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Small and Medium-sized Enterprise Financing in Canada

2003

Canada

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(strategis.gc.ca/fdi)

Cat. No. Lu4-7/2003E
ISBN 0-662-36118-0
54058E

Aussi offert en français sous le titre *Financement des petites et des moyennes entreprises au Canada*

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EXECUTIVE SUMMARY

Background

Small and Medium-sized Enterprise (SME) Financing in Canada, 2003 is a report on the state of financing for small and medium-sized enterprises in Canada. As part of a five-year joint process involving Industry Canada, Finance Canada and Statistics Canada, this is the second of an ongoing series that will report on SME financing in Canada. For further details on this initiative visit the Industry Canada Small Business Policy and Research Web site (**http://strategis.gc.ca/fdi**).

The information gathered in this report originates from a number of groundbreaking Statistics Canada surveys, including the *Survey on Financing of Small and Medium-sized Enterprises, 2000 and 2001*, and the *Survey of Suppliers of Business Financing, 2000 and 2001*. The data sets from these surveys focus 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 (**http://strategis.gc.ca/fdi**). The report also includes results and data from other sources, including the Canadian Federation of Independent Business, the Conference Board of Canada and Macdonald & Associates Limited.

While the data presented in this analysis 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 initially intended to provide parliamentarians with accurate and relevant information on the state of SME financing in Canada, and assist them in forging timely and effective public policy.

Highlights of the Report

SME Financing in Canada is presented in four parts:

- **Part I** examines SMEs' behaviour during 2001 against the backdrop of changes in the economy, focussing on two key forms of financing — commercial debt and leasing
- **Part II** examines the use of financial instruments within a firm's capital mix (financial structure) and the distribution of their equity shares (ownership structure). This part also examines whether business characteristics (gender/age of business owner or high-growth orientation) influences SMEs' financial structure
- **Part III** reviews financing issues from a suppliers' perspective and examines the major providers of business financing — domestic banks, other banks, credit unions and caisses populaires, and other market participants such as finance companies. This part focusses on financing to all businesses in Canada and does not distinguish SMEs from other enterprises
- **Part IV** examines four risk capital instruments used by SMEs (seed financing, start-up financing, initial public offering and quasi-equity financing) at various stages of development, and discusses their economic importance

The following sections highlight key findings of the report.

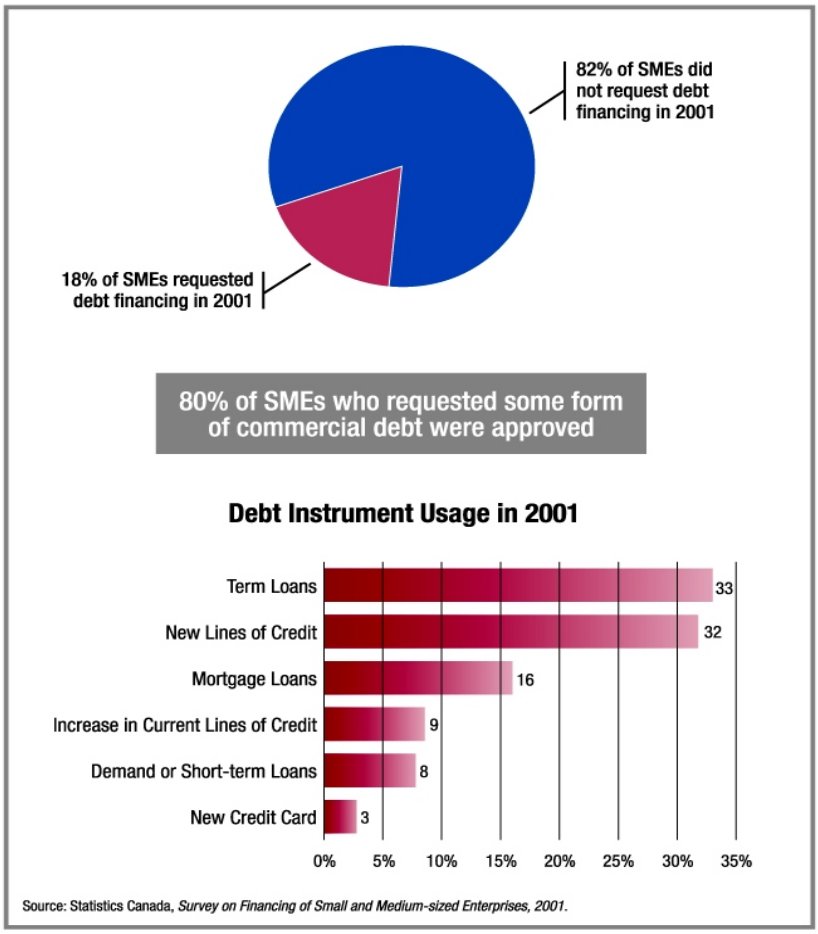
PART I: FINANCING CONDITIONS FOR SMEs IN 2001

The Canadian economy slowed in 2001, according to several key macroeconomic indicators — the growth rate of the gross domestic product (GDP), interest rates and consumer spending. It appears that these economic conditions influenced the requests (demand for) and approvals (supply of) commercial debt and leasing.

Commercial Debt

Figure 1 provides an overview of commercial debt financing in 2001. While only 18 percent of SMES requested commercial debt in 2001, 80 percent of requests were approved. These figures are down from 2000, when 23 percent of SMEs requested some form of commercial debt and 82 percent were approved. While it may appear that the economic slowdown in 2001 lowered demand for commercial debt by SMEs, the effects of similar conditions over a number of observations would be needed to conclude which, if any, economic factors most influenced borrowers' behaviour.

Figure 1
Percentage of SMEs Requesting Debt Financing in 2001



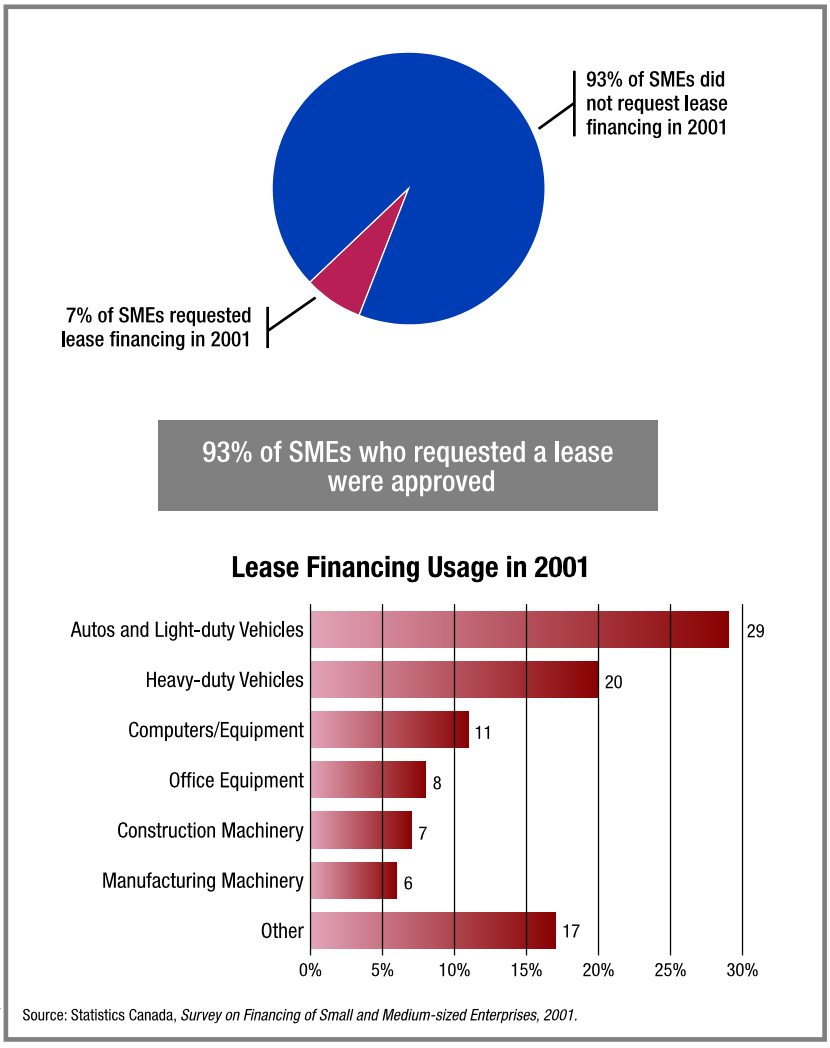
Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2001.*

Leasing

Figure 2 provides an overview of lease financing in 2001. Although only 7 percent of SMEs requested lease financing in 2001, 93 percent were approved. These figures are down from 2000 when 9 percent of SMEs requested leasing and 98 percent were approved. While it may appear that the economic slowdown in 2001 lowered SMEs' demand for leasing, more data collection and analysis will be needed to determine if this is a meaningful trend.

Figure 2

Percentage of SMEs Requesting Lease Financing in 2001



Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2001.*

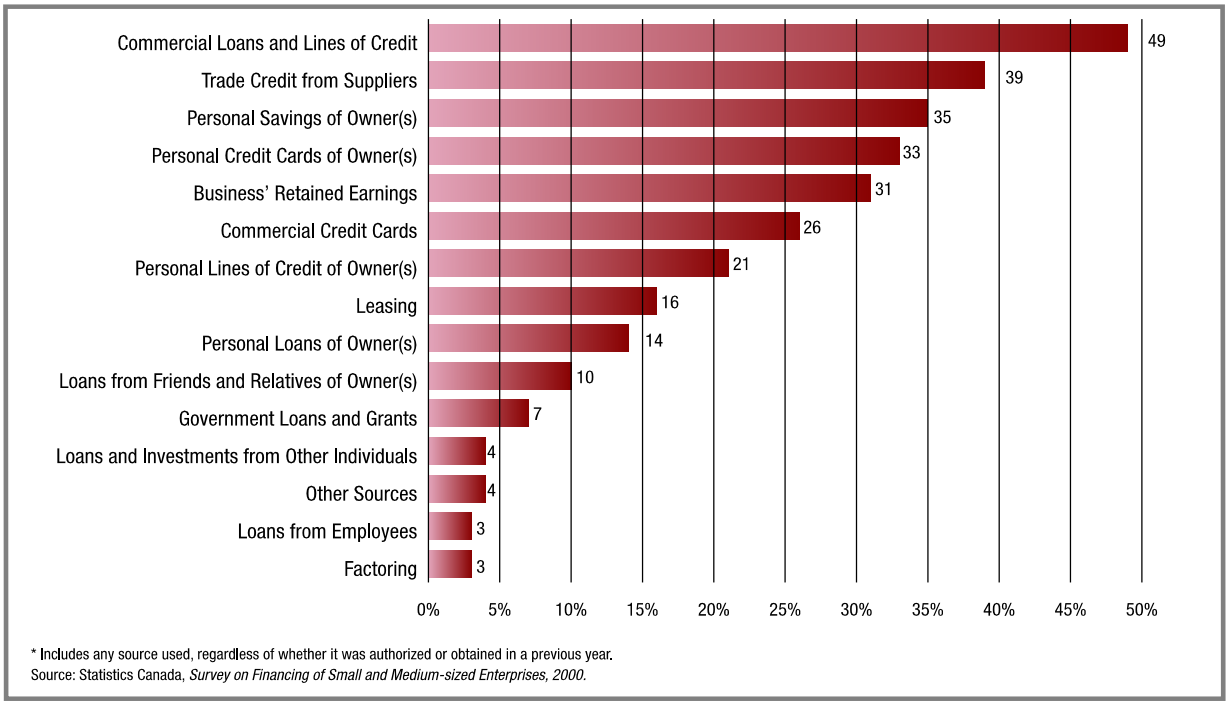
PART II: FINANCIAL STRUCTURE OF CANADIAN SMEs

SMEs financed their operations with a wide range of financial instruments in 2000, which can be broadly categorized as formal or informal. Formal types of financing are instruments obtained from external suppliers/sources which are in the business of providing financing. Informal types of financing are obtained from suppliers/sources that are not in the business of financial lending or are funds acquired from the businesses' activities (e.g. retained earnings) or derived from the owners (e.g. personal savings).

In 2000, SMEs preferred commercial financing products (49 percent) over all other forms of financing. However, SMEs also made substantial use of informal personal financing instruments when access to financing was not particularly difficult. As seen in Figure 3, 35 percent of SMEs financed their operations with personal savings, followed closely by the businesses' retained earnings (31 percent). These findings could indicate that SMEs use personal sources of financing to provide a "bridge" until more permanent financing is available, or they may be related to some financial institutions' bundling of commercial and personal banking.

Figure 3

Percentage of SMEs Using Financial Instruments in 2000, by Type*



* Includes any source used, regardless of whether it was authorized or obtained in a previous year.
Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000.*

A number of factors influence SMEs' financial structure and use of formal and informal types of financing. The most significant factors are sector, size of business (by number of employees), and stage of business. Other business characteristics, such as gender of business owner, appear to be important (but less so than sector), while age of business owner and growth patterns of the firm appear to have less influence. Some key findings in 2000 included the following:

Stage of business development

- 66 percent of start-up SMEs used personal savings of the owner(s), compared with 35 percent of all SMEs
- 29 percent of start-up SMEs used commercial loans and lines of credit, compared with 49 percent of all SMEs

Sector of operation

- Resource-based and goods-producing sectors used more formal types of financing
- Service sectors used more informal types of financing (e.g. 37 percent of knowledge-based firms used retained earnings – the highest rate of all sectors)

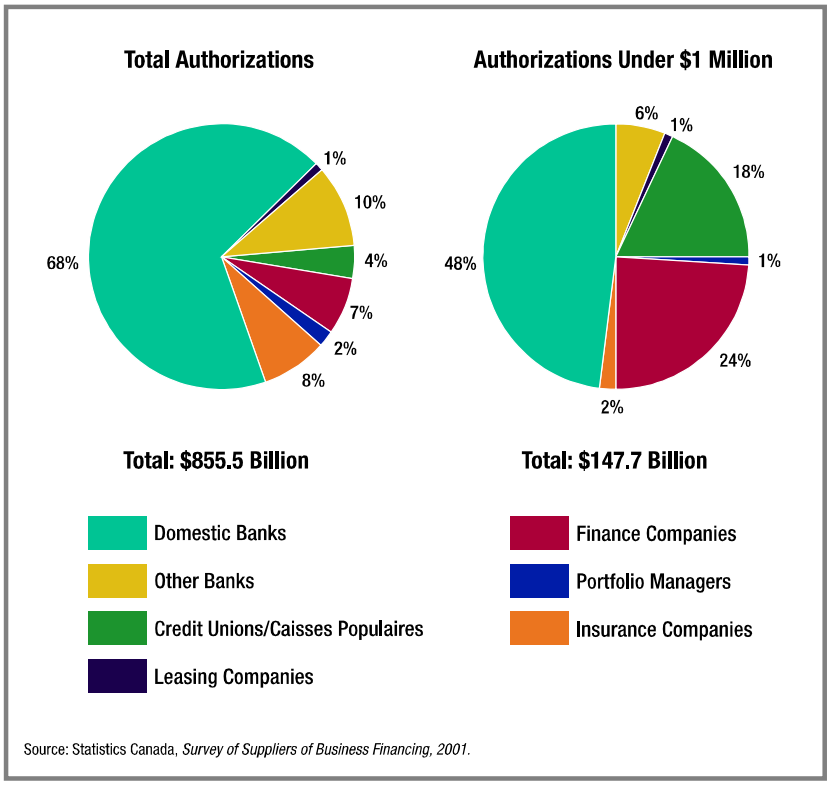
Size of business

- 36 percent of self-employed SMEs used personal savings. Smaller businesses used informal financing instruments, such as the business owner's savings or personal credit facilities
- Medium-sized firms used formal commercial instruments and the business' resource (e.g. 86 percent used commercial loans and lines of credit, compared with 49 percent of all SMEs)

PART III: FINANCIAL SERVICES SECTOR — PROVIDERS OF BUSINESS FINANCING

This section adopts the perspective of authorization size rather than size of business (by number of employees). As a rough proxy, authorizations of less than $1 million represent lending to SMEs. Over the past decade, technical innovation, globalization and increased competition from foreign suppliers have spurred rapid structural changes in the financial services sector. As a result, the financial services sector has become increasingly dominated by large financial groups that provide a variety of services, such as deposit taking, insurance, trusts and securities. These players operate alongside "monoline" or "niche" companies that focus on one or a few business lines, such as credit cards or Internet/telephone-based retail banking. This market structure influences SMEs' access to financing, especially for businesses in specific regions and sectors.

Figure 4
Authorizations of Commercial Debt by Financial Service Providers, as of December 31, 2001



Source: Statistics Canada, *Survey of Suppliers of Business Financing, 2001.*

Figure 4 illustrates financial suppliers' market share of all commercial debt authorized and shows smaller authorization amounts (under $1 million) as of December 31, 2001. The figure shows that domestic banks continue to be an important supplier of commercial debt for all authorization sizes. Other large institutions focus more on the larger authorizations (over $1 million); smaller authorizations typically represent a small percentage of their overall commercial debt portfolio.

Credit unions and caisses populaires focus more on smaller authorizations (under $1 million) (see Figure 4), which account for close to one fifth of the market. This is an important feature of the SME financing market, since SMEs typically seek financing in smaller authorization amounts.[1]

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

Understanding the sources of SMEs' commercial debt provides a window to issues of accessibility, particularly related to SMEs operating in certain regions and sectors. Many financial service providers are regionally-based (see Figure 45). For example, credit unions typically serve the western provinces and caisses populaires tend to serve enterprises in Quebec; domestic banks are distributed across Canada, but are most prominent in Ontario and the Atlantic provinces. Therefore, the potential of more consolidation (mergers and acquisitions) among financial service providers may have implications for SMEs' access to financing.

PART IV: PROFILE OF RISK CAPITAL FINANCING

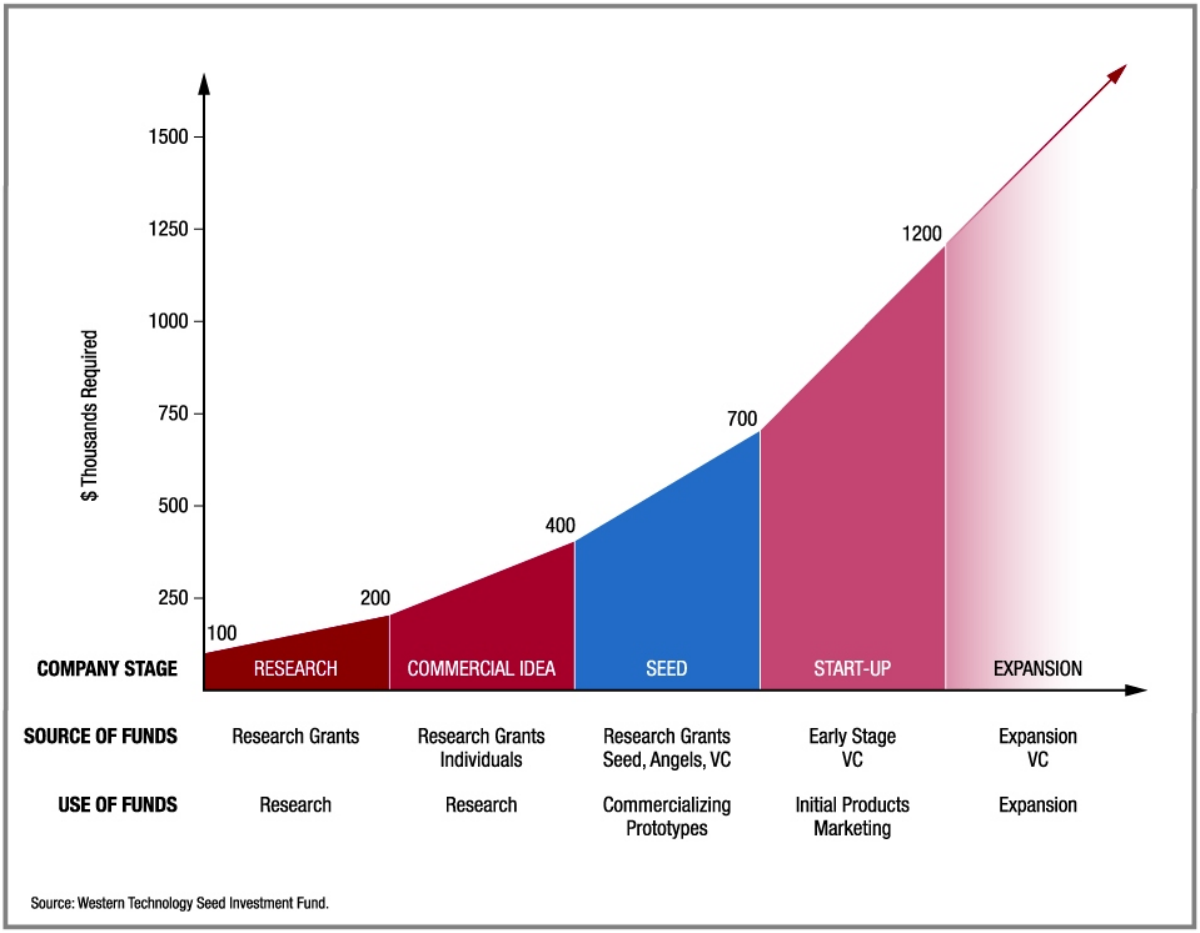
Risk capital is only one of many financing instruments available to Canadian SMEs. However, this instrument is not a panacea for economic development or for all SME financing challenges. Risk capital is often a more appropriate financing instrument for high-growth-potential and start-up SMEs, particularly for those in knowledge-based industries (KBI). Risk capital investors' stringent criteria mean that fewer than 2 percent of firms will access this form of financing. However, these firms tend to be dynamic and innovative and represent the most interesting investment opportunities.

As businesses grow, they typically require several stages of financing, involving a combination of financial products. Risk capital follows the same pattern; what is appropriate at one stage of development may not be appropriate at another stage.

Figure 5 shows risk capital financing through the various stages of a firm's development. During the seed and start-up stages, technology-driven high-growth SMEs are often almost entirely dependent on risk capital from the owner's personal resources and informal investors (family, friends, private individuals or business angels) to finance their initial operations, such as research and product development. In the seed stage, equity financing is initially obtained from entrepreneurs or from family and friends. Subsequently, financing may be supplemented by seed capital investment from informal private investors and, in a few cases, (e.g. high-growth-potential firms), by seed financing funds and venture capitalists. For high-growth-potential start-ups, informal investment and/or early-stage venture capital investment are the main sources of external financing. In the expansion stage, SMEs generally require increasing amounts of equity to maintain R&D and product commercialization and to expand marketing and sales activities.

Figure 5

Types and Amounts of Risk Capital Financing by Stage of Development — Technology-driven Businesses



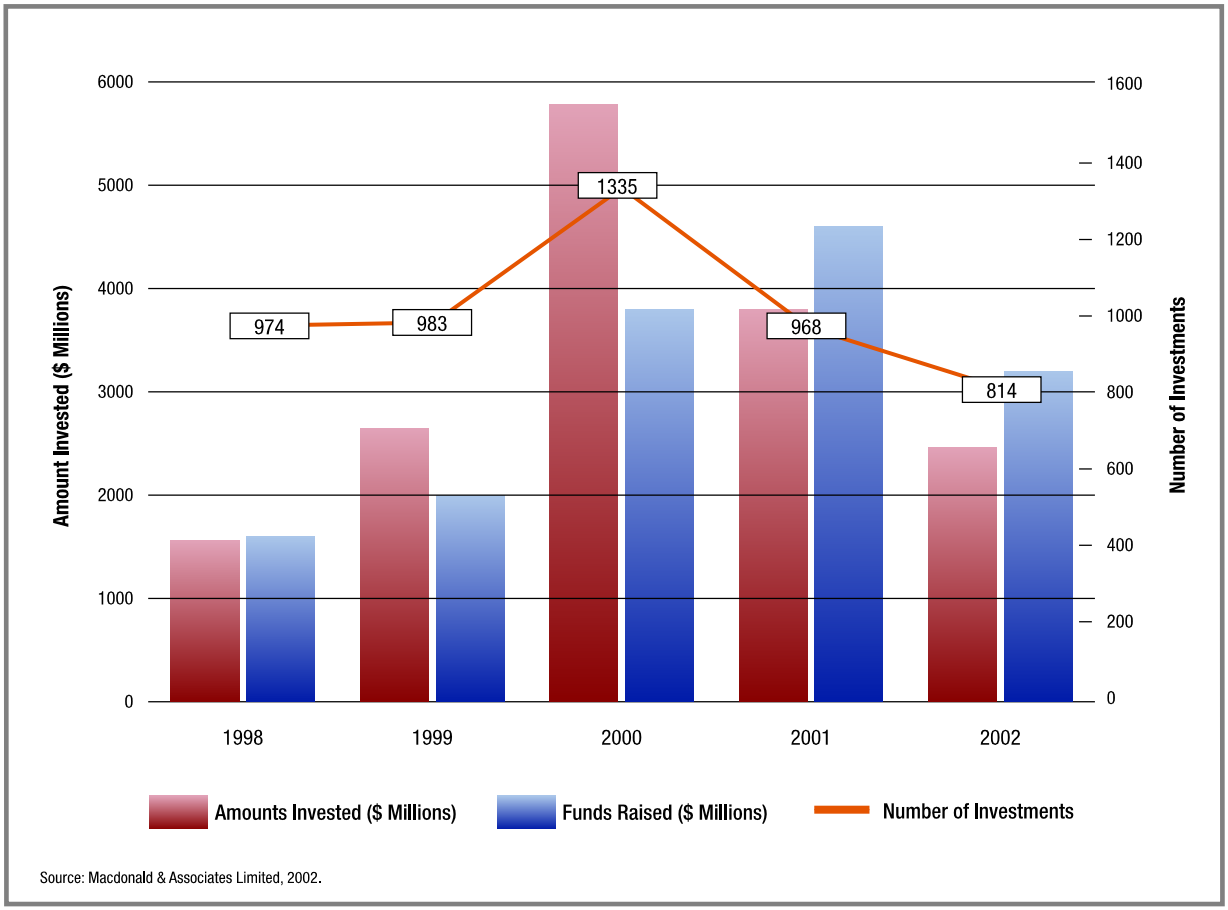
Source: Western Technology Seed Investment Fund.

As companies continue to expand, they often require growing amounts of equity investment — amounts that are normally only available through initial public offerings (IPOs) on stock exchanges. Not only do IPOs supply growth capital, they provide exit avenues for venture capitalists and other early-stage investors. Timely exits allow investors to recuperate their original investments, realize their gains and reinvest in new, innovative, early-stage firms.

Venture Capital Activity in Canada in 2001 and 2002

Despite the tightening investment climate since 2001, the Canadian VC industry showed signs of vigour and enjoyed a stronger-than-expected year in 2002, investing $2.5 billion in 677 firms (see Figure 6). While this figure represented a sharp drop from the $3.8 billion invested in 2001 and the $5.8 billion invested in the peak year 2000, it was in line with the level of investment in 1999, $2.7 billion.

Figure 6
Canadian VC Activity, 1998–2002



Source: Macdonald & Associates Limited, 2002.

Initial Public Offerings (IPO)

Canadian firms have low post-IPO survival rate

Very small issues by small or very small companies (under $1 million in net assets) with short track records have an extremely small chance of succeeding. Of the 153 companies with gross proceeds under $1 million that launched an IPO between 1991 and 1995:

- 53 percent were unsuccessful, either because they were written off, had negative net assets or ended up with net assets worth less than their transaction values
- 28 percent survived over five years and had a positive book return with net assets worth more than the proceeds of the IPO
- 6 percent survived over five years with net assets exceeding $10 million, and these could be considered real successes.

NOTE TO READERS ON SOURCES AND USES OF DATA

Sources

Many statistical findings presented in this report were collected by Statistics Canada in two series of surveys: *The Survey on Financing of Small and Medium-sized Enterprises,* conducted in 2000 and 2001 and *The Survey of the Suppliers of Business Financing,* conducted in 2000 and 2001. For comparative purposes, results related to *The Survey of the Suppliers of Business Financing, 2000* have been included; the summary tables for that year can be found at the end of this report.

All data in Part I and Part II are derived from *The Survey on Financing of Small and Medium-sized Enterprises, 2000 and 2001,* unless otherwise stated. All data in Part III come from the *Survey of the Suppliers of Business Financing, 2000 and 2001,* unless otherwise stated. All data on venture capital and quasi-equity presented in Part IV originated with Macdonald & Associates Limited, unless otherwise stated. The initial public offering (IPO) data in Part IV was taken from *"Les émissions initiales au Canada: bilan, anomalies et dysfonctions"* a study commissioned by Industry Canada in 2003.

A Glossary of Terms can be found at the end of this report.

Uses and Interpretation of Data

***Survey on Financing of Small and Medium-sized Enterprises, 2000*:** Since the data reported relate to firms that were operating at the end of the calendar year 2000, it does not capture data on those businesses that failed nor those entrepreneurs who planned to start a business but failed to do so, whether because of financing or other difficulties. In many places in this report, correlations and observations are made by region, industry, gender of business owner and other business characteristics. Given the relatively small sample sizes, caution must be exercised in drawing strong conclusions. The purpose of this report is to provide initial observations and interpretations of the data. Likewise, it is not possible to form conclusions about long-term trends on the basis of one or two observations. Following last year's preliminary report, this is the first of a regular series of reports, and these issues will be examined in more detail as more data are collected.

***Survey on Financing of Small and Medium-sized Enterprises, 2001*:** All data reported relate to firms that were operating at the end of calendar year 2001. The survey did include entrepreneurs who tried to start a business but were unsuccessful. The survey targeted businesses with 0 to 499 full-time equivalent employees. Financing and leasing businesses, cooperatives, subsidiaries, non-profit organizations, government agencies, educational institutions, hospitals and other public sector organizations were excluded. Many parts of this report feature comparisons and observations by region, industry and gender of business owner, between 2000 and 2001. Given the relatively small sample sizes (especially in 2001), caution must be applied is ascribing causality or in distinguishing long-term trends from short-term anomalies. The purpose of this report is to provide initial observations and interpretations of the data.

Survey of the Suppliers of Business Financing, 2000 and 2001*:* All data reported regarding total amounts authorized, total amounts outstanding, total value of leases and total lease amounts outstanding are all stock data. In other words, data for these categories has been aggregated over all clients up to a certain time and do not represent the amounts in a particular year. Due to current limitations with the survey questionnaire, the quality of data in the debt category is more complete than the data from the leasing category. The SME Financing Data Initiative is working on improving the survey design to allow all survey respondents to provide the same level of quality in the information reported.

Surveys' comparability: It is difficult to draw comparisons between the *Survey on Financing of Small and Medium-sized Enterprises* and the *Survey of the Suppliers of Business Financing* as the two surveys use different regional and industry breakdowns. In addition, the *Survey on Financing of Small and Medium-sized Enterprises* categorizes businesses by their number of employees and provides five employment size breakdowns, while the *Survey of the Suppliers of Business Financing* only provides total amounts of debt and leasing, broken down by eight authorization sizes. The SME Financing Data Initiative partners are examining ways to reconcile the two surveys.

SME MARKETPLACE

Small and medium-sized enterprises (SMEs) are a dynamic and diverse component of the Canadian economy, and cover a broad spectrum of business activities. These businesses play a vital and evolving role in the Canadian economy by stimulating employment and fostering economic growth. In 2001, more than 1.5 million businesses in Canada were considered small or medium-sized enterprises.[2]

As major engines of growth in the Canadian economy, SMEs help to determine the economy's current performance and future expansion. The financial services sector plays a critical role in this expansion by providing the capital that SMEs need to succeed. Financing allows SMEs to invest in research and development, which increases innovation and productivity. This in turn contributes to the future growth of the Canadian economy through job and new wealth creation. However, due to the heterogeneity of SMEs, the demand for financing is not uniform across region, sector, size or stage of business. As a result, discussing the distribution of SMEs across Canada is critical to understanding the role of financing in SMEs' growth and development. This in turn will help to inform policy-making that will support or expand SMEs' access to financing.

This section describes the SME marketplace in 2001 in three sections:

- The first section provides a snapshot of the distribution of SMEs by region and highlights the different regional economic structures in Canada
- The second section breaks down the distribution of SMEs by sector in 2000 and 2001
- The third section examines SME distribution by size of business (number of employees) and examines the importance of medium-sized firms in light of the new economy

National and Regional Perspective

The distribution of SMEs varies widely across Canada, as shown in Figure 7:

- **Atlantic provinces (7 percent of total population)**: 93 075 (6 percent of all SMEs, a 9-percent increase from 2000)
- **Quebec (24 percent of total population)**: 353 170 (23 percent of all SMEs, an 11-percent increase from 2000)
- **Ontario (38 percent of total population)**: 533 495 (35 percent of all SMEs, a 4-percent increase from 2000)
- **Manitoba/Saskatchewan/Nunavut (7 percent of total population)**: 135 391 (9 percent of all SMEs, a 6-percent increase from 2000)
- **Alberta/Northwest Territories (10 percent of total population)**: 194 799 (13 percent of all SMEs, a 2-percent increase from 2000)

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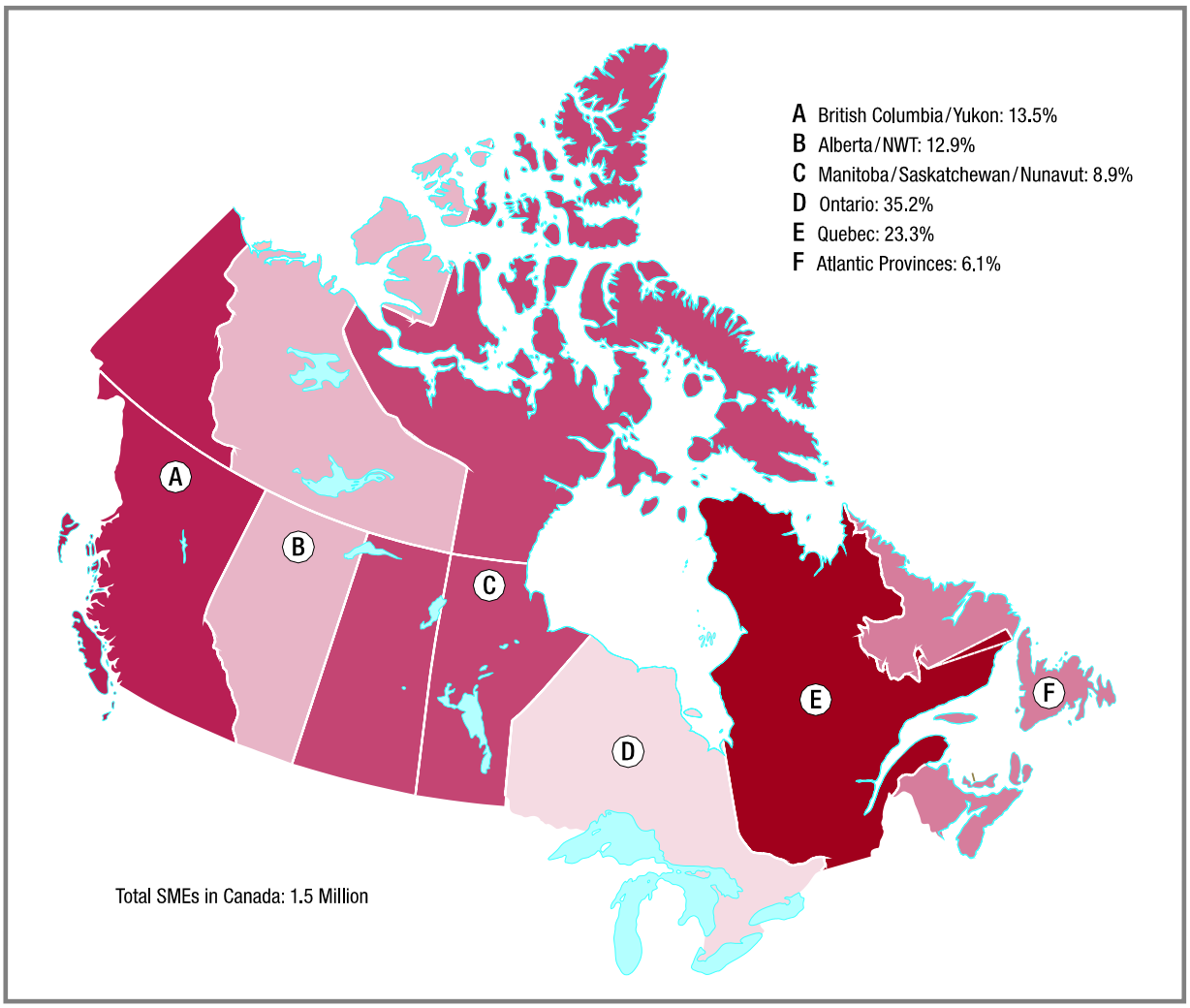
2. The target population for the *Survey on Financing of Small and Medium-sized Enterprises, 2001* includes SMEs with fewer than 500 full-time-equivalent employees and less than $50 million in annual revenue. Excluded from the population are unincorporated firms with less than $30 000 in revenues, non-profit organizations, government organizations, schools, hospitals, subsidiaries, co-operatives, and financing and leasing companies.

- **British Columbia/Yukon (13 percent of total population)**: 204 426 (14 percent of all SMEs, an 8-percent increase from 2000)
- **Canada**: 1 514 356 (a 6-percent increase from 2000)

Figure 7
Distribution of Canadian SMEs, 2001



SMEs are concentrated in highly populated regions

The regional distribution of SMEs is governed primarily by population density and by other factors such as sectoral concentration. As illustrated in Figure 7, Ontario and Quebec held more than half of the SME population in Canada in 2001, followed by the western provinces and Atlantic Canada. As will be seen throughout this report, these regional variations in SME populations influence businesses' sector of operations, capital structure (as seen in Part II) and access to financing. To ensure that regional variations are attributed to the appropriate market phenomena, regional comparisons will be made against national averages (where applicable).

Regional economic structures vary across Canada

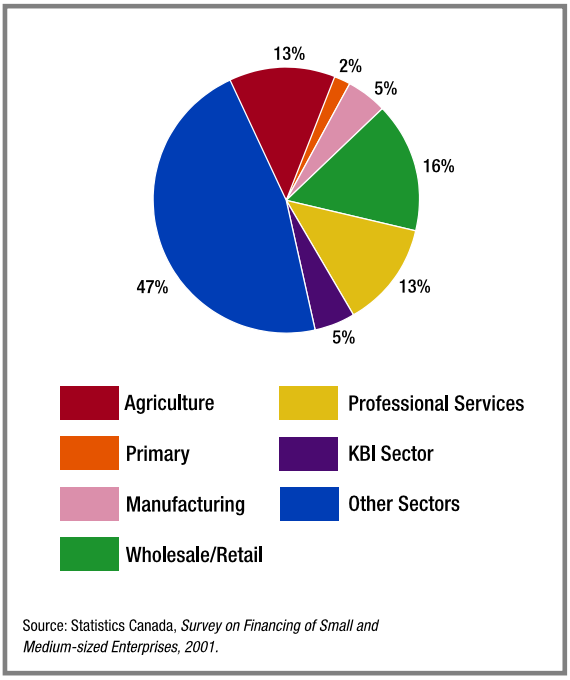
Some regions depend on agriculture and primary industries; others are dominated by manufacturing, services or knowledge-based firms. As will be seen in Part II, these industrial sectors have different financial services needs; these are also reflected in the regional differences. For example, agriculture is an important sector in Manitoba and Saskatchewan compared with other regions (see Table 9). Since agricultural firms generally require high amounts of debt (which can be secured against the hard assets that are common to most agricultural interests), results for SMEs in these regions can be attributed to the preponderance of the agricultural sector.

Sector Perspective

The sectoral distribution of SMEs across Canada in 2001 was consistent with the findings from 2000.[3] Nearly half (47 percent) of SMEs operated in the "other sector"[4] category, which includes a number of service industries such as health care and social assistance, accommodation and food services, and warehousing and couriers (see Figure 8). A significant number of SMEs operate in agriculture and manufacturing. As will be seen throughout the report, the sector of operation is an important determinant of an SMEs' financial structure (Part II of this report) and ability to access certain types of financing (e.g. commercial debt).

Figure 8

Distribution of Canadian SMEs by Sector in 2001



Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2001.*

Size of Business

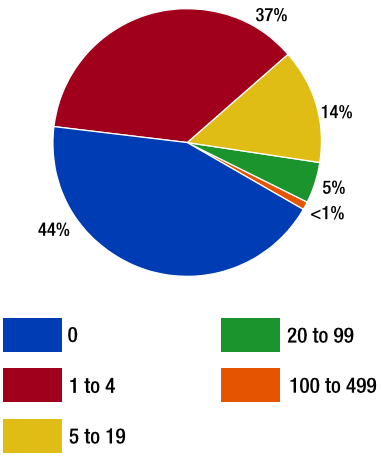
Nearly all Canadian businesses are small (by number of employees)

More than 80 percent of the SME population is comprised of either self-employed individuals (0 employees) or micro-businesses (1–4 employees). As will be seen in Part II, size of business is an important determinant of an SMEs' financial structure. More importantly, SMEs in the small size categories are typically less profitable, have fewer assets and larger debt/equity ratios than mid-size firms. As a result, these businesses encounter difficulties accessing formal types of financing (e.g. commercial debt).

3. Industry Canada, *Small and Medium-sized Enterprise (SME) Financing in Canada, 2002.*

4. Other sector includes construction; transportation; warehousing and couriers; information and cultural industries; real estate, rental and leasing; administration and support; waste management and remediation; health care and social assistance; arts, entertainment and recreation; accommodation and food services; and other services.

Figure 9
Distribution of Canadian SMEs by Size of Business (by Number of Employees) in 2001



Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2001.*

Size of business varies by sector

As illustrated in Figure 9, the distribution of SMEs by employment size is not consistent across sectors. Agricultural firms and those in the services sector (professional services, KBI and wholesale/retail) have a higher percentage of micro businesses (1–4 employees). By comparison, sectors such as manufacturing and primary industries tend to feature larger businesses. As will be seen in Part II, the relationship between size of business and sector is important — sector of operation may influence the pattern of ownership of certain sizes of businesses. For example, the high percentage of self-employed businesses in the agricultural sector may influence the financial structure of firms in this size category. Similarly, the number of medium-sized firms (100–499 employees) in the manufacturing industry appears to influence the financial structure of medium-sized SMEs. A more detailed discussion is presented in Part II.

Medium-sized firms: potential for growth

Medium-sized firms represent 2 percent of all businesses in Canada, whereas parallel firms in the United States constitute over 5 percent of the business population. While they represent a small proportion of all SMEs, medium-sized firms' characteristics distinguish them from their smaller counterparts and highlight the disproportionate, positive contribution they can make to Canada's economy. For example (all percentages below represent the percentage of medium-sized firms versus the percentage of small firms):

- medium-sized firms are high-growth firms[5] (22 percent versus 12 percent);
- medium-sized firms perform more R&D (50 percent versus 24 percent); and
- medium-sized firms are more export-oriented (47 percent versus 11 percent).

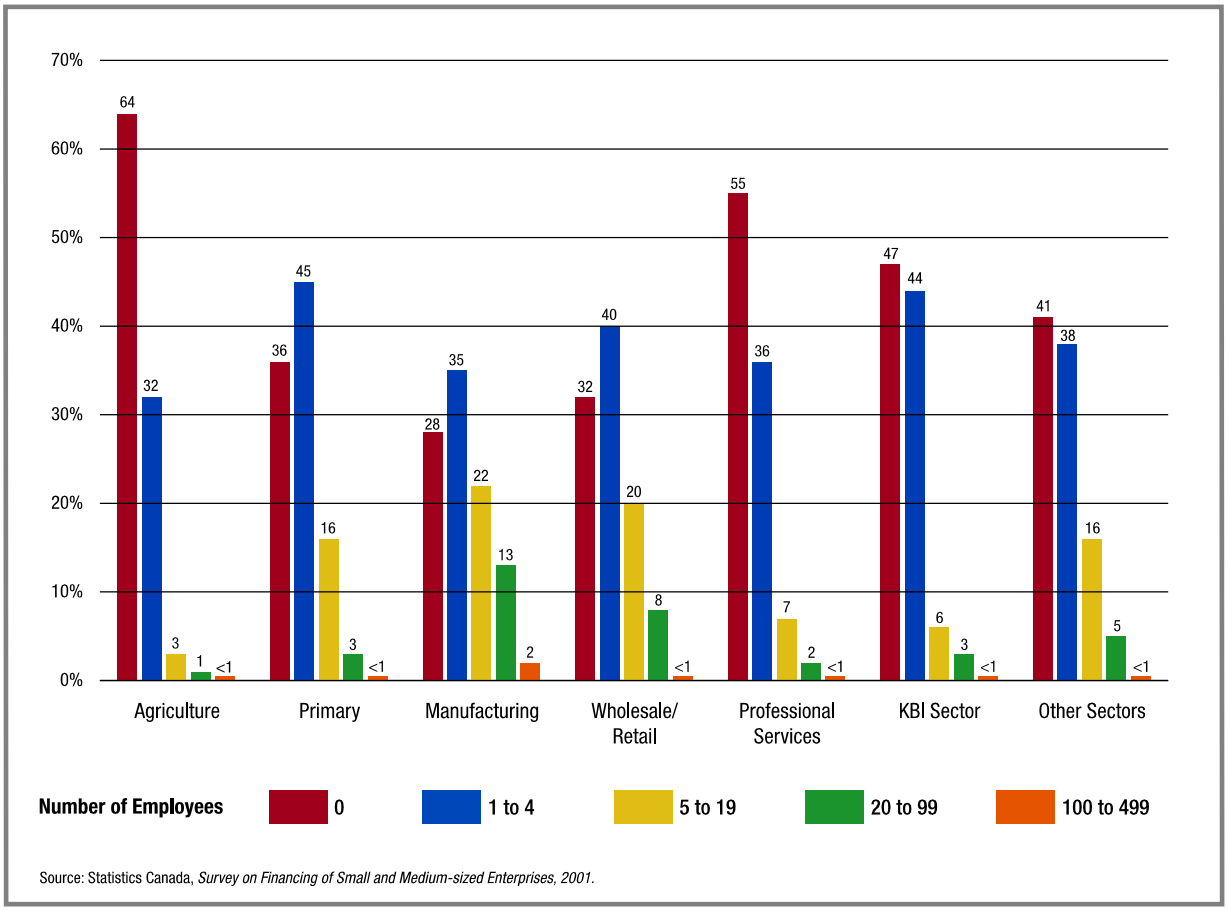
Most medium-sized firms are found in the manufacturing industry. As high-growth firms, they offer the possibility of high returns on investment. Their R&D performance contributes to product and business strategy innovation and increases Canada's capacity to commercialize research. Finally, their export readiness gives them a head start in successfully taking on global competitors. However, one of the key challenges facing small businesses is making a successful transition from a small to a mid-sized firm.

5. A high-growth firm is one whose revenues have grown by more than 50 percent over a consecutive three-year period.

Research to date shows that few small firms (1–99 employees) grow into medium-sized firms; from 1985 to 1999, just over 3 percent managed to make the leap.

Figure 10

Distribution of SMEs by Employment Size by Sector in 2001



Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2001.*

Other Characteristics of SMEs in 2001

Proportion of SMEs that exported their products or services in 2001	11.1%
Main destination for exportation	26% in U.S. 6% in Asia 3% in Europe
Proportion of business that invested in R&D by percentage of budget	73% — 0% of their investment expenditure 13% — 1–5% of their investment expenditure 8% — 6–10% of their investment expenditure 5% — over 10% of their investment expenditures
Proportion of SMEs owned by women (>50 % owned by women)	17.8%
Proportion of SMEs owned by youth(<30)	2.4%
Proportion of SMEs by language	64.9% — English 22.1% — French 13.0% — Other
Proportion of SMEs that are home-based	58%

Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2001*.

Summary Table

Table 1 — Distribution of SMEs in 2001

	Number of SMEs	Proportion of SMEs (%)
Total	**1 514 356**	**100**
EMPLOYMENT SIZE		
0 employees	663 756	44
1-4 employees	565 904	37
5-19 employees	210 982	14
20-99 employees	67 567	4
100-499 employees	6147	0
SECTOR		
Agriculture	189 938	13
Primary	32 235	2
Manufacturing	77 336	5
Wholesale/Retail	235 003	16
Professional services	189 111	12
KBI sector	73 222	5
Other sectors NEC	717 512	47
REGION		
Atlantic provinces	93 075	6
Quebec	353 170	23
Ontario	533 495	35
Manitoba/Saskatchewan/Nunavut	135 391	9
Alberta/NWT	194 799	13
British Columbia/Yukon	204 426	13

Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2001*.

PART I: FINANCING CONDITIONS FOR SMES IN 2001

Part I reports on some of the results of the recently completed supplemental *Survey on Financing of Small and Medium-sized Enterprises, 2001*. The analysis focusses on commercial debt and lease financing (equity financing[6] is addressed in Part IV) and examines whether prevailing economic conditions compelled SMEs to change their behavior in 2001.

This part of the report is divided into four sections. Where possible, comparisons are made with the 2000 survey results:

The first section reviews the economic climate for SME financing in 2001.

The second section examines SMEs' demand for financing by reviewing application and approval rates for commercial debt in 2001.

The third section analyzes the type of debt instruments requested by SMEs and the conditions for accessing debt in 2001.

The last section examines SMEs' request and approval rates for lease financing, to determine whether the economic conditions in 2001 influenced requests and approvals.

1. THE ECONOMIC ENVIRONMENT IN 2001

Review of the main economic indicators in 2001:

- **Gross domestic product** growth fell to 2 percent in 2001, compared with 5 percent in 2000 — weakest annual growth since 1992
- **Interest rate:** 4 percent at the end of 2001 — a 50-year low, down from over 7 percent at the end of 2000
- **Consumer spending:** declined until the final quarter of 2001. Tax reductions increased consumers' disposable income
- **Inflation:** 2.6 percent in 2001 — consistent with 2000 (2.7 percent)
- **Commercial bankruptcy:** Slight increase of 3 percent from 2000
- **Unemployment:** increased to 7.2 percent in 2001 — up from 6.8 percent in 2000

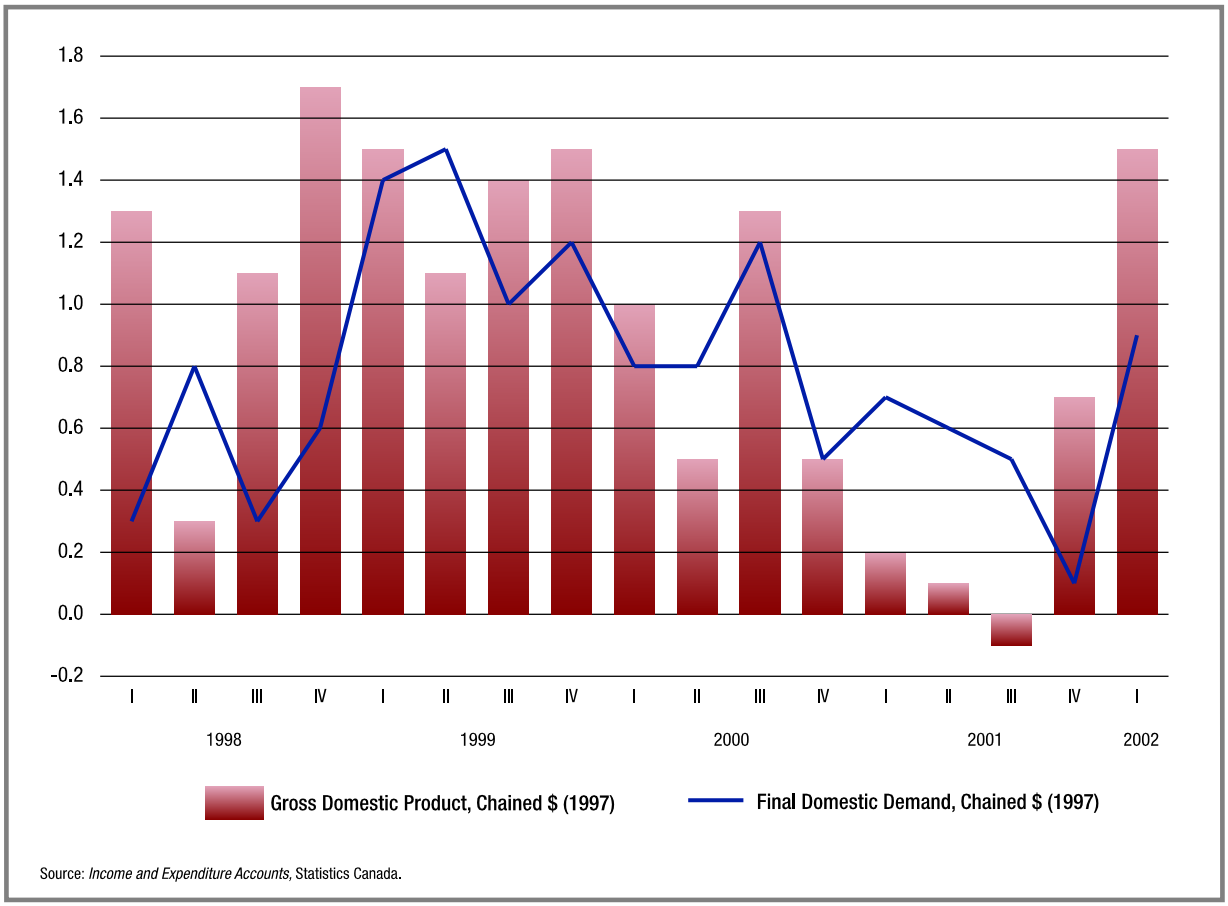
6. Data limitations linked to the sample size of the supplemental survey did not allow this type of analysis. Alternative sources such as the Macdonald & Associates Limited quarterly and annual venture capital activity reports and specialized studies commissioned by Industry Canada were used to provide an overview of equity financing in Part IV.

