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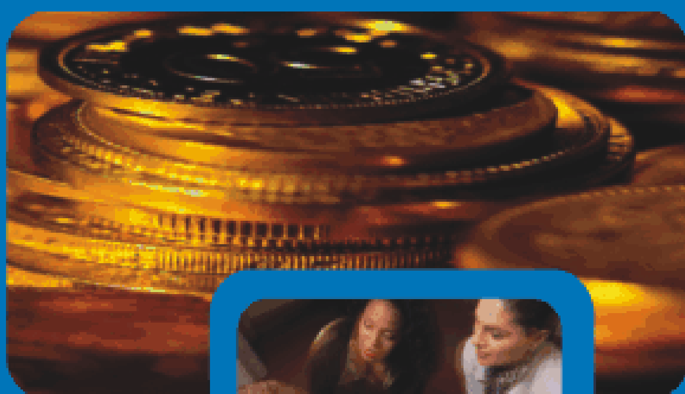
SMALL AND MEDIUM-SIZED ENTERPRISE (SME) FINANCING IN CANADA



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THE BACKGROUND

SME FINANCING IN CANADA is a report on the state of financing for small and medium-sized enterprises (SMEs) in Canada. This report is the first to include an analysis of three ground-breaking surveys from Statistics Canada and Industry Canada, and probes the complexities of SME financing in Canada. These surveys have been synthesized with a diverse body of existing public and private sector research to create this profile of SME financing.

The information gathered in this report is part of an ongoing process of understanding SME financing. As such, SME FINANCING IN CANADA is but one step in a five-year joint process that Industry Canada, Finance Canada and Statistics Canada began over a year ago. For further details on this initiative, see Part Three of this report.

While the data presented in this report will attract and inform a broad audience, this report was initially conceived as a resource for the House of Commons Standing Committee on Industry, Science and Technology. The research was first intended to provide parliamentarians with accurate and relevant information on the state of financing for SMEs, thus assisting them in forging timely and effective public policy.

A Glossary of Terms is provided in Appendix B.

HIGHLIGHTS OF THE REPORT

SME FINANCING IN CANADA presents its findings in three parts. Part One is an analysis of the research conducted on special instruments — including debt, equity, leasing and factoring. Part Two provides a general overview of the SME marketplace and details the specific conditions faced by women entrepreneurs, youth, Aboriginal and minority groups. Part Three offers a history of the SME Financing Data Initiative and explores how this project will be expanded in the future.

The recently completed *Survey on Financing of Small and Medium-Sized Enterprises, 2000* and *Survey of the Suppliers of Business Financing, 2000* conducted by Statistics Canada as part of the SME Financing Data Initiative, are data sets on the supply of and demand for financing in Canada. These summary tables are currently available on-line at the Industry Canada, Small Business Policy and Research Web site at: http://strategis.ic.gc.ca/fdi. In addition, the Université de Québec à Trois Rivières conducted a survey for Industry Canada, entitled *Financing SMEs: Satisfaction, Access, Knowledge and Needs, 2001*, which probed the attitudes and perceptions of SMEs regarding issues related to financing. A report produced from this survey will soon be published on the above-noted Web site. The results of these surveys, as well as data from several other sources, including the Canadian Federation of Independent Business, the Canadian Bankers Association, and the Conference Board of Canada, have been brought together to produce this report on the state of SME financing. All of the following results are from the *Survey on Financing of Small and Medium-Sized Enterprises, 2000* unless otherwise stated.

Financing Stages of Growth

A firm's financing needs evolve with its growth. A capital structure that is appropriate at one stage may not be appropriate at another. This is not an area where there are "right" answers; rather, SMEs need to have a variety of options open to them to meet their financing needs. Table 1 is a snapshot of the sources of financing used by firms, according to size, in 1996 (note that multiple answers were accepted, making the total higher than 100). It shows that firms use a variety of financing instruments.

Table 1 - Sources of Financing Used by SMEs (in %, 1996)

Source of Capital	Fewer than 20 Employees	0-500 Employees
Retained Earnings	57.5	60.7
Personal Capital	59.1	54.8
Short-term Debt	58.4	61.9
Receivables	40.7	43.4
Long-term Debt	36.2	40.4
Leasing	23.6	28.1
Love Money (Debt)	17	15.3
Informal Investment	5.3	5.6
Love Money (Equity)	5.1	5.1
Venture Capital	2.6	2.8
Public Equity	1.1	2.8

Source: Orser, Gasse and Riding. *Factors Relating to SME Growth: A Review of Findings.* May 1996, p. 46

Start-up Capital

Typically the major challenge of firms starting up is to put together an equity stake usually consisting of the personal investment of entrepreneurs and of family and friends ("love money"). Firms without a track record may have difficulty raising debt, and if a firm has not yet begun sales, this might not be the most appropriate form of financing.

Financing Growth

Firms usually finance growth by re-investing their income in the business, in the form of retained earnings. Once a firm has established an equity base and a record of success, a number of other financing options usually become available, including a number of debt instruments. The financing challenge of growing firms is to match the instruments used with the growth prospects of the firm.

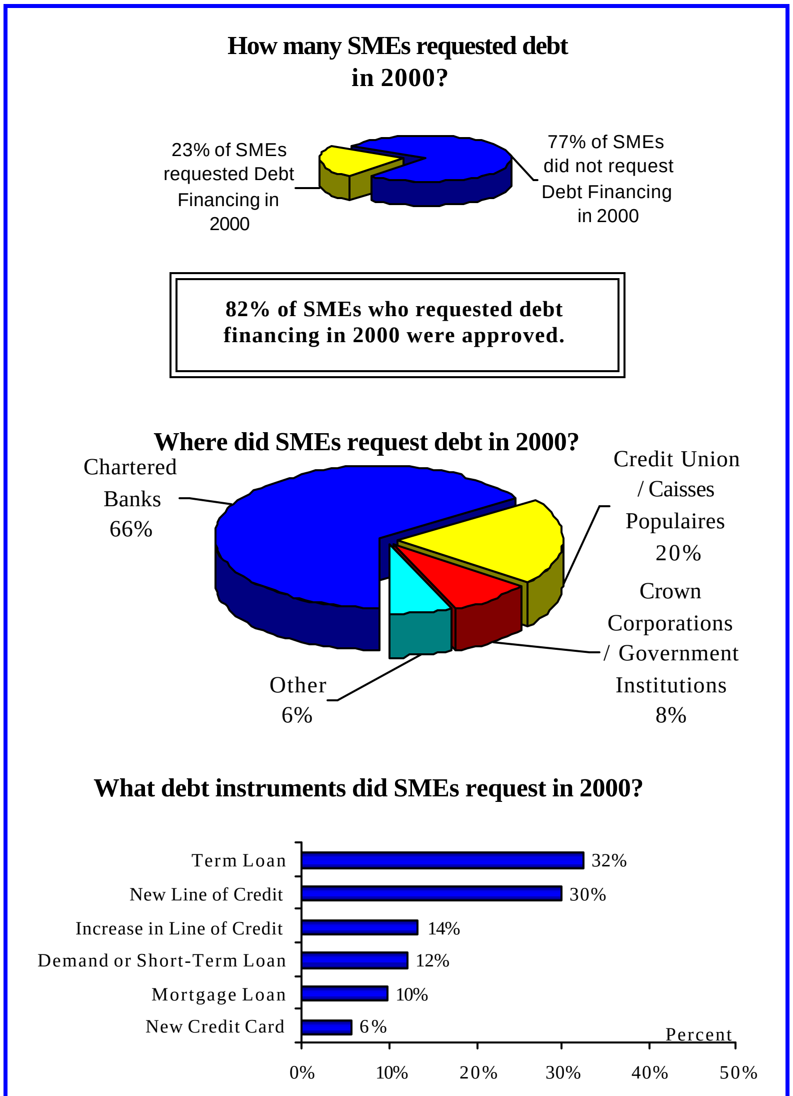
Financing Rapid Growth

Occasionally, firms are able to grow at exponential rates. Although they are a small minority, they are vital for the economy because they become the large firms of tomorrow. Their financing needs vary significantly from those of other firms. Generally they require outside equity from a relatively early stage in their development to support their expansion. This might mean seeking informal (or "angel") investment, venture capital and listing on a public stock exchange.

DEBT FINANCING

Figure 1 provides an overview of recent debt financing activity in Canada.

Figure 1 - Debt Financing Overview



Source: Statistics Canada, *Survey on Financing of Small and Medium - sized Enterprises 2000*

In 2000, 23 percent of SMEs made a request for debt, with an overall approval rate of 82 percent; approval rates increased as the size of firms increased. Of all debt instruments that SMEs applied for, term loans were the most sought after, followed by new lines of credit, and increase in current line of credit. The majority of requests for debt (66 percent) were made to chartered banks.

At 88 percent, credit unions / caisses populaires had the highest overall approval rate.

Only 1.3 percent of SMEs saw a reduction in their credit limit in 2000. Nineteen percent of SMEs experienced automatic renewal of their credit in 2000.

Business credit of less than $1 million[1] extended by the chartered banks in 2000 represented 22.8 percent of total business credit extended by them that year, compared with 26.8 percent in 1996. This represents a nearly 16 percent decline in the amount lent below the $1 million threshold. However, it may reflect increased use of personal credit instruments by SMEs or improving financial conditions facing SMEs. More study would be required to determine the cause.

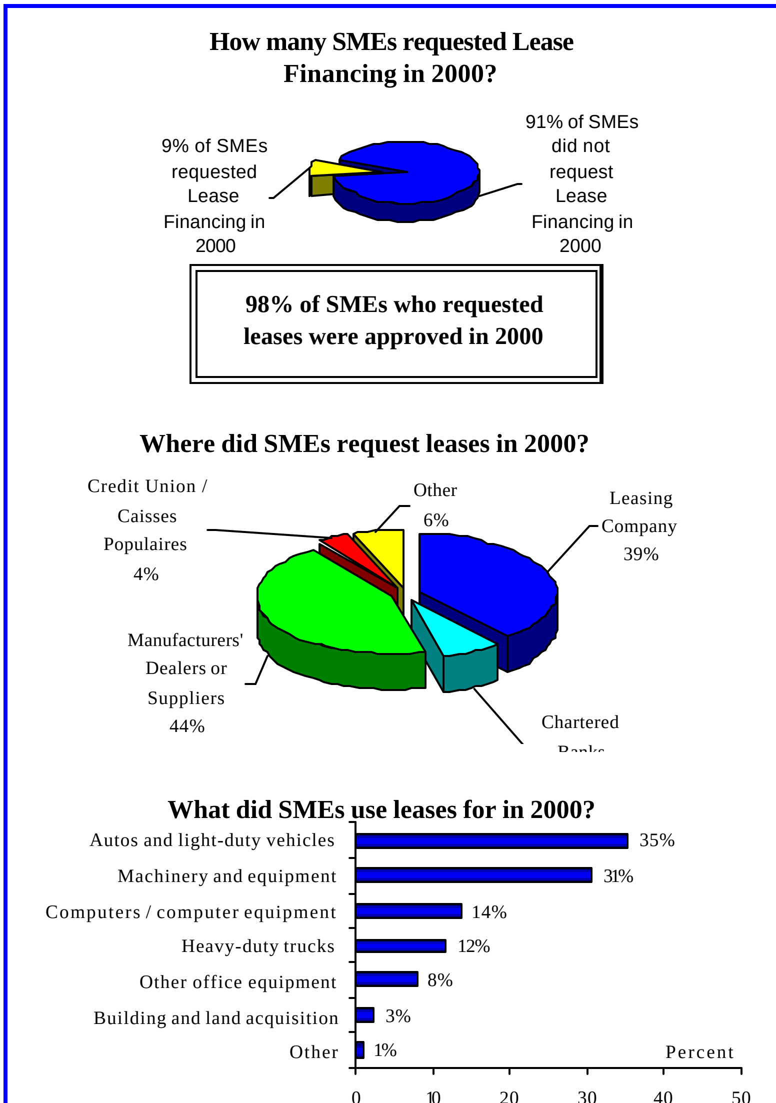
[1] Loans of less than $1 million is a proxy definition that the Canadian Bankers Association uses for loans to SMEs.

LEASE FINANCING

Figure 2 provides an overview of recent lease financing activity in Canada.

In 2000, 9 percent of SMEs made a request for a lease, with an overall approval rating of almost 98 percent. More than 80 percent of leasing was provided by leasing companies, manufacturers' dealers, or suppliers. Demand for lease financing varies somewhat by size of SME, industry or region, but little in approval rate. While larger businesses were more likely to apply for a lease, the Canadian Finance and Leasing Association say that about 60 percent of SME owners used lease financing because it allowed them to finance the full value of their leased assets, without tying up their operating capital.

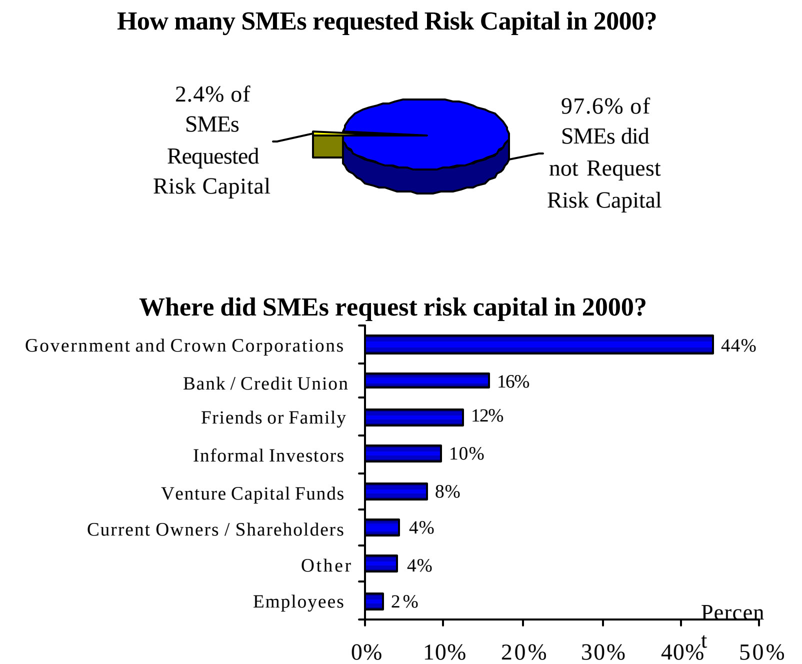
Figure 2 - Lease Financing Overview



Source: Statistics Canada, *Survey on Financing of Small and Medium - sized Enterprises 2000*

RISK CAPITAL

Figure 3 - Risk Capital Overview



Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*

Figure 3 provides an overview of recent activity in risk capital in Canada.

Only 2.4 percent of SMEs reported that they made a request for risk capital in 2000. Nevertheless, risk capital, especially in the form of equity, is a vital element in financing, especially for growing SMEs. Figure 3 shows that the institutions most commonly approached for risk capital are governments, Crown corporations, banks and credit unions. These results are somewhat anomalous, given that these institutions typically do not make risk capital investments. It may be a reflection of the survey methodology. For example, the survey question grouped venture capital with government grants, as these forms of financing are often treated similarly for accounting purposes. Future surveys will include separate questions about venture capital and government grants and will also attempt to discern whether SMEs that report securing risk capital at banks and credit unions were actually securing funds, or advice about how to raise funds.

In 2001, the total amount of venture capital invested in Canada was $4.9 billion in a total of 818 companies. This was down by 27 percent from the $6.6 billion invested in 2000, but was still well above 1999 levels. Venture capital investment in the United States dropped by 65 percent in 2001. One of the major trends observed in 2001 was the growing importance of foreign venture capital investors in the Canadian market. Their share has risen from 19 percent in 1999 to 24 percent in 2000 and 33 percent in 2001.[2]

Early-stage equity investment in companies not traded on stock exchanges, also known as informal or angel investment, is an important source of risk capital at a crucial stage in a company's development. Previous research on investment patterns of informal investors suggests the combined annual investment made by informal investors in Canadian SMEs ranges from $1 billion to as much as $20 billion. The *Survey on Financing of Small and Medium-Sized Enterprises, 2000*, found that 18 percent of majority business

[2] Macdonald and Associates Limited.

owners have invested privately in other companies. As part of the SME Financing Data Initiative more data will be gathered to determine their total contribution to the financing of SMEs.

Other Sources of Financing

Supplier Credit

- Twenty-nine percent of all SMEs made purchases using supplier credit in 2000.
- Larger firms and those in the manufacturing sector were most likely to use supplier credit.

Quasi-equity

- In 2000, 347 companies (about 0.024 percent of all SMEs) received a total of $117 million in quasi-equity; in the first nine months of 2001, the market grew by 9 percent (in terms of value of transactions) compared to the same time period for 2000.
- Expansion-stage firms were more likely to use quasi-equity: 83 percent of such transactions were directed to such companies.
- The vast majority (94 percent) of quasi-equity transactions were $1 million or less.

Factoring

- Only 0.4 percent of SMEs used factoring in 2000.

Profiles of SMEs and Entrepreneurs

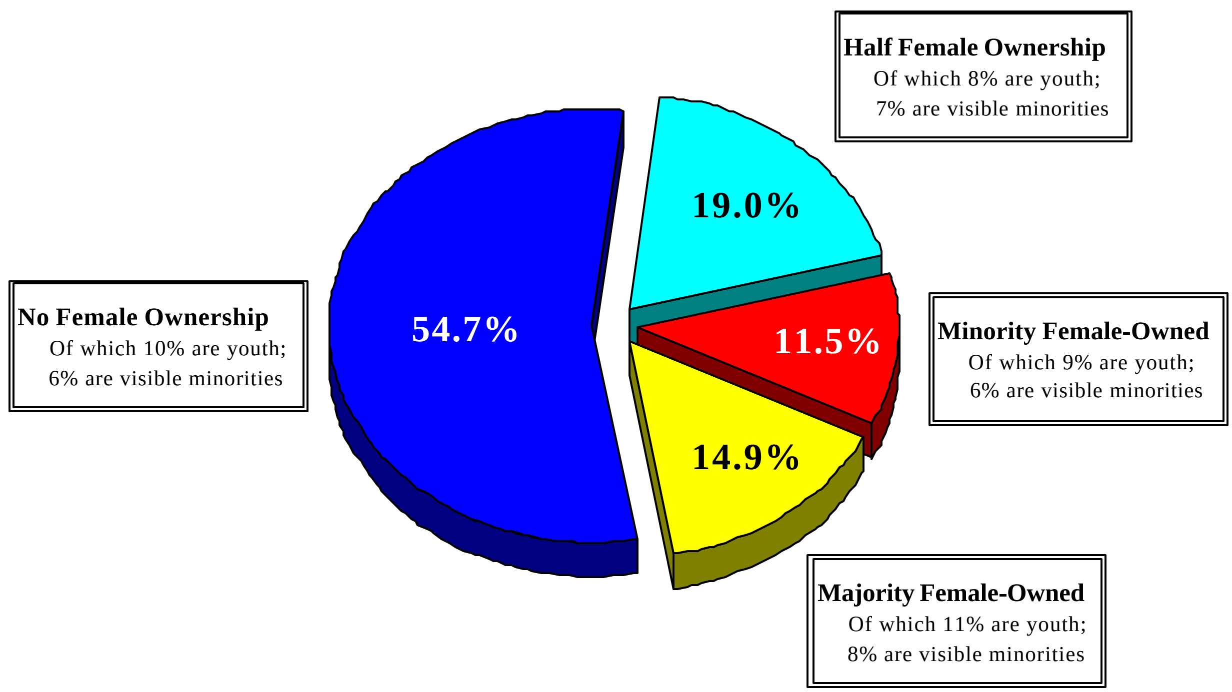
See Figure 4 (page 13) for the demographics of business ownership.

About half of SMEs were wholly or partly owned by women (about 15 percent of businesses were majority owned by women). In comparable sectors and sizes of business there was no variation in approval rates of female and male entrepreneurs who applied for debt financing. SMEs owned by women tended to operate in the wholesale/retail and professional services sectors, and they tended to be small businesses growing slowly.

Young entrepreneurs accounted for 9 percent of SMEs and were concentrated in the knowledge-based industries (KBIs). Aboriginal entrepreneurs owned about 1 percent of all SMEs and were concentrated in agriculture and primary industries.

Visible-minority entrepreneurs owned 7 percent of SMEs, most of which were larger than the average SME. They were concentrated in the wholesale/retail and KBI sectors. There was little variation in approval rates for financing businesses owned by visible minority entrepreneurs and businesses owned by others with comparable sizes and in the same business sectors.

Figure 4 - Demographics of Business Ownership, 2000



Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*

Majority Female		Majority Male
34%	**French Speaking**	66%
23%	**English Speaking**	77%
18%	**Non-Official Language**	82%

Source: The Research Institute for SMEs, Université du Québec à Trois-Rivières, *Financing SMEs: Satisfaction, Access, Knowledge and Needs, 2001*, commissioned by Industry Canada, 2002.

NOTE TO READERS ON SOURCES AND USES OF DATA:

Many statistical findings presented in this report were collected by Statistics Canada in two surveys: *The Survey on Financing of Small and Medium-sized Enterprises, 2000* and *The Survey of the Suppliers of Business Financing, 2000,* conducted during the summer and fall of 2001.

The Survey on Financing of Small and Medium-sized Enterprises, 2000 was completed by over 11 000 firms across Canada with 0 to 499 full-time equivalent employees. Financing and leasing companies, co-operatives, subsidiaries of other firms, not-for-profit organizations, government offices, schools, hospitals and other public sector organizations were excluded.

Information was collected from SMEs based on their financing practices and experience during 2000. Only firms in operation at the time of the survey were surveyed. The accuracy of the results diminishes as statistics for sub-groupings of the total SME population are broken out (e.g. regional, size of business and industry categories are less accurate than estimates for the entire Canadian SME population, as defined above)

The Survey of the Suppliers of Business Financing, 2000 was based on a sample of financial service providers with assets of $5 million or more in selected financing and leasing industries. Enterprises providing venture capital financing and federal Crown financial institutions were also surveyed. While some crown corporations were included, the survey excluded other government and public sector organizations (e.g. Atlantic Canada Opportunities Agency), not-for-profit organizations, informal suppliers such as business angels and family members, and foreign suppliers.

A third survey by Université de Québec à Trois Rivières (UQTR) conducted for Industry Canada, *Financing SMEs: Satisfaction, Access, Knowledge and Needs, 2001*, probed the attitudes and perceptions of 2000 SMEs over the summer of 2001 on issues related to financing of their firms. The data produced from this survey will soon be published at http://strategis.ic.gc.ca/fdi

All results in this report are from *The Survey on Financing of Small and Medium-sized Enterprises, 2000* unless otherwise stated.

Note on Interpretation: First it is important to note that all data reported here relate to firms that were operating at the end of the calendar year 2000, therefore it does not capture any data on those businesses that failed or on those entrepreneurs who planned to start up a business but failed to do so, whether because of problems accessing financing or for other reasons. In many places in this report, correlations and observations are made of data by region, industry, gender of business owner, etc. Given the relatively small sample sizes related to some of these correlations, one needs to be very cautious in drawing strong conclusions about them. The purpose of this report is to provide some initial observations and interpretations of the data. Likewise, it is not possible on the basis of one observation to say anything about trends. This is the first of a regular series of reports, and these issues will be examined in more detail as more data is collected.

DEBT FINANCING

Debt is the major source of financing for SMEs in Canada. This section of the report analyses the results of the *Survey on Financing of Small and Medium-sized Enterprises, 2000* by Statistics Canada and a variety of other sources to create a profile of the demand for debt financing in Canada. The report outlines key issues such as application and approval rates; the suppliers and instruments used by SMEs; the collateral and application requirements faced by firms of different employment sizes, industries and regions; and other factors.

USE OF DEBT FINANCING: SHORT-TERM VS. LONG-TERM INSTRUMENTS

Debt financing is available in a variety of short-term and long-term instruments. Short-term debt includes operating lines of credit, supplier credit and credit cards. Longer-term debt includes term and demand loans. Sound corporate finance practice dictates linking the revenue stream from an asset to the payment stream for the financing instrument. For example, firms buying equipment or a building would normally use longer-term debt, repaying it over the life of the asset. Similarly, firms financing inventory would normally use short-term debt, as inventories turn over quickly.

One critical difference between short-term and long-term debt is the predictability of payments. Short-term debt is often given at a variable rate, and in any event is subject to changes in interest rate when the debt comes due and is re-financed. Long-term debt can come with a variable interest rate, but is generally made at a fixed interest rate. Normally inventories and receivables are financed using short-term instruments that can rise and fall according to need. It does not make sense to have a long-term loan outstanding, paying interest on the entire balance, when needs vary over time. Financing a large, long-term asset using short-term credit instruments can expose a firm to the risk that interest rates will rise, resulting in increased interest costs without an increase in the ability to meet this expense.

DEMAND FOR DEBT FINANCING: CONTRIBUTING FACTORS

In 2000, a majority of businesses — 77 percent — made no request for new debt[3]. A recent survey

[3] Statistics Canada's *Survey on Financing of Small and Medium-Sized Enterprises, 2000* asked firms to report on their last request for debt in 2000. It is important to note that the statistics presented in this section do not include businesses that planned but failed to start up, or the ones that ceased operations, either during 2000 or after.

conducted by the Canadian Federation of Independent Business (CFIB)[4] reports that debt instruments were the most common forms of financing used by SMEs. The most frequently used instruments reported were (in order of frequency): lines of credit (short-term debt), business loans (demand or short-term debt), commercial mortgages and personal loans/mortgages (long-term debt).

The *Survey on Financing of Small and Medium-sized Enterprises* found that 23 percent of SMEs requested some form of debt in 2000. The survey also found that there was a variable pattern of application for the various types of debt instruments across industries, size of businesses and regions. There may also be a changing pattern of loan authorizations[5]. The findings of this survey, which shows less than one-quarter of SMEs making a request for debt in 2000, corroborate other recent studies which report a decreasing demand for debt financing among SMEs. The CFIB reports that there has been a 'steady downward trend (1987 - 2000, in requests for debt financing, which) does not appear related to the business cycle'.

The Conference Board of Canada study, *A Changing Demand for Debt Financing*[6], reports that loans outstanding under $1 million accounted for 69 percent of authorized amounts in 1995, and 67 percent in 1999 and suggest that borrowers were likely more focussed on repaying loans during this period of an economic upswing. Other factors which could be contributing to this phenomenon include:

- increased use of retained earnings;
- increased use of lease financing;
- a perceived or real barrier to access due to credit scoring practices of the major suppliers of debt; and
- larger institutions transferring their SME clients from commercial banking to their personal banking divisions.

The pattern of demand for debt is determined by a number of factors. In the sections that follow, the borrowing practices of Canadian SMEs will be reviewed in a number of different contexts by industrial sector, region, the demographic characteristics of the business owner and other characteristics. This report does not include the kind of detailed analysis that can precisely define the causal factors in the results that are presented. Further studies will look at these questions in more detail.

- **Regional Economic Structures:** The economic structure of Canada's regions varies considerably, with some regions more dependent on agriculture and primary industries and others more on manufacturing, services or knowledge-based firms. As these industrial sectors have significantly

[4] Canadian Federation of Independent Business, *Banking on Entrepreneurship*, March 2001. http://www.cfib.ca/

[5] "Loan authorization" refers to the maximum amount of money a financial services supplier agrees to provide a client. This should not be confused with outstanding loans, which are the actual amount of debt owed to a supplier at any given time.

[6] Conference Board of Canada, *A Changing Demand for Debt Financing?*, January 2001.

different financial services needs, the regional differences seen with respect to financial services may be linked primarily to the structure of the regional or provincial economy. For example, Manitoba and Saskatchewan have a greater reliance on agriculture than other provinces (Table 17 on page 62 provides a breakdown of the contribution of a variety of industries in Canada's regions). Agriculture generally has a great need for debt and — because of the nature of the assets that are financed — a higher approval rate for debt applications. Thus the regional differences observed between Manitoba and Saskatchewan and other regions are likely not a result of factors specific to the behaviour of financial institutions in those provinces, or of all businesses in those provinces, but are a result of the importance of agriculture in their economies.

- **Structure of the Financial Services Industry:** There are a wide variety of firms providing financial services across Canada, and a considerable variation in their distribution. Part of this is explained by regional economic structure: some suppliers of financial products tend to specialize in certain business activities. For example, credit unions / caisses populaires are historically linked to agriculture and therefore agricultural regions. (This is not to say that these suppliers deal only with farms or are only found in agricultural regions, but that proportionately more of their business is done with this sector and in those regions.) The major chartered banks are most active in the urban markets, and particularly in Ontario and Atlantic Canada.

