

## A CHALLENGING YEAR

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The past year has been challenging. Numerous issues have battered SME confidence such as inflation, the strong Canadian dollar, a weakened US economy, sagging consumer confidence, and job losses in the manufacturing sector. Canadian entrepreneurs, known for their eternal optimism, have begun to waver. A year ago, 15% of SMEs were expecting weaker performance for their business. Today that number has jumped to one in four (25%) businesses (CFIB—June 2008).

This growing pessimism is based on both a sagging confidence in the economy at large and on direct business experience. The Small Business Research Board Canadian Small Business Confidence Index dropped 15.4% between Q2 2007 and Q1 2008. The top reason cited for this drop was “Economic Conditions”.

In June 2008, the CFIB Quarterly Business Barometer, another measure of SME confidence confirmed this ever-deepening level of concern when it reached its lowest index level (100.7) since the third quarter of 2001.

It is not just a perception issue either. SMEs have experienced real challenges first-hand. Twice as many businesses reported weaker performance over the last 12 months than had anticipated it. Even among those that experienced growth it was not what was expected. In June 2007, nearly half (49%) believed they would have stronger performance. However a year later, when they reflected on the previous twelve months, only 37% of SMEs could boast of any sort of improvement.

	Expectation for next 12 months (%) (June 2007)	Experience from past 12 months (%) (June 2008)
Much weaker	3	8
Somewhat weaker	12	23
About the Same	36	32
Somewhat stronger	40	29
Much stronger	9	8

### Energy

The biggest single issue identified as negatively impacting business performance is energy costs. Gasoline prices have reached a level that nearly every small business in Canada is feeling the negative effect. Between December 2007 and June 2008, the CFIB found that the percentage of businesses suffering under rising energy prices skyrocketed from 62% to 82%. This response rate dwarfed any other business concern. Of course it is an issue that not only affects an entrepreneur’s business but his personal life as well.

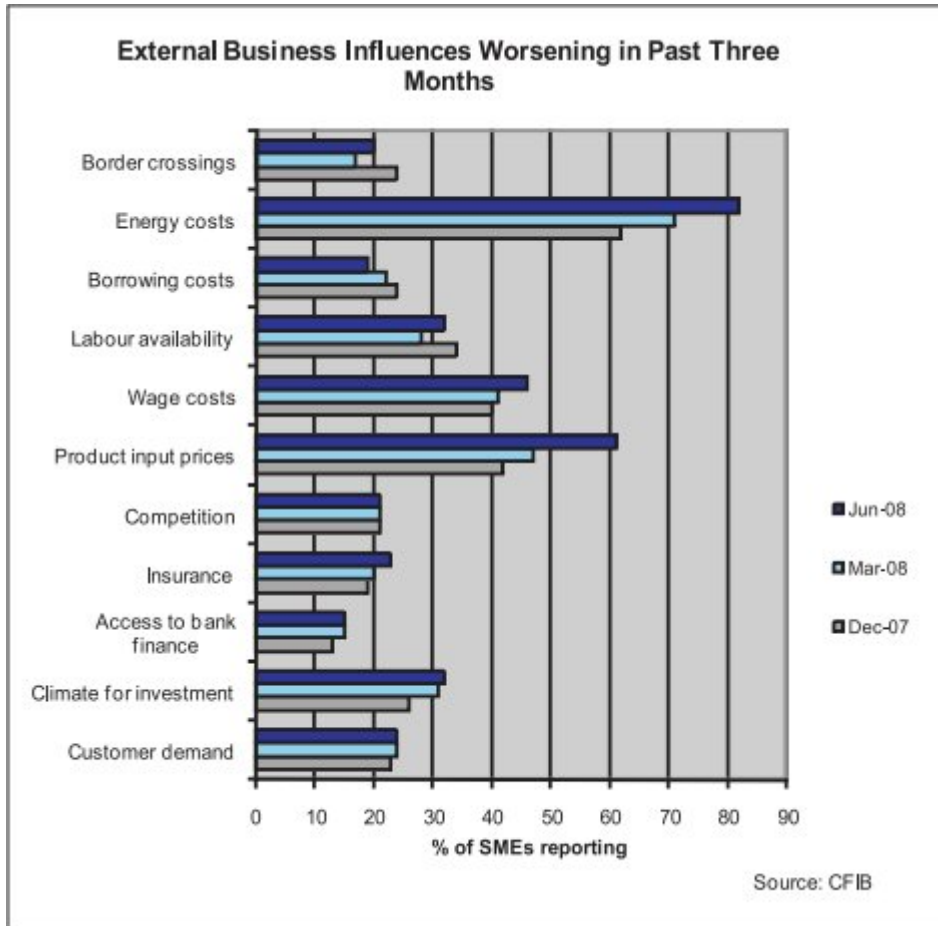
The options available to small businesses that did not anticipate the impact of such energy increases are limited. The easiest action and consequently most popular is to raise prices. While this can be a quick solution to cash shortages, it is not likely sustainable in the long-term as energy prices continue to rise.