Requests (demand for) and approvals (supply of) of formal types[7] of commercial debt are influenced by the overall economic climate. This section reviews the Canadian economy in 2001 to provide context to the results of the supplemental *Survey on Financing of Small and Medium-sized Enterprises, 2001*. This section establishes the analytical framework adopted throughout Part I, and discusses the relationship between changing economic conditions and SMEs' access to financing.

In 2001, the Canadian economy slowed, as illustrated by falls in a number of key macroeconomic indicators — the growth rate of gross domestic product (GDP), interest rates and consumer spending (see text box). As seen in Figure 11, nominal GDP fell to 1.5 percent in 2001, a decrease of 3 percent from 2000. In fact, the Canadian economy experienced negative growth in the third quarter of 2001, though it did rebound in the fourth quarter.

Figure 11

Gross Domestic Product of Canada, 1998–2002

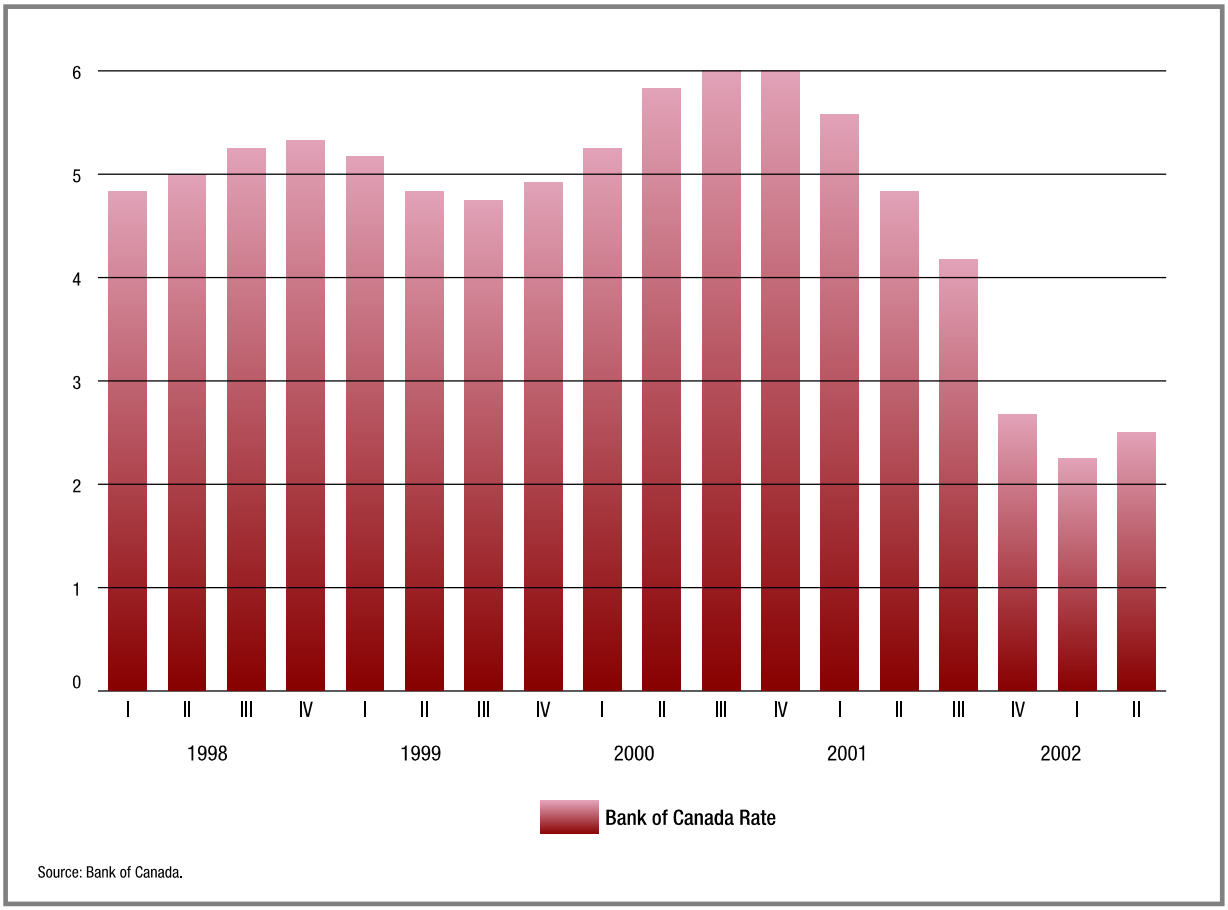


Source: *Income and Expenditure Accounts*, Statistics Canada.

7. Formal types of financing are instruments obtained from suppliers/sources, external to the firm, that are in the business of providing financing.

Similarly, interest rates dropped more than 3 percent between 2000 and 2001 to reach a 50-year low (see Figure 12). Falling interest rates carry significant impacts for an economy. First, consumers' tendency to take advantage of cheaper credit raises consumer spending. After dropping initially in 2001 (before recovering in the fourth quarter), consumer spending has been growing at an annual average rate of 3 percent.[8] Second, low interest rates benefit SMEs directly by lowering the cost of financing and increasing business credit. However, as Part I will demonstrate, these links do not apply to all types of financial instruments, or to all regions and sectors.

Figure 12
Interest Rate Variations, 1998–2002



Source: Bank of Canada.

According to some research,[9] small business activity was relatively unaffected by the economic slowdown in 2001. In fact, for the first time in more than 20 years, small business' economic activity outpaced that of the rest of the economy during a period of economic slowdown. This is

8. Benjamin Tal. *Canadian Small Business — A Growing Force*. CIBC World Markets, September 2003.

9. Benjamin Tal. *Canadian Small Business — A Growing Force*. CIBC World Markets, September 2003.

significant, since small businesses have tended to suffer more than larger firms during periods of tightening economic conditions. The 2001 survey revealed similar findings — SMEs' access to financing was relatively unchanged between 2000 and 2001, despite the economic slowdown. The following sections expand on these results.

2. COMMERCIAL DEBT: APPLICATION AND APPROVAL RATES

The primary objective of the *Survey on Financing of Small and Medium-sized Enterprises, 2001* was to measure the effect of the economic slowdown on SMEs' access to financing. This section examines whether SMEs changed their behaviour during 2001 as a reaction to the market context. To evaluate this issue, this section presents results pertaining to request and approval rates for debt on a national, regional and sectoral basis.

2.1 National Overview

The *Survey on Financing of Small and Medium-sized Enterprises, 2001* found that debt instruments were the most common forms of financing used by SMEs. The most commonly used debt instruments in 2001 were (in order of requests):

- term loans (33 percent)
- new lines of credit (31 percent)
- mortgage loans (16 percent)
- demand or short-term loans (8 percent)

The *Survey on Financing of Small and Medium-sized Enterprises, 2001* found that 18 percent of SMEs requested some form of debt in 2001, and 80 percent were approved (see Table 3). These figures are down from 2000, when 23 percent of SMEs requested some form of debt and 82 percent were approved. Although it may appear that the economic slowdown resulted in a fall in the demand for debt in 2001, two observations do not constitute a trend. More data collection and analysis will be needed to determine whether this is a long-term trend or a short-term aberration.

Debt: SMEs Behaviour Highlights in 2001

- **Demand for debt:** 18 percent of SMEs requested debt in 2001
- **Approval rate for debt:** 80 percent of SMEs' requests were approved
- **Financial institutions:** 66 percent of SMEs requested debt from **chartered banks**; 20 percent requested debt from **caisses populaires and credit unions;** 10 percent from **Crown corporations and government institutions**

Sectoral Findings:

- **Agricultural** SMEs had the highest approval rates for debt in 2001(94 percent); similar to the results from 2000
- **Wholesale and retail industries** SMEs secured 15 percent more debt in 2001, compared with 2000

Regional Findings:

- **Ontario** SMEs had the lowest approval rates in Canada in 2001 (78 percent)

The fall in demand for debt is a well-documented phenomenon and these findings are consistent with other research studies. According to a Conference Board of Canada study,[10] loans outstanding under $1 million accounted for 69 percent of authorized amounts in 1995 and 67 percent in 1999. The report also suggested that during periods of economic upswing, SMEs were probably more focussed on repaying loans rather than borrowing for expansion.

The pattern of demand for debt is determined by a number of factors. As will be seen in Part II, the borrowing practices and the types of financing sought by Canadian SMEs will be reviewed from the perspectives of industrial sector, region, size of business (by number of employees), stage of business and demographic characteristics of the business owner.

2.2 Other Findings Concerning Application and Approval Rates for Debt in 2001

The following sections review SMEs' application and approval rates by region and industrial sector and present request and approval results for rural and urban SMEs, and for women and youth entrepreneurs.

Regional overview

As noted in *SME Marketplace*, the economic structure of Canada's regions varies considerably — some regions depend on agriculture and primary industries and others concentrate on manufacturing, services or knowledge-based industries. As Part II will show, different sectors require different financial structures, which in turn influence SMEs' use of formal types of financing. For example, agricultural SMEs have a higher demand for debt than firms in most sectors. Since they also tend to have a high asset base against which to secure their debt, agricultural SMEs have higher approval rates and secure higher amounts of financing. The regional analysis of application and approval rates must take local industrial structure and sector of operation into account.

Figures 13 and 14 show request and approval rates for firms across Canada. As was the case in 2000,[11] firms in Western Canada had the highest request rates for commercial debt in 2001. These results reflect the prevalent industrial sectors in these regions — agriculture and primary industries. As Part II will demonstrate, SMEs in these sectors use commercial loans and credit to finance their operations more than any other financial instrument. In fact, 71 percent of agricultural SMEs used commercial loans to finance their operations (higher than the national average of 49 percent) in 2000. This tendency was also reflected regionally — Manitoba, Saskatchewan and Nunavut had the highest percentage of SMEs using commercial loans and credit to finance their operations in 2000. Therefore, it is not surprising that SMEs in these provinces have higher request rates for debt than SMEs in other regions.

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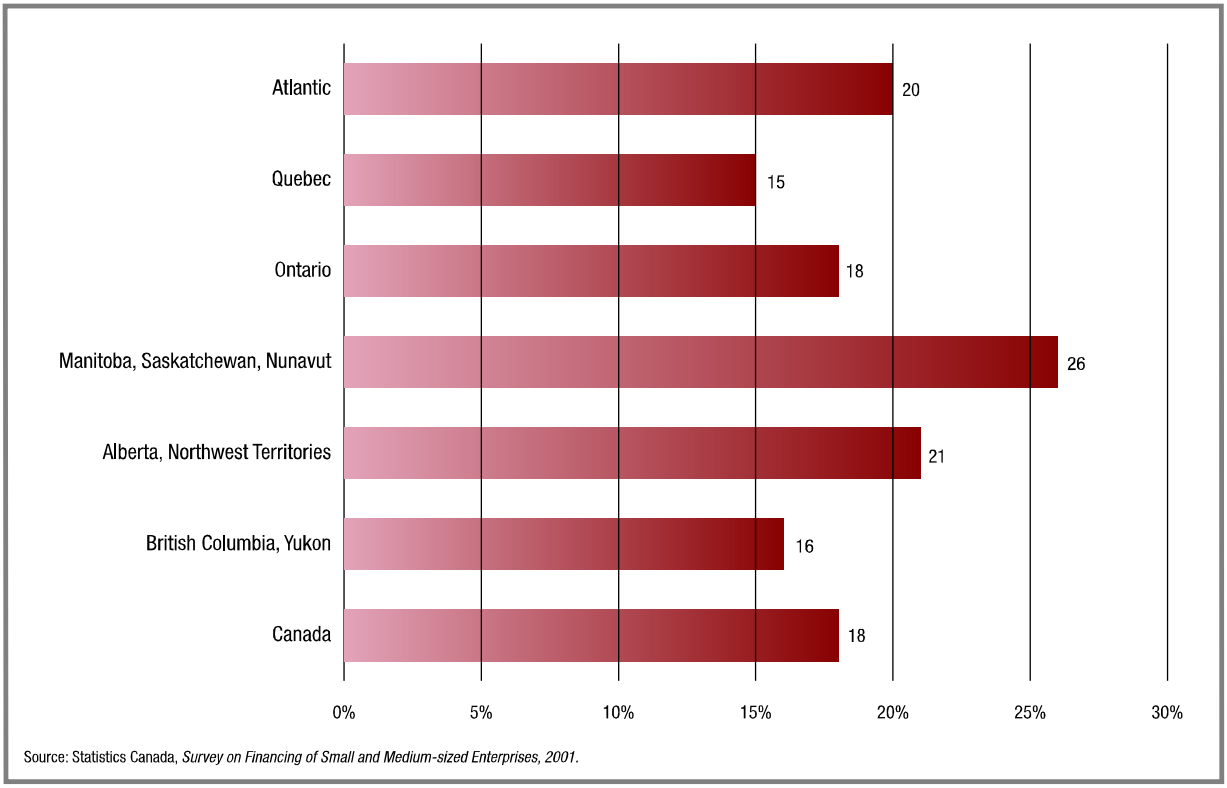
10. Conference Board of Canada, *A Changing Demand for SME Debt Financing?*, January 2001.

11. Industry Canada, *Small and Medium-sized Enterprise (SME) Financing in Canada, 2002.*

Approval rates for SMEs in Canada remained relatively stable between 2000 and 2001. As noted in previous reports, SMEs in Manitoba, Saskatchewan and Nunavut had the highest approval rates — a reflection of regional economic structures. As will be seen in Part II, agricultural firms, which account for a high proportion of these regions' economic activity, tend to have high asset bases and low long-term debt to equity ratios. When reviewing debt applications, financial suppliers evaluate opportunities and risks based on these criteria.

Figure 13

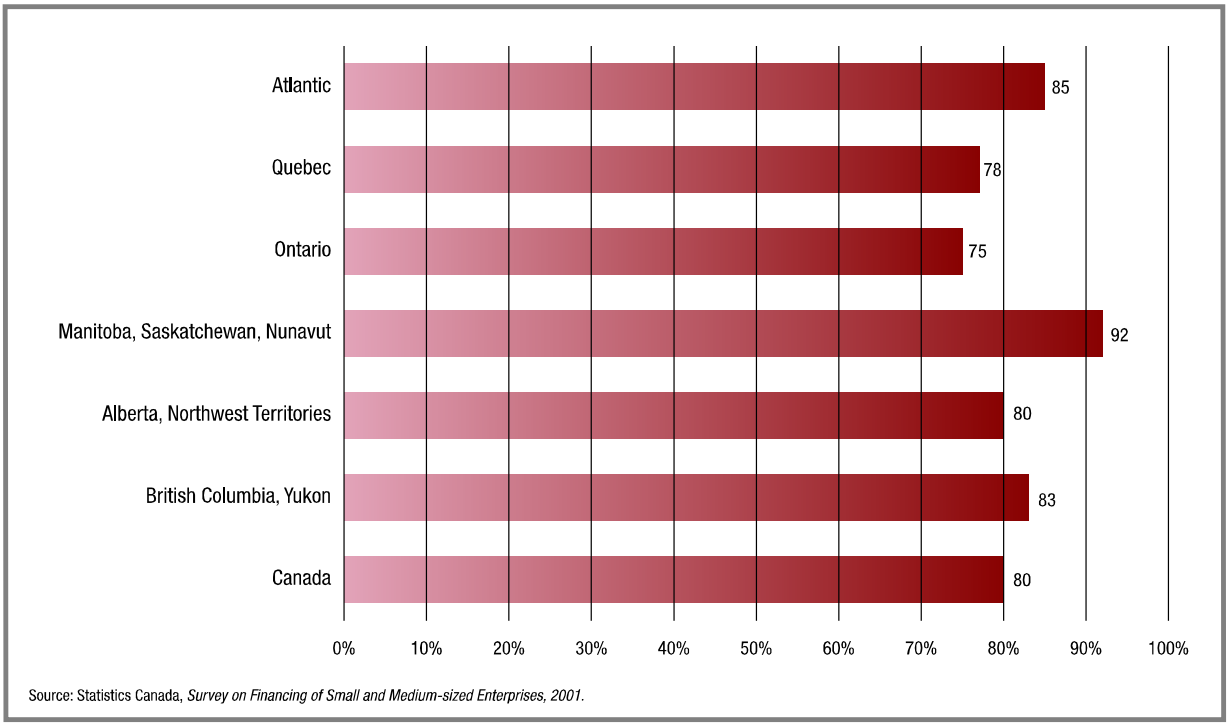
SMEs' Request Rate for Debt by Province in 2001



Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2001.*

Figure 14

SMEs' Approval Rate for Debt by Province in 2001



Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2001.*

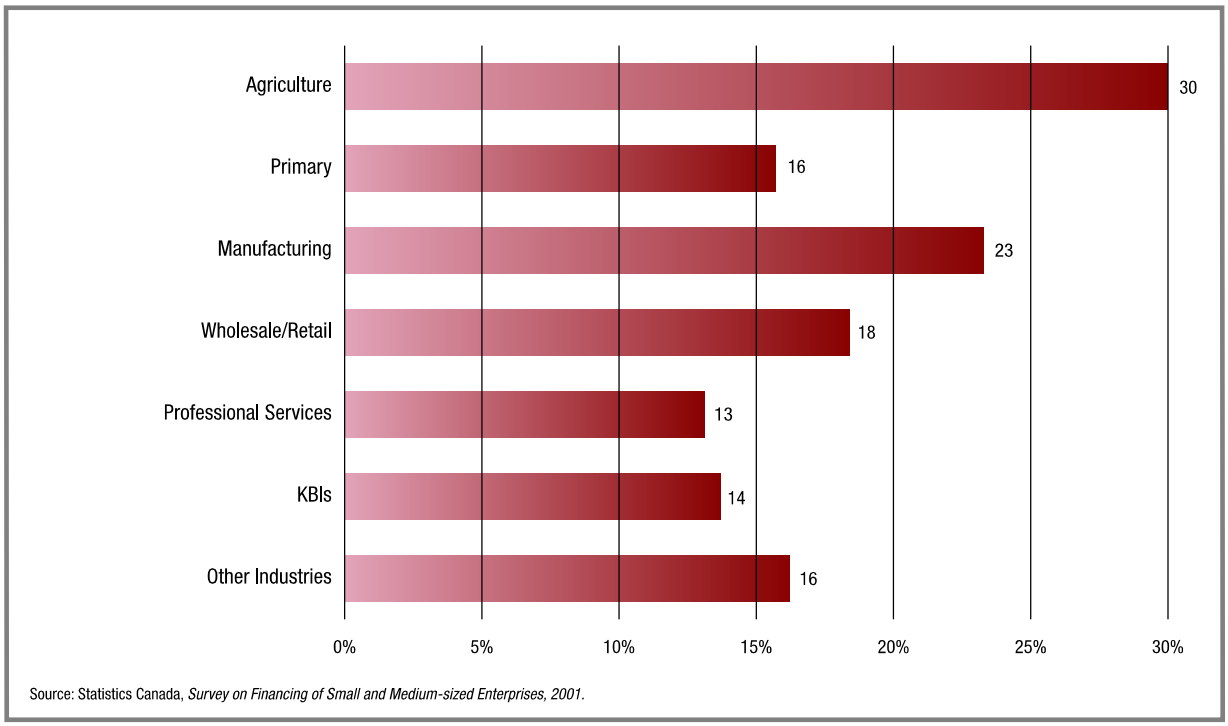
Industry Sector Overview

Figures 15 and 16 show request and approval rates of firms in different industries. As was the case in 2000,[12] agricultural and primary industry firms were more likely to request debt than firms in knowledge-based industries and professional services. As noted above, this likely reflects regional and sectoral variations in financial structure and requirements for formal types of financing.

The economic slowdown did affect the debt request rates in some industries. In particular, there was a decline in debt requests for SMEs in primary (11 percent) and agricultural (10 percent) industries between 2000 and 2001. This could reflect the more cautious approach by firms in these industries during the economic slowdown. For example, requests to buy machinery or equipment declined (10 percent) in 2001 for primary industry and agricultural SMEs. Since these assets are typically sought by SMEs in these industries, the economic slowdown may have influenced their financing patterns and business strategies.

12. Industry Canada, *Small and Medium-sized Enterprise (SME) Financing in Canada, 2002.*

Figure 15
SMEs' Request Rate for Debt by Sector in 2001

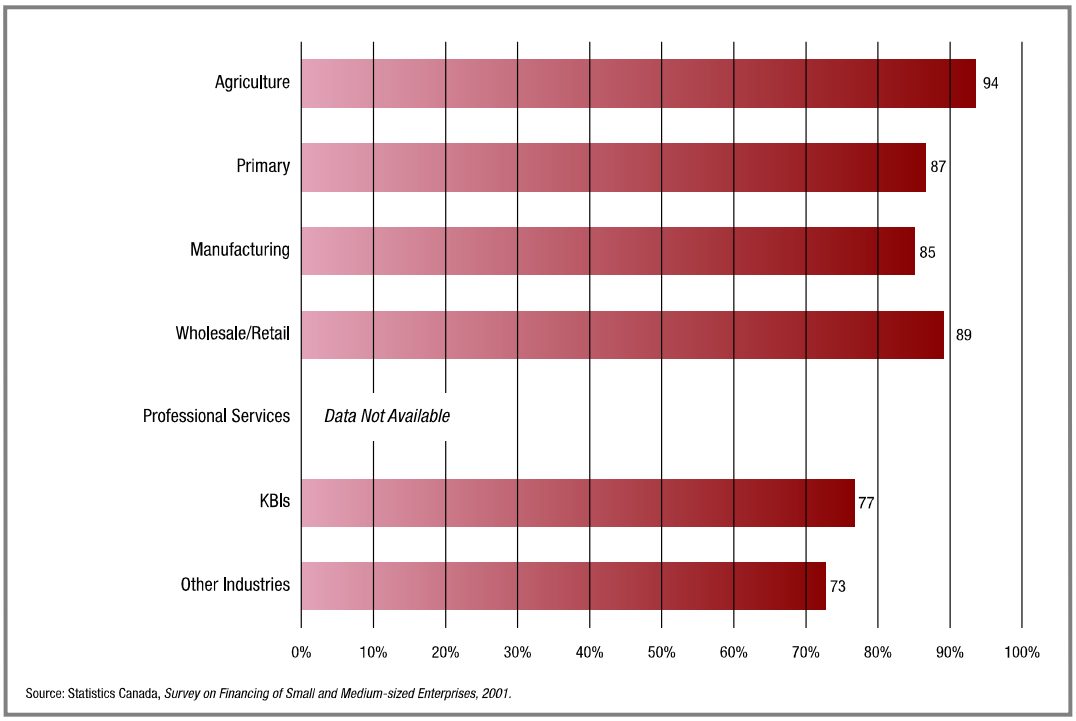


Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2001.*

The 2001 findings were consistent with those from 2000 — agricultural and primary industry SMEs had high approval rates for debt, while KBI and other industry SMEs had the lowest approval rates. This is related to agricultural businesses' tendency to hold land or equipment as collateral, while firms in the services sector may lack assets to pledge as security. As will be seen in Part II, agricultural SMEs tend to have high assets and low long-term debt to equity ratios, which financial suppliers evaluate when providing formal types of financing.

Approval rates for wholesale and retail SMEs increased by 15 percent between 2000 and 2001, possibly a result of the increase in consumer spending noted above. Canadian consumers' willingness to maintain spending levels during the economic slowdown may have contributed to wholesale and retail firms' strong performance. However, data limitations prevent a more thorough analysis. Additional data collection and analysis will be required to determine whether these are short-term or long-term trends and to evaluate implications for wholesale and retail SMEs' access to financing.

Figure 16
SMEs' Approval Rate for Debt by Sector in 2001



Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2001.*

Other highlights regarding request and approval rates in 2001:

- **Rural and Urban communities**: 17 percent of urban SMEs[13] requested debt, compared with 22 percent of rural SMEs. The higher requests for debt in rural communities reflects the fact that agricultural, manufacturing and primary sectors use more debt financing than firms in other sectors (see Figure 15). Moreover, rural SMEs' demand for debt fell 9 percent between 2000 and 2001. This is consistent with the findings noted above — agricultural and primary businesses also had fewer requests during the same year.
- **Youth entrepreneurs**: 27 percent of youth-owned SMEs (under 30) requested debt in 2001. As will be discussed in Part II, youth-operated firms tend to be early-stage and expansion businesses. These firms may not have internal sources of financing such as retained earnings to finance their operations, and so rely on external formal types of financing. In 2000, 53 percent of youth-owned businesses used commercial loans and credit to finance their operations, slightly higher than the national average (49 percent).
- **Women entrepreneurs**: Despite the economic slowdown in 2001, requests for debt by women entrepreneurs remained relatively stable between 2000 and 2001. In 2001, 15 percent of women-owned businesses requested debt, compared with 17 percent for men-owned businesses. This finding is not surprising, given the tendancy of women entrepreneurs to gravitate to the professional services and wholesale/retail industries — industries that tend to make fewer requests for debt (see Figure 15).

13. See the Glossary of Terms at the end of this report for a definition of rural and urban locations.

3. TYPE OF DEBT INSTRUMENT REQUESTED BY SMEs

This section highlights the requests for various types of financing instruments in 2001. As with the results from 2000,[14] the type of debt instrument requested is linked to an SMEs' sector of operation. For example, SMEs in agricultural and primary industries had the highest (53 percent and 45 percent) request rates for term loans, which reflects the type of assets that these firms finance through debt — machinery and equipment, land and buildings. A more detailed discussion of the types of financing used by SMEs is provided in Part II.

Among SMEs that applied for debt financing in 2001:

- 33 percent requested a **term loan**
- 32 percent requested a **new line of credit**
- 16 percent requested a **mortgage loan**
- 9 percent requested an **increase in the credit limit of current lines**
- 3 percent applied for a **new credit card**

3.1 Conditions for accessing debt

The financing conditions imposed by financial institutions could represent barriers for SMEs seeking debt financing. For example, the amount of documentation and collateral requested or delays in financial suppliers' decisions could force SMEs to seek alternative forms of financing (i.e. personal lines of credit). This section will examine whether tightening credit conditions compelled suppliers of financing to change their behaviour in 2001 by:

- Requesting more documentation as part of the application process
- Increasing requirements for collateral

Requests for Documentation
As seen in Table 2, more than 82 percent of SMEs that requested financing in 2001 had to provide some sort of documentation — a 2-percent increase from 2000 — most commonly in the form of financial statements. Three out of four SMEs who requested financing had to provide a business financial statement in 2001 — a 25-percent increase over 2000.

The overall increase in the level of documentation requested by financial suppliers may have reduced access to financing for some small businesses; for example, this documentation represents a cost to SMEs. The trend in 2001 indicated that financial suppliers were applying more due diligence to their credit decisions.

Increasing Requirements for Collateral
Financial institutions often require that SMEs seeking financing provide collateral as security. Collateral can include land and buildings or security that can be used for the payment of debt.

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14. Industry Canada, *Small and Medium-sized Enterprise (SME) Financing in Canada, 2002.*

The businesses' assests, the entrepreneurs' personal assets, or guarantees from third parties are commonly used as security. The level of guarantee that financial suppliers require of SMEs is directly linked to the perceived level of risk. It is important to note that a request for collateral by the financial supplier increases the SMEs' overall financing cost.

In 2001, more than 40 percent of SMEs were asked by their financial suppliers to provide some sort of collateral (business or personal assets) to guarantee their financing, unchanged from 2000. Moreover, there was no preference in the type of collateral provided; financial suppliers requested personal and business guarantees with the same frequency.

Other key findings regarding collateral include:

- **Small business:** A size of business analysis reveals significant variation in the type of collateral requested from SMEs — micro-enterprises were requested more often to provide personal assets, rather than business assets. By contrast, a higher proportion of medium-sized firms (100–500 employees) were asked to provide business assets, rather than personal assets in 2000.[15]
- **Agriculture and primary-based:** Sectoral analyses reveal differences in the asset mix requested by financial suppliers. For example, financial suppliers requested a larger proportion of business assets from firms in well-established sectors such as agriculture and primary sectors, whereas KBI firms were asked to provide a higher proportion of personal assets.

Table 2 — Documents Requested by the Last Credit Supplier Approached as Part of the Application Process for Debt Financing, 2000 and 2001

	2000 (%)	2001 (%)	Variation (%)
No documentation requested	16.3	18.3	2.0
Formal application for financing	21.1	29.6	8.5
Business financial statement	48.6	75.5	26.9
Business plan	13.6	20.0	6.4
Personal financial statement	20.5	27.8	7.3
Appraisals of assets to be financed	9.3	16.6	7.3
Franchise agreement	1.5	1.9	0.4
Cash flow projection	10.6	15.7	5.1
All other documents	5.0	12.4	7.4

Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises 2000, 2001.*

15. Data do not permit such a comparison for 2000.

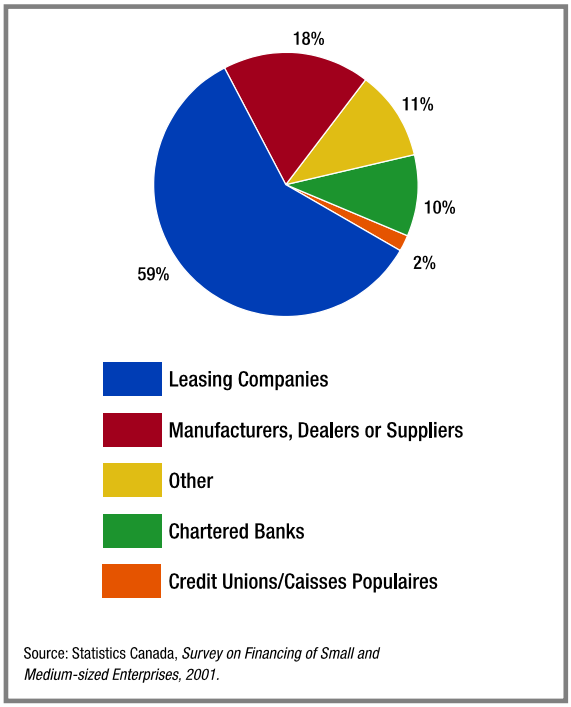
4. LEASE FINANCING

The economic slowdown in 2001 had ripple effects throughout Canadian capital markets, including the debt and leasing markets.[16] This section identifies 2001 leasing market trends from the SMEs' perspective – particularly the request and approval rates for leases, the type of assets sought through leases, and the sources of the lease financing. The supply of leasing by financial service providers is summarized in Part III of this report.

In 2001, 7 percent of SMEs requested lease financing; almost all — 94 percent — were approved. Both requests and approvals for leases have dropped since 2000 (9 percent request rate and 98 percent approval rate), which may reflect the economic slowdown. However, more data collection and analysis will be needed to correlate these findings.

As shown in Figure 17, SMEs sought most (59 percent) of their lease financing from leasing companies, followed by manufacturers, dealers and suppliers (18 percent). Restrictions in the *Bank Act* have meant that chartered banks provided less (10 percent) lease financing to SMEs. These restrictions prevent banks from leasing passenger vehicles and light trucks, which are the single largest segment of the market.[17] This is consistent with the findings in Part III, which found that domestic banks supplied 9 percent of the leasing market for leases under $1 million (amounts typically sought by SMEs) as of December 31, 2001. The other major suppliers of leasing included finance and leasing companies.

Figure 17
Requests for Leasing by Type of Supplier in 2001



Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2001.*

16. For the purposes of this report, the term "lease" refers to both capital and operating leases. See the *Glossary of Terms* for a definition of these terms.

17. The *Bank Act* restrictions are outlined in more detail in Part III of this report.

5. SUMMARY TABLES

Table 3 — SME Request and Approval Rates for Debt in 2001

	Request	Approval
	2001 (%)	2001 (%)
CANADA	18.1	80.0
SIZE OF BUSINESS		
0 employees	11.9	77.3
1 to 4 employees	21.2	79.7
5 to 19 employees	26.6	84.0
20 to 99 employees	23.1	x
100 to 499 employees	x	x
SECTOR		
Agriculture	29.9	93.5
Primary	15.7	87.3
Manufacturing	23.3	85.1
Wholesale and Retail	18.4	89.1
Professional Services	13.1	x
Knowledge-based Industries	13.7	77.1
Other sectors	16.2	72.7
REGIONS		
Atlantic	20.3	85.3
Quebec	15.2	78.4
Ontario	17.8	74.5
Manitoba, Saskatchewan and Nunavut	25.3	91.8
Alberta and Northwest Territories	20.9	80.2
British Columbia and Yukon	15.6	82.6

Continued . . .

Table 3 — SME Request and Approval Rates for Debt in 2001

	Request	Approval
	2001 (%)	2001 (%)
FEMALE OWNERSHIP		
≥0% and <50%	18.2	80.7
50%	20.9	81.4
>50%	14.8	74.8
0%	17.3	77.5
AREA		
Rural	21.9	87.3
Urban	16.7	76.3
AGE OF OWNER		
Less than 30	27.2	x
30 to 39	22.2	72.7
40 to 64	18.3	82.9
65 and over	6.4	89.7

Note: "x" refers to estimates suppressed to meet the confidentiality requirements of the *Statistics Act* and/or for data quality reasons.

Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2001*.

Table 4 — SMEs Approval and Request Rates for Lease Financing, 2001

	Request	Approval
	2001 (%)	2001 (%)
CANADA	7.3	93.6
SIZE OF BUSINESS		
0 employees	4.1	88.0
1 to 4 employees	6.9	97.9
5 to 19 employees	13.9	90.9
20 to 99 employees	19.3	98.3
100 to 499 employees	22.6	96.3
SECTOR		
Agriculture	6.3	95.4
Primary	7.3	98.6
Manufacturing	9.8	84.0
Wholesale and Retail	6.5	x
Professional Services	5.3	96.3
Knowledge-based Industries	6.1	96.8
Other sectors	8.2	95.7
REGIONS		
Atlantic	7.6	99.3
Quebec	6.4	86.7
Ontario	5.4	92.9
Manitoba, Saskatchewan and Nunavut	10.2	91.7
Alberta and Northwest Territories	9.4	96.6
British Columbia and Yukon	9.6	99.3

Continued . . .

Table 4 — SMEs Approval and Request Rates for Lease Financing, 2001

	Request	Approval
	2001 (%)	2001 (%)
FEMALE OWNERSHIP		
≥0% and <50%	7.5	93.1
50%	7.8	90.7
>50%	6.1	99.8
0%	6.7	92.9
AREA		
Rural	6.1	97.8
Urban	7.7	92.4
AGE OF OWNER		
Less than 30	12.9	x
30 to 39	7.7	94.1
40 to 64	7.8	93.7
65 and over	1.8	100.0

Note: "x" refers to estimates suppressed to meet the confidentiality requirements of the *Statistics Act* and/or for data quality reasons.

Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2001*.

Table 5 — Proportion of SMEs Requesting Grants or Subsidies from Government or Community Programs

	2001 (%)
CANADA	4.1
SIZE OF BUSINESS	
0 employees	3.5
1 to 4 employees	3.6
5 to 19 employees	5.5
20 to 99 employees	8.4
100 to 499 employees	15.8
SECTOR	
Agriculture	12.1
Primary	2.1
Manufacturing	6.7
Wholesale and Retail	2.9
Professional Services	2.3
Knowledge-based Industries	5.1
Other sectors	2.5
REGIONS	
Atlantic	7.3
Quebec	4.9
Ontario	1.9
Manitoba, Saskatchewan and Nunavut	5.6
Alberta and Northwest Territories	7.6
British Columbia and Yukon	2.7

Continued . . .

Table 5 — Proportion of SMEs Requesting Grants or Subsidies from Government or Community Programs

	2001 (%)
FEMALE OWNERSHIP	
≥0% and <50%	3.9
50%	5.9
>50%	3.0
0%	3.4
AREA	
Rural	6.2
Urban	3.3
AGE OF OWNER	
Less than 30	6.8
30 to 39	2.4
40 to 64	4.3
65 and over	5.4

Note: "x" refers to estimates suppressed to meet the confidentiality requirements of the *Statistics Act* and/or for data quality reasons.

Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2001*.

Table 6 — Amount of Debt Financing Requested and Authorized in 2001

	Amount requested	Amount authorized
	2001 (Millions of dollars)	2001 (Millions of dollars)
CANADA	38 878	28 261
SIZE OF BUSINESS		
0 employees	5 591	4 926
1 to 4 employees	11 482	9 277
5 to 19 employees	11 623	5 336
20 to 99 employees	6 299	5 084
100 to 499 employees	3 881	3 639
REGIONS		
Atlantic	2 829	2 418
Quebec	12 630	6 853
Ontario	12 261	9 096
Manitoba, Saskatchewan and Nunavut	2 435	2 304
Alberta and Northwest Territories	3 815	3 303
British Columbia and Yukon	4 906	4 287
SECTOR		
Agriculture	5 477	5 313
Primary	1 889	982
Manufacturing	5 209	4 505
Wholesale and Retail	6 003	4 776
Professional Services	2 240	1 612
Knowledge-based Industries	937	542
Other sectors	17 120	10 531
FEMALE OWNERSHIP		
≥0% and <50%	21 406	21 408
50%	4 291	4 291
>50%	2 562	2 562
0%	14 015	14 015
RURAL OR URBAN LOCATION		
Rural	12 515	7 246
Urban	26 361	21 015

Note: “x” refers to estimates suppressed to meet the confidentiality requirements of the *Statistics Act* and/or for data quality reasons.

Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2001*.

Table 7 — Percentage of Total Requests for Debt by Type of Supplier in 2001

	Chartered banks	Caisses populaires/ credit unions	Crown corporation/ government institution	Other credit suppliers
	2001 (%)	2001 (%)	2001 (%)	2001 (%)
CANADA	67.6	20.3	6.6	5.5
SIZE OF BUSINESS				
0 employees	61.8	22.9	10.8	4.5
1 to 4 employees	67.7	20.1	5.9	6.3
5 to 19 employees	70.9	20.4	2.9	5.7
20 to 99 employees	81.9	10.0	4.7	3.4
100 to 499 employees	x	x	7.7	1.7
SECTOR				
Agriculture	45.4	26.4	23.9	4.3
Primary	70.3	20.1	3.1	6.5
Manufacturing	68.7	14.6	12.5	4.1
Wholesale and Retail	69.4	22.2	2.6	5.7
Professional Services	87.2	7.6	0.4	4.8
Knowledge-based Industries	65.4	19.9	8.3	6.5
Other sectors	73.5	20.2	0.1	6.2
REGIONS				
Atlantic	89.5	16.6	3.3	10.6
Quebec	45.9	47.8	3.5	2.8
Ontario	87.7	2.6	3.5	6.3
Manitoba, Saskatchewan and Nunavut	49.4	34.4	13.0	3.3
Alberta and Northwest Territories	67.9	11.6	19.4	1.0
British Columbia and Yukon	x	25.1	x	13.0
AREA				
Rural	51.5	27.9	14.1	6.5
Urban	75.6	16.5	2.9	5.0

Note: “x” refers to estimates suppressed to meet the confidentiality requirements of the *Statistics Act* and/or for data quality reasons.

Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2001*.

Table 8 — Proportion of SMEs Requesting Specific Debt Instruments, 2001

	Demand of short term loan	Term loan	Mortgage loan	Line of Credit	Credit Card
CANADA	7.9	33.3	16.1	31.7	3.1
SIZE OF BUSINESS					
0 employees	15.4	32.9	17.3	28.7	2.5
1 to 4 employees	4.9	33.0	16.2	32.4	3.7
5 to 19 employees	3.6	35.1	16.4	33.2	2.8
20 to 99 employees	10.0	x	8.4	x	1.5
100 to 499 employees	2.5	x	x	x	0.7
SECTOR					
Agriculture	11.3	53.4	16.30	20.9	0.2
Primary	13.2	46.2	7.0	38.4	5.5
Manufacturing	9.0	25.1	10.4	33.9	0.3
Wholesale and Retail	3.3	19.2	13.1	43.0	1.4
Professional Services	4.1	20.3	8.2	x	1.1
Knowledge-based Industries	7.4	24.6	5.1	x	7.5
Other sectors	8.4	32.9	21.1	28.5	5.4
REGIONS					
Atlantic	10.9	20.0	23.0	25.5	5.1
Quebec	10.9	35.9	32.6	24.2	2.5
Ontario	5.0	27.1	10.1	37.2	3.1
Manitoba, Saskatchewan and Nunavut	9.3	43.6	13.8	24.0	4.6
Alberta and Northwest Territories	9.2	46.5	9.4	27.3	3.5
British Columbia and Yukon	6.7	27.0	13.8	x	0.2
AREA					
Rural	7.5	40.2	20.2	25.5	2.7
Urban	8.1	29.9	14.1	34.7	3.2

Note: "x" refers to estimates suppressed to meet the confidentiality requirements of the *Statistics Act* and/or for data quality reasons.

Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2001.*

PART II: FINANCIAL STRUCTURE OF CANADIAN SMES

Part II examines the financial and ownership structures of Canadian SMEs.[18] The proportional use of different financial instruments within a firm's capital mix (financial structure) and the distribution of the firm's equity shares (ownership structure) reflect the SMEs' financing strategy for growth and expansion. An optimal financial structure satisfies the business' capital requirements and minimizes the cost of capital.[19] Part II examines the relationship between specific firm characteristics and financial structure.

The first section reviews the financial structures of SMEs, and the extent and causes of regional variation.

The second and third sections examine SME financing based on various factors, including the following:

- stage of business development
- sector of operation
- size of business

The last sections examine the financial structure of the following:

- SMEs owned by women entrepreneurs
- SMEs owned by young entrepreneurs
- high-growth SMEs (GSMEs)

The type of financial structure adopted by SMEs in a given sector or size category leads to tentative conclusions about the existence and nature of potential gaps in the SME financing market. Financial market imperfections or gaps arise when categories of businesses are systematically unable to secure the financing that they should have access to, based on objective criteria. However, as seen in Part IV, not all types of financing are appropriate to all types of firms; the observation that some firms cannot obtain a particular form of financing is not necessarily evidence of a market failure (or gap).

18. The information on the financial structure of SMEs used in the following discussion originate from the recent Statistics Canada *Survey on Financing of Small and Medium-sized Enterprises 2000*, which included a supplementary section on SMEs' financial structure and financial instrument usage.

19. Guy Gellatly, Allan Riding and Stewart Thornhill (2003) *Growth History, Knowledge Intensity and Capital Structure in Small Firms.* Economic Analysis Research Paper Series, Statistics Canada.

Identifying gaps in the financing markets is essential to resolving the long-standing debate about whether SMEs have appropriate access to financing.[20]

1. NATIONAL OVERVIEW AND REGIONAL VARIATIONS

1.1 Financial Structure of SMEs: National Overview

Characteristics of an average Canadian SME in 2000:

- Business Population: 1.4 million SMEs
- Years in Business: 75 percent of SMEs were older than five years
- Fixed Assets: averaged $291 000
- Debt Outstanding: averaged $294 000
- Profitability: averaged $54 000 net income before taxes
- Total Equity: averaged $210 000
- Long-term Debt-To-Equity Ratio: 0.75
- Demand for Financing: 23 percent of SMEs requested debt, 82 percent were approved

Formal versus Informal Types of Financing

As seen in Figure 18, SMEs used a wide range of formal and informal financial instruments in 2000. ***Formal types of financing*** are obtained from sources external to the firm, that are in the business of providing financing. With the exception of factoring and government grants, formal types of financing often appear on the business' financial statements as amounts owed by the business.

Informal types of financing are obtained from sources that are not in the business of financial lending, or are acquired through the business' activities (e.g. retained earnings) or from the owners (e.g. personal savings). Informal financing may not always appear on the business' financial statements.

20. More information on the analytical framework used to uncover factors that affect Canadian SMEs' access to financing is available on the SME Financing Data Initiative Web site (**strategis.ic.gc.ca/fdi**). Refer to Equinox Management Consultants, (2002) *Gaps in SME Financing: An Analytical Framework*, a report prepared for Industry Canada.

Formal Types of Financing in 2000[21]

- 49 percent of all SMEs used commercial loans and lines of credit
- 26 percent used commercial credit cards
- 16 percent used leasing
- 7 percent used government loans or grants

Informal Types of Financing in 2000

- 39 percent of all SMEs used trade credit from suppliers
- 35 percent used the personal savings of the owner(s)[22]
- 33 percent used the personal credit cards of the owner(s)
- 31 percent used the business' retained earnings[23]
- 21 percent used the personal lines of credit of the owner(s)
- 14 percent used the personal loans of the owner(s)

Types of Financial Instruments Available

Formal types of financing include the following:

- commercial loans and lines of credit
- commercial credit cards
- government loans or grants
- leasing
- factoring

Informal types of financing include the following:

- retained earnings of the business
- trade credit from suppliers
- personal savings of owner(s)
- personal credit of owner(s) (i.e. loans, lines of credit, credit cards)
- loans from friends or relatives of owner(s)
- loans from employees
- loans from other individuals (i.e. angels)

These findings are similar to those from the Canadian Federation of Independent Business (CFIB) surveys, which found that while commercial loans and lines of credit comprise the majority of small business debt, personal financing and trade credit are also common financing options.[24] The importance of personal debt to small business may also indicate that:

- Many chartered banks have moved small business clients from commercial to personal banking divisions
- Personal sources of financing provide a "bridge" until more permanent financing is available (term debt or other forms of commercial credit)

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21. These figures on instrument use reflect the percentage of SMEs that used a particular type of financing in 2000, regardless of whether is was authorized or obtained in a previous year. For example, a business may have received a commercial line of credit from a financial institution in 1990, but as long as the business was still using that instrument in 2000, it is reported here as part of their capital mix in 2000.

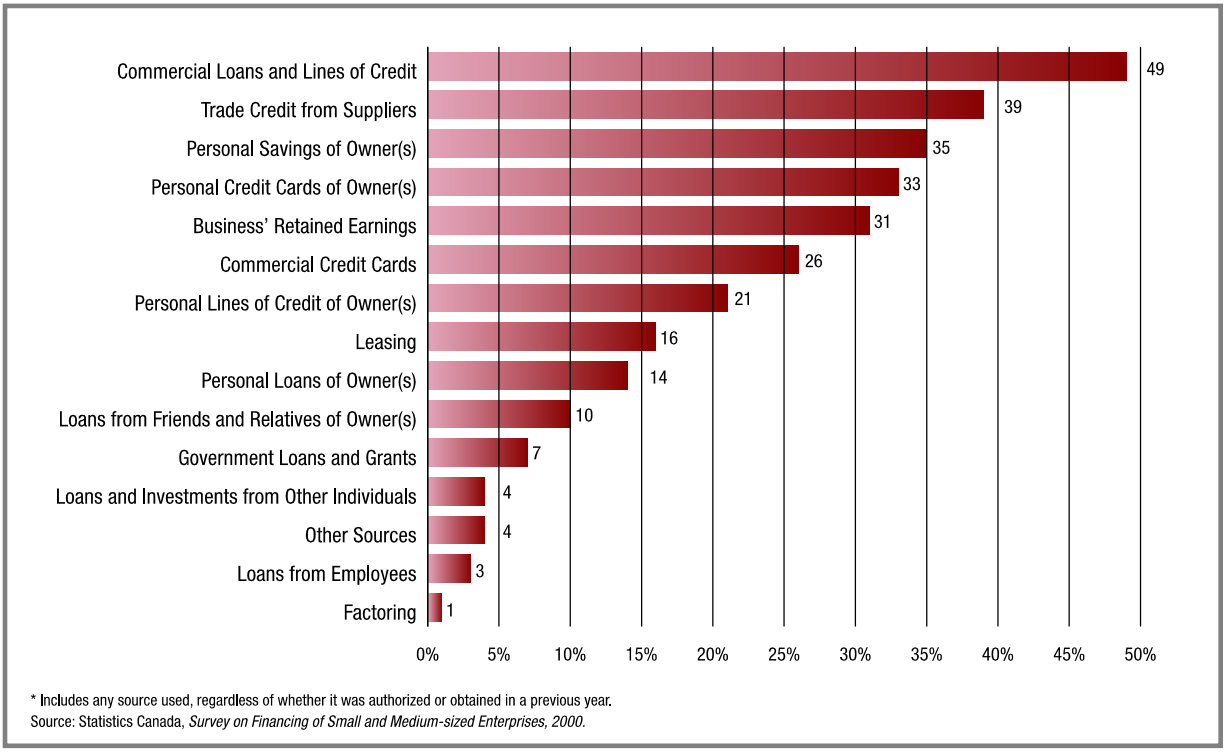
22. This may include, among other things, capital obtained from liquidating pension funds, RRSPs and life insurance, or remortgaging assets.

23. The Statistics Canada *Survey on Financing of Small and Medium-sized Enterprises, 2000* found that SMEs on average had just over $83 000 in retained earnings in 2000.

24. Canadian Federation of Independent Business (2001) *Banking on Entrepreneurship: Results of the CFIB Banking Survey*.

Figure 18

Types of Financial Instruments in Use by SMEs in 2000*



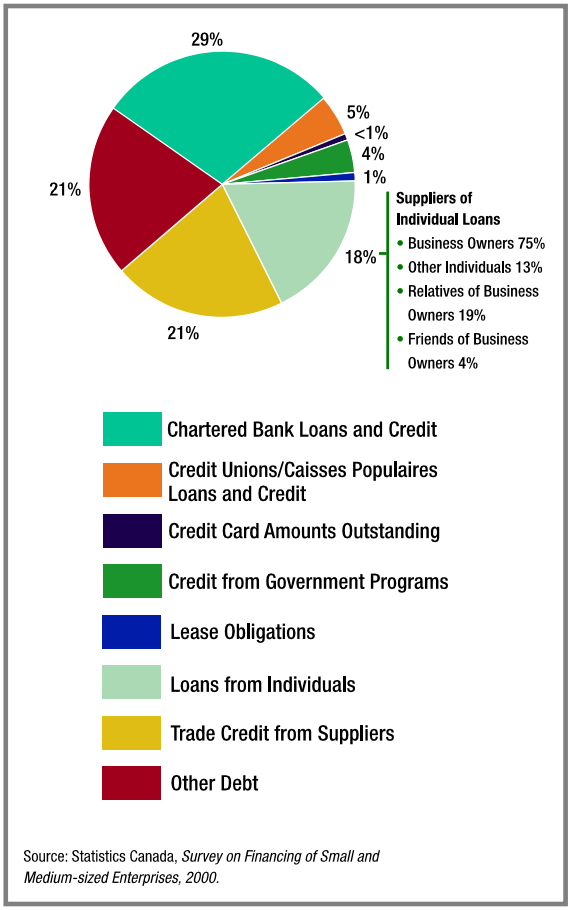
* Includes any source used, regardless of whether it was authorized or obtained in a previous year.
Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000.*

It is unclear whether the decision to use personal sources of short-term credit for business purposes is a matter of personal choice or reflects the financial community's unwillingness to advance capital to small businesses. The latter would likely constitute a market imperfection, but more detailed data are required before conclusions can be drawn in this regard.

Figure 19 shows that suppliers of informal financial products are as important to SMEs' debt structure as formal sources. Informal types financing (supplied through loans from individuals and trade credit from suppliers) accounted for nearly 40 percent of the outstanding debt owed by Canadian SMEs in 2000. This was equivalent to the amount of debt owed to formal financial providers (40 percent of outstanding SME debt), including chartered banks, credit unions, caisses populaires, government and lessors.

Figure 19

Average Distribution (%) of Debt Outstanding by SMEs in 2000, by Supplier



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

SME Ownership Capital in 2000

Business owners can obtain significant amounts of capital by selling equity shares in their firm. This financing strategy is often used by firms that require substantial amounts of growth or expansion capital, or by those that lack collateral.

The majority of ownership in 2000 rested in the hands of the business owner/operator (see Figure 20), with very limited use of equity financing from other sources. While this is true of SMEs in general, Part IV will discuss a class of high-growth SMEs that use equity financing to support rapid growth.[25]

Debt-intensity among Canadian SMEs is high, since so few use equity as a financing strategy. Using the long-term debt to equity ratio as a measure of the reliance of SMEs on debt as their primary source of financing, debt accounted for 75 percent of SMEs' long-term financing structure in 2000. From the available data, it is not yet possible to determine whether this capital mix is optimal or whether it reflects the adjustments of SMEs to market imperfections. It seems that equity capital comes at too high a cost to many SME owners — 41 percent of Canadian SME owners said that they would refuse to share ownership in their firms in return for equity capital.[26]

Key Findings on the Ownership of SMEs:

- There was $299 billion in total ownership capital, or $209 818 per SME
- 86 percent were owned by the business owner/operator
- 3.7 percent were owned by friends or relatives of the owner (love money)
- 1.2 percent were owned by private foreign or domestic investors (angels)
- 0.3 percent were owned by foreign or domestic venture capital funds

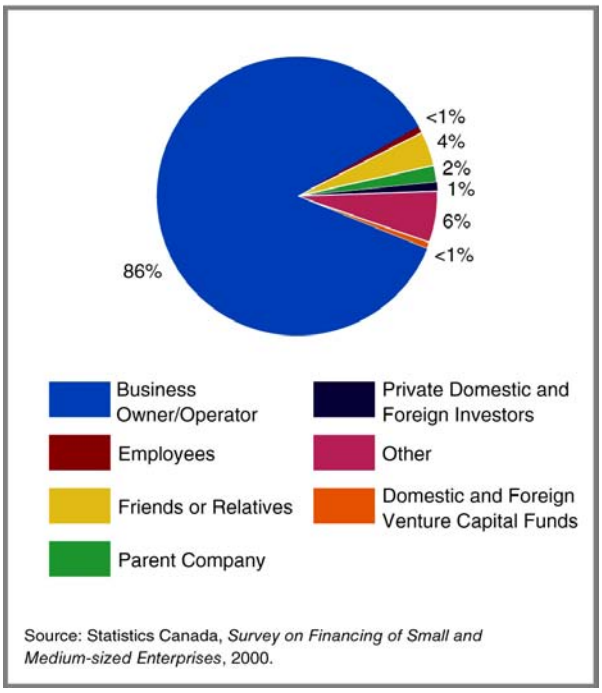
25. More discussion on informal investors is available in Part IV of this report.