- **Economic Performance:** At any given time there is a degree of variation in the economic performance of regions and sectors of the economy. This can be a factor in explaining differences in the behaviours of both the users and suppliers of financial services across the country. Table 18 on page 62 provides the recent GDP growth rates for Canada's regions.

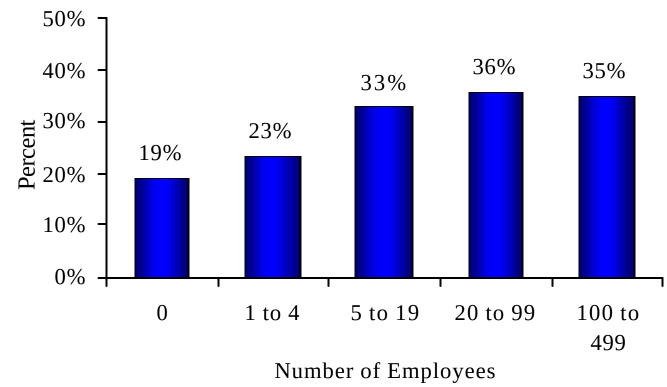
- **Changing Business Strategies and Other Sources of Financing:** In Canada's dynamic economy and financial services sector, new business approaches and financial services are being tried all the time. This may be affecting historic patterns seen between, for example, the growth of small businesses and the amount of term debt outstanding. The knowledge-based sector with its relative lack of "hard" assets is a challenge for a financial system that has traditionally dealt with asset-backed financial products. Knowledge-based firms often need risk capital, in the form of equity investment, rather than debt. In recent years leases have become an increasingly popular form of financing, and this situation is likely cutting into the demand for other financial services. Credit cards and other short-term instruments are also increasingly being used by small businesses. These are complicated developments that likely advantage some firms and disadvantage others. One of the objectives of the SME Financing Data Initiative will be to document these trends so that conclusions on the impact of these changes can be made.

Debt Financing: Application and Approval Rates

In 2000, 23 percent of SMEs made a request for debt and 82 percent were approved (see Table 5, page 28). These figures vary somewhat from other recent surveys done on similar issues. A 1998 study, for example, done for the Canadian Bankers Association,[7] found that 38 percent of SMEs had applied for debt and that the approval rate was 93 percent. The CFIB reported in a study that 60 percent of firms responding to a survey of their members applied for either a term loan, new line of credit or an increase in an existing line of credit in the past three years. The CFIB also states that there has been a "steady downward trend [over 1987 - 2000 in applications for debt financing] that does not appear to be related to the business cycle."[8] Therefore, the findings of the recent survey by Statistics Canada may be the latest indicators of a decreasing demand for debt by SMEs, however additional research will assist in affirming this claim.

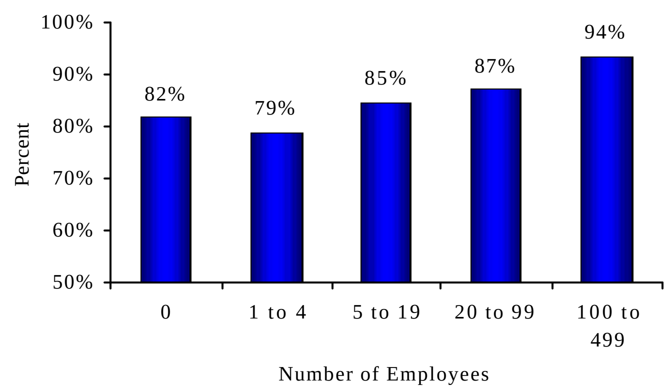
The Statistics Canada Survey on Financing of Small and Medium-sized Enterprises will be administered regularly every three years, and this will provide a stable set of data to identify trends.

Figure 5 - Debt Request Rates by Size of Business in 2000



Source: Statistics Canada, *Survey on Financing of Small-and Medium-sized Enterprises, 2000*

Figure 6 - Debt Approval Rates by Size of Business in 2000



Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*

There are clear differences in request and approval rates across different sizes of businesses. As illustrated in Figure 5, larger businesses were more likely to request debt financing. This is consistent with findings in the 2001 survey by the CFIB.

Figure 6 illustrates the trend in approval rates across businesses of different sizes.

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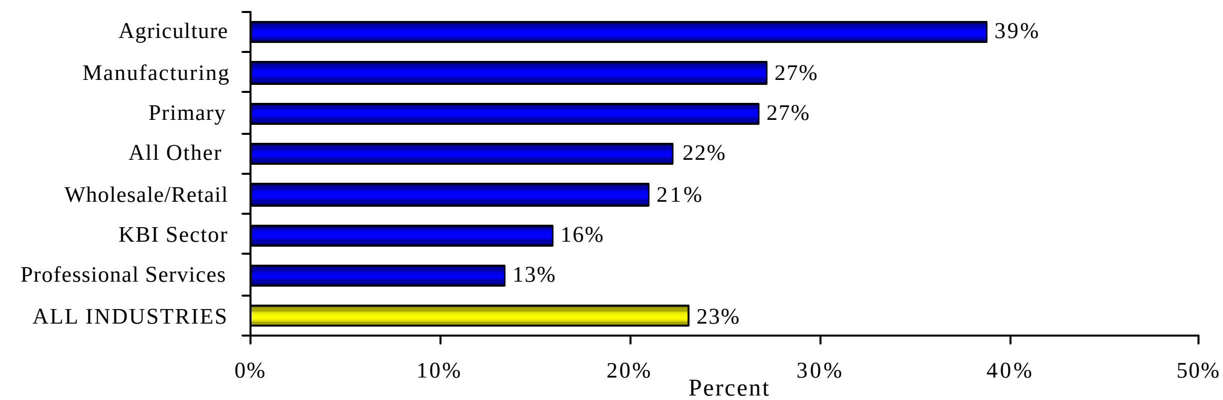
[7] Thompson Lightstone & Company Limited, *Small and Medium-Sized Businesses in Canada: An Ongoing Perspective of their Needs, Expectations and Satisfaction with Financial Institutions*, prepared for the Canadian Bankers Association, 1998. http://www.cba.ca/eng/Small_Business/1998sme.htm

[8] Canadian Federation of Independent Business, *Banking on Entrepreneurship*, March 2001.

These approval rates are consistent with the findings of the study completed by UQTR,[9] which show that firms with more employees are more likely to have their requests approved for a line of credit or a medium- or long-term loan. The CFIB also reports that larger firms experience lower rates of loan rejection.

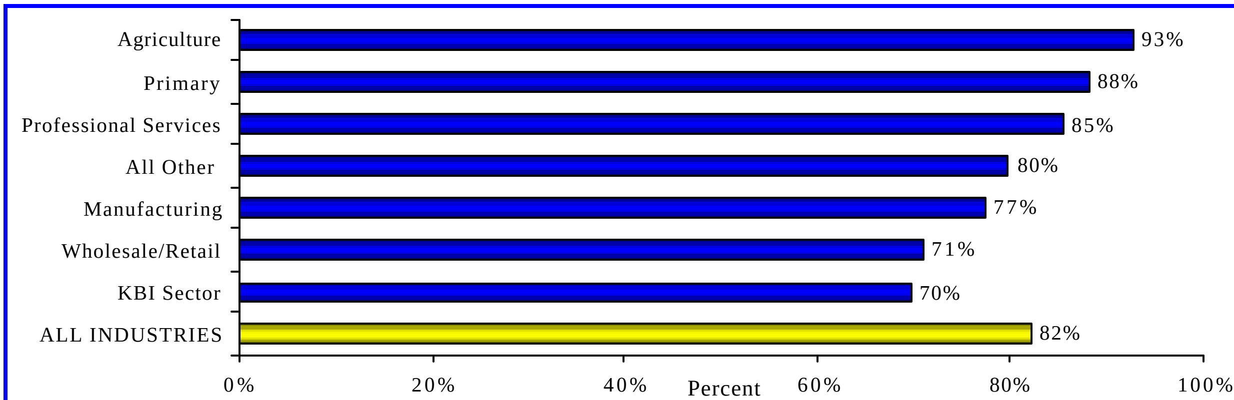
Figures 7 and 8 illustrate request and approval rates, respectively, of firms in different industries. Firms in the agricultural sector were most likely to make a request for debt, while those in the professional services or KBI[10] sectors were least likely to do so in 2000. As well, businesses in the agriculture or primary sectors had very high approval rates for their requests for debt, while businesses in the wholesale/retail trade, and KBI sectors had the lowest approval rates. Agricultural firms usually have land or equipment to use as collateral, while firms in the services sector may not have many business assets. More than 55 percent of agricultural businesses that requested debt in 2000 used business assets as collateral, as compared with 41 percent for all SMEs (see Table 8, page 33).

Figure 7 - Debt Request Rates by Industry in 2000



Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*

Figure 8 - Debt Approval Rates by Industry in 2000



Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*

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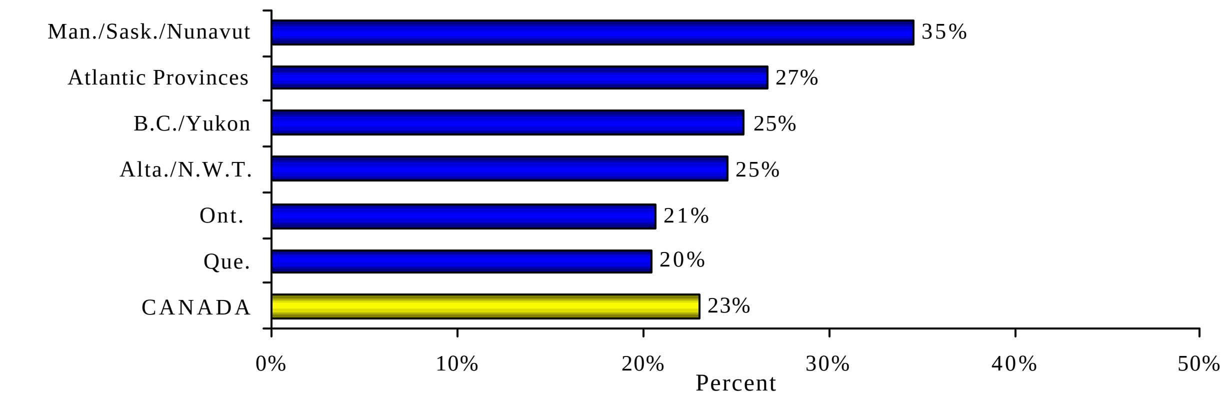
9 The Research Institute for SMEs, Université du Québec à Trois-Rivières, *Financing SMEs: Satisfaction, Access, Knowledge and Needs, 2001*, commissioned by Industry Canada, 2002.

10 See Appendix A (page 100) for a description of the North American Industrial Classification System (NAICS) classification of a knowledge-based industry (KBI).

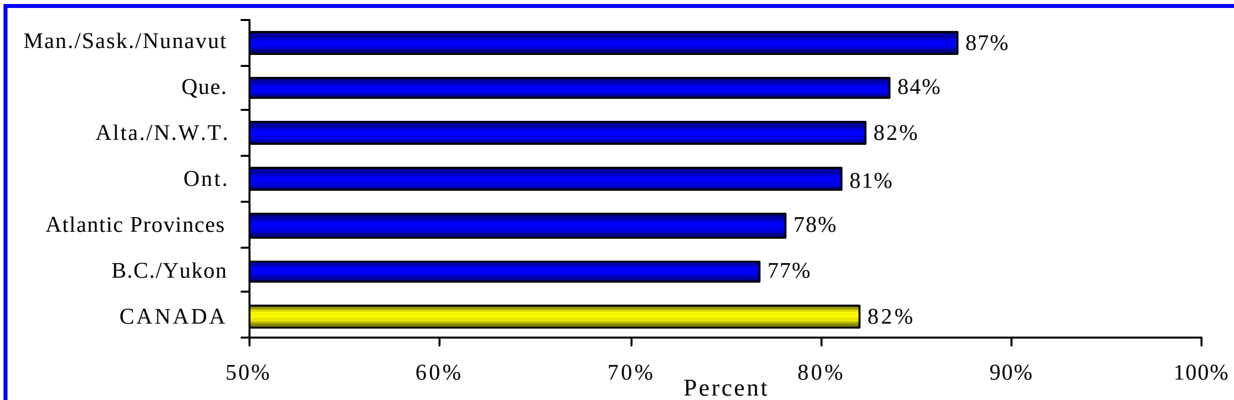
There was some variation in the request and approval rates for debt in 2000 across the different regions of Canada (see Figures 9 and 10). As noted earlier, any analysis of the regional distribution of request and approvals must take into account the economic structure of the regions being studied. For example, as we have seen, agriculture has high debt request and approval rates. This sector also makes a large contribution to the Manitoba and Saskatchewan economies (see table 17 on page 62), so these are probably factors contributing to the Prairies' high debt request rates (see Figure 9) and high approval rates (see Figure 10). When the agriculture sector is removed from the figures, the variation between regional request and approval rates and the national average is reduced considerably.

Figure 9 - Debt Request Rates by Region in 2000



Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*

Figure 10 - Debt Approval Rates by Region in 2000



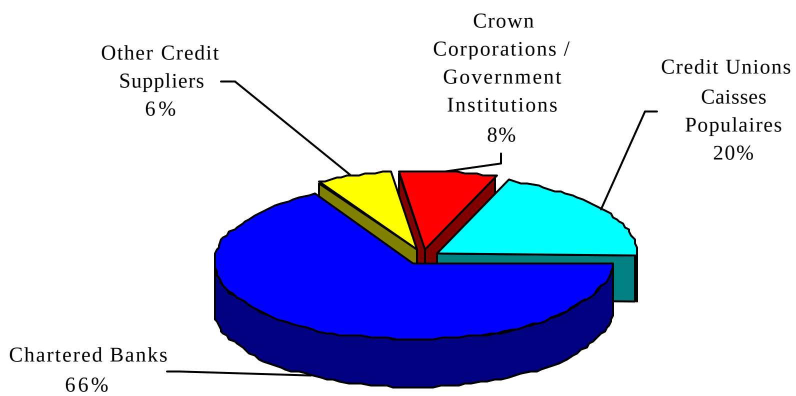
Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*

Another important factor to consider is the differing structure of the financial services industries in the various parts of the country. The major chartered banks are found in every region of the country, while credit unions and caisses populaires have a greater presence in Quebec and Western Canada than elsewhere. The concentrations of credit unions and banks have been changing over the last couple of decades as well. For example, in Manitoba and Saskatchewan combined, there has been a 16-percent decline in the number of bank branches from 1988 to 2000,[11] whereas the number of branches grew in every other part of the country but Alberta. Table 4 (page 27) indicates a strong tendency to seek face-to-face contact with financial service suppliers; so, taking the decline in bank branches into account, perhaps it is not surprising to see credit unions receiving a much larger proportion of applications in Manitoba/Saskatchewan and Alberta. The availability of access points may well be a determining factor in the choice of institution; however, until now there has not been as much of a focus on this factor, so further data collection and analysis are required to understand its importance to the patterns of small business demand for debt.

Results suggest that SMEs in British Columbia and the Atlantic regions had lower approval rates than SMEs overall when requesting debt. Regional economic conditions may possibly explain the variance of approvals for debt financing in these regions. It is equally possible that this is a statistical phenomenon, for example, the variation in the confidence intervals of the survey estimates could account for this variation. However, it is also worth noting that firms in each of these regions are among the heaviest users of chartered banks, and chartered banks show slightly lower than average rate of approval. Determining which factor is the major contributor to these variations, will require further analysis and observations.

DEMAND FOR DEBT BY TYPE OF INSTITUTION

Figure 11 - Percentage of Total Requests for Debt by Type of Supplier in 2000



Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*

Chartered Banks: The major banks received 66 percent of the requests from SMEs for debt financing in 2000 (see Table 6, page 29). However, in 2000 they accounted for 55 percent of total debt[12] that was outstanding to SMEs and accounted for about 57 percent of outstanding debt of less than $1 million in authorization (see Table 2 and Figure 12 on page 22).

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[11] Canadian Bankers Association Web site: http://www.cba.ca/eng/Statistics/stats/db144Aweb.htm

[12] According to the *Survey of the Suppliers of Business Financing, 2000*, chartered banks have lower than average loans outstanding — particularly for loans under $1 million.

- Larger firms were more likely to seek and obtain debt financing from chartered banks.
- More than three quarters of firms in the professional service or KBI sectors that applied for debt financing approached a chartered bank for short-term debt instruments, which may be related to the stronger presence of these institutions in urban areas, where most KBIs are located.

Credit Unions / Caisses Populaires:

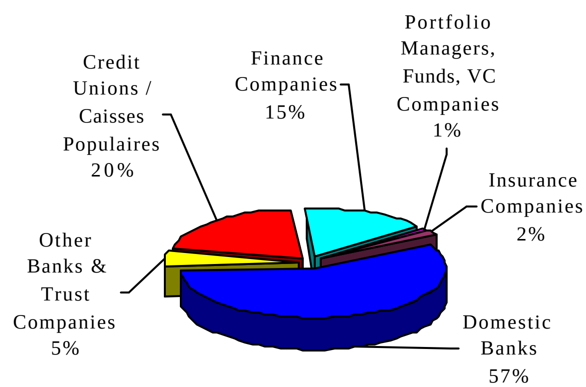
- **Pattern of request for debt:** These institutions received nearly half of the requests for debt in the Prairie provinces and nearly 40 percent in Quebec.
- **Rural firms** were more likely to apply to credit unions / caisses populaires (34 percent, versus 20 percent for Canada overall), reflecting these suppliers' presence in rural areas.
- **Small firms** with fewer than 5 employees were more likely to apply to credit unions / caisses populaires than larger firms (more than 20 percent of requests of firms with fewer than five employees, versus less than 16 percent for larger firms).
- **Sectors:** Firms in the agriculture, primary and manufacturing sectors were the most likely to use credit unions / caisses populaires for debt (36 percent, 28 percent and 20 percent, respectively).

Table 2 -Total Commercial Debt by Type of Supplier in 2000*

Suppliers	Share
Domestic Banks	55%
Insurance Companies	19%
Finance Companies	8%
Credit Unions and Caisses Populaires	6%
Portfolio Managers, Funds, VC Companies	2%
Other Banks & Trust Companies	10%

Source: Statistics Canada, *Survey of Suppliers of Business Financing, 2000*
* Supplier categories do not directly correspond with the supplier categories in the *Survey on Financing of Small*

Figure 12 - Outstanding Debt (less than $1million) by Type of Supplier in 2000.*



Source: Statistics Canada, Survey of Suppliers of Business Financing, 2000
* Supplier categories do not directly correspond with the supplier categories in the Survey of Financing of Small and Medium- sized Enterprises, 2000

Crown Corporations / Government Institutions: Just over 8 percent of requests for financing were made to these institutions. Most of these requests came from firms in agriculture, manufacturing and primary industries.[13]

[13] Some of these Crown institutions have policy mandates to target specific sectors. Farm Credit Canada's mandate is to serve farms and farm-related businesses. The Business Development Bank of Canada has traditionally focused on the manufacturing industries, but is now growing its business with KBI firms. Still other institutions (e.g.

OTHER FINDINGS CONCERNING REQUEST RATES FOR DEBT IN 2000

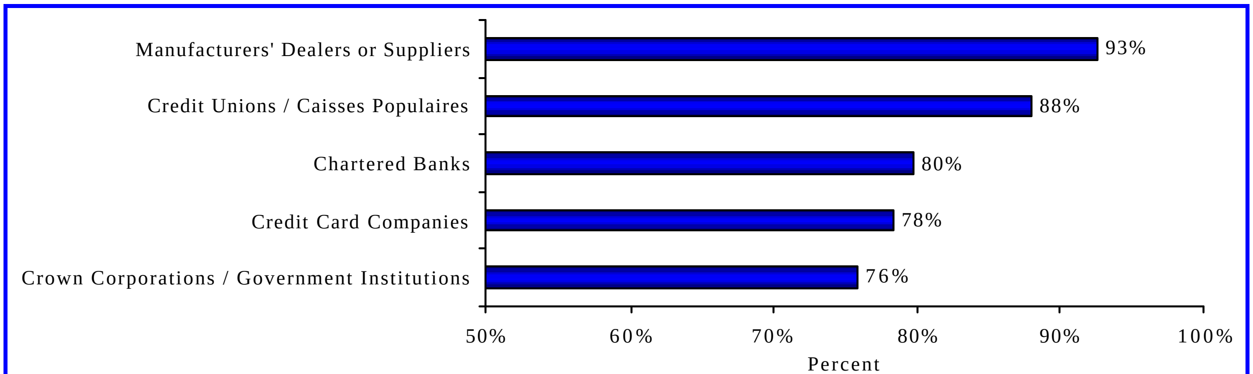
Exporting Firms: 36 percent of these firms made a request for debt compared to 22 percent of non-exporters. In this context it is worth noting that exporters tend to be larger businesses (see Table 15 on page 60). Larger businesses also tend to request more debt financing than other firms (see Figure 5, page 18). So this observation may have more to do with the characteristics of the size of the business than with its exporting activities.

Urban Firms: 21 percent of urban-based SMEs[14] made a request for debt as compared with 31 percent of those located in rural areas. This probably reflects the impact of the agricultural and primary sectors in rural areas — two sectors that most often request debt financing (see Table 5, page 28).

REASONS REQUESTS FOR DEBT ARE REJECTED

In 2000, about 82 percent of the firms that sought debt financing were able to obtain it (see Figure 13). A request may be rejected for a variety of reasons. In 2001, the CFIB reported that younger and smaller businesses, as well as businesses with high account manager turnover, were more likely to have their financing request rejected.[15] Of the 18 percent who were not approved for debt in 2000, 85 percent were turned down, 3 percent had their application still under review at the time of the survey and 10 percent withdrew their application.

Figure 13 - Debt Approval Rates by Type of Supplier in 2000



Source: Statistics Canada, *Survey on Financing of Small-and Medium-sized Enterprises, 2000*

According to the Statistics Canada survey these SMEs cited five main reasons given by the debt financing supplier for rejection:

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the Alberta Treasury Branches) are important in regions where oil and gas production is predominant. Detailed information on the activities of Crown agencies is available in their annual reports.

[14] See the Glossary (Appendix B) for a definition of a rural- and an urban-based firm.

[15] Canadian Federation of Independent Business, *Banking on Entrepreneurship*, March 2001.

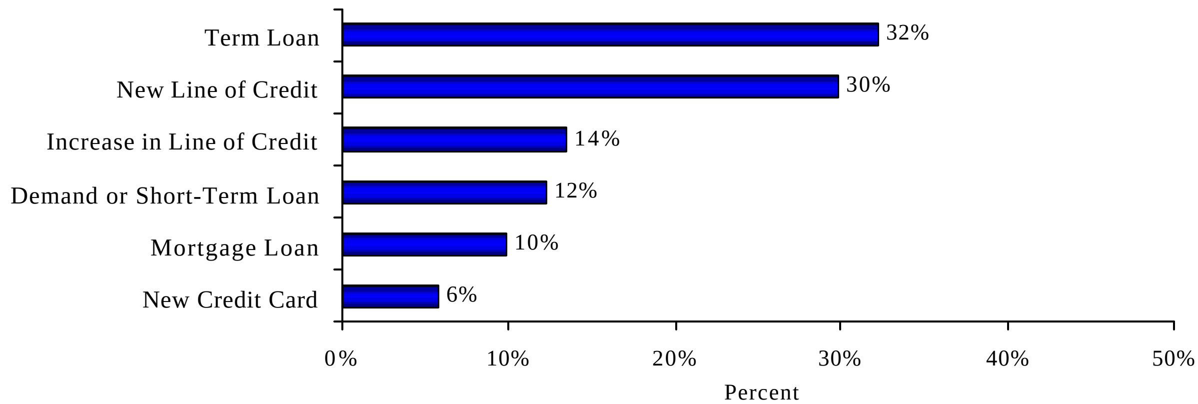
- they had insufficient income, revenue or sales (23 percent);
- they had a poor credit history (13 percent);
- they could not produce sufficient collateral or security (11 percent);
- their business had insufficient cash flow (10 percent); or
- their business was too young (8 percent).

In 11 percent of the cases where a request for debt was turned down, SMEs reported that no reason was given. Of those rejected who recall being given a reason for the turndown, only 27 percent were satisfied with the reason given.

TYPES OF INSTRUMENTS MOST REQUIRED

Following are highlights with respect to the requests for various financing instruments (see Table 7, page 31 and Figure 14):

Figure 14 - Debt Instruments Most Frequently Requested in 2000



Source: Statistics Canada. *Survey on Financing of Small and Medium-sized Enterprises, 2000*

- **Firms with no employees** had a slightly higher than average rate of request for credit cards and term loans. While it is not surprising to find the self-employed using flexible short-term debt like credit cards, it is surprising to find that they were the most likely to request new term loans. The high number of requests for term loans is likely due to the large concentration of the self-employed in the agricultural sector.
- **Agricultural and primary sectors** were the most likely to request short-term debt, which possibly reflects their use of these instruments for seasonal operating credits. These sectors are probably also financing machinery, equipment, land and buildings through debt, as they are also the sectors that requested term loans most often.
- **Professional services and KBIs** appear to apply disproportionately for lines of credit and credit cards. As these sectors are also more likely than most to use personal assets to secure a loan and as these instruments typically do not require as much collateral as term loans, it is not surprising that there is an apparent preference for these instruments. However it may not be a preference by choice but rather by circumstance (i.e., they may have no other choices). Further study will be done on this issue.

- **Manitoba/Saskatchewan/Nunavut**-based firms had higher than average request rates for demand loans. This reflects the heavy use of these kinds of instruments by the agricultural and primary industries, which are so important to the economies of these provinces.
- **British Columbia / Yukon and Ontario** had lower than average request rates for term loans.
- **Urban-based SMEs** tended to apply for more short-term debt, such as lines of credit or increases in lines of credit, while rural-based SMEs tended to request demand and term loans, which is consistent with the patterns of use by the agricultural and primary industrial sectors explained earlier.

CONDITIONS FOR ACCESSING FINANCING: COLLATERAL

Collateral is any asset that a borrower must pledge as security for a financial arrangement. Lack of collateral, for start-up firms or those in KBIs for example, can create a major obstacle to accessing debt. Anecdotal evidence suggests that SMEs often believe lenders are excessive in their demands for collateral. Of course, for lenders the amount and type of collateral available are often key considerations in the financing decision. Business owners are often asked to use personal assets for collateral when tangible business assets are not available. In general, goods-producing industries use business assets as collateral more frequently than the personal assets of the owner, while the opposite is true for service industries. Size of business is also a key factor in determining the type of asset used as collateral. These factors, along with types of suppliers, are most likely the influencing factors affecting regional variations. Overall, for debt approved in 2000, 39 percent of SMEs used personal assets as collateral, and 41 percent used business assets[16] (see Table 8 on page 33).

The following are key findings with respect to collateral:

- **Smaller Businesses:** Firms of fewer than 20 employees are equally as likely to use personal assets as collateral as they are to use business assets, while larger firms are much more likely to use business assets rather than personal assets. This is not surprising, as larger firms are also more likely to have such assets to pledge and are most likely to request term debt. Term loans are usually used to finance fixed assets, as those assets can be used to secure the loan.
- **Agriculture-based SMEs:** 56 percent of these firms used business assets as collateral. This is the highest rate of any sector, which is as expected given that these businesses tend to be asset-rich (equipment, land and buildings).
- **Wholesale/Retail and KBI Sectors:** 45 percent of firms in these sectors used personal assets as collateral — the highest rate of any sector. These are also the sectors that most frequently requested short-term debt, which is usually used for operating capital. Possibly these instruments have a lower collateral requirements, though more study would be required to make this correlation.
- **Rural-based SMEs:** 54 percent of these firms pledge business assets as collateral as compared to 34 percent of urban-based firms — consistent with the findings for the agricultural sector.

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[16] Note that in this study firms could have used both personal and business assets as collateral.

- **Alberta / Northwest Territories:** 49 percent of firms in this region used personal assets as collateral, more than in any other region in Canada. This is a higher level than realized within the various ranges for size of business, or for industry breakdowns, therefore another factor must be at play, such as the lending practices of suppliers in this region.
- **Manitoba/Saskatchewan/Nunavut:** 53 percent of firms in this region used business assets as collateral, and this reflects the fact that 45 percent of SMEs located here are classified as agricultural, which is an influencing factor on type of collateral used, as stated above.
- **Quebec:** Only 28 percent of firms based in Quebec used personal assets as collateral — the lowest of any region. Although the size of the business and the industry are influencing factors on collateral requirements, they do not seem to account for Quebec's low levels of collateral usage, therefore further study will be required on this issue.

