Intelligence MEMOS

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To: Small Business Watchers

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Re: **Solving Canada's SME Financing Conundrum**

Canada's small and medium-sized enterprises (SMEs) play an out-sized role in generating jobs and promoting economic prosperity. Even so, Canadian growth-oriented SMEs lag behind those of other advanced countries and face financing hurdles, in raising debt and attracting equity investments.

Our new C.D. Howe Institute **Commentary** provides an overview of the state of SME financing, aiming to offer a better understanding of the nature of SME growth, and the barriers they face in accessing finance and gaps present in Canadian financial markets. We also offer public policy recommendations that might facilitate access to the kinds of financial capital necessary to increase job-creating growth.

The birth and growth of young firms are key drivers of job creation and economic welfare. The OECD has reported that approximately 72 percent of job creation across 18 OECD countries – including Canada – was attributable to firms with fewer than 250 employees, among which young firms (under five years old) accounted for 40 percent of job creation while more established firms (older than five) accounted for the remaining 32 percent.

However, in Canada, SMEs do not grow as rapidly as their US and European counterparts. And Canada's proportion of high-growth firms with 10 or more employees in the service-producing sector is below the OECD average, both when a high-growth firm is defined as one with more than 20-percent growth in employees and when it is defined in terms of revenue growth. The percentage of high-growth firms in goods-producing sectors also lags the OECD average when growth is measured in terms of revenues.

A key factor is financing. Growth requires financing, and there is evidence Canadian SMEs are falling behind here as well. One **study** found Canadian firms wait longer before they start raising funds, raise funds less frequently and raise less money over time compared to similar tech companies. Moreover, Canadian SMEs face some of the highest borrowing rates among the OECD countries in terms of spreads relative to large firms. The gaps between US and Canada angel financing and a dearth of VC investments at the $2 million-to-$5 million range also indicate potential pressure points.

Despite Canada's healthy supply of debt financing, access to financing appears to be of particular concern among certain types of firms including those that are young, growth-oriented, and exporters. Plus, Canadian SMEs in general face relatively high borrowing costs compared to those in other OECD countries. As for equity capital – such as angel financing and venture capital (VC) – there appear to be shortages in financing for companies that seek investments of less than $5 million. Of particular importance, the scale of angel financing in the US dwarfs that which is evident in Canada.

Among our recommendations: The federal government should consider re-structuring the fee payment schedule on Canada Small Business Financing loans for young growing firms so that fees can accumulate over the loan's life and be repaid by a balloon payment at maturity. This would reduce annual borrowing costs for the most vulnerable borrowers. For high-growth firms, the CSBF program could also be amended to allow it to cover the portion of requested loan amounts larger than financial institutions are willing to provide. For exporters, Export Development Canada could help reduce exchange rate volatility through its foreign exchange facility guarantee program.

As well, a national co-investment fund that would invest alongside angels and VCs to leverage their investment and expertise could address the gap in the supply of angel and seed/early stage financing in Canada. One approach might be through expansion of existing programs such as the National Research Council of Canada's Industrial Research Assistance, the Venture Capital Action Plan and the Venture Capital Catalyst Initiative programs.

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