Risk involved with new ventures (start-ups), limited experience and credit history

Source: Statistics Canada, *Financing Data Initiative Survey*, 2004.

²³ See the Bank of Canada's *Business Outlook Survey* of Winter 2008 later in this document.

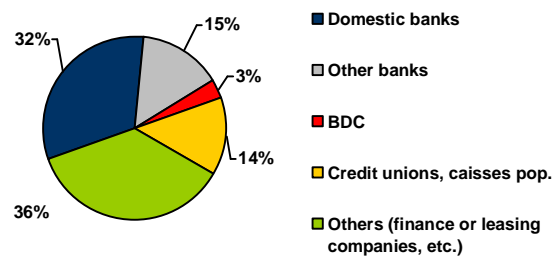
²⁴ Statistics Canada, *Financing Data Initiative Survey*, 2004.

Term debt outstanding for SMEs

BDC Financing only offers term debt. In 2004 (the latest year available for the demand-side of FDI data), 18.5% of all SMEs sought debt financing, of which 48.9% requested term and mortgage loans.

Based on the supply-side survey of the FDI data, BDC's term debt market share was estimated to be 3.4% in 2005 (out of a total of \$255B).

Suppliers of term debt in 2005
(% of amount outstanding, \$B)



Source: Statistics Canada, *Survey on Financing of Small and Medium Enterprises (supply-side)*, 2005.

7. SME outlook

There are a number of surveys monitoring the level of confidence of business owners. The main surveys that we rely on are provided on a quarterly basis by the Bank of Canada and the Canadian Federation of Independent Business. Statistics Canada also produces a similar survey which is useful, as it deals more specifically with the manufacturing sector.

Bank of Canada Business Outlook Survey (Winter 2008)

In general, companies remain positive about the outlook. The zero balance of opinion on future sales growth indicates that, overall, firms expect sales to increase at the same pace over the next 12 months. Expectations of solid domestic demand are helping to offset the dampening effect of the most recent appreciation of the Canadian dollar and a weaker outlook for U.S. economic growth on firms' sales expectations.

The balance of opinion on credit conditions indicates a tightening in firms' terms and conditions for obtaining financing over the past three months. Most companies attributed the tightening to a market-wide re-pricing of risk. The shift in the balance of opinion

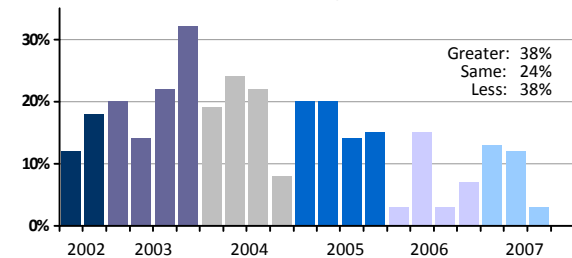


from a position of "easing" to one of "tightening" occurred in the autumn survey. This largely reflects the impact of the credit-related financial market turmoil that began in August 2007.

The following charts show answers to two questions:

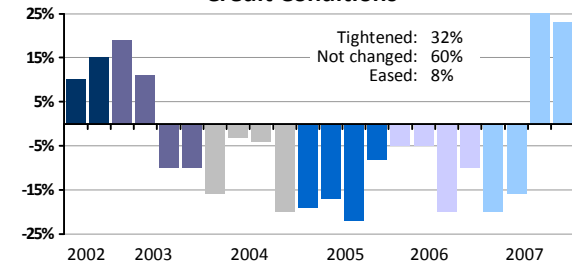
- 4 Future sales growth: *Over the next 12 months, the rate of increase in your firm's sales volume (compared with the past 12 months) is expected to be...*, plotted as a balance of opinion (percentage of firms expecting faster growth minus percentage expecting slower growth);
- 4 Credit Conditions: *Over the past 3 months, how have the terms and conditions for obtaining financing changed (compared with the previous 3 months)*, plotted as a balance of opinion (percentage of firms reporting tightened minus percentage reporting eased).

Future sales growth



Note that the balance of opinion for 2007Q4 is zero.

Credit Conditions



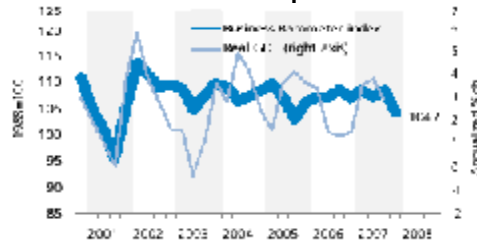
Note that 25 firms had no response to this question.

Source: Bank of Canada, *Business Outlook Survey*, Winter 2007-08. The survey was conducted from November 15 to December 14, 2007. It summarizes interviews conducted by the Bank's regional offices with the senior management of about 100 firms selected in accordance with the composition of Canada's gross domestic product.