CONDITIONS FOR ACCESSING DEBT: DOCUMENTATION AND APPLICATION PROCESS

The perception of SMEs regarding the application process and documentation requirements for obtaining financing is one factor that could inhibit them from requesting financing. For example, concerns about onerous requirements may lead an SME owner to use a personal line of credit rather than seek to establish a business line.

Table 3 - Debt Application Information Requirements in 2000

Document	Percentage of Applicants Required to Provide
Business Financial Statement	48.6%
Formal Application	21.2%
Personal Financial Statement	20.5%
No Documents Required	16.3%
Business Plan	13.6%
Cash Flow Documentation	10.6%
Appraisal of Assets	9.3%
Other	5.0%
Franchise Agreement	1.5%

Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*

Table 3 provides a breakdown of the documents that SMEs reported providing when applying for financing. Overall, SMEs reported that 16 percent of the applications made did not require any documentation. As 64 percent of SMEs that applied for debt reported that they made a request where they already did business, it is likely that the financial institution already had access to the required information. Personal or business financial statements are among the most commonly requested documents.

In close to one third of the requests that required documentation, the SMEs were given the opportunity to revise the documents following their initial submission.

Table 4 provides a breakdown of how SMEs reported the requests for financing were made. The vast majority of SMEs reported that when they requested debt financing in 2000, they did so via a personal discussion either at a branch or over the telephone. This indicates that one-on-one contact with an account manager is still the most important type of contact between an entrepreneur and a financial service provider.

Table 4 - Application Method used by SMEs who Requested Debt in 2000

Method	Percentage of Applicants Applying by Method
Personal Discussion	57.3%
Request at the Branch	23.6%
Applied by Phone	17.3%
Approached by Credit Supplier	4.4%
Other	3.8%
Mail or Courier	2.5%
Applied by Fax	1.3%
Applied by Internet	0.3%

Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*

* More than one method was used by some businesses, therefore these numbers do not add up to 100 percent.

CREDIT CONDITIONS: REDUCTION IN CREDIT LIMITS

In 2000, only 1.3 percent of SMEs experienced a reduction in a credit limit authorized prior to 2000. No statistically significant variation was seen for firms of different sizes, regions or industries.

Table 5 - SME Request and Approval Rates for Debt in 2000

Overall	Request Rate	Approval Rate
	23.4.0%	81.7%
Size of SME		
0 Employees	19.2%	81.7%
1 to 4 Employees	23.4%	79.1%
5 to 19 Employees	33.1%	84.5%
20 to 99 Employees	35.7%	87.2%
100 to 499 Employees	35.3%	93.7%
Regions		
Quebec	20.4%	83.6%
Ontario	20.7%	81.1%
Alberta / Northwest Territories	24.5%	82.4%
British Columbia / Yukon	25.4%	76.7%
Atlantic Provinces	26.7%	78.1%
Manitoba/Saskatchewan/Nunavut	34.6%	87.1%
Industry		
Agriculture	38.8%	92.8%
Manufacturing	27.2%	77.4%
Primary	26.7%	88.1%
All Other	21.7%	79.7%
Wholesale/Retail	23.4%	74.3%
KBI Sector	15.9%	69.7%
Professional Services	13.4%	85.4%
Financial Institution		
Chartered Banks	66.1%	79.7%
Credit Unions / Caisses Populaires	20.2%	87.9%
Crown Corporations / Government Institutions	8.2%	75.9%
All Other Institutions	6.0%	-
Areas		
Rural	30.8%	86.9%
Urban	20.6%	78.8%

Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*

Table 6 - Percentage of Total Requests for Debt by Type of Supplier in 2000

NB: 23 percent of SMEs made debt requests in 2000; this table shows where they made their requests.

	Chartered Banks	Credit Unions / Caisses Populaires	Crown Corporation / Government Institution	Other Credit Suppliers*
Overall				
	65.5%	20.2%	8.2%	6.0%
Size of SME				
0 Employees	61.2%	23.7%	8.2%	7.0%
1 to 4 Employees	67.2%	20.8%	7.6%	4.4%
5 to 19 Employees	68.7%	15.5%	8.5%	7.3%
20 to 99 Employees	71.4%	12.1%	10.5%	6.0%
100 to 499 Employees	80.0%	8.3%	4.2%	7.4%
Regions				
Quebec	46.3%	38.7%	7.9%	7.1%
Ontario	82.1%	6.6%	5.6%	5.7%
Alberta / Northwest Territories	60.9%	11.6%	n/a	n/a
British Columbia / Yukon	74.0%	17.1%	n/a	n/a
Atlantic Provinces	73.6%	11.4%	9.3%	5.7%
Manitoba/Saskatchewan/ Nunavut	44.9%	43.7%	7.0%	4.4%
Industry				
Agriculture	45.6%	35.8%	13.6%	5.8%
Manufacturing	66.0%	19.4%	11.0%	3.6%
Primary	52.6%	28.4%	11.0%	8.1%
All Other	69.8%	17.0%	6.0%	7.1%
Wholesale/Retail	74.3%	12.4%	7.1%	6.2%
KBI Sector	75.6%	10.2%	9.4%	4.7%
Professional Services	81.2%	11.9%	3.0%	3.9%

Continued...

Table 6 - Percentage of Total Requests for Debt by Type of Supplier in 2000

NB: 23 percent of SMEs made debt requests in 2000; this table shows where they made their requests.

	Chartered Banks	Credit Unions / Caisses Populaires	Crown Corporation / Government Institution	Other Credit Suppliers*
Intended Use of Request[a]				
Building or Land Acquisition	11.2%	9.3%	21.7%	2.9%[3]
Vehicle	6.4%	7.9%	2.9%	41.0%[3]
Machinery or Equipment	19.2%	32.2%	24.4%	29.8%[3]
Inventory Financing	7.1%	6.2%	6.5%	8.4%[3]
Working Capital	46.6%	37.9%	22.5%	12.7%[3]
Research and Development	0.7%	0.6%	1.2%	0%[3]
Instrument Requested[-]				
Demand or Short-term Loan	10.6%	15.2%	9.6%	12.8%[3]
Term Loan	26.4%	41.2%	49.5%	n/a
Mortgage Loan	8.4%	11.2%	24.3%	0.3%[3]
New Line of Credit	36.7%	22.1%	11.0%	4.6%[3]
New Credit Card	5.6%	2.3%	2.6%	n/a
Areas				
Rural	46.3%	33.7%	12.5%	7.6%
Urban	76.4%	12.6%	5.8%	5.3%

Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*

* Includes the manufacturers' dealers or suppliers and credit card companies

[a] Not all possible intended purposes of financing included in the survey are included in this table.

[3] Manufacturers' dealer or supplier only

[-] Not all possible types of debt financing requested included in this survey are included in this table.

Table 7 - Percent of SMEs Requesting Specific Debt Instruments in 2000*

NB: 23 percent of SMEs made debt requests in 2000; this table shows what debt instruments they requested.

	Demand or Short-term Loan	New Term Loan	Mortgage Loan	New Line of Credit	New Credit Card	Increase in Line of Credit	Increase in Credit Card
Overall							
	12.2%	32.2%	9.9%	29.8%	5.8%	13.5%	1.0%
Employment Size							
0 Employees	14.1%	35.5%	11.2%	27.6%	7.0%	9.8%	1.5%
1 to 4 Employees	12.6%	29.8%	7.6%	34.0%	5.9%	13.7%	0.8%
5 to 19 Employees	8.5%	30.0%	11.4%	28.4%	4.2%	17.3%	0.7%
20 to 99 Employees	11.6%	32.1%	9.8%	24.3%	3.4%	22.8%	0.2%
100 to 499 Employees	7.4%	-	4.3%	16.5%	0.2%	19.6%	0.0%
Regions of Canada							
Atlantic Provinces	7.7%	38.9%	9.5%	26.6%	4.3%	14.0%	0.6%
Quebec	7.1%	40.6%	8.5%	27.4%	6.1%	12.5%	0.0%
Ontario	13.1%	23.5%	10.7%	33.6%	6.4%	15.2%	1.7%
Manitoba/Saskatchewan/ Nunavut	23.5%	35.3%	12.4%	21.3%	3.6%	13.0%	0.5%
Alberta / Northwest Territories	12.6%	43.6%	5.4%	27.4%	6.3%	9.6%	2.1%
British Columbia / Yukon	8.8%	23.1%	12.0%	36.5%	6.2%	15.5%	0.5%
Industrial Breakdown							
Agriculture	21.8%	45.3%	9.7%	19.8%	3.6%	7.9%	0.8%
Primary	13.3%	50.5%	6.5%	18.6%	3.1%	6.9%	1.1%
Manufacturing	9.2%	33.7%	8.3%	29.2%	5.2%	15.6%	0.9%
Wholesale/Retail	7.2%	24.2%	7.7%	37.4%	4.7%	19.3%	1.4%
Professional Services	8.9%	17.1%	7.9%	49.2%	5.7%	15.9%	1.7%
KBI Sector	10.7%	16.3%	3.0%	45.8%	10.8%	13.5%	2.7%
All Other	10.4%	30.8%	11.8%	28.8%	7.1%	14.0%	0.8%

Continued...

Table 7 - Percent of SMEs Requesting Specific Debt Instruments in 2000*

NB: 23 percent of SMEs made debt requests in 2000; this table shows what debt instruments they requested.

	Demand or Short-term Loan	New Term Loan	Mortgage Loan	New Line of Credit	New Credit Card	Increase in Line of Credit	Increase in Credit Card
Suppliers							
Chartered Banks	10.6%	26.4%	8.4%	36.7%	5.6%	16.4%	1.3%
Credit Unions / Caisses Populaires	15.2%	41.2%	11.2%	22.1%	2.3%	13.2%	0.1%
Crown Corporations / Government Institutions	9.6%	49.5%	24.3%	11.0%	2.6%	1.2%	0.0%-
Areas							
Rural	18.6%	45.2%	8.6%	19.1%	4.3%	10.7%	1.7%
Urban	8.6%	24.9%	10.6%	35.9%	6.6%	15.2%	0.6%

Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*

* Multiple instruments could be requested, therefore figures do not always equal 100 percent for each variable

Table 8 - Percent of SMEs who were Authorized for Debt that used Personal and Business Assets as Collateral in 2000

	Personal Assets of Owner as Collateral	Business Assets as Collateral
Overall		
	38.6%	41.2%
Size of SME		
0 Employees	39.9%	38.9%
1 to 4 Employees	34.3%	36.9%
5 to 19 Employees	43.4%	45.2%
20 to 99 Employees	38.5%	66.4%
100 to 499 Employees	27.1%	73.9%
Regions		
Quebec	28.1%	37.6%
Ontario	39.1%	39.8%
Alberta / Northwest Territories	49.0%	45.7%
British Columbia / Yukon	42.1%	35.6%
Atlantic Provinces	33.2%	38.5%
Manitoba / Saskatchewan / Nunavut	40.6%	52.8%
Industry		
Agriculture	39.5%	56.2%
Manufacturing	31.5%	45.9%
Primary	39.3%	42.7%
Wholesale/Retail	45.5%	37.0%
KBI Sector	44.6%	26.1%
Professional Services	38.7%	26.8%
All Other	36.1%	37.9%
Areas		
Rural Area	35.5%	53.6%
Urban Area	40.3%	34.2%

Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*

LEASE FINANCING: AN ATTRACTIVE OPTION FOR SOME SMES

A lease contract is an agreement under which the owner of an asset conveys to the user the right to use the asset in return for a number of specified payments over an agreed period of time. The owner of the asset is referred to as the "lessor"; the user of the asset is known as the "lessee".

Generally speaking, there are two types of leases: capital and operating. A capital lease is a contract which transfers substantially all of the risks and benefits of ownership of the leased property to the lessee. The lessee is responsible for maintenance, taxes, and insurance costs. An operating lease does not transfer substantially all the benefits and risks incident to ownership of property and the lessee can acquire the use of equipment for just a fraction of the useful life of the asset.

Since leasing is simply a way of acquiring an asset without paying cash, taking a loan, or employing other forms of financing, just about anything can be leased. According to the Canadian Financing Leasing Association (CFLA), Canada's leasing industry has a portfolio of nearly $100 billion with business customers and consumers in Canada. The CFLA estimates that approximately 60 percent of the industry's customers are SMEs. Leasing allows SMEs to obtain an asset while keeping debt off their balance sheets. For many SMEs, leasing makes economic sense. When cash is tied up in fixed assets, it is not available to finance inventory, production, distribution or marketing. For this reason, many owners seek to lease assets. Other attractive features of lease financing include:

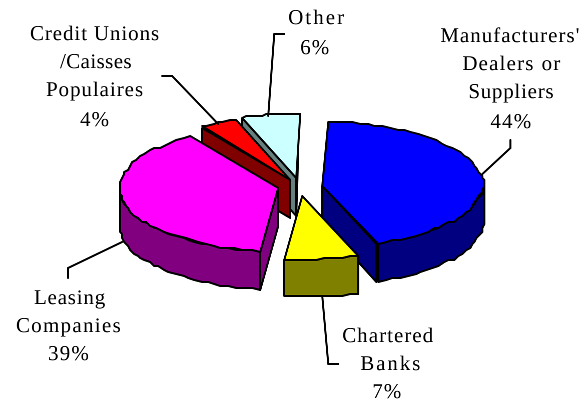
- long-term financing, usually at a fixed rate;
- possibility of upgrading equipment at the end of a lease contract;
- lower transaction costs; and
- sales-tax deferral in a capital lease.

According to the CFLA, SME leases are used primarily for the following types of assets:

- automobiles and light-duty vehicles;
- machinery and equipment;
- computers and computer equipment;
- heavy-duty trucks;
- office equipment other than computers; and
- buildings or land.

Overall, 9 percent of SMEs made a request for lease financing in 2000. Nearly all of these requests — 98 percent — were approved. Table 9, on page 36, shows types of leases requested, and Table 10 (page 37) includes a breakdown of request and approval rates for SMEs of different sizes, industries and regions. As shown in Figure 15, manufacturers' dealers and suppliers, combined with leasing companies, provided the bulk of lease financing — almost 85 percent — to SMEs in 2000.The Bank Act restricts the leasing activity of chartered banks so they are not able to make leases for passenger vehicles and light trucks which, according to Table 9 (page 36), is the single largest segment of the market. This probably accounts for their relatively small contribution to the supply of lease financing, as compared to their contribution to the debt market.

Figure 15 - Requests for Leasing by Type of Supplier in 2000



Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*

As outlined in Table 10 (page 37), although there was little variation in approval rates by the various business characteristics examined, there was some variation in request rates. There was some variation in the use of leases by the size of firm. Larger businesses tended to use leases more. Also, large businesses were more likely to apply for leases at chartered banks, while businesses with fewer employees were more likely to apply for leases from manufacturers' dealers or suppliers. SMEs in the manufacturing sector were common users of leases, but also had a slightly lower approval rate. Also, manufacturing SMEs were more likely to seek lease financing from chartered banks.

Other leasing highlights for 2000:

1. **Automobiles and light-duty vehicles:** As shown in Table 9 (page 36), the majority of leasing requests were for the purpose of acquiring these assets.
2. **Exporters**: were twice as likely to apply for lease financing than SMEs that did not export (see Table 10 on page 37). As will be seen in Table 15, on page 60, larger firms tend to export more than smaller firms; Table 10 (page 37) also shows that larger firms are most likely to request lease financing, so the finding that exporting firms are more likely to request lease financing for assets than non-exporting firms is consistent with other findings.
3. **Rural SMEs:** tended to approach credit unions / caisses populaires and manufacturers' dealers, or suppliers for lease financing, while urban SMEs approached leasing companies. This is consistent with

the pattern of financing we have already seen regarding debt financing.

4. **Manufacturers:** tended to lease assets more than SMEs in other sectors. This is not surprising given the fact that machinery and equipment form the second largest single segment of the lease financing market (see Table 10, page 37) and these types of assets are typically seen as critical to this industry.
5. **Agricultural firms**: while agricultural SMEs use of lease financing is consistent with the national average (as shown in Table 10 on page 37); firms in rural areas were the single largest requesters of lease financing for machinery and equipment, autos and light trucks which are the largest segments of the lease financing market. Further data gathering and study will be needed to clarify what factors might explain this apparent anomaly.

Table 9 - Types of Leases Requested in 2000

	All Firms	Urban	Rural	Exporter	Non-Exporter
Buildings and Land	2.5%	2.6%	2.2%	1.2%	2.8%
Autos and Light-duty Vehicles	35.2%	34.1%	38.3%	29.4%	36.9%
Heavy-duty Trucks	11.7%	10.7%	14.4%	17.4%	10.2%
Computers and Computer Equipment	13.6%	16.1%	7.2%	20.3%	12.2%
Other Office Equipment, Faxes	8.0%	10.6%	1.3%	10.3%	7.5%
Machinery and Equipment	30.6%	27.5%	39.0%	21.7%	32.4%

Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*

Table 10 - SME Request and Approval Rates for Leases in 2001

	Request Rate	Approval Rate
Overall		
	9.0%	97.5%
Size of SME		
0 Employees	5.1%	98.9%
1 to 4 Employees	9.6%	96.4%
5 to 19 Employees	15.6%	97.5%
20 to 99 Employees	22.4%	98.2%
100 to 499 Employees	28.9%	99.1%
Regions		
Quebec	8.3%	96.4%
Ontario	9.1%	98.1%
Alberta / Northwest Territories	9.5%	97.7%
British Columbia / Yukon	8.0%	99.1%
Atlantic Provinces	10.3%	95.7%
Manitoba/Saskatchewan/Nunavut	9.6%	97.1%
Industry		
Agriculture	8.5%	98.8%
Manufacturing	13.7%	94.4%
Primary	9.5%	96.1%
Wholesale/Retail	8.1%	98.6%
KBI Sector	9.3%	97.8%
Professional Services	8.3%	99.2%
All Other	8.9%	97.1%
Areas		
Rural	8.9%	98.9%
Urban	9.0%	97.0%

Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*

THE ROLE OF RISK FINANCING

SME creation and growth usually require several stages, of financing, involving a variety of instruments — depending on the type of business, its growth prospects, market conditions and a number of other factors. While debt is the most commonly sought-after form of external financing by Canadian SMEs, no business can be financed by debt alone. All businesses require an equity base, and this can be provided through personal investments by a firm's owners, through the re-investment of income in the form of retained earnings, or through risk capital investments made by outside parties who become part-owners in the firm.

Sound corporate finance requires an appropriate balance between debt and equity based on the nature of the income that a business is likely to produce. A relatively low-risk business with highly predictable cashflows can take on more debt than a firm with variable and volatile cashflows. The advantage of debt is that it does not require an entrepreneur to give up ownership. Its disadvantage is that it normally requires a fixed schedule of repayment, regardless of the performance of the business. If a firm cannot make its monthly payments, it can find itself in default. Lenders are generally less willing to lend to new firms that lack a track record, because these firms' cashflows are much more difficult to predict. In the early stages in a firm's development, a large part of the financing is likely to be in the form of risk capital — the personal stake of the entrepreneur, retained earnings and love money. Risk capital is a more "patient" form of capital, as the returns are linked directly to the earnings of the firm.

Risk capital financing is particularly important for firms in the knowledge-based sector of the economy. Typically these firms do not have many tangible assets, particularly at the early stages in their growth, that can act as security for providers of debt. If the firm is developing a product or service that will take time to get to market, debt is rarely a good financing alternative because the firm does not have the means to pay interest until that product or service is available for sale. Indeed, debt on the balance sheet can be destabilizing for these firms; thus risk capital is usually the most appropriate form of financing.

Rapid-growth firms generally reach a point where the owners must consider taking in outside risk capital investors. This is a key decision for an entrepreneur, because especially at early stages of a firm's growth, outside investors are likely to want to play an active role in management. The vast majority of entrepreneurs decide not to take this step and decide to grow more slowly. For those firms that do take on outside investors, the first step is usually to go to informal investors (also known as business angels or private investors). These are individuals who make relatively small investments in private companies with high growth prospects.

Successful firms quickly outgrow the ability of angels to provide growth capital. The next stage in risk capital financing is usually to go to the venture capital market. It should be noted that this is used by a very small number of firms. In 2001 there were only 1,077 formal venture capital deals shared among 818 firms in Canada. However, these are among the most important firms for Canada's future, as they have the potential to grow exponentially and become the large firms of tomorrow. Firms that grow successfully through venture capital typically get listed on a stock exchange and raise further risk capital in the form of public stock issues.

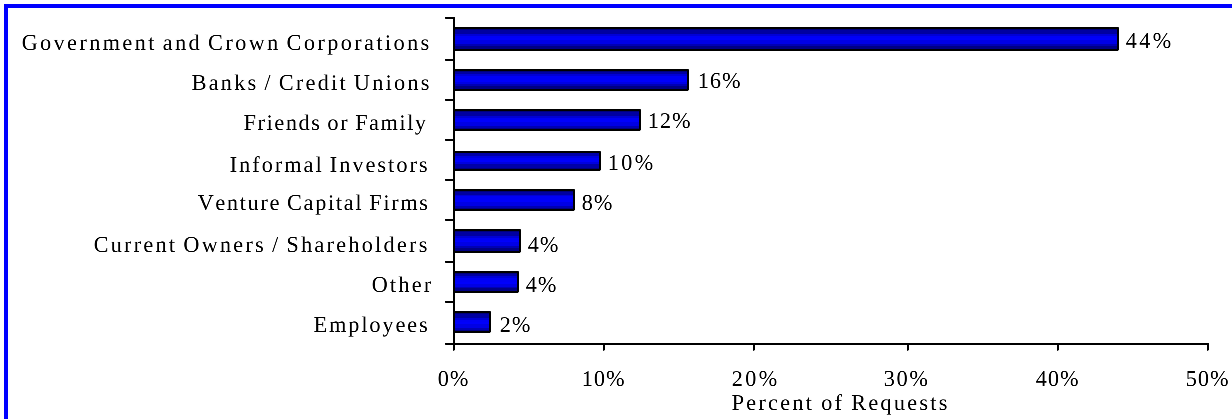
In the section that follows, the report examines the state of the risk capital market in Canada in 2000. It should be noted, however, that the report does not examine two of the most important sources of risk capital: the personal investments made by entrepreneurs in their businesses, and retained earnings. These sources of risk capital will be the subject of future studies.

WHERE SMEs GO FOR RISK CAPITAL FINANCING?

As shown in Figure 16, various sources are available as potential providers of risk capital to SMEs. In 2000, 2.4 percent of SMEs made a request for risk capital.[17] The Statistics Canada survey asked whether SMEs applied for "risk capital or a grant" and this explains the high number of requests in this section to government and crown corporation. SMEs that sought risk capital also reported approaching banks and credit unions. This result is somewhat anomalous, given that these institutions typically do not make risk capital investments. This may be a result of survey methodology. For example, as the survey question grouped venture capital with government grants, these forms of financing are often treated similarly for accounting purposes. Future surveys will include separate questions about venture capital and government grants and will also attempt to discern whether SMEs that report securing risk capital at banks and credit unions were actually securing funds, or advice about how to raise funds. Informal providers of risk capital, such as friends, family and informal investors, ranked high for those SMEs seeking risk capital in 2000. However, to put this in context it is important to recall that only 2 percent of the total SME population sought equity financing in 2001.

Figure 16 - Risk Capital Sources Approached by SMEs in 2000

NB: Of the 2.4 percent of SMEs which requested risk capital in 2000, this figure shows where they made their requests. As multiple answers were possible, the results do not add to 100.



Source: Statitistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*

Note: Survey questionnaire asked SMEs about requests made for risk capital from investors and venture capitalists as well as requests for grants from government and community programs.

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[17] Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*.

INFORMAL INVESTORS[18]

Informal investor activity in Canada: The *Survey on Financing of Small and Medium-Sized Enterprises, 2000*, which found that 18% of business owners have invested privately in other companies. As part of the SME Financing Data Initiative, more data will be gathered to determine their total contribution to the financing of SMEs. Data on informal risk capital investments in Canada are scarce, partly because informal investors often prefer to remain anonymous and do not tend to operate in visible networks and channels.[19] Estimates of informal investment activity in Canada vary widely between $1 billion [20] and $20 billion annually, with 60 percent of this amount targeted at SMEs in the early stages of growth[21]. In the U.S. angels have been identified as the single most important source of risk capital for SMEs.[22]

Value-added by Informal Investors: The value that informal investors provide business ventures extends beyond financing. For instance, SME owners in the Ottawa region cited in a study conducted for Industry Canada[23] six other ways in which informal investors contributed to their growth and success. As shown in Figure 17 (page 41), the study found that the two most common non-financial contributions of informal investors were advice and introductions to contacts and networks. Informal investors use their business knowledge and experience to assist owners with corporate and strategic planning, marketing, and managerial and general business guidance. Informal investors also sometimes sit on the boards of directors,

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[18] While all informal investors put their own money at risk in making an investment in a firm, not all informal investors are of the same type. Some are seeking investment opportunities with high rates of return as a professional investor. Others are approached to make investments which will support the growth of their industry to the benefit of their own firm as well as the investee. There may be many types of informal investors, which are yet to be described and understood. The SME Financing Data Initiative, and other work, has only begun to come to grips with this important source of risk capital investment. Some of the initial studies on informal investors can be found at http://strategis.ic.gc.ca/fdi.

[19] Current estimates of aggregate annual investments were developed around methodologies that extrapolate on regional studies of the size of local angel communities to a national level, therefore making numerous assumptions that need to be refined and tested.

[20] Riding & Short, "On the Estimation of the Investment Perspectives of Informal Investors: A Capture-Recapture Approach," *Journal of Small Business and Entrepreneurship*, Vol.5, 1998, pp. 26-40.

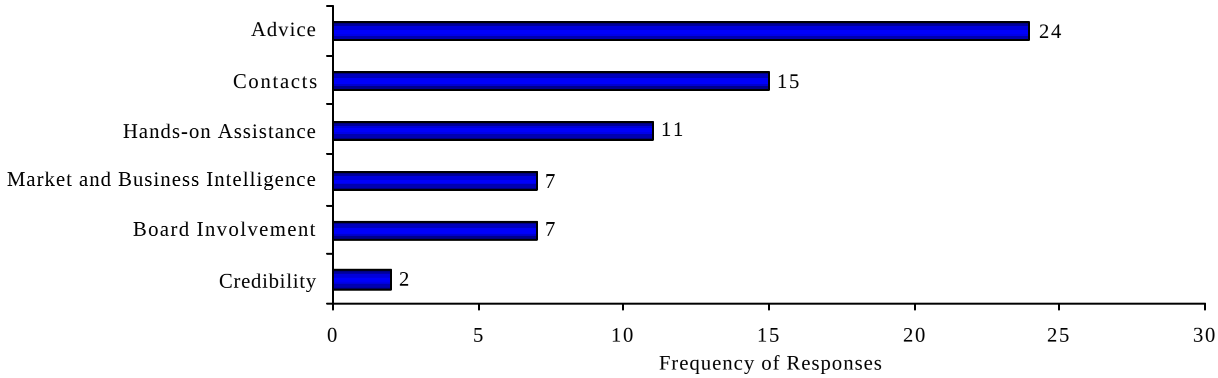
[21] E. Farrell, *Informal Venture Investments in Atlantic Canada: A Representative View of Angels*. Atlantic Canada Opportunities Agency and St. Mary's University, Halifax, 1998.

[22] The Centre for Venture Economics, in a 1995 report for the Office of Advocacy of the U.S. Small Business Administration, estimated that approximately 250 000 angel investors were investing about US$30 billion in 30 000 small companies each year. This is approximately twice the value of annual investments by U.S. institutional venture capital funds and about 15 times the number of companies receiving (formal) venture capital investment (Freer, Sohl and Wetzel, 1996 in Acs and Tarpley, 1998).

[23] Equinox Management Consultants Ltd., *Value Added by Informal Investors*, 2001, commissioned by Industry Canada.

providing industry information and lending credibility, particularly with respect to future financing.