Other businesses are attempting to deal with the crisis by reducing other costs. In a separate survey of sales professions, more than half (53.5%) indicated that they are decreasing the number of trips or sales calls they make. This is likely in response to the fact that many businesses are not providing assistance to their sales force. Only 35% of companies have raised their mileage or car allowances in the past two years. (LeapJob—July 2008)

<b>SME Business response to fuel prices</b>	
1	64% Raising prices
2	53% Reducing other costs
3	45% Reducing business travel
T-4	23% Adding or increasing shipping/handling costs
T-4	23% Eliminating routes or reducing length of delivery routes
T-4	23% Boosting miles per gallon efficiency on existing vehicles
T-5	20% Ordering fewer materials
T-5	Ordering materials from sources closer to the business operations
Source: SBRB May 2008	

The concern with most of these actions is that it will not be long before they will directly impact sales levels. Constantly raising prices and cutting back on sales calls will eventually have consequences.

It is worth noting that boosting energy efficiency and sourcing locally—changes in operations not just spending— are only considered by a few companies as viable responses. Of course, both of these are strategies as opposed to reactions.



	Dec-07	Mar-08	Jun-08
Customer demand	23	24	24
Climate for investment	26	31	32
Access to bank finance	13	15	15
Insurance	19	20	23
Competition	21	21	21
Product input prices	42	47	61
Wage costs	40	41	46
Labour availability	34	28	32
Borrowing costs	24	22	19
Energy costs	62	71	82
Border crossings	24	17	20

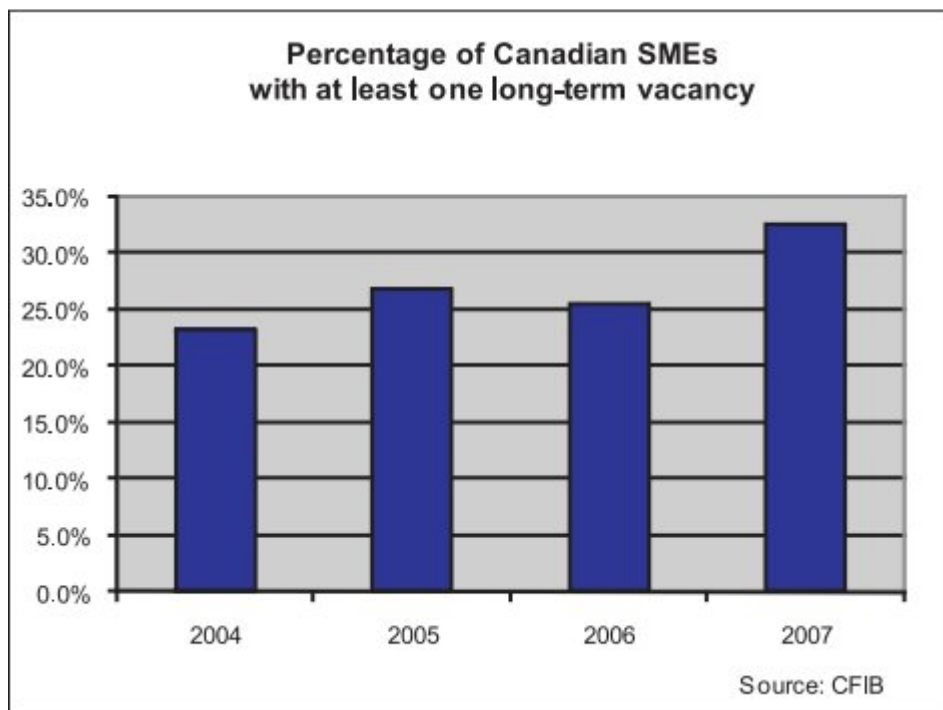
In addition to energy prices, SMEs also identified rising product input prices as a significant factor. Between December 2007 and June 2007 the percentage of businesses negatively affected on this issue