26. The Research Institute for SMEs, Université du Québec à Trois-Rivières (2002) *Financing SMEs: Satisfaction, Access, Knowledge and Needs, 2001,* a report prepared for Industry Canada.

1.2 Financial Structure of SMEs: Regional Variations

With few exceptions, the financial structure of SMEs is fairly consistent across Canada.[27] Where regional variations do arise, they can usually be attributed to the economic and industrial composition of provinces (regarding the types of financing used) and/or the regional concentration of certain financial suppliers (regarding the sources of financing). This section focusses on the variation from the national averages outlined above.

Figure 20
Distribution (%) of Ownership Capital in SMEs, 2000



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

Factors Affecting Regional Demand

As seen in Part I, different types of firms have different priorities and requirements. Manufacturing concerns (which are concentrated in Central Canada) have different financing needs than agricultural firms (which are concentrated in Western Canada). These sectoral factors strongly influence the financial structure of SMEs, and must be taken into account to avoid mistaking regional variations for financial market gaps.

Factors Influencing Regional Supply

Chartered banks are the single largest suppliers of SME financing in Canada. However, other suppliers also exert a strong regional presence across the country. For example, credit cooperative movements are heavily concentrated in Quebec (caisses populaires) and in the Prairies (credit unions).[28] Financing available through government programs is also regionally concentrated, a tendency that is illustrated by the importance of the Atlantic Canada Opportunities Agency to the Atlantic region and Farm Credit Canada and Western Economic Diversification Canada to Western Canada. The regional concentrations of suppliers must be taken into account to avoid confusing regional variations in SME funding with the realities of the financial services sector.

27. A complete listing of financial structures and instrument usage by region is available in tables 11, 12, 13 and 14. The sampling for the *Survey on Financing of Small and Medium-sized Enterprises, 2000*, in some cases, limits data reporting to regional, not provincial, findings.

28. An in-depth discussion on the regional supply of financing and access points is available in Part III.

1.2.1 Atlantic Provinces

Formal versus Informal Types of Financing

Formal Types of Financing in 2000
- 54 percent of SMEs in Atlantic Canada used commercial loans or lines of credit (second highest of all regions, compared with the 49-percent national average)
- 8 percent used government loans or grants (third highest in Canada)

Informal Types of Financing in 2000
- 46 percent of SMEs in Atlantic Canada used trade credit from suppliers (highest of all regions, compared with the 39-percent national average)
- 25 percent used the personal lines of credit of the owner(s) (compared with 21 percent for SMEs overall)
- 35 percent used the personal savings of business owner(s)

The higher use of both formal and informal types of debt in the Atlantic provinces is supported by the findings discussed in Part I — Atlantic SMEs had among the highest debt request rates in 2000 and 2001 (see Table 3, Part I). Atlantic Canadian SMEs owed 27 percent of their debt to chartered banks in 2000 (in line with the 29-percent national average). Government suppliers of financing held 12 percent of the Atlantic SME debt, much higher than the 4-percent national average.

Atlantic SMEs owed much less debt to credit unions/caisses populaires than SMEs across the country (accounting for 2 percent of Atlantic SMEs' debt versus 5 percent nationally). These financing trends reflect the structure of the financial marketplace in Atlantic Canada.[29]

1.2.2 Quebec

Formal versus Informal Types of Financing

Formal Types of Financing in 2000
- 51 percent of SMEs in Quebec used commercial loans and lines of credit (third highest in Canada; compared with the national average of 49 percent)
- 11 percent used leasing (lowest of all regions; compared with the 16-percent national average)

Informal Types of Financing in 2000
- 37 percent of SMEs in Quebec used trade credit from suppliers (second lowest of all regions, compared with the national average of 39 percent)
- 27 percent used the personal credit card of the business owner(s) (lowest of all regions, compared with 33 percent nationally)

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29. The Credit Union Central of Canada reports a combined total of 73 credit unions throughout the Atlantic region, which operate 145 locations (**www.cucentral.ca**).

- 12 percent used the personal lines of credit of the owner(s) (lowest of all regions, compared with the 21-percent national average)
- 22 percent used the business' retained earnings (lowest of all regions, compared with the 31-percent national average)

Despite the lower than average use of trade credit of SMEs in Quebec, this source of informal financing accounted for a larger than average share of Quebec SMEs' debt than was the case for SMEs in the rest of Canada. In fact, in 2000, trade credit from suppliers represented 28 percent of Quebec firms' debt, compared with 21 percent nationally. While fewer SMEs in Quebec used this instrument, those that did tended to use it for higher amounts. As discussed below, trade credit is associated with manufacturing, wholesale and retail, and professional services. In Quebec, the highest proportion of SMEs are in the manufacturing sector, followed by the wholesale and retail sector. More data will need to be gathered to build a more complete understanding of SME financing trends in Quebec.

1.2.3 Ontario

As discussed earlier in *SME Marketplace,* Ontario is home to the highest percentage of Canada's SMEs, which accounts for the lack of variation between the findings for Ontario and those for Canada as a whole.

Formal versus Informal Types of Financing

Formal Types of Financing in 2000
- 44 percent of SMEs in Ontario used commercial loans and lines of credit (lowest of all regions, compared with 49 percent nationally)
- 4 percent used government loans or grants (lowest of all regions, compared with the 7-percent national average)

Informal Types of Financing in 2000
- 37 percent of SMEs in Ontario used trade credit from suppliers (compared with 39 percent nationally)
- 36 percent used the personal savings of the owner(s) (compared with 35 percent nationally)
- 33 percent used the business' retained earnings (compared with 31 percent nationally)
- 4 percent used loans from other individuals (second highest of all regions)

Excluding loans from other individuals (mostly "angel" investments), Ontario SMEs' use of informal types of financing showed little variation from the national averages. Formal types of financing, however, were used proportionally less by Ontario SMEs, which may be a function of the diversity of the financial marketplace in Ontario. Alternative financing methods such as leasing, and a far more developed risk capital market (as discussed in Part IV) are available to Ontario SMEs.

Chartered banks are the leading suppliers of formal financing in Ontario, holding nearly a third of Ontario's SME debt in 2000 (31 percent, slightly higher than the 29-percent national average). Given chartered banks' market presence in Ontario (86 percent of the points of service

available), it is not surprising that they are the leading supplier of formal debt. Credit unions and/or caisses populaires were owed only 3 percent of Ontario's SME debt (compared with 5 percent nationally), although this proportion appears to be in line with their market presence in Ontario. Currently, there are 581 credit unions or caisses populaires operating in Ontario,[30] which accounts for approximately 14 percent of the points of service available from chartered banks and credit unions/caisses populaires.[31]

1.2.4 Manitoba/Saskatchewan/Nunavut

Formal versus Informal Types of Financing

Formal Types of Financing in 2000

- 61 percent of SMEs in Manitoba/Saskatchewan/Nunavut used commercial loans and lines of credit (highest of all regions, compared with 49 percent nationally)
- 20 percent used leasing (highest of all regions, compared with 16 percent nationally)
- 14 percent used government loans or grants (highest in Canada; compared with the national average of 7 percent)

Table 9 — Manitoba/ Saskatchewan/Nunavut: Sectoral Distribution of SMEs, 2000

Agriculture	44.8%
Knowledge-based industries	1.9%
Manufacturing	3.0%
Primary	1.2%
Professional services	4.3%
Wholesale and retail	8.2%
All other	36.7%

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

Informal Types of Financing in 2000

- 28 percent of SMEs in Manitoba/ Saskatchewan/ Nunavut used the owner(s)'s personal lines of credit (highest in Canada, compared with the 21-percent national average)
- 19 percent used the personal loans of the owner(s) (highest in Canada; compared with 14 percent nationally)

As discussed in *SME Marketplace*, the agricultural sector dominates much of this region's economic activity; Table 9 shows that agricultural firms accounted for nearly half of the SME market in Manitoba, Saskatchewan, and Nunavut — nearly four times the proportion of agricultural firms in other regions.[32] As discussed later in this part, the pattern of instrument usage (i.e. higher than average use of formal instruments and personal resources of the owner) is a reflection of agricultural SMEs' use of formal sources of debt. Much of the debt owed by SMEs in this region is to formal suppliers, including chartered banks (37 percent of SME debt, compared with 29 percent nationally), and credit unions/caisses populaires (12 percent of SME debt, compared with 5 percent nationally). In fact, in this region, debt owed to credit unions represents the highest proportion of SME debt of any region in Canada. This reflects the strong

30. This figure is based on the combined locations of the 204 credit unions and 13 caisses populaires currently operating in Ontario. (Credit Union Central of Canada, (**www.cucentral.ca**)).

31. Of Canada's 52 chartered banks, 3 644 branches are located throughout Ontario. (Ontario Economic Development, (**www.2ontario.com**).

32. Industry Canada, *Small and Medium-sized Enterprise (SME) Financing in Canada, 2002.*

market presence of this supplier in Manitoba and Saskatchewan: 181 credit unions are currently operating in 515 locations in the region.[33]

1.2.5 Alberta/Northwest Territories

Formal versus Informal Types of Financing

Formal Types of Financing in 2000

- 28 percent of SMEs in Alberta/Northwest Territories used commercial credit cards (highest in Canada; compared with 26 percent nationally)
- 9 percent used government loans or grants (second highest in Canada, compared with the 7-percent national average)

Informal Types of Financing in 2000

- 43 percent of SMEs in Alberta/Northwest Territories used trade credit from suppliers (third highest region, compared with the 39-percent national average)
- 41 percent used the personal credit cards of the owner(s) (highest of all regions, compared with 33 percent nationally)
- 37 percent used the business' retained earnings (highest in Canada, compared with the 31-percent national average)

In Alberta, the strong market presence of the ATB Financial (formerly Alberta Treasury Branches) has influenced trends in the sources of financing, and explains the proportionally high use of government financing programs in this region. ATB Financial is a government-owned financial institution that has provided financing to over 20 000 business customers (roughly 14 percent of Alberta's SMEs). In 2000, government sources were owed 8 percent of the SME debt in this region (compared with 4 percent nationally). The presence of the ATB Financial also likely lowered the region's reliance on chartered banks, which accounted for 24 percent of the debt of SMEs (compared with 29 percent nationally).

Despite having the second highest regional concentration in agriculture in 2000, the financial structure of SMEs in Alberta and the Northwest Territories was not strongly influenced by the particular financing needs of agricultural firms. The relatively balanced sectoral distribution in this region reconciles their use of formal and informal instruments with the overall national averages. It is worth noting that as with businesses in British Columbia, SMEs in Alberta and the Northwest Territories tend to finance operations through the business' own retained earnings. In contrast to other regions, SMEs in Alberta and the Northwest Territories tend to rely much less on external formal types of financing.

33. Credit Union Central of Canada (**www.cucentral.ca**).

From one observation, however, it is not possible to determine whether this is a result of cyclical economic factors, sectoral factors, lack of access to formal sources of financing or whether it reflects SME owners' preferences.

1.2.6 British Columbia / Yukon

Formal versus Informal Types of Financing

Formal Types of Financing in 2000

- 46 percent of SMEs in British Columbia/Yukon used commercial loans and lines of credit (second lowest region after Ontario, compared with 49 percent nationally)
- 22 percent used commercial credit cards (lowest of all regions, compared with the 26-percent national average)

Informal Types of Financing in 2000

- 36 percent of SMEs in British Columbia / Yukon used trade credit from suppliers (lowest of all regions, compared with the 39-percent national average)
- 39 percent used the personal savings of the owner(s) (highest in Canada, compared with the 35-percent national average)
- 34 percent used the business' retained earnings (second highest region after Alberta)
- 5 percent used loans from other individuals (highest in Canada)

The pattern of financing in British Columbia / Yukon is similar to that in Alberta/Northwest Territories. Business owners tend to depend on their firms' financial self-reliance rather than on external sources of formal financing. This may be a function of this region's relatively balanced sectoral spread. In this region, "other" sectors, which includes a diverse array of industry groupings,[34] constitute the highest percentage of SMEs of any region. Given the diversity of firms in this grouping, this region does not appear to have a dominant financing pattern. As with the situation in Alberta, it is not possible to identify causality on the basis of one observation. More data and detailed analysis will be needed to determine what factors contribute to financing patterns in this region.

34. "Other" sectors include, for example, construction, transportation, warehousing, information and publishing, real estate and rental, administration, arts and entertainment, recreation, accommodation and food services, etc.

2. STAGE OF BUSINESS DEVELOPMENT

Key Findings about SME Start-Ups:

- 2 out of 5 new firms do not survive beyond their second year of operation
- The majority of start-up financing originates from the owner's personal savings, lines of credit or credit cards
- Only 29 percent of start-up SMEs are financed through commercial loans or lines of credit from financial institutions, compared with 49 percent of established SMEs
- Similar variations in financial structure for start-ups and established businesses are found by region, sector and business size

The Challenge of Access to Financing for Start-ups

Business creation and development typically involve several stages of financing and a variety of debt and equity instruments. These instruments vary depending on the type and growth prospects of the business and on prevailing market conditions.[35] Often, however, high failure rates among new entrants (see insert) represent a degree of risk that falls outside the risk appetites of many financial institutions. For example, Thompson Lightstone (1997) found that rejection rates by financial institutions for business start-ups exceeded 40 percent, compared with 13 percent for SMEs overall.[36] An earlier study by Riding and Haines (1994) found that new firms represented fewer than 5 percent of financial institution clients. As a result, start-ups use informal sources of external financing, and tend to rely more on the personal credit and savings of the business owners.

The "Revolving Door" of Entrants into the SME Marketplace

The reality of the marketplace is that the majority of new entrants do not survive beyond start-up, leading many to refer to the marketplace as a "revolving door." In fact, a recent Statistics Canada report found that failure rates among new entrants were extremely high; 40 percent exited the market by their second year. The study found that the survival time for new businesses was approximately six years on average. While it is clear that new entrants face many challenges during their formative years, the likelihood of survival does increase as firms mature.

Source: Baldwin, John, Lin Bian, Richard Dupuy (2000), *Failure Rates for New Canadian Firms: New Perspectives on Entry and Exit*. Statistics Canada.

35. For a more detailed discussion of the spectrum of risk capital financing options employed by Canadian SMEs throughout their growth cycles, see Part IV.

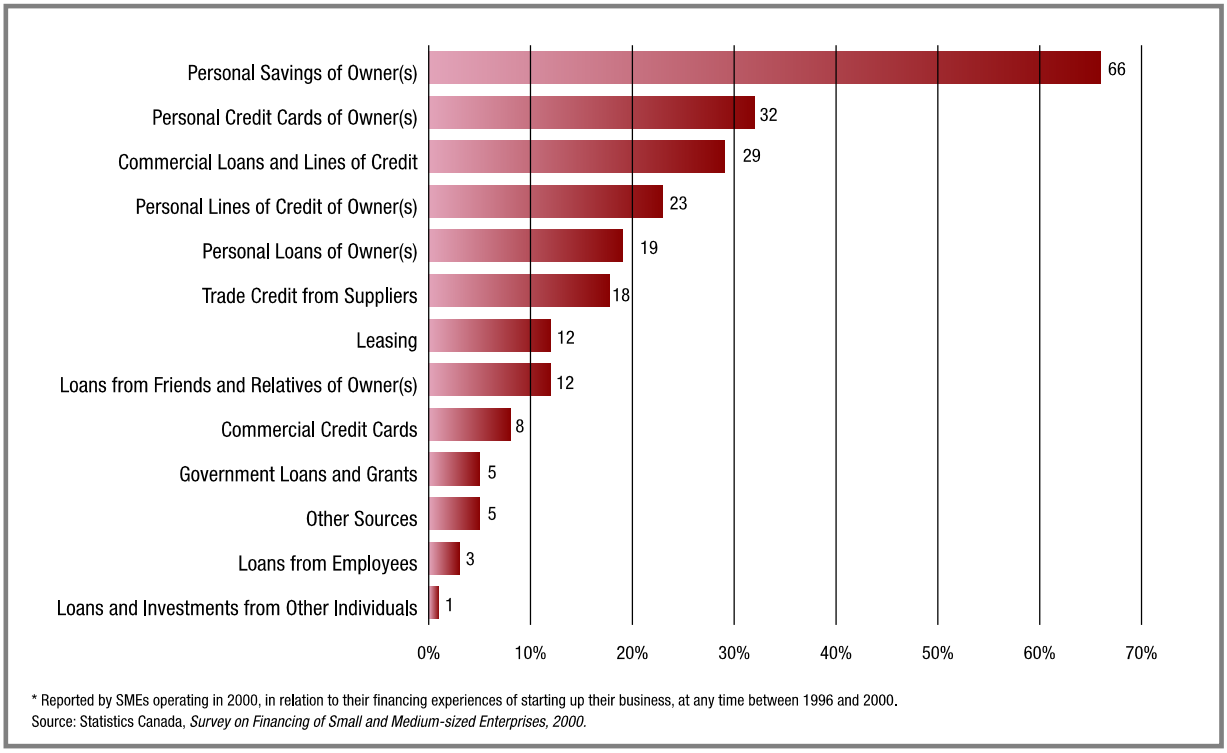
36. Thompson Lightstone & Company Ltd. (1997), *Small and Medium-sized Businesses in Canada: An Ongoing Perspective of their Needs, Expectations and Satisfaction with Financial Institutions.* A report prepared for the Canadian Bankers Association.

Formal versus Informal Types of Financing Used during Start-Up

Figure 21 shows the financial instruments used by start-up SMEs.[37] There was a stark contrast between financing trends for start-up firms and the trends for overall SME financing in Canada (see Figure 18).

Figure 21

Types of Financial Instruments Used by Start-up SMEs*



* Reported by SMEs operating in 2000, in relation to their financing experiences of starting up their business, at any time between 1996 and 2000.
Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000.*

Formal Types of Financing used During Start-up

- 29 percent of start-up SMEs used commercial loans and lines of credit (compared with 49 percent for all SMEs)
- 12 percent used leasing (compared with 16 percent for all SMEs)
- 8 percent used commercial credit cards (compared with 26 percent for all SMEs)
- 5 percent used government loans or grants (compared with 7 percent for all SMEs)

Informal Types of Financing used During Start-up

- 66 percent of start-up SMEs used the personal savings of the owner(s) (compared with 35 percent for all SMEs)
- 23 percent used the personal lines of credit of the owner(s) (compared with 21 percent for all SMEs)

37. For the purposes of comparison, *start-up SMEs* are defined as businesses started from scratch by the owner(s) prior to the first sale of products or services, at any time between 1996 and 2000. *Established SMEs* are those firms started prior to 1998, and data on these businesses are only available by size of firm. *All SMEs* include both start-ups and established firms.

- 19 percent used the personal loans of the owner(s) (compared with 14 percent for all SMEs)
- 12 percent used loans from friends or family of the owner(s) (compared with 10 percent for all SMEs)

The overall pattern of SME financing discussed earlier in Section 1 centred on commercial lending, trade credit and retained earnings. For start-up firms however, the financial capacity of the owner, rather than that of the business, is a more significant determinant of the firm's financial structure.

Regional and Sectoral Picture of Start-ups

Start-up businesses had a similar regional and sectoral variation to that discussed for all SMEs in Part II, Section 1 and Section 3. If a particular region or sector has lower usage rates of a particular instrument among SMEs overall (see Table 11), comparable start-up firms tend to follow similar financing patterns (see Table 10). The difference for start-up firms is one of scope. Start-up SMEs tend to use formal sources of financing far less than established businesses. One example from Table 10 shows the following start-up rates of usage of commercial loans and lines of credit, regionally and by sector.

Regional usage of commercial loans and lines of credit by start-ups:

- 37 percent of Atlantic Canada's start-ups used commercial loans or lines of credit (compared with 54 percent for all SMEs in Atlantic Canada)
- 26 percent usage by start-ups in Ontario (compared with 44 percent for all Ontario SMEs)
- 45 percent usage by start-ups in Manitoba/Saskatchewan/Nunavut (compared with 61 percent for all SMEs in that region)

Sectoral usage of commercial loans and lines of credit by start-ups:

- 62 percent of agricultural start-ups used commercial loans or lines of credit (compared with 72 percent for all agricultural SMEs)
- 40 percent usage by start-ups in manufacturing (compared with 51 percent for all manufacturing SMEs)
- 8 percent usage by start-ups in KBI sectors (compared with 21 percent for all KBI SMEs)

Impact of Size of Business on Type of Financing Used by Start-Ups[38]

Business size influences the financial structure of start-ups. The following two examples from tables 10 and 11 compare established SMEs' with start-up firms' use of commercial loans, lines of credit, and the personal savings of the business owner(s).

Use of commercial loans and lines of credit among start-ups by size of business:

- 21 percent of start-ups without employees used commercial loans and lines of credit (compared with 34 percent of established firms in that size category)
- 32 percent usage by start-ups with 1–4 employees (compared with 50 percent)

38. Size of business, as defined by number of employees, reflects the size of firm in 2000, rather than at the time of business start-up.

- 42 percent usage by start-ups with 5–19 employees (compared with 66 percent)
- 45 percent usage by start-ups with 20–99 employees (compared with 69 percent)
- 71 percent usage by start-ups with 100–499 employees (compared with 86 percent)

Use of the personal savings of the owner(s) among start-ups by size of business:

- 64 percent of start-ups without employees used the personal savings of the owner(s) (compared with 36 percent of established firms in that size category)
- 69 percent usage by start-ups with 1–4 employees (compared with 32 percent)
- 66 percent usage by start-ups with 5–19 employees (compared with 33 percent)
- 66 percent usage by start-ups with 20–99 employees (compared with 17 percent)
- 37 percent usage by start-ups with 100–499 employees (compared with 11 percent)

Size of firm is a major determinant of SMEs' use of formal types of financing — use of commercial loans or lines of credit is positively correlated to the size of business. This pattern is reversed in the case of informal financing; reliance on the owner's personal savings is more common among smaller firms. As will be discussed in Section 4, smaller firms' greater reliance on informal types of financing occurs independent of the business' age. Both start-ups and established smaller businesses make more use of informal financing than larger firms do. However, it is not possible to conclude from a single observation whether this presents an accurate picture, or whether these findings are influenced by sectoral or economic factors. These differences may suggest a substantial gap in the financing market for early-stage formal financing, but more data is needed on the relative impact of the various factors (e.g. risk of business failure, lack of an established credit history, absence of sufficient assets to pledge as security for financing or other sectoral or economic factors).

3. INDUSTRY SECTOR

Industry sector influences SMEs' financial structure. The sector of operation has long been one of the "Five Cs" used by financial institutions to assess a firm's creditworthiness.[39] More recently, industry sector has become a primary consideration in financial institutions' credit scoring models. These models account for the fact that different sectors typically have different asset structures, profitability levels, risk of default or failure rates.[40] That different sectors use different kinds of financing is not, in itself, evidence of a financial market imperfection or gap. Many factors may determine these patterns, but from one set of observations it is not possible to identify the direction of causality.

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39. The Five Cs in the Credit Decision: *Capacity* is the extent to which a firm is able to meet its repayment obligations; *capital* is the amount of equity built up within a business; *collateral* is the value of assets available to pledge as security against loans; *character* is the track record of the business and its owners**;** *conditions* refers to the nature and size of the market and industrial climate. (Allan Riding, *Financing Entrepreneurial Firms: Legal and Regulatory Issues* (1998). Research Paper prepared for the Task Force on the Future of the Canadian Financial Services Sector).

40. Allan Riding, *Financing Entrepreneurial Firms: Legal and Regulatory Issues* (1998). Research Paper prepared for the Task Force on the Future of the Canadian Financial Services Sector.

Sectoral differences in the use of formal and informal types of financing

The sectoral differences in financial structure are most apparent in comparisons between resource-based sectors (e.g. agriculture) and service sectors (e.g. knowledge-based industries). For instance, agricultural firms typically have more fixed asset collateral, which enables them to support higher levels of formal sources of debt. Since SMEs in service industries do not typically have as high an asset base, they tend to use informal sources of debt. The discussion that follows is derived from Tables 11 and 12.

3.1 Resource-Based and Goods-Producing Sectors

Figure 22 shows the distribution of financing instruments in the resource-based and goods-producing sectors in 2000. With few exceptions, the resource-intensive agricultural and primary sectors and the goods-producing manufacturing industry finance their operations through formal types of debt, the owner's personal savings or the business' retained earnings. To illustrate the debt intensity among the resource and goods-producing sectors, agriculture and manufacturing trends are examined more closely below.

Key Findings for Industry Sector

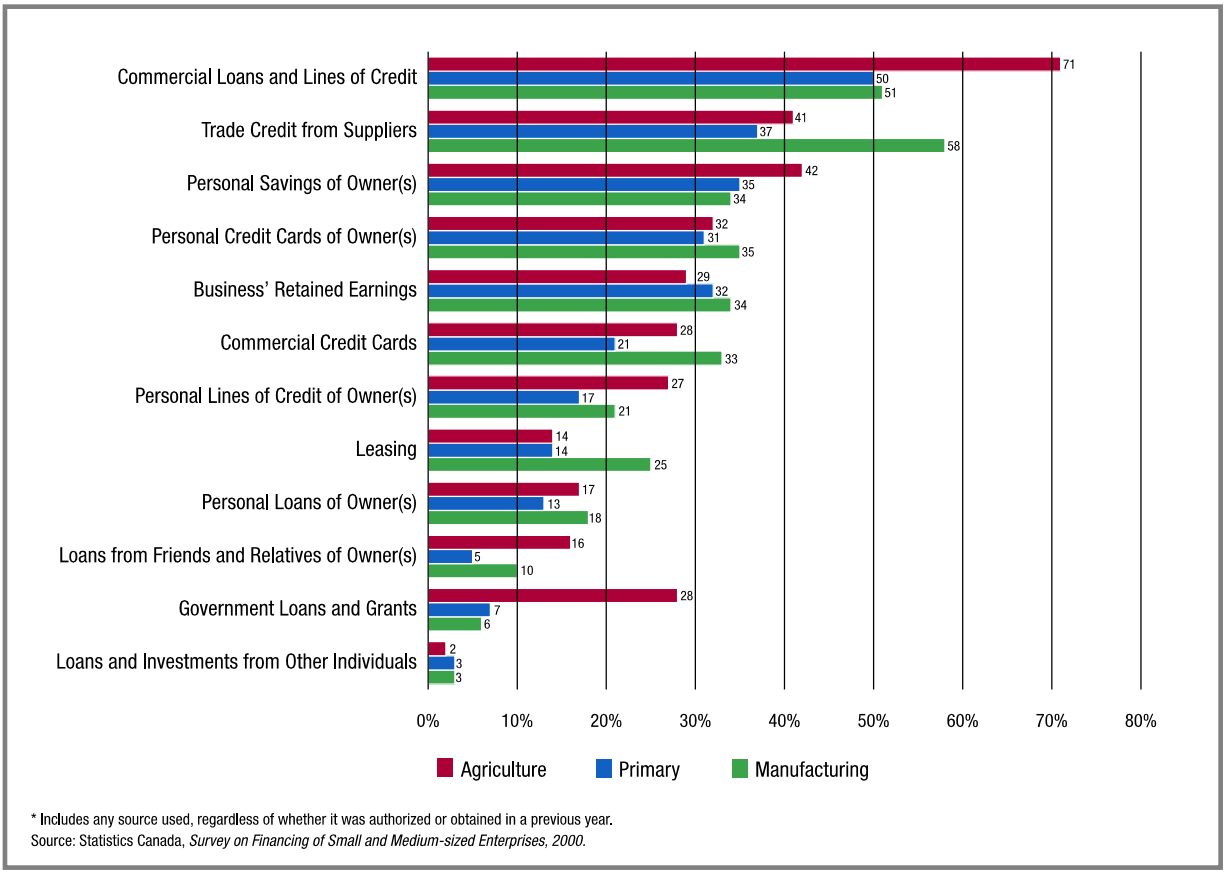
Resource-based and goods-producing sectors' higher use of formal types of financing:

- 71 percent of agricultural firms used commercial loans and lines of credit
- 28 percent of agricultural firms used government loans or grants — highest of all sectors
- 58 percent of manufacturing firms used trade credit from suppliers
- 25 percent of manufacturing firms used leasing — highest of all sectors

Service sectors' higher use of informal types of financing:

- 37 percent of KBI firms used retained earnings — highest of all sectors.
- 21 percent of KBI firms used commercial loans and lines of credit — lowest of all sectors
- 35 percent of wholesale/retail firms used the owner's personal savings — among the highest of all sectors

Figure 22
Types of Financial Instruments in Use by Resource-based or Goods-producing SMEs in 2000*



* Includes any source used, regardless of whether it was authorized or obtained in a previous year.
Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000.*

3.1.1 Agricultural Sector

Characteristics of an average agricultural SME in 2000:

- Share of Business Population: 13 percent of the 1.4 million SMEs
- Years in Business: 85 percent of agricultural SMEs were older than five years
- Fixed Assets: averaged $581 000
- Debt Outstanding: averaged $309 000
- Profitability: averaged $28 000 net income before taxes
- Total Equity: averaged $470 500
- Long-Term Debt-To-Equity Ratio: 0.48
- Demand for Financing: 39 percent of SMEs requested debt, 93 percent were approved

Formal versus Informal Types of Financing

Formal Types of Financing in 2000

- 71 percent of agricultural SMEs used commercial loans and lines of credit (highest of all sectors, compared with the 49-percent national average)
- 28 percent used government loans or grants (nearly four times the national average)[41]

Informal Types of Financing in 2000

- 42 percent of agricultural SMEs used the personal savings of owner(s) (highest of all sectors, compared with the 35-percent national average)
- 29 percent used the business' retained earnings (lowest of all sectors, compared with the 31-percent national average)
- 28 percent used the personal lines of credit of the owner(s) (highest of all sectors, compared with the 21-percent national average)
- 16 percent used loans from friends or relatives of the owner(s) (highest of all sectors, 60 percent higher than the national average)

Agricultural SMEs' high use of formal types of debt is likely related to:

- ***The availability of fixed assets to pledge as debt security:*** Agricultural firms had the highest fixed asset holdings of all industries (averaging $581 000 in fixed assets per SME, compared with $291 000 for SMEs overall, in 2000) and therefore had more collateral to secure their debt
- ***Their more established credit history with their financial institution:*** Many firms in this sector have reported longer relationships with their financial providers
  - 83 percent claimed to have dealt with the same financial institution for more than seven years, compared with 60 percent of SMEs overall
  - CFIB[42] reports that longer track records and longer-term relationships with account managers and financial institutions improves access to financing
  - Since the majority of agricultural SMEs are more mature firms, they tend to have well-established credit histories, and as a result, they enjoy better access to financing

The financial structure of agricultural SMEs suggests that control of the firm's financial assets is an important consideration. This tendency is evident in agricultural SMEs' high use of debt instruments of all kinds (both formal and informal), and their low reliance on retained earnings. However, the debt intensity in agricultural firms' capital mix is not reflected in their long-term debt to equity ratio. On average, in 2000, debt comprised 48 percent of agricultural SMEs' long-term financing structure. The reason for this comparatively low ratio is not that SMEs in this sector do not rely on debt, but rather that they have more equity in their businesses than other sectors, and also tend to use shorter-term instruments.

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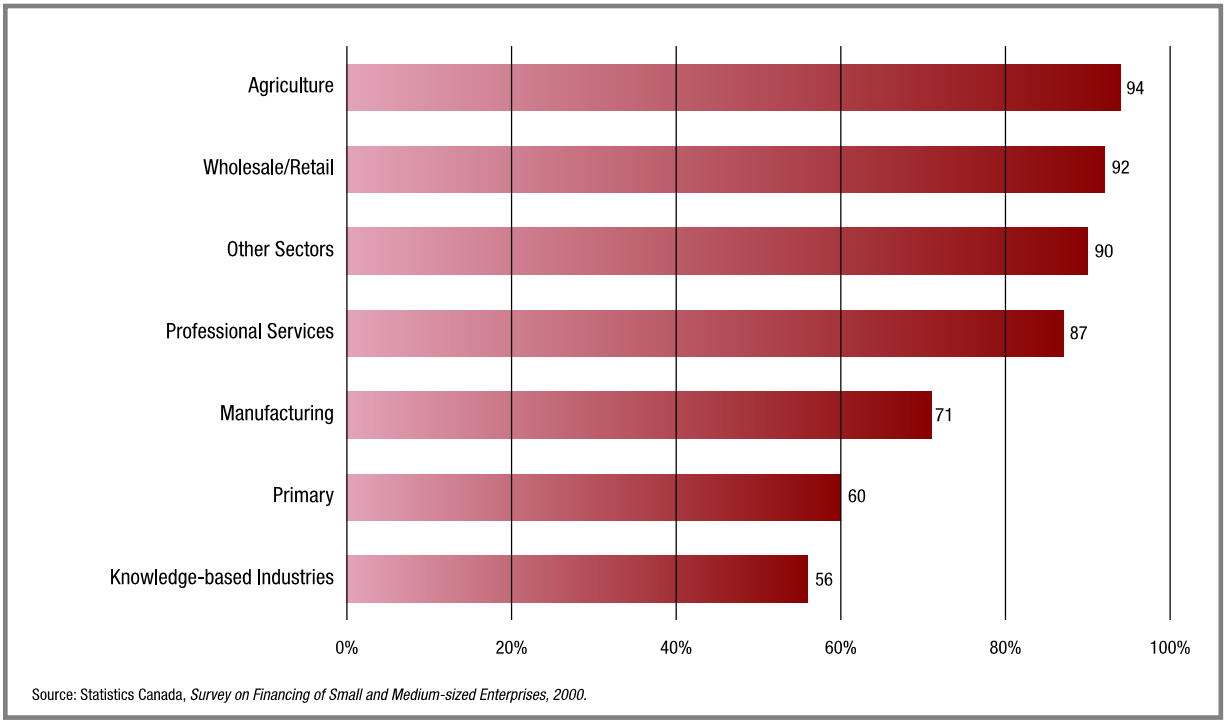
41. The regional importance of ATB Financial and the impact of the Farm Credit Corporation (FCC) are the main factors underlying the higher than average usage of government programs by the agricultural industry.

42. Canadian Federation of Independent Business (2001) *Banking on Entrepreneurship: Results of CFIB Banking Survey*.

This debt intensive financial structure is also evident in agricultural SMEs' higher than average debt owed to chartered banks (34 percent of debt owed, compared with the 29-percent national average) and credit unions/caisses populaires (11 percent of debt owed, compared with 5 percent nationally).

Figure 23

Percentage of Ownership Capital Owned by the Business Owner/Operator in 2000, by Sector



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

SME Ownership Capital in 2000

In 2000, there was $361 000 in average owner's equity in agricultural SMEs. Of this equity, 94 percent was owned by the business owner/operator (highest of all sectors, compared with the 86-percent national average).

3.1.2 Manufacturing Sector

Characteristics of an average manufacturing SME in 2000:

- Share of Business Population: 5 percent of the 1.4 million SMEs
- Years in Business: 72 percent of manufacturing SMEs were older than five years
- Fixed Assets: averaged $372 000
- Debt Outstanding: averaged $531 500
- Profitability: averaged $91 000 net income before taxes
- Total Equity: averaged $332 000
- Long-Term Debt-To-Equity Ratio: 0.62
- Demand for Financing: 27 percent of SMEs requested debt, 77 percent were approved

Formal versus informal types of financing

Formal Types of Financing in 2000

- 51 percent of manufacturing SMEs used commercial loans and lines of credit (third among sectors: close to the overall SME average of 48 percent)
- 33 percent used commercial credit cards (highest of all sectors, compared with the 26-percent national average)
- 25 percent used leasing (highest of all sectors; compared with the national average of 16 percent)

Informal Types of Financing in 2000

- 58 percent of manufacturing SMEs used trade credit from suppliers (highest of all sectors, compared with the national average of 39 percent)
- 34 percent used the business' retained earnings (second highest of all sectors, compared with the 31-percent national average)
- 35 percent used the personal credit cards of the owner(s) (second highest among sectors, compared with the average of 33 percent)

The types of financing instruments used by manufacturing SMEs in 2000 (trade credit from suppliers, leasing, commercial, or personal credit cards and lines of credit) indicate a preference for flexible financing arrangements. These instruments allow firms to react to changing supply and demand conditions, to control costs, and to exploit opportunities.

The debt structure of manufacturing SMEs reflects their mix of financial instruments. Trade credit from suppliers accounted for a higher percentage of manufacturing firms' debt in 2000 (representing 30 percent of debt owed by manufacturing SMEs, compared with 21 for all sectors). Trade credit debt owed by the manufacturing sector even exceeded debt owed to chartered banks, 27 percent in 2000 (slightly less than the 29-percent average among all sectors).

SME Ownership Capital in 2000

In 2000:

- 71 percent of manufacturing SMEs' ownership capital was owned by the business owner/operator (third lowest of all sectors, compared with the 86-percent national average)
- 8 percent was owned by the parent company
- 5 percent was owned by friends or relatives of the owner(s) (highest of all sectors; compared with the 4-percent national average)
- 4 percent was owned by private foreign and domestic (angel) investors

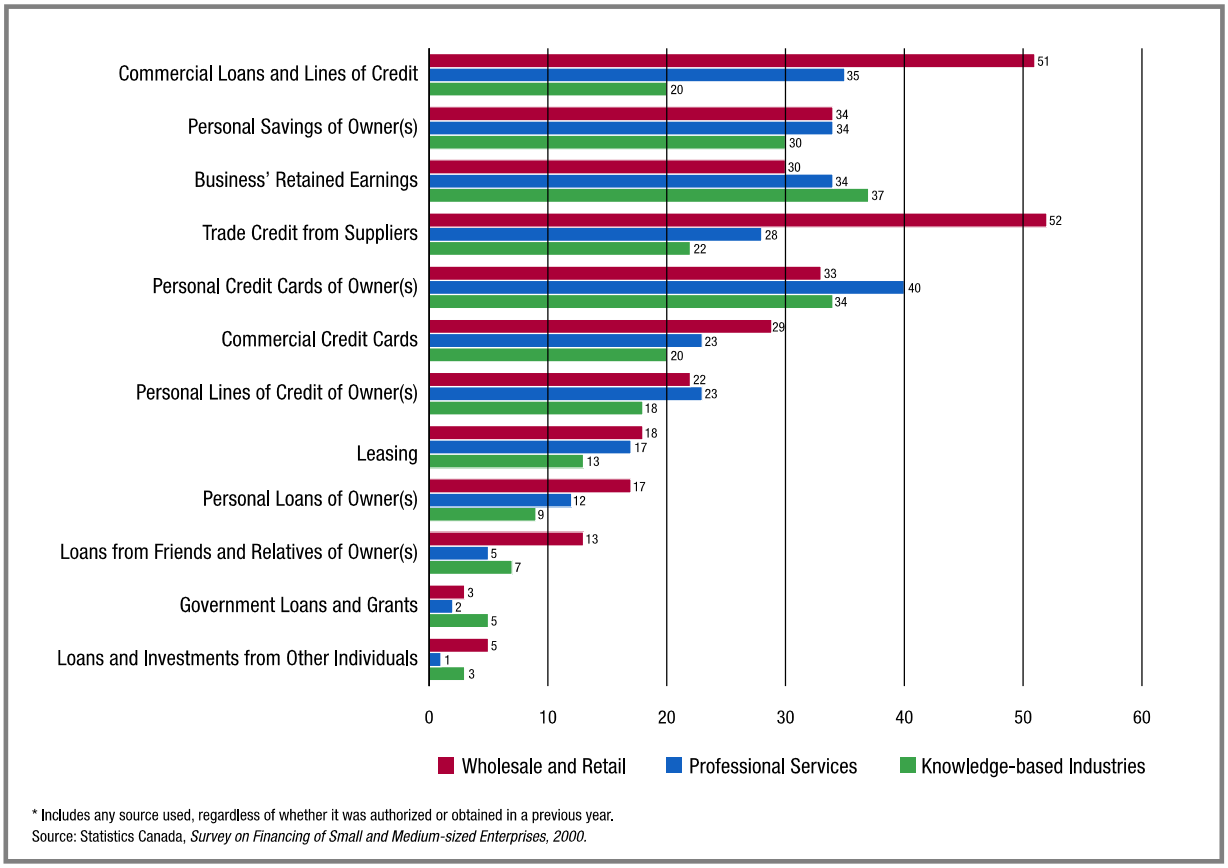
As will be discussed in Section 7, the manufacturing sector produced the highest percentage of high-growth firms (17 percent of manufacturing SMEs reported cumulative sales growth in excess of 50 percent over a three-year period ending in 2000). Financing cumulative rounds of growth requires substantial capital, and often requires firms to seek sources of equity financing. The comparatively high level of external equity ownership in manufacturing firms is a reflection of this growth phenomenon.

3.2 Service Sectors

Figure 24 provides the distribution of financing instruments used by SMEs in Canada's service sectors in 2000. Unlike the resource-based and goods-producing sectors, there are fewer discernable similarities among the financing sources employed by the service industries. Rather, service sectors have diversified financial structures and tend to use more informal types of financing. This pattern was also apparent in the regional analysis of financing structures in Alberta and British Columbia, where service industries dominate. The following section examines two of the sectors that have the widest variations — knowledge-based industries and firms in the wholesale/retail sector.

Figure 24

Types of Financial Instruments Used by Service Sector SMEs in 2000*



* Includes any source used, regardless of whether it was authorized or obtained in a previous year.
Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000.*

3.2.1 Knowledge-Based Industries (KBIs)

Characteristics of an average KBI SME in 2000:

- Share of Business Population: 5 percent of the 1.4 million SMEs
- Years in Business: 55 percent of KBI SMEs were older than five years
- Fixed Assets: averaged $127 000
- Debt Outstanding: averaged $186 500
- Profitability: averaged $33 000 net income before taxes
- Total Equity: averaged $205 000
- Long-Term Debt-To-Equity Ratio: 0.36
- Demand for Financing: 16 percent of SMEs requested debt, 70 percent were approved

Formal versus informal types of financing

Formal Types of Financing in 2000

- 20 percent of KBI SMEs used commercial loans and lines of credit (lowest of all sectors: far below the 49-percent national average).
- 20 percent used commercial credit cards (lowest of all sectors: compared with the 26-percent national average).

Informal Types of Financing in 2000

- 37 percent of KBI SMEs used the business' retained earnings (highest of all sectors, compared with the 31-percent national average).
- 34 percent used the personal credit cards of the owner(s) (compared with 33 percent nationally).
- 30 percent used the personal savings of the owner(s) (lowest of all sectors, compared with the 35-percent national average).

KBI financing trends show that not all forms of financing are appropriate to all firms — formal and informal sources of debt (the major form of financing for most SMEs) are often inappropriate for KBI firms. The risks associated with market volatility and developing new technologies, products and processes, are often beyond the risk appetites of formal financial providers. In fact, the Business Development Bank of Canada (2000) reported that knowledge-based SMEs face the most difficulty in accessing debt financing.[43] The perception is that financial institutions may be reluctant to lend to these SMEs; many of their assets are intangible (e.g. knowledge, expertise, intellectual property, products or services) and cannot be easily liquidated to cover outstanding debt, and their equipment can rapidly become obsolete.

Figure 24 shows KBI SMEs' reaction to these difficulties. These firms have the most diversified use of financial instruments of all sectors. Unlike other industries, in which formal and informal

43. Business Development Bank of Canada (2000) *Financing Services to Canadian Small and Medium-sized Enterprises: Report on Focus Group Research*. A report prepared by the Angus Reid Group.

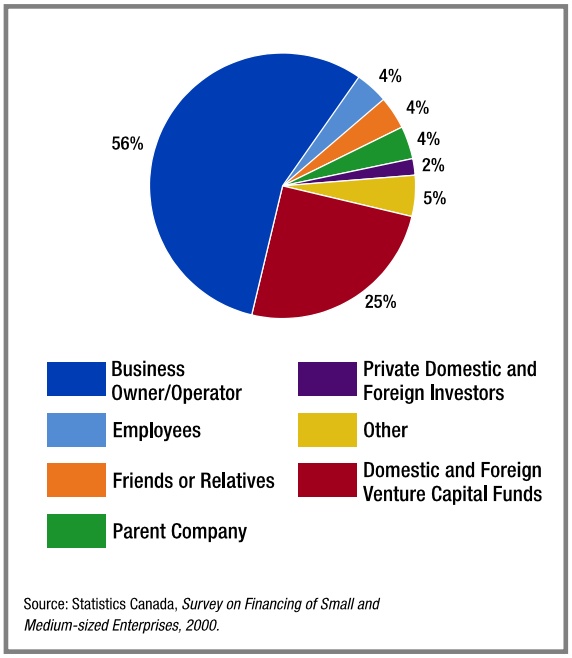
sources of external debt are the primary source of financing, KBI firms tend to have less debt-intensive financial structures. In 2000, only 36 percent of KBI firms' long-term financing structure was comprised of debt (long-term debt-to-equity ratio of 0.36). A similar tendency was seen in the debt owed by KBI firms to suppliers of formal sources of debt. On average, only 14 percent of KBI debt was owed to chartered banks (compared with the 29-percent national average) and only 1.7 percent was owed to credit unions/caisses populaires (compared with the 5-percent national average).

SME Ownership Capital in 2000

In 2000:

- $193 500 in average owner's equity in KBI SMEs.
- 56 percent was owned by the business owner/operator (lowest of all sectors, compared with the 86-percent national average).
- 5 percent was owned by foreign and domestic venture capitalist.
- 4 percent was owned by friends or relatives of the owner(s).
- 4 percent was owned by foreign and domestic private investors (angels) (highest of all sectors, compared with 1 percent for the national average).

Figure 25
Distribution (%) of an Average KBI SME's Ownership Capital, 2000



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

KBI SMEs are among the highest users of risk capital in Canada. Shown in Figure 25, only 56 percent of the ownership in KBI firms was held by the business owner/operator in 2000. Consistent with this sector's risk profile and particular financing needs, KBI SMEs were the lowest users of formal and informal debt. Instead, these firms relied on the internal resources of the firm: in 2000, 37 percent of KBI SMEs used the business' retained earnings. Figure 24 showed that KBI firms use more venture capital funds or private investors than SMEs in other sectors. Whether this represents a market imperfection in access to formal debt needs to be monitored over the longer term to ensure that such gaps do not impede the sector's growth.

3.2.2 Wholesale and Retail

Characteristics of an average wholesale/retail SME in 2000:

- Share of Business Population: 16 percent of the 1.4 million SMEs
- Years in Business: 73 percent of wholesale/retail SMEs were older than five years
- Fixed Assets: averaged $151 500
- Debt Outstanding: averaged $330 000
- Profitability: averaged $43 000 net income before taxes
- Total Equity: averaged $169 000
- Long-term Debt-To-Equity Ratio: 0.64
- Demand for Financing: 23 percent of SMEs requested debt, 74 percent were approved

Formal versus informal types of financing

Formal Types of Financing in 2000

- 51 percent of wholesale/retail SMEs used commercial loans and lines of credit (second highest of all sectors, compared with the 49-percent national average)
- 29 percent used commercial credit cards (second highest following manufacturing, compared with the 26-percent national average)
- 18 percent used leasing (second highest following manufacturing, compared with the 16-percent national average)

Informal Types of Financing in 2000

- 52 percent of wholesale/retail SMEs used trade credit from suppliers (second highest following manufacturing, compared with 39 percent for the national average)
- 35 percent used the personal savings of the owner(s) (second only to the agriculture sector)
- 13 percent used loans from friends or relatives of the owner(s) (second highest sector, following agriculture)
- 5 percent used loans and investments from other individuals (i.e. angels) (highest of all sectors, compared with the 4-percent national average)

Wholesale and retail SMEs and manufacturing firms followed similar patterns in their use of formal types of debt, leasing and trade credit from suppliers in 2000. As with manufacturing SMEs, wholesale/retail firms owed most of their debt to trade suppliers — 38 percent of their total outstanding debt. Chartered banks only held 21 percent of the debt owed by wholesale and retail SMEs.

It is too early to confirm whether the higher than average use of informal financing (e.g. owner's personal savings, loans from friends and relatives; financing patterns which closely match those of the agricultural sector) indicates a sectoral financing gap. As discussed in Part I, SMEs in this sector had the second lowest approval rate for commercial debt in 2000 (74 percent approval compared with 82 percent overall). As shown above (see insert), wholesale/retail SMEs had among the highest long-term debt-to-equity ratios (0.64) of all sectors, which may contribute to the lower approval rates, and may encourage the use of informal financing.

SME Ownership Capital in 2000

- 92 percent of ownership capital in wholesale/retail SMEs was owned by the business owner/operator (second highest following agriculture, compared with the 86-percent national average)
- 4 percent was owned by friends or relatives of the owner(s)

Most of the ownership in wholesale/retail firms was held by the business owner/operator (92 percent) — second only to 94 percent for the agricultural sector (see Figure 23). This suggests that raising capital by selling equity shares is not a common method of financing in the wholesale/retail sector.

Nevertheless, love money from friends and relatives was obtained by 13 percent of firms in this sector, and friends and relatives held 4 percent of wholesale/retail firms' ownership.

4. BUSINESS SIZE

Key Findings for Business Size:

The size of a business, independent of age, has a strong impact on financial and ownership structures.

Self-employed businesses had the highest use of informal types of financing:

- 37 percent used personal credit cards
- 36 percent used personal savings of the owner(s)
- 34 percent used commercial loans and lines of credit

Micro businesses had a balanced use of both formal and informal financing:

- 50 percent used commercial loans and lines of credit
- 36 percent used personal credit cards of the owner(s)
- 34 percent used retained earnings

Medium-sized firms have the highest use of formal types of financing and trade credit (a similar pattern to that seen in the manufacturing sector):

- 86 percent used commercial loans and lines of credit
- 56 percent used leasing
- 75 percent used trade credit from suppliers

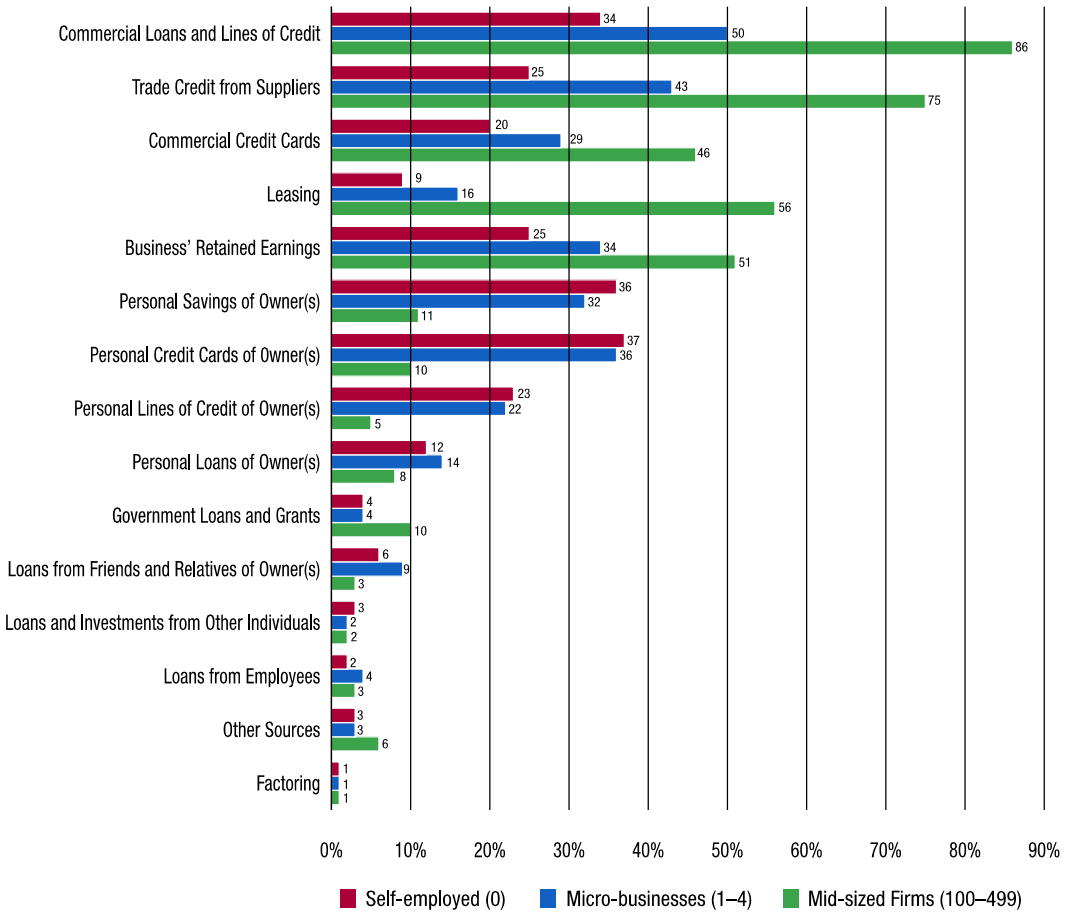
Business size, measured by number of employees, is the strongest determinant of a business' financial structure, regardless of the age of the firm.[44] Removing the influence of age by only examining established SMEs over two years of age shows that smaller businesses relied on informal financing, such as the business owner's savings or personal credit facilities, as

44. In this section, findings are only presented for established businesses older than two years. The rationale for excluding start-up firms from the business size analysis is to remove the influence of start-up financing, which consists mostly of formal financing. Excluding these firms allows a more accurate determination of whether business size has an impact on a firm's financial structure.

commonly as do start-up SMEs. Medium-sized firms, on the other hand, tend to turn to formal commercial instruments and the resources of the business. To highlight these differences, Figure 26 examines the financial structures of three business size categories: the self-employed, micro-businesses and mid-sized firms.[45]

Figure 26

Financial Instruments in Use by Established SMEs in 2000, by Size of Business*



* Includes any source used, regardless of whether it was authorized or obtained in a previous year.
Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000.*

45. Data on the financial structure and sources of financing used by other business size categories is available in Tables 11, 12, and 14.