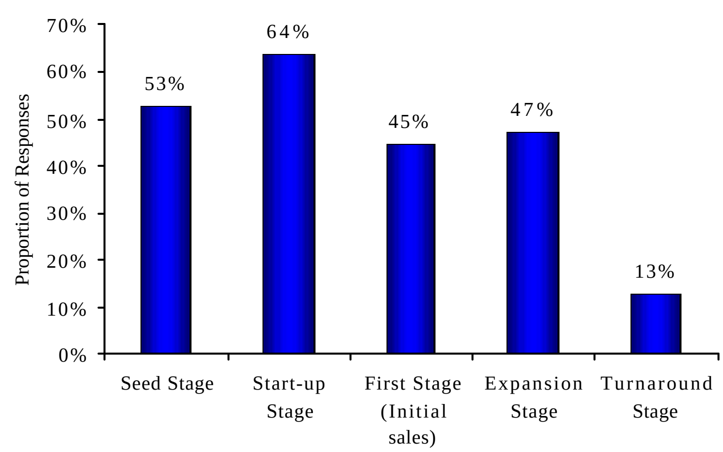
Figure 17 - Contributions Made to SMEs by Informal Investors



Source: Equinox Management Consultants Ltd., *Value Added by Informal Investors, 2001* , commissioned by Industry Canada.
Note: Number of mentions in a survey of 33 Ottawa-based angel financed companies

Stage of business development for investment: Informal investors typically invest in the earlier stages of growth. A recent study by Equinox Management Consultants Ltd.[24] found that 50 percent of investors responded that they had invested at the seed stage of projects, while more than 60 percent said that they had invested at the start-up stage (see Figure 18).

Figure 18 - Informal Investors' Preferred Stage(s) of Business for Investment



Source: Equinox Management Consultants Ltd., *Practices and Patterns of Informal Investment*, 2001, commissioned by Industry Canada.
Note: multiple answers were allowed

Finding investment opportunities: To find investment opportunities, most informal investors use their own networks, including professional contacts such as accountants, bankers, lawyers, and other investors.

Determinants of investment: generally, informal investors consider three factors when evaluating potential investment: the people involved, the product or technology, and the non-financial value that they see themselves adding to the venture.

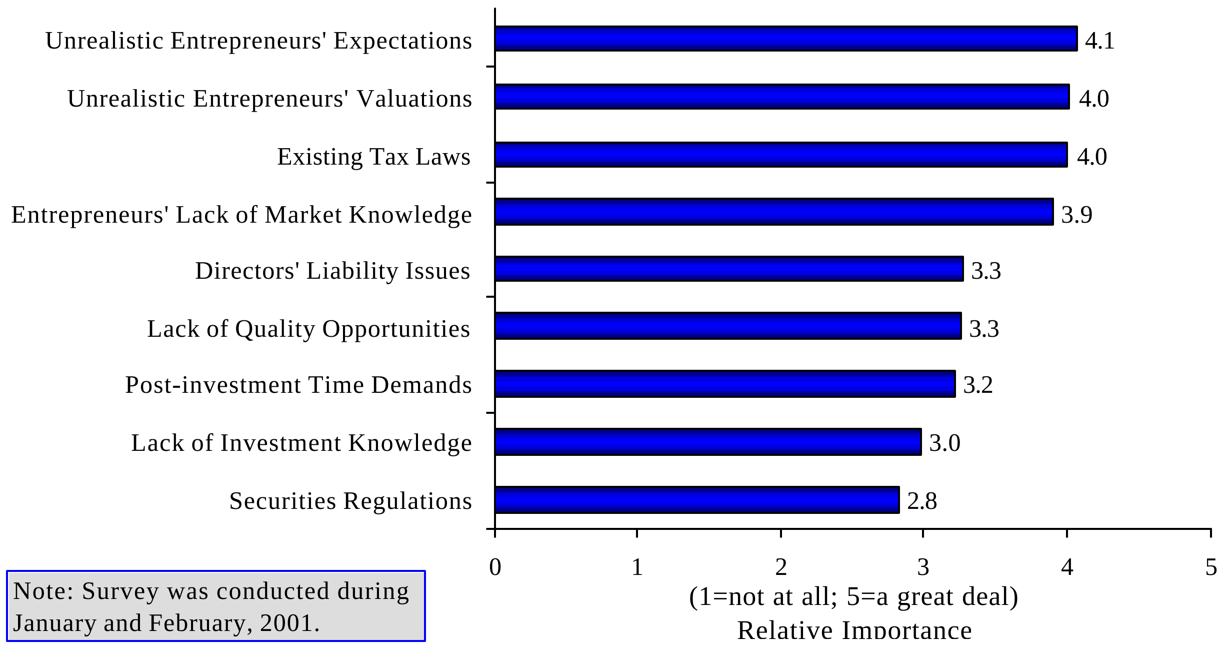
Approval rates: for informal investors who examine, on average, 24 proposals each year are low by

[24] Equinox Management Consultants Ltd., *Practices and Patterns of Informal Investment,* 2001, commissioned by Industry Canada. This study surveyed 51 informal investors in ten centres across Canada who made investments large and small in many different sectors.

comparison with other forms of financing: just 12 percent of proposals were accepted according to a recent study.[25]

Reasons for not investing: Generally, informal investors believe that most potential SMEs are not "investor ready," either because business plans and market knowledge are not well developed or because business owners are unwilling to relinquish control of their businesses. In fact, as shown in Figure 19, informal investors claim that lack of preparedness by SMEs for investment is the leading factor inhibiting informal investment in Canada, edging out taxation and regulation.

Figure 19 - Inhibitors to Investment According to Informal Investors



Source: Equinox Management Consultants Ltd., *Practices and Patterns of Informal Investment, 2001*, commissioned by Industry Canada.

Exit Strategies: To realize a high level of capital gain, informal investors typically negotiate exit strategies at the outset of their investments. Usually, the terms are specified in the shareholders' agreement. Typical exit strategies may include buyout by a venture capital fund, third-party acquisitions, management buy-backs or initial public offerings.

[25] Ibid.

VENTURE CAPITAL MARKET

Investments in 2001: Canada's venture capital (VC) industry broke records in 2000 but faced new challenges in 2001 including limited exit opportunities that dampened the level of investment, sending it to 27 percent below the previous year. Nonetheless, 2001 actually remained well above 1999 levels.

Canadian vs. U.S. VC activity: In the U.S. total investment dropped 65 percent in 2001, bringing the annual total in line with levels experienced in 1998.[26] With a smaller relative decline in VC investments in Canada in 2001, this left Canadian VC activity at about 9 percent of that the U.S., taking currency exchange into account, this compares with 4 percent in 2000.

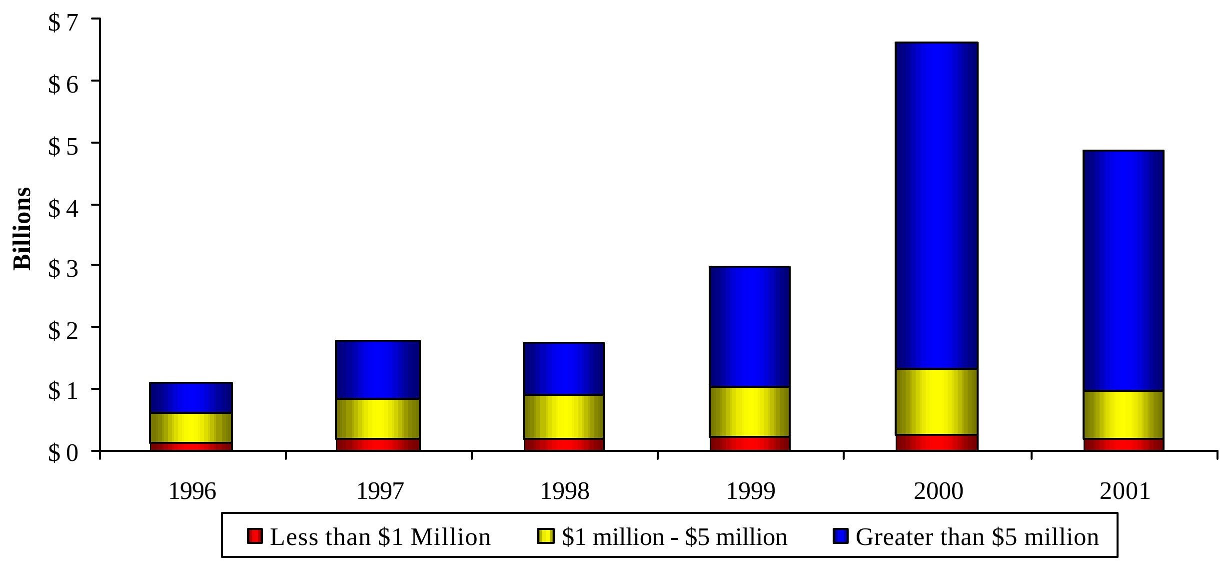
Stage of business development: In 2001, $2.9 billion (60 percent of total for 2001) was invested in early-stage businesses - an increase from the 46 percent of total VC directed at early-stage firms in 2000.

- **Value of investment in 2001:** As shown in Figure 20 (page 44), $4.9 billion was invested in 2001, compared to $6.6 billion[27] in 2000.
- **Number of investees, in 2001:** 818 companies received VC, down from 1,132 in 2000.
- **Size of Investments:** average deal size in 2001 was $4.5 million, up from $4.4 million in 2000. Deals involving more than $5 million accounted for 80 percent of the 2001 deals, slightly higher than the 78 percent seen in 2000.
- **Assets under management:** The VC industry had $20.1 billion under management in 2001, up from $18.6 billion in 2000 — an 8 percent increase.
- **Funds available for investment:** at the end of 2001, $6.2 billion was available for investment, up from $4.2 in 2000 — nearly a 48 percent increase, representing about 15 months of investment at the 2001 pace of investment.

[26] Macdonald & Associates Limited, 2002.

[27] The previously reported total disbursements for 2000 were $6.3 billion. This discrepancy is explained by new methodology used by Macdonald & Associates. It entails the fact that previously the reporting of RRSP fundraising numbers for the LSVCCs were recorded through the end of the RRSP season (end of February) and reported in the prior year; however, they will now be reported based solely on the calendar year. Historical data has been refined to reflect this change in methodology.

Figure 20 - Annual VC Investment by Size of Investment



Source: Macdonald & Associates Limited, 2002

VENTURE CAPITAL INVESTMENT: A REGIONAL PERSPECTIVE

Considering that a total of only 818 firms received venture capital in Canada in 2001, variation in regional performance can be significant year over year. In regions which have had a small base of investments in the past, a very small number of investments can make dramatic shifts in the regional distribution. Given the small numbers involved, it is perhaps less useful to focus on absolute numbers in any given year, but rather to look at trends over a longer period.

The overall pool of venture capital has been rising. So even if a particular region's "share" of total investments does not change much relative to other regions, this still reflects a substantial increase in actual dollars invested in firms located in that region. For example while, the Atlantic region's share of VC investments was about 1 percent of total investments in 2001, this represented an increase from about $33M in 1996 to about $50M in 2001 -- a 50 percent increase.

- **VC Funds**: the last five years have seen a rapid growth in the number of VC funds in Canada. Moreover, there is an increasing trend toward specialization and less concentration in Central Canada. For example, 181 VC funds have been created since 1996 bringing the total to 293 (216 VC firms existed in 2001). Of the total VC funds in Canada, 162 are specializing in information technology and 78 in life sciences. There are 18 located in Alberta, 8 in Atlantic Canada, 39 in British Columbia, 125 in Ontario, 80 in Quebec, and 23 in Manitoba and Saskatchewan[28].
- **Ontario:** In 2001 the amount of venture capital invested in Ontario dropped 31 percent from $2.9 billion in 2000 to $2 billion, as shown in Figure 21 (page 46). This is a slightly higher decline than

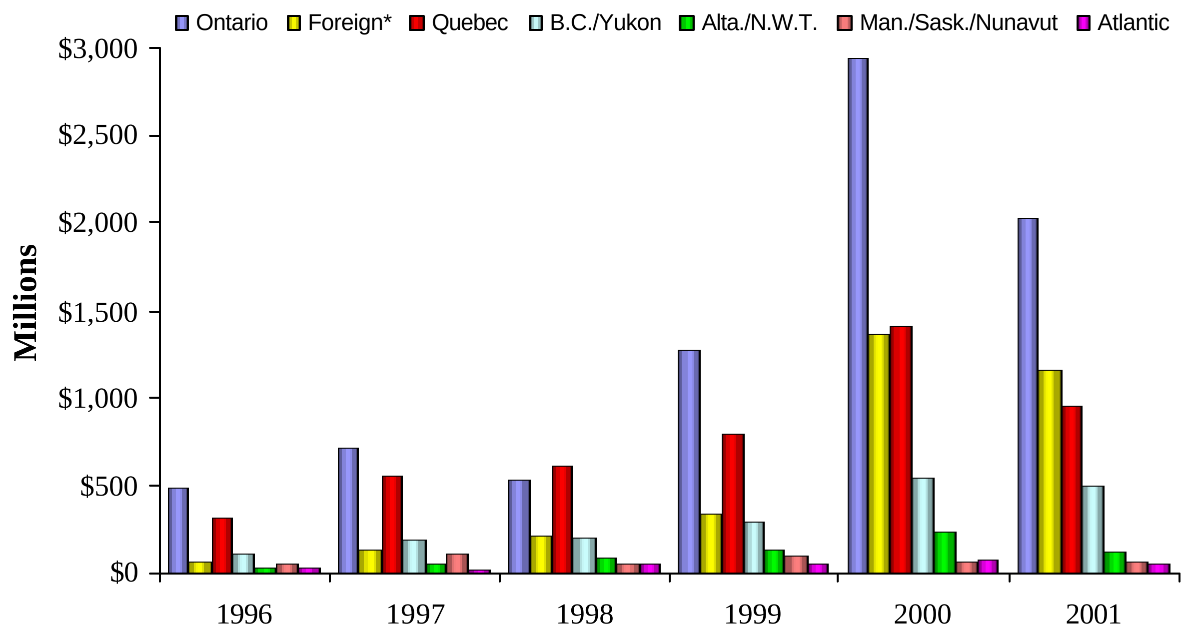
[28] Macdonald & Associates

the 27 percent decline experienced across Canada.

- **British Columbia:** In contrast to the national decline of 27 percent in total venture capital experienced in 2001, British Columbia-based firms attracted 8 percent less in 2001 than in 2000.
- **Quebec:** in absolute terms Quebec has seen a dramatic increase in the value of VC investments from $323 million in 1996 to $956 million in 2001; however, as noted in Figure 21 (page 46) this region has seen a decline in VC investments in 2001.
- **Alberta:** Firms in Alberta saw a 50 percent decline in VC investment last year, relative to that in received in 2000. A recent report by Ernst and Young LLP[29] reported that Alberta firms were having some difficulty raising VC funds in the $1M to $5M range, which the report suggests may be a factor contributing to this decline. It is notable, from Figure 20 on previous page, that this segment has seen a significant decline in the last year.
- **Canadian VC investments in foreign firms:** in absolute terms 24 percent of all investments by Canada VC firms went to foreign-based firms, up from 19 percent in 2000. Macdonald & Associates reports that large financings in technology-intensive firms located in the U.S., Europe and Asia have contributed to this growing trend. As this phenomenon has only emerged in the last few years, there has been little study to determine its nature, what is driving it, and what are the factors contributing to it. More study and data gathering will be needed to determine these questions.

[29] Ernst & Young LLP, The third annual Alberta Technology Report, 2001. http://www.albertatechreport.com/

Figure 21 VC Investment by Region of Investee, 1996-2001



	1996	1997	1998	1999	2000	2001
Ontario	$482	$706	$531	$1,278	$2,939	$2,028
Foreign*	$60	$128	$219	$348	$1,360	$1,158
Quebec	$323	$560	$615	$791	$1,410	$956
B.C./Yukon	$106	$195	$203	$294	$540	$502
Alta./N.W.T.	$40	$53	$86	$133	$243	$119
Man./Sask./ Nunavut	$44	$108	$49	$89	$63	$58
Atlantic	$33	$23	$48	$53	$75	$53

Source: Macdonald & Associates Limited, 2002
* Indicates Canadian venture capital invested in companies outside of Canada

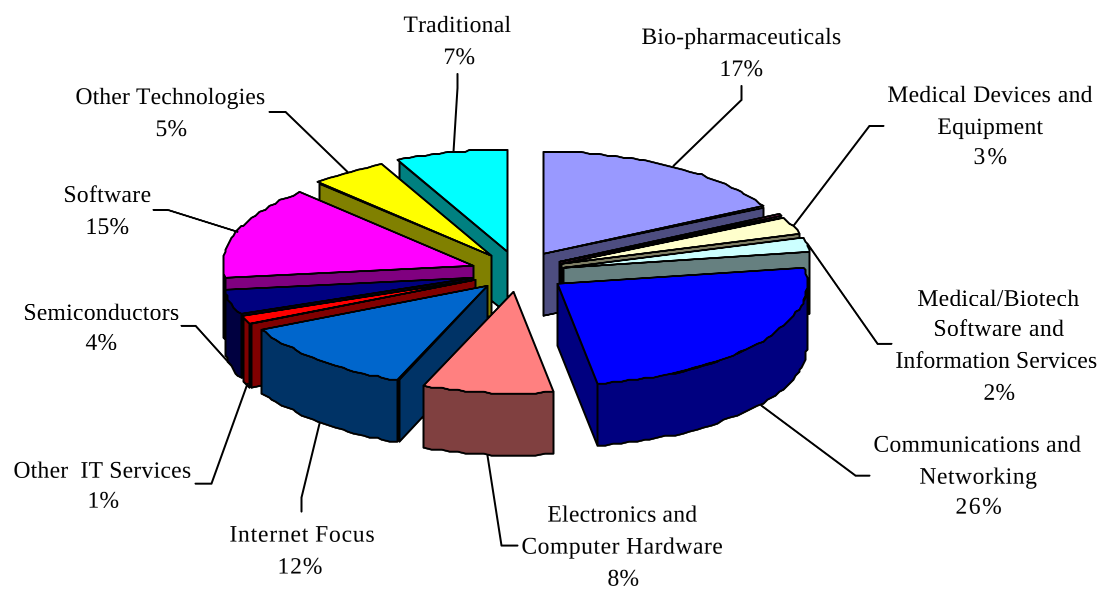
INFORMATION TECHNOLOGY IN 2000 AND 2001

Information technology companies continued to attract a substantial portion of VC invested. Again in 2001, as in 2000, 65 percent of total VC was invested in the IT sector, while 22 percent was invested in life sciences.

- **Communications and networking:** claimed one quarter of the total investments, up from 20 percent in 2000.
- **Software companies**: received 15 percent of total capital, equal to the previous year.
- **Internet-related firms:** In 2001, 12 percent of total venture capital went to these firms, down from 19 percent in 2000.
- **Bio-pharmaceutical companies**: within the life sciences sector, attracted 17 percent of total

capital, up from 10 percent in 2000.

Figure 22 - VC Investment by Sector in 2001

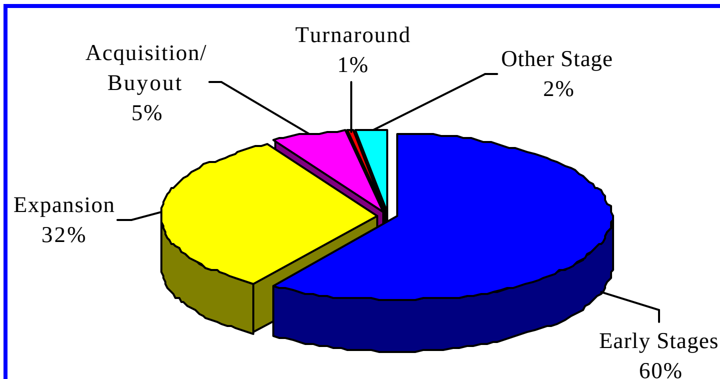


Source: Macdonald & Associates Limited, 2002

EARLY-STAGE FIRMS DOMINATE VC INVESTMENTS IN 2001

Continuing the growing focus on investment in early-stage firms including seed, start-up and other early-stage firms, seen in 2000, 60 percent of capital invested in 2001 was in 451 early-stage firms. This amounted to a total of $2.9 billion invested directly in early-stage firms. This was an increase relative to the 46 percent of total VC investment seen in 2000 which was made in 545 companies totalling $3 billion.

Figure 23 - VC Investment by Stage of Business in 2001

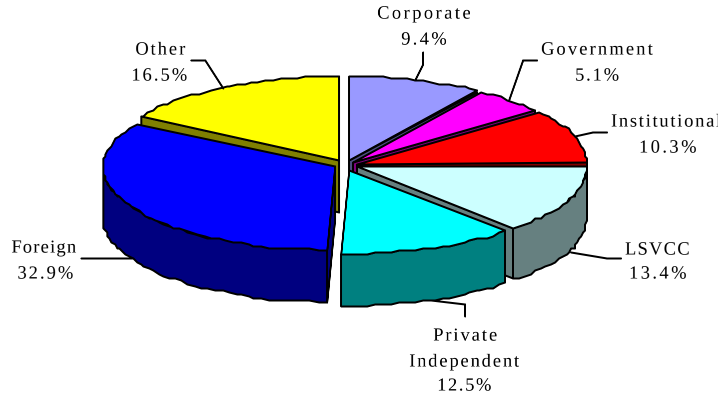


Source: Macdonald & Associates Limited, 2002

While focus on early-stage firms continues, fewer expanding companies are receiving financing. In 2001, one third of all investments were made in expansion projects, down from 47 percent of total capital invested seen in 2000 (see Figure 23). The number of companies that received financing for expansion dropped to 380 in 2001, well down from the 683 deals in 2000 worth $3.1 billion.

Foreign VC investors: played a critical role, bringing $1.6 billion to the Canadian VC total annual investment and lifting their share of investment to 33 percent of the aggregate (see Figure 24). In 2000, foreign investors contributed 24 percent of the total, and 19 percent in 1999. Macdonald & Associates Limited suggests that Canadian VC groups may be increasingly co-investing with U.S.-based VC funds in their Canadian investments. This may account for the apparent rapid growth in foreign VC investment in Canada.

Figure 24 - VC Investment by Type of Supplier in 2001



Source: Macdonald & Associates Limited, 2002

Clearly this is a new trend which will require more study to understand its implications. On the surface it appears to be a good thing that Canadian firms are able to attract foreign-based venture capital investments to support their growth. However, time will tell what impact this trend has on the future of these firms. It would be troubling, for example, if this led to an increase in firms leaving Canada and moving to foreign markets, thereby representing a net loss for Canada. On the other hand it may be that accessing foreign VC also gives Canadian firms more access to important foreign markets which can help them to grow rapidly, both in Canada and in these new markets. As this is an emerging trend, more study will be required to determine its net impact.

Canadian VC investors: the second largest domestic VC investors behind foreign investors, were Labour-Sponsored Venture Capital Corporations (LSVCCs) with 13 percent of total investments in 2001, followed by private independent funds with 12 percent then pension funds and insurance companies (such as Caisse de Dépôt et de Placement, the Ontario Municipal Retirement System, and the Ontario Teachers Pension Fund) which contributed $526 million, or 10 percent of total capital invested in 2001.

[30] In 2000, methodology for data reporting was revised to account for the increasingly important role being assumed by Canadian institutional sources — particularly Quebec's Caisse de Dépôt et de Placement, the Ontario Municipal Retirement System, and the Ontario Teachers Pension Plan — as direct investors.

INITIAL PUBLIC OFFERINGS

Entry into public equity markets offers mature SMEs increased access to the capital they need to finance larger-scale operations and to facilitate sustained growth. Post-initial public offering (IPO) risk capital financing is required for SMEs to meet financing needs that have exceeded their ability to borrow. This type of financing is particularly important for SMEs in KBIs.

An IPO of shares on a stock exchange is often the "exit strategy" of choice for VC funds, as once a public market is established they can sell their shares. Through IPOs, historically, venture capitalists have achieved the maximum value for their investment. However, going public is not without its disadvantages. The capital raised through an IPO is seldom sufficient to meet all the company's growth requirements. However, once on the stock market the company's ability to raise capital through further issues of shares is dependent to a large extent on the performance of the stock market, which may be little influenced by an individual company's performance.

Getting the price, the size and the timing of the share issue right is an art, and the extent to which the company succeeds in this will have an influence on its ability to make future issues. However, these are only some of the factors that influence any decision to use this financing option. Other factors relate to the internal readiness of the firm — demonstrated by a strong financial position — which is needed to carry it through the IPO and sometimes difficult post-IPO stages.[31] These factors may include:

- a capable and experienced management team;
- a prominent board of directors;
- an experienced team of financial, legal and underwriter advisors;
- innovative new products;
- a new business concept;
- a large market share; and
- a consistent record of high growth or high growth potential.

Achieving many of these criteria is difficult, especially for SMEs in the high growth stage. Apart from this, the success of any IPO ultimately depends on firm performance, economic and market conditions. If these conditions deteriorate when a company wants to go public, valuation acceptable to the marketplace may not provide sufficient capital to the company, and could dilute the ownership and valuations of existing shareholders to the point where it is not attractive to undertake the IPO — which could lead to prolonged problems for the company.

[31] E. Wayne Clendenning & Associates, *Issues Surrounding Venture Capital, Initial Public Offering (IPO) and Post-IPO Equity Financing for Canadian SMEs*, 2001, commissioned by Industry Canada.

Structure of Canadian Exchanges

In 1999 the Toronto Stock Exchange (TSE), along with the Montreal, Vancouver and Alberta exchanges were restructured which brought the competition that once existed among the Canadian exchanges to an end, although the competition between exchanges and markets worldwide has never been greater. The TSE has become Canada's premier stock exchange, capturing 98 percent of value traded on Canadian stock exchanges in 2000 and becoming the fourth most active stock exchange in North America after the New York Stock Exchange (NYSE), NASDAQ (North American Securities Dealers' Quotations) and the Chicago Stock Exchange.[32] In 2000, NASDAQ Canada[33] was opened in Montreal as a wholly-owned subsidiary of the New York-based NASDAQ market. This new stock exchange gives Canadians the opportunity to invest directly from Canada in all 4,100 NASDAQ stocks through Canadian brokers. According to NASDAQ Canada, 142 Canadian securities are listed on NASDAQ and 42 Canadian companies are solely listed on NASDAQ U.S.

The Canadian Venture Exchange was created in 1999 through the merger of the Vancouver and Alberta exchanges, creating a national junior market in Canada with offices in Calgary, Vancouver, Winnipeg and Toronto. The Montreal Exchange continues to service the needs of the Quebec junior markets through an affiliation with the Canadian Venture Exchange (CDNX).

The CDNX specializes in financing for emerging companies and fostering their development so they can graduate to senior markets, such as the TSE. Of the IPOs on the TSE in 2000, 38 percent were graduates of the CDNX.[34] In July 2001 the TSE announced that it would acquire the CDNX. The CDNX has a Capital Pool Company (CPC) Program[35] that focusses on providing risk equity to early-stage businesses, and is designed to increase their visibility and provide an opportunity to work toward having a presence on senior exchanges. Since CPC began in 1987, more than $369 million in capital was raised for qualified companies. Companies that graduated from the CPC program have gone on to raise more than $3 billion in financing since the inception of the program. Additionally, of the 38 percent of former CDNX companies that issued IPOs on the TSE, one quarter were formerly CPC issuers.

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[32] The Toronto Stock Exchange, http://www.tse.com

[33] For additional detail on the launching of NASDAQ Canada, visit http://www.nasdaq-canada.com/

[34] The Canadian Venture Exchange, *Facts at a Glance*, http://www.cdnx.com.

[35] For more information on the Capital Pool Company Program, visit http://www.cdnx.com/Listing/MarketingPubs/CPCBrochure.pdf

Highlights of Canadian Exchanges during 2000-2001

According to a survey of IPO activity in Canada in 2001published by PriceWaterhouseCoopers[36], there were 74 IPOs brought to market in 2001, down 27 percent from 2000 (see Table 11). The technology and media sector saw the largest decline in the number of IPOs, with 80 percent fewer in 2001. The mining sector also saw the number of IPOs issued drop in half, while the oil and gas sector experienced a significant increase.

Researchers suggest that owing to the events of September 11, 2001 and the then present economic downturn, a pent-up supply of IPOs may be on the horizon waiting for a more opportune time to go public. According to PriceWaterhouse Coopers, markets are "cyclical and unpredictable," therefore companies hoping to issue an IPO should be well prepared and ready to move quickly when the market is receptive to their company and industry's growth potential.

The total value of Canadian IPOs in 2001 dropped by 14 percent from 2000 (see Table 12). The sectors hardest hit were technology, media and life sciences. The focus of IPOs in 2001 shifted away from these sectors and toward what is often referred to as "bricks and mortar." Large increases were evident in the products and real estate sectors.