rose from 42% to 61%. These rising input costs are also likely related to increases in energy costs, as producers pass on their own increased costs. The end result is that SME margins are being squeezed from a number of different directions.

### Labour

In addition to external issues, Canadian SMEs are also facing a number of chronic internal challenges. The most significant among these is labour. Time and time again, small businesses identify finding qualified labour as a significant problem.

The percentage of SMEs as a whole with long-term vacancies has continued to grow over the last four years. It is estimated that in 2007, 309,000 jobs were unfilled in the Canadian SME sector. Nearly one-third of all SMEs had at least one long-term vacancy.

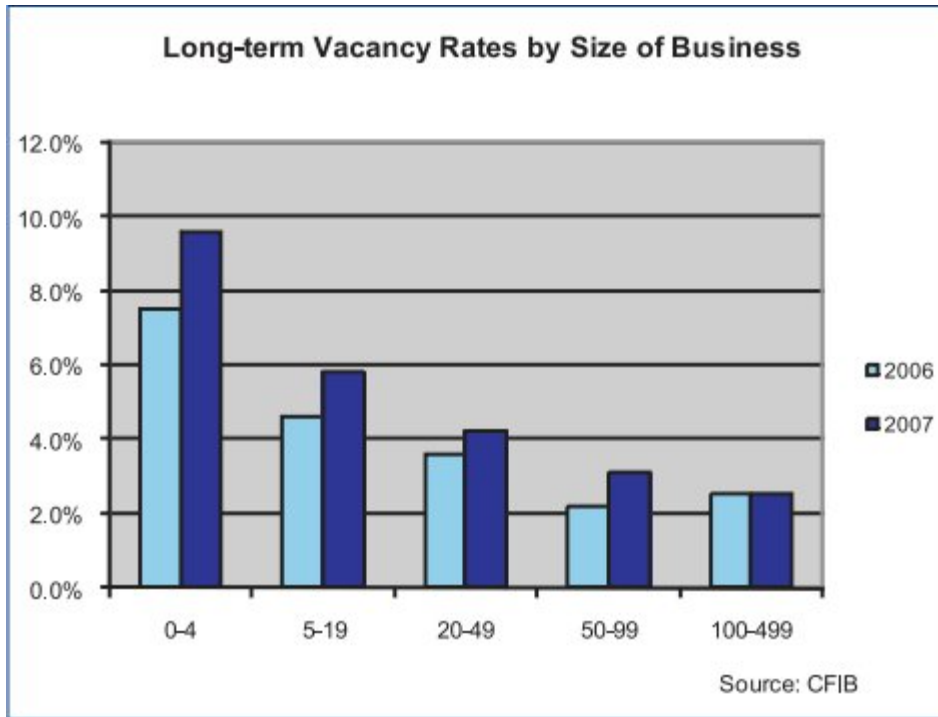


2004	23.20%
2005	26.80%
2006	25.50%
2007	32.50%

Micro businesses (0-4 employees) have found it particularly challenging to fill skilled positions. The long-term vacancy rate for businesses in this category has consistently been the highest among all SME groupings and has grown from 7.5% in 2006 to 9.6% in 2007.