4.1 Self-Employed Firms (Firms without Employees)

Characteristics of an average self-employed firm in 2000:

- Share of Business Population: 46 percent of the 1.4-million SMEs
- Years in Business: 78 percent of self-employed firms were older than five years
- Fixed Assets: averaged $268 500
- Debt Outstanding: averaged $200 500
- Profitability: averaged $31 000 net income before taxes
- Total Equity: averaged $173 500
- Long-Term Debt-To-Equity Ratio: 0.80
- Demand for Financing: 19 percent of SMEs requested debt, 82 percent were approved

Formal versus informal types of financing

Formal Types of Financing in 2000

- 34 percent of established self-employed firms used commercial loans and lines of credit (lowest of all business sizes, compared with the 49-percent national average)
- 20 percent used commercial credit cards (lowest of all size categories, compared with 26 percent nationally)
- 9 percent used leasing (also lowest of all size categories, compared with 16 percent nationally)

Informal Types of Financing in 2000

- 37 percent of established self-employed firms used the personal credit cards of the owner(s) (highest of all business sizes, compared with the 33-percent national average)
- 36 percent used the personal savings of the owner(s) (highest of all sizes categories, compared with 35 percent nationally)
- 25 percent used the business' retained earnings (lowest of all size categories, compared with 31 percent nationally)

Self-employed businesses relied more on informal financing than larger firms; they tended to use the owner's personal savings or other easily acquired and flexible instruments (e.g. personal credit cards or lines of credit) rather than formal sources of debt or leasing.

The limited use of formal debt may indicate a market gap in self-employed firms' access to financing, since they tend to have among the fewest assets to pledge as collateral for debt, the lowest profit levels and a higher than average long-term debt to equity ratio, which indicates that these firms are more highly leveraged than other size categories. As discussed in Section 3, these characteristics mean that the risks associated with financing self-employed firms are often beyond financial institutions' comfort zone.

SME Ownership Capital in 2000

In 2000 there was:

- $117 000 in average owner's equity in self-employed businesses
- 94 percent wass owned by the business owner/operator (highest of all size categories; compared with the 86-percent national average)
- 2 percent was owned by friends or relatives of the owner(s)

As discussed in *SME Marketplace*, 20 percent of self-employed businesses operate in agricultural sectors. This influences self-employed firms' ownership patterns — most of the ownership capital in self-employed businesses is owned by the business owner/operator. However, from available data it is premature to determine whether this is the result of the influence of the agricultural sector or whether it reflects self-employed firms' preference to retain ownership and managerial control.

4.2 Micro Businesses (Firms with One to Four Employees)

Characteristics of an average micro-business in 2000:

- Share of Business Population: 35 percent of the 1.4 million SMEs
- Years in Business: 70 percent of micro-businesses were older than five years
- Fixed Assets: averaged $190 000
- Debt Outstanding: averaged $157 000
- Profitability: averaged $52 500 net income before taxes
- Total Equity: averaged $144 000
- Long-Term Debt-To-Equity Ratio: 0.65
- Demand for Financing: 23 percent of SMEs requested debt, 79 percent were approved

Formal versus informal types of financing

Formal Types of Financing in 2000

- 50 percent of established micro businesses used commercial loans and lines of credit (compared with the 49-percent national average)
- 16 percent used leasing (similar to the national average)
- 4 percent used government loans or grants (slightly below the 7-percent national average)

Informal Types of Financing in 2000

- 36 percent of established micro businesses used the personal credit cards of the owner(s) (higher than the 33-percent national average)
- 34 percent used the business' retained earnings (higher than the 31-percent national average).
- 32 percent used the personal savings of the owner(s) (lower than the 35-percent national average)

Micro business financing trends mirror the overall trends in SME financing: both categories tend to use informal and formal types of financing to similar degrees. As discussed in *SME*

Marketplace, this may reflect the fact that micro-businesses include an array of firms from all industry sectors; no particular sector affects the overall financial structure of these firms.

The debt structure of micro-businesses is also similar to the overall average for all business sizes. Twenty-nine percent of the debt owed by micro-businesses was held by chartered banks (similar to the national average). Twenty-three percent of their debt was owed to other individuals (including friends, relatives, angels, etc.) — higher than the 18-percent national average. Micro businesses also tended to fall within the mandate of credit unions and caisses populaires. Consistent with the client profile of these suppliers as providers of smaller amounts of capital to personal and smaller business clients, micro-businesses owed 8 percent of their debt to credit unions or caisses populaires, which accounted for the highest proportion of debt owed to these suppliers of any size category.[46]

SME Ownership Capital in 2000

In 2000 there was:

- $95 000 in average owner's equity in micro businesses
- 88 percent was owned by the business owner/operator (above the 86-percent national average)
- 6 percent was owned by friends or relatives of the owner(s) (highest of all size categories; compared with the 4-percent national average)
- 2 percent was owned by the parent company

4.3 Medium-Sized Firms (Firms with 100 to 499 Employees)

Characteristics of an average medium-sized firm in 2000:

- Share of Business Population: 0.3 percent of the 1.4 million SMEs
- Years in Business: 88 percent of medium-sized firms were older than five years
- Fixed Assets: averaged $5 753 000
- Debt Outstanding: averaged $6 870 000
- Profitability: averaged $1 151 500 net income before taxes
- Total Equity: averaged $4 511 500
- Long-Term Debt-To-Equity Ratio: 0.69
- Demand for Financing: 35 percent of SMEs requested debt, 94 percent were approved

Formal versus informal types of financing

Formal Types of Financing in 2000

- 86 percent of established medium-sized firms used commercial loans and lines of credit (by far the highest of all business sizes, compared with the 49-percent national average)
- 56 percent used leasing (highest of all size categories, compared with the 16-percent national average)

46. For a more detailed discussion of the financing provided by credit unions and caisses populaires, see Part III.

- 46 percent used commercial credit cards (highest of all size categories, compared with the 26-percent national average).

Informal Types of Financing in 2000
- 75 percent of established medium-sized firms used trade credit from suppliers (highest of all business sizes, compared with the 39-percent national average).
- 51 percent used the business' retained earnings (compared with the 31-percent national average).
- 11 percent used the personal savings of the owner(s) (lowest of all size categories, compared with the 35-percent national average).

Medium-sized firms tend to use more formal debt than firms in other business size categories. The fact that these firms hold significant fixed assets (to provide collateral security), have high profit levels (to provide debt coverage) and moderate debt to equity ratios (indicating that they are not highly leveraged) means that these firms are likely to have easier access to formal forms of financing and are in a better position to finance their operations through the internal resources of the business (i.e. retained earnings). In fact, chartered banks were the leading suppliers of financing for medium-sized firms, accounting for 39 percent of the debt owed by these businesses. Loans and credit from credit unions or caisses populaires only accounted for 1 percent of the debt owed by medium-sized firms.

Another determinant of medium-sized firms' financial structure is the fact that 32 percent of these businesses operate in the manufacturing sector. As discussed in Section 3.1.2 of this part of the report, manufacturing firms have a comparatively balanced financial structure in terms of debt (e.g. commercial debt, trade credit, leasing) and equity (e.g. retained earnings, informal investment), and medium-sized firms and manufacturing firms share similar ownership structures. Further data and analysis will be required to determine whether the financial, debt and ownership structures of mid-sized firms are related to sector of operation in this size class or if other factors determine their in access to financing.

SME Ownership Capital in 2000

In 2000, there was:

- $2 million in average owners' equity in medium-sized firms
- 64 percent was owned by the business owner/operator (far below the 86-percent national average)
- 5 percent was owned by private foreign and domestic investors (angels) (higher than the 1-percent national average)
- 4 percent was owned by the parent company
- 4 percent was owned by friends or relatives of the owner(s)

5. WOMEN ENTREPRENEURS

Characteristics of an average woman-owned SME in 2000:

- Share of Business Population: 15 percent of the 1.4 million SMEs
- Years in Business: 72 percent of women-owned SMEs were older than five years (compared with 77 percent for men-owned SMEs)
- Fixed Assets: averaged $152 000 (compared with $337 000 for men-owned SMEs)
- Total Debt Outstanding: averaged $152 000 (compared with $351 500 for men-owned SMEs)
- Profitability: averaged $34 000 net income before taxes (compared with $65 000 for men-owned SMEs) (see insert)
- Total Equity: averaged $117 000 (compared with $235 500 for men-owned SMEs)
- Long-Term Debt-To-Equity Ratio: 0.80 (compared with 0.77 for men-owned SMEs)
- Demand for Financing: 17 percent of women-owned SMEs requested debt, 82 percent were approved (compared with 23-percent request for debt and 80-percent approval for men-owned SMEs)

The financing structure of Canadian SMEs has thus far been examined by stage of business development, industrial sector and size of business. These characteristics exert a strong influence on SMEs' financing structure. This section examines the financial structure of SMEs by gender of ownership.[47]

Over the last decade, research has explored the existence of gender discrimination in access to financing, with mixed findings.[48] Generally, difficulties in access to financing are related to size, sector and age of the business, rather than to the gender of the owner.[49]

Formal versus informal types of financing

Formal Types of Financing in 2000

- 42 percent of women-owned SMEs used commercial loans and lines of credit (compared with 50 percent among SMEs owned by men)
- 23 percent used commercial credit cards (compared with 27 percent)
- 3 percent used government loans or grants (compared with 6 percent)

47. Women entrepreneurs, or women-owned SMEs, are defined in this section as those businesses with female majority ownership – over 51 percent. Shown in the insert, these majority women-owned SMEs represented 15 percent of Canada's SME population in 2000. When all other degrees of ownership (i.e. minority ownership, partnership, etc.) are factored in, however, 45 percent of Canada's SME population have at least one female owner.

48. Allan Riding, *Financing Entrepreneurial Firms: Legal and Regulatory Issues* (1998). Research Paper prepared for the Task Force on the Future of the Canadian Financial Services Sector, page 27 (*Gender and SME Lending).*

49. Industry Canada, *Small and Medium-sized Enterprise (SME) Financing in Canada, 2002.*

Informal Types of Financing in 2000

- 35 percent used the personal credit cards of the owner(s) (compared with 32 percent)
- 30 percent used trade credit from suppliers (compared with 41 percent)

Key findings for women entrepreneurs

- Women entrepreneurs relied less on formal financing than men entrepreneurs (42 percent of women used commercial debt versus 50 percent of men)
- Informal financial instruments were more popular among women-owned SMEs (40 percent of women used their personal savings versus 34 percent of men; 35 percent of women used personal credit cards versus 32 percent for men)
- Most of the equity in women-owned SMEs was held by the business owner/operator (90 percent), compared with 85 percent of male-owned SMEs
- Sector, business size, age and firm performance are stronger indicators of access to financing than the gender of the owner

Figure 27 shows the distribution of financial instruments by the gender of the SME's majority owner in 2000. Women entrepreneurs had slightly higher usage rates of informal financing instruments (e.g. owner's personal savings, personal credit cards, etc.), whereas SMEs owned by men tended to use more formal types of financing (e.g. commercial loans and lines of credit, trade credit from suppliers, etc.). However, women- and men-owned SMEs had similar rates of debt owed to suppliers of formal debt (see Figure 28), 31 percent to chartered banks (compared with 30 percent of debt owed by men), and 6 percent to credit unions/caisses populaires (compared with 5 percent).

Women-owned SMEs' high use informal types of financing is linked to several factors.

***Sectors and business size*:**

- Women entrepreneurs are concentrated in the professional services and wholesale/retail sectors (23 percent and 19 percent of SMEs in these sectors).[50] These sectors, particularly wholesale/ retail, tend to have higher than average use of the personal savings of the owner(s) (see Figure 23). The fact that women are more concentrated in service sectors may also mean that their businesses have fewer assets to pledge as security for formal debt
- More than 87 percent of women-owned SMEs are micro businesses, compared with only 80 percent of male-owned SMEs.[51] As discussed, the use of informal types of financing is positively correlated with smaller business sizes and service sectors firms

***Firm performance*:** In 2000, majority women-owned SMEs averaged, across all sectors and sizes, annual net incomes of $33 834, compared with $64 809 for men. After sector is taken into account, nearly a 50 percent income gap in gender remains, and this gap is particularly acute in the professional services and manufacturing sectors (see Table 16). Women-owned firms also tended to be more highly leveraged than SMEs owned by men (0.80 debt-to-equity ratio for

50. Industry Canada, *Small and Medium-sized Enterprise (SME) Financing in Canada, 2002.*

51. The Research Institute for SMEs, Université du Québec à Trois-Rivières (2002) *Financing SMEs: Satisfaction, Access, Knowledge and Needs, 2001*, a report prepared for Industry Canada, annex C.

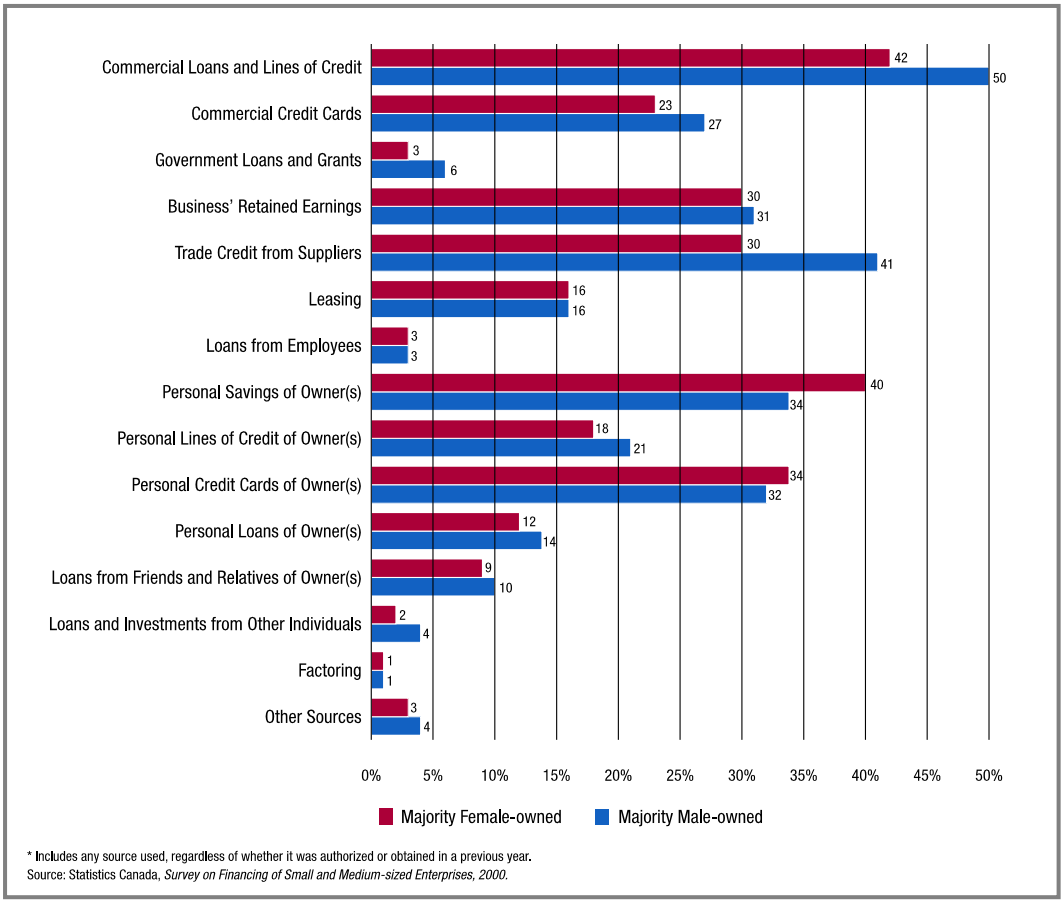
women-owned SMEs, compared to 0.77 for men). Lower net income levels combined with more leveraged equity in the business may impair access to formal types of financing.

***Age of business and stage of development*:** Twenty-eight percent of women-owned SMEs were established within the last five years. For many newer firms, formal types of financing may not be the most appropriate financing strategy to grow and develop the business. As will be discussed in Part IV, personal financing (e.g. savings or love money) or other forms of early-stage equity financing are often more suitable to start-up firms.

From one observation it is not possible to discern which of these factors (or others) influence the financial structure of firms owned by women, or if these findings indicate a gap in the formal financing market for women. However, these findings are consistent with those from *SME Financing in Canada, 2002* — factors other than the gender of the business owner appear to be the strongest determinants of access to financing.[52]

Figure 27

Types of Financial Instruments in Use by SMEs in 2000, by Gender of Owner*



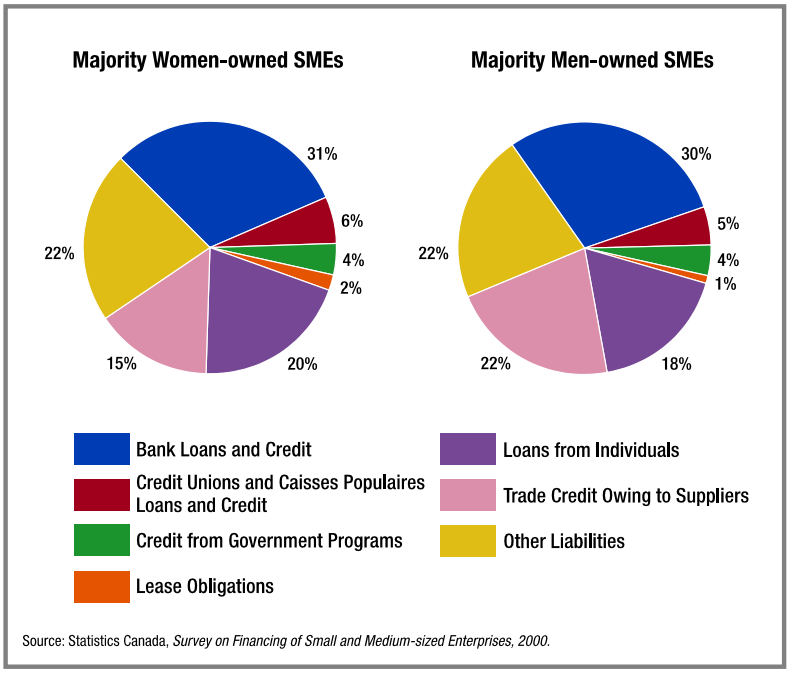
* Includes any source used, regardless of whether it was authorized or obtained in a previous year.
Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000.*

52. Industry Canada, *Small and Medium-sized Enterprise (SME) Financing in Canada, 2002.*

SME Ownership Capital in 2000

- $58 000 in average owner's equity in women-owned SMEs (compared with $142 000 among SMEs owned by men)
- 90 percent was owned by the business owner/operator (compared with 85 percent owned by men)
- 6 percent was owned by friends or relatives of the owner(s) (compared with 3 percent owned by men)

Figure 28
Average Distribution (%) of SME Debt Outstanding in 2000, by Supplier and Gender of Owner



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

Women operate smaller and younger businesses, and the capital structure of these firms reflects the size, sector and age of their businesses. For example, a similar ownership structure was found in wholesale/retail SMEs, in which many women concentrate, in Section 3.2.2 of Part II. Less reliance on equity sources likely contributed to the higher long-term debt-to-equity ratio found among women-owned SMEs (0.80), compared with men-owned firms (0.77).

6. YOUNG ENTREPRENEURS

This section examines SMEs' financial structure by the age of the business owner by adopting a similar comparison as was used in the previous section on women entrepreneurs. This section considers the unique characteristics of the financial structure of youth-owned SMEs compared with that of more mature business owners.[53]

53. In this section, young entrepreneurs refers to SME owners under 35 with over 51 percent ownership in the firm (majority owners). For comparative purposes, the financial structure of young entrepreneurs is contrasted against SMEs that are majority owned by individuals between the ages of 45 and 64. For a complete listing of data by these, and other age categories, see tables 11, 12 and 14.

The Challenge of Access to Financing for Young Entrepreneurs

While young entrepreneurs face similar challenges to any business owner, these hurdles are exacerbated by inexperience, lack of credit history and insufficient assets to pledge as security for financing.

Several factors complicate these firms' access to financing: (1) young entrepreneurs are more concentrated in higher-risk, knowledge-based industries; (2) their firms are newer and less established, and; (3) their businesses are typically small.[54]

Key Findings for Young Entrepreneurs in 2000:

- Young entrepreneurs had higher capital needs than other age groups (37-percent debt request rate versus 23 percent for all ages)
- Their financial structure reflects the high use of *both* formal instruments (53 percent of youth used commercial debt, 23 percent used leasing), and informal instruments (44 percent used personal savings of the owner(s), 42 percent used personal credit cards of the owner(s))
- 94 percent of the equity in youth-owned SMEs was held by the business owner/operator

Characteristics of an average youth-owned SME in 2000:

- Share of Business Population: 9 percent of 1.4 million SMEs
- Years in Business: 43 percent of youth-owned SMEs were older than five years (compared with the 75-percent national average)
- Fixed Assets: averaged $203 500 (compared with the $291 000 national average)
- Total Debt Outstanding: averaged $220 000 compared with the $294 000 national average)
- Profitability: averaged $26 500 net income before taxes (compared with the $54 000 national average)
- Total Equity: averaged $133 500 (compared with the $209 000 national average)
- Long-term Debt-To-Equity Ratio: 0.91 (compared with the 0.75 national average)
- Demand for Financing: 37 percent of youth-owned SMEs requested debt, 78 percent were approved (compared with 23-percent request and 82-percent approval for SMEs overall)

Formal versus informal types of financing

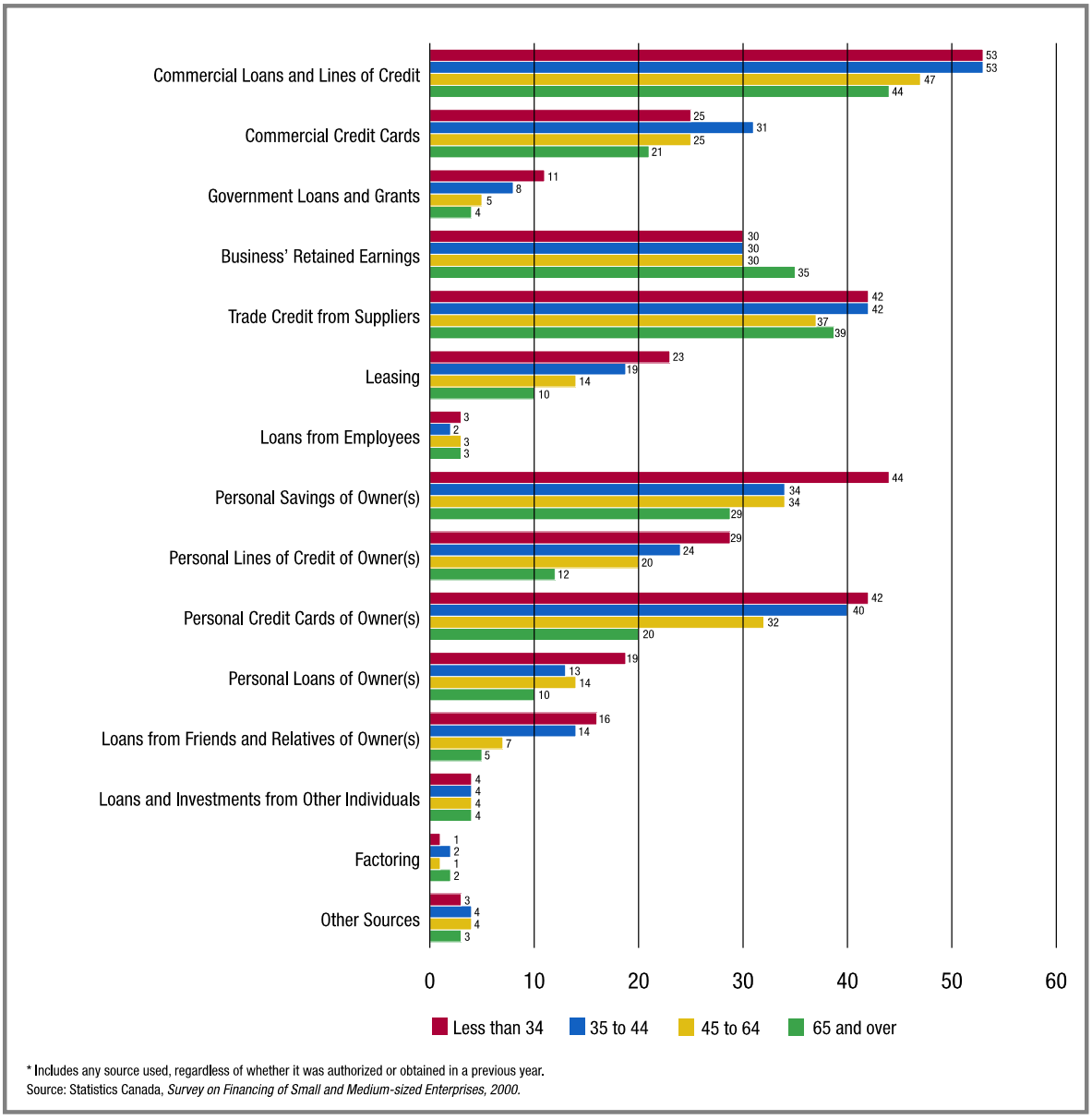
Formal Types of Financing in 2000

- 53 percent of youth-owned SMEs used commercial loans and lines of credit (compared with 47 percent among owners aged 45–64)
- 23 percent used leasing (compared with 14 percent)
- 11 percent used government loans or grants (compared with 5 percent)

54. A complete profile of youth-owned SMEs is available in Industry Canada (2002) *SME Financing in Canada, 2002.* A report presented to the House of Commons Standing Committee on Industry, Science and Technology as part of the SME Financing Data Initiative.

Figure 29

Types of Financial Instruments in Use by SMEs in 2000, by Age of Owner*



* Includes any source used, regardless of whether it was authorized or obtained in a previous year.
Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000.*

Informal Types of Financing in 2000

- 44 percent of youth-owned SMEs used the personal savings of the owner(s) (highest of all age groups compared with 34 percent for owners aged 45–64)
- 42 percent used the personal credit cards of the owner(s) (highest of all age groups compared with 32 percent)
- 19 percent used personal loans of the owner(s) (highest of all age groups compared with 14 percent)
- 16 percent used loans from friends and relatives of the owner(s) (highest of all age groups compared with 7 percent)

Figure 29 shows the distribution of financial instruments used by SMEs by the age of the majority owner. Focussing on two age categories for comparative purposes, under age 35 and aged 45–64, reveals much higher use of all types of financing among the younger age cohort. Differences among age groups are particularly evident in the use of informal instruments: younger entrepreneurs relied more on personal savings, personal loans or credit cards, or financing from friends and relatives. This was also apparent in the large percentage of debt owed to private individuals (i.e. friends, relatives and private investors), which accounted for 22 percent of all debt owed by youth in 2000, the highest proportion of all age groups.

Younger entrepreneurs' high use informal types of financing is related to:

- ***Fewer fixed assets to pledge as debt security*:** Younger entrepreneurs have yet to acquire the asset base of mature entrepreneurs. Youth-owned SMEs averaged $203 500 in fixed assets in 2000, the lowest of all age categories, which may be related to the concentration of youth-owned businesses in service sectors. Younger entrepreneurs are most concentrated in the knowledge-based industries, which represents 13 percent of SMEs in this sector. Firms in this sector had the lowest request and approval rates for debt regardless of the business owner's age
- ***Appropriateness Financing Tools*:** The majority of youth-owned SMEs (57 percent) were established within the last five years. Fifteen percent of youth-owned SMEs were considered start-ups in 2000.[55] For many newer firms, formal types of financing may not be appropriate to grow and develop the business. As discussed in Part IV, types of personal financing (e.g. savings or love money) or other forms of early-stage equity financing are often more suitable to start-up firms
- ***Firm performance*:** Lower profitability combined with more leveraged equity may impair younger entrepreneurs' access to formal types of debt
  - Average net income for youth was $26 500 in 2000 — an income gap of approximately 50 percent between youth and the second-lowest income group, the 45–64-year-old cohort.
  - In 2000, 26 percent of the $24.5 billion of debt owed by youth consisted of bank loans or credit. Measuring financial leverage reveals a 0.91 debt-to-equity ratio among younger entrepreneurs, the highest of all age groups. Since younger entrepreneurs are the most highly leveraged age category, it follows that they have lower than average approval rates for formal debt

From one observation it is impossible to determine which of these factors (or others) influence the financial structure of firms owned by young entrepreneurs, or if these findings indicate a gap in the formal financing market for youth. More data will be required to gauge the impact of economic and industry conditions and to conclude what factors determine financial structure.

SME Ownership Capital in 2000

- $78 000 in average owner's equity in youth-owned SMEs (compared with $123 000 among owners aged 45–64)

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55. The Research Institute for SMEs, Université du Québec à Trois-Rivières (2002) *Financing SMEs: Satisfaction, Access, Knowledge and Needs, 2001*. A report prepared for Industry Canada.

- 94 percent was owned by the business owner/operator (highest of all age groupings, compared with 86 percent)
- 3 percent was owned by friends or relatives of the owner(s) (compared with 3 percent)

Youth-owned SMEs retained the highest equity ownership by the business owner/operator of any age cohort. This suggests that selling equity shares in the business to obtain capital was not a popular financing strategy among younger entrepreneurs. This tendency emerged despite the fact that KBI firms (in which many youth are concentrated), as well as firms with low assets and profitability, are prime candidates for this means of financing. Nonetheless, youth are more willing than other age groups to give up ownership of their firms to finance expansion or growth (71 percent of younger entrepreneurs indicated that they were prepared to share control of their business).[56] This suggests a possible gap in the early-stage equity financing market for younger entrepreneurs; however, more data and analysis are required to determine the presence and significance of market gaps.

7. HIGH-GROWTH SMES (GSMES)

Characteristics of an average GSME in 2000:
- Share of Businesses: 12 percent of the 1.4 million SMEs
- Total Equity: averaged $254 500
- Demand for Financing: 31 percent of GSMEs requested debt; 80 percent were approved
- Prominent Sectors: 17 percent of manufacturing SMEs, followed by 16 percent of KBI firms
- Business Size: 22 percent of medium-sized businesses (100–499 employees)
- Regional Presence: consistent across Canada, ranging from 11 percent of SMEs in Quebec to 13 percent in Alberta

A small subset of SMEs contribute disproportionately to Canada's economic growth — high-growth SMEs (GSMEs).[57] A common characteristic of these firms is their ability to sustain above-average growth rates over long periods. GSMEs are not only responsible for a significant proportion of new job creation, they are also major contributors to innovation.

Formal versus informal types of financing

Formal Types of Financing in 2000
- 50 percent of GSMEs used commercial loans and lines of credit (similar to the 49-percent national average)
- 32 percent used commercial credit cards (compared with the 26-percent national average)
- 20 percent used leasing (higher than the 16-percent national average)

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56. The Research Institute for SMEs, Université du Québec à Trois-Rivières (2002) *Financing SMEs: Satisfaction, Access, Knowledge and Needs, 2001*. A report prepared for Industry Canada.

57. GSMEs (also known as gazelles) are defined in this analysis as having cumulative annual growth rates in sales of 50 percent or more over a three-year period, from 1997 to 2000.

Informal Types of Financing in 2000

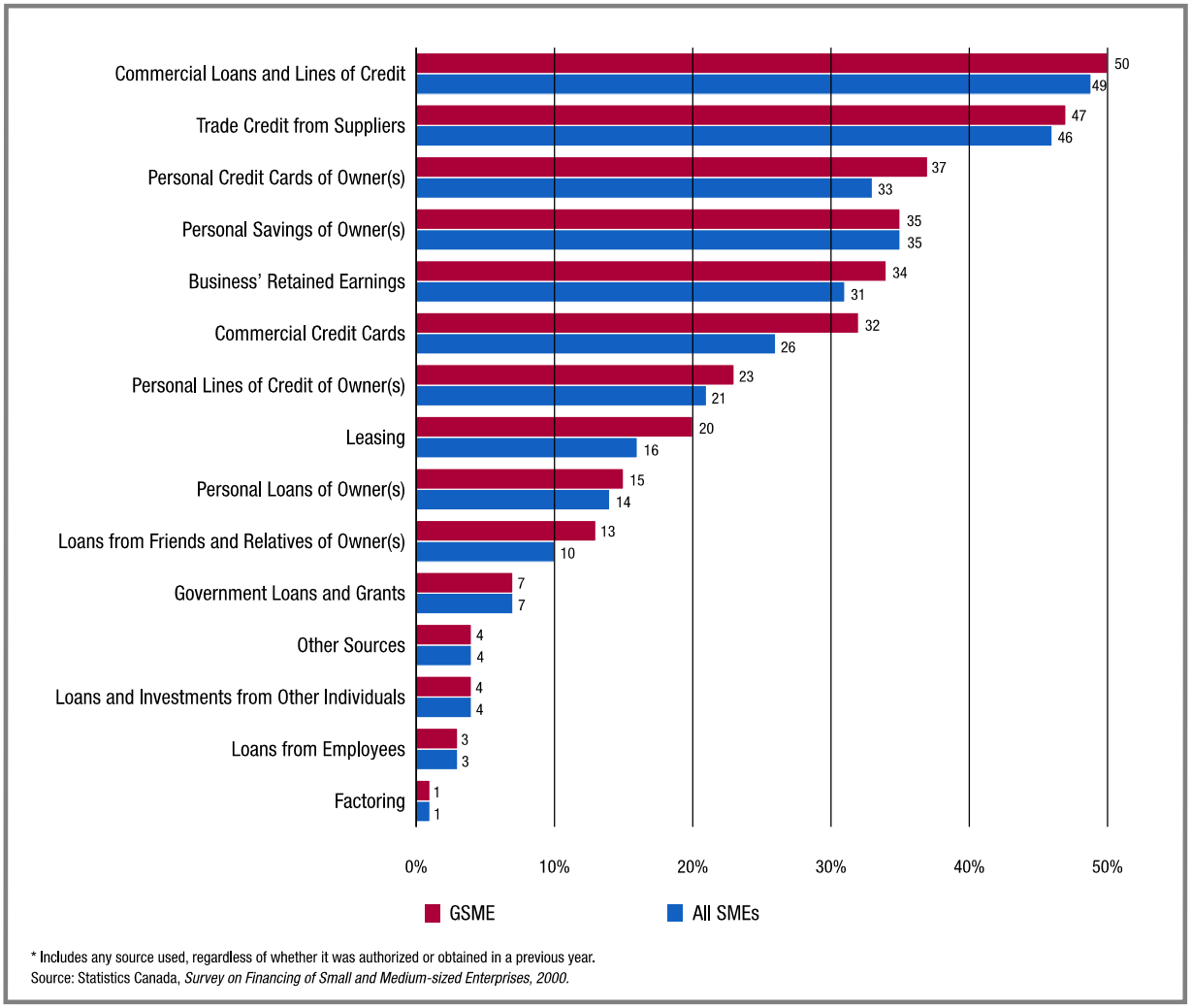
- 47 percent of GSMEs used trade credit to suppliers (higher than the 39-percent national average)
- 37 percent used the personal credit cards of the owner(s) (higher than the 33-percent national average)
- 35 percent used the personal savings of the owner(s) (similar to the national average).
- 13 percent used loans from friends and relatives of the owner(s) (compared with the 10-percent national average)

Figure 30 shows that GSMEs, compared with all SMEs, have either equal or higher rates of use of both formal and informal types of financing. However, as discussed below, use of formal and informal debt does not come at the expense of financing through ownership capital. GSMEs have an equally high use of risk capital, which is likely related to GSMEs' sector of operation and high-growth potential.

Key Findings for High-Growth SMEs (GSMEs) in 2000:

- GSMEs' financial structures reflected the high use of formal instruments (50 percent of GSMEs used commercial debt, 20 percent used leasing) and informal instruments (46 percent used trade credit, 35 percent used personal savings)
- GSMEs used more risk capital than other SMEs - two times the angel investment and six times the VC investment
- Sectors include:
  - 17 percent of manufacturing firms were high-growth (high use of commercial debt and trade credit)
  - 16 percent of KBI firms were high-growth (high use of retained earnings,

Figure 30
Types of Financial Instruments in Use by GSMEs in 2000*

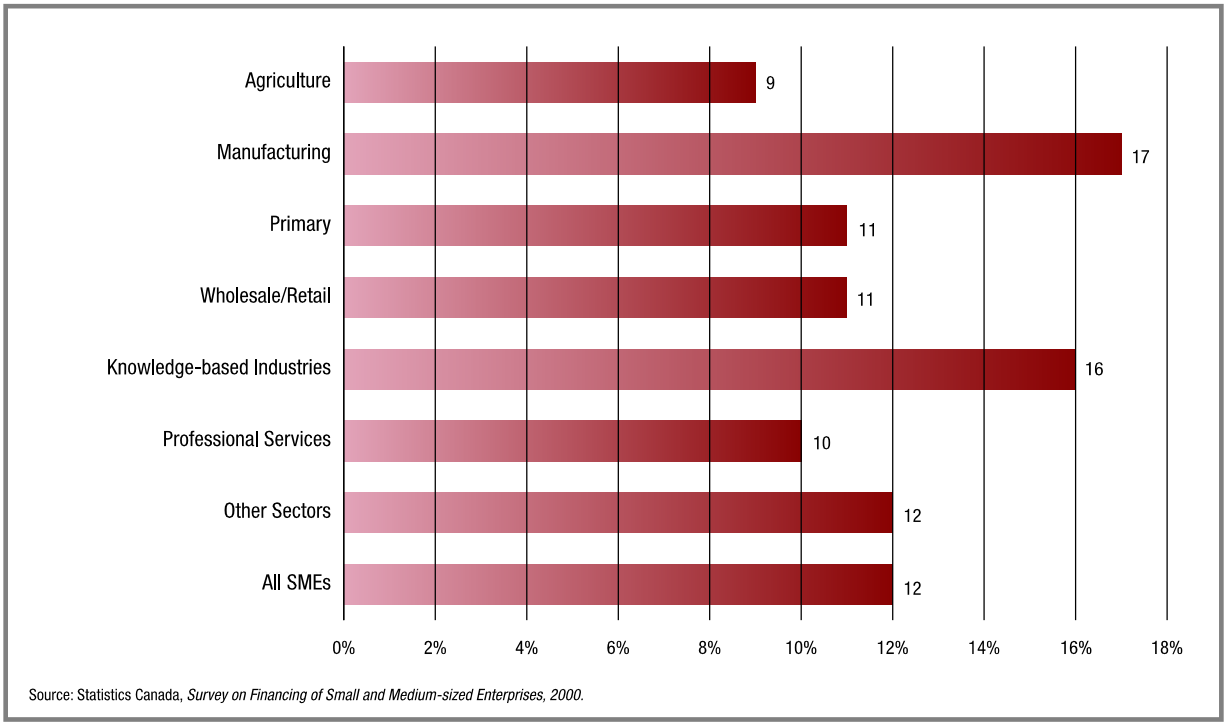


* Includes any source used, regardless of whether it was authorized or obtained in a previous year.
Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2000.*

Sectoral Influence on the Financial Structure of GSMEs

Knowledge-based industries accounted for 16 percent of firms in this sector, compared with 12 percent of SMEs overall. As discussed in Section 3.2.1 of this part, KBI SMEs were among the least debt-intensive of all sectors in 2000, and tended to rely on the internal resources of the business (i.e. retained earnings) or external equity financing.

Figure 31
Sectoral Distribution of GSMEs, 2000



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

High-growth firms do not operate exclusively in high technology sectors. As seen in Figure 31, 17 percent of GSMEs operate in the manufacturing sector. This is consistent with the findings of an Ontario Ministry of Economic Development and Trade study[58] of Ontario's high-growth firms. This study found that GSMEs' financial structure reflects the fact that a significant portion of these firms operate in manufacturing sectors. Discussed in Section 3.1.2 of this part, manufacturing SMEs were among the highest users of both formal and informal debt, and had a particular preference for flexible financial instruments such as commercial credit cards and leasing, both of which are prevalent in GSMEs' capital mix.

GSME Ownership Capital in 2000

- $120 500 in average owner's equity in GSMEs
- 57 percent was owned by the business owner/operator (below the 86 percent for all SMEs)
- 5 percent was owned by foreign and domestic venture capitalists (higher than the 0.3 percent for all SMEs)
- 4 percent was owned by foreign and domestic private investors (compared with the 1 percent for all SMEs)

Beyond formal and informal debt, GSMEs use more external equity than other SMEs. This difference is most evident in the ownership held by the business owner/operator. Whereas

58. Ministry of Economic Development and Trade (1999) *The Universe of Ontario's Leading Growth Firms*, Government of Ontario.

86 percent Canadian businesses' equity was owned directly by the business owners, this proportion was 72 percent for GSMEs, indicating a much higher propensity to accept equity. In fact, angels and venture capitalists invested nearly $2 billion in GSMEs in 2000 — twice the amount of informal (angel) investment and six times the amount of venture capital than was invested in SMEs overall.

Other Statistics Canada studies on innovative and small firms in Canada have found that many smaller firms in knowledge-intensive environments (home to many GSMEs) rely on risk capital and retained earnings rather than debt financing. One of these studies suggests that debt-intensive capital structures constrain growth opportunities and R&D, whereas equity offers more flexibility and investment support.[59]

These data begin to build a picture of GSMEs' contributions to the economy and touch on whether market imperfections (gaps) impair GSMEs' access to appropriate types and levels of financing.[60] Of particular concern, in light of the findings regarding initial public offerings of company stock discussed in Part IV, is the presence of risk capital providers with access to sufficiently large pools of investment capital to support the expansion of GSMEs over the longer term. Timely access to risk capital can be a critical factor in determining whether a firm optimizes its full market potential and develops products in a rapidly changing environment, fails, or is sold and its Canadian operation wound down. Continued monitoring is required to ensure that such gaps do not impede these firms' growth prospects, especially in light of their disproportionate contribution to the Canadian economy.

59. John Baldwin, Guy Gellatly and Valérie Gaudreault (2002) *Financing Innovation in New Small Firms: New Evidence from Canada*, a report prepared by the Micro-Economic Analysis Division of Statistics Canada.

60. Industry Canada has also undertaken a separate major study on GSMEs, covering a 15-year period (1985–1999), that is expected to provide revealing complementary results. These results are expected to be available later in 2003.

8. FINANCIAL STRUCTURE OF CANADIAN SMEs: STATISTICAL TABLES

Table 10 — Percentage of SMEs Using Financing During Business Start-Up, by Instrument Type*

	Commercial loans and lines of credit	Commercial credit cards	Government loans and grants	Trade credit from suppliers	Leasing	Loans from employees	Personal savings of owner(s)	Personal lines of credit of owner(s)	Personal credit cards of owner(s)	Personal loans of owner(s)	Loans from friends or relatives	Loans and investment from individuals	Other sources of financing
	Percentage												
All Small and Medium-sized Enterprises													
	28.95	7.8	5	18	12	2.671	66	22.55	32.385	18.78	11.57	0.46382	4.7372
All Businesses by Size (Number of Employees)													
0	21.3	6.2	3.6	12	11	3.234	64	20.76	30.73	15.69	8.011	0.26762	4.4938
1 to 4	32.25	8	6.4	18	11	2.119	69	23.96	35.452	19.78	15.2	0.64964	2.6707
5 to 19	41.95	12	4.5	34	16	x	66	24.64	30.052	23.82	11.07	0.5	9.3345
20 to 99	44.97	13	7.2	40	22	1.574	66	19.75	17.896	32.41	12.05	1.01159	25.944
100 to 499	71.03	x	11	50	41	0	37	x	x	x	x	1.40839	x
Sector													
Agriculture	61.92	x	27	x	20	x	76	40.75	28.319	35.51	25.57	0.0106	x
Knowledge-based Industries	8.171	5	6	7.4	6.7	1.741	65	16.08	33.007	11.79	7.414	1.67147	2.3206
Manufacturing	40.28	8.5	6.8	30	17	0.943	68	20.78	32.757	21.85	11.94	0.40043	6.1581
Primary	42.03	8.4	7.6	15	10	0.565	57	24.69	23.161	25.62	12.13	0.82805	5.3136
Professional Services	10.97	4.8	1.8	6.9	9.2	3.495	65	21.56	33.12	12.16	4.397	0.45345	5.3395
Wholesale and Retail	34.49	9.7	2.1	24	16	x	61	21.23	26.797	22.21	20.86	0.7	5.5252
Other Sectors	34.09	9.2	4.5	22	12	4.132	68	23.37	34.784	19.57	10.62	0.38431	4.5909

Continued . . .

Table 10 — Percentage of SMEs Using Financing During Business Start-Up, by Instrument Type*

	Commercial loans and lines of credit	Commercial credit cards	Government loans and grants	Trade credit from suppliers	Leasing	Loans from employees	Personal savings of owner(s)	Personal lines of credit of owner(s)	Personal credit cards of owner(s)	Personal loans of owner(s)	Loans from friends or relatives	Loans and investment from individuals	Other sources of financing
	Percentage												
Region													
CANADA	28.95	7.8	5	18	12	2.671	66	22.55	32.385	18.78	11.57	0.46382	4.7372
Atlantic	36.45	9.3	8.1	20	13	x	59	28.95	30.058	19.73	10.93	0.7	3.4889
Quebec	34.31	6	9	19	8.7	1.59	68	21.83	30.999	21.29	10.82	0.72951	4.9585
Ontario	25.64	11	3	16	10	2.872	65	19.69	29.928	11.14	9.904	0.36897	5.0238
Manitoba, Saskatchewan and Nunavut	44.99	5.2	x	9.1	19	x	68	37	21.383	34.38	19.5	x	2.0512
Alberta and Northwest Territories	25.21	5	x	24	18	4.962	72	26.22	44.262	23.87	12.01	0.5	5.461
British Columbia and Yukon	23.06	7.2	3.2	17	14	x	65	18.31	34.158	21.3	13.06	x	4.6
Year Business Began Operations													
1999–2000	29.0	9.0	6.0	19.0	12.0	5.0	62.0	19.0	34.0	21.0	14.0	3.0	6.0
1997–1998	26.0	6.0	4.0	16.0	11.0	1.0	68.0	23.0	29.0	17.0	10.0	1.0	4.0
Female Ownership													
Male/Female Partnership	30.8	8.5	9.5	15	10	3.6	68	21.9	33.6	23.4	12.1	0.2	3.7
Majority Female-Owned	24.7	4.9	4.3	13	7.4	2.3	63	24.5	31.3	18.6	14.1	0.7	1.8
Majority Male-Owned	29.5	8.4	3.8	20	14	2.5	67	22.2	32.3	17.4	10.7	0.5	5.8

Continued . . .

Table 10 — Percentage of SMEs Using Financing During Business Start-Up, by Instrument Type*

	Commercial loans and lines of credit	Commercial credit cards	Government loans and grants	Trade credit from suppliers	Leasing	Loans from employees	Personal savings of owner(s)	Personal lines of credit of owner(s)	Personal credit cards of owner(s)	Personal loans of owner(s)	Loans from friends or relatives	Loans and investment from individuals	Other sources of financing
	Percentage												
Majority Age of Owner													
Less than 34	31.7	8.7	6.7	15	9	x	70	20.4	31.2	15.9	15	0.5	2.8
35 to 44	34.5	11	5.2	19	16	3.2	66	27.4	38.3	18.8	13.5	0.7	4.5
45 to 64	21.7	4.9	4.1	18	11	3.1	65	19.7	28.5	20.5	8.6	0.4	6.2
65 and over	32.2	x	x	13	x	x	57	12	14.6	15.3	x	0	2.3
Exporter and Non-exporter SMEs													
Exporter	16.1	8	6.8	25	17	0.3	78	31.8	43.9	22.3	22.7	1.2	9.2
Non-exporter	30.7	7.8	4.7	17	12	3	65	21.3	30.8	18.3	10.1	0.4	4.1
Urban	25.8	7.6	3.7	16	11	2.1	66	21.1	31.1	16	11.4	0.6	4.5
Rural	41.9	8.5	9.9	25	19	4.8	68	28.3	37.7	29.9	12.3	0	5.8
Visible Minority Ownership													
Visible Minority	21	8.5	2.7	16	11	0.7	57	19.7	25.6	24.1	15.2	0.5	x
Non-visible Minority	29.9	7.7	5.3	18	12	2.9	68	22.9	33.2	18.1	11.1	0.5	4.4

*Reported by SMEs operating in 2000, in relation to their financing experiences of starting up their businesses, at any time between 1996 and 2000.

Note: "x" refers to estimates suppressed to meet the confidentiality requirements of the *Statistics Act* and/or for data quality reasons.

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

Table 11 — Percentage of SMEs Using Financing in 2000, by Instrument Type*

	Commercial loans and lines of credit	Commercial credit cards	Government loans and grants	Business' retained earnings	Trade credit from suppliers	Leasing	Loans from employees	Personal savings of owner(s)	Personal lines of credit of owner(s)	Personal credit cards	Personal loans of owner(s)	Loans from friends or relatives	Loans and investment from individuals	Factoring
	Percentage													
All Small and Medium-sized Enterprises														
	48.7	26.4	6.5	30.9	39.0	15.8	2.5	34.6	21.1	33.3	13.7	9.6	3.7	1.2
All Businesses by Size (Number of Employees)														
0	39.1	19.8	7.0	25.0	26.3	9.3	1.9	36.0	22.2	35.2	12.3	8.9	3.9	0.9
1 to 4	51.1	28.2	5.4	34.0	44.3	16.2	3.5	35.1	20.5	33.9	14.2	9.9	2.8	1.3
5 to 19	66.8	37.9	7.0	35.9	57.9	28.1	1.8	33.2	21.5	30.1	17.1	10.9	5.1	1.6
20 to 99	70.4	43.3	8.7	53.1	67.0	40.3	3.8	19.0	11.5	19.3	14.0	9.2	4.6	2.4
100 to 499	78.9	48.7	13.8	52.0	78.1	44.4	2.7	12.7	6.1	11.8	6.7	5.1	3.5	1.2
Established Businesses by Size (Number of Employees)**														
0	34.0	20.0	4.0	25.0	25.0	9.0	2.0	36.0	23.0	37.0	12.0	6.0	3.0	1.0
1 to 4	50.0	29.0	4.0	34.0	43.0	16.0	4.0	32.0	22.0	36.0	14.0	9.0	2.0	1.0
5 to 19	66.0	41.0	7.0	41.0	57.0	28.0	2.0	33.0	22.0	32.0	18.0	8.0	3.0	2.0
20 to 99	69.0	44.0	7.0	57.0	66.0	36.0	4.0	17.0	9.0	18.0	13.0	8.0	4.0	2.0
100 to 499	86.0	46.0	10.0	51.0	75.0	56.0	3.0	11.0	5.0	10.0	8.0	3.0	2.0	1.0
Sector														
Agriculture	71.5	27.7	27.5	29.4	40.6	14.0	2.5	41.9	27.5	31.5	17.3	15.8	2.7	2.5
Knowledge-based Industries	20.7	20.4	5.0	37.4	22.1	13.4	2.8	30.4	17.7	34.3	9.6	6.6	2.7	1.1
Manufacturing	51.3	32.9	6.1	34.2	58.1	24.5	1.8	33.8	21.4	34.6	18.4	10.4	3.1	0.8
Primary	50.4	21.1	6.8	32.0	36.5	13.6	2.1	34.9	16.5	31.1	13.2	4.9	3.1	1.0
Professional Services	35.2	23.2	2.5	34.3	27.8	16.5	4.1	34.1	23.0	39.5	12.0	5.3	1.7	1.2
Wholesale and Retail	51.8	28.9	3.9	30.2	52.0	18.8	2.5	34.9	22.1	33.0	17.1	13.0	5.4	1.9
Other Sectors	47.1	26.0	2.9	29.8	36.5	14.4	2.3	33.0	19.1	32.4	11.9	8.2	4.1	0.6

Continued . . .

Table 11 — Percentage of SMEs Using Financing in 2000, by Instrument Type*

	Commercial loans and lines of credit	Commercial credit cards	Government loans and grants	Business' retained earnings	Trade credit from suppliers	Leasing	Loans from employees	Personal savings of owner(s)	Personal lines of credit of owner(s)	Personal credit cards	Personal loans of owner(s)	Loans from friends or relatives	Loans and investment from individuals	Factoring
Region														
CANADA	48.7	26.4	6.5	30.9	39.0	15.8	2.5	34.6	21.1	33.3	13.7	9.6	3.7	1.2
Atlantic	53.5	24.0	8.0	31.2	46.4	17.3	1.4	35.2	24.6	35.8	13.7	7.4	3.7	1.7
Quebec	51.3	27.3	7.9	21.7	36.7	10.7	1.7	27.9	12.0	26.8	15.4	10.2	2.7	0.6
Ontario	43.5	27.0	3.6	32.6	37.3	16.9	3.3	35.8	22.3	33.1	11.6	9.6	4.4	0.9
Manitoba, Saskatchewan and Nunavut	61.3	27.9	14.1	33.9	45.1	20.2	2.9	37.1	28.4	34.9	18.6	11.2	3.2	1.3
Alberta and Northwest Territories	51.2	28.0	8.7	36.7	42.7	17.5	2.5	35.7	24.0	40.5	14.0	8.5	2.8	2.1
British Columbia and Yukon	45.5	21.8	3.9	34.1	36.4	16.0	2.4	39.2	23.5	35.5	13.1	9.6	4.7	1.7
Year Business Began Operations														
1999–2000	37.0	23.0	5.0	33.0	41.0	21.0	4.0	48.0	21.0	39.0	18.0	17.0	5.0	1.0
1997–1998	41.0	21.0	2.0	29.0	31.0	15.0	2.0	40.0	25.0	37.0	13.0	12.0	2.0	2.0
1996 and prior	46.0	27.0	5.0	32.0	38.0	15.0	3.0	33.0	21.0	35.0	13.0	7.0	3.0	1.0
Gender of Owner														
Male/Female Partnership	50.4	27.3	10.8	32.1	38.9	15.6	2.3	32.2	24.5	35.5	13.9	9.3	2.6	1.3
Majority Male-Owned	49.8	26.9	6.0	30.8	41.2	15.7	2.5	34.0	20.7	32.4	14.0	9.9	4.4	1.1
Majority Female-Owned	41.9	22.9	3.2	30.0	29.6	16.4	2.9	40.1	18.4	34.6	12.3	8.6	2.3	1.4
Age of Owner														
Less than 34	52.9	24.6	11.4	30.3	42.4	22.6	2.6	44.3	28.8	41.6	18.7	16.3	4.1	0.7
35 to 44	53.0	31.4	8.7	30.9	42.3	18.9	2.0	34.2	43.5	39.3	13.3	14.1	3.5	1.5
45 to 64	46.8	25.1	5.2	30.2	36.8	14.3	2.6	34.4	20.4	31.6	14.1	7.2	3.6	1.0
High-Growth SMEs (GSMEs)														
GSMEs	50.0	32.0	7.0	34.0	46.0	20.0	3.0	35.0	23.0	37.0	15.0	13.0	4.0	1.0
All SMEs	48.7	26.4	6.5	30.9	39.0	15.8	2.5	34.6	21.1	33.3	13.7	9.6	3.7	1.2

Continued . . .