Table 11 - Number of IPOs on Canadian Exchanges

Sector	2000	2001	% Change
Financial Services	24	33	37.5%
Mining	20	10	-50.0%
Oil and Gas	3	8	166.7%
Technology and Media	35	7	-80.0.%
Life Sciences	11	5	-54.5%
Products	7	5	-28.6%
Other	1	3	200.0%
Real Estate	0	3	-
Forestry	0	0	-
Total	**101**	**74**	**-26.7%**

Source: PriceWaterhouseCoopers, *Survey of IPOs in Canada in 2001* http://www.pwcglobal.com

Table 12 - Gross Value of all IPOs on Canadian Exchanges (Millions of Dollars)

Sector	2000	2001	% Change
Financial Services	$3,716.8	$4,071.8	9.6%
Mining	$25.0	$5.9	-76.4%
Oil and Gas	$51.1	$22.4	-56.2%
Technology and Media	$2,682.7	$26.0	-99.0%
Life Sciences	$289.3	$30.3	-89.5%
Products	$40.0	$798.7	1,896.8%
Other	$30.0	$416.9	1,289.7%
Real Estate	-	$505.0	-
Total	**$6,834.9**	**$5,877.0**	**-14.0%**

Source: PriceWaterhouseCoopers, *Survey of IPOs in Canada in 2001* http://www.pwcglobal.com

[36] Source: PriceWaterhouseCoopers, Survey of IPOs in Canada in 2001 http://www.pwcglobal.com/

Canadian and American Stock Exchanges : Initial Public Offerings

Research indicates that Canadian markets have somewhat fewer regulatory requirements than American markets, particularly for smaller firms[37]. It costs considerably more in time and money for Canadian firms to go public in the United States than in Canada. This is particularly true for Canadian companies undertaking a joint issue — an issue involving both a Canadian and an American stock exchange — because they must have both American and Canadian advisors to deal with each set of regulatory and process requirements. According to recent research,[38] companies going public in Canada tend to be much smaller than their U.S. counterparts. Canadian exchanges have different listing requirements than U.S. exchanges. Canadian SMEs, however, continue to go public in the U.S., either solely in American markets or jointly with a Canadian stock exchange[39]. This suggests that other factors, such as the size and depth of American markets, may allow for easier access to capital, and override the regulatory benefits of going public in Canada.

When launching an IPO a company has to take into account the likelihood that its issue will be underpriced.[40] There may be many reasons for this, including the interest of issue underwriters (investment dealers and brokers) to guarantee that they can sell out an issue of shares completely in the shortest possible time. This creates a tension between the company's need to have the price high enough to provide sufficient capital for the firm's growth requirements and the investment dealer's interest in having the issue price low enough to ensure a wide investor interest and complete subscription. Thus it is understandable that underpricing of IPOs is a common characteristic of all public capital markets.

Many studies have concluded, however, that IPO issues tend to be less underpriced in the Canadian market than elsewhere.[41] This may be largely explained by the influence or aggressiveness of large institutional investors in the U.S. marketplace, which results in lower valuations and greater underpricing of new issues in the American market. Such investors are the major market for new issues. They are interested in seeing under-priced issues, since this helps to boost their portfolios as the market adjusts post-issue to the "real" price of the shares. While institutional investors are important players in the Canadian market as well, they have not wielded the same degree of influence as seen in the U.S. markets. Given the greater underpricing of issues in the U.S. public capital markets and the increased costs associated with

[37] The Conference Board of Canada, *Going to Market: The Cost of IPOs in Canada and the United States*, June 2000.

[38] E. Wayne Clendenning & Associates, *Issues Surrounding Venture Capital, Initial Public Offering (IPO) and Post-IPO Equity Financing for Canadian SMEs*, 2001, commissioned by Industry Canada.

[39] According to the recent survey of IPOs by PriceWaterhouseCoopers, in 2000, two Canadian companies listed exclusively on the NASDAQ, down from three in 1999.

[40] According The Conference Board of Canada and *Canadian IPO Environment in the 1990s* (Jog, 2001), underpricing of IPOs is a characteristic of all financial markets. Underpricing means that the initial issue price of the shares does not equal the full book value of the company – at least as perceived by the current owners.

[41] Vijay Jog, *Canadian IPO Environment in the 1990s*, March 2001.

the issuance of a Canadian IPO in the U.S., it might appear paradoxical that Canadian companies continue to issue there. However, it is likely this choice is less a function of the regulatory structure or the disadvantage of underpricing of issues and more related to relative market conditions. Recent research[42] suggests that this may be partly a function of business strategy, i.e. an attempt by the company to attract not only investors but also greater visibility among potential customers and strategic partners in the major market. It may also be a function of differing market conditions in Canada and the United States public capital markets. For example, it may reflect the capacity of the market to absorb IPOs. Given the relative sizes of the Canadian and U.S. markets, a very large IPO in Canada's terms may just be a medium or small one in U.S. terms and can easily be accommodated, whereas it would be considered too risky for issuance on a Canadian stock exchange. Likewise, Canadian market makers may perceive a "glut" of IPOs from a certain sector at a particular moment. The same numbers of IPOs from that sector in the U.S. may be viewed very differently. Other market conditions may also contribute to making U.S. capital markets more attractive than the Canadian market at a given moment for a Canadian issuer. Indeed, there may be many other factors which contribute this choice, further study would be required to provide a definitive answer. Further research may be conducted by the SME Financing Data Initiative to provide insight into the benefits and drawbacks of where a company conducts its IPO.

[42] E. Wayne Clendenning & Associates, *Issues Surrounding Venture Capital, Initial Public Offering (IPO) and Post-IPO Equity Financing for Canadian SMEs*, 2001, commissioned by Industry Canada.

SUPPLIER CREDIT

Supplier credit, sometimes referred to as trade credit, is a type of financing whereby a supplier gives a firm a period of delay, often 10 to 30 days, to pay its invoices. In 2000, 29 percent of Canadian SMEs made purchases using supplier credit (See Tables 13 and 14). Only 4 percent of SMEs that attempted to finance a purchase with supplier credit reported being turned down.

The following are key findings concerning the use of supplier credit:

- **Larger SMEs**: were more likely to use supplier credit than smaller SMEs. In 2000, 53 percent of SMEs with more than 100 employees used supplier credit.
- **KBI sector:** firms in this sector were slightly more likely to have a request to use supplier credit refused.
- **Manufacturing sector:** firms in this sector were most likely to use supplier credit, while those in the professional services sector were least likely to use supplier credit.

Table 13 - Percent of SMEs who used Supplier Credit by Sector in 2000

Agriculture	32.4%
Primary	24.0%
Manufacturing	41.7%
Wholesale/Retail	39.9%
Professional Services	15.6%
KBI Sector	20.3%
Other Sectors	27.2%

Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*

Table 14 - Percent of SMEs who used Supplier Credit by Region in 2000

Atlantic Provinces	34.8%
Québec	22.0%
Ontario	27.7%
Man./Sask/Nunavut	40.8%
Alberta / NWT	34.0%
BC / Yukon	30.0%

Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*

FACTORING

Factoring is the sale of accounts receivable, at a discount, to a third party. When a firm provides another with goods on a promise to pay in a period of time it essentially extending supplier credit and creating an "account receivable" at a later date. As we have seen that is a very common form of informal financial arrangement. When the supplier wants to realize immediately the value of its receivables rather than waiting for them to be paid by her or his customer, he or she will sell the account receivable to the factor. This kind of a sale usually leaves the seller with a percentage of the value of the receivable, to compensate the factor for the risk of not collecting on the receivables.

In 2000, only 0.4 percent of Canadian SMEs used factoring. It appears that the factoring activities of Canadian financial institutions tend not to be reported separately. The market for factoring appears to be much more developed in the U.S. than in Canada. Given the very small number of observations, any conclusions about the Canadian factoring market are tentative and preliminary. Following are some findings concerning the factoring market in 2000:

1. **Size of SME:** Factoring is a slightly more common for larger SMEs than for smaller ones.
2. **Sectors:** factoring is slightly more common in manufacturing, wholesale/retail, and KBI, with 0.6 percent of SMEs in each of these industries using factoring in 2000.
3. **Regional usage:** Factoring was used by 1 percent of SMEs in the region of British Columbia and the Yukon. This figure is higher than in all other regions, where SMEs using factoring varied between 0.1 percent and 0.4 percent.
4. **Exporters:** SMEs that export used factoring more often than non-exporters — 1.5 percent compared to 0.2 percent. This is most likely due to the nature of work that exporting SMEs tend to do (i.e. goods producing).
5. **Urban SMEs**: were more likely to use factoring than rural SMEs in 2000 — 0.5 percent versus 0.1 percent.

QUASI-EQUITY FINANCING

Quasi-equity financing, often referred to as mezzanine financing or subordinated debt, involves a mix of the characteristics of debt and equity. As an investment it provides the cash flow of term lending along with the capital gains of share ownership. According to Macdonald & Associates Limited,[43] it is generally defined as including subordinated convertible debt and yield-based preferred shares, often structured with warrants or options. This type of financing tends to be an attractive financing option for companies that prefer not to relinquish full or partial control of the business by selling shares. The equity component allows investors the ability to achieve a higher rate of return depending upon the success of the company, while the debt element entails a premium price contributing to the overall return of the investor. Unlike term or demand debt, this type of financing is more flexible and is constantly evolving to respond to emerging market needs. This market segment has seen recent growth since it was introduced by a few financial institutions in the mid-1990s.

[43] See http://www.canadavc.com

In the first nine months of 2001, $234 million of quasi-equity was disbursed in 337 transactions. This is 9 percent higher than during the same time period the previous year.[44]

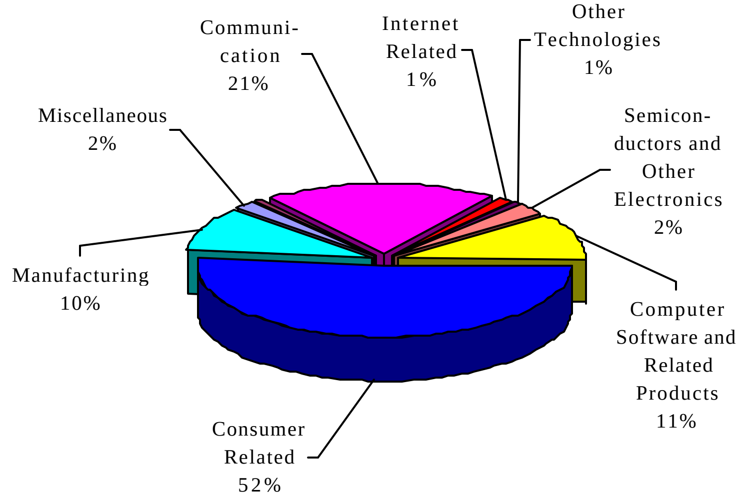
Traditional sectors received the majority (64 percent) of financing in the first nine months of 2001, unlike the same period in 2000 when 54 percent flowed to technology sectors during the same period.

Consumer products (at 52 percent) was by far the sector of choice among quasi-equity providers, followed by communications and networking, which received 21 percent of the total amount invested.

The Business Development Bank of Canada (BDC) is the largest provider (almost three quarters) of quasi-equity to companies in traditional sectors, a large increase from 56 percent one year earlier. The BDC directed almost half (48 percent) of its disbursements to consumer-orientated firms, and 26 percent to manufacturing firms.

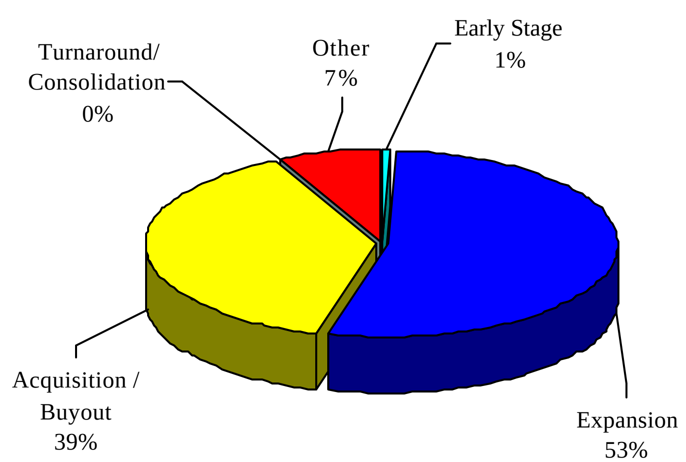
Quasi-equity providers have traditionally provided financing to companies in the expansion stage, as shown in Figure 26. In 2001, firms at this stage accounted for the largest proportion (53 percent) of total financing in the first nine months of 2001, and 83 percent of all deals. This focus is similar to what was seen in 2000.

Figure 25 - Quasi-equity Investment by Sector, First 9 Months of 2001



Source: Macdonald & Associates Limited, *Quasi-Equity Activity, First 9 months of 2001*, prepared for Industry Canada

Figure 26 - Quasi-equity Investment by Stage of Business, First 9 Months of 2001



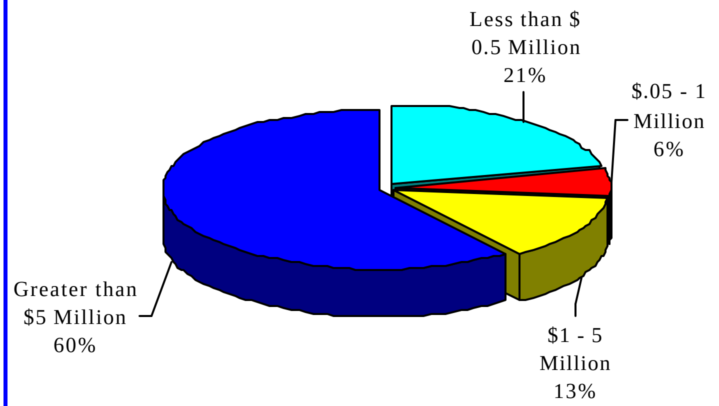
Source: Macdonald & Associates Limited, *Quasi-equity, First 9 months of 2001* , prepared for Industry Canada

44 Macdonald & Associates Limited, *Quasi-Equity Activity*, prepared for Industry Canada, 2001.

The BDC provided 74 percent of its quasi-equity funds to expanding companies.

Quasi-equity activity during the first nine months of 2001 was more polarized between large and small deals, with the heavy focus on deals of less than $1 million. Ninety-four percent of quasi-equity transactions involved $1 million or less, although as shown in Figure 27, large deals of over $5 million do absorb the lion's share of capital invested (60 percent).

Figure 27 - Quasi-Equity Investment by Deal Size, First 9 Months of 2001.



Source: Macdonald & Associates Limited, *Quasi-equity, First 9 months of 2001*, prepared for Industry Canada

The overall increase in quasi-equity activity is impressive given the relatively weak economy in 2001. The first three quarters of 2001 saw an increase in the number of transactions (439 in 2001 versus 227 in the first nine months of 2000), as well as in total capital provided ($234 million versus $214 million) relative to the same time period in 2000.

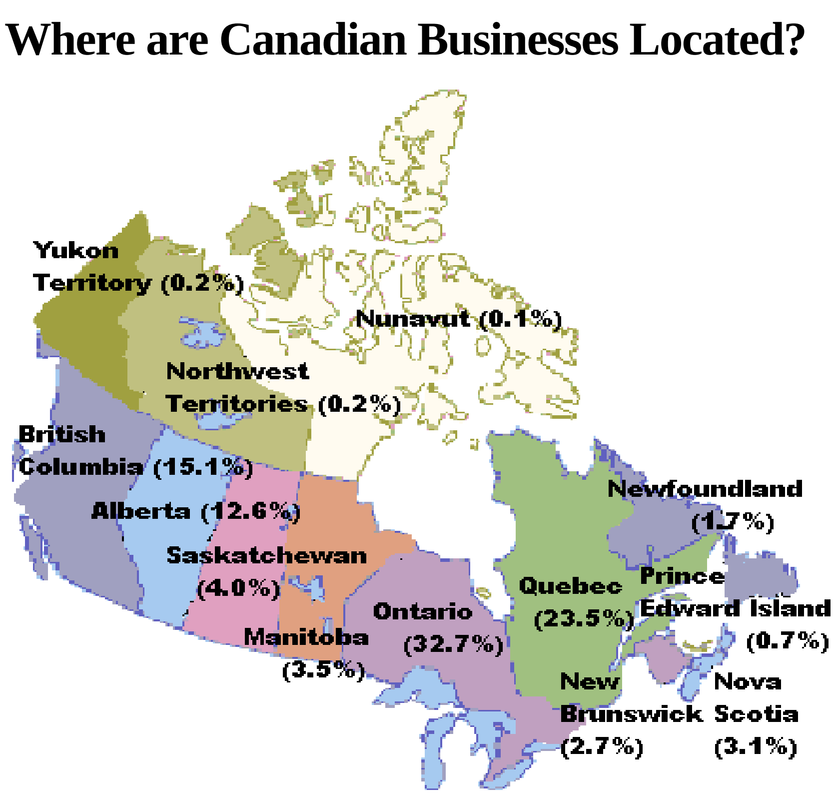
Part Two

A - Profiles of SMEs and Entrepreneurs

PROFILE OF SMES IN CANADA

SMEs represent a diverse and dynamic component of the Canadian economy and provide an important source of economic growth and prosperity. SMEs comprise 99.7 percent of the one million employer businesses in Canada.[45] Fifty-eight percent of employer businesses are considered micro-enterprises, or SMEs, with one to four employees.

Figure 28 - Distribution of Canadian SMEs



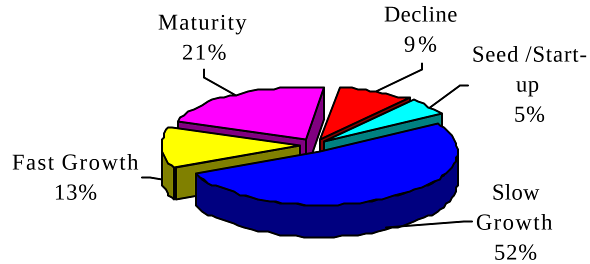
Source: Statistics Canada, Business Register, Dec. 2000

[45] According to Statistics Canada's Business Register, the total number of business establishments as of December 2000 was 2 024 508. About one-half of these (1 042 204) maintained a payroll of at least one person (possibly the owner), and are referred to as "employer businesses."

STAGE OF BUSINESS DEVELOPMENT AND FINANCING

A recent report commissioned by Industry Canada and conducted by Université du Quebec à Trois Rivières examined SMEs' financing experiences for the period 1998-2001. As part of this survey, 2200 SME owners/managers were asked to report on how they perceived the state of development of their business, according to the categories defined below. Figure 29 shows that the majority of Canadian SMEs considered themselves in a slow-growth stage. Given what we know from other work, we are beginning to get a picture of what types of financing firms use at which stages of development.[46]

Figure 29 - Stages of Development of Canadian SMEs?



Source: The Research Institute for SMEs, Université du Québec à Trois-Rivières, *Financing SMEs: Satisfaction, Access, Knowledge and Needs, 2001* , commissioned by Industry Canada, 2002.

- **Slow-growth Firms (52 percent of SMEs):** These firms have sales that are slowly growing. They typically finance their growth through a combination of debt, retained earnings and sometimes from an informal investor, friends or family or perhaps employees (love money).

- **Mature Firms (21 percent of SMEs):** These firms have sales that have stopped growing and typically use retained earnings for the bulk of their financial requirements, often supplemented by short- and long-term debt instruments to meet specific capital needs.

- **Fast-growth Firms (13 percent of SMEs):** These firms are growing much more quickly than the rate of the economy. Their financing requirements often include risk capital. These firms may also be candidates for quasi-equity financing.

- **Declining Firms (9 percent of SMEs):** These firms are seeing their sales decrease. They may well be under-capitalized and facing severe to moderate competitive pressures.

- **Seed/Start-up Firms (5 percent of SMEs):** These firms have no or very little revenue, and are financing their operations through the savings of their principals, love money and short-term debt instruments. Once they are past the establishment phase and are readying their product(s) for market,

[46] The Research Institute for SMEs, Université du Québec à Trois-Rivières, *Financing SMEs: Satisfaction, Access, Knowledge and Needs, 2001*, commissioned by Industry Canada, 2002. It should be noted that these results are determined by the self-reporting of the firm. These stages of development are somewhat different from those used earlier in discussing venture capital.

they may need additional equity. Companies expecting to achieve high growth will seek this in the form of risk capital from informal investors.

Exporters

A critical factor contributing to the competitiveness of Canadian SMEs is their ability to compete in export markets. Certainly there are many SMEs for which exporting is not a strategic objective. This may be because they are operating in a sector (e.g. professional services or the retail sector) for which exporting is not a major activity. However, they may also be indirect exporters, contributing to the exports of their customers (e.g. a components supplier to a computer manufacturer that exports most of its production). As Table 15 illustrates, generally speaking, the larger the firm the more likely it is to export. A previous survey of SMEs conducted by Thompson Lightstone & Company Limited[47] found that 15 percent of SMEs export, which is not significantly different from the 11 percent found in the recent Statistics Canada survey. Further observations from future surveys will be required to determine whether the difference is attributable to a downward trend or whether it is a case of statistical variation due to different survey techniques.

Table 15 - Percent of SMEs that Export and Invest in R&D by Business Size

Size of Business (Number of Employees)	Percent of SMEs That Export	Percent of SMEs That Invest in R&D for Products, Services and Processes
0	8.4%	22.0%
1-4	9.5%	22.2%
5-19	14.7%	28.7%
20-99	28.4%	41.2%
100-499	47.3%	49.9%
All SMEs	10.6%	23.9%

Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*

Research and Development

The ability to commercialize research and development (R&D) is a critical determinant of a country's capacity to innovate. This is also a key contributor to the competitiveness of firms. Table 15 illustrates that the larger the SME the more likely it is to invest in R&D for products, services and process activity. Almost one quarter (24 percent) of SMEs stated that they invested in R&D in 2000, and one half of SMEs with more than one hundred employees stated they invested in R&D. However, no matter the size of the firm, R&D activities are a key part of its business investment strategies. For even the smallest firms, one in five makes an investment in R&D. Previous findings by Thompson Lightstone (1998) found that 34 percent of Canadian SMEs carried out R&D activities. While differing definitions and surveying discrepancies may explain this variation, further monitoring of this issue will be required to determine whether a trend is present.

[47] Thompson Lightstone & Company Limited, *Small and Medium-sized Businesses in Canada: An ongoing perspective of their needs, expectations and satisfaction with financial institutions*, 1998.

Table 16 - SMEs' Sectors of Operations by Region in 2000

	Agriculture	Primary	Manufacturing	Wholesale/ Retail	Professional Services	KBI Sector	Other Sectors*	Total
Atlantic Provinces	6.6%	9.4%	5.1%	15.0%	7.5%	2.3%	54.2%	100%
Quebec	9.7%	1.7%	7.1%	13.2%	10.8%	4.0%	53.4%	100%
Ontario	8.5%	0.7%	5.6%	10.4%	12.5%	5.6%	56.7%	100%
Man/Sask/ Nunavut	44.8%	1.2%	3.0%	8.2%	4.3%	1.9%	36.7%	100%
Alberta/ NWT	20.2%	3.8%	3.5%	6.8%	12.3%	5.1%	48.3%	100%
BC/ Yukon	3.9%	3.2%	5.5%	10.2%	12.7%	4.2%	60.4%	100%
Canada	12.9%	2.2%	5.4%	10.6%	11.1%	4.5%	53.4%	100%

Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*

Sector of Operations [48]

The key SME sectors in terms of percentage of firms in Canada (as shown in Table 16) are:

- **Agriculture** (13 percent);
- **Professional services** (11 percent); and
- **Wholesale/retail industries** (11 percent).

Regional Perspective

- **Atlantic Canada**: has higher percentages of SMEs in wholesale/retail (15 percent vs. 11 percent) and primary (9 percent vs. 2 percent) than the Canadian distribution.
- **Manitoba/Saskatchewan/Nunavut and Alberta / Northwest Territories**: have a high ratio of SMEs in agriculture (45 percent and 20 percent respectively).
- **British Columbia / Yukon**: region has a much lower percentage of SMEs in agriculture than the rest of Canada (4 percent).

As shown in Table 17 (page 62), the industrial composition within the regions has a profound impact on the contribution to GDP within each region. Quebec and Ontario have the highest contributions from

[48] The target population for the *Survey on Financing of Small and Medium-sized Enterprises, 2000* includes SMEs with fewer than 500 full-time equivalent employees and less than $50 million in annual revenue. Excluded from the population are unincorporated firms with less than $30 000 in revenues, non-profit organizations, government organizations, schools, hospitals, subsidiaries, co-operatives, and financing and leasing companies.

manufacturing (58 percent and 55 percent, respectively). The contribution to GDP from agriculture is highest throughout the Prairie provinces.

Table 17 - Percentage of GDP of Each Region by Selected Industries,* 2000

	Agriculture	Primary	Manufacturing	Wholesale/ Retail Trade	Professional Services	Other sectors
Atlantic Provinces	2.8%	12.7%	23.0%	20.7%	4.5%	36.5%
Quebec	3.2%	3.2%	58.1%	15.6%	0.4%	19.6%
Ontario	2.2%	2.1%	55.5%	17.4%	0.4%	22.5%
Manitoba	11.4%	5.3%	30.4%	19.6%	2.2%	30.8%
Sask/Nunavut	15.1%	24.6%	11.7%	16.7%	3.2%	28.7%
Alberta/NWT	5.0%	36.2%	19.1%	11.8%	0.9%	27.1%
BC/Yukon	3.7%	16.2%	29.6%	15.5%	1.3%	33.7%

Source: Statistics Canada
*Excluding Utilities, Finance and Insurance, Management of Companies and Enterprises, Educational Services, Public Administration, and Hospitals

Table 18 - Percentage Change in GDP of Each Industry by Region, 2000*

	Agriculture		Primary		Manufac-turing		Wholesale/ Retail Trade		Professional Services		Other Sectors	
Year	1998-1999	1999-2000	1998-1999	1999-2000	1998-1999	1999-2000	1998-1999	1999-2000	1998-1999	1999-2000	1998-1999	1999-2000
Atlantic Region	3.8%	-1.6%	7.4%	20.4%	8.7%	2.8%	-2.7%	3.9%	-	4.9%	-2.6%	0.6%
Quebec	3.0%	-5.5%	2.4%	2.8%	8.4%	6.8%	-	5.1%	-	4.9%	-	-15.7%
Ontario	2.9%	-3.4%	-6.3%	1.3%	8.9%	4.7%	-	5.8%	-	4.9%	-	3.5%
Manitoba	-1.2%	4.1%	-14.4%	10.3%	-0.5%	0.4%	-	2.9%	-	4.9%	-	0.8%
BC/Yukon	5.5%	2.3%	7.9%	5.6%	6.7%	4.2%	-	2.7%	-	4.%9	-	3.3%
Alberta/NWT	-	-2.4%	-	6.6%	-	6.0%	-	18.6%	-	-	-	14.9%
Sask/Nunavut	-	-4.7%	-	10.7%	-	8.6%	-	5.3%	-	4.9%	-	2.7%

Source: Statistics Canada
*Missing values reflect missing observations in data.

Table 19 - SME Business Size Categories by Region in 2000

Employee Size	Canada	Atlantic Canada	Québec	Ontario	Man/Sask/ Nunavut	Alberta/ NWT	BC/ Yukon	Total
0	45.9%	3.8%	18.9%	38.3%	11.5%	14.8%	12.7%	100%
1-4	35.1%	8.0%	24.9%	32.8%	7.4%	12.6%	14.3%	100%
5-19	15.0%	7.9%	24.8%	36.9%	5.9%	11.5%	13.0%	100%
20-99	3.7%	6.9%	27.7%	35.3%	6.0%	10.8%	13.4%	100%
100-499	0.3%	7.2%	32.0%	36.0%	5.1%	14.0%	5.7%	100%

Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*

Size of Business

As shown in Table 19, nearly half (45.9 percent) of Canadian SMEs have no employees.

Regional Perspective

The distribution for each business size across the regions changes somewhat for larger firms.

- **Atlantic Canada**: accounts for over 7 percent of Canadian SMEs with over 100 employees, yet it represents only 4 percent of Canada's self-employed segment.
- **British Columbia / Yukon**: has a somewhat lower percentage of SMEs, with over 100 employees accounting for only 6 percent of Canada's SMEs in this size category. However, this region accounts for 14 percent of Canada's micro-businesses (1 to 4 employees).

B - Demographic Factors

BUSINESS OWNER CHARACTERISTICS: A FACTOR IN ACCESSING FINANCING?