	2006	2007
0-4	7.5%	9.6%

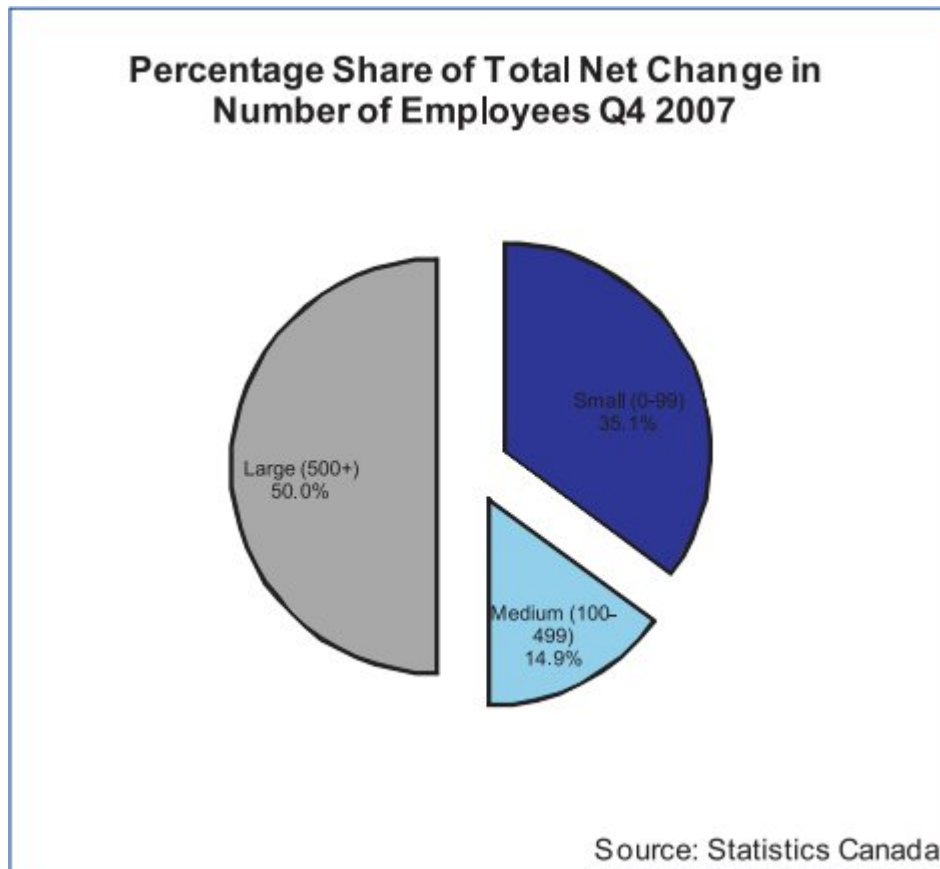
5-19	4.6%	5.8%
20-49	3.6%	4.2%
50-99	2.2%	3.1%
100-499	2.5%	2.5%



For many micro businesses though, filling vacant positions was the least of their worries in 2007. Many were actually forced to downsize their existing workforce. In Q4 2007, there was a net loss of 7,818 jobs in this business-size range.

Total Net Change in Number of Employees Q4 2007 by Business Size	
Employee-size	Absolute Change (Jobs)
0-4	-7,828
5-19	60,490
20-49	38,219
50-99	21,298
100-299	27,573
300-499	20,131
500+	160,058

Source: Statistics Canada



Luckily for the Canadian economy, the rest of the SME sector picked up the slack and managed to still account for 50% of the net new number of jobs in Canada. The sector actually produced 1,398 less net new jobs than a year earlier but given the challenges, the contribution was significant.

### **Business Counts**

Despite the fact that most SMEs now acknowledge the severity of the current economic situation, some economists feel Canadian small businesses are still not taking the situation seriously enough. The vast majority of SMEs (92%) believe they can withstand any financial difficulties. In fact, two-thirds of these businesses are so confident that they do not have any contingency plan in place in the event of a prolonged economic downturn (BMO—April 2008).

For those businesses that have a contingency plan, most intend to deal with financial challenges by using business savings. Over 40% of entrepreneurs say they are prepared to use their own personal savings in the event of financial difficulties. The next most popular “contingency plan” is to identify inefficiencies and addresses challenges by streamlining processes. Experts believe that small businesses need to develop more comprehensive strategies if they are to navigate through current conditions.