Table 11 — Percentage of SMEs Using Financing in 2000, by Instrument Type*

	Commercial loans and lines of credit	Commercial credit cards	Government loans and grants	Business' retained earnings	Trade credit from suppliers	Leasing	Loans from employees	Personal savings of owner(s)	Personal lines of credit of owner(s)	Personal credit cards	Personal loans of owner(s)	Loans from friends or relatives	Loans and investment from individuals	Factoring
	Percentage													
Exporter and Non-exporter SMEs														
Exporter	51.5	39.7	8.7	40.5	50.0	28.5	4.6	36.8	24.0	40.0	15.6	11.7	5.2	2.0
Non-exporter	48.4	24.8	6.2	29.8	37.7	14.3	2.3	34.3	20.7	32.5	13.5	9.3	3.5	1.1
Urban and Rural SMEs														
Urban	44.6	26.3	3.9	31.2	37.3	16.7	2.7	33.6	20.2	32.6	12.6	8.6	3.7	1.2
Rural	59.6	26.5	13.3	30.3	43.5	13.5	2.0	37.1	23.3	35.3	16.8	12.3	3.7	1.2
Visible Minority Ownership														
Visible Minority	48.0	23.7	4.5	30.8	39.7	16.2	2.1	40.1	24.0	25.4	16.9	10.2	3.5	3.0
Non-visible Minority	48.8	26.6	6.6	30.9	39.0	15.8	2.6	34.1	20.9	33.9	13.5	9.5	3.7	1.1

*Includes any source used, regardless of whether it was authorized or obtained in a previous year.

**Refers to businesses two years of age or older.

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

Table 12 — Distribution (%) of an Average SME's Debt Outstanding in 2000, by Supplier

	Loans from Chartered Banks	Loans from Credit Unions and Caisses Populaires	Credit card amounts outstanding	Credit from government programs	Lease obligations	Loans from individuals	Trade credit owing to suppliers	Other liabilities
	Percentage							
All Small and Medium-sized Enterprises								
	29.3	5	0.4	4.2	1.3	17.8	20.8	21.2
Size of Business (Number of Employees)								
0	31.7	7.1	0.4	5.2	0.6	21.2	8.4	25.4
1 to 4	28.5	7.7	0.5	5.1	1.4	22.7	16.4	17.7
5 to 19	27.9	3.6	0.5	3.3	1.3	16.1	26.6	20.8
20 to 99	24.7	2.0	0.1	2.8	2.2	12.4	36.6	19.4
100 to 499	38.8	1.1	0.0	4.4	2.7	9.9	24.5	18.5
Sector								
Agriculture	34.3	11.3	0.4	16.1	0.4	17.4	7.3	12.8
Knowledge-based Industries	13.7	1.7	x	x	3.5	23.7	23.0	30.3
Manufacturing	27.1	3.9	0.3	4.1	3.0	14.4	30.0	17.2
Primary	20.8	4.8	0.2	4.7	2.7	16.3	21.9	28.6
Professional Services	27.0	0.9	x	x	2.3	19.8	18.7	29.8
Wholesale and Retail	21.3	3.9	0.4	2.3	1.4	16.2	37.7	16.7
Other Sectors	32.9	4.5	0.4	2.0	1.0	18.7	16.5	24.1

Continued . . .

Table 12 — Distribution (%) of an Average SME's Debt Outstanding in 2000, by Supplier

	Loans from Chartered Banks	Loans from Credit Unions and Caisses Populaires	Credit card amounts outstanding	Credit from government programs	Lease obligations	Loans from individuals	Trade credit owing to suppliers	Other liabilities
Region								
Atlantic	27.3	2.2	0.5	12.0	1.9	10.6	22.1	23.4
Quebec	26.3	11.3	0.2	4.7	1.8	16.1	28.0	11.6
Ontario	31.4	2.7	0.3	1.7	1.0	17.0	19.7	26.0
Manitoba, Saskatchewan and Nunavut	36.6	11.6	0.5	9.5	1.2	13.4	14.8	12.4
Alberta and Northwest Territories	24.1	3.3	0.5	7.8	1.9	20.9	18.0	23.6
British Columbia and Yukon	27.1	2.6	0.4	1.8	1.1	26.2	20.7	20.1
Year Business Began Operations								
1999–2000	25	7	1	4	2	22	19	21
1997–1998	32	2	1	3	3	21	21	17
1996 and prior	26	4	x	3	1	19	22	24
Gender of Owner								
Male/Female Partnership	25.5	6.9	0.8	7.7	1.7	18.6	19.9	19
Majority Female-Owned	31	5.9	0.4	4.1	1.7	19.9	15.3	21.6
Majority Male-Owned	29.7	4.6	0.3	3.6	1.2	17.5	21.6	21.6
Age of Owner								
Less than 34	26	5.6	0.5	7.8	1.1	21.5	24.9	12.6
35 to 44	28.6	6.9	0.4	4.4	1.6	15.7	22.2	20.2
45 to 64	27.7	5.6	0.4	4.9	1.5	17.3	20.4	22.3
65 and over	34.5	1.4	0.1	1.2	0.9	20.4	19.2	22.2

Continued . . .

Table 12 — Distribution (%) of an Average SME's Debt Outstanding in 2000, by Supplier

	Loans from Chartered Banks	Loans from Credit Unions and Caisses Populaires	Credit card amounts outstanding	Credit from government programs	Lease obligations	Loans from individuals	Trade credit owing to suppliers	Other liabilities
Exporter and Non-exporter SMEs								
Exporter	24	2.6	0.2	3.6	2.1	14.6	31.1	21.7
Non-exporter	30.6	5.6	0.4	4.3	1.2	18.6	18.3	21.1
Urban and Rural SMEs								
Urban	29.5	3.2	0.4	2.7	1.4	17.1	22.6	23.2
Rural	28.2	11.5	0.4	9.6	1.2	20.3	14.6	14.1
Visible Minority Ownership								
Visible Minority	28.7	1.9	0.3	5.2	0.8	27.9	17.3	17.9
Non-visible Minority	29.3	5.2	0.4	4.1	1.4	17.1	21.1	21.5

Note: "x" refers to estimates suppressed to meet the confidentiality requirements of the *Statistics Act* and/or for data quality reasons.

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

Table 13 — Total Amount ($ millions) of SMEs' Total Debt Outstanding in 2000, by Supplier

	Loans from Chartered Banks	Loans from Credit Unions and Caisses Populaires	Credit card amounts outstanding	Credit from government programs	Lease obligations	Loans from individuals	Trade credit owing to suppliers	Other liabilities
	Millions of Dollars ($)							
All Small and Medium-sized Enterprises								
	122 818	20 937	1 500	17 530	5 653	74 739	87 519	89 102
Size of Business (Number of Employees)								
0	41 628	9 315	583	6 770	729	27 872	11 047	33 304
1 to 4	22 405	6 079	367	4 008	1 078	17 871	12 874	13 945
5 to 19	27 767	3 602	474	3 288	1 308	16 013	26 517	20 732
20 to 99	20 672	1 645	68	2 301	1 808	10 332	30 538	16 184
100 to 499	10 346	298	8	1 164	730	2 651	6 542	4 937
Sector								
Agriculture	19 208	6 351	202	9 016	213	9 745	4 110	7 193
Knowledge-based Industries	1 635	201	x	x	412	2 822	2 738	3 606
Manufacturing	11 031	1 589	113	1 676	1 208	5 871	12 193	7 001
Primary	2 125	490	16	481	272	1 668	2 238	2 914
Professional Services	6 649	225	x	x	574	4 874	4 611	7 323
Wholesale and Retail	16 161	2 966	278	1 754	1 064	12 272	28 613	12 690
Other Sectors	66 007	9 115	705	3 947	1 911	37 487	33 016	48 375
Region								
Atlantic	5 874	475	101	2 584	399	2 283	4 751	5 023
Quebec	19 758	8 474	179	3 506	1 343	12 080	21 049	8 687
Ontario	58 977	5 149	619	3 261	1 955	31 884	37 051	48 770
Manitoba, Saskatchewan and Nunavut	11 939	3 799	153	3 098	397	4 379	4 830	4 055
Alberta and Northwest Territories	13 063	1 781	263	4 215	1 014	11 344	9 747	12 804
British Columbia and Yukon	13 206	1 260	185	866	545	12 769	10 091	9 762

Continued . . .

Table 13 — Total Amount ($ millions) of SMEs' Total Debt Outstanding in 2000, by Supplier

	Loans from Chartered Banks	Loans from Credit Unions and Caisses Populaires	Credit card amounts outstanding	Credit from government programs	Lease obligations	Loans from individuals	Trade credit owing to suppliers	Other liabilities
	Millions of Dollars ($)							
Gender of Owner								
Male/Female Partnership	14 688	3 963	467	4 428	989	10 727	11 455	10 948
Majority Female-Owned	10 147	1 931	126	1 338	560	6 517	4 996	7 074
Majority Male-Owned	97 983	15 043	908	11 763	4 105	57 495	71 068	71 079
Age of Owner								
Less than 34	6 421	1 385	135	1 916	271	5 308	6 153	3 103
35 to 44	27 007	6 465	409	4 163	1 468	14 782	20 957	19 020
45 to 64	58 833	11 811	825	10 359	3 146	36 633	43 397	47 312
65 and over	30 557	1 276	131	1 092	768	18 015	17 012	19 666
Exporter and Non-exporter SMEs								
Exporter	24	2.6	0.2	3.6	2.1	14.6	31.1	21.7
Non-exporter	30.6	5.6	0.4	4.3	1.2	18.6	18.3	21.1
Urban and Rural SMEs								
Urban	29.5	3.2	0.4	2.7	1.4	17.1	22.6	23.2
Rural	28.2	11.5	0.4	9.6	1.2	20.3	14.6	14.1
Visible Minority Ownership								
Visible Minority	28.7	1.9	0.3	5.2	0.8	27.9	17.3	17.9
Non-visible Minority	29.3	5.2	0.4	4.1	1.4	17.1	21.1	21.5

Note: "x" refers to estimates suppressed to meet the confidentiality requirements of the *Statistics Act* and/or for data quality reasons.

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

Table 14 — Distribution (%) of an Average SME's Ownership Capital in 2000

	Business Owner/ Operator	Friends or Relatives	Parent Company	Private Domestic and Foreign Investors	Employees	Domestic and Foreign Venture Capital Funds	Other
				Percentage			
All Small and Medium-sized Enterprises							
	86.4	3.7	2.2	1.2	0.4	0.3	5.8
Size of Business Number of Employees)							
0	94.1	1.6	0.3	0.8	x	x	x
1 to 4	88.1	5.9	2.2	0.8	x	x	x
5 to 19	80.4	5.2	1.4	x	0.5	x	11.0
20 to 99	79.7	3.0	8.1	2.2	1.3	6.0	5.2
100 to 499	63.7	4.1	4.3	4.6	x	x	20.1
Sector							
Agriculture	93.7	2.6	x	x	x	x	x
Knowledge-based Industries	56.3	4.0	3.5	3.8	1.9	5.2	25.3
Manufacturing	71.4	4.9	7.7	3.5	0.7	x	x
Primary	60.1	3.5	0.4	1.8	x	x	34.1
Professional Services	86.6	2.2	x	0.3	0.8	x	x
Wholesale and Retail	91.9	4.2	1.7	x	x	x	x
Other Sectors	90.3	4.3	3.2	1.6	x	x	0.3
Region							
Atlantic	91.1	3.7	1.1	x	x	x	x
Quebec	89.5	1.9	4.0	1.2	0.2	0.7	2.5
Ontario	87.6	3.6	2.5	1.3	0.5	0.3	4.2
Manitoba, Saskatchewan and Nunavut	85.0	3.7	0.3	x	0.2	x	x
Alberta and Northwest Territories	82.7	4.1	0.8	1.2	x	x	11.0
British Columbia and Yukon	81.7	6.6	2.9	1.5	x	x	5.8

Continued . . .

Table 14 — Distribution (%) of an Average SME's Ownership Capital in 2000

	Business Owner/ Operator	Friends or Relatives	Parent Company	Private Domestic and Foreign Investors	Employees	Domestic and Foreign Venture Capital Funds	Other
Gender of Owner							
Male/Female Partnership	89.5	5.5	1	x	x	x	x
Majority Female-owned	90.2	6.4	x	x	0.6	x	x
Majority Male-owned	85.2	2.9	2.7	1.5	0.4	0.5	6.8
Age of Owner							
Less than 34	94.1	3.2	x	x	x	x	x
35 to 44	86.8	3.5	2	1.8	0.1	0.5	5.3
45 to 64	86.2	3.1	2.6	1	0.3	0.4	6.5
High-Growth SMEs (GSMEs)							
GSMEs	56.5	3.7	1.2	4.2	0.7	5.3	28.3
All SMEs	86.4	3.7	2.2	1.2	0.4	0.3	5.8
Exporter and Non-exporter SMEs							
Exporter	76.6	3.6	5.4	1.6	0.5	1.3	11.0
Non-exporter	88.8	3.7	1.5	1.1	0.3	0.1	4.5
Urban and Rural SMEs							
Urban	83.5	4.2	3.0	1.5	0.5	0.4	6.8
Rural	92.5	2.5	0.6	0.5	0.1	x	x
Visible Minority Ownership							
Visible Minority	74.8	9.3	x	x	0.7	x	13.4
Non-visible Minority	86.9	3.4	2.3	1.2	0.4	0.4	5.4

Note: "x" refers to estimates suppressed to meet the confidentiality requirements of the *Statistics Act* and/or for data quality reasons.

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

Table 15 — Key Financial Statement Figures in Average Dollars per SME, 2000

	Total Assets	Fixed Assets	Total Debt Outstanding (Liabilities)	Total Equity	Owner's Equity	Sales of Goods or Services	Net Profit/ Loss	Debt to Equity Ratio
				Dollars ($)				
All Small and Medium-sized Enterprises								
	504 243	291 831	294 424	209 818	123 539	590 164	54 131	0.75
Size of Business (Number of Employees)								
0	374 011	268 485	200 561	173 450	117 047	134 114	31 387	0.80
1 to 4	301 170	190 258	157 033	144 137	95 289	305 819	52 624	0.65
5 to 19	726 183	364 734	466 164	262 019	131 104	1 223 873	76 899	0.83
20 to 99	2 331 633	845 853	1 577 630	754 002	x	5 199 744	177 020	0.68
100 to 499	11 381 360	5 752 941	6 869 761	4 511 598	2 115 128	16 343 501	1 151 601	0.69
Sector								
Agriculture	779 801	580 795	309 226	470 575	360 952	248 364	27 802	0.48
Knowledge-based Industries	391 586	127 336	186 465	205 121	193 536	365 969	33 319	0.36
Manufacturing	863 777	371 675	531 403	332 375	x	1 419 946	91 294	0.62
Primary	843 345	533 639	322 121	521 224	416 489	546 558	54 910	0.31
Professional Services	301 437	170 561	154 496	146 941	87 604	352 648	67 606	0.45
Wholesale and Retail	498 540	151 579	329 939	168 601	x	1 304 868	43 021	0.64
Other Sectors	434 903	285 830	293 431	141 472	74 961	425 946	59 450	1.25
Region								
Atlantic	432 540	270 217	249 066	183 474	91 566	541 489	57 395	0.72
Quebec	428 086	233 916	234 501	193 584	122 520	597 288	43 658	0.62
Ontario	568 837	332 798	365 450	203 387	116 969	666 395	68 593	0.95
Manitoba, Saskatchewan and Nunavut	495 148	316 576	254 201	240 947	145 487	418 879	37 725	0.65

Continued . . .

Table 15 — Key Financial Statement Figures in Average Dollars per SME, 2000

	Total Assets	Fixed Assets	Total Debt Outstanding (Liabilities)	Total Equity	Owner's Equity	Sales of Goods or Services	Net Profit/ Loss	Debt to Equity Ratio
				Dollars ($)				
Alberta and Northwest Territories	587 759	339 546	287 048	300 711	180 928	536 669	57 517	0.51
British Columbia and Yukon	412 929	223 799	258 271	154 657	85 330	563 009	38 814	0.84
Gender of Owner								
Male/Female Partnership	405 366	245 534	210 711	194 654	112 412	496 872	33 471	0.60
Majority Female-owned	269 182	151 976	152 300	116 882	58 206	317 798	33 834	0.80
Majority Male-owned	586 922	337 365	351 400	235 522	141 746	679 754	64 809	0.77
Age of Owner								
Less than 34	353 423	203 539	220 011	133 411	78 362	375 760	26 351	0.91
35 to 44	385 440	211 318	236 313	149 127	100 077	495 863	60 387	0.75
45 to 64	489 207	283 176	278 176	211 031	122 801	621 518	48 927	0.70
65 and over	1 004 824	613 025	584 584	420 240	222 563	839 487	84 474	0.81
Exporter and Non-exporter SMEs								
Exporter	141 772	60 504	84 039	57 723	31 634	1 565 748	14 319	0.55
Non-exporter	577 190	355 596	335 748	241 441	144 512	473 917	62 863	0.79
Urban and Rural SMEs								
Urban	530 574	295 312	329 010	201 564	111 935	678 845	63 887	0.82
Rural	188 388	120 789	90 787	97 600	64 210	358 294	13 294	0.60
Visible Minority Ownership								
Visible Minority	39 780	22 712	26 845	12 935	8 961	461 701	2 349	1.11
Non-visible Minority	679 182	393 388	392 952	286 229	167 185	599 781	74 832	0.73

Note: "x" refers to estimates suppressed to meet the confidentiality requirements of the *Statistics Act* and/or for data quality reasons.

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

Table 16 —- Average Net Profit by Gender of Ownership and by Sector in 2000

	Total	Majority Women-Owned	Majority Men-Owned	Male/Female Partnership
	Dollars ($)			
SECTOR				
Agriculture	27 802	x	39 565	21 836
Knowledge-based Industries	33 319	33 034	x	46 320
Manufacturing	91 294	40 601	133 069	57 172
Primary	54 910	31 661	76 234	x
Professional Services	67 606	35 261	223 360	39 918
Wholesale and Retail	43 021	21 806	45 265	54 476
Other Sectors	59 450	37 301	x	24 958
CANADA	54 131	33 834	64 809	33 471

Note: “x” refers to estimates suppressed to meet the confidentiality requirements of the Statistics Act and/or for data quality reasons.

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

PART III: FINANCIAL SERVICES SECTOR — PROVIDERS OF BUSINESS FINANCING

The financial services sector plays a critical role in a market economy, providing start-up capital for new businesses and growth capital for existing businesses. Part III reviews SME financing from the suppliers' perspective and examines the major providers of business financing.

While Parts I and II analyzed SMEs by employment size and revenues, supply surveys did not measure the amount of financing by either of these criteria (most financial suppliers did not supply this information). Accordingly, this section focusses on authorization size rather than making direct comparisons across SMEs. While SMEs can be associated with certain authorization size ranges, this is a measure of the amount of financing obtained, rather than a measure of the size of the business. At best, authorization size is a rough proxy for lending to SMEs. As noted in the Appendix, the SME Financing Data Initiative is working with a number of financial data suppliers (e.g. lenders, lessors, Canadian Bankers Association, etc.) to resolve this issue and to link authorization sizes to a standard employment size range.[61]
Part III is divided into five sections:

The first section reviews the financial services sector and covers recent structural changes (following the recommendations made by the Task Force on the Future of the Canadian Financial Services Sector). It also examines the impact of these structural changes on SMEs' access to commercial debt — a common form of external SME financing (see Figure 18, Part II).

The second section describes the different types of financing supplied by the various financial service providers and explains how their concentration of activity within each market changes. The types of financing examined include commercial debt, leasing and factoring.

The third section examines the role of particular types of the following financial suppliers:
- domestic banks
- other banks
- credit unions and caisses populaires
- other market participants such as finance and leasing companies

This section reviews each type of financial institution's provision of small authorizations, and analyzes the risk of lending to businesses seeking smaller authorization amounts.

The **last two sections** present a regional and sectoral analysis of the commercial debt market. Due to data limitations, these sections examine general findings related to all businesses in Canada and will not focus exclusively on SMEs.[62]

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61. More details on linking financial authorizations with firm size (by number of employees) can be found in the appendix of this report.

62. Data related to region and sector by authorization categories has not been released by Statistics Canada from the *Survey of Suppliers of Business Financing (2000 and 2001)*. Therefore, any analysis conducted from a regional or sectoral perspective covers the entire commercial debt market of all businesses across Canada.

1. CANADA'S FINANCIAL SERVICE PROVIDERS: AN EVOLVING LANDSCAPE

The financial services sector has undergone rapid change over the past decade in response to technological innovation and globalization. This has led to the breakdown of what were formerly known as the four "pillars" of the financial services sector: banks, trust companies, insurers and securities dealers. These "pillars" have given way to less specialized "financial groups," or conglomerates that offer the full spectrum of financial products and services. As a result, the financial service sector has become increasingly dominated by large financial groups that provide a variety of services, operating alongside narrow-focus "monoline" and "niche" companies that concentrate on credit cards or internet or telephone-based retail banking. This section examines the various providers in the financial services sector, and their importance in the marketplace.

There are many factors that have influenced the changes in the financial services sector (technology improvements, globalization); however, two in particular include the following:

- **Changes to federal laws and regulations**: These changes have permitted other competitors to enter the market. In particular, foreign banks and financing firms have increased their presence in Canada by 23 percent over the past six years (see Table 17). These large financial institutions provide large authorizations, while smaller providers focus on smaller authorization categories

- **Consolidation of key financial institutions**: Significant consolidation through mergers and acquisitions has resulted in a decline in the number of firms, which in turn has created increased concentration. For example, the credit unions and caisses populaires which have traditionally served Western Canada and Quebec, have reduced their points of service by nearly a quarter (23 percent) over the 1997–2002 period (see Table 17)

Table 17 — Distribution of Financial Institutions from 1997 to 2001

Type of Financial Institution	Number of companies, 1997[1]	Number of companies, 2001[2]	Percentage Change
Domestic Banks Small Large	 6 5	 9 6	 50 20
Foreign Banks (includes branches)	44	54	23
Trust (excl. bank subsidiaries)	34	25	-26
Insurance Companies[3]	367	350	-5
Credit Unions & Caisses Populaires	2 289	1 772	-23
Mutual Fund Companies	78	80	3

Notes:
1) Data is derived from the MacKay Task Force Report, 1997.
2) Data is derived from *Competition in the Canadian Financial Services Sector,* Canadian Bankers Association, January, 2003 and the Department of Finance Canada.
3) Includes life, health and P&C insurance companies.

1.1 Access to Financing by SMEs — Delivery Channels

Ensuring that SMEs have reliable access to capital is an issue of great importance for the government. SMEs have traditionally accessed financing through well-established branch networks. In 2001, 76 percent of SMEs reported that they requested debt through a personal discussion in a branch (see Table 18).

Table 18 — Application Method Used by SMEs Who Requested Debt in 2001

Method	Percentage of Applicants Applying by Method*
Personal Discussion	58.8
Request at the Branch	17.1
Applied by Phone	13.1
Approached by Credit Supplier	3.9
Other	2.9
Mail or Courier	1.8
Applied by Fax	1.6
Applied by Internet	0.9

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

Source: Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises*, 2001.

However, the rapid development of new technologies such as the Internet and telephone networks opened new horizons to financial providers, and they invested heavily in these new technologies. Between 1996 and 2002, the six largest banks in Canada invested more than $21 billion[63] ($4.0 billion in 2002) in upgrades and developments to allow for internet and telephone banking. Although the initial goal of these investments was to provide their customers (consumers and businesses) with alternative ways to access financial services, SMEs tend not to make use of these methods. In 2001, only 13 percent of SMEs made a request for debt over the phone (down from 17 percent in 2000), and even fewer (less than one percent) made a request over the Internet.

Despite the importance of branch banking to SMEs, the financial services sector is expected to continue branch downsizing over the next five years, a tendency that was confirmed in the 2002 accountability statement of the six largest banks. For example, the Canadian Imperial Bank of Commerce had a net reduction of 30 branches, and faces a potential 150 additional closures over the next three years. During the same period, the Royal Bank of Canada had a net decrease of seven branches; TD Canada Trust had a net closure of 150 branches in 2002. These reductions have not been limited to the chartered banks — caisses populaires and credit unions also experience considerable consolidation over the last ten years. As access to financing is a fundamental issue for the government, the SME Financing Data Initiative (SME FDI) will continue to monitor the state of branch closures across Canada.

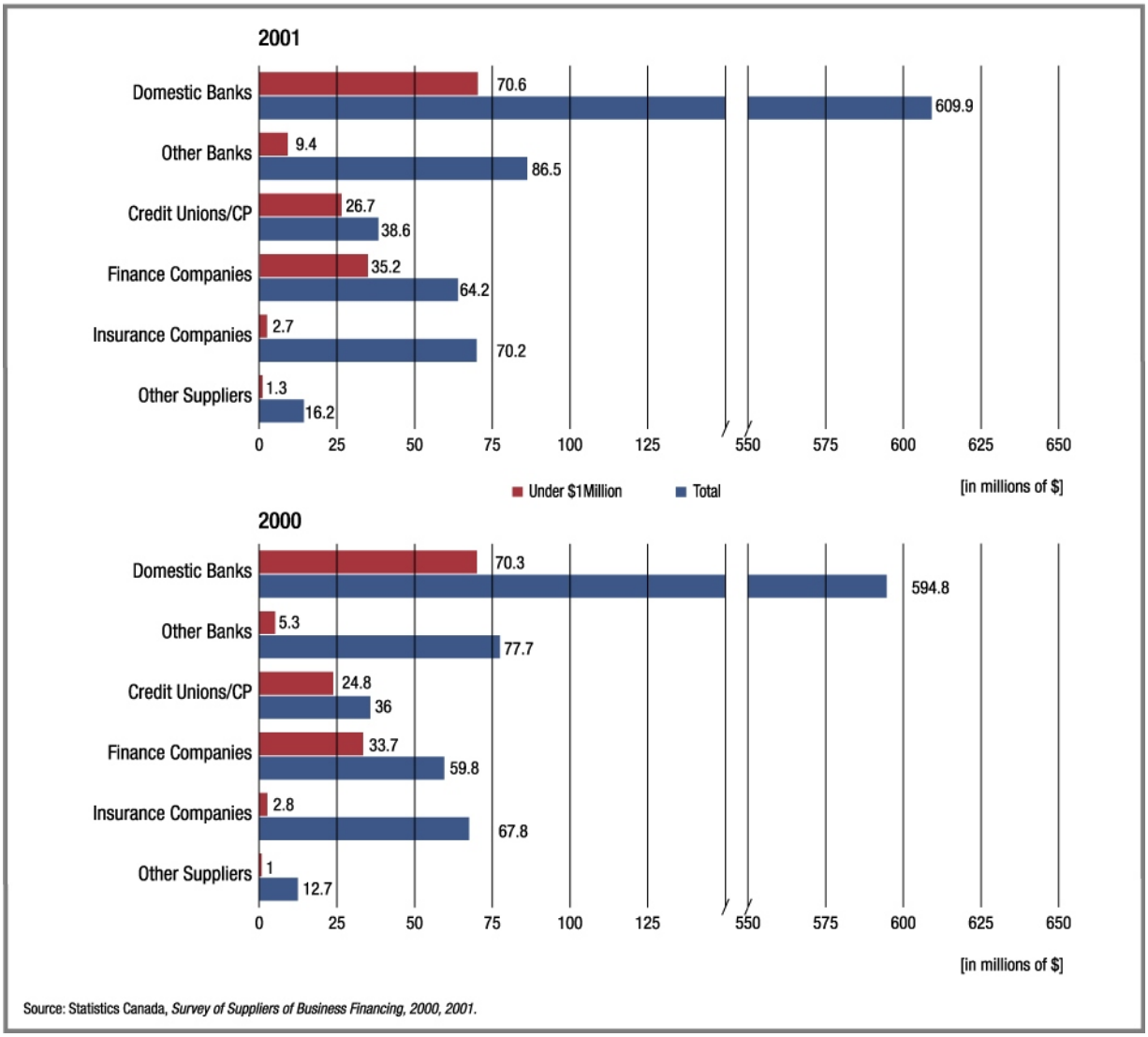
63. Canadian Bankers Association, Banking and Innovation: A Canadian Success Story, September 2002.

1.2 Serving the Smaller Authorization Market

Changes in the structure of the financial services sector have led financial institutions to concentrate on the smaller authorization market. Figure 32 shows that domestic banks served the smaller authorization categories for commercial debt, authorizing $71 billion as of December 31, 2001, the highest of any other financial service provider. However, as will be seen in Section 3.1, domestic banks' authorizations of smaller commercial debt amounts represented a small percentage of domestic banks' overall commercial debt portfolio. By comparison, institutions such as credit unions, caisses populaires and finance companies tended to focus on smaller authorization categories, which represent a larger portion of their overall commercial debt portfolio.

The distribution of commercial debt by certain financial service providers has implications for businesses seeking smaller authorization amounts. As will be demonstrated, many of these financial service providers are regionally based (see Figure 45). For example, credit unions typically serve the western provinces and caisses populaires serve enterprises in Quebec; domestic banks are distributed across Canada, but are proportionally more active in Ontario and the Atlantic provinces. Further consolidation among financial service providers may have implications for SMEs' access to financing.

Figure 32
Amount of Commercial Debt Authorized by Financial Suppliers as of December 31, 2000 and 2001



Source: Statistics Canada, *Survey of Suppliers of Business Financing, 2000, 2001.*

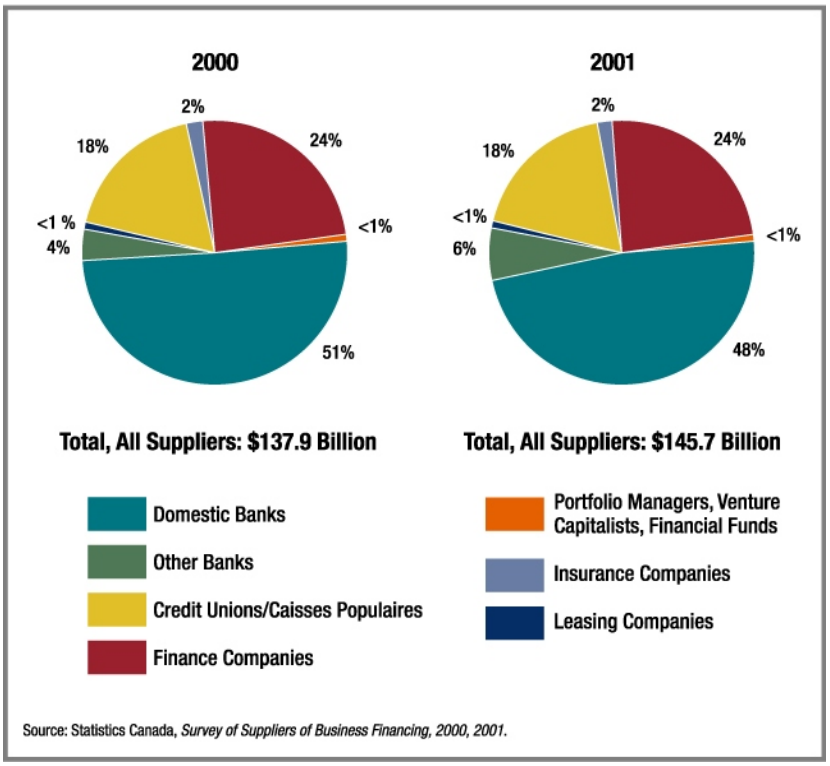
2. OVERVIEW OF FINANCIAL INSTITUTIONS' SERVICES

This section provides a general overview of the different types of financing supplied by the various financial service providers and explains how their presence within each market segment differs (e. g. domestic banks focus on lending while specialized finance companies focus on leasing). This section covers commercial debt, leasing and factoring. Risk capital financing, which is used by less than 5 percent of SMEs, is addressed in Part IV.

2.1 Commercial Debt

Commercial debt was the most common type of financing sought by SMEs in 2001 (49 percent) (see Table 11). As noted earlier, the proxy definition of SMEs is loan authorizations of less than $1 million. Figure 33 illustrates the market share of commercial debt authorized under $1 million by key institutions as of December 31, 2000 and 2001.

Figure 33
Market Share of Commercial Debt Authorized, Under $1 Million, by Financial Suppliers as of December 31, 2000 and 2001



Source: Statistics Canada, *Survey of Suppliers of Business Financing, 2000, 2001.*

Some key findings include:

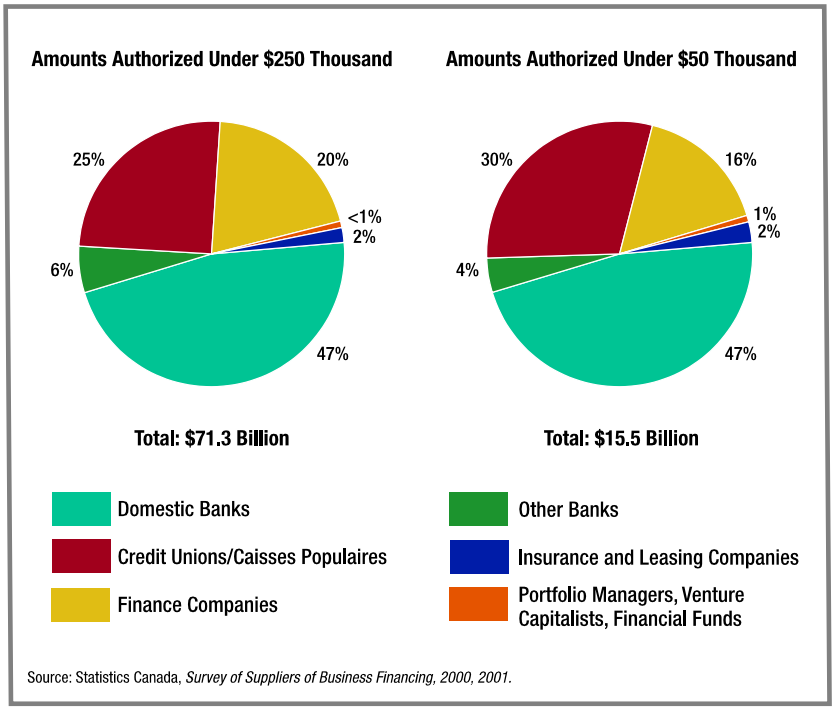
- ***Smaller authorization (less than $1 million) amounts of commercial debt*[64] *from all sources increased by 6 percent,*** from $137 billion to $146 billion during the 2000–2001 period
- ***Domestic banks were an important supplier of commercial debt for smaller authorization amounts***, representing half of the market in 2000 and 2001

64. The *Survey of Suppliers of Business Financing* defines the **total amount authorized** as the maximum a client is allowed to borrow, aggregated over all clients falling into the particular size instrument, industrial or geographic category. This may or may not be the amount that a client actually borrowed.

- ***Other banks have nearly doubled their market share*** of smaller authorization amounts[65]
- ***Credit unions and caisses populaires authorized nearly one fifth (18 percent) of commercial debt in smaller authorization amounts***. Although these institutions are not evenly distributed across Canada, their financing activity in the smaller authorization marketplace is significant, constituting $27 billion to businesses in these categories in 2001, compared with $25 billion in authorizations in 2000
- ***Insurance companies were not key suppliers of small authorization amounts***: As of December 31, 2001, insurance companies authorized $2.6 billion of commercial debt under $1 million, representing 4 percent of their overall commercial debt portfolio

The market for commercial debt changes for even smaller authorization amounts (less than $250 000). As illustrated in Figure 34, credit unions and caisses populaires' market share increased significantly for authorizations of less than $250 000, from 18 to 25 percent. These institutions' market share increased to 30 percent for debt authorized under $50 000. Conversely, financial providers such as other banks and finance companies tended not to focus on the smaller (less than $250 000) amounts, as evident in their decreasing market share. Domestic banks, however, continued to play an important role.

Figure 34
Commercial Debt Authorized, Under $250 000, by Financial Suppliers as of December 31, 2001



Source: Statistics Canada, *Survey of Suppliers of Business Financing, 2000, 2001.*

65. The change in market share is a result of coverage change that occurred during the 2000 and 2001 surveys. Some institutions were included in the "other banks" category in the 2001 survey that were not included in the 2000 survey.

Some key findings as of December 31, 2001 include:

- **Domestic banks**: led the market for authorizations for:
  - **less than $250 000:** $33 billion (46 percent of all debt in this authorization category)
  - **less than $50 000:** $7 billion (45 percent of all debt in this authorization category)

- **Credit unions and caisses populaires**:
  - **less than $250 000:** $18 billion (25 percent of all debt in this authorization category)
  - **less than $50 000:** $4 billion (26 percent of all debt in this authorization category)
- **Finance companies** focussed on larger authorization amounts more than credit unions and caisses populaires
  - **less than $250 000:** $15 billion (21 percent of all debt in this authorization category)
  - **less than $50 000:** $3 billion (19 percent of all debt in this authorization category)

2.2 Lease Financing in Canada[66]

As of December 31, 2001, the total value of leases authorized to all businesses amounted to $32.4 billion, a 20-percent increase from 2000 (see Table 22).[67] According to the Conference Board of Canada, the growth in the leasing market may reflect businesses' use of leasing rather than borrowing.[68] While data limitations preclude accurate consludions about this issue, the SME Financing Data Initiative will continue to monitor this situation.

The Canadian Finance and Leasing Association[69] suggests that lessors, especially larger institutions (e.g. domestic banks), are becoming more selective in their considerations of certain types of new businesses and are focussing on serving large ticket transactions. This change in behaviour by large lessors could account for the significant increase in the amount of leases authorized in 2001.

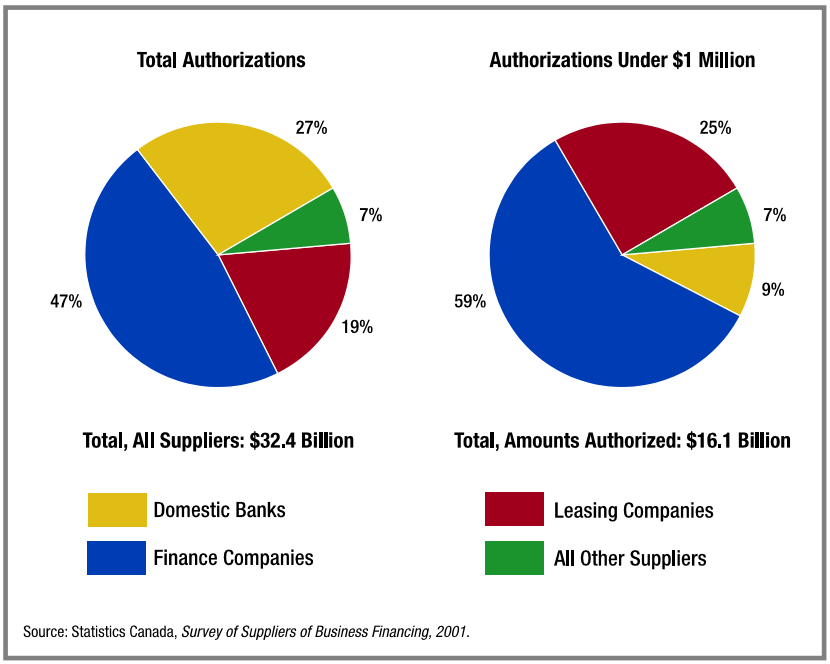
66. The *Survey of Suppliers of Business Financing* categories do not differentiate between capital and operating leases. The definition includes leases on assets such as cars, trucks, machinery, equipment, computers and office equipment (fax machines, photocopiers, printers, etc.). It excludes leases on real estate and office space and short-term rentals (i.e. less than one year). Future surveys will include clear distinctions between operating and capital leases.

67. Since lease authorization size is tied to the value of the asset being leased, rather than to the borrowing capacity of the borrower, it is not possible to apply the same definition of an SME (under $1 million in authorization) to leases as was applied for commercial debt.

68. Conference Board of Canada, *A Changing Demand for SME Debt Financing*, January 2001.

69.David Powell. *Asset-based Financing and Leasing in Canada: An Overview*, Canadian Finance & Leasing Association, 2003.

Figure 35
Market Share of Commercial Leases Authorized by Financial Suppliers as of December 31, 2001



Source: Statistics Canada, *Survey of Suppliers of Business Financing, 2001.*

Amounts of leasing authorized to all businesses in Canada by key financial service providers as of December 31, 2001 were composed of (see Figure 35):

Finance companies:	$15 billion (20-percent increase from 2000)
Domestic banks:	$9 billion (13-percent increase from 2000)
Leasing companies:	$6 billion (18-percent increase from 2000)
Other suppliers:	$2 billion (16-percent increase from 2000)

As shown in Figure 35, finance and leasing companies accounted for two thirds (66 percent) of the leasing market in 2001, and domestic banks maintained approximately one quarter of the market. The lower participation by the domestic banks may be connected to the restrictions imposed by the *Bank Act*,[70] which prevent banks from leasing automobiles and light-duty vehicles — the kind of equipment that accounted for the most leasing requests by SMEs in 2000.[71]

As a result of these factors, domestic banks have been less involved in supplying leasing for the smaller authorization categories. As illustrated in Figure 35:

70. *Bank Act*, section 417 which states "Restriction on leasing - A bank shall not engage in Canada in any personal property leasing activity in which a financial leasing entity, as defined in subsection 464(1) is not permitted to engage." Section 464(1) is a list of definitions under the investment powers in the *Bank Act*.

71. Industry Canada, *Small and Medium-sized Enterprise (SME) Financing in Canada, 2002.*

- domestic banks' market share for leases authorized under $1 million was 15 percent lower than their share for leases over $1 million; and
- finance and leasing companies' market share for leases under $1 million was 15 percent higher than their share for leases under $1 million, with leasing companies accounting for the majority of the difference (10 percent).

Other Leasing Highlights[72]

Firms in the transportation and warehousing sector were authorized 30 percent — $9.8 billion of leases by all suppliers as of December 31, 2001 (see Table 19). Manufacturers captured the second-highest proportion, with $7.5 billion authorized. This is consistent with the findings from Part II — that these two sectors were the highest users of lease financing. For example, 25 percent of manufacturing SMEs used leasing to finance their operations in 2000 (the highest of all sectors).

2.3 Factoring

As of December 31, 2001, $127 million in factoring was provided to all businesses in Canada, slightly less than the total for 2000 ($131 million). Factoring is not often used by all businesses, and this is particularly true for SMEs. Generally, this type of financing is used by larger firms in manufacturing, wholesale/retail and knowledge-based industries. Factoring is obviously a marginal type of financing (as seen in Part II, factoring constituted approximately 1 percent of SME financing in 2000).

3. KEY FINANCIAL INSTITUTIONS

The previous section reviewed financial service providers of three types of financing: commercial debt, leasing and factoring. This section builds on that analysis and presents key findings related to individual suppliers: domestic banks, other banks, credit unions and caisses populaires, and other market participants (e.g. finance companies).

3.1 Domestic Banks

Domestic banks remain the major suppliers of financing to all businesses in Canada. Combined, these institutions dominated the Canadian financial services sector, reporting $1080 billion in domestic assets in 2000, or over half of the sector's total assets in Canada. The five largest banks[73] accounted for about 90 percent of total bank assets in 2000.[74] In 2001, the top five domestic banks each had shareholders' equity of more than $11 billion and total assets in excess of $230 billion.

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72. There are insufficient data to support an analysis of lease financing loss rates.

73. The top five domestic banks include BMO Financial Group, CIBC, RBC Financial Group, Scotiabank and TD Bank Financial Group.

74. *The Canadian Financial Services Sector*, Department of Finance, June 2002.

Debt Authorized

Commercial debt was the most common form of financing provided by domestic banks to all businesses in Canada. As of December 31, 2001:

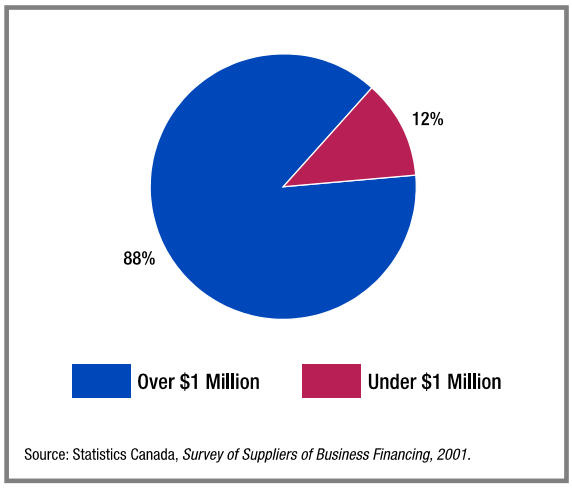
- **$610 billion** of commercial debt was authorized by domestic banks to all businesses in Canada (see Table 19) — a marginal increase from 2000 (3 percent).[75] This represented 70 percent of the total commercial debt market in 2001
- **$201 billion** of commercial debt was outstanding, slightly lower than the $207 billion outstanding in 2000

Key findings about domestic banks:

- Total debt authorized under $1 million: $71 billion (similar to 2000)
- Loss rates on commercial debt in 2001:
  - Overall: 0.44 percent
  - SMEs: 0.9 percent (80-percent increase from 2000)
- Debt primarily authorized to firms in:
  - Ontario (65 percent)
  - Alberta (9 percent)
  - British Columbia (6 percent)
- Key sectors served by domestic banks:
  - Finance/insurance (32 percent)
  - Manufacturing (14 percent)
  - Primary industries (7 percent)

Figure 36

Distribution of Commercial Debt Authorized by Domestic Banks as of December 31, 2001



Source: Statistics Canada, *Survey of Suppliers of Business Financing, 2001.*

These two observations indicate a decrease in the demand for debt; however, further analysis would be required to confirm the significance of this trend.

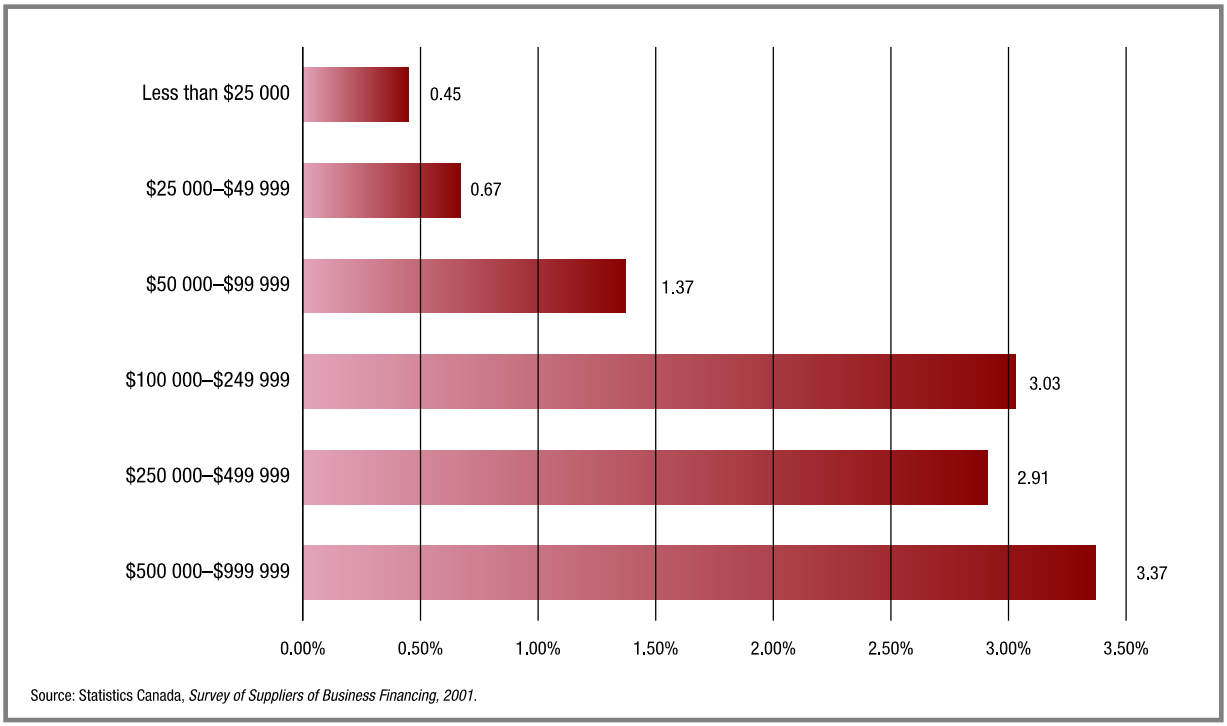
Nearly 50 percent of SMEs had outstanding loans or other forms of credit owed to domestic banks (see Table 11). Nonetheless, for domestic banks, smaller authorizations represented a marginal proportion of overall lending activity (12 percent — see Figure 36).

Domestic banks made 12 percent of their debt authorizations in amounts under $1 million, and tended to focus on the larger authorization amounts (88 percent) for commercial debt. As seen in Figure 37, the majority (9 percent) of the 12 percent of lending consisted of loans over $100 000.

75. Although the Canadian Bankers Association previously collected authorization amounts of domestic banks, the *Survey of Suppliers of Business Financing* defines the category of domestic banks differently. Therefore, comparisons with the CBA data are not feasible and consequently there is no consistent measure of the activities of domestic banks over time. However, efforts are being made to resolve this issue so that future results can provide valid comparisons.

Figure 37

Percentage of Total Commercial Debt Authorized by Domestic Banks Under $1 Million (by Size of Authorization) as of December 31, 2001



Source: Statistics Canada, *Survey of Suppliers of Business Financing, 2001.*

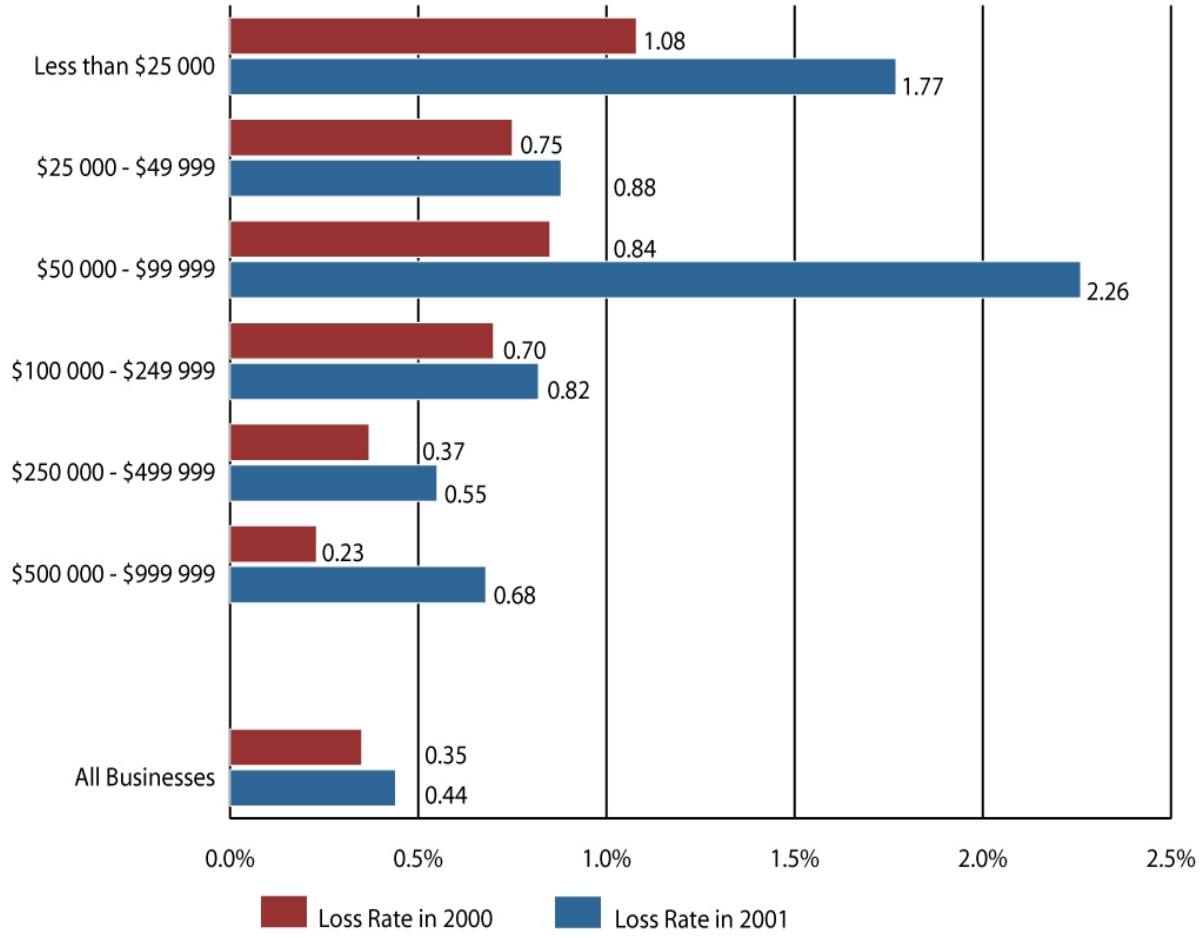
Risk of Lending: Loss Rates for 2000 and 2001

As seen earlier, domestic banks are key providers of debt to Canadian businesses, and are particularly important for debt authorizations under $1 million. However, it is important to analyze these institutions' risk of lending to better understand their lending practices. This section reviews the risk of lending (using loss rates as a proxy definition of risk) in 2000 and 2001, with a particular emphasis on debt under $1 million. For the purpose of this analysis, loss rates are defined as the amount of losses over the amounts outstanding in a given year. Although this approach has limitations (see text box), it does illustrate the risks associated with lending small authorization amounts.