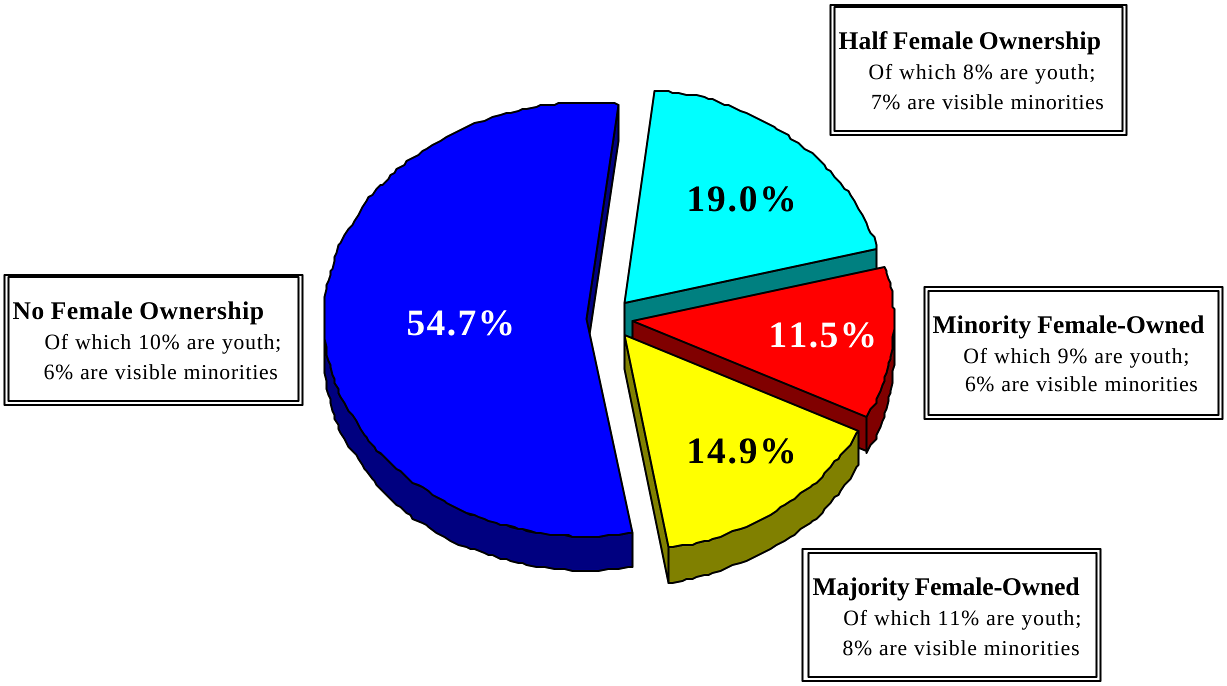
INTRODUCTION

Over the last decade there has been a debate, not only about access to financing for SMEs in general, but also about whether specific demographic characteristics of ownership contribute to or inhibit their access to financing. For the most part this debate has focussed on market failures, otherwise known as "gaps" in the financing market. There has been considerable academic literature generated in the last two decades on this concept. This paper does not intend to revisit this debate. Its purpose is to report on the relevant findings of Statistics Canada's *Survey on Financing of Small and Medium-sized Enterprises, 2000* and the survey on *Financing SMEs: Satisfaction, Access, Knowledge and Needs, 2001,* commissioned by Industry Canada from the Université du Québec à Trois-Rivières. While the debate concerning the financing of SMEs owned by female entrepreneurs (discussed later in this section) has attracted the most attention in the last few years, the financing experiences of other groups of entrepreneurs have received less attention. While these surveys do not purport to be the final word on the financing experiences of these groups, they do shed light on the experiences of various demographic groups, in some cases for the first time. More data gathering and analysis will be needed to provide definitive conclusions on the degree of weight attributable to any single characteristic of a firm in assessing whether it has greater or lesser difficulty accessing financing.

TENTATIVE CONCLUSION

The findings outlined in this section suggest that the characteristics of a business — such as size and sector of operation — may be stronger determinants of a firm's success in accessing financing than the demographic characteristics of business ownership. This is consistent with earlier findings, but more research will be required to determine the weight to attach to each characteristic in assessing its contribution to a firm's likelihood of success in accessing financing.

Figure 30 - Demographics of Business Ownership, 2000



Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*

Majority Female		Majority Male
34%	**French Speaking**	66%
23%	**English Speaking**	77%
18%	**Non-Official Language**	82%

Source: The Research Institute for SMEs, Université du Québec à Trois-Rivières, *Financing SMEs: Satisfaction, Access, Knowledge and Needs, 2001*, commissioned by Industry Canada,

GENDER OF PRINCIPAL OWNER OF CANADIAN SMEs

Of all Canadian SMEs:

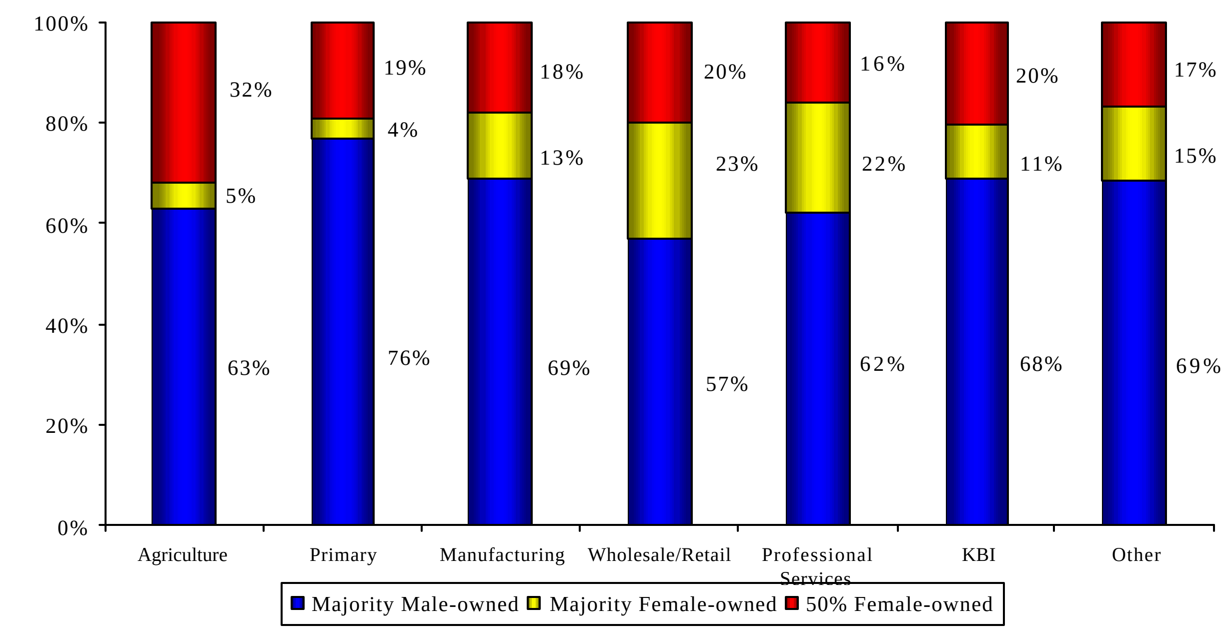
- 54.7 percent are 100 percent owned by men;
- 45.4 percent are wholly or partially owned by women;
- 19.0 percent are owned equally by men and women; and
- 14.9 percent are wholly owned by women.

Sector of Operations

As seen earlier (see Figure 30, page 65), 45 percent of all SMEs have at least one female owner. For 34 percent of all SMEs, women hold 50 percent ownership or more. Figure 31 focusses on the sectors in which these businesses operate, where they account for the following percentages of all SMEs:

- **Wholesale/retail**: 43 percent (of which 20 percent are half-owned by women)
- **Professional Services**: 38 percent (of which 16 percent are half-owned by women)
- **Agriculture**: 37 percent (of which 32 percent are half-owned by women)
- **Manufacturing**: 31 percent (of which 18 percent are half-owned by women)
- **KBIs**: 31 percent (of which 20 percent are half-owned by women)
- **Other sectors**: 31 percent (of which 17 percent are half-owned by women)
- **Primary Industries**: 23 percent (of which 19 percent are half-owned by women)

Figure 31 - Gender Distribution of SME Ownership Across Industry Sectors



Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*

As will be seen later in this section, earlier research found that these factors appear to be significant in determining whether businesses owned by female (or male) entrepreneurs are successful in accessing financing. However, recent research suggests that size of business and sector of operations tend to be stronger determinants than gender when it comes to success in accessing financing.

Size of Business

Majority female-owned businesses tend to have fewer employees, accounting for 16 percent of SMEs with fewer than 5 employees, and 4 percent of SMEs with more than 100 employees.

Structure of Firms

- 44 percent of majority female-owned SMEs are incorporated, compared with 55 percent for majority male-owned SMEs. This likely reflects the fact that SMEs owned by women tend to be smaller. The smaller the firm the more likely it is to be unincorporated, irrespective of the gender of the business owner. Over 90 percent of firms with more than 100 employees are incorporated, whereas only 58 percent of firms with fewer than five employees are incorporated.
- 51 percent of female-owned businesses operate sole proprietorships. Again this is a characteristic of the size of the business — the smaller the business the more likely it is to operate as a sole proprietorship (nearly 50 percent of firms with no employees are sole proprietorships, compared with only 3 percent of firms with over 100 employees).
- 5 percent are partnerships. Again, gender does not appear to be a determining factor, since only 8 percent of majority male-owned SMEs are partnerships. Rather, this ownership structure is more often found in certain industry sectors. Partnerships are most often found in the agricultural sector (25 percent) and in the wholesale/retail sector (27 percent).

Stage of Development

- 58 percent of SMEs that are majority-owned by female entrepreneurs are in a slow-growth stage of development.
- 9 percent of SMEs with majority female ownership report being in fast growth—significantly fewer than those majority-owned by males.

Table 20 - Stage of Reported Business Development by Gender of Owner in 2000

	Majority Male Ownership	Majority Female Ownership
Start-up	5%	4%
Slow Growth	49%	58%
Fast Growth	14%	9%
Maturity	23%	18%
Decline	9%	10%

Source: The Research Institute for SMEs, Université du Québec à Trois-Rivières, *Financing SMEs: Satisfaction, Access,Knowledge and Needs, 2001*, commissioned by Industry Canada, 2002.

Compared to male owners, fewer female owners reported being in the fast growth stage of development or having attained maturity. These findings are indicative of the sectors in which women operate (wholesale/retail), the lower average age of female owners (43 vs. 49 for men), and the lower age of their firms relative to those owned by men. Taken as a whole, these elements have a profound effect on the development of female-owned firms.

Age of Businesses Owner

It is far from clear how the age of the business owner has a bearing on the prospects of a firm's accessing financing; however, as illustrated in the following section, it may be a consideration in the financing decision when it comes to non-collateralized "character" lending or investing. Female business owners are, on average, 6 years younger than their male counterparts (43 years of age vs. 49).[49] More research will be needed to determine whether this difference is a significant factor in accessing financing.

Years in Operation
Comparing firms majority-owned by males and females:

- 76 percent of the females have more than 9 years of experience in the industries in which they operate; and
- 87 percent of the males have that level of experience.

The experience of the principal business owner may have an impact on the perception of riskiness of her/his promise to repay a debt or on the projections of returns an investor might expect from the firm. Further research will be required to determine whether this experience factor has a significant impact on firms' access to financing.

Regional Perspective
There are few regional variations in women's entrepreneurship, except that the Prairie provinces have slightly fewer women-owned SMEs than the national average. More research and analysis may reveal that this is due to the relatively high proportion of family farms, where ownership is often shared, compared to the overall business population in this region.

Exports
Findings indicate that 8 percent of majority women-owned SMEs export, compared with 11 percent of majority male-owned SMEs. This variation is within the margin of error of the survey; however, there may be a positive correlation between exporting and the two variables of business size and industry sector (see Table 15 on page 60). Larger SMEs tend to be more export oriented, whereas smaller firms, which tend to be female-owned, are less likely to export. Given their concentration in the retail sector and since only 14 percent of wholesale/retail firms export (a sector where women play a significant role), it is not surprising that female-owned SMEs are less likely to export. These findings correspond to the 1998 Thompson Lightstone & Company study, which found that male ownership is significantly more common among SMEs that export. The findings indicate that 55 percent of Canadian SMEs that export are exclusively male-owned, whereas 47 percent of the entire SME population is majority male-owned.[50]

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[49] The Research Institute for SMEs, Université du Québec à Trois-Rivières, *Financing SMEs: Satisfaction, Access, Knowledge and Needs, 2001*, commissioned by Industry Canada, 2002.

[50] Thompson Lightstone & Company Ltd., *Small and Medium-sized Businesses in Canada: An Ongoing Perspective of their Needs, Expectations and Satisfaction with Financial Institutions*, 1998.

FINANCING FEMALE-OWNED SMEs

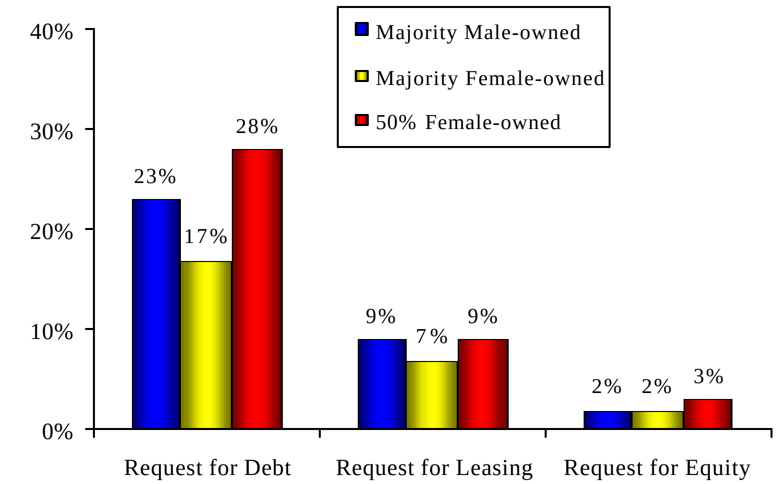
Requests by Gender

In 2000, SMEs owned by women made fewer requests for debt and leasing than SMEs owned by men.

Requests for Debt

As seen in Figure 32, only 17 percent of firms that were majority female-owned requested debt in 2000. This finding is not surprising given that a large number of female entrepreneurs own smaller businesses and often operate in the professional services industries. Both of these characteristics show lower than average request rates for debt. As shown in Table 5 (page 28), 19 percent of SMEs with 0 employees requested debt in 2000 and only 13 percent of firms in the professional services sought debt.

Figure 32 - Requests for Financing by Gender in 2000



Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*

Requests for Lease Financing

The slightly lower demand for lease financing by majority female-owned SMEs is sector related, given that the wholesale/retail sector is the least likely to use this form of financing, and this is the sector in which the most majority female-owned SMEs operate. Given the relatively small numbers of businesses reporting the use of leases, this variation may be within the statistical margin of error of the survey and thus may not be significant.

Requests for Equity (Risk Capital) Financing

Given that the numbers of requests for such financing are small, the variation for firms that are owned 50/50 by men and women is not statistically significant.

Debt Approval Rates by Gender in 2000

The gender of the business owner did not have a significant impact on debt approval rates for SMEs. As illustrated in Table 21, there was no difference in the rates of approval between majority female-owned SMEs and SMEs overall in 2000. More data may reveal whether or not the slightly higher approval rates for firms owned equally by men and women is statistically significant. It is possible that the survey results were heavily influenced by the joint ownership of many family farms. Thirty-two percent of agricultural businesses have this ownership structure — the highest of any sector — and agricultural SMEs have also reported the highest rates of request and approval for debt financing. Given these factors, it is likely that sectoral considerations have more of an influence than ownership structure per se.

Table 21 - Debt Financing Approval Rates by Gender in 2000

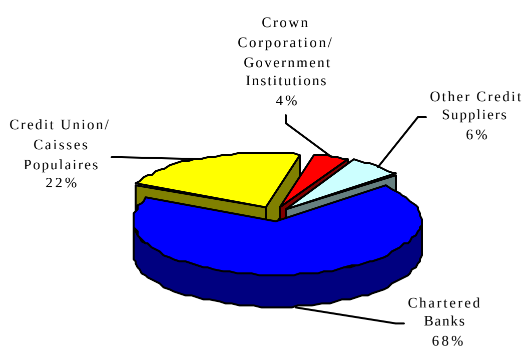
Ownership	Approval Rate
Majority Male-owned	80%
Majority Female-owned	82%
50% Female-owned	87%
All SMEs	82%

Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*.

Debt Financing – Suppliers

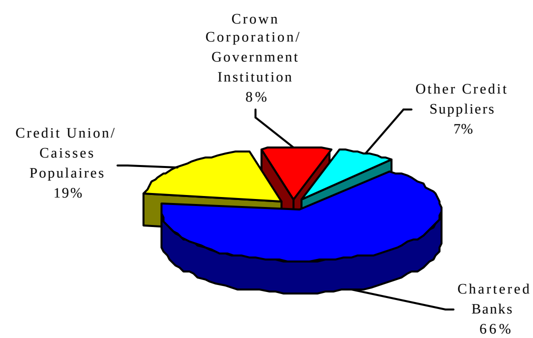
There was also little variation between men and women in the type of lender they approached for debt financing, with the exception of Crown corporations and government institutions. Of the women entrepreneurs who made requests for debt in 2000, only 4 percent approached Crown corporations or other government lending institutions, compared to 8 percent of SMEs overall, despite the presence of some government financing programs targeting women. Given the small numbers involved, this may not be a statistically significant observation, but it merits further research.

Figure 33 - Finance Suppliers Where Majority Female-owned SMEs Requested Debt in 2000



Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*

Figure 34 - Finance Suppliers Where Majority Male-owned SMEs Requested Debt in 2000



Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*

Financing Application Process

Perceptions: The *Survey on Financing of Small and Medium-sized Enterprises, 2000* found that women SME owners who required financing but did not apply often claimed that the difficulty surrounding the application process, and the likelihood of not being authorized, made them reluctant to request any form of financing.

Experience: In contrast to these perceptions, women who did apply for debt financing were not required to provide any more documentation to credit suppliers than were SME owners in general. In fact, 23 percent of SMEs owned by women that applied for debt in 2000 were not required to provide any documentation — compared to 16 percent of male-owned SMEs.

Collateral Requirements for Debt Financing

Collateral requirements appear to be similar for men and women. There was no difference reported between SMEs owned by women and SMEs owned by men concerning the use of personal assets of the owner as collateral for credit. Rather, the industry in which owners operate appears to be a much stronger determinant of this requirement. For example, 46 percent of firms in the wholesale/retail sector — a sector in which many women entrepreneurs operate — were required to use personal assets as collateral, compared to 39 percent for all sectors.

Use of business assets to secure debt also seems to be based more on industry sector than gender. Business assets are used to a greater extent in male-dominated industry sectors, such as agriculture, manufacturing and the primary sectors. Accordingly, SMEs owned by men used business assets as collateral 40 percent of the time, compared to only 35 percent for SMEs owned by women.

DEBATE ON FINANCING OF SMES OWNED BY WOMEN ENTREPRENEURS

Much of the recent debate about the financing experiences of particular population groups of entrepreneurs has centred on women entrepreneurs. In a 1995 study comparing SMEs owned by women with similar businesses owned by men, the Canadian Federation of Independent Business suggested that there is a "financing double standard" within the Canadian financing market.[51] According to this study, SMEs owned by women were 20 percent more likely to be turned down for financing by a bank than similar firms owned by men.

Other research, including some conducted by Statistics Canada,[52] found that women entrepreneurs operated more small service or retail establishments than male entrepreneurs. These types of establishments and sectors, regardless of the gender of the owner, are often identified by financial institutions as slow

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[51] Martine Marleau, *Double Standard: Financing Problems Faced by Women Business Owners*, Canadian Federation of Independent Business, March 1995.

[52] Statistics Canada, *National Survey on Financing of SMEs*, 1995.

growth, low profitability and high risk. It has been suggested that these characteristics of the service and retail sectors, rather than the gender of the business owner, are the underlying causes of financing differences. In fact, women in high-risk, low-margin sectors appear to face no more of a financing barrier than do their male counterparts in these sectors.[53]

The findings outlined above would appear to support the general observation that it is the sector in which a business operates and its size, and not the gender of the business owner, that are the key determinants of access to financing. Women tend to own firms in slower growth, higher risk sectors, such as wholesale/retail, in which access to financing is relatively more challenging than for other, less risky industries. In 2000, out of 23 percent of wholesale/retail firms that requested debt financing, 74 percent were approved, one of the lowest approval rates among the industries studied. Furthermore, there is a clear correlation between access to financing and size of business operations. Smaller firms, in which a higher concentration of female owners can be found, had lower approval rates in 2000 than firms with 20 or more employees. These two factors — sector and size — while perhaps not revealing the complete financing picture facing women entrepreneurs in Canada, are certainly contributing factors.

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[53] G.H. Haines, B.J. Orser and A.L. Riding, "Myths and Realities: An Empirical Study of Banks and the Gender of Small Business Clients," *Canadian Journal of Administrative Sciences*, vol. 16(4), 1999.

Introduction

Young entrepreneurs owned 8 percent of Canadian SMEs in 2000. The changing economic landscape has introduced entrepreneurship as an increasingly attractive and viable alternative for Canadian youth. As an example of this phenomenon, data for British Columbia indicate that the number of young SME owners has grown by more than 70 percent since 1995.[54] Nonetheless, Statistics Canada reports that 14 percent of Canada's population falls within this age group, yet young people own only 8 percent of businesses.

Table 22 - Percentage of SMEs Owned by Youth (age 25-34) by Region in 2000

Youth-owned SMEs	
Canada	8%
Atlantic Provinces	9%
Quebec	12%
Ontario	7%
Man/Sask/Nunavut	8%
Alberta/NWT	9%
BC/Yukon	7%

Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*

Regional Perspective:

As shown in Table 22, there is little variation from the national average across the regions, with the exception of Quebec. Given the limited number of observations within the survey sample, it is not clear whether the slightly larger percentage of businesses owned by young entrepreneurs in Quebec is statistically significant. While this percentage appears to be within the margin of error of the survey, more data over time will be needed to determine its significance.

Table 23 - Percentage of SMEs Owned by Youth (age 25-34) by Business Size Categories in 2001

Youth-owned SMEs	
0 Employees	7%
1-4 Employees	11%
5-19 Employees	9%
20-99 Employees	5%
100-499 Employees	2%

Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*

Youth-owned SMEs face the same challenges as all new ventures in securing financing, but meeting the criteria of finance providers may be more difficult for the young. In making a credit decision, financiers typically look at factors such as number of years of experience in managing a business and credit history, which puts young applicants at a natural disadvantage. For a higher-risk application, a lender may be more likely to seek additional security in the form of a pledge of personal assets; again, a young entrepreneur may be less likely to be able to meet this requirement. As young entrepreneurs tend to operate smaller businesses (see Table 23), few will likely be able to attract outside risk capital. Therefore, the financing options may be relatively few — a personal equity investment and "love money" from family and friends — until a financial track record can be established and debt secured.

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[54] B.C. Stats, Western Economic Diversification Canada, and B.C. Ministry of Small Business, Tourism and Culture, *Small Business Profile 2000: A Profile of Small Business Growth and Employment in British Columbia*, 2000, http://www.wd.gc.ca

PROFILE OF YOUTH-OWNED SMEs

Size of SMEs
As shown in Table 23 (page 73), SMEs owned by young entrepreneurs represented 11 percent of all SMEs with 1 to 4 employees, and only 20 percent of SMEs with more than 100 employees. Given this, it is not surprising that businesses owned by youth had less formal corporate structures, for example incorporation, than other SMEs.

Education
Business owners under the age of 30 have achieved the highest level of academic accomplishment compared to other groups of business owners, with 34 percent having earned a university degree and a further 27 percent having earned a college education.[55]

Years of Experience in Industry of Operation
Business owners under the age of 30 have, on average, 7 years of experience in the industries in which they operate, compared with 22 years of experience, on average, for all age cohorts.[56]

Sectors of Operation
As shown in Table 29 (page 91) at the end of this section, compared to entrepreneurs in general, businesses operated by youth are more heavily concentrated in the new knowledge-based industries. In fact, in 2000, entrepreneurs aged 15-34 accounted for 13 percent of SMEs in the KBI sector, the highest of any sector. The percentage of businesses owned by young entrepreneurs in other sectors is consistent with the percent of their overall business ownership.

Stage of Business Development
As would be expected, the vast majority of youth-owned SMEs are still in the earlier stages of business development. As illustrated in Table 24 (page 75),

- 86 percent of SMEs owned by young people under the age of 30 are in the seed/start-up or slow growth stage of development; and,
- only 4 percent of young entrepreneurs report their business has reached maturity.

SMEs majority-owned by young females, visible minorities and Aboriginals

- 19 percent of SMEs owned by young people were majority female-owned, contrasting with 15 percent of all SMEs that were majority female-owned;
- 12 percent of SMEs owned by young people had majority visible-minority owners, contrasting with

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[55] The Research Institute for SMEs, Université du Québec à Trois-Rivières, *Financing SMEs: Satisfaction, Access, Knowledge and Needs, 2001*, commissioned by Industry Canada, 2002.

[56] Ibid.

- 12 percent of SMEs owned by young people had majority visible-minority owners, contrasting with 7 percent of all SMEs with majority visible-minority owners; and
- 4 percent of SMEs owned by young people have majority Aboriginal owners, contrasting with 1 percent of all SMEs with majority Aboriginal owners.

Table 24 - Reported Stage of Business Development by Age of Entrepreneur in 2000

	30 years old or less	31-40 years old	41-50 years old	51-60 years old	over 60 years old
Start-up	15%	6%	5%	4%	2%
Slow Growth	71%	56%	53%	51%	36%
Fast Growth	10%	20%	15%	9%	4%
Maturity	4%	15%	20%	24%	38%
Decline	1%	3%	7%	12%	21%

Source: The Research Institute for SMEs, Université du Québec à Trois-Rivières, *Financing SMEs: Satisfaction, Access, Knowledge and Needs, 2001*, commissioned by Industry Canada, 2002.

Exports

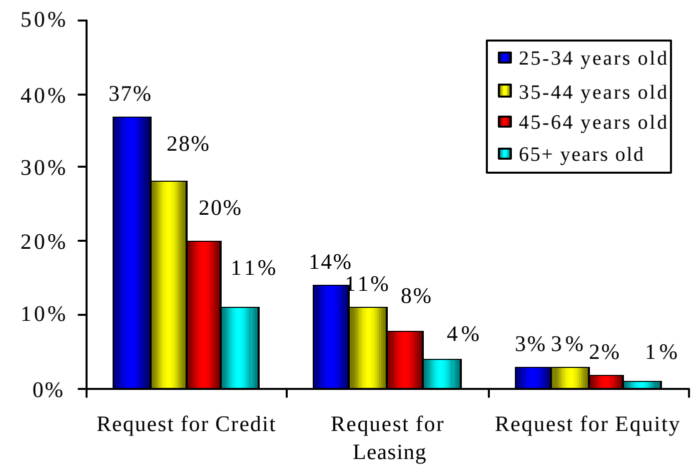
Fewer SMEs owned by young entrepreneurs exported than did SMEs overall — 7 percent, compared to 11 percent on average. As noted earlier, there appears to be a positive correlation between the size of business and the likelihood of its being an exporter (see Table 15, page 60). As shown in Table 23 (page 73), SMEs majority owned by young people are smaller than other SMEs, and a very small number have 50 employees or more. The fact that a smaller than average percentage of youth-owned SMEs export is very likely attributable to the size of operations.

FINANCING HIGHLIGHTS OF SMEs MAJORITY OWNED BY YOUNG PEOPLE

Requests for Financing: Compared with the general population of SMEs, those owned by young people, on average, made more requests for all forms of financing in 2000 (see Figure 35):

- 37 percent requested debt financing, vs. 23 percent for SMEs overall;
- 14 percent requested leasing, vs. 9 percent; and
- 3 percent requested equity financing, vs. 2 percent.

Figure 35 - Proportion of SMEs Requesting Financing by Age of Owner in 2000



Source: Statistics Canada, Survey on Financing of Small and Medium-sized Enterprises, 2000

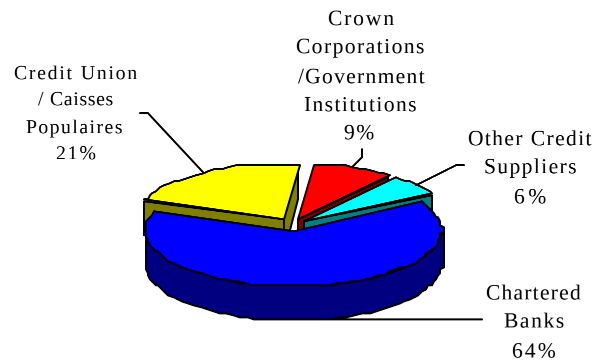
The fact that younger age groups have a markedly higher demand for financing is not surprising when the resources and needs of younger business owners are taken into consideration. As discussed, youth are typically operating firms that are still in the early, expansion stages of growth. These firms may not yet have the internal financing sources, such as retained earnings, to finance their operations. However, other factors may also be contributing to the higher demand for financing by younger entrepreneurs.