PwC recommends six key long-term and three short-term strategies:

### **Long-Term Strategies**

1. Know and focus on your core strategic advantages
2. Identify your key customers—and their risks to you
3. Prepare for the actions of your competitors

4. Develop a detailed budget model and update it frequently
5. Use a systematic approach to identify potential cost-cutting areas
6. Protect your liquidity

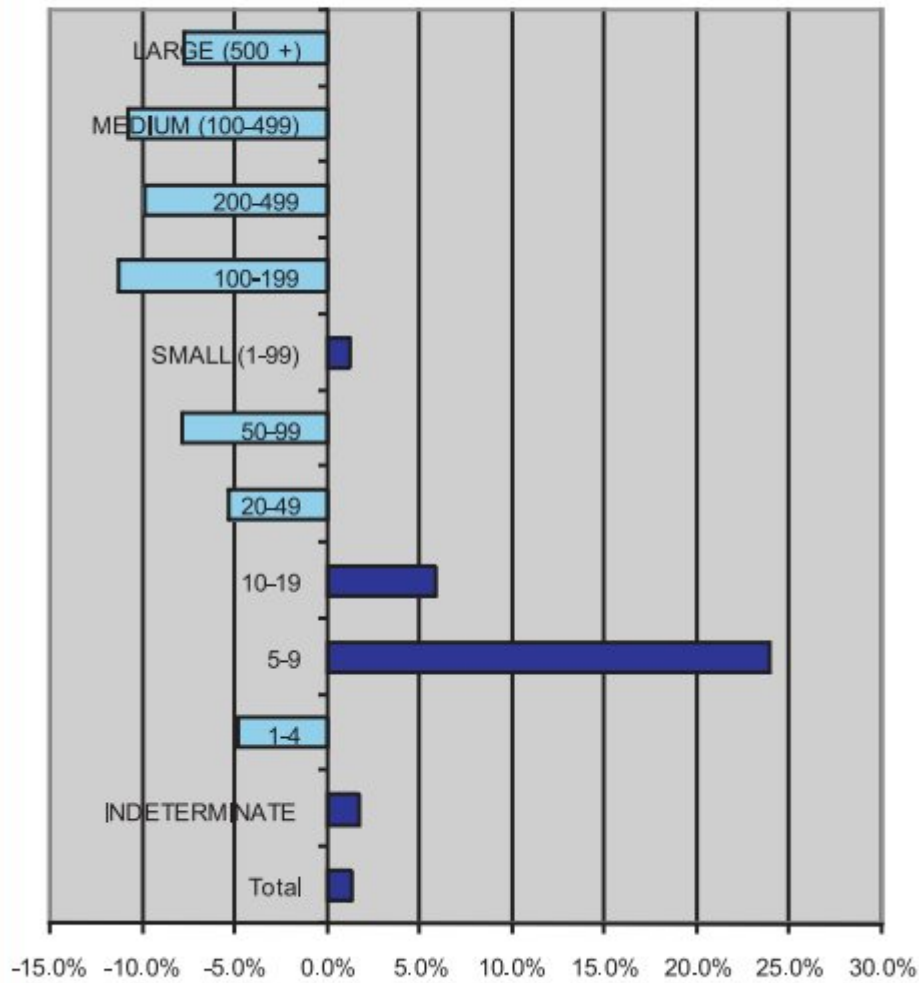
### **Short-Term Strategies**

1. Be careful with new customers or large orders from existing customers
2. Actively monitor your existing customers' accounts receivable balances
3. Prepare weekly cash flow forecasts

For some small businesses, the consequences of not having a comprehensive contingency plan have already been realized. The net number of businesses in Canada dropped between 2006 and 2007 in nearly every business size range.