Caveats On the Definition of Loss Rates:

The loss rate is typically defined as the amount of total losses (net of recoveries) divided by the original amount of the debt authorized. However, the *Survey of Suppliers of Business Financing* does not capture the original amount of the debt supplied. Therefore, the amount outstanding will be applied as a close proxy of the amount of debt borrowed. It should be noted that the amounts outstanding are cumulative so that loans from a number of years are included in this analysis.

Figure 38
Loss Rates on Commercial Debt of Domestic Banks by Size of Authorization in 2000 and 2001



Source: Statistics Canada, *Survey of Suppliers of Business Financing, 2000, 2001.*

As shown in Figure 38, the loss rates for domestic banks in 2000 and 2001 were as follows:

- Overall: 0.44 percent (slight increase from 2000)
- SMEs: 0.9 percent (more risky debt is prevalent in the smaller authorization categories)
- Larger businesses: 0.3 percent

Further analysis reveals significant increases in loss rates for authorizations of less than $100 000:

- $50 000 to $99 999: 2.26 percent (increase of 169 percent from 2000)
- less than $25 000: 1.77 percent (increase of 64 percent from 2000)

These observations suggest that smaller authorization amounts incur higher risks than larger amounts. However, loss rates tend to be volatile and are heavily influenced by business cycles and other economic factors. Consequently, more data and analysis will be needed to determine what factors account for the higher loss rates in the smaller authorization categories.

Lease Financing Provided by Domestic Banks[76]

Although domestic banks focussed mainly on commercial debt in 2000 and 2001, they also increased their stake in the leasing market (see Figure 35).[77] These institutions operate in the leasing market either alone or in alliances with other suppliers who specialize in this form of financing (as is the case of the Bank of Montreal).

Key findings related to lease financing provided by domestic banks in 2000 and 2001 include:[78]

Leases authorized[79]: $9 billion (26 percent of the overall market)[80] — a 13-percent increase from 2000

Leasing by Domestic Banks by authorization size: As of December 31, 2001:

- $2 billion came in authorizations under $1 million (33 percent of overall lease market)
- 67 percent consisted of larger authorization categories – similar to their proportion for commercial debt

Domestic banks in Quebec authorized 25 percent more lease contracts in 2001, compared with 2000: According to the Canadian Finance & Leasing Association (CFLA),[81] chartered banks are becoming more selective in their consideration of new businesses. These institutions are shifting attention to due diligence and risk management and the large-ticket transaction market. The supply data do not distinguish between the amounts of leases authorized to SMEs and to larger businesses. However, given that only 11 percent of SMEs in Quebec used leasing to finance their operations in 2000, the increase in domestic banks' market share is likely related to their tendency to concentrate on larger businesses. Further data collection and analysis will be needed to better understand this market.

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76. The *Survey of Suppliers of Business Financing* categorizes leases on assets such as cars, trucks, machinery, equipment, computers and office equipment (fax machines, photocopiers, printers, etc.). It excludes leases on real estate and office space and short-term rentals (i.e. less than one year). Future surveys will include clear distinctions between operating and capital leases.

77. As noted earlier, domestic banks are restricted from leasing certain assets, such as automobiles and light-duty vehicles.

78. Unlike commercial debt, there are insufficient data to support an analysis on loss rates for lease financing.

79. The *Survey of Suppliers of Business Financing* defines the total value of leases authorized as the original value of the lease, aggregated over all clients falling into the particular size instrument, industrial or geographic category.

80. Unlike debt, there is no accepted proxy for linking lease authorization size to size of business.

81. David Powell, *Asset-based Financing and Leasing in Canada: An Overview*, Canadian Finance & Leasing Association, 2003.

3.2 Other Banks

Key findings about other banks in 2001:

- Total commercial debt authorized under $1 million: $9 billion (56 percent-increase from 2000)
- 5 percent more debt owed by SMEs compared with 2000
- 11 percent decrease in the loss rate of debt authorized to SMEs
- Debt primarily authorized to firms in:
  - Ontario (52 percent)
  - Alberta (19 percent)
  - British Columbia (15 percent)
- Key sectors served by other banks:
  - Manufacturing (21 percent)
  - Finance/insurance (15 percent)
  - Wholesale trade (14 percent)

Other banks[82] have been increasing their role in the debt marketplace. As noted earlier, changes in federal regulations have allowed a number of foreign banks to enter the Canadian financial services sector. Foreign banks, which have been operating in Canada since 1980 through regulated Canadian subsidiaries, have concentrated on providing wholesale financial services in urban markets.

Debt Authorized

Key findings regarding commercial debt authorized by other banks as of December 31, 2001 include:

- **$87 billion** authorized to all businesses in Canada
- **$9 billion** authorized in amounts less than $1 million (10 percent of overall portfolio, compared with 11 percent for domestic banks)
- **1 percent** of the overall commercial debt portfolio was for authorizations less than $100 000

As was the case with domestic banks, other banks have not focussed on the smaller authorization categories in terms of their overall debt portfolio. However, there has been a significant increase in the amount of debt authorized to SMEs (56 percent increase between 2000 and 2001), due in part to a coverage change of the supply sample. The survey coverage of federal and provincial government business enterprises was more extensive in 2001 than it was in 2000, which has resulted in higher estimates for some supplier types, particularly other banks.

Risk of lending: Loss Rates in 2000 and 2001

Applying the same definition of loss rates used in the analysis of domestic banks (losses divided by amounts outstanding), leads to several conclusions about other banks' loss rates in 2001:

- **Overall:** 1.03 percent (second-highest loss rate after portfolio managers/venture capital companies and financial funds)
- **SMEs:** 0.61 percent (second-lowest loss rate after insurance companies)
- **Larger businesses:** 1.1 percent (compared with domestic banks at 0.3 percent)

Other banks carried a riskier portfolio of commercial debt for all business in 2001 (compared with domestic banks), as the loss rate increased by 30 percent from 2000 (when the overall loss rate was 0.8 percent). While the data are insufficient to analyze each authorization category separately to determine the origin of the increase in loss rates, the data do indicate that loss rates

82. Other banks include foreign banks, trust companies and all other deposit-accepting institutions except credit unions and caisses populaires.

on commercial debt authorized under $1 million fell between 2000 and 2001. In fact, compared with loss rates of other financial service providers to these enterprises, other banks' loss rates on commercial debt authorized to under $1 million were the second lowest among financial providers. Limitations in the data complicate firm conclusions on other banks' risk of lending to SMEs. However, continued data collection and reporting will determine the role of these institutions in supplying commercial debt to SMEs.

3.3 Credit Unions and Caisses Populaires

Canada's credit unions and caisses populaires play an important role in the Canadian financial services sector. They differ from banks in that they are co-operative financial institutions that are owned and controlled by their members. Their ownership and corporate governance are based on co-operative principles, and each individual credit union and caisse populaire maintains a separate identity. Given their autonomous local structure, credit unions and caisses populaires are generally much smaller than other deposit-taking institutions in terms of asset size.

Key findings about credit unions & caisses populaires:

- 8 percent more debt authorized to SMEs compared with 2000
- 4-percent increase in debt owed by SMEs compared with 2000
- 24-percent decrease in loss rates on debt to SMEs.
- Debt primarily authorized to firms in:
  - Quebec (62 percent)
  - Manitoba (6 percent)
  - Saskatchewan (6 percent)
- Key sectors served by these institutions:
  - Agriculture (22 percent)
  - Real estate/rental (15 percent)
  - Retail trade (9 percent)

Unlike domestic and other banks, credit unions and caisses populaires are provincially regulated, and as a result their activities remain primarily within provincial boundaries, although some of these suppliers of financing do provide financing outside of their home province.

Distribution of Credit Unions and Caisses Populaires across Canada

As of 2001, Canada's credit union sector consisted of about 700 credit unions and almost 1100 caisses populaires, with more than 3600 locations and 3900 automated teller machines.[83] The significance of the credit union movement varies substantially from province to province. Saskatchewan and Manitoba account for about 32 percent of all credit unions in Canada, whereas Atlantic Canada features a much lower rate of penetration (see Figure 39). In Quebec, the Mouvement Desjardins is a dominant market force, accounting for more than 36 percent of deposit-taking institutions' assets in Quebec and benefiting from a strong market position in many product lines.

Debt Authorized

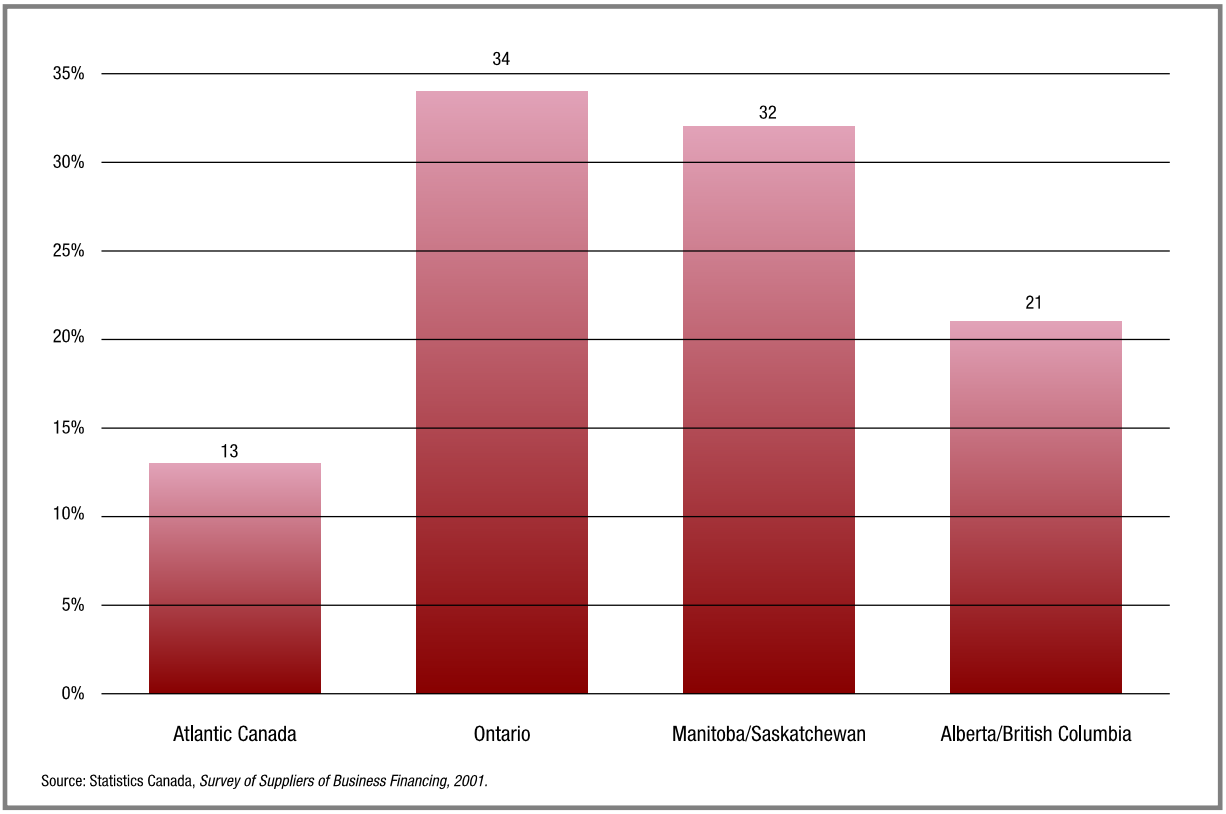
Commercial debt authorized as of December 31, 2001 included:

- **$39 billion** to all businesses in Canada (4 percent of the market)
- **$27 billion** to SMEs (18 percent of all debt authorized to SMEs)

83. *The Canadian Financial Services Sector*, Department of Finance, June 2002.

- **69 percent** of commercial debt portfolio authorized to SMEs (compared with 11 percent for domestic banks)

Figure 39
Distribution of Credit Unions Across Canada

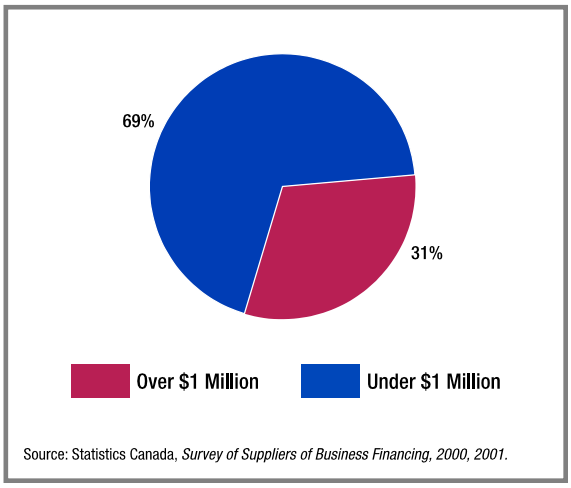


Source: Statistics Canada, *Survey of Suppliers of Business Financing, 2001.*

Unlike the larger institutions (domestic and other banks), credit unions and caisses populaires focussed on commercial debt authorizations under $1 million (69 percent of overall portfolio as of 2001 — see Figure 40). This was likely due to their smaller asset size and their community approach to banking. Furthermore, these institutions are concentrated in rural communities where businesses are typically small.

The percentage of commercial debt authorized to SMEs by credit unions and caisses populaires is consistent with the demand for debt seen in Part II. However, examining the number of clients (type of financing instrument used) served in this authorization category by these institutions, smaller authorizations represented the majority (50 percent, see Table 19). It seems that these institutions

Figure 40
Distribution by Size of Authorization of Commercial Debt Authorized by Credit Unions and Caisses Populaires as of December 31, 2001

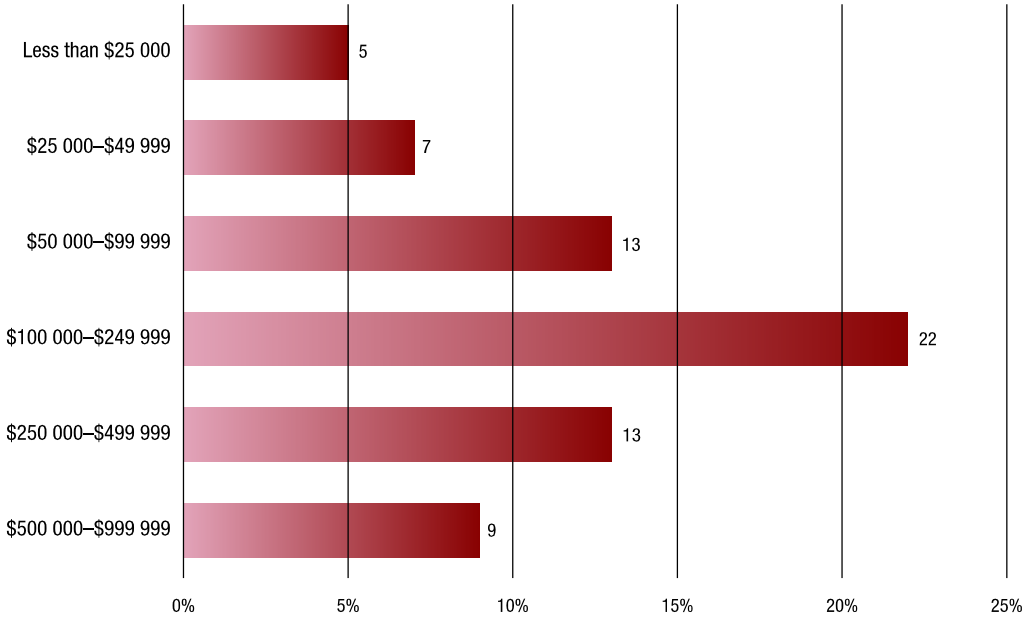


Source: Statistics Canada, *Survey of Suppliers of Business Financing, 2000, 2001.*

focussed on very small authorization amounts. While limitations to the data prevent a complete analysis of this market (as seen in the Note to Readers), the SME Financing Data Initiative will continue to monitor this situation.

Figure 41

Percentage of Commercial Debt Authorized by Credit Unions and Caisses Populaires to SMEs (by Size of Authorization) as of December 31, 2001



Source: Statistics Canada, *Survey of Suppliers of Business Financing, 2000, 2001.*

Risk of lending: loss rates in 2000 and 2001

Loss rates for credit unions and caisses populaires as of December 31, 2001 include:

- Overall: 0.79 percent (30 percent higher than the loss rate of all suppliers): 40 basis points higher than domestic banks
- SMEs: 1.12 percent (24-percent decrease from 2000): 20 basis points higher than domestic banks
- Larger businesses: 0.6 percent: 30 basis point higher than domestic banks

Unlike the larger institutions (domestic and other banks), loss rates on commercial debt authorized by credit unions and caisses populaires dropped significantly (24 percent) in 2001 (see Figure 42). The fall in loss rates was most significant in the lower authorization categories, particularly loans of less than $100 000. The amounts of outstanding loans authorized in the under $100 000 category remained relatively stable (on a percentage basis) between 2000 and 2001. Accordingly, the significant decrease in loss rates for credit unions and caisses populaires could indicate that they have been more diligent in their assessment of risks. Moreover, as indicated in Parts I and II, credit unions and caisses populaires tend to focus on agricultural businesses, which tend to have a high asset base to pledge as security for other loans. This tendency may be related to the trend toward industry consolidation; credit unions and caisses

populaires are now better able to assess price and manage risk. Limitations in the supply data preclude a more conclusive explanation. Further data collection and analysis on loss rates by sector will clarify the potential impact of debt authorized to agricultural firms and how this affects these suppliers' overall loss rates.

3.4 Other Market Participants

A number of other participants in the sector, such as specialized finance companies, offer financing to SMEs; most of these operate beyond the scope of federal regulation.[84] Among these are security dealers, specialized financing companies, money managers and advisers. Some of the institutions in these sectors are among the most innovative and successful in the Canadian financial services marketplace (e.g. General Electric Capital Corporation [GE Capital]). These specialized finance companies have carved out an important market niche that includes business financing (typically in leasing) and commercial debt financing (typically in secured loans and conditional sales agreements). Specialized finance companies serve as another financing alternative for SMEs.Other financial suppliers include factorers, however, as noted earlier and in Part II, only 1 percent of SMEs reported using this type of financing in 2000. Accordingly, these suppliers are included in the "other supplier" category and will not be a focus of discussion in this section.

Finance Companies[85]

The Conference Board of Canada reports that business financing from specialized finance companies, such as GE Capital, has increased substantially in recent years, reflecting the rapid growth of these financial services intermediaries. While many finance companies are subsidiaries of manufacturers, or "captives," the number of independent companies that have become major alternative sources of credit for large and small businesses has grown substantially in recent years.[86]

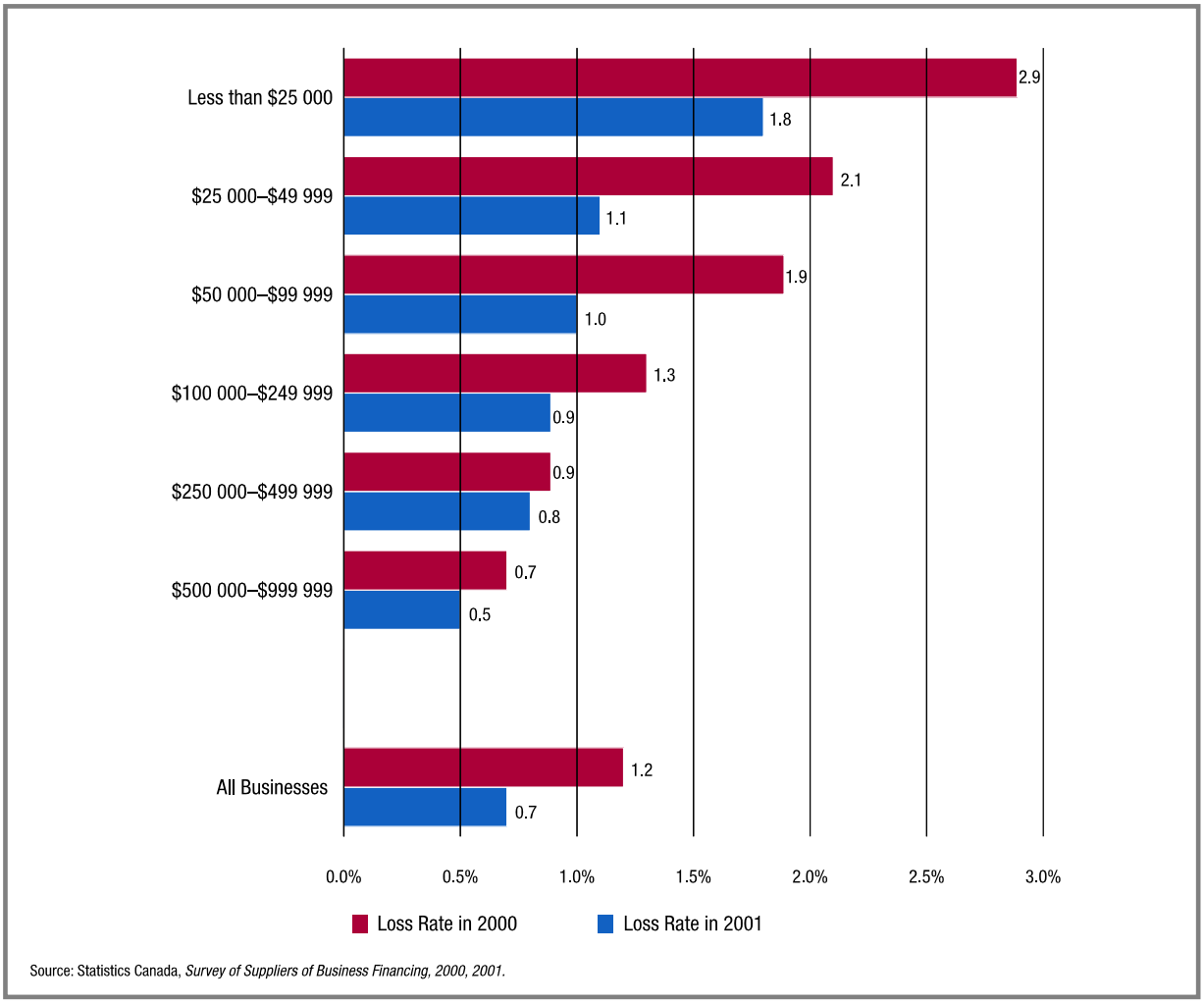
84. Finance and leasing companies are not regulated as financial institutions, since they do not carry out certain "core activities" such as fiduciary activities, underwriting insurance, dealing in securities and deposit taking (Department of Finance, June 2002). The difference is that they are subject to market rather than regulatory discipline. However, as they make use of public markets and typically secure their assets with regulated institutions, they are often subject to similarly rigorous scrutiny of their assets and practices as are fully regulated institutions.

85. For the purpose of the *Survey of Suppliers of Business Financing*, and for this report, finance companies include enterprises that provide financing to businesses, often for the purchase of goods and services, but do not accept deposits. Debt financing is commonly provided, but companies that purchase accounts receivable, or provide both debt and lease financing, are also included. Examples include the acceptance companies of vehicle and equipment manufacturers, factoring companies and several Crown financial institutions. Enterprises providing only lease financing are usually classified as leasing companies.

86. *A Changing Demand for SME Debt Financing*, Conference Board of Canada, January, 2001.

Figure 42

Loss Rates of Commercial Debt Authorized by Credit Unions and Caisses Populaires to SMEs (by Size of Authorization) in 2000 and 2001



Source: Statistics Canada, *Survey of Suppliers of Business Financing, 2000, 2001.*

Commercial Debt Authorized by Finance Companies[87]

Commercial debt authorized as of December 31, 2001:

- **$64 billion** to all businesses in Canada (7 percent of all debt authorized to SMEs)
- **$35 billion** to SMEs (24 percent of all debt authorized to SMEs)

87. These figures represent finance companies, which include Government Business Enterprises (GBEs).

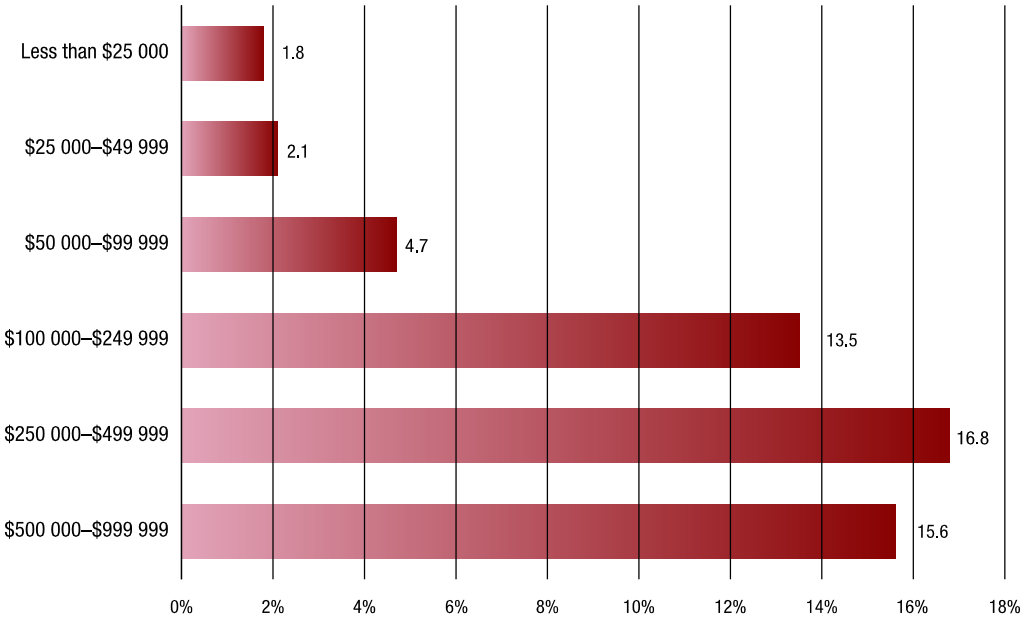
As noted earlier, finance companies are becoming important suppliers of commercial debt to Canadian businesses. As seen in Figure 33, these financial service providers represented one quarter (24 percent) of the commercial debt market in 2000 and 2001. In terms of the distribution of commercial debt, nearly half of their overall portfolio was for authorizations under $1 million. However, unlike credit unions and caisses populaires, whose lending peaked in the $100 000–$249 000 range, most of the debt authorized under $1 million by finance companies (55 percent or $35 billion) came in authorizations of between $250 000 and $1 million.

Key findings for finance companies:

- 7 percent more debt authorized to SMEs compared with 2000
- 8 percent more debt owed by SMEs compared with 2000
- 23 percent decrease in loss rates of debt to SMEs
- Debt primarily authorized to firms in:
  - Ontario (45 percent)
  - Quebec (19 percent)
  - Alberta (13 percent)
- Key sectors served by these institutions:
  - KBI (28 percent)
  - Agriculture (24 percent)
  - Manufacturing (16 percent)

Figure 43

Percentage of Commercial Debt Authorized by Finance Companies to SMEs (by Size of Client Authorization) as of December 31, 2001



Source: Statistics Canada, *Survey of Suppliers of Business Financing, 2000, 2001.*

Risk of Lending: loss rates in 2000 and 2001

Loss rates for finance companies as of December 31, 2001:

- **Overall:** 0.65 percent (similar to the overall loss rate of all suppliers)
- **SMEs:** 0.72 percent (23-percent decrease from 2000)
- **Larger businesses:** 0.6 percent

Commercial debt loss rates by finance companies dropped significantly (24 percent) in 2001. However, following the pattern for domestic banks, there were significant increases in the loss rates in the lower authorization categories (less than $250 000), while loss rates fell in the larger authorization categories. Supply data limitations preclude a more thorough analysis of loss rates: for example, determining how factors such as sector or size of business influence the loss rates in these authorization categories. Further data collection and analysis will be required to better understand the risks that finance companies assume in lending to SMEs.

Lease Financing provided by Finance and Leasing Companies

While finance companies do authorize debt, they are also major players in the leasing industry. Some key findings related to institutions' leasing activities include (as of December 31, 2001):

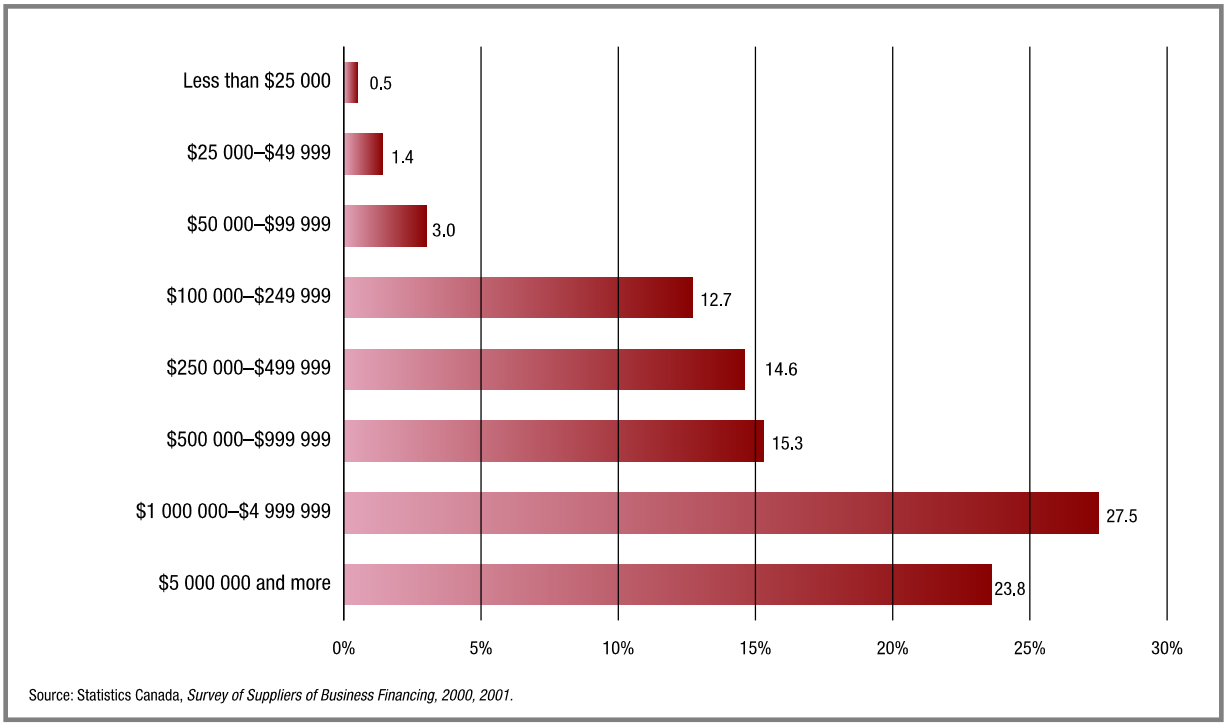
- **Total leases authorized:** $15 billion (47 percent of the total leasing market)
- **Leases authorized (under $1 million):** $10 billion (60 percent of the under $1-million market)

As seen earlier (see Figure 35), finance companies led the industry in lease authorizations as of December 31, 2001, concentrating on mid-sized authorizations. In this category, leases were used primarily to finance automobiles and light-duty vehicles — activities that accounted for the most leasing requests by SMEs in 2000. Since domestic banks are restricted from leasing these types of assets, it is not surprising that finance companies focus primarily on this segment of the market.

Government Business Enterprises (GBEs)

For the purposes of statistical reporting, the category of finance companies includes some Government Business Enterprises (GBEs), defined as Crown corporations (e.g. the BDC) and federal or provincial agencies that offer financing (e.g. ABT Financial Inc.). The other banks category included those GBEs with deposit-taking capabilities. These institutions contributed considerably to the supply of financing. In fact, as seen in Part II of this report, nearly 7 percent of SMEs secured financing from government loans and grants in 2000. These institutions and government programs are important, since they allow SMEs to access financing that would normally be unavailable.

Figure 44
Distribution of Commercial Debt Authorized by Size of Authorization by GBEs as of December 31, 2001



Source: Statistics Canada, *Survey of Suppliers of Business Financing, 2000, 2001.*

Some key findings concerning GBEs as of December 31, 2001 include:

- **Amounts authorized:** $35 billion to businesses in Canada
- **Amounts outstanding:** $25 billion owed by businesses in Canada

Of the $35 billion in commercial debt authorized by GBEs as of December 31, 2001, approximately half ($17 billion) was authorized to SMEs (under $1 million in authorizations). A closer examination of their distribution of commercial debt authorized by the various authorization categories (see Figure 44) reveals that GBEs focussed on larger authorizations. Nearly half (43 percent) of this debt came in authorizations under $500 000. This trend is supported by Crown Corporation financial reports. For example, the BDC reported that the average loan size in 2001 amounted to approximately $324 000.

Due to the confidentiality requirements of the *Statisitcs Act*, more detailed data are not yet available.[88] However, the SME Financing Data Initiative is conducting research on GBEs' amount of financing and target population (in terms of sector and region). More precise conclusions on GBEs' financing of SMEs will be included in future reports.

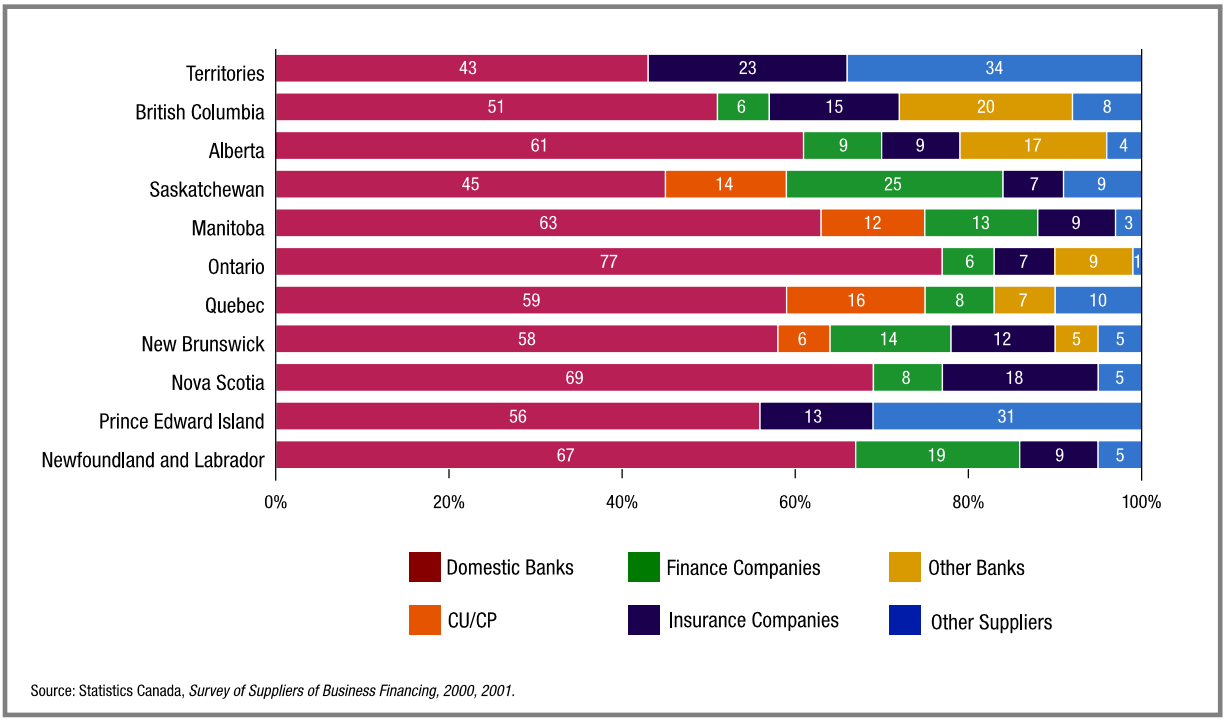
88. For example, data on losses was not available because of confidentiality constraints or poor quality.

4. COMMERCIAL DEBT: A REGIONAL PERSPECTIVE[89]

As seen in sections 1–3, a wide variety of firms provide financial services to Canadian SMEs, and the geographic distribution of these providers depends on the scope of their activity. As illustrated in Figure 45, domestic banks are represented across Canada and are an important supplier of debt in each province and territory.[90] However, as noted in Part II, the regional variations in economic and industrial composition have led to regional concentrations of financial suppliers that focus on particular industries.

Figure 45

Market Share of Financial Service Providers Provision of Commercial Debt by Province/Territory, as of December 31, 2001



Source: Statistics Canada, *Survey of Suppliers of Business Financing, 2000, 2001.*

For example, although credit unions are located throughout Canada, they are more prominent in the western provinces; the same is true for the caisses populaires in Quebec. As was reported in Part II, this distribution affects SMEs' access to financing in various regions, particularly for formal types of financing such as debt.

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89. Provincial data were collected in the *Survey of Suppliers of Business Financing (2000 and 2001),* which allows for the groupings listed above. However, data were collected by region in the *Survey of SME Financing, 2000.* Efforts are being made to ensure consistency between the collection methods of these two surveys so that more in-depth analysis can be pursued.

90. The data are not currently available from the *Survey of Suppliers of Business Financing (2000 and 2001)* to allow for analysis of SMEs by province, therefore any analysis conducted from a regional perspective covers the entire commercial debt market of all businesses across Canada. Nor are the data available to conduct a regional analysis of the leasing market. Other forms of financing, such as risk capital, are examined in part IV.

Atlantic Canada (see Table 21)

Newfoundland and Labrador:
- Commercial debt authorized: $5 billion
- Commercial debt outstanding: $3 billion

Prince Edward Island:
- Commercial debt authorized: $2 billion.
- Commercial debt outstanding: $1 billion

Nova Scotia:
- Commercial debt authorized: $11 billion
- Commercial debt outstanding: $7 billion

New Brunswick:
- Commercial debt authorized: $8 billion
- Commercial debt outstanding: $5 billion

In 2000, among SMEs in Atlantic Canada:

- 54 percent used commercial loans and credit (second highest of all regions)
- 27 percent of an average SMEs' debt outstanding was to chartered banks
- 2 percent of an average SMEs' debt outstanding was to credit unions and caisses populaires
- 8 percent used government loans and grants (third highest in Canada)
- 46 percent used trade credit (highest of all regions)

As seen in Figure 45, domestic banks were an important supplier of commercial debt to businesses in this region in 2001. These findings reflect conclusions from Part II (summarized in the textbox above) — a significant proportion (27 percent) of formal debt owed by SMEs was to chartered banks. Although other providers of commercial debt, such as insurance companies, operate in this region (second largest supplier of debt to this region in 2001), they do not focus on smaller authorization amounts (see Figure 32). The SME Financing Data Initiative will continue to monitor this issue and will collect more detailed data on businesses' access to formal types of financing.

Finance Companies

Finance companies (which include some Government Business Enterprises) are active in this region, particularly in Newfoundland and Labrador (19 percent) and New Brunswick (14 percent). These market shares likely represent GBEs rather than specialized finance companies; however, as discussed earlier more detailed data are needed to determine government programs' roles in Atlantic Canada and their impact on SMEs' access to financing.

Quebec (see Table 21)

- Commercial debt authorized: $148 billion
- Commercial debt outstanding: $73 billion

In Quebec, domestic banks were an important supplier of commercial debt, representing nearly 60 percent of the market for debt authorized to all firms as of December 31, 2001. However, unlike Atlantic Canada and Ontario, businesses in Quebec have access to other providers of formal types of financing — particularly the caisses

In 2000, among SMEs in Quebec:

- 51 percent used commercial loans and credit
- 26 percent of an average SMEs' debt outstanding was to chartered banks
- 11 percent of an average SMEs' debt outstanding was to credit unions and caisses populaires
- 8 percent used government loans and grants
- 37 percent used trade credit

populaires (18 percent, see Figure 33). As a result, access to formal types of financing is more diversified in Quebec than elsewhere in Canada.

Caisses populaires serve an important role in Quebec, since they concentrate on smaller authorization categories — amounts typically sought by SMEs (see Figure 33). As seen in Part II, nearly half of SMEs in Quebec used a commercial loan or credit in 2000 (see Table 11). The fact that 16 percent of commercial debt authorized to all businesses in Quebec originated from caisses populaires indicates that these institutions are a viable alternative to domestic banks for formal types of financing. More importantly, these institutions tend to authorize debt to high-risk SMEs that domestic banks would be unlikely to consider (see Figure 41). While it is not yet possible to calculate what percentage of commercial debt authorized by financial suppliers flows to SMEs, the demand survey results (summarized in the box) reveal that commercial forms of financing are an important source of financing for Quebec SMEs. More detailed data, coupled with the information found in Part II, will provide a better understanding of the supply of formal types of debt to SMEs in Quebec.

Ontario (see Table 21)

- Commercial debt authorized: $512 billion
- Commercial debt outstanding: $164 billion

Domestic banks were the leading suppliers of debt in 2001, authorizing almost $400 billion (more than 77 percent) in debt financing to Ontario businesses. This may reflect Ontario's industrial and economic landscape and the range and size of businesses in this province. Nearly a quarter of all medium-sized firms (100–499 employees) in Canada are located in Ontario.

In 2000, among SMEs in Ontario:

- 44 percent used commercial loans and credit (lowest of all regions)
- 31 percent of an average SME's debt outstanding was to chartered banks (highest of all regions)
- 3 percent of an average SME's debt outstanding was to caisses populaires
- 4 percent used government loans and grants (lowest of all regions)
- 37 percent used trade credit

As seen in Part II, close to 80 percent (see Table 11) of medium-sized firms used a commercial loan or credit, indicating that formal types of financing are an important source of financing for these businesses. Additionally, in 2000 close to 40 percent of an average medium-sized firm's outstanding debt was for loans from chartered banks. These financial institutions are the most important supplier of financing to SMEs in Ontario. Consolidations among these institutions could have an impact on Ontario SMEs' access to formal types of financing.

Other banks and insurance companies were also key suppliers of debt to Ontario businesses; as of December 31, 2001 these suppliers captured 9 percent and 7 percent of the total authorized debt market. However, as noted earlier, these financial service providers do not typically serve the SME market, but tend to focus on larger businesses. Of all regions in Canada, Ontario SMEs' access to formal types of financing will be most affected by financial services consolidation, since they have the highest reliance on formal types of financing and domestic banks.

Western Provinces (see Table 21)

Manitoba:
- Commercial debt authorized: $20 billion
- Commercial debt outstanding: $11 billion

Saskatchewan:
- Commercial debt authorized: $17 billion
- Commercial debt outstanding: $10 billion

Alberta:
- Commercial debt authorized: $93 billion
- Commercial debt outstanding: $48 billion

British Columbia:
- Commercial debt authorized: $69 billion
- Commercial debt outstanding: $43 billion

As seen in Part II, SMEs' use of formal types of financing in this region was consistent with the national average (48 percent); in some provinces, such as Manitoba or Saskatchewan, usage rates are higher than the national average (61 percent). This reflects the market share of agricultural and primary-based industries in this region, and their need for asset-based financing.

In 2000, among SMEs in Western Canada:

Manitoba/Saskatchewan/Nunavut:
- 61 percent used commercial loans and credit (highest of all regions)
- 37 percent of an average SMEs debt outstanding was to chartered banks
- 12 percent of an average SMEs debt outstanding was to credit unions and caisses populaires (highest of all regions)
- 14 percent used government loans and grants

In 2000, among SMEs in Alberta/NWT:
- 51 percent used commercial loans and credit

In 2000, among SMEs in British Columbia/Yukon:
- 46 percent used commercial loans and credit

From a supply perspective, domestic banks were an important provider of commercial debt to all businesses in the western provinces. As of December 31, 2001 domestic banks provided $111 billion out of $198 billion (56 percent of authorizations to all businesses). This was significantly lower than the $121 billion authorized by domestic banks in 2000. Since overall authorizations remained stable, this indicates that other financial suppliers gained market share in the supply of commercial debt — most notably credit unions and other banks.

As seen in Figure 45, credit unions were active in Western Canada and were an alternative to domestic banks for businesses seeking formal types of commercial debt, particularly for SMEs or for businesses seeking authorization amounts under $1 million (see Figures 33 and 34). This is consistent with evidence from Part II, which showed that in 2000, 12 percent of the average SMEs' debt outstanding in these provinces was to credit unions or caisses populaires (significantly higher than the national average of 5 percent). This represented the highest proportion of SME debt to credit unions and caisses populaires of any region in Canada (see Table 11).

Although credit unions were the third largest providers of debt in Saskatchewan and Manitoba , representing 14 and 12 percent of the market in 2001, these suppliers were less active in Alberta and British Columbia. However, other banks were key suppliers of debt to businesses in Alberta

and British Columbia, representing one fifth of the debt market. Other banks include provincial deposit-taking agents, such as the ATB Financial Inc., which may explain why these institutions attracted a higher market share than other banks in other regions.

The diversity of financial suppliers in this region may also be related to domestic banks' sale of branches to credit unions over the past decade. While the Public Accountability Statements on the sale and purchase of bank branches provides basic information, there are few data on the actual number of domestic bank branches in Canada. Given that 80 percent of SMEs applied for debt in person at a branch (see Table 18), the availability of access points may determine the choice of institution. However further data collection and analysis will be required to understand the importance of this issue to the patterns of small business demand for debt.

Territories (see Table 21)

- Commercial debt authorized: $1.5 billion
- Commercial debt outstanding: $806 million

As seen in Figure 45, domestic banks were the main source of commercial debt financing for businesses in the Northwest Territories, Yukon and Nunavut. Domestic banks in Yukon authorized $494 million of debt out of a total amount of $671 million (74 percent of the market). Other financial providers, including insurance companies and finance companies, authorized $116 million and $60 million of debt as of December 31, 2001.

5. COMMERCIAL DEBT: A SECTORAL PERSPECTIVE

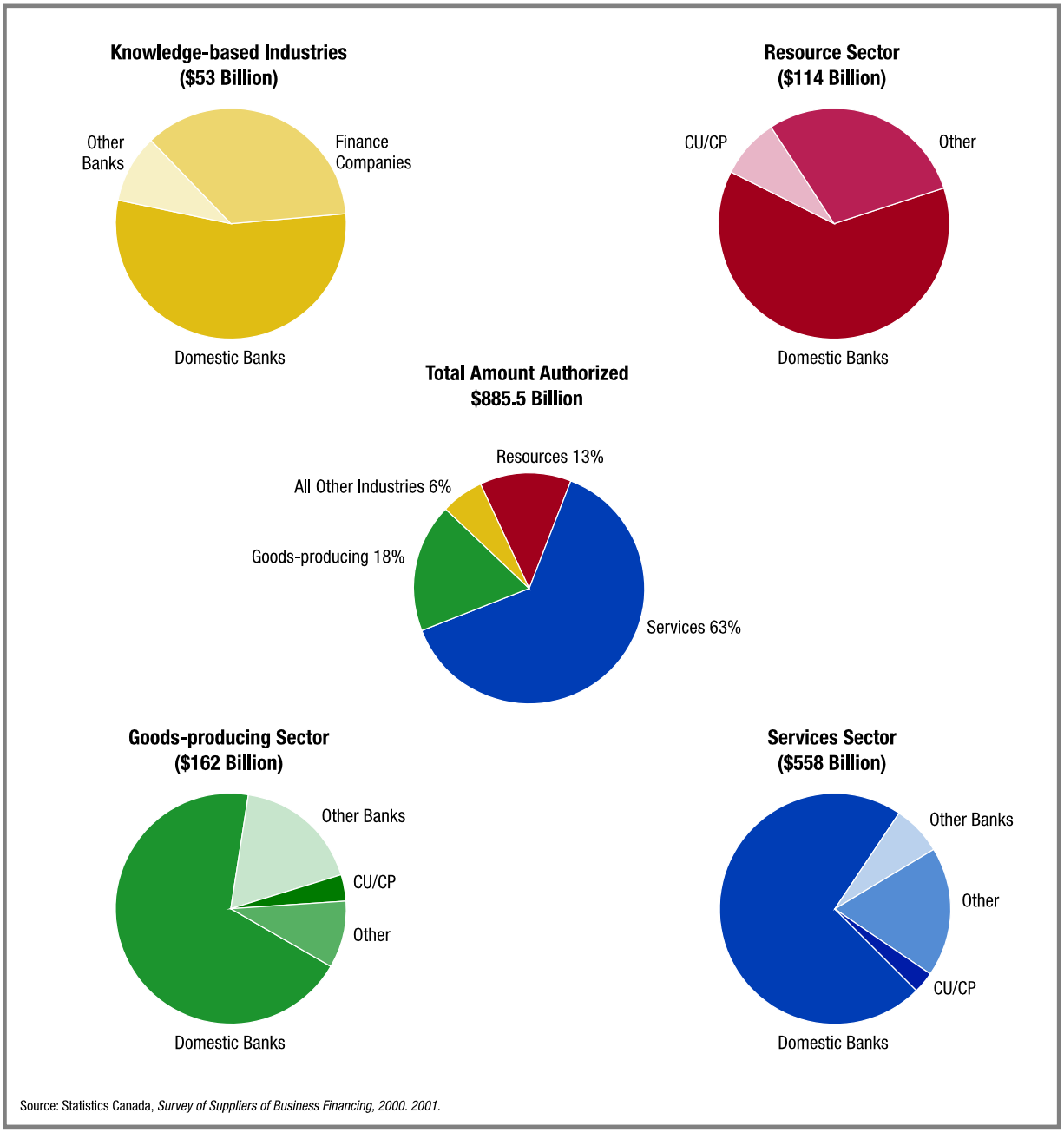
This section examines the distribution of commercial debt by financial service providers and distinguishes how this distribution differs across sectors. It should be noted that the analysis reflects commercial debt authorized to all businesses in Canada and is not limited to SMEs.

As noted in Part II of this report, industry sector has a strong influence on a business' financial structure. Resource-based (e.g. agriculture and other primary industries) and goods-producing firms have more fixed asset collateral, which enables them to support higher levels of formal debt, and eases their access to formal sources of debt. In fact, as of December 31, 2001, more than one third (36 percent) of commercial debt was authorized to businesses in the goods-producing and resources sectors (see Figure 46).

The service sector constituted the largest (63 percent) portion of commercial debt authorizations as of December 31, 2001. As noted in Part II, compared with firms in the resources or goods-producing sectors, services sector financial structures tend to be more diversified and they use more informal types of financing. This may reflect the range of industries in the services sector and the degree to which they use formal types of financing. At one end of the spectrum are knowledge-based firms that typically have a low asset base and are therefore less likely to use conventional debt instruments. The other end of the spectrum includes industries that use asset-based financing and rely on formal types of financing. A more detailed review of the resource-based, goods-producing and services sectors is presented below.

Figure 46

Distribution of Commercial Debt Authorized by Financial Service Providers by Sector as of December 31, 2001



Source: Statistics Canada, *Survey of Suppliers of Business Financing, 2000. 2001.*

Resource-Based Sector

As of December 31, 2001, the amounts authorized for firms in the resource-based sector include:

- **Agriculture:** $55 billion (6 percent of overall authorized debt)
- **All other primary industries**: $58 billion (7 percent)
- **Total resource-based sector**: $114 billion (13 percent)

As seen in Figure 46, domestic banks were an important supplier of commercial debt for resource-based firms. Of the $114 billion of commercial debt authorized to all Canadian resource-based firms, over two-thirds (62 percent) was authorized by domestic banks. The remainder was divided among credit unions and caisses populaires (8 percent) and other suppliers (30 percent). This is not surprising given the findings in Part II, which showed that 72 percent of agricultural SMEs used commercial loans (the highest of all sectors). More importantly, 34 percent of an average SME's debt outstanding was to domestic banks and a further 11 percent was owed to credit unions and caisses populaires. Although these preliminary results suggest some consistencies between the demand and supply of commercial debt among SMEs, further data collection and analysis will be required to understand the relationship between the suppliers of formal types of financing and small businesses' demand for commercial debt.

Goods-Producing Sector

As of December 31, 2001, the amounts authorized for firms in the goods-producing sector include:

- **Manufacturing:** $123 billion (14 percent of overall authorized debt)
- **Construction**: $39 billion (4 percent)
- **Total goods-producing sector**: $162 billion (21 percent)

Domestic banks were the most important supplier of commercial debt to businesses in the goods-producing sector, accounting for nearly 71 percent ($115 billion) of debt authorizations in 2001. Of the $115 billion authorized by domestic banks, 75 percent was authorized to manufacturing firms. This was consistent with the findings in Part II, which found that 51 percent of manufacturing SMEs used commercial loans and credit to finance their operations in 2000. Moreover, 27 percent of manufacturing SMEs had debt outstanding to a chartered bank in 2000. Again, limitations of the supply survey data prevent a more thorough examination of the supply of commercial debt to SMEs. Data collection and analysis will illuminate the relationship between domestic banks and small businesses' demands for commercial debt. The concentration of manufacturing industries in Ontario and Quebec helps explain the important market presence of domestic banks in these provinces.