Approval Rates for Debt Financing: Of all requests for debt by firms majority owned by young people in 2000, 78 percent were successful in obtaining financing, compared to 82 percent[57] for all SMEs. While this variation is within the margin of error of the survey, it may reflect factors such as lack of an earnings history, size of firm and sector of operations. With regard to the latter, it is worth noting that firms majority-owned by young people tend to operate more in the KBI sector, which reported the lowest approval rates of all sectors. The fact is that the firms in this sector, irrespective of their ownership, often lack the kind of tangible business assets that financing suppliers look for as collateral for debt. As we have seen, young entrepreneurs are more often operating smaller, newer businesses, many at the start-up or expansion stages of development. These are often perceived as higher risk and therefore are of less interest to suppliers of debt. As a result, many young entrepreneurs must turn to capital from private sources, including personal savings, loans from family and friends, informal investors, and other sources of risk capital.

[57] Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*.

Financing Suppliers: Contrasting Figure 36 with Figure 11 on page 21, we can see that SMEs owned by young people approached the same suppliers of debt in roughly the same proportions as SMEs in general.

Figure 36 - Finance Suppliers Where Majority Young Entrepreneurs Requested Debt in 2000



Source: Statistics Canada, *Survey on Financing of Small-and Medium-sized Enterprises, 2000*

Application Process for Debt Financing: Similar to the perspectives of many women who reported that they needed financing but did not pursue the application process, young entrepreneurs cited more frequently than other age groups the likelihood of a turndown and the difficulty of the application process as the primary reasons for their reluctance to apply for financing.

Collateral Requirements for Debt Financing: Providing collateral, particularly in the form of personal assets, is another oft-cited problem for young entrepreneurs seeking access to financing. A report by Angus Reid Group suggested that the young entrepreneur's lack of personal assets was the major impediment to obtaining financing.[58] Findings in 2000 about the experience of young entrepreneurs, however, did not support this claim. Given that proportionally more SMEs owned by young people made requests for financing of all types as noted above, it is rather surprising that the *Survey on Financing of Small and Medium-sized Enterprises, 2000*[59] found that young entrepreneurs were required to provide fewer personal and business assets as collateral than other businesses:

- **Personal Assets:** Fewer youth-owned SMEs were required to provide personal assets as collateral in 2000 than were SMEs in general — 30 percent compared with 39 percent.
- **Business Assets:** Youth-owned SMEs were also less likely to provide business assets as collateral for their financing — 37 percent compared with 41 percent of SMEs overall.

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[58] Angus Reid Group, *Financing Services to Canadian Small and Medium-sized Enterprises: A Report to the Business Development Bank of Canada*, 2000, http://www.bdc.ca

[59] Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*.

Introduction

The 1996 census reported that visible minorities constituted 11 percent of the Canadian population. Visible-minority owners of SMEs accounted for majority ownership in 7 percent of all Canadian SMEs in 2000. Regionally, visible-minority-owned SMEs had a higher concentration in Ontario and British Columbia, representing 9 percent and 13 percent of SMEs in those provinces, respectively. In Quebec, visible-minority business entrepreneurs owned 3 percent of the overall population of SMEs.

As compared with all SMEs operating in Canada, those majority owned by visible minorities have several distinct characteristics. The research outlined here begins the work of building our understanding of them, and of the factors and issues that may arise in relation to their seeking financing. As mentioned in the Note on Interpretation at the beginning of this report, the degree of statistical accuracy of survey results declines rapidly for sub-groups of the SME population. A case in point is the 11 percent of SMEs that reported having majority visible-minority owners; the sample was too small to use to draw anything more than preliminary inferences about behaviour and performance.

PROFILE OF VISIBLE-MINORITY OWNED SMEs

Size of Business

SMEs owned by visible minorities tended to be larger than average, accounting for 9 percent of all SMEs with between 20 and 99 employees in 2000, but represented only 6 percent of the self-employed in Canada. Similarly, the 1998 Thompson Lightstone study[60] found that visible-minority entrepreneurs tended to own larger firms, on average, in terms of both employees and annual revenues.

Corporate Structure

In 2000, 64 percent of visible minority-owned SMEs were incorporated, compared with 53 percent of Canadian SMEs in general.

Sectors of Operation

As compared with their 7 percent contribution to the overall SME population, majority visible-minority-owned SMEs were found disproportionally in the KBI sector (representing 11 percent of all SMEs in that sector) and the wholesale/retail sector (representing 10 percent of SMEs in that sector); and least often in the agricultural sector (representing 2 percent of SMEs in that sector) and the primary industries sector (representing 2 percent of SMEs in that sector).

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[60] Thompson Lightstone & Company Ltd., *Small and Medium-sized Businesses in Canada: An Ongoing Perspective of Their Needs, Expectations and Satisfaction with Financial Institutions*, a report prepared for the Canadian Bankers Association, 1998.

Demographics

There was no statistically significant variation in age between visible-minority-owned firms and non-visible-minority-owned firms; however, there were a number of other distinctions:

- **Gender of Business Owner:** Male and female ownership among visible-minority-owned businesses followed a slightly different pattern than that for SMEs overall:
  - 18 percent of visible minority-owned SMEs were majority female-owned vs.15 percent for businesses overall; and,
  - 60 percent of visible-minority-owned SMEs were majority male-owned, vs. 66 percent for businesses overall.

- **Experience of Business Owner in Industry of Operation:** As illustrated in Table 25, visible minority entrepreneurs have fewer years of managerial experience (73 percent have more than 9 years experience vs. 86 for all SMEs). This study does not make it clear whether the number of years of experience a firm's owner has in the industry contributes positively or otherwise to the SME's access to financing. However, it is reasonable to suppose that bankers might consider this factor, among others, in assessing the risk of lending to younger businesses, particularly ones operating in riskier sectors.

Table 25 - Years of Experience in Industry of Operation reported by Visible-Minority-Owners in 2000

	Visible-minority-owned Firms	Other Firms
Less than 2 years	3%	2%
2 to 5 years	14%	6%
6 to 8 years	9%	6%
More than 9 years	73%	86%

Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*

- **Educational Attainment:** Visible-minority business owners are more likely to hold a university degree than other SME owners: 51 percent of visible-minority entrepreneurs have a university education, compared with only 31 percent of other SME owners.[61]

Exports

SMEs owned by visible minorities were slightly more likely to be exporters than were SMEs overall — 13 percent compared to 11 percent. As stated earlier (with respect to female-owned firms), this finding is likely correlated to size of business. However, for some in this group, particularly those owners who are relatively recent immigrants, family or business connections abroad may also be a factor.

[61] The Research Institute for SMEs, Université du Québec à Trois-Rivières, *Financing SMEs: Satisfaction, Access, Knowledge and Needs, 2001*, commissioned by Industry Canada, 2002.

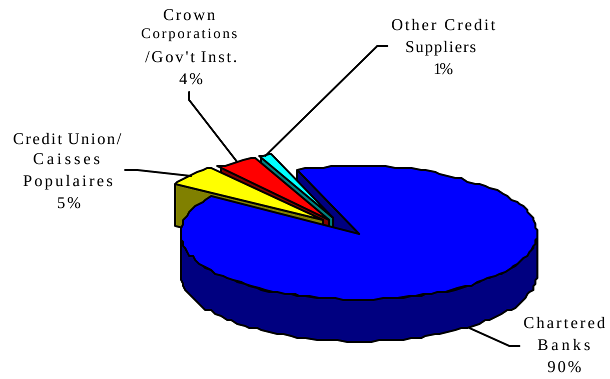
FINANCING HIGHLIGHTS OF VISIBLE-MINORITY-OWNED SMEs

Overall, the supply of and demand for financing by visible-minority-owned SMEs in 2000 did not vary substantially from those of other SMEs.

Request Rates for Debt Financing: In 2000, there was no difference between visible-minority-owned SMEs and other firms in their request rates for financing.

Approval Rates for Debt Financing: There was no variation in the rates of approval for debt financing between SMEs owned by visible-minority entrepreneurs and other SMEs in 2000 — 83 percent compared with 82 percent, respectively.

Figure 37 -Suppliers Where Majority Visible-Minority-owned SMEs Requested Debt in 2000



Source: Statistics Canada, *Survey on Financing of Small-and Medium-sized Enterprises, 2000*

Suppliers of Debt Financing: SMEs owned by visible-minority entrepreneurs were much more likely than the general population of SMEs to approach chartered banks for their debt financing in 2000 — 90 percent compared to 66 percent (for comparative data, see Figure 11 on page 21). Visible-minority-owned SMEs were not as likely to approach credit unions or caisses populaires (5 percent), or Crown corporations or other government lending programs (4 percent), compared with 21 percent and 9 percent respectively for other SMEs. The overall demand for debt from chartered banks is high in the regions where visible-minority-owned firms are most heavily concentrated. So the location of visible-minority-owned firms, rather than any particular preference for chartered banks, may explain this outcome.

Application Process for Debt Financing: Survey findings indicate differences in the preferences and perceptions of visible-minority entrepreneurs toward the financing process. Visible-minority-owned SMEs reported that they were required to provide more documents, such as financial statements and appraisals of assets, than other SMEs. For 17 percent of non-visible- minority-owned firms, no documents were required, compared with only 8 percent of visible-minority-owned firms. Perhaps related to this, visible-minority-owned SMEs perceived more difficulty in the application process for financing. This reason was cited by visible-minority entrepreneurs more frequently than by other SME owners — 7 percent compared with 2 percent — in their decision not to pursue debt financing in 2000, despite a need for it. A number of factors may explain these findings. First, visible-minority-owned firms are found to be more concentrated than other SMEs in the KBI and wholesale/retail sectors. These sectors sometimes have more difficulty in securing debt. Secondly, visible-minority-owned firms tend to have fewer years of experience in operation than other firms. Thirdly, visible-minority-owned firms tend to secure debt from chartered banks, which have a slightly lower than average approval rate for SMEs overall (at 79 percent vs. 82 percent overall). Additional data and analysis will be required to determine the weights in the factors that explain the different experience of visible-minority entrepreneurs.

Introduction

According to Aboriginal Business Canada (ABC),[62] there were more than 20 000 Aboriginal business owners in Canada in 1996, representing 3.9 percent of the Aboriginal population. This compares with 7.9 percent of the general Canadian population who own businesses. The rate at which Aboriginal Canadians are becoming entrepreneurs is growing at approximately 7 percent per year.[63] Given the relatively small population base of Aboriginal-owned SMEs in Canada, national surveys of the general SME population do not identify a sufficient amount of statistically significant data. Accordingly, in some areas this report has had to rely on supplemental information to offer a more complete portrait of Aboriginal-owned SMEs.

While Aboriginal entrepreneurs face all the same challenges in starting up and finding financing for a business as other SME owners, they face some unique challenges, depending on the location of their business. On-reserve Aboriginal businesses operate within a legal framework that makes accessing financing a challenge, though not necessarily an impossibility. Under the *Indian Act*, no individual can pledge on-reserve assets — particularly real property — in return for debt financing. While it is possible to create corporate entities to work around this problem, it has been seen as a barrier to on-reserve financing and almost certainly has affected the growth of on-reserve businesses. This is a complex legal-treaty issue whose details are well beyond the scope of this report.

Another key issue for Aboriginal entrepreneurs is the remoteness of some of their communities from key markets and sources of financing. This creates its own special challenges, as the mass of capital and resources critical to building a successful firm can be difficult to find far from major population centres. Likewise, access to markets is more expensive, affecting the margins that firms in remote locations can expect, which in turn impact their ability to attract capital, as they may present an increased risk profile to lenders.

PROFILE OF ABORIGINAL ENTREPRENEURS

Overall, according to the 1996 Census, Aboriginal peoples accounted for 3 percent of the Canadian population. In contrast, just 1.4 percent of all Canadian SMEs were majority owned by Aboriginal persons.

[62] This organization, affiliated with Industry Canada, manages the federal government's investments in a network of Aboriginal capital corporations across Canada that provide loans and risk capital financing to Aboriginal businesses, on and off reserve. In this capacity ABC studies the needs of Aboriginal entrepreneurs from a number of angles, including financing.

[63] Aboriginal Business Canada, *Aboriginal Entrepreneurs in Canada: Progress & Prospects*, 2001.

Regional Distribution: The pattern of concentrations of Aboriginal business ownership mirrors the distribution of concentrations of the general Aboriginal population. Aboriginal-owned businesses represent the following percentages of all the SMEs in the following regions:

- **Alberta and the Northwest Territories** – 4 per cent of all SMEs in the region;
- **Manitoba/Saskatchewan/Nunavut** – 2 per cent; and
- **Atlantic provinces** – 2 percent.

Sectors of Operation: Aboriginal-owned SMEs represent the following percentages of all the SMEs in the following sectors:

- **Agriculture** – 2 percent of all SMEs in the sector;
- **Primary industries** – 2 percent;
- **Professional services** – 1 percent; and
- **KBIs** – less than 1 percent.[64]

Demographics: This rapidly growing cadre of business owners (as noted earlier, the population of Aboriginal business owners is growing by 7 percent per year) is characterized by the presence of young people and the relative absence of Aboriginal women business owners.[65]

- **Aboriginal youth** are approximately twice as likely as Canadian youth in general to become entrepreneurs.
- **Aboriginal women** are less than one half as likely to start an SME as Canadian women in general. The number of SMEs owned by Aboriginal women, however, is growing at a rate higher than any other group.

Exports: Recent findings indicate that majority Aboriginal-owned SMEs account for 2 percent of SME exporters in Canada.[66] This is in line with the 1.4 percent of Canadian SMEs that are owned by Aboriginals.

[64] These figures correspond with those found in the 1997 Aboriginal Peoples Survey and the 1998 Thompson Lightstone & Company Limited study, which found that Aboriginal-owned SMEs were more concentrated in agriculture, primary and retail sectors, and notably in fishing, logging and mining.

[65] Aboriginal Business Canada, *Aboriginal Entrepreneurs in Canada: Progress & Prospects*, 2001.

[66] This figure contrasts with the 6 percent found in the 1997 Aboriginal Peoples Survey and is likely simply a result of the small sample size.

FINANCING HIGHLIGHTS OF ABORIGINAL-OWNED SMES

Introduction: Overall, information from the recent *Survey on Financing of Small and Medium-sized Enterprises* [67] was not conclusive on the financing practices of Aboriginal-owned SMEs. As noted above, surveys of the general business population usually do not yield statistically significant data for the study of the Aboriginal-owned businesses.

This section relies on a 1998 study,[68] which found that 56 percent of Aboriginal entrepreneurs had inadequate access to debt and equity capital to finance their businesses. Other significant findings of the study are highlighted below.

Debt Financing Suppliers:[69] Banks are the primary source of start-up capital (47 percent), followed by Aboriginal development corporations (24 percent), federal government programs (11 percent), family and friends (10 percent) and provincial/territorial government programs (7 percent).

Application Process for Debt Financing: Issues seen to affect access to capital included:

- lack of collateral – 40 percent;
- inability to use assets on reserve as collateral – 30 percent;
- lack of local financial institutions – 27 percent; and
- having an unprofitable business – 22 percent.

Debt Financing Instruments: Aboriginal entrepreneurs were asked what sources of financing they used in 1998. The responses[70] may be summarized as follows:

- sourced financing from personal loans from family and friends – 48 percent;
- supplier credit – 30 percent;
- loans from Aboriginal lending institutions – 22 percent;
- non-guaranteed commercial bank loans – 20 percent;
- government guaranteed bank loans – 15 percent; and
- conditional sales agreements – 11 percent.

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[67] Statistics Canada, 2001.

[68] David Caldwell and Pamela Hunt, *Aboriginal Businesses: Characteristics and Strategies for Growth*, Aboriginal Business Canada, Industry Canada Occasional Paper 20, 1998.

[69] Ibid.

[70] See chart on p. 6 of the Caldwell and Hunt study. Like the methodology used in the 1996 Orser, Gasse and Riding study cited here, respondents were asked to choose all forms of financing they had used, so the results will not equal 100 percent.

Equity Financing: The same study asked respondents about their perceptions of equity financing. The most frequently cited reasons for lack of access to this type of financing among Aboriginal entrepreneurs were:

- lack of personal resources – 58 percent;
- lack of access to venture capital – 36 percent;
- inadequate retained earnings – 32 percent;
- absence of community investment funds – 31 percent; and
- inability of family and friends to invest – 16 percent.

Types of Start-up Financing: Of all respondent Aboriginal entrepreneurs who had started a business:

- 88 percent relied on personal investment, vs. 55 percent for all SMEs;[71]
- 31 percent used retained earnings, vs. 60 percent for all SMEs;
- 21 percent received investments from family and friends, vs. 5 percent for all SMEs;
- 7 percent obtained investments from community investment funds; and
- 5 percent relied on venture capital, vs. 2.8 percent of all SMEs.

Requirements Start-up Financing: At start-up, of all Aboriginal firms:

- 32 percent required less than $5000;
- 32 percent required between $5000 and $25 000; and
- 12 percent required more than $100 000.

Risk Capital Usage: Aboriginal SMEs used more equity than debt in their capital structure when starting their businesses:

- 45 percent were entirely financed by equity at start-up; and
- 17 percent were entirely financed by debt at start-up.

[71] Ibid.

Introduction

Until now, little empirical evidence has been collected on the financing needs and conditions facing language groups in Canada. Most of the statistics highlighted in this section were extracted from the study conducted for Industry Canada by the Université du Quebec à Trois Rivières during the spring and summer of 2001.

LANGUAGE PROFILES OF ENTREPRENEURS

The mother tongue of Canadian entrepreneurs are very similar to those of the overall population:

- 59 percent English for SME owners vs. 59 percent of the overall population;
- 27 percent French vs. 23 percent; and
- 14 percent non-official language vs. 16 percent.

The average age of SME owners, by mother tongue is:

- 46 years of age for entrepreneurs whose mother tongue is French;
- 48 years of age for entrepreneurs whose mother tongue is English; and
- 49 years of age for other language groups.

Non-official language minority business owners are more likely to be male than are any other group.

Educational Attainment: As shown in Table 26, entrepreneurs whose mother tongue was French tended to have less formal education than other SME owners: 24 percent had a university degree vs. 33 percent for entrepreneurs whose mother tongue was English and 37 percent for other languages.

Table 26 - Educational Attainment by Mother Tongue of Entrepreneur in 2000

Highest level of Education Attained	English-speaking	French-speaking	Non-official Language Mother Tongue
Elementary	6.3%	9.9%	6.1%
High School	38.0%	43.7%	30.6%
College	23.2%	22.2%	25.9%
University	32.4%	24.2%	37.4%

Source: The Research Institute for SMEs, Université du Québec à Trois-Rivières, *Financing SMEs: Satisfaction, Access, Knowledge and Needs, 2001*,

Stage of Business Development: With respect to their enterprises, French-speaking entrepreneurs tended to own older firms in more advanced stages of business development. As shown in Table 27 (page 86), these entrepreneurs also had the lowest percentage of business start-ups compared to other language groups.

Table 27 - Reported Stage of Business Development by Linguistic Profile of Entrepreneur in 2000

	English-Speaking	French-Speaking	Non-official Language Mother Tongue
Start-up	5%	1%	14%
Fast Growth	13%	12%	13%
Slow Growth	51%	54%	50%
Maturity	22%	21%	19%
Winding Down	9%	12%	5%
Total	100%	100%	100%
Average Growth Expected Over Next Two Years	37%	25%	49%

Source: The Research Institute for SMEs, Université du Québec à Trois-Rivières, *Financing SMEs: Satisfaction, Access, Knowledge and Needs, 2001*, commissioned by Industry Canada, 2002.

Growth Expectations by Language Group: SMEs were asked what growth their businesses would have to achieve over the next two years to meet their goals. They reported that their business would have to see:

- 49 percent growth (for entrepreneurs with a non-official language mother tongue);
- 37 percent growth (for English-speaking entrepreneurs); and,
- 25 percent growth (for French-speaking entrepreneurs).

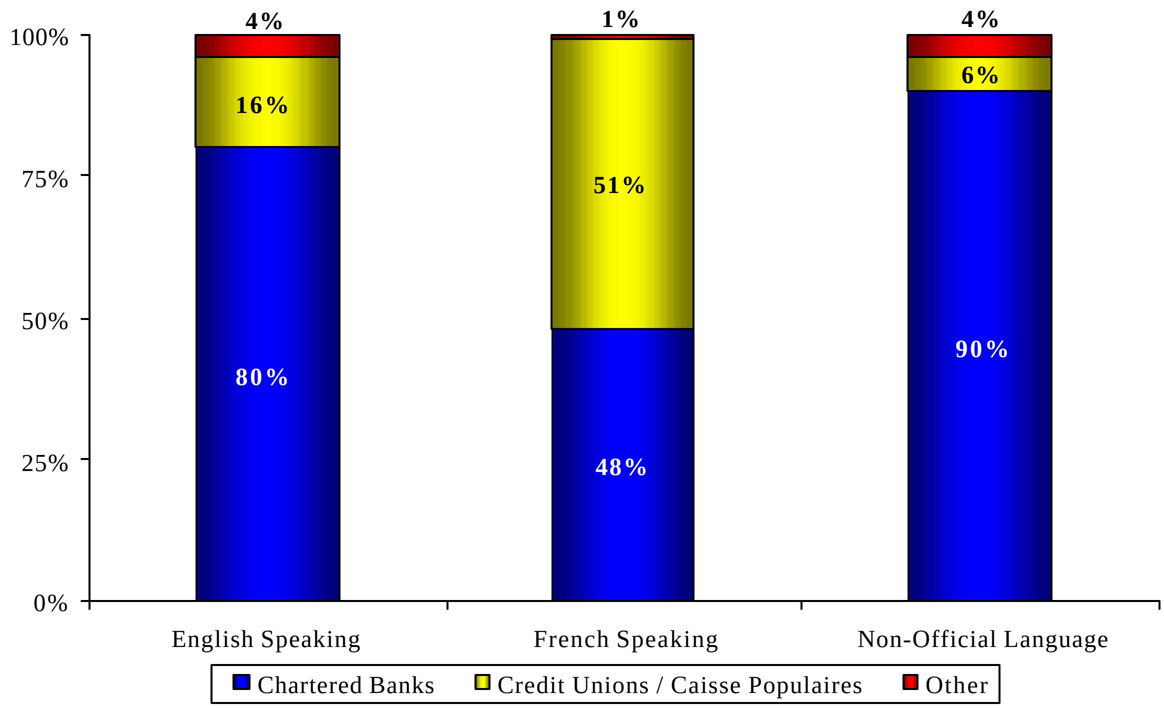
Export Activity: Non-official language groups were also more likely to be exporters:

- 26 percent of non-official language owners exported;
- 21 percent of English-speaking owners exported; and
- 13 percent of French-speaking entrepreneurs exported.

Financing Highlights of SMEs by Language Group

There do appear to be some substantial differences in the suppliers used and in approval rates among language groups. As illustrated in Figure 38 (page 87), 48 percent of French-speaking SME owners reported their main financial institution for their daily operations to be a credit union or caisse populaire. In contrast, 80 percent of English-speaking business owners dealt with chartered banks for their daily financing needs, as did 90% of non-official language entrepreneurs (see Table 6 on page 29).

Figure 38 - Main Financial Institution Reported by Entrepreneur for Business' Daily Operations, by Linguistic Profile of Entrepreneur in 2000



Source: The Research Institute for SMEs, Université du Québec à Trois-Rivières, *Financing SMEs: Satisfaction, Access, Knowledge and Needs, 2001* , commissioned by Industry Canada, 2002.

These patterns may reflect the structure of the financial services industry across the country more than any actual preference for the institutions among the business owners from these language groups.

Approval Rates for Debt Financing: This study found that, with an overall approval rate of 82 percent of all SMEs, firms owned by non-official language minority entrepreneurs faced the lowest approval rates for financing:

For applications for lines of credit, the acceptance rates were:

- non-official language SME owners – 69 percent;
- French-speaking SME owners – 91 percent; and
- English-speaking SME owners – 81 percent.

For applications for medium- and long-term loans, acceptance rates were:

- non-official language minority SME owners – 75 percent;
- French-speaking SME owners – 94 percent; and
- English-speaking SME owners – 83 percent.

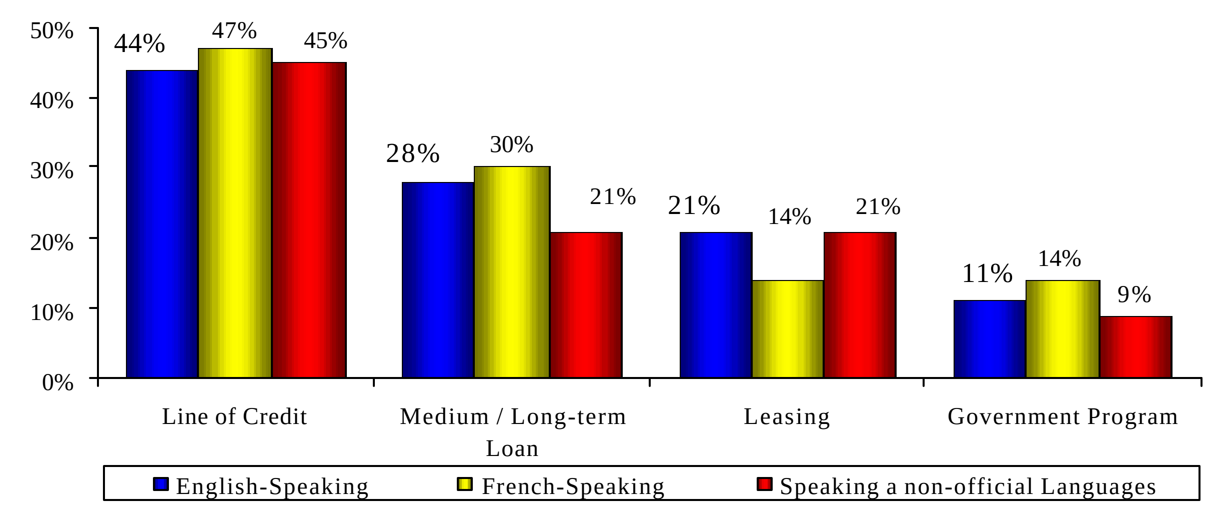
Further data gathering and analysis will be needed to reveal whether these variations reflect statistical anomalies or are more strongly correlated to the sectoral, age and regional profiles of their enterprises. Non-official language minority-owned SMEs are comparably younger and have a higher percentage of start-up ventures than other firms.

Debt Financing Instruments: Very little variation was found in application rates for various financial instruments between language groups, with the exception of leasing. As shown in Figure 39 (page 88), French-speaking entrepreneurs were slightly less likely than other language groups to request leasing.

Risk Capital: A key characteristic of risk capital is that investors expect to share the ownership of the firm in return for their investment. Entrepreneurs who seek risk capital financing must be willing to share the ownership of their business in order to attract this type of financing. It is interesting to note that while Quebec has arguably the most highly developed system for investing risk capital in small business of any region in Canada, French-speaking owners are more resistant to diluting ownership of their SMEs, as the following findings indicate:[72]

- one half of French-speaking SME owners reported that they would not sell part ownership in their SME to finance its growth or expansion;
- 39 percent of English-speaking owners reported that they would not sell part ownership in their SME to finance its growth or expansion; and
- 35 percent of non-official language mother-tongue entrepreneurs owners reported that they would not sell part ownership in their SME to finance its growth or expansion.

Figure 39 - Proportion of Firms Making an Application for Financing, by Instruments and Linguistic Profile of Entrepreneur between 1998-2000



Source: The Research Institute for SMEs, Université du Québec à Trois-Rivières, *Financing SMEs: Satisfaction, Access, Knowledge and Needs, 2001* , commissioned by Industry Canada, 2002.

[72] The Research Institute for SMEs, Université du Québec à Trois-Rivières, *Financing SMEs: Satisfaction, Access, Knowledge and Needs, 2001*, commissioned by Industry Canada, 2002.

Requests for Risk Capital: Compared to other language groups, French-speaking entrepreneurs made slightly fewer requests for "internal equity financing:"[73]

- 2 percent of French-speaking SME owners requested internal equity financing, compared to
- 5 percent of English-speaking SME owners; and
- 4 percent of non-official language minority SME owners.