Micro (-4.8%), medium (-10.8%), and large firms (-7.8%) all had net losses in their business counts. The only size groupings with significant growth were businesses with 5-9 employees (23.9%) and 10-19 employees (5.9%). Together these two groups nearly single-handedly fuelled the 1.3% growth in total number of businesses to 2,342,029. (*Statistics Canada*)

### Percentage Change in Business Counts by Employee-size range (2006 vs 2007)



Source: Statistics Canada

Total	1.3%
<b>Indeterminate</b>	<b>1.7%</b>
1-4	-4.8%
5-9	23.9%
10-19	5.9%
20-49	-5.3%
50-99	-7.8%
<b>Small (1-99)</b>	<b>1.2%</b>

100-199		-11.2%
200-499		-9.8%
<b>Medium (100-499)</b>		<b>-10.8%</b>
500 +		-7.8%
<b>Net Change in Business Counts (2006 vs. 2007)</b>		
<b>Indeterminate Businesses</b>		
<b>Rank</b>	<b>Fastest Growing</b>	<b>Fasting Declining</b>
1	Miscellaneous Intermediation	Beef Cattle Ranching and Farming, including Feedlots
2	All Other Financial Investment Activities	Animal Combination Farming
3	Real Estate Property Managers	Real Estate Agents
<b>Small Businesses (1-99 employees)</b>		
<b>Rank</b>	<b>Fastest Growing</b>	<b>Fasting Declining</b>
1	Offices of Physicians	Miscellaneous Intermediation
2	General Warehousing and Storage	Administrative Management and General Management Consulting Services
3	All Other Professional, Scientific and Technical Services	Lessors of Non-Residential Buildings (except Mini-Warehouses)
<b>Medium Businesses (99-499 employees)</b>		
<b>Rank</b>	<b>Fastest Growing</b>	<b>Fasting Declining</b>
1	Supermarkets and Other Grocery (except Convenience) Stores	Lessors of Non-Residential Buildings (except Mini-Warehouses)
2	Aboriginal Public Administration	Miscellaneous Intermediation
3	Religious Organizations	Residential Building Construction
Source: Statistics Canada		

The industries with the fastest growth and most severe declines were not those usually expected. The Internet and IT were absent from all top rankings.

Among indeterminate businesses (businesses without full-time employees), Venture Capitalists (Miscellaneous Intermediation) led the way in net growth. Interestingly, larger VCs in the small and medium business categories were among the worst performing in net business counts. The greatest declines among indeterminate businesses were cattle and animal combination farms as well as real estate agents without full-time employees.

Among small businesses, doctors' offices were the leaders followed by general warehouse and storage, while consultants and lessors of non-residential buildings were among the hardest hit by the year's challenges.

The medium-size category saw an odd and unexpected collection. Supermarkets, aboriginal public administration, and religious organizations top the list of net gains, while lessors of non-residential buildings and VCs figure prominently among the losers.

### **New Entrepreneurs**

Despite the challenges of the last year, Canadians have not lost their entrepreneurial spirit. In fact, 3.3 million Canadians are planning to start a new business within the next five years (RBC/Ipsos—Aug 2007). The most popular sector for women is Personal services/Arts/Crafts with more than one in five (22%) indicating they plan to operate in this sector. Men are more inclined to start a business in Construction/Trade/ Manufacturing (12%) or in Internet/Online Services (12%).

Most of these aspiring entrepreneurs expect their biggest challenge will be finding financing. Existing business owners however recall other much more significant challenges at startup. First and foremost was finding clients and developing their market, as indicated by nearly half (48%) of entrepreneurs. This was followed by keeping a steady workload (31%) and working long hours (28%).

The top three tips existing entrepreneurs have for aspiring entrepreneurs are:

1. Know the competition
2. Develop a business plan
3. Research the market

The challenges faced by SMEs over the last year are formidable and by all indications long-term. They will not disappear overnight. Business operations will need to be adjusted to meet this new reality. Contingency plans will need to be comprehensive and realistic. Optimism alone is not enough. More than ever Canadian entrepreneurs will need to rely on their persistence, determination, and most importantly, their confidence in success.

John has been helping Canadian entrepreneurs find market and industry data since 1997. His two websites [gdsourcing.com](http://gdsourcing.com) and [statslinkcanada.com](http://statslinkcanada.com) provide comprehensive and economical research assistance.