Other banks were also important suppliers to firms in this sector, with 21 percent of other banks' debt authorizations going to manufacturing firms. This tendency was likely due to the nature of their activities and their high asset base to secure collateral. In addition, other banks authorized the second largest amount of commercial debt to firms in the construction industry, accounting for $5 billion (14 percent) as of December 31, 2001.

Services Sector

As of December 31, 2001, the amounts authorized in the services sector include:

- **Finance/insurance**: $227 billion (26 percent of overall authorized debt)
- **Real estate/rental/leasing**: $67 billion (8 percent)
- **Retail trade**: $ 60 billion (7 percent)
- **Transportation/wharehousing**: $41 billion (5 percent)
- **Entertainment/accommodation**: $33 billion (4 percent)
- **Information/culture**: $30 billion (3 percent)
- **Utilities**: $ 25 billion (3 percent)
- **Professional/scientific/technical**: $17 billion (2 percent)
- **Education/health care**: $ 20 billion (2 percent)
- **Wholesale trade**: $38 billion (4 percent)
- **Total services sector**: $558 billion (63 percent)

Of the more than $500 billion in commercial debt authorized to the services sector, the distribution of debt authorized among financial suppliers, as of December 31, 2001, consisted of:

- **Domestic banks:** $407 billion (73 percent of debt authorized to this sector)
- **Other banks:** $50 billion (9 percent)
- **Credit unions and caisses populaires:** $17 billion (3 percent)
- **Other suppliers:** $84 billion (15 percent)

For the domestic banks, the majority (53 percent) of debt authorized was to finance and insurance companies. Typically, firms in these industries seek larger authorization amounts, which may explain the tendency of domestic banks to provide large amounts of commercial debt to these firms and may account for these firms' reliance on domestic banks (see Figure 36). Other major service sector industries served by the domestic banks include retail trade, real estate/rental/leasing and knowledge-based industries.

From a general perspective the findings on the supply of commercial debt seem to be consistent with the findings on the demand for debt, which were reported in Part II. Although there was no distinct "services sector" category in Part II, many of these SMEs were categorized as "other industries." As reported in the summary tables of Part II, 47 percent of SMEs in other industries used formal debt to finance their operations — consistent with the national average and similar to the supply of debt noted above. However, nearly one third of an average SME's debt outstanding was to chartered banks in 2000, higher than the national average, and also the highest percentage of debt owed across all sources of financing.

Given the data limitations, these observations about the supply of and demand for commercial debt must remain general. Efforts are under way to improve data and analysis in order to better understand the sectoral distribution of commercial debt. As noted in Part II, understanding the relationship between the supply of and demand for commercial debt across various sectors is key to analyzing the issues surrounding SMEs' access to financing.

6. SUMMARY TABLES

Table 19 — Amount of Commercial Debt Authorized and Outstanding by Authorizations as of December 31, 2001

	Domestic banks	Other banks	Credit unions and caisses populaires	Finance companies	Portfolio managers, venture capital companies, financial funds	Insurance companies	Leasing companies	Total - all suppliers
LESS THAN $25 000								
Amounts authorized ($ millions)	3 118.5	280.7	2 073.7	1 181.8	220	x	x	7 153.5
Amounts outstanding ($ millions)	1 547.9	146.5	1 092.3	323.2	165	x	x	3 430.9
Number of clients (thousands)	416	24.4	175.5	177.4	28.4	x	x	859.3
$25 000–$49 999								
Amounts authorized ($ millions)	4 183.2	393.2	2 520.0	1 366.6	161.7	78.3	32.6	8 735.6
Amounts outstanding ($ millions)	2 439.4	231.2	1 478.1	706.7	87.4	9.7	18.9	4 971.4
Number of clients (thousands)	121	11.5	72.5	39	4.6	2.2	0.9	251.7
$50 000–$99 999								
Amounts authorized ($ millions)	8 454.8	901.4	4 830.3	3 060.0	350.4	x	x	17 797.3
Amounts outstanding ($ millions)	5 165.8	566.3	3 100.8	1 734.2	218.7	x	x	10 859.9
Number of clients (thousands)	125.2	13.5	70.7	43.8	5	x	x	261
$100 000–$249 999								
Amounts authorized ($ millions)	17 775.2	2 403.5	8 543.9	8 698.9	550.5	409.8	249.2	38 631.0
Amounts outstanding ($ millions)	11 826.0	1 659.8	5 715.4	4 921.1	253.5	142.6	143.1	24 661.5
Number of clients (thousands)	115.7	15.3	56.4	56.7	3.5	2.6	1.6	251.8
$250 000–$499 999								
Amounts authorized ($ millions)	17 211.8	2 437.6	5 004.5	10 830.0	163.5	370.7	70	36 088.1
Amounts outstanding ($ millions)	11 580.2	1 686.8	3 463.1	6 452.8	114.4	214.5	26.5	23 538.3
Number of clients (thousands)	49.6	7	14.7	31.8	0.5	1.1	0.2	104.9
$500 000–$999 999								
Amounts authorized ($ millions)	19 895.1	3 056.4	3 682.8	10 067.3	424.2	1 433.2	81.9	3 8640.9
Amounts outstanding ($ millions)	13 081.0	1 976.8	2 469.9	6 666.8	323.6	1 021.6	33.6	25 573.3
Number of clients (thousands)	28.6	4.5	5.5	14.7	0.6	1.9	0.1	55.9

Continued . . .

Table 19 — Amount of Commercial Debt Authorized and Outstanding by Authorizations as of December 31, 2001

	Domestic banks	Other banks	Credit unions and caisses populaires	Finance companies	Portfolio managers, venture capital companies, financial funds	Insurance companies	Leasing companies	Total - all suppliers
SUB-TOTAL OF SMEs								
Amounts authorized ($ millions)	70 638.6	9 472.8	26 655.2	35 204.6	1 870.3	2292	433.7	14 7046.4
Amounts outstanding ($ millions)	45 640.3	6 267.4	17 319.6	20 804.8	1 162.6	1 388.4	222.1	93 035.3
Number of clients (thousands)	856.1	76.2	395.3	363.4	42.6	7.8	2.8	1 784.6
$1 000 000–$4 999 999								
Amounts authorized ($ millions)	5 7201.3	10 556.9	5 815.5	16 250.6	3 987.6	22 018.4	121.3	115 951.6
Amounts outstanding ($ millions)	35 343.5	6 667.5	3 526.6	10 906.3	2 742.9	15 185.7	58.6	74 431.1
Number of clients (thousands)	27	5	3.3	7.4	1.6	9.3	0.1	53.7
$5 000 000 AND MORE								
Amounts authorized ($ millions)	482 060.8	68 237.4	6 091.2	12 750.3	9 614.1	48 331.4	4 370.0	631 455.2
Amounts outstanding ($ millions)	120 533.9	28 849.2	3 596.3	8 127.6	6 343.9	32 539.6	799.5	200 790.0
Number of clients (thousands)	10.1	2.5	0.4	0.7	0.4	3.9	0.1	18.1
TOTAL — ALL CLIENTS								
Amounts authorized ($ millions)	609 900.7	88 267.1	38 561.9	64 205.5	15 472.0	73 004.2	5 041.8	894 453.2
Amounts outstanding ($ millions)	201 517.7	41 784.1	24 442.5	39 838.7	10 249.4	49 280.4	1 143.6	368 256.4
Number of clients (thousands)	893.2	83.7	399	371.5	44.6	53.2	11.2	1 856.4

Note: “x” refers to estimates suppressed to meet the confidentiality requirements of the *Statistics Act* and/or for data quality reasons.

Source: Statistics Canada, *Survey of Suppliers of Business Financing, 2001*.

Table 20 — Amount of Commercial Debt Authorized and Outstanding by Industry as of December 31, 2001

2001			
	Amounts authorized ($ millions)	Amounts outstanding ($ millions)	Number of clients (thousands)
Agriculture, forestry, fishing	54 848.5	36 135.9	381.8
Mining, oil, gas extraction	59 757.5	2 3703	51.3
Utilities	25 193.5	9 316	12.4
Construction	40 031.9	20 477.5	141.4
Manufacturing	123 352.2	53 916.3	129.3
Wholesale trade	35 716.9	14 977.7	53.4
Retail trade	61 470.1	31 289.7	239.1
Transportation, warehousing	40 657.8	18 112.0	71.1
Information, culture	30 613.7	9 691.2	24.5
Finance, insurance	228 960.4	35 539.3	50.3
Real estate, rental, leasing	69 187.3	47 582.7	142.5
Professional, scientific, technical	17 204.5	7 838.8	91.6
Education, health	20 052.3	10 151.2	66.6
Entertainment, accommodation	34 339.7	19 256.3	112.6
Knowledge-based industries	42 082.2	21 551.6	73
All other industries, unknown	53 066.7	30 268.5	288.1
Total - all industries	894 453.0	368 256.1	1 856.0

Source: Statistics Canada, *Survey of Suppliers of Business Financing, 2001.*

Table 21 — Debt Authorized and Outstanding by Province as of December 31, 2001

2001			
	Amounts authorized ($ millions)	Amounts outstanding ($ millions)	Number of clients (thousands)
Newfoundland and Labrador	4 800.2	3 053.3	16.3
Prince Edward Island	2 012.4	1 297.7	8.8
Nova Scotia	12 240.5	7 060.2	65.9
New Brunswick	7 570.7	4 649.3	32.4
Quebec	151 832.2	73 469.8	502.2
Ontario	515 965.4	164 160.7	610
Manitoba	19 491.3	11 097.4	96.3
Saskatchewan	16 780.4	10 252.0	118.5
Alberta	93 539.1	49 251.3	234.9
British Columbia	68 698.9	43 108.4	167.2
Yukon	479.4	327.9	1.3
Northwest Territories	609.7	379.6	1.3
Nunavut	432.5	148.9	1.2
Canada	894 452.7	368 256.5	1 856.3

Source: Statistics Canada, *Survey of Suppliers of Business Financing, 2001*.

Table 22 — Amount of Lease Financing Authorized and Outstanding by Authorizations as of December 31, 2001

	Domestic banks	Finance companies	Leasing companies	All other suppliers	Total - all suppliers
LESS THAN $25 000					
Amounts authorized ($ millions)	13.8	559.9	1 419.0	160.8	2 153.5
Amounts outstanding ($ millions)	11.9	365.9	863.7	110.1	1 351.6
Number of clients (thousands)	1.1	105.6	193.6	13.2	313.5
$25 000–$49 999					
Amounts authorized ($ millions)	38.1	6 293.2	1 022.5	50	7 403.8
Amounts outstanding ($ millions)	33.9	2 295.1	550.6	34	2 913.6
Number of clients (thousands)	1.1	189.1	32	1.4	223.6
$50 000–$99 999					
Amounts authorized ($ millions)	111.5	980.5	464.7	240.2	1 796.9
Amounts outstanding ($ millions)	98.4	745.1	273.9	186.2	1 303.6
Number of clients (thousands)	1.7	13	6.7	3.2	24.6
$100 000–$249 999					
Amounts authorized ($ millions)	343	451.6	552.2	131.9	1 478.7
Amounts outstanding ($ millions)	297.4	331.2	301	93.4	1 023.0
Number of clients (thousands)	2.5	3	4	0.8	10.3
$250 000–$499 999					
Amounts authorized ($ millions)	445.5	500.4	241	108.2	1 295.1
Amounts outstanding ($ millions)	379.3	372.6	134.2	85	971.1
Number of clients (thousands)	1.4	1.4	0.7	0.3	3.8
$500 000–$999 999					
Amounts authorized ($ millions)	567	708.3	286.1	397.4	1 958.8
Amounts outstanding ($ millions)	469.2	531.9	142.9	334.9	1 478.9
Number of clients (thousands)	0.9	1	0.4	0.5	2.8
$ 1 000 000–$4 999 999					
Amounts authorized ($ millions)	1 633.1	2 165.6	536.9	491.5	4 827.1
Amounts outstanding ($ millions)	1 266.4	1 676.3	282.7	370.8	3 596.2
Number of clients (thousands)	0.9	1	0.3	0.2	2.4

Continued . . .

Table 22 — Amount of Lease Financing Authorized and Outstanding by Authorizations as of December 31, 2001

	Domestic banks	Finance companies	Leasing companies	All other suppliers	Total - all suppliers
$5 000 000 AND MORE					
Amounts authorized ($ millions)	5 417.1	3 651.0	1 751.4	693.1	11 512.6
Amounts outstanding ($ millions)	4 511.4	2 800.1	1 091.8	511.1	8 914.4
Number of clients (thousands)	0.7	0.1	0.1	0.1	1
TOTAL — ALL CLIENTS					
Amounts authorized ($ millions)	8 569.1	15 310.5	6 273.8	2 273.1	32 426.5
Amounts outstanding ($ millions)	7 067.9	9 118.2	3 640.8	1 725.5	21 552.4
Number of clients (thousands)	10.3	314.2	237.8	19.7	582

Source: Statistics Canada, *Survey of Suppliers of Business Financing, 2001.*

Table 23 — Amount of Lease Financing Authorized and Outstanding by Industry as of December 31, 2001

2001			
	Amounts authorized ($ millions)	Amounts outstanding ($ millions)	Number of clients (thousands)
Agriculture, forestry, fishing	2 397.8	1 131.2	62.9
Mining, oil, gas extraction	1 479.9	1 039.3	7.4
Utilities	249.9	166.8	1
Construction	3 275.7	1 636.3	69.3
Manufacturing	7 465.6	5 251.3	84.2
Wholesale trade	944.2	683.8	20.2
Retail trade	1 631.0	1 243.8	18.7
Transportation, warehousing	8 227.8	5 662.8	139.4
Information, culture	309.3	241.5	1.6
Finance, insurance	674.9	506	15.4
Real estate, rental, leasing	641.4	521.4	4.9
Professional, scientific, technical	778.4	544.3	24
Education, health	1 076.6	783.9	22
Entertainment, accommodation	1 473.2	973	28.3
Knowledge-based industries	408.2	251.4	0.6
All other industries, unknown	1 801.1	1 166.8	82.9
Total – all industries	32 426.8	21 552.2	582.2

Source: Statistics Canada, *Survey of Suppliers of Business Financing, 2001.*

Table 24 — Amount of Lease Financing Authorized and Outstanding by Province as of December 31, 2001

2001			
	Amounts authorized ($ millions)	Amounts outstanding ($ millions)	Number of clients (thousands)
Newfoundland and Labrador	397.5	273.5	6
Prince Edward Island	x	x	x
Nova Scotia	423	291.4	8.6
New Brunswick	410.6	275	8.5
Quebec	5 543.3	3 940.7	98.9
Ontario	13 019.1	9 233.7	210.5
Manitoba	4 269.7	1 739.6	102.5
Saskatchewan	1 121.8	790.4	17.9
Alberta	3 766.3	2 458.2	58.3
British Columbia	3 192.5	2 319.2	67.9
Yukon	x	x	x
Northwest Territories	x	x	x
Nunavut	x	x	x
Canada	32 426.5	21 552.3	581.8

An “X” refers to estimates suppressed to meet the confidentiality requirements of the Statistics Act and/or for low data quality reasons.

Source: Statistics Canada, *Survey of Suppliers of Business Financing, 2001*.

Table 25 — Loss Rates (%) on Commercial Debt, by Authorization Categories, of Financial Suppliers in 2001

	Domestic banks	Other banks	Credit unions and caisses populaires	Finance companies	Portfolio managers, venture capital companies, financial funds	Insurance companies	Leasing companies	Total - all suppliers
LESS THAN $25 000	1.77	X	1.83	1.36	5.56	x	x	1.68
$25 000–$49 999	0.88	x	1.18	1.73	X	x	0.53	1.1
$50 000–$99 999	2.26	x	1	0.89	x	x	x	1.59
$100 000–$249 999	0.82	0.5	0.9	0.81	x	x	x	0.82
$250 000–$499 999	0.55	0.53	0.87	0.67	x	x	x	0.66
$500 000–$999 999	0.68	0.76	0.53	0.53	7.09	0.24	0.89	0.69
SUB-TOTAL OF SMEs	**0.91**	**0.61**	**1.12**	**0.72**	**6.41**	**0.32**	**3.36**	**0.88**
$1 000 000–$4 999 999	0.25	0.7	x	0.56	3.97	0.26	x	0.5
$5 000 000 AND MORE	0.32	1.19	x	0.59	2.89	0.34	x	0.54
TOTAL — ALL CLIENTS	**0.44**	**1.03**	**0.79**	**0.65**	**3.4**	**0.31**	**0.84**	**0.62**

An "x" refers to estimates suppressed to meet the confidentiality requirements of the Statistics Act and/or for low data quality reasons.

Source: Statistics Canada, *Survey of Suppliers of Business Financing, 2001*.

PART IV: PROFILE OF RISK CAPITAL FINANCING

Part IV examines four types of financing used by small and medium-sized firms at various stages of development, and discusses their economic importance:

- informal financing
- venture capital financing
- initial public offerings (IPOs)
- quasi-equity financing (also known as mezzanine financing or subordinated debt)

The first section describes the spectrum of risk capital financing, discusses the type of companies that typically receive it and outlines firms' financial needs from seed to expansion stage.

The second section describes informal investment (love money and angel financing), and the current state and future direction of research in this area through the SME Financing Data Initiative.

The third section explains the state and the economic impact of venture capital in 2001 and 2002, by sector, region, stage of investment, type of investor and first-time versus follow-on financing, and compares Canada and US venture capital activity over the 1996–2002 period.

The fourth section discusses research on the costs, issues and regulations associated with raising first-time capital on the Canadian stock market, and evaluates the short- and medium-term success of Canadian IPOs.[91]

The last section discusses the state of quasi-equity financing in Canada in 2002.

1. RISK CAPITAL FINANCING — AN OVERVIEW

Risk capital is only one of many financing instruments available to Canadian SMEs. As discussed earlier in Part II, most SME debts are secured by business assets — short-term debt by accounts receivable and inventories, and long-term debt by fixed assets, such as land, buildings, machinery or equipment. SMEs also commonly use lease financing and quasi-equity debt. These involve flexible repayment terms over a relatively long period and royalty participation in the success of the business. Risk capital, on the other hand, is totally unsecured.

91. Cécile Carpentier, Maher Kooli, J.M. Suret, *"Les Émissions Initiales au Canada: Bilan, Anomalies, et Dysfonctions,"* 2003 (**http://strategis.ic.gc.ca/fdi**).

The main characteristics of firms that are financed by risk capital are:

- ***High-growth orientation*** involving rapid potential and actual growth in terms of sales and market share, based on competitive advantage and dominant market position
- ***International orientation*** requiring strong potential for penetration of foreign markets and rapid growth in exports and/or foreign business operations
- ***High rates-of-return on equity*** arising from rapid sales growth and wide profit margins (or a high potential to achieve these targets). Generally, venture capitalists invest in firms that provide annual rates of return in the 35-to-40-percent range over a three-to-seven-year period (or at least returns proportional to the perceived risk)
- ***High R&D spending*** for product development and the creation of unique products, with the potential for a variety of applications that are required to maintain rapid sales growth and high profit margins in domestic and foreign markets;
- ***Strong management teams*** with a combination of technical, financial and marketing skills, ideally with experience raising and exiting risk capital investments
- ***Ownership structures*** providing for approximately one third ownership holdings by each of the initial informal investors or venture capitalists (up to a maximum of 50 percent), follow-on venture capitalists and founders

Which firms typically seek risk capital financing?

High-growth and KBI firms usually develop an idea, concept or product that requires an incubation period before generating revenues and profits. These firms face unique challenges in securing access to timely and appropriate financing, since they lack sufficient tangible assets to secure bank loans or other types of formal financing. Risk capital is often a more appropriate financing instrument for high-growth-potential and start-up SMEs, particularly in knowledge-based industries. It can originate from a number of sources, including: the entrepreneur's own investment, investment by family and friends (love money), informal private investment by wealthy individuals (angel investors), venture capital investment and investment through initial public offerings on stock exchanges.

Venture capital is an important source of financing for a small number of technology-based start-up firms. In 2002, the majority of venture capital investments (84 percent) were concentrated in two technology-intensive sectors — information and communications technologies (65 percent) and life sciences (19 percent) — while traditional sectors attracted 11 percent of VC investments. However, low technology companies[92] in traditional sectors with a unique idea or product and high market potential may also attract risk capital investment.

The spectrum of risk capital financing

Most businesses use a variety of financial tools throughout their life cycle. Business creation and company growth usually require several stages of financing, involving both debt and risk capital. In fact, what is appropriate at one stage of development may not be appropriate at another stage. For example, although SMEs commonly use traditional debt, this type of financing is often not appropriate or accessible for fast-growth and start-up KBI firms, for at least two reasons:

92. Paul Gompers, *A Note on the Venture Capital Industry,* Harvard Business School, July 2000.

- These firms are knowledge-based and technology-driven, so their assets may be intangible and financial institutions are usually unable to realize any value in the event of a default
- Their products may take time before generating revenues and profits, so firms may be unable to service the debt during this preprofit period

As shown in Figure 47, during the seed and start-up stages, technology-driven high-growth SMEs are often almost entirely dependent on risk capital from owners' personal resources and informal investors (family, friends, private individuals or business angels) to finance their initial operations, such as research and product development. In the seed stage, equity financing is initially obtained either from the entrepreneur or from family and friends. Subsequently, financing may be supplemented by seed capital investment from informal private investors and, in a few cases, (e.g. high-growth-potential firms), by seed financing funds and venture capitalists. For high-growth-potential start-ups, informal investors and/or early-stage venture capital investors are the main source of external financing. In the expansion stage, SMEs generally require increasing amounts of equity to maintain R&D and product commercialization while expanding marketing and sales activities.

As companies continue to expand, they often require growing amounts of equity investment — amounts normally only available through IPOs on stock exchanges. Not only do IPOs supply growth capital, they also provide exit avenues for venture capitalists and other early-stage investors. Timely exits allow investors to recoup their original investments, realize their gains and reinvest their capital.

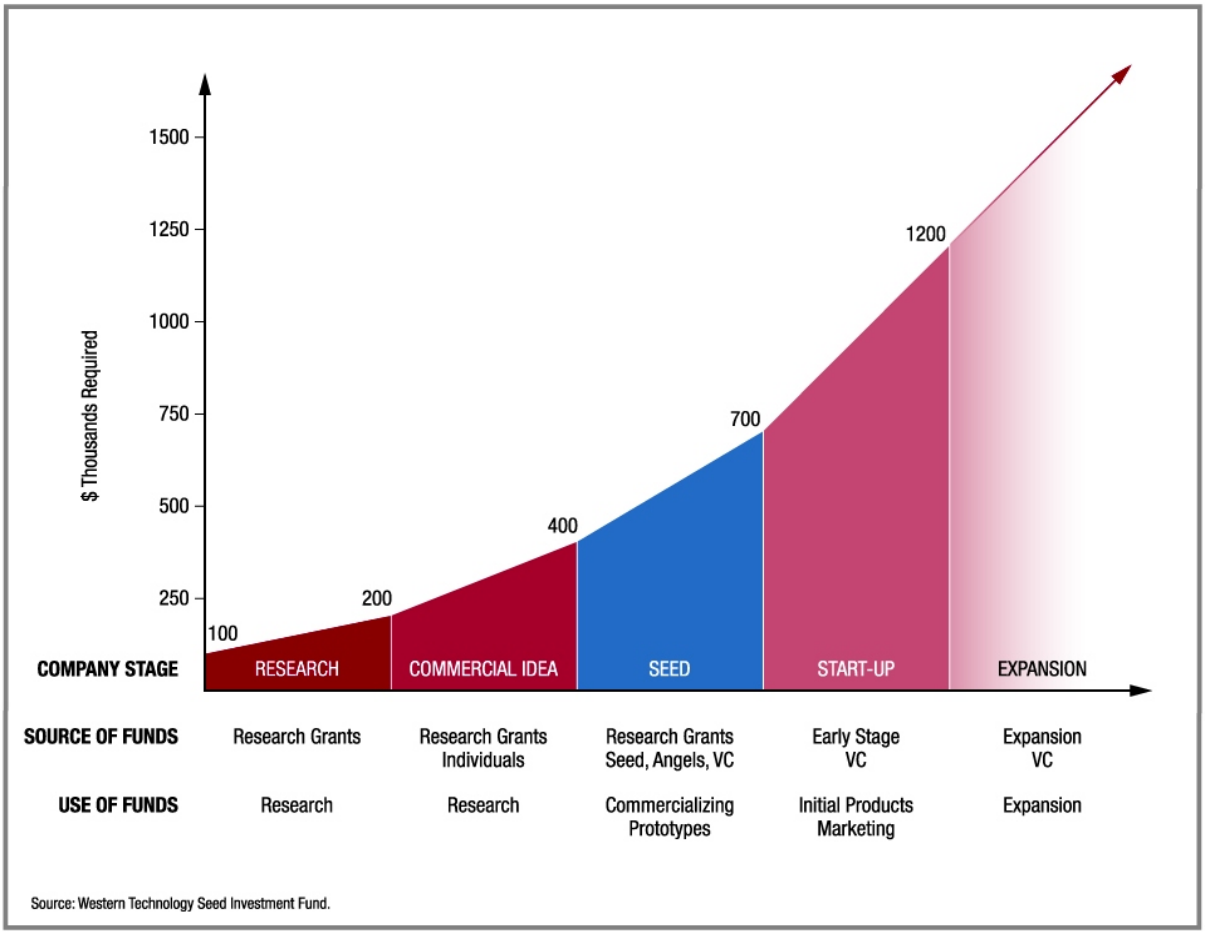
Risk capital encompasses a broad spectrum of financing options for companies at various stages of development. For investors, these options are highly interdependent, since market conditions that affect one type of risk capital often affect others. These market conditions determine the likelihood of a profitable exit from an investment, which in turn has a direct bearing on the availability of risk capital for other investments. From the investee company's perspective, market conditions determine whether they can access risk capital. For example, the availability of venture capital often depends on conditions in the IPO market. When venture capitalists see high prices and active markets for new firms on stock exchanges, they are more willing to invest in early-stage firms. A healthy IPO market goes hand-in-hand with a robust venture capital sector.[93] Without the ability to liquidate their positions in companies by taking them public, venture capitalists cannot, realize their profits and reinvest in other high-growth-potential firms. However, as will be discussed later in Section 4, IPOs are not always an appropriate financing option for SMEs.

The following sections examine three closely related sources of SME financing — informal investors, venture capital and initial public offerings — and assess the level of activity and impact of each type of financing on SMEs' development.

93. Josh Lerner, *Venture Capital, Technological Innovation, and Growth*, 2001, Harvard Business School.

Figure 47

Types and Amounts of Risk Capital Financing by Stage of Development — Technology-driven Businesses



Source: Western Technology Seed Investment Fund.

2. INFORMAL INVESTORS — FRIENDS, FAMILY AND ANGELS

There are important linkages between informal investors, the VC industry and public markets. As seen in Figure 47, before seeking VC, new firms likely obtain initial funding through informal channels (family, friends and angels investors).

Informal investors play an important role in the initial phases of SMEs' development, particularly for start-ups and early-stage firms. These investors have had an increasingly important impact on the businesses they finance, providing investment capital and managerial support. In the US, the informal investor market has been identified as the most important source

of risk capital.[94] Data on the Canadian informal market are still scarce and regionally focussed, which makes it difficult to assess the size of the informal venture capital market. In fact, current estimates of total annual informal investments range from $1 billion to $20 billion.[95] However, it is likely that the volume of angel investment is somewhat larger than that of venture capital. As discussed later in this section, assessing the role and impact of informal investors (particularly business angels) on SMEs is one of the key research objectives of the SME Financing Data Initiative.

Love money: very early-stage source of financing

Measuring the impact of love money on start-ups is challenging, as this market remains highly informal and unstructured. Some research suggests that investments provided by relatives, friends and associates makes up more than 90 percent of the start-up capital in Canada.

Due diligence requirements are often less stringent for love money investments than they are for more formal sources of financing. Family and friends tend to base their decisions on the nature of their relationship with the investee, and pay less attention to the nature of the deal or the potential risk. Love money generally comes in smaller amounts and is usually exhausted before a firm has reached a sustainable stage of development.

Defining an Angel:

Angels are individuals (and not the firm's principals) investing their own funds, often assuming unsecured, highly illiquid risks. Sometimes they play an active role in the management or finances of the firm, and they generally gain an equity position in the firm in exchange for the investment. Angel investments are generally said to be long-term, or "patient," often with no predetermined end or "exit."

Source: Ellen Farrell, *Literature Review and Industry Analysis of Informal Investment in Canada: A Research Agenda on Angels, 2000.*

Angel investors: providers of early-stage financing and intellectual capital

Business angels usually go through an extensive due diligence process and base their investment decisions on the expectation of high rates-of-return. Angel investors also provide value-added managerial expertise to their portfolio firms. While some start-up companies remain with business angels throughout their entire life cycle, others eventually turn to VC financing to meet the rising costs associated with later stages of development. Studies show that in the US, business angels work in cooperation with the VC sector by seeking out and screening new projects, which encourages start-ups and increases deal flow for VC firms. In fact, studies have

94. The Centre for Venture Economics (1995), in a report of the Office of Advocacy of the US Small Business Administration, estimated that approximately 250 000 angel investors were investing about US $20 billion in 30 000 small companies each year. That is approximately twice the value of annual investment by US institutional venture capital funds and about fifteen times the number of companies receiving investment (Freer, Sohl and Wetzel, 1996 in Acs and Tarpley, 1998).

95. Equinox Management Consultants Ltd., *"Informal Equity Capital for SMEs: A Review of Literature,"* 2000.

found that more than half of all VC-funded high technology projects in the US had business angel participation, and that this proportion was even higher among smaller and newer firms.[96]

The presence of a well-regarded and connected business angel in a previous financing deal may assure VC investors of the quality of the firm and deal. In addition to supplying capital, business angels provide business advice, contacts and access to an extensive, well-developed business network, which can assist the firm to make appropriate strategic decisions as it grows.[97]

Angels are wealthy and business-savvy investors and:

- predominantly either current or former entrepreneurs
- 98 percent of them were male, their average age was 50
- had between $50 000 and $250 000 to invest (sometimes more, but almost always less than $1 million)
- their own net worth was often over $1 million, and their average annual income was over $150 000

Source: *Informal Equity Capital for SMEs: A review of Literature*, Equinox Management Consultants, 2000.

Recent research on SMEs reveals that since 1990, 11 percent of Canadian SME owners have invested privately in 217 000 other businesses. Seven in ten of these SME owners were involved as operators in these other businesses; three in ten invested less than $25 000, one third invested between $25 000 and $100 000 and 38 percent invested more than $100 000.[98]

Financial impact of business angels on SMEs: a research agenda

Angel investors fulfill an important role in financing businesses, particularly SMEs. Since angels generally prefer to remain anonymous, however, their investment strategies and impact on SMEs' development are not well documented. The general conclusion of several research studies commissioned by Industry Canada was that future areas of study should focus on a more rigorous empirical approach to assess the financial contribution and economic impact of informal investors.[99]

From a public policy perspective, determining the potential population of informal investors and their potential investment capacity is essential to determining future policy recommendations to stimulate informal investment. A methodology to capture current and potential informal investment activity is being developed as part of the SME Financing Data Initiative.

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96. The VC industry allocated 42 percent of total capital invested (or $1 billion) towards companies in early development stages. See Freear and Wetzel (1990) and Fenn, Liang and Prowse (1998).

97. Equinox Management Consultants, *Value Added By Informal Investors, 2001.*

98. Statistics Canada, *Survey on Financing of Small and Medium-sized Enterprises, 2001.*

99. Ellen Farrell, *"A Literature Review and Industry Analysis of Informal Investment in Canada: A Research Agenda on Angels,"* Prepared for Industry Canada, March 2000, page 43; and Equinox Management Consultants, *Informal Equity Capital for SMEs: A Review of Literature*, March 2000, a report prepared for Industry Canada.

In 2002, Industry Canada held a research workshop involving academics from across Canada, the US and the UK to discuss the various measurement challenges involved in sampling informal investors. Researchers agreed that a random household survey would capture an accurate estimate of current and potential angel investments; they also recognized the importance of friends and family as a significant source of informal financing.

As noted earlier, many high-growth-potential start-ups that survive the seed financing stage turn to venture capital financing for development and expansion. The following section examines Canadian venture capital activity in 2001 and 2002 — two years of intense market turmoil. The data show that despite difficult market conditions, the Canadian VC industry remained strong, especially compared to its American counterpart.

3. VENTURE CAPITAL FINANCING

3.1 What is venture capital financing?

VC is long-term, hands-on equity investment in privately-held, high-growth-potential companies, undertaken and managed by professional investors.[100] These investors normally organize themselves into VC firms (through private partnerships or closely-held corporations) that establish one or more VC funds to raise capital from individual and institutional investors — capital that is subsequently invested in equity-type instruments (e.g. shares) issued by SMEs.

VC will never be used by more than a tiny proportion of businesses, since it requires:

- the dilution of high-growth-potential firms' ownership
- firms with innovative ideas;
- potential returns ranging between 30 percent and 40 percent annually over an extended period
- involvement of the VC firm in the company's management

VC is usually invested in new, young and rapidly growing companies that have the potential to develop into significant players in their respective markets. Venture capitalists evaluate several hundred investment opportunities each year, but only invest in a few companies that have the potential for high rates of return within five-to-seven years.[101] According to one study, American venture capitalists finance only one out of a hundred prospective projects.[102]

3.2 Venture capital is not a financing panacea

As mentioned above, venture capital financing usually comes into play during the early and expansion stages of a firm's development. While this type of financing provides essential growth and expansion capital to high-growth-potential firms, it is not a panacea for the range of challenges that SMEs face in accessing financing. VC investments represent very high risks for

100. National Venture Capital Association.

101. *Ibid.*

102. Paul Gompers, July 2001. A Note on the Venture Capital Industry., Harvard Business School.

investors, and these investors expect to be compensated by high returns. Not all businesses are able or willing to make the growth commitment necessary to meet these requirements.

Moreover, the stringent criteria of venture capitalists ensure that this market remains limited to a few high-growth-potential firms. Only a very small percentage of growing SMEs (less than 1 percent of all SMEs in any given year, or approximately 87 000 businesses)[103] is considered a potential investment target by VC firms. From an entrepreneur's perspective, accessing VC is difficult, costly and often associated with surrendering managerial control or ownership of their business. In 2001, 40 percent of SMEs were not prepared to exchange ownership control for risk capital even if it were to lead to rapid growth.[104]

3.3 VC is an active, risky and transitional investment

Venture capitalists play an active role in the management of their portfolio firms. Most VC investors aspire to hold, collectively, a majority ownership position so that they can add value (for example by providing advice, helping recruit the management team, identifying and analysing new market opportunities and providing access to professionals) and influence the management decisions of the company (by visiting the firm periodically, reviewing monthly reports and serving on the board of directors).

According to a 1997 study by Paul Gompers,[105] the disproportionate allocation of control to the VC fund (an outgrowth of the fund's adoption of the financial risk) is a critical feature of this governance structure. While the fund provides a critical influx of capital, this transition of authority is not always advantageous for the entrepreneur: venture capitalists often professionalize the management of investee firms by replacing the "lone-wolf" entrepreneur with a professional manager.[106]

One of the major risk factors facing venture capitalists is the lack of information about the operations and performance of potential investment targets. As a result, pricing is problematic and often causes conflict between VC investors and portfolio companies. Venture capitalists often assume great investment risks because they are investing in new concepts and technologies with unproven market potential. These risks are particularly acute in information technology and life sciences investments, due to the length of time between innovative concept and marketplace

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103. According to Statistics Canada's *Study of Growth SMEs in 1996*, only 5 percent of growing SMEs (about 0.04 percent of all SMEs in Canada) would be considered potential investment targets by venture capitalists.

104. Université du Québec à Trois-Rivières, *Financing Small and Medium-Sized Entreprises: Satisfaction, Access, Knowledge and Needs,* 2002 (**http://strategis.gc.ca/fdi**).

105. Paul Gompers, *Ownership and control in entrepreneurial firms: an examination of convertible securities in venture capital investments.* Harvard Business School Working Paper, 1997.

106. In one of their most recent studies (*On the Fundamental Role of Venture Capital, 2002,* Graduate School of Business at Stanford University), Hellman, Thomas, Puri and Manju found that VC is associated with higher degrees of professionalization (e.g. introduction of stock option plan, recruitment of professional staff through professional channels, appointment of vice president of marketing and sales, etc.), value-added services and assistance to companies to become established in the marketplace.

penetration in these sectors. Long product development cycles compound the uncertainties associated with new technologies and products, since investors risk that the product will not reach full potential before being superceded by a competing technology. To compensate for these high risks, VC fund managers require prospects for rapid and substantial growth and a share in the firm's profits. Once the rapid-growth phase of a company is completed, venture capitalists generally seek to liberate and re-invest their capital or return it to their investors.

The risk that venture capitalists are prepared to accept, particularly at the growth stage, is often dictated by economic and market factors that influence exit opportunities (primarily IPOs or merger and acquisition transactions). The IPO is usually the preferred exit option because it tends to offer the greatest return on investment. However, as will be seen later in Section 4, this is often not the best financing option for smaller firms (with less than $10 million in assets).

3.4 The economic impact of venture capital

According to the results of the most recent survey on the economic impact of VC in Canada, carried out for the Business Development Bank of Canada,[107] the growth of VC-financed companies (particularly information technology and life sciences firms) outstripped the growth of the economy as a whole. On average between 1995 and 1999, the VC-backed companies surveyed increased:

- employment by 39 percent annually (60 percent for information technology firms and 47 percent for life sciences firms)
- sales by 31 percent annually (53 percent for information technology firms and 66 percent for life sciences firms)
- exports by 38 percent annually (58 percent for information technology firms and 52 percent for life sciences firms)
- R&D expenditures by 52 percent annually (56 percent for information technology firms and 60 percent for life sciences firms)

A study by the Graduate School of Business at Stanford University[108] found that the presence of VC financing increased the likelihood that a start-up will bring a product to market by 79 percent.[109]

107. Business Development Bank of Canada, *Economic Impact of Venture Capital in 2000*, 2001.

108. Thomas Hellman, Manju Puri, Graduate School of Business at Stanford University, 2002. *On the Fundamental Role of Venture Capital.*

109. Based on the Stanford Project on Emerging Companies (SPEC) — an interdisciplinary research project that analyzed 170 technology start-up firms.

In 2002, VC-backed firms in the US:

- Contributed nearly $1.1 trillion to the US GDP
- Employed 12.5 million people directly (15 million indirectly), representing 11 percent of US GDP and 11 percent of employment in 2000
- Outperformed other companies in terms of sales, taxes paid, exports and investments in R&D (when adjusted for size)
- Boosted innovation by financing projects that were far too risky for more traditional financial suppliers
- Played an important role in creating industry clusters, such as medical, health and computer security

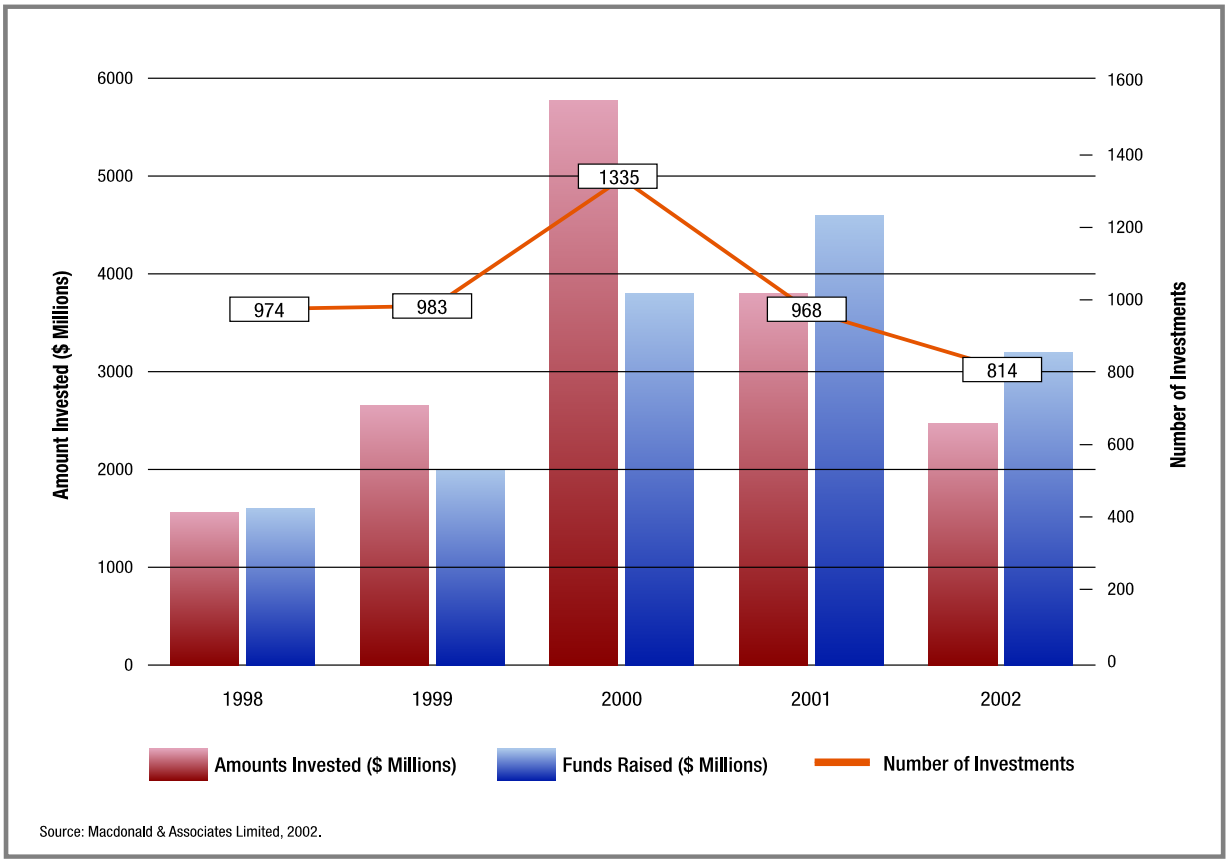
Source: *2003 NVCA Yearbook,* Venture Economics.

3.5 Venture Capital Activity in Canada in 2001 and 2002

3.5.1 Overview

Slower activity level since 2001, but encouraging developments in 2002
Despite the tightening of the investment situation since 2001, the Canadian VC industry showed signs of vigour and enjoyed a stronger-than-expected year in 2002, investing $2.5 billion in 677 firms. While this figure represented a sharp drop from the $3.8 billion invested in 2001 and the $5.8 billion invested in the peak year 2000, it was in line with the level of investment in 1999, $2.7 billion.

Figure 48
Canadian VC Activity, 1998–2002



Source: Macdonald & Associates Limited, 2002.

3.5.2 VC Activity: Deal Size, New versus Follow-On Deals, Investment Stage

Greater concentration in larger transactions in 2002

The concentration of investments in the larger deal category ($5 million and over) could stem from the financial market turmoil in 2001 and 2002. The tighter investment climate discouraged venture professionals from making new investments and compelled them to inject greater amounts of money into established companies, notably in the information technology area.

Share of total VC investments by size of transaction

- Very small transactions (< $500 000):
  - 2 percent in 2002 ($57 million)
  - 2 percent in 2001 ($66 million)
- Small transactions ($500 000–$1 million):
  - 3 percent in 2002 ($67 million)
  - 3 percent in 2001 ($97 million)
- Mid-sized transactions ($1–$5 million):
  - 24 percent in 2002 ($581 million)
  - 19 percent in 2001 ($713 million)
- Large transactions ($5 million and over):
  - 71 percent in 2002 ($1.8 billion)
  - 77 percent in 2001 ($2.9 billion).

Later-stage investments accounted for most VC investments[110]

In 2002, venture capitalists concentrated their investments in later-stage transactions, which captured a 58 percent market share ($1.4 billion). Conversely, in 2001 61 percent ($2.3 billion) of total investments went to early-stage transactions. While this was consistent with the 40:60 historical ratio between early-stage and later-stage investments (Figure 49), early-stage firms did manage to secure VC financing, mostly from LSVCCs.

VC investments by stage

- Early stage share of total VC investments:
  - 42 percent in 2002 ($1 billion)
  - 61 percent in 2001 ($2.3 billion)
- Later-stage share of total VC investments:
  - 58 percent in 2002 (or $1.4 billion)
  - 39 percent in 2001 (or $1.5 billion)

New investments:
- 26 percent in 2002 ($646 million)
- 23 percent in 2001 ($860 million)

Follow-on invetsments:
- 74 percent in 2002 ($1.8 billion)
- 77 percent in 2001 ($2.9 billion)

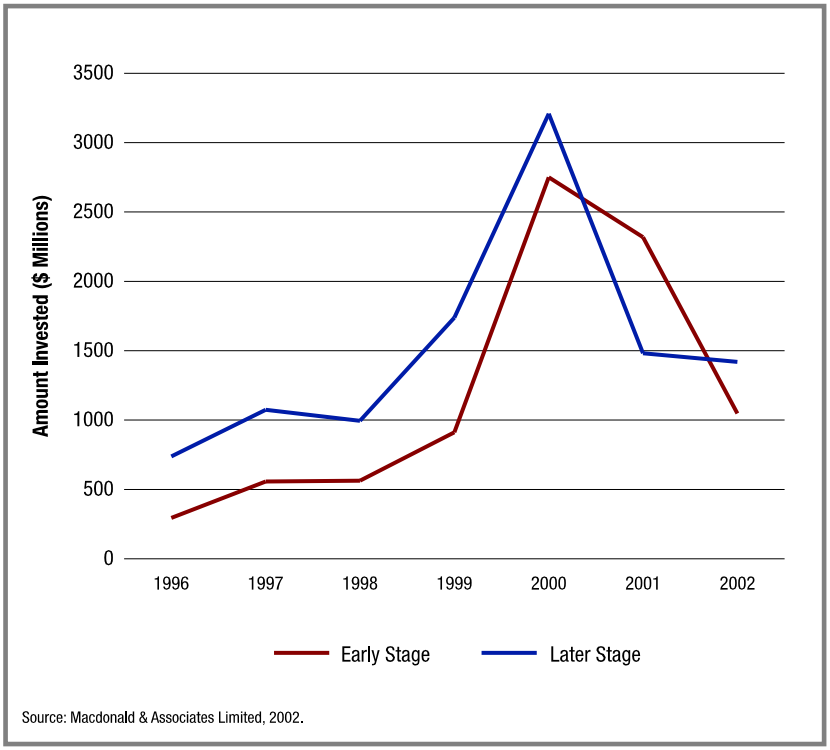
Most investments went to follow-on financing

In 2002, the gap between new and follow-on[111] investment continued to grow. Venture capitalists invested more money in follow-on transactions, and scaled back investment in firms seeking new financing. This trend may be related to a tightening investment climate, which limits returns potentials, diminishes exit opportunities and forces venture capitalists to support investments in portfolio companies for longer periods, reducing their capacity to free capital for new transactions.

110. Stage of investment refers to critical points on the growth continuum for firms assisted by venture capital and other types of private equity. Typically, a venture-backed company receives cumulative rounds of financing to facilitate its progression from one stage of development to the next. See Glossary for a more complete definition.

111. Typically, venture-backed firms go through several rounds of financing. The original round of financing, or "new" financing, is often followed by further follow-on financing as the company grows and develops.

Figure 49
Investment Trends by Stage of Development, 1996–2002



Source: Macdonald & Associates Limited, 2002.

3.5.3 Type of Investor

Labour-Sponsored Venture Capital Corporations[112]

While most Canadian venture capital investors significantly reduced their level of investments in 2002, LSVCCs maintained their investment pace and captured a 25-percent market share (see Figure 50). LSVCCs made 36 percent of their investments in businesses seeking capital for the first time (compared to 26 percent in 2001).

LSVCCs market share
- 25 percent in 2002 ($627 million)
- 17 percent in 2001 ($650 million)

Foreign investors market share
- 26 percent in 2002 ($650 million)
- 29 percent in 2001 ($1.1 billion)

Private independent investors market share
- 13 percent in 2002 ($313 million)
- 16 percent in 2001 ($602 million)

112. The Labour-sponsored venture capital corporations are a mixture of large and small VC funds sponsored by labour unions and capitalized by a large number of individual shareholders who receive tax incentives in exchange for committing their capital for long periods, usually over eight years.

Foreign investments continued to play an important role

Since 1999, foreign investors, mainly American venture and strategic corporate funds, have increased their investments in the Canadian VC industry. Their primary investment focus has been on information technology and life sciences (see Figure 50).

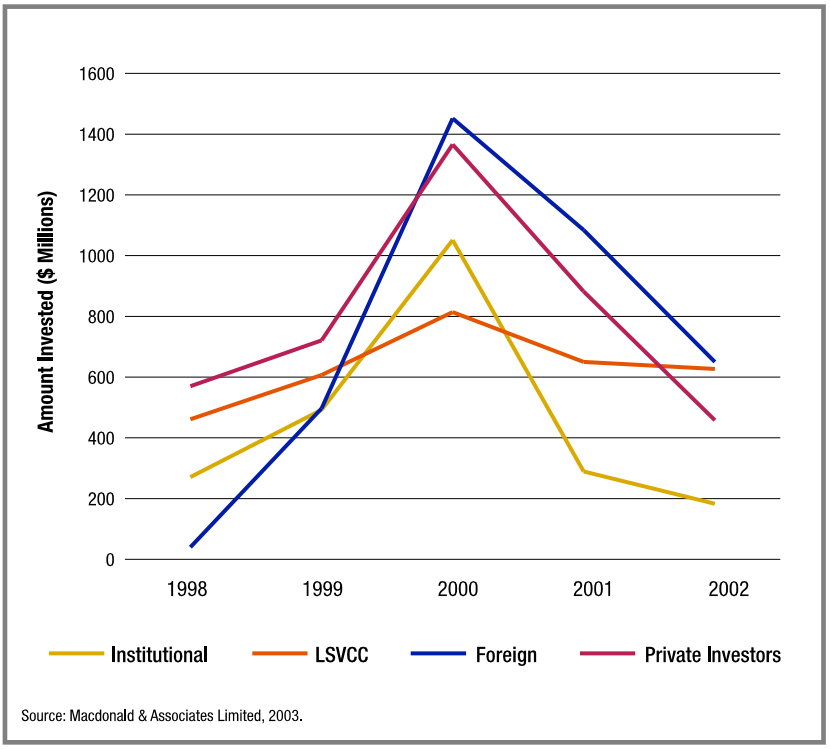
As capital inflows and the investment levels dropped in 2000 and 2001, foreign investors steadily increased their market share, from 19 percent of total investments in 1999, to 25 percent in 2000 and to 29 percent in 2001. In 2002, foreign VC investments reached 26 percent of total VC activity in Canada and negotiated the largest deals.

Foreign Investors' Activity

- **Total investments:** $1.1 billion in 2001; $640 million in 2002
- **Market share:** 25 percent in 2001; 26 percent in 2002
- **Average deal size:** $11 million in 2001; $9 million in 2002
- **Sectoral Distribution of Investments in 2002**
  - **information technology sector**: $559 million (86 percent)
  - **other technologies sectors (including energy and environment):** $40 million (6 percent)
  - **life sciences**: $36 million (about 6 percent)
  - **traditional sectors (including manufacturing, retailers, consumer and business services, and consumer products):**
  - $15 million (2 percent)

Figure 50

VC Types: Trends, 1998–2002



Source: Macdonald & Associates Limited, 2003.

Institutional investors were more active despite their limited role[113]
In 2002, institutional investors invested $183 million (7 percent of total investment) compared with $289 million in 2001 (8 percent of total investment) and $1 billion in 2000 (or 18 percent). Although pension funds have recently increased new capital inflows, their average market share over the 1996–2002 period rested at 14 percent. However, recent federal budget measures, the new Canadian funds of funds and the recently published performance benchmarks may encourage institutional VC investment.