Similarly, for external forms of equity financing[74] such as venture capital, French-speaking SME owners made fewer requests. The statistics are:

- 1 percent of French-speaking SME owners;
- 4 percent of English-speaking SME owners; and,
- 4 percent of non-official language minority SME owners.

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[73] The definition of internal equity financing, according to the UQTR study, includes financing from friends and family as well as from employees.

[74] UQTR defines external equity financing to include informal investors, venture capital and financing from Crown corporations.

Table 28 - Key Profile and Financing Statistics of SMEs, by Percentage of Female Ownership in 2001

	Greater Than 50% Owned by Women	50% Owned by Women	Less Than 50% Owned by Women	0% Owned by Women
Overall				
	14.9%	19.0%	11.5%	54.7%
Size of SME				
0 Employees	15.1%	20.0%	8.1%	56.9%
1 to 4 Employees	16.2%	18.5%	12.5%	52.8%
5 to 19 Employees	12.5%	18.7%	16.4%	52.3%
20 to 99 Employees	9.5%	13.3%	23.0%	54.3%
100 to 499 Employees	4.3%	4.9%	32.1%	58.7%
Regions				
Atlantic Provinces	15.5%	12.8%	12.5%	59.3%
Quebec	15.4%	10.1%	11.7%	62.8%
Ontario	16.7%	17.7%	9.3%	56.3%
Manitoba/Saskatchewan/ Nunavut	10.9%	29.8%	16.7%	42.7%
Alberta / Northwest Territories	11.0%	29.1%	14.7%	45.3%
British Columbia/Yukon	15.2%	22.8%	9.9%	52.1%
Industry				
Agriculture	4.7%	32.3%	17.4%	45.5%
Primary	4.4%	19.3%	15.1%	61.2%
Manufacturing	13.2%	18.2%	11.4%	57.1%
Wholesale/Retail	19.0%	19.5%	13.3%	48.2%
Professional Services	23.4%	15.4%	9.5%	51.7%
KBI Sector	11.5%	19.8%	12.6%	56.1%
Other Sectors	15.2%	16.1%	9.5%	59.2%
Areas				
Urban	16.1%	16.6%	11.5%	55.8%
Rural	11.6%	25.4%	11.4%	51.6%
Debt Financing				
Rate of Request	16.9%	28.4%	23.0%	21.8%
Rate of Approval	82.1%	87.0%	80.0%	78.5%
Lease Financing				
Rate of Request	6.9%	9.2%	9.3%	8.6%
Rate of Approval	99.1%	98.4%	97.1%	96.7%

Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*

Table 29 -Key Profile and Financing Statistics of SMEs in 2001, by Percentage Ownership of Disabled, Aboriginal, Visible Minority, and Age

	Persons With a Disability	Aboriginal Persons	Visible Minorities	Less Than 25 Years of Age	25 to 34 Years of Age
Overall	2.1%	1.4%	7.0%	0.6%	8.4%
Size of SME					
0 Employees	2.4%	1.2%	5.6%	0.6%	6.9%
1 to 4 Employees	2.2%	1.4%	7.5%	0.5%	10.6%
5 to 19 Employees	1.4%	1.6%	9.5%	0.6%	9.2%
20 to 99 Employees	1.9%	2.0%	9.2%	0.4%	5.4%
100 to 499 Employees	0.3%	0.6%	6.2%	0.4%	1.7%
Regions					
Atlantic Provinces	3.3%	2.1%	2.4%	0.6%	8.6%
Quebec	2.0%	0.4%	3.4%	1.0%	11.5%
Ontario	2.5%	0.9%	9.1%	0.2%	7.2%
Manitoba/Saskatchewan/Nunavut	1.6%	2.0%	3.2%	0.5%	7.6%
Alberta / Northwest Territories	1.3%	4.1%	6.3%	0.6%	8.7%
British Columbia/Yukon	2.2%	1.0%	12.7%	0.7%	6.9%
Industry					
Agriculture	2.9%	2.3%	1.9%	0.5%	8.5%
Primary	2.1%	2.2%	1.5%	0.4%	9.2%
Manufacturing	2.8%	1.4%	8.5%	0.7%	8.2%
Wholesale / Retail	1.9%	0.9%	10.0%	0.3%	7.2%
Professional Services	2.2%	0.8%	6.3%	0.1%	5.2%
KBI Sector	2.0%	0.2%	10.9%	0.8%	12.2%
Other Sectors	2.0%	1.5%	7.2%	0.7%	9.2%
Areas					
Urban	2.1%	1.2%	9.1%	0.5%	8.3%
Rural	2.2%	1.9%	1.4%	0.8%	8.8%
Debt Financing					
Rate of Request	X	X	24.3%	X	36.5%
Rate of Approval	X	X	82.7%	X	78.1%
Lease Financing					
Rate of Request	X	X	8.0%	X	13.7%
Rate of Approval	X	X	91.2%	X	97.0%

Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000*
Note X - data is not statistically significant

Part Three

SME Financing Data Initiative: History and Outlook

BACKGROUND

In 1996 the federal government commissioned the Task Force on the Future of the Canadian Financial Services Sector (the MacKay Task Force) to examine public policies affecting the financial services sector. As a small part of a much wider mandate, the government asked the Task Force to make recommendations relating to the financing of SMEs.

In late 1998, the MacKay Task Force issued its report which responded in detail to the rest of its mandate, but concluded with regard to the financing of SMES that there was insufficient data available for them to be able to make any recommendations. In light of this, the Task Force recommended that the government make a concerted effort to improve the quality and the quantity of information on SME financing, covering all financial service providers as well as SMEs themselves.

In June, 1999 the government responded to the report of the Task Force. As a part of this response, the government accepted this recommendation and mandated Industry Canada, the Department of Finance and Statistics Canada to work together to gather data on SME financing and report on regularly to the House of Commons Industry Committee ion the state of SME financing in Canada. To this end these government organizations have formed a partnership to design and implement the SME Financing Data Initiative (SME FDI) and have committed resources to establish this data collection regime. Through this Initiative, other research and analysis they plan to provide a comprehensive picture of SME financing, covering the entire spectrum of financing products and services.

STATE OF SME DATA COLLECTION : BEFORE THE SME FINANCE DATA INITIATIVE

Prior to the SME Financing Data Initiative, data collection on small business financing consisted mainly of reports of various industry groups and Statistics Canada labour force and industry surveys. For example, since 1995 the Canadian Bankers Association (CBA) has published statistics on the SME lending activities of the major chartered banks. In addition, the Canadian Venture Capital Association (CVCA) and the Canadian Finance and Leasing Association (CFLA), have provided regular reports on the activities of their members in financing SMEs. The Canadian Federation of Independent Business (CFIB) has also administered regular surveys of its members to determine their perceptions and experience with respect to the availability of credit.

Although these efforts have resulted in substantial progress in the collection of data on small business financing, they shared no single conceptual framework through which to observe the overall state of SME financing in Canada. As a result, critics, including the MacKay Task Force have raised issues of comparability between data sources, lack of coverage for all significant providers of financing, and the possibility of bias in the analysis and reporting of results. All of this pointed to the need for consistent, comprehensive and impartial SME finance data collection.

DESIGN AND IMPLEMENTATION OF THE SME FINANCING DATA INITIATIVE (FDI)

In developing the research agenda for the SME Financing Data Initiative, the government partners drew upon the experience of the CBA and the CFIB. The SME FDI, however, will expand the depth and breadth of data collection to include all significant suppliers of financing to small business in Canada, in both the debt and equity markets.

The initial design of the SME Financing Data Initiative envisaged two surveys one of suppliers of financing to SMEs and the other on SMEs' demand for financing which together set out to uncover the broad issues surrounding debt and equity financing in Canada. The more intricate details of SME financing were to have been explored using the results of specialized studies, (four of which have been completed to date and have been discussed in Parts I and II of this report.) While this general structure of data collection and research emerged from nationwide consultations with key stakeholders in the field of SME financing, it was significantly more sharply focussed as a result of these consultations.

CONSULTATIONS

In general this initiative is meant to alter permanently the approach of gathering and reporting on the availability of, and demand for, all kinds of financing for SMEs. As there were no models, either domestic or foreign to follow, the partners undertook a comprehensive set of consultations on the approach, methodologies and survey instruments with a diverse range of stakeholders As noted in the May 2000 report to the House of Commons Standing Committee on Industry[75], developing this initiative involved extensive consultation with various groups having a vested interest in the state of SME access to financing in Canada, including organizations representing SMEs, providers of SME financing, and government organizations. At the outset, the approach involved two rounds of consultations during the spring and summer of 2000.

More than 75 firms, organizations and individuals participated in meetings held in Montreal, Quebec City, Toronto, Vancouver and Ottawa. The partners also held more detailed discussions with key stakeholders on specific details of questionnaire content. As their views and participation are crucial to the success of this endeavour, stakeholders will continue to be involved in the development of survey design and research plans.

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[75] Industry Canada, Statistics Canada, SME Financing Data Initiative, *Report to the House of Commons Standing Committee on Industry*, May, 2000.

FIRST ROUND OF CONSULTATIONS

The goal of this round of consulations was to obtain general support for the need for the Initiative and stakeholders views about the proposed approach. During these consultations, which concluded in April 2000, the participants generally agreed that there was a need for improved information on SME financing in Canada. Encouraged by the government's commitment to fill this long-standing information gap on such a key segment of business, stakeholders welcomed the opportunity to participate in the initiative. The concerns that arose tended to focus on the:

- length of questionnaires,
- complexity of the requested data elements;
- need for greater clarity in terminology and definitions;
- need to minimize the response burden for survey respondents.

To satisfy stakeholder concerns, the approach and tools for data collection were re-evaluated. Survey questionnaires were shortened and simplified. The partners, in consultation with key stakeholder groups, began the process of developing standard definitions for complex data elements.

To address the compliance burden concerns, the proposed methodology for data collection was refined. This was done by condensing the data requested from suppliers of financing, and expanding the amount and scope of data to be collected through the SME survey. Since many financial providers do not systematically record client-based information and since concerns arose about the confidentiality of information, elements that were transferred from the supplier survey to the SME survey included many of the qualitative data relating to business and business owner characteristics. Financial service providers questioned their ability to provide the data required for the initiative — at least in the short term. To address this concern, it was agreed to extend the implementation agenda over five years to give respondents the time required to adapt their systems.

SECOND ROUND OF CONSULTATIONS

The goal of the second round of consultations, conducted in June and July 2000, was to seek agreement for, and commitment to, the five-year implementation plan to improve the collection and analysis of information. The second round also focussed on the technical aspects of the proposed data elements in the supplier survey, the selection of specific data elements to be collected and their appropriateness, and the suppliers' ability to provide the data within the time frame requested.

The stakeholder response to the technical aspects of the data collection program was generally favourable and constructive. Stakeholders acknowledged that many of the requested data elements were in fact already collected — and in some cases even reported — for many industry groups. Stakeholders were often concerned about elements for which they had no data — elements such as employee size and postal code listings of clients, standard terminology of knowledge-based industries (KBIs), and the measurement of financial flows.

Recognizing these limitations, the partners incorporated the suggestions received during consultations into the data collection program. For the initial baseline survey of suppliers of financing, "number of employees" was replaced by "approval size" as a measure of business size. As a proxy for measuring financial flows, the partners plan to conduct quarterly surveys of suppliers and to collect data on outstanding amounts, or stocks, at a single point in time. Geographic detail has also been pared back to the provincial/territorial level. The reduction in detail during the initial rounds of surveys will allow financial providers to modify their data systems so that Statistics Canada can collect the required information from respondents in later surveys.

DATA COLLECTION PROGRAM

As a result of the consultative planning process, the partners launched a revised two-pronged data collection process, consisting of baseline surveys and specialized studies. Statistics Canada has the main responsibility for implementing regular baseline surveys of SMEs (demand-side surveys), as well as of providers of financing to SMEs (supply-side surveys). These surveys aim to measure the total value of new and outstanding financing by supplier, instrument, region, industry and size of SME, as well as to shed light on the financing practices and patterns of SMEs across Canada.

While the surveys will be comprehensive, they may not provide sufficient detail to allow and in-depth understanding of certain niche areas of the SME financing market, for example, informal investors, KBI, and Aboriginal businesses. This is why the baseline surveys are being complemented by specialized studies conducted by Industry Canada and/or Statistics Canada. Among the studies under way within Industry Canada is a biannual survey of the attitudes, perceptions and expectations of small-business owners toward SME financing in Canada. The SME Attitude Survey is similar in design and approach to the Thompson-Lightstone study, commissioned in 1996, 1997 and 1998 by the CBA.

REPORTING OF BASELINE SURVEY FINDINGS

The first demand-side survey, in 2001, was conducted by telephone with a follow-up fax to collect additional information. This work will provide information from businesses about the debt and equity financing they request and obtain. The triennial survey has two broad objectives: first, to learn the nature and outcomes of businesses' applications for financing; and second, to determine the relative importance of the different instruments and sources of financing that businesses use. In addition to an industry breakdown, other important criteria for data analysis and reporting will be size of business (defined by number of employees), geographic region, and age of business. Business-owner characteristics have also been gathered to assess whether they have an impact on SMEs' ability to access financing.

The first survey of suppliers of financing was, conducted in 2001, surveyed domestic banks, credit unions, caisses populaires, factoring companies, some federal Crown corporations, mutual funds, venture capital funds, insurance companies, vehicle and equipment leasing companies. This survey, which will become quarterly over the next two years, reports on aggregate amounts outstanding and losses by type of supplier, approval size, instrument, region, and industry.

PLANNING AND PRIORITIES FOR IMPROVED DATA COLLECTION

Given the scope of the SME Financing Data Initiative, the partners established a five-year horizon for bringing the data collection and research program to maturity. A long-term strategy was needed because of aspects of the data collection that require survey respondents to make system changes.

The schedule below reflects the issues outlined in the government's mandate and research topics recommended for further study in the MacKay Task Force report, as previously shared with the Industry Committee. Included is the projected time frame for future baseline surveys, as well as an overview of specialized studies planned for the near future. Additional studies and brief surveys will likely be conducted as the data analysis from the baseline surveys suggests topics for more in-depth research.

Baseline Surveys	2000/2001	2001/2002	2002/2003	2003/2004	2004/2005
Demand Survey	Pilot Survey (June 2000)	Benchmark Survey (June 2001)	Supplemental Survey	Supplemental Survey	Benchmark Survey
Supply Survey	Benchmark Survey (March 2001)	Benchmark Survey (January 2002)	Semi-annual Surveys (January and July 2002)	Quarterly Surveys (April, July, October, January)	Quarterly Surveys (April, July, October, January)
Specialized Studies and Research Reports	• Practices and Patterns of Informal Investors • Value Added by Informal Investors • Venture Capital and IPO	• Business-Owner Characteristics • Venture Capital Profiles • Financing Gap Analysis	• Pension Funds • Micro-credit • KBI and Innovation • International Venture Capital • Rural/Urban • Electronic Financing • R&D • Price vs. Risk		
SME Attitude Study		SME Attitude Study		SME Attitude Study	

The data collection schedule outlined above represents a preliminary plan that will require continued monitoring and re-evaluation as new research issues and priorities emerge and survey results are assessed. In particular, the content and timing of the specialized studies after 2001/2002 will depend largely on the analysis of earlier studies and the baseline survey data. Both the surveys of financial suppliers and those of SMEs across Canada will be used to flag areas of financing that require further exploration, but lack the baselines to provide in-depth analysis. The niche areas of financing that the partners have targeted thus far are described below.

COMPLETED STUDIES

PRACTICES AND PATTERNS OF INFORMAL INVESTORS

Updated profiles of typical informal investors were obtained using empirical data. This study collected data pertaining to the habits, perceptions, and opinions of investors on the investment climate in Canada. The methodology involved meeting with 11 focus groups of informal investors across Canada, and allowed for capture of regional differences.

VALUE ADDED BY INFORMAL INVESTORS: FINDINGS FROM A PRELIMINARY STUDY

This was a report on the types of contributions, such as advice, contacts, and market and business intelligence, made by private investors, and also a documentation of business owners' perceptions of the value of these contributions. The aim of this study was to increase understanding of the role that private investors play in the growth of Canadian SMEs.

ISSUES SURROUNDING VENTURE CAPITAL, INITIAL PUBLIC OFFERING (IPO) AND POST-IPO EQUITY FINANCING FOR CANADIAN SMEs

This study provides an overview of the venture capital and IPO markets in Canada and the United States to inform the future research agenda in these areas. The study examines access, costs, sectoral and regional differences, supply versus demand, and cross-border flows.

FINANCING SMALL AND MEDIUM-SIZED ENTERPRISES: SATISFACTION, ACCESS, KNOWLEDGE AND NEEDS

This study measures the level of satisfaction of SMEs in Canada with the quality of service received from financial service providers. It reports on the needs, concerns, perceptions, knowledge and awareness that SMEs have of the various financial instruments available to them.

BUSINESS-OWNER CHARACTERISTICS AND EFFECTS ON ACCESS TO FINANCING

This report provides a literature review of recent work examining the obstacles to small business financing attributed to business-owner characteristics, with particular emphasis on barriers attributed to gender, age, language profile, and whether the business owner is an Aboriginal or a member of a visible minority. Based on the findings of this research, a corresponding methodological report was developed, which informs our future research agenda on these issues.

FINANCING GAP ANALYSIS STUDY

This study examined existing research to identify market failures in access to, and/or provision of, financing to Canadian SMEs. As part of the report, the study provides an analytical framework to analyse baseline survey data and determine where market failures may occur and how to effectively measure these gaps.

ONGOING STUDIES

PROFILES OF VC INVESTORS

Updated profiles of typical venture capital investors will be developed using empirical data. This study will collect data pertaining to the habits, perceptions and backgrounds of venture capitalists in Canada.

UPCOMING SURVEYS AND STUDIES

SUPPLEMENTAL DEMAND SURVEY

In the years between the benchmark demand surveys, a brief supplemental survey will gather pertinent information to gauge access to financing by SMEs on an ongoing basis.

PENSION FUNDS AND THEIR INVESTMENT IN SMES

Current investment practices of Canadian pension funds and those of American fund managers will be examined in detail in this study.

AVAILABILITY OF MICRO-CREDIT FINANCING

This study will evaluate the issues surrounding micro-entrepreneurs seeking financing amounts of less than $25 000 and the supply of such financing.

VENTURE CAPITAL INTERNATIONAL COMPARISONS

International comparisons of venture capital activity are often challenging, as different G-8 countries use different definitions for VC. This study will compare the data coming from these sources in an attempt to reconcile Canada's VC investment performance relative to its major competitors.

KNOWLEDGE-BASED INDUSTRIES AND INNOVATION: ACCESS TO FINANCING

This research will identify the financing needs specific to SMEs in the KBI sector. Baseline data will contribute to a specific agenda for the study.

ACCESS TO FINANCING: RURAL VERSUS URBAN

This study will examine the differences, if any, in access to financing by SMEs in rural and urban Canada, and the changing factors that impact on that access.

ELECTRONIC FINANCING

This study will identify emerging trends in electronic methods of financing — such as Internet credit applications and matchmaking services — and their usage by SMEs.

Seed and Research and Development Financing Needs
This survey will identify the financing needs specific to SMEs in the seed stage of development, and those enterprises with significant research and development requirements.

Price versus Risk of Capital
This report will examine options available to finance risky SME ventures as projects move up the risk curve, to determine if there are gaps in access to debt or equity financing.

Initial Public Offerings: Why Issue in Canada and/or the United States?
This study will report on the statements of benefits and drawbacks given by companies that have conducted an IPO in Canada and/or the United States. There are reported advantages and disadvantages determining which country and exchange a company should use when conducting an IPO. This study will probe the reasons behind the decisions of companies that have undertaken this process.

Demographic Study of Informal Investors in Canada
This study will aim to transform angel profile data (refer to the completed study *Practices and Patterns of Informal Investment*) into national proxy data, allowing for a better understanding of the presence of informal investors in Canada and their potential impact on the economy.

National Survey of Informal Investors
Using the results of previous research that profiled typical informal investors, this study will develop a national representative survey of informal investors to estimate their total financing impact annually.

Data Availability

For those seeking additional information regarding the SME Financing Data Initiative, including research results and findings, there is a dedicated Web site as a part of Industry Canada's Strategis site (http://strategis.ic.gc.ca/fdi). It enables stakeholders to find out about a project's origins, partners, objectives, data studies and findings. Information about upcoming surveys and past studies will be published on this Web site. Users will find the summaries, methodologies and key findings of surveys and studies that have been conducted. In addition, some aggregate data from the studies will be available for further analysis. As much detailed data as possible will be available from Statistics Canada, consistent with protecting confidentiality.

DEFINITION OF KNOWLEDGE-BASED INDUSTRIES

In 1996, based on research undertaken by Industry Canada and the Business Development Bank of Canada, a definition of knowledge-based industries (KBIs) was developed using the Standard Industrial Classification (SIC). This has since been converted to the North American Industrial Classification System (NAICS). Since there was no single definition of a KBI, Industry Canada proposed the use of a two-tiered categorization of industries that would be appropriate for identifying industries as knowledge based:

- Tier I – a narrow band of science and technology-based firms composed of knowledge producers; and
- Tier II – a broad band of "high knowledge" firms that, based on measures of research and development and knowledge worker inputs, could be considered to be business innovators and high-knowledge users.

Examples of industries in the Tier I group are listed below.

Aerospace products and parts	Post-production and other motion picture and video industries
Audio and video equipment	Radio
Cable and other program distribution	Research and development in the physical sciences
Computer and peripheral equipment	Satellite communications
Computer systems design and related services	Semi-conductor and other electronic components
Data-processing services	Software publishers
Engineering and life sciences	Telecommunications resellers
Environmental consulting services	Telephone apparatus
Motion picture and video production	Television broadcasting
Navigational and guidance instruments	Wireless communications
Pay and specialty television	
Pharmaceutical and medicine	

Examples of industries in the Tier II group are listed below.

Adhesives	Nuclear power generation
Alkali and chlorine	Paper industry machinery
Architectural services	Pesticide and agricultural chemical
Basic inorganic chemicals	Petrochemical
Chemical fertilizer (except potash)	Petroleum and coal products
Custom compounding of purchased resins	Petroleum refineries
Electric power distribution	Pipeline transportation of crude oil
Engineering services and drafting services	Pipeline transportation of natural gas
Explosives	Pipeline transportation of refined petroleum products
Fossil-fuel electric power generation	Power distribution and specialty transformers
Heating equipment and commercial refrigeration equipment	Printing ink
Hydro-electric power generation	Pumps and compressors
Industrial and commercial fan and blower and air purification equipment	Relay and industrial control apparatus
Industrial gas	Resin and synthetic rubber
Material handling equipment	Rubber and plastics industry machinery
Mining and oil and gas field machinery	Sawmill and woodworking machinery
	Switchgear and switchboard
	Synthetic dye and pigment

Mixed fertilizer Motors and generators Motor vehicles and electronic equipment	Turbines and turbine generator units

GLOSSARY OF TERMS

Aboriginal: A person who identifies with at least one Aboriginal group (i.e. North American Indian, Métis or Inuit) and/or who is a Treaty Indian or a Registered Indian as defined by the *Indian Act of Canada* and/or who is a member of an Indian Band or First Nation.

Credit Risk: Risk that a borrower may default on obligations, thus a danger that repayment will not take place.

Collateral: An asset or security that is pledged to support or secure a loan (e.g. a collateral mortgage on a house or a pledge of a bond taken as security by a bank to support a term or operating loan).

Debt: The money that one owes.

Debt Financing: A form of financing, other than leasing or factoring, that results in a debt on the part of the borrower.

Demand Loan: A loan that must be repaid in full on demand.

Disbursements: The total amount flowing from investors to investee companies.

Equity: The residual value of a business or investment after all debts and other claims are settled.

Equity Financing: Any form or financing based on the equity of the business.

Factoring: The sale of receivables from one company to another at a discount.

Fast-growth Stage: The stage at which a business is growing at a rate much faster than the economy.

Financial Institutions: Establishments that handle monetary affairs, including banks, trust companies, investment dealers, insurance companies, leasing companies and institutional investors.

Financings and Investments: A transaction with an investee company representing one round of financing, in which multiple investors can participate. For example, if three investors participated in one transaction, it would be recorded as one round of financing and three investments.

Investee Company: A firm that has secured an equity or quasi-equity investment from one or more venture capital investors.

Knowledge-based Industries: Since there is no consensus on a definition of KBIs, Industry Canada has proposed the use of a two-tiered categorization of industries that would be appropriate for selecting Standard Industrial Classification (SIC) codes as indicators for banks lending to KBIs. The categories are:
Tier I - a narrow band of science and technology-based firms, comprising knowledge producers; and
Tier II - a broad band of "high knowledge" firms that, based on measures of research and development and knowledge worker inputs, could be considered businesses of innovators and high-knowledge users (see Appendix A (page 100)for additional detail).

Labour-sponsored Venture Funds: Venture capital corporations established by labour unions. They function as other venture capital corporations but are subject to government regulation.

Lease: An agreement to rent for a period of time at an agreed price.

Line of Credit: An agreement negotiated between a borrower and a lender that establishes the maximum amount against which a borrower may draw. The agreement also sets out other conditions, such as how and when money borrowed against the line of credit is to be repaid.

Maturity Stage: The stage at which sales have stopped growing.

Mezzanine Financing: According to Macdonald & Associates Limited, a senior investment that provides the cash flow of term lending with the capital gains of share ownership. Mezzanine financing generally includes subordinated convertible debt and yield based on preferred shares, often structured with warrants or options.

Winding-down Stage: The stage at which sales have started to decrease.

Woman-owned Business: A business that is more than 50 percent owned by a woman or women.

Mortgage: A debt instrument by which the borrower (mortgager) gives the lender (mortgagee) a lien on property as security for the repayment of a loan.

Operating Loan: A loan intended for short-term financing to support cash flow or to cover day-to-day operating expenses. Loans of this type are part of the line of credit.

Partnership: A non-incorporated business venture of two or more individuals or companies. Profits and losses flow directly and equally to the partners.

Quasi-Equity Financing: A type of financing that involves a mix of debt and equity. The equity allows investors to achieve a high rate of return upon the success of the company, while the debt component entails premium price contributing to the return of the investor.

Request: The act of approaching any type of credit supplier for new or additional credit for business purposes.

Refusal: The act of refusing to authorize a final request for financing in a given year.

Retained Earnings: The amount of earnings retained and reinvested in a business and not distributed to the shareholders as dividends.

Rural Location: A location in which the second digit of the postal code is zero (except in the province of New Brunswick). A community with less than 1500 points of call (or POCs — destinations to which mail is delivered) or where a majority of the POCs are concentrated in an area with a population density of less than 400 per square kilometer. Areas within a community that are separate from the population concentration of the community and are served through one or more postal installations that have less than 1500 POCs. Additionally, a post office that does not have a letter carrier associated with it can be deemed a rural office.

Seed Stage: The stage at which a business has no clients yet and has not fully developed its business plan.

Slow-growth Stage: The stage at which a business's sales are slowly increasing.

Small and Medium-sized Enterprises: Firms with less than 500 employees and less than $50 million in annual revenues.

Start-up Stage: The stage at which a project is clearly defined or the prototype is finished and the business is starting commercialization.

Subordinated Debt: A non-conventional financing instrument whereby the lender accepts a reduced rate of interest in exchange for equity participation.

Term: Usually the duration of a loan.

Term Loan: A loan intended for medium-term or long-term financing to supply cash to purchase fixed assets such as machinery, land or buildings, or to renovate business premises.

Underpricing: The difference between the closing or opening price of a product on the first day of trading and the initial offering price of the firm, expressed as a percentage of the initial offering price.

Urban Location: A location in which the second digit of the postal code is not zero (except in the province of New Brunswick). A community (defined as a city, town, township or settlement) that has 1500 points of call (POCs – destinations to which mail is delivered) or more and where the majority of these POCs are concentrated in an area of the community with a minimum population density of 400 per square kilometer. Also, a post office with letter carriers assigned to it is considered urban.

Venture Capital: Risk capital invested in privately held companies by VC firms, through the underwriting of newly issued stock and/or convertible bonds

Venture Capitalist: An entity investing in a company or companies that have an element of risk but offer potentially above-average returns.

Visible Minorities: Persons other than Aboriginal persons who are non-Caucasian or non-white.

Working Capital: The excess of current assets over current liabilities. This represents the amount of net non-fixed assets required for day-to-day operations.

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