CFIB Business Barometer Index

The CFIB quarterly survey is particularly focused on SMEs. Results from CFIB's latest quarterly survey on business expectations show that the Business Barometer® index fell sharply to 104.2 in December from its September level of 108.4. The index is at its second lowest level since 2001. It seems that echoes from this summer's earlier financial market volatility, together with concerns about the health of the U.S. economy, appear to have reached Canada's SMEs.

Business Expectations

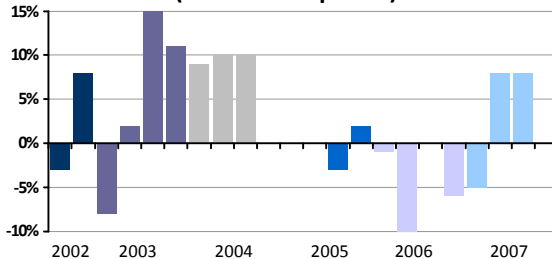


Source: CFIB, *Business Barometer*, December 2007, 1,751 respondents. Findings are based on 1,751 responses, collected between November 21 and December 5, to a survey on own-business expectations.

Statistic Canada Quarterly Manufacturing Conditions Survey

Despite increased pressure from the rising Canadian dollar, manufacturers remain overall bullish about production and employment prospects in the third quarter of 2007. However, given the events surrounding the Canadian dollar in November, the next quarterly survey will be important to gauge the impact on manufacturers.

Expected volume of production for next 3 months (Balance of opinion)



Source: Statistics Canada, *Manufacturing Conditions Survey*, October 2007.

BDC's loan portfolio outlook (as at December 31, 2007)

Since BDC's loan portfolio is composed of quite small businesses, it could be considered a leading indicator on the health of the economy. Certainly, chances of failure are higher for smaller firms when there is a recession.

All of our internal indicators continue to reveal a portfolio that remains relatively steady at a strong quality performance level. Generally speaking, our clients have been able to absorb the effect of the exchange rate and other negative economic news. However, some recent developments have occurred:

- 4 Delinquency rate (arrears of payments for more than a month):
 - BDC delinquency rate remains at an extremely low level (the peak during the past 10 years was 2001 at 4.9%).
 - Tourism and resources sectors are experiencing more challenging conditions than other sectors, although these sectors have very respectable rates.
 - Manufacturing has worsened a little; however those sectors that export are experiencing more difficulties.
 - Transport (considered by BDC as a lead indicator of its own portfolio)²⁵ slightly deteriorated during Q4 compared to Q3, but is much better than last year.
- 4 Impaired loans (when repayment is unlikely) remains at a very low level. However, BDC witnesses that impaired rates tend to increase with clients whose exports account for more than 40% of their sales.

As well, BDC's Working Capital Early Warning System (WCEWS), based on credit bureau reports from our clients, deteriorated very slightly in Q4 of 2007. In particular, there was a slight shift in the transportation sector, which nonetheless remains at a low level. The WCEWS is a BDC custom index that is the main lead indicator of the future evolution of the portfolio. It is a proxy for a business' current cash flow and working capital situation.

²⁵ Anecdotal evidence suggests that small transport companies are the first BDC clients to feel the impact of an economic downturn, as shipments drop off.

Conclusion

We hope this first issue of *Entrepreneurial Insight* provides you with a better understanding of the challenges that Canadian SMEs face today, their vital contribution to the economy and the factors that influence their success.

Here are some of the key take-away points in this issue:

- 4 Most Canadian enterprises are SMEs and are very present in all industries and all regions of the country.
- 4 SME characteristics and needs are better understood when companies are segmented (e.g. according to size, stage of development, etc.).
- 4 Their contribution to the economy is significant, more specifically for newly created ventures and high-growth firms.
- 4 Survival and growth is not an easy task. This means that investments in managerial capacity and other intangible assets are as important as physical capital.
- 4 SMEs face specific challenges related to their size. Their external financing needs and access to financing vary, as well as their investment capacity.
- 4 Despite constant changes in economic conditions that require on-going adjustments, SMEs generally show optimism and resilience.

To conclude, SMEs face a considerable number of external and internal challenges that often prevent them from achieving their true potential in this increasingly competitive and globalized marketplace. As Canada's development bank for SMEs, BDC has an important role to play by helping them reach their full potential and providing entrepreneurs invaluable experience and support.

You can also look forward to hearing more from us. BDC is planning to supplement this *Entrepreneurial Insight* with subsequent issues, which will be shorter and provide a more in-depth look at specific topics. We believe that BDC's added value here is being able to draw on our day-to-day experience with our clients.