3.6 Sectoral Activity

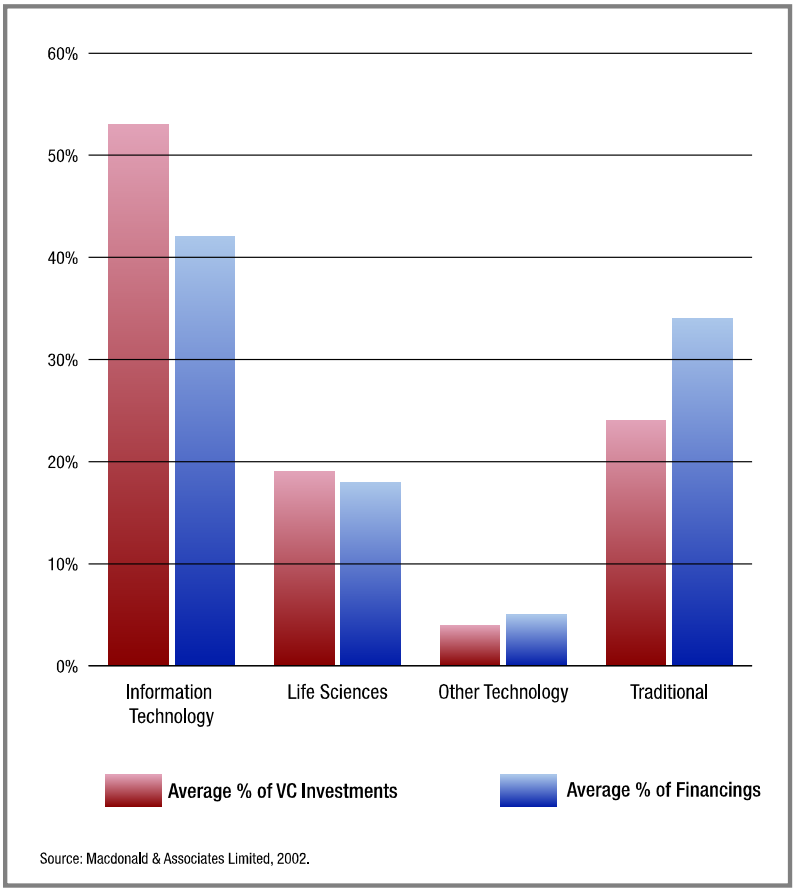
Overall trend

Sectoral VC activity trends confirm high technology firms' dependence on VC
The sectoral distribution of VC activity between 1996 and 2002 indicates a strong focus on information technology and life sciences firms, which attracted:

- 89 percent ($2 billion) of total VC investments in 2002
- 91 percent in 2001 ($3.5 billion)
- 87 percent in 2000 ($5 billion)
- 80 percent of total VC investments in 1996–2002

113. Through the late 1980s and the first half of the 1990s, pension funds were generally unwilling to consider VC investments as part of their portfolio. However, beginning in 1999, large public sector pension plans revised their strategies to include direct VC investment in Canadian SMEs as part of their overall investment activities. As a result, a few very large Canadian public sector pension fund organizations now lead the VC industry as sources of new VC investments. The positive impact of tax measures introduced in the recent federal budgets, the emergence of Canadian funds of funds (e.g. TD Capital, EdgeStone Capital and BDC) and the recent publication of performance returns benchmarks should all help to encourage the long-term position of institutional investors in the VC industry.

Figure 51
Average Share of VC Investments and VC Financings by Sector, 1996–2002



Source: Macdonald & Associates Limited, 2002.

Information Technology

Information technology continues to dominate VC activity

Despite the burst of the technology bubble, information technology has driven VC investment in recent years. Renewed activity in communications and networking, software and other information technology sectors accounted for much of the rise in capital invested in Canada.

Most information technology investments were in Ontario

Information technology financings came in relatively large deal sizes (nearly

VC activity in the information technology sector

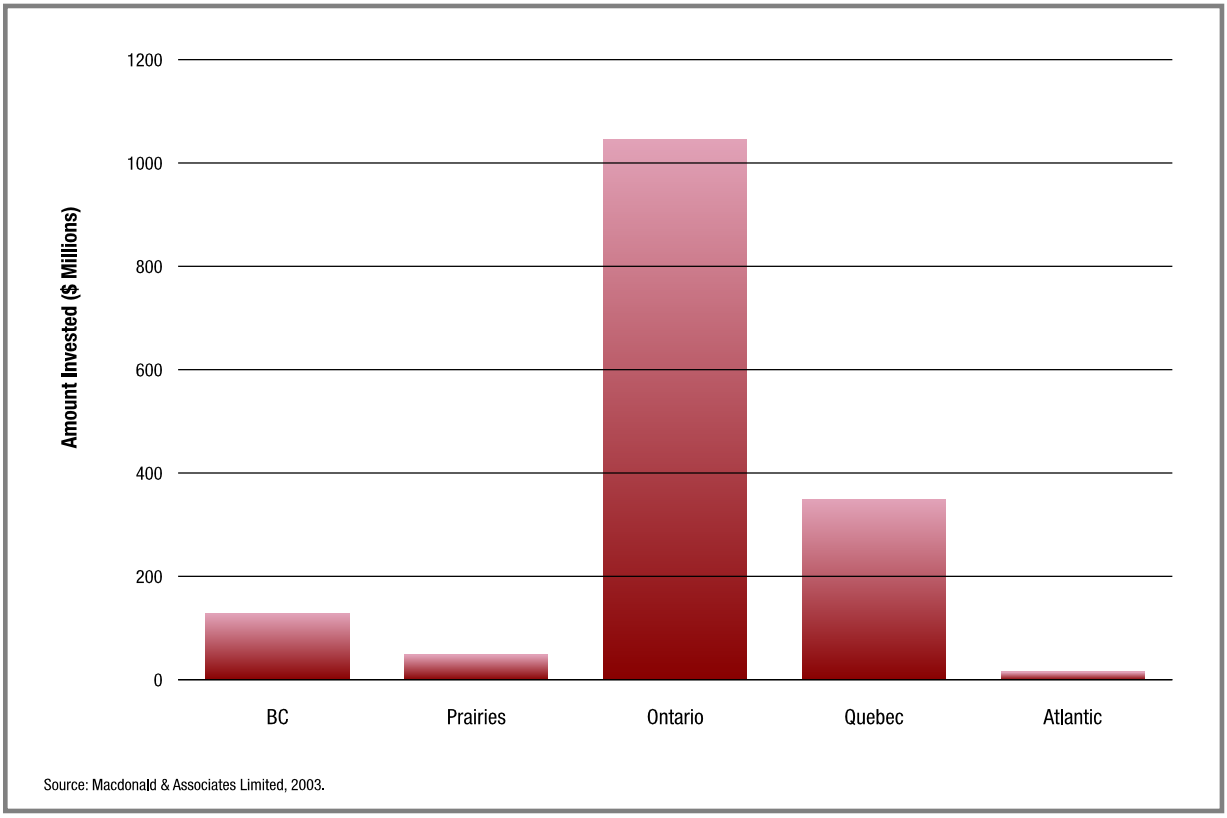
- **Investments:**
  - $1.6 billion in 2002 (44 percent of total VC invested)
  - $2.7 billion in 2001 (70 percent of total investments) in 2001
- **Investments by information technology sub-sector:**
  - communications industries: 42 percent in 2002; 38 percent in 2001
  - software industries: 22 percent in 2002 24 percent in 2001
  - internet industries: 11 percent in 2002 16 percent in 2001
  - semiconductors: 15 percent in 2002; 7 percent in 2001

$6 million — more than twice the average in other sectors), and were mostly located in Ontario, which captured an average share of:

- 66 percent of investments ($1 billion) in 2002 (compared with 22 percent for Quebec and 8 percent for British Columbia)
- 68 percent of investments (or $1.8 billion) in 2001 (compared with 20 percent for Quebec and 8 percent for British Columbia)

Figure 52

VC Investment in Information Technology by Region, 2002



Source: Macdonald & Associates Limited, 2003.

Life Sciences

Small increase in VC activity in 2002

Despite a general downturn in VC investments, the life sciences sector saw a slower decline than overall VC investments. Life sciences investment fell 28 percent, compared with 35 percent for overall VC investment. As a result of these trends, the life sciences sector's share of investments increased from 17 percent in 2001 to 19 percent in 2002.

Life sciences VC activity concentrated in Quebec and British Columbia in 2002

- Life sciences investments in Quebec represented 47 percent ($217 million) of total life sciences investment in Canada. This concentration was rooted in several prominent biopharmaceutical company financings in the Greater Montréal region (e.g. Gemin X Biotechnologies and Phytobiotech)
- Life sciences investment in Ontario represented 29 percent ($134 million) of life sciences investments in Canada
- In British Columbia, VC investments in life sciences have declined significantly in recent years, from 31 percent ($204 million) in 2001 to 13 percent ($61 million) in 2002
- The Prairies attracted 7 percent (or $31 million) of total life sciences investment
- Atlantic Canada attracted 4 percent ($20 million) of VC investments in life sciences (double its share of overall VC investments)

VC activity in life sciences sector

- **Investments:**
  - $463 million (19 percent of total VC invested) in 2002
  - $651 million (17 percent of total VC invested) in 2000
- **Investments by life sciences subsector:**
  - biopharmaceutical sector: 62 percent in 2002; 74 percent in 2001
  - medical devices and equipment: 27 percent in 2002; 8 percent in 2001
  - medical/biotech software and information services: 9 percent in 2002; 13 percent in 2001

Traditional Sectors

Investments mostly located in Western Canada

Traditional sectors attracted less VC investment with:[114]

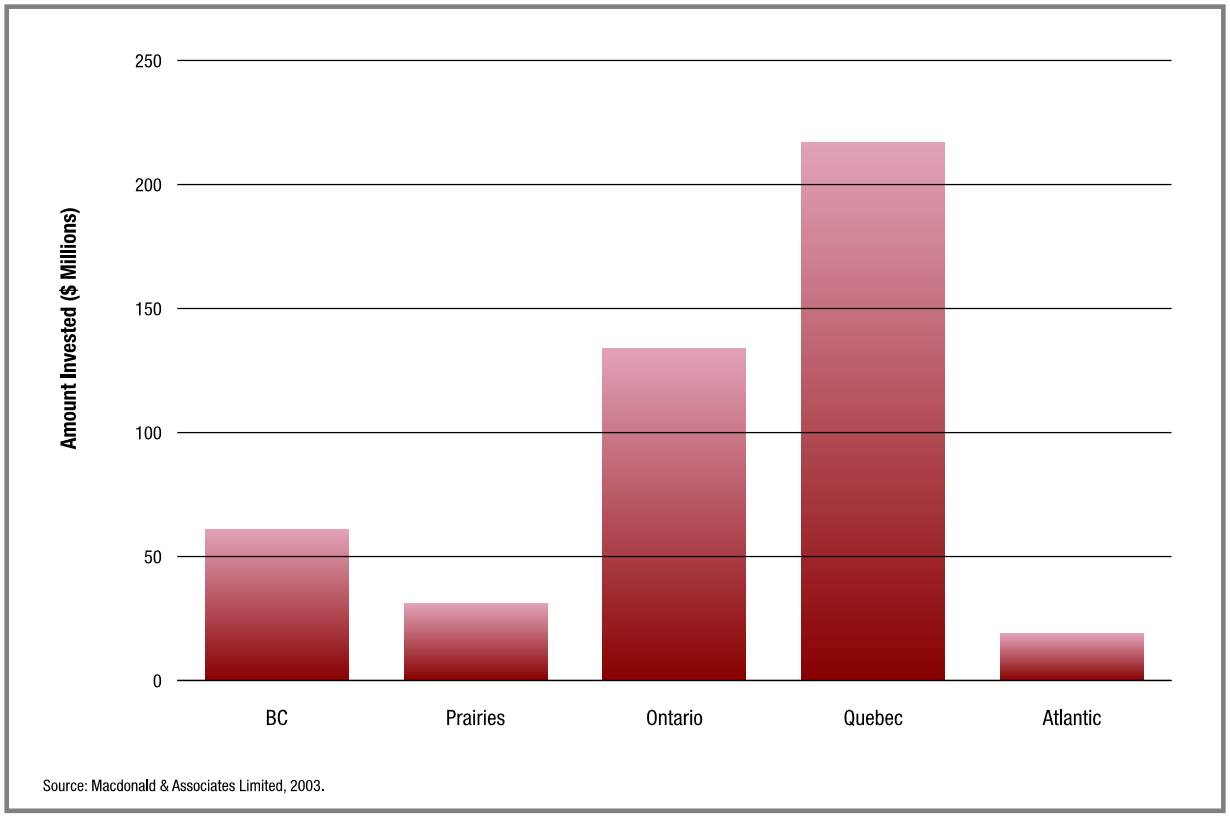
- $278 million, or 11 percent of total VC investments, in 2002
- $336 million, or 9 percent of total VC investments, in 2001
- the number of financings remaining stable between 2001 and 2002 — 223 and 224

Between 1996 and 2002, VC investors in Manitoba and Saskatchewan focussed their investments in traditional sectors. Average provincial traditional sector investment shares for the 1996–2002 period were:

- 68 percent in Manitoba (compared with 20 percent for life sciences and 11 percent for information technology)
- 60 percent in Saskatchewan (compared with 20 percent for life sciences and 7 percent for information technology)
- 39 percent in Atlantic provinces (compared with 3 percent for life sciences and 2 percent for information technology)
- 33 percent in Quebec (compared with 40 percent for life sciences and 21 percent for information technology)
- 17 percent in Ontario (compared with 30 percent for life sciences and 66 percent for information technology)

114. Traditional sectors include consumer and business services, consumer products, manufacturing, retailers and miscellaneous.

Figure 53
VC Investment in Life Sciences by Region, 2002

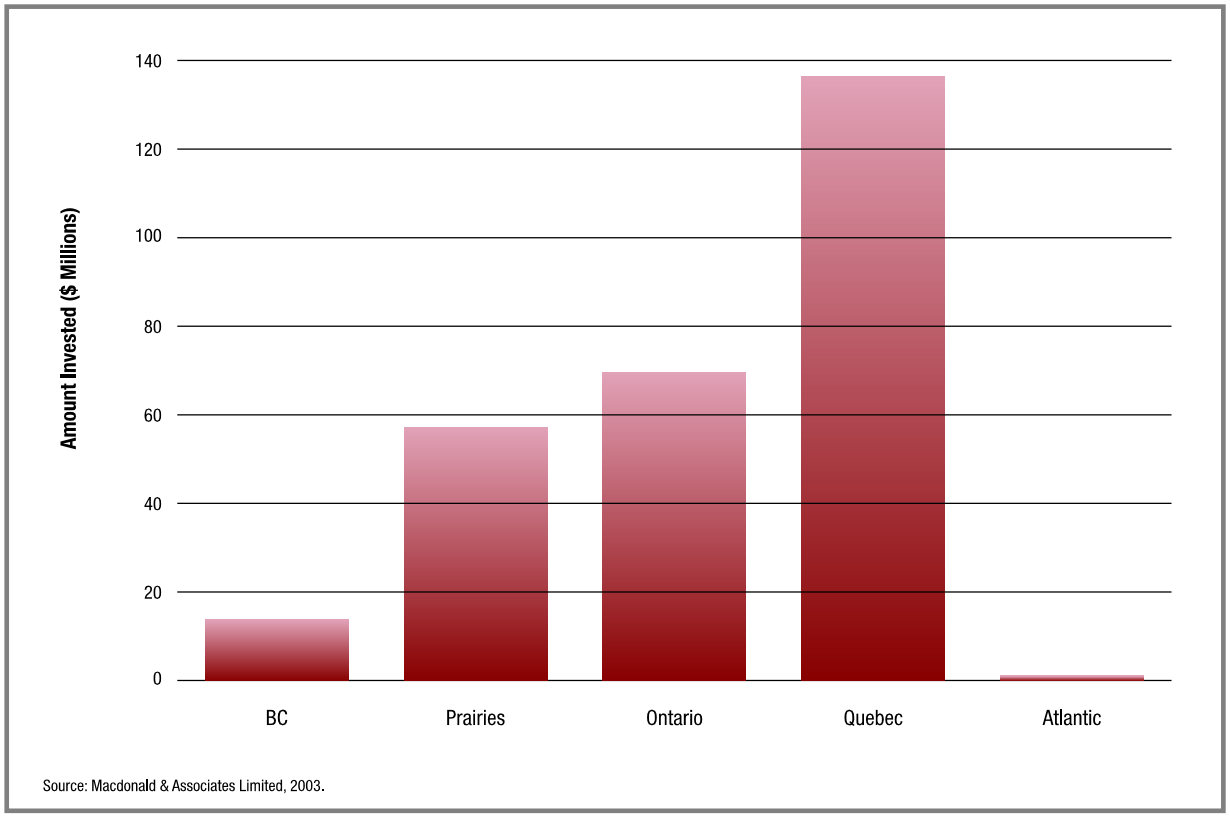


Source: Macdonald & Associates Limited, 2003.

3.7 Regional Activity

This section reviews regional VC activity in 2001 and 2002, and refers to key trends since 1996.VC investment in Canada, in absolute terms, has concentrated in a few technology-intensive regions — Ontario, Quebec and British Columbia. While the regional concentration of VC activity is endemic to the industry, a relative comparison of the regional data suggests two gaps in the distribution of VC activity across Canada: the Prairies, and, to a lesser extent, Atlantic Canada. Data also show that in relative terms, Canada's VC activity over 1990–2002 has been comparable to American activity. Canada experienced neither the extreme upswing in 1999–2000 nor the dramatic drop in activity that took place in the US over the last two years. In Canada, VC fundraising has continued, whereas some US VC funds have been returning investment funds to their investors due to the lack of viable investment opportunities and appropriate performance returns over the last 18 months.

Figure 54
VC Investment in Traditional Sectors by Region, 2002



Source: Macdonald & Associates Limited, 2003.

The analysis of the regional distribution of VC activity in Canada needs to take into account both absolute and relative measures. Given that there are no precise measures of the 'optimal' or 'appropriate' amount of VC investment for an economy (or a particular region), most countries have used benchmarks against the US as a proxy. Unfortunately, basing performance on the American experience is not necessarily appropriate in all situations or for all regions. Nonetheless, on a relative basis, the data reveal that Canada's VC activity over 1990–2002 has been similar to the rate of investment in the US, although some of the US market's volatility has been moderated in Canada.

Understanding the regional distribution of overall VC activity in Canada depends on relative measures. In order to be meaningful and useful to policy makers, the current regional distribution of VC must be analyzed using the most appropriate benchmarks. The most frequently used benchmarks are population, economic activity (GDP) and/or the number of KBI firms in the region. Since VC funding is generally directed towards KBI firms, it is appropriate to use the number of KBI firms by region as a major benchmark. However, this is not a perfect measure. This review will present several perspectives across Canada to make a comparative analysis of the regional distribution of VC investment.

Overall Trend

Strong growth in VC activities in all regions

In terms of dollars invested, VC activity in Canada since 1996 has been concentrated in Ontario, Quebec and British Columbia. In these provinces, market patterns seem very similar. For example, a dedicated technology-oriented focus (information technology and life sciences sectors), particularly in industry clusters centred on Ottawa, Montréal and Vancouver.

While there are some indications that venture capitalists are now more specialized and thus increasingly open to investing in opportunities wherever they are located, VC has historically had a strong local component, mostly because of the management role usually played by venture capitalists. The fading importance of local restrictions can be seen in the increasing level of foreign investment in Canada (and the increasing level of investment by Canadian VC investment abroad) and the growing number of VC funds that invest in all regions.

The type of business that attract VC funding also contributes to the concentration of investment in a few regions. As noted previously, VC is only appropriate for, and used by, a very small number of firms (677 in 2002), which are usually concentrated in the knowledge-based industries. Most often, investment opportunities are found in the technology sectors, which are generally concentrated in specific metropolitan regions such as:

- Ottawa (information technology focus)
- Montréal (life sciences focus)
- Vancouver (life sciences focus)
- Toronto (information technology focus)

Figure 55 illustrates the distribution of VC activities in Canada by region, compared to regional distribution of economic activity and KBI firms. While Ontario received 51 percent of VC investment over the 1996–2001 period, 45 percent of Canada's KBI firms were located in that province. The figure shows that Ontario and Quebec have attracted VC investment in excess of their share of the GDP or KBI firms. This may reflect the achievement of a critical mass of several technology clusters in these provinces. In contrast, VC investment in the Prairies and Atlantic Canada has been lower than these regions' share of economic activity or KBI firms.

In Ontario:

- Ottawa (technology cluster), with only 9 percent of Ontario's population, attracted 56 percent of total VC invested in Ontario-based firms in 2001 and 2002, due to the high concentration of technology firms

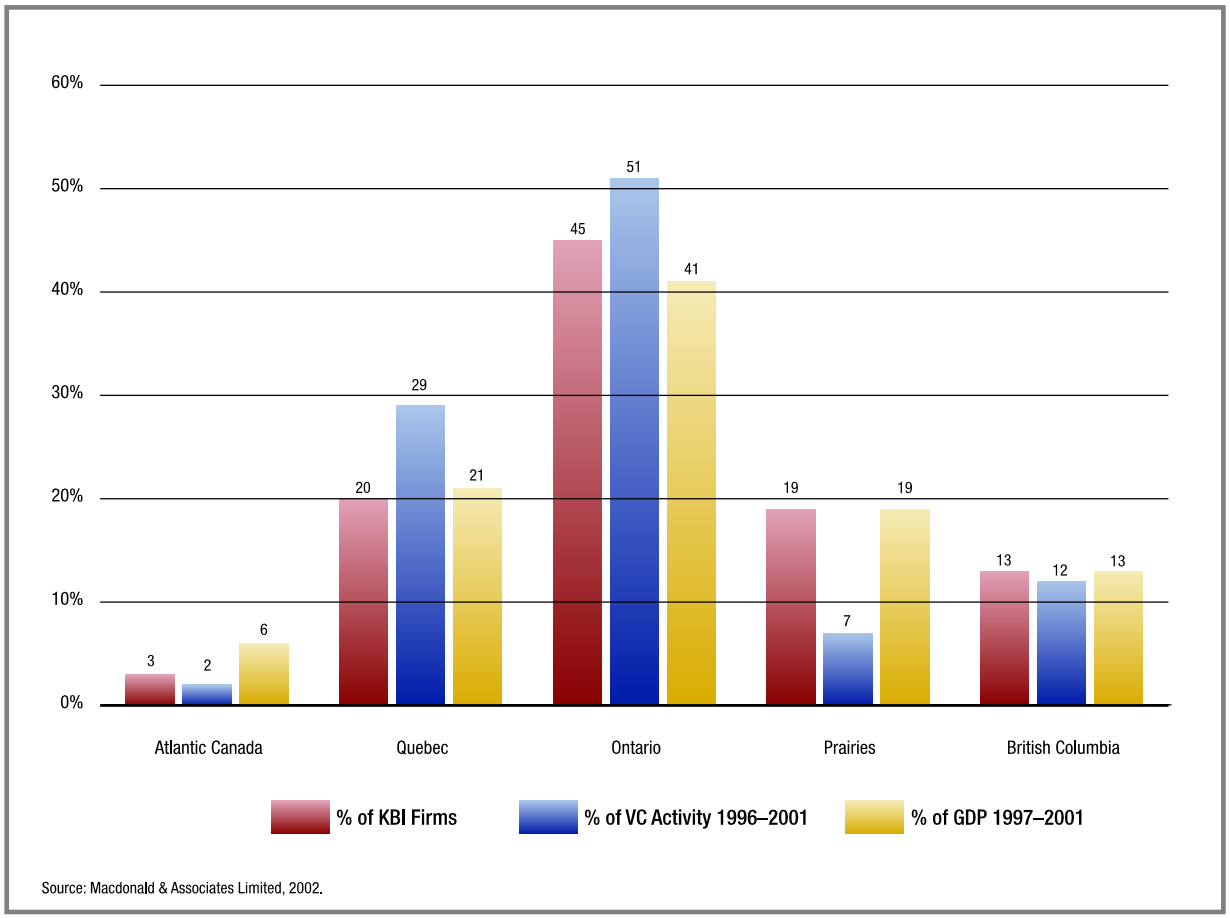
In Quebec:

- VC investments in Montréal captured 69 percent of Quebec's VC investment in 2001 and 73 percent in 2002

In British Columbia:

- VC investment to the Vancouver area represented 93 percent of provincial VC investment, and 90 percent in 2002

Figure 55
Regional Distribution of VC Investment, KBI Firms and GDP in Canada, 2002



Source: Macdonald & Associates Limited, 2002.

Investment Gap Observed in the Prairies and Atlantic Canada

Investment gap in the Prairies

On an absolute basis, VC investments in the Prairies increased by 93 percent, from $82 million in 1996 to $159 million in 2002 (with a peak at $309 million in 2000). However, relative to other regions, the 93-percent growth of VC investments in the Prairies has remained below the national average investment growth of 139 percent. The average share of total VC activity in the Prairies (7 percent over 1996–2002, 4 percent in 2001 and 6 percent in 2002) was much lower than its share of KBI firms (19 percent) and GDP (19 percent) in 2001. The average deal size in the Prairies from 1996 to 2002 was lower than the national average, at $578 000 (compared with $2.7 million in Canada over the same period).

As described in greater detail in the next section, compared with other provinces and regions, the Prairies have attracted a low share of information technology (3 percent) and life sciences (6 percent) VC investments since 1996. Over the same period, traditional sectors accounted for 24 percent of total VC investment in Canada. This sectoral distribution and the absence of a critical mass of high technology firms in the Prairies may explain this region's difficulties in attracting VC. However, a recent study on the link between VC and the creation of technology

clusters[115] concluded that it is not axiomatic that technology clusters can only flourish where ample risk capital is available. The early years of Ottawa's developing technology cluster, for example, showed remarkable growth without the benefit of VC. One positive observation is that the number of VC funds in all three provinces has increased considerably since 1996:

- **Alberta** — 19 funds in 2002, compared with 5 in 1996 (increase of 263 percent)
- **Manitoba** — 7 funds in 2002, compared with 3 in 1996 (increase of 43 percent)
- **Saskatchewan** — 12 funds in 2002, compared with 7 in 1996 (increase of 58 percent)

Investment gap in Atlantic Canada

Annual VC investments in Atlantic Canada increased by 33 percent over the 1996–2002 period, but remained below the national average growth of 139 percent. The number of active funds increased at a faster rate in Atlantic Canada (120 percent) than in Canada overall (117 percent). Over that period, provinces in Atlantic Canada attracted an average of 2 percent of total VC investments in Canada. While this was lower than the region's share of Canada's GDP (6 percent in 2001), it was in line with its share of KBI firms (3 percent in 2001).

Ontario

Most VC activity concentrated in Ontario

As mentioned earlier, information technology has attracted the highest share of VC investment in Canada. Consequently, although VC activity declined significantly after peaking in 2000, VC investments in Ontario (particularly in Ottawa) continued to perform well and to lead other regions investments in 2001 and 2002.

Ottawa cluster

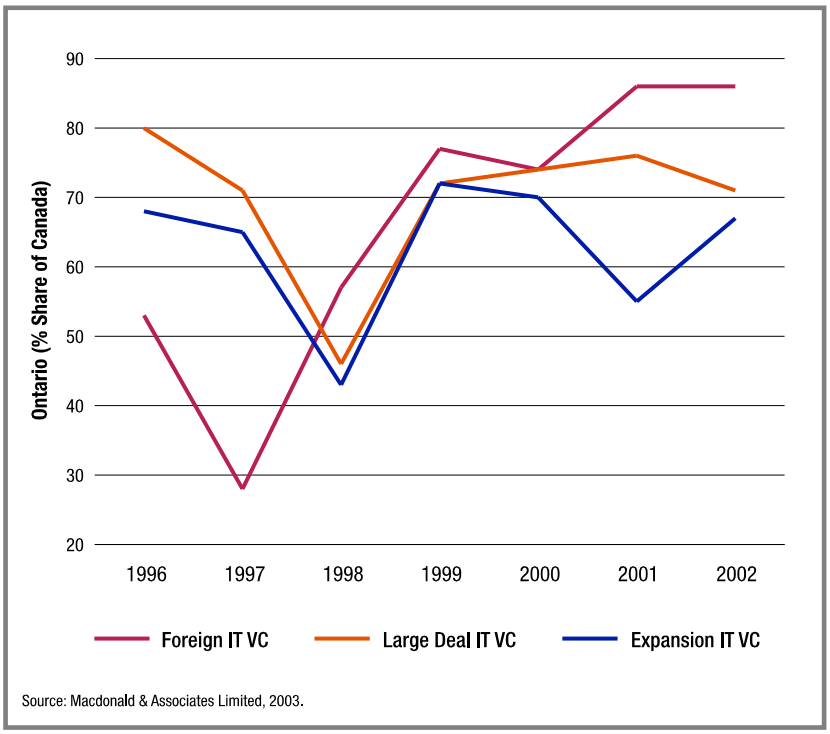
Ottawa-based firms have played a major role in the development of the VC industry in Canada since 1996. Between 1996 and 2002, investment in the Ottawa region accounted for 38 percent of the total amount of VC invested in Ontario-based firms, and this investment was the engine behind Ontario's strong performance over the past several years. Between 1996 and 2002, VC investment in Ottawa increased 1063 percent, from $63 million to $735 million. The number of deals grew by 71 percent between 1996 and 2002, from 38 to 65. The average deal size in Ottawa ($7 million) over the 1996–2002 period was also largely responsible for the growth of the average deal size in Canada ($2.7 million in 2002) over the same period.

VC activity in Ontario

- **Ontario's share of total investments:**
  - 52 percent in 2002 ($1.3 billion)
  - 55 percent in 2001 ($2.1 billion)
- **Ottawa's share of provincial VC investments:**
  - 57 percent in 2002 ($735 million)
  - 55 percent in 2001 ($1.2 billion)
  - strong focus on information technology sectors, which attracted most foreign VC in the past two years
- **Large deals captured:**
  - 60 percent of total deals in 2002; 62 percent in 2001
  - 59 percent (on average) over 1996–2002

115. Colin Mason et al., Hunter Centre for Entrepreneurship in the UK. *The Role of Venture Capital in the Development of High Technology Clusters: The Case of Ottawa, 2002.*

Figure 56
Ontario VC Investment in Information Technology, 1996–2002



Source: Macdonald & Associates Limited, 2003.

Information technology industries drove VC investments in Ontario

Despite a steep decline in overall investment and VC activity in 2001 and 2002, the proportion of VC investment activity (in dollar value) in Ontario generated by the information technology sector continued to increase. Concurrently, the life sciences sector's importance in Ontario has faded in recent years.

This decline of life sciences investment in Ontario occurred despite a revival in life sciences investment in 2001 and 2002 across North America, and despite significant increases in public and private investment in life science, health care and research in Ontario. However, it appears that the life sciences sector in Ontario has suffered from the increasing focus on information technology and perhaps from a shift of life sciences investments towards Quebec and British Columbia.

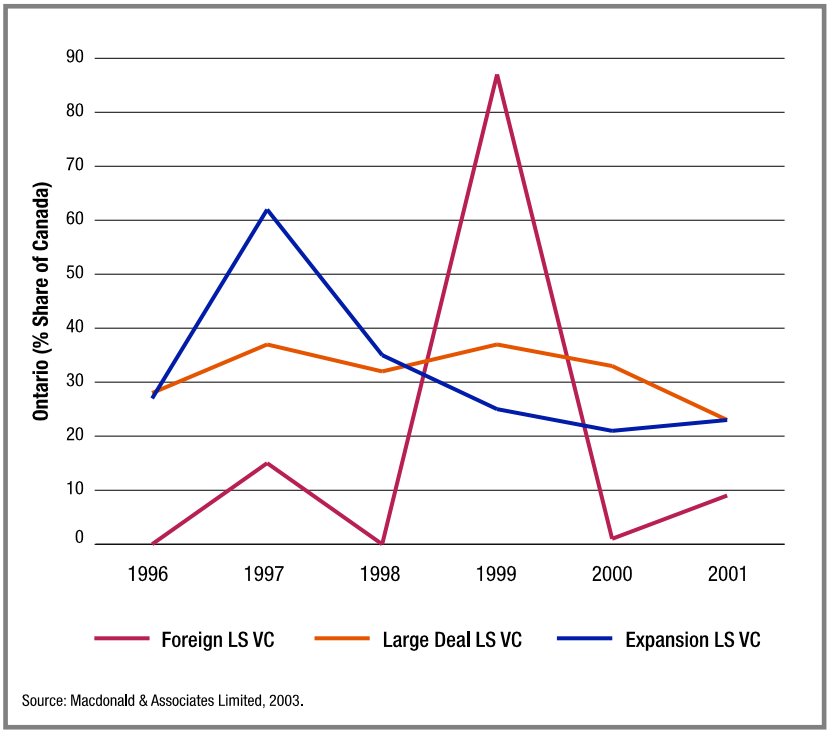
Ontario information technology sector

- **Share of total Ontario VC investments:**
  - 81 percent in 2002
  - 87 percent in 2001
- **Share of total information technology VC investments in Canada**:
  - 66 percent in 2002 ($1 billion)
  - 68 percent in 2001 ($1.8 billion)
  - 66 percent over 1996–2002

Ontario life sciences sector

- **Share of total Ontario VC investments:**
  - 10 percent in 2002 ($134 million)
  - 8 percent in 2001 ($158 million)
  - 10 percent over 1996–2002
- **Share of total life sciences VC investments in Canada:**
  - 29 percent in 2002 ($462 million)
  - 24 percent in 2001 ($158 million)
  - 30 percent over 1996–2002

Figure 57
Ontario VC Investment in Life Sciences, 1996–2002



Source: Macdonald & Associates Limited, 2003.

Figures 56 and 57 confirm the increasing investor focus on the information technology sector and away from the life sciences sector in Ontario. Relative to other provinces, Ontario's share of information technology venture capital investment has increased steadily since 1998, while investments in life sciences have decreased steadily. The concentration of foreign information technology VC in Ontario has also increased, from 28 percent of the total amount invested in Canada in 1997 to 86 percent in 2002. This concentration in Ontario could be linked to a number of factors,[116] including the strong presence of high technology firms in Ontario, a high concentration of investee firms, networks and other venture capitalists in Ontario and increased regular flights to the area. These factors help decrease search, information and transaction costs, which results in increased rates of return on investment for foreign venture capitalists and their investors.

The majority of foreign investments are in Ontario

With VC investments declining in 2001 and 2002, foreign investors' share of total investments in Ontario rose to:

- 42 percent in 2002 (compared with the national level of 26 percent)
- 38 percent in 2001 (compared with 29 percent)

116. *Foreign VC Investment in Canada: A Profile of Foreign Investors and Domestic Investees* (Forthcoming).

It should be noted that the increases in disbursement dollars and market share were not limited to Ontario; overall, foreign investors increased their market share from 3 percent of Canadian VC investment in 1996 to 26 percent in 2002.

Quebec

VC activity in Quebec declined in 2001 and 2002. While more capital was disbursed to Ontario firms, Quebec had the highest number of transactions (404) — primarily small and mid-sized deals. Between 1996 and 2002, Quebec averaged 48 percent of the total number of financings in Canada, and the number of VC deals increased by 50 percent — from 269 transactions in 1996 to 404 in 2002. Figure 58 illustrates Quebec's increasing share of small and mid-sized transactions, from 44 percent and 32 percent of Canadian totals in 1996 to 50 percent and 48 percent of transactions in 2002. LSVCCs' tendency to finance smaller deals contributed to this trend: of the 1208 Quebec LSVCC financings over 1996–2002, 1087 (or 90 percent) were mid-sized or smaller deals.

Montréal Cluster

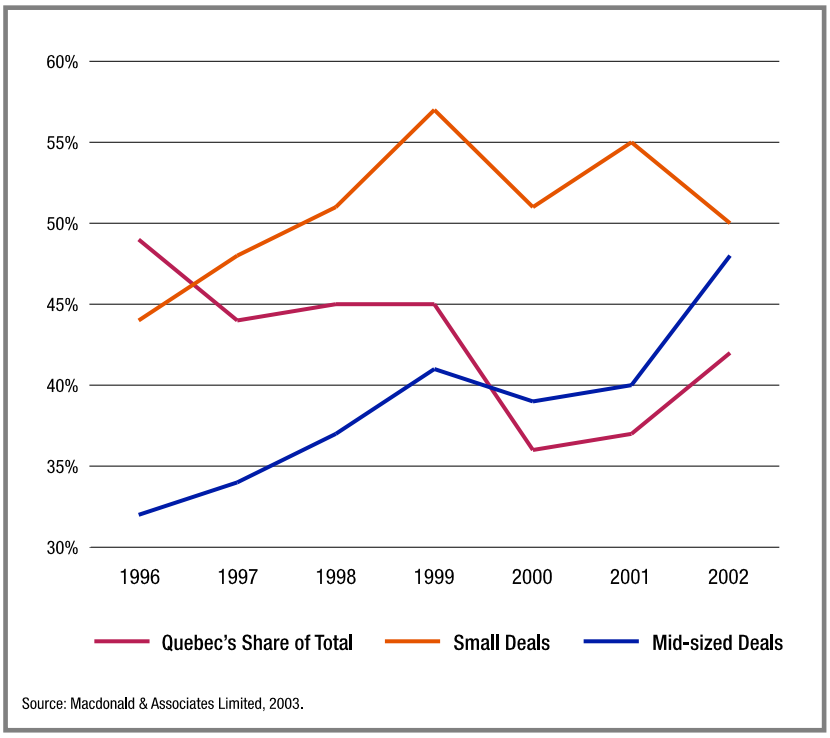
Investment in Montréal has played a critical role in the vitality of Quebec's VC activity in recent years. Investment in Montréal increased by 124 percent, from $236 million in 1996 to $530 million in 2002 (peaking at $1.1 billion in 2000). The average deal size in Montréal over the period was $2 million — slightly higher than that in Quebec ($1.6 million) but lower than the national average of $2.7 million.

Firms in Quebec attracted less foreign VC

Foreign investment fell at a faster rate in Quebec than in Canada overall. Amounts invested by foreign venture capitalists in Quebec:

- Fell from $93 million in 2001 to $49 million in 2002, a reduction of 47 percent, compared with a 40-percent decrease in Canada overall.
- Represented only 7.5 percent of total amounts invested in 2002, compared with 8.5 percent in 2001. Foreign investment accounted for 26 percent of total investments in Canada overall in 2002.

Figure 58
Venture Capital Investment in Quebec, 1996–2002



Source: Macdonald & Associates Limited, 2003.

A number of structural factors may explain why foreign VC investors have demonstrated less interest in Quebec firms:

- Foreign investors seem to be mostly interested in information technology industries, particularly communication and networking sectors, which tend to be concentrated in the Ottawa Valley, while Quebec has been developing a stronger focus on life sciences
- Compared with other provinces, Quebec's VC deals tend to be smaller and more numerous. Given the affinity of most of US VC funds for large information technology financings and the average deal size ($1.8 million in 2002 compared with $6 million in Ontario) and sectoral distribution in Quebec, it is not surprising that foreign venture capitalists tend to invest in Ontario
- The Quebec government's active role in the VC market, particularly the participation of public institutional players, which are usually more active in the seed and start-up phases, may have replaced or crowded-out private sector VC players. Private sector investors may have not been able to invest at later stages, given the large capital requirements of such transactions
- Quebec has a number of significant players, such as the Solidarity Funds, whose social missions may limit their capacity to partner with US private players, particularly at the expansion stage

Evidently, more information on foreign VC investors' characteristics and investment criteria would help to clarify why foreign investors have shown less interest in Quebec.

British Columbia

VC activity in British Columbia declined by 51 percent (compared with 35 percent in Canada), from $514 million in 2001 to $251 million in 2002.

VC activity in British Columbia

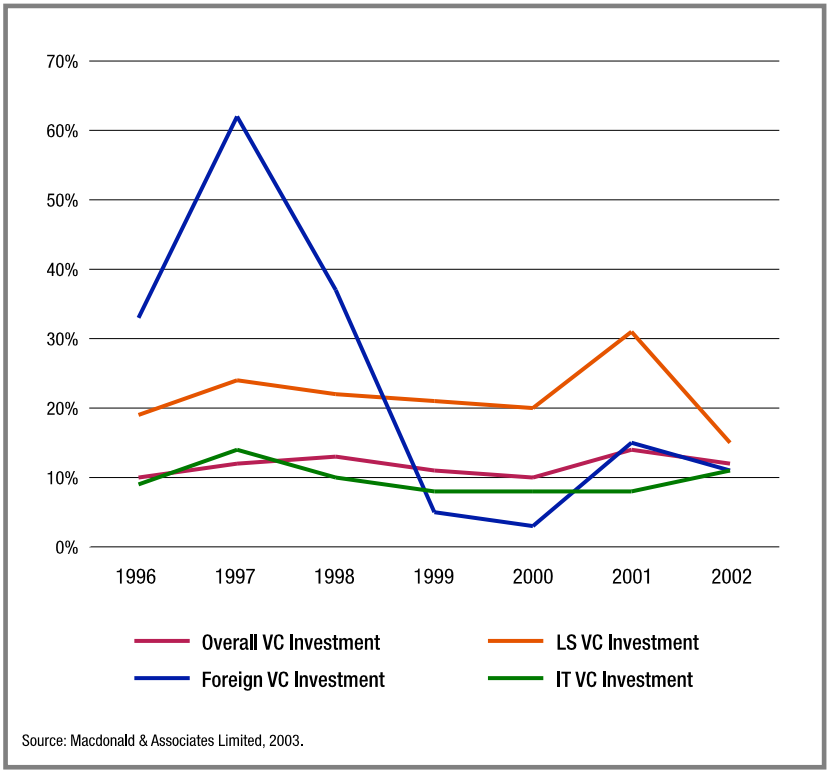
- **Share of total VC activity:**
  - 10 percent in 2002 ($251 million)
  - 14 percent in 2001 ($514 million)
- **Share of total deals:**
  - 10 percent in 2002 (80 deals)
  - 11 percent in 2001 (110 deals)
- **Average deal size declined from:**
  - $3.1 million in 2002 ($3 million for Canada)
  - $4.7 million in 2001
- **Vancouver continued to dominate the province's VC activity, capturing:**
  - 90 percent ($226 million) of the province's investments in 2002
  - 87 percent in 2001 ($477 million)
- **Information technology led** in 2002 with a 51-percent investment share ($128 million), followed by life sciences, with 24 percent ($61 million), and other technologies, with 10 percent ($47 million)

VC investments in British Columbia focussed on information technology and life sciences

Information technology attracted the greatest share of British Columbia's VC investments in 2002, despite a 39-percent decrease in dollars invested (from 2001 levels). Capital invested in life sciences firms fell 70 percent between 2001 and 2002. This significant drop is probably linked to the fact that in 2001, two biopharmaceutical companies (Xenox Genetics Inc. and Cellfor Inc.) secured exceptionally large financings (with a relatively small number of investments, such transactions can affect regional numbers considerably). Nonetheless, the overall distribution of Canadian life sciences VC investments between 1996 and 2002 showed that British Columbia averaged 22 percent of Canada's life sciences investments, third behind Quebec (40 percent) and Ontario (30 percent).

The proportion of Canadian life sciences and information technology VC investment in British Columbia remained stable between 1996 and 2002. Figure 59 depicts changes in the provincial distribution of total life sciences, information technology and foreign investment. Although British Columbia's foreign investment share decreased from 61 percent in 1997 to 11 percent in 2002, the major reason for this change was Ontario's explosion of foreign information technology investment.

Figure 59
VC Investment in British Columbia, 1996–2002



Source: Macdonald & Associates Limited, 2003.

Prairies[117]

Increase in VC investments

Unlike the other regions in Canada, VC investments in the Prairies recovered to $159 million in 2002 after a decrease to $146 million in 2001. Investors concluded fewer transactions, but negotiated larger financings. This was reflected in the modest increase in average deal size in 2002.

VC activity in the Prairies

- **Prairies' share of total VC activity:**
  - 6 percent in 2002 ($159 million)
  - 4 percent in 2001 ($146 million)
- **Average deal size:**
  - $1.8 million in 2002
  - $1.4 million in 2001
- **Number of deals:**
  - 88 in 2002
  - 101 in 2001

117. While detailed analyses of each province and territory would be of wider utility, data for some provinces and territories are not sufficient to provide a significant comparison and analysis. The small amount of VC investment in any given year in provinces such as Manitoba and Saskatchewan make it difficult to conclude which factors may contribute to any observed growth or decline, as a few large deals in one sector can significantly change the overall distribution of the investment. As a result, the Prairies and Atlantic provinces are being analyzed and compared on an aggregate basis in this report.

Traditional sectors led VC investments in the Prairies

Investors' strong focus on traditional sectors in the Prairies (particularly in Manitoba and Saskatchewan) may account for the region's lower level of VC investment. However, a recent study on the link between VC and the creation of technology clusters concluded that it is not axiomatic that technology clusters can only flourish where ample risk capital is available.[118] The early years of Ottawa's developing technology cluster, for example, showed remarkable growth without the benefit of VC.

VC investments in traditional sectors:
- 20 percent in 2002 ($57 million)
- 10 percent in 2001 ($36 million)
- 46 percent of the region's average VC investments over 1996–2002 (against 24 percent for Canada)

VC investments in information technology:
- 3 percent in 2002 ($54 million)
- 3 percent in 2001 ($77 million)
- 20 percent over 1996–2002

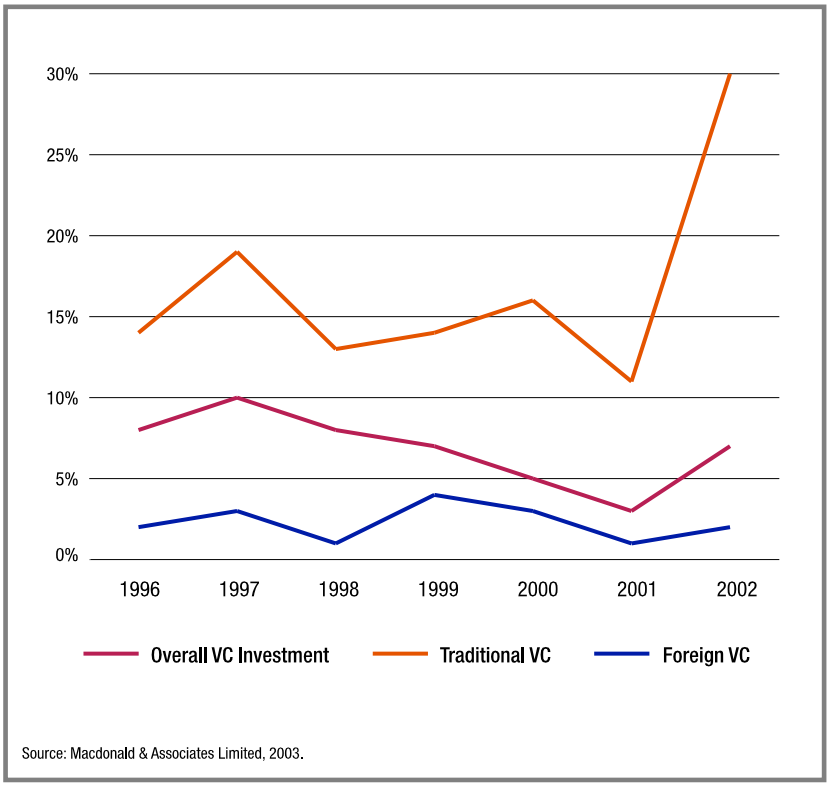
VC investments in life sciences:
- 7 percent in 2002 ($31 million)
- 4 percent in 2001 ($28 million)
- 22 percent over 1996–2002

A concentration on non-technology sectors may explain this region's inability to attract a large portion of VC investment in past years; venture capitalists prefer to invest in innovative high-growth-potential firms in high technology sectors. Other possible reasons include the absence of a tax credit for LSVCCs in Alberta and the absence of a critical mass of potential VC opportunities. These issues merit further investigation to determine why the Prairies' share of VC activity is disproportionately low compared to its share of KBI firms and GDP.

Figure 60 shows that until 2001, overall and foreign VC investments in the Prairies had been decreasing, along with VC investments in traditional sectors. While overall and foreign VC investment levels have risen since 2001, traditional sector VC investment has increased at a much greater rate. In 2002, LSVCCs provided 40 percent of traditional VC in Canada, whereas they provided only 20 percent of traditional VC in the Prairies. Government, private independent and "other sources" investors financed a sizable amount (60 percent) of traditional investments in this region.

118. Colin Mason et al., Hunter Centre for Entrepreneurship in the UK. *The Role of Venture Capital in the Development of High Technology Clusters: The Case of Ottawa, 2002.*

Figure 60
VC Investment in the Prairies, 1996–2002



Source: Macdonald & Associates Limited, 2003.

Atlantic

The Atlantic region's average share of total VC investments remained low in 2002, at 2 percent. The slowdown in investments across Canada, however, was less dramatic in this region. VC investment fell 10 percent between 2001 and 2002 in the Atlantic region, compared with 35 percent in Canada.

Life sciences attracted the highest proportion of VC investments in 2002, notably through a large medical devices and equipment deal.

Foreign investors have tended to avoid VC investment in the Atlantic provinces. Over the 1996–2002 period, foreign VC investment in the Atlantic provinces represented less than 0.15 percent of total foreign venture capital in Canada.

VC activity in Atlantic Canada

- **Share of total VC investments:**
  - 2 percent in 2002 ($44 million)
  - 1 percent in 2001 ($49 million)
  - 2 percent over 1996–2002
- **Deal size:**
  - $2.2 million in 2002
  - $1.7 million in 2001
- **Number of deals:**
  - 20 deals in 2002
  - 28 deals in 2001
- **Investments in life sciences attracted 62 percent ($27 million) of VC investments in 2002**, followed by information technology with 34 percent ($15 million) and traditional sectors with 2 percent (close to $2 million)

Trends 1996–2002
Notwithstanding the lower levels of VC investment compared with other regions:

- **VC investments** increased 33 percent over the 1996–2002 period, from $33 million to $44 million;
- **Number of VC deals** declined by 13 percent, from 23 in 1996 to 20 in 2002;
- **The average deal size** for the Atlantic region, while lower than the national average, increased by 52 percent, from $1.4 million in 1996 to $2.2 million in 2002, with an average deal size of $1.7 million over the period; and
- **Number of VC funds** increased from 5 in 1996 to 11 in 2002.

3.8 First performance returns data published by CVCA in 2003

As noted earlier, there is a direct relationship between VC investments and investment performance.[119] Periods of strong performance returns have led to increased fundraising activities, which in turn have preceded alarming downturns in returns. Before March 2003, there were no performance data available in Canada (in the US this information has been available since the early 1990s). As a result, it is impossible to draw historical links between the growth of performance returns and VC activity in Canada. However, it is likely that the lack of performance data in Canada has had a negative impact on the past growth of the Canadian VC industry, as investors have had no solid information upon which to base their investment decisions. To address this discrepancy, the CVCA, in collaboration with Macdonald & Associates Limited, Réseau Capital and Industry Canada, has recently published the first Canadian performance data on VC and private equity funds, up to the end of 2001.

According to the first Canadian performance returns database (see Table 26), the Canadian VC industry has offered three year returns of 15 percent and five-year returns of 13 percent. This database will allow investors to monitor and evaluate the performance of VC investments, which should increase the flow of capital to VC funds and, downstream, to innovative small and emerging businesses.

Table 26 — Performance of VC and Private Equity Funds in Canada, as of December 31, 2001

	1 Year	3 Years	5 Years
Early-stage VC	-7.2	22.5	17.5
Balanced VC	-12.2	14.3	12.8
All VC	-10.7	15.7	13.3
Buyout and mezzanine	10.6	9.2	15.7
All VC and private equity	-7.9	14.6	13.7

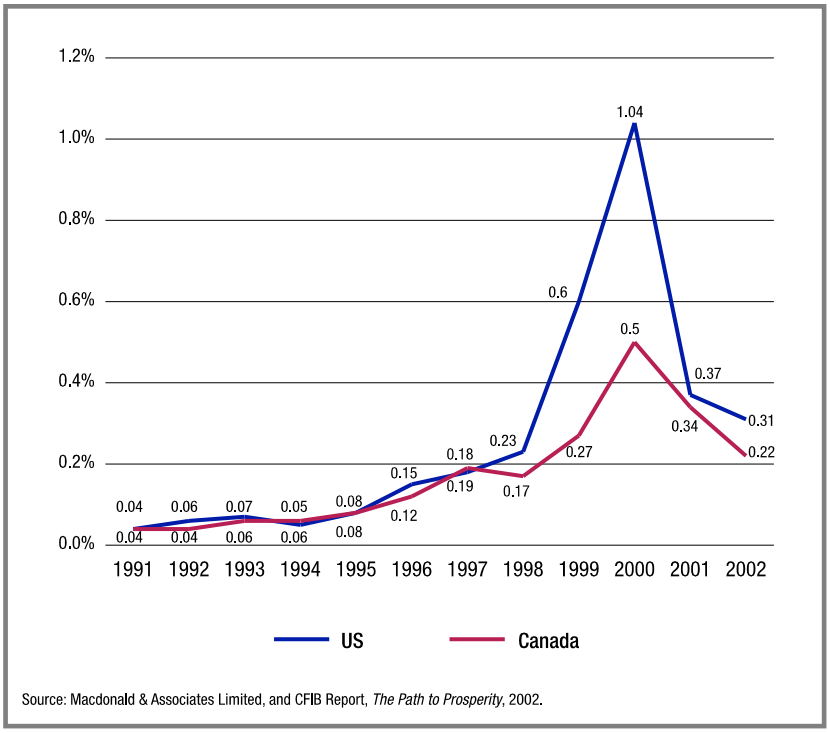
Sources: Canadian Venture Capital Association and Macdonald & Associates Limited, 2003.

119. Paul A. Gompers, Harvard Business School. *A Note on the Venture Capital Industry*, 2001.

3.9 Canada–US comparison[120]

Contrary to the general perception, the Canadian VC market has performed relatively well compared to the US and to other OECD countries. One available measure to compare the relative performance of the Canadian and VC industries involves VC investments and venture capital under management as percentages of GDP. The data reveal that throughout the 1990s, the relative size of the Canadian VC market was similar to the American market.

Figure 61
VC Investments as a Percentage of GDP in the US and Canada, 1996–2002



Source: Macdonald & Associates Limited, and CFIB Report, *The Path to Prosperity*, 2002.

After the American VC market explosion in 1999 and its collapse in 2001, the gap between the two North American markets narrowed (Figure 61). In fact, most of the negative perception about the Canadian VC market was formed during the 1999–2000 bubble, which was an anomaly for the US market.

The more stable performance of the Canadian VC industry (and the significant decline in the US), has narrowed the gap between Canadian VC investments as a percentage of US investments. In 2002, the value of Canadian VC investments was 8 percent of the value of US VC investments (adjusted to take into account the exchange rate). This proportion was much higher than the 3 percent, 4 percent and 6 percent observed in 1999, 2000 and 2001. The percentage for 2002 was consistent with the relative size of the two economies

120. For the purpose of this report, an average exchange rate of 1.5 percent has been calculated for 1996–2002 based on United Nations Department of Statistics (**www.unstats.un.org/unsd/cdb/sdb_simple_data_extract.asp**).

(Canadian GDP stood at 7 percent of US GDP in 2002) and represents roughly Canada's share of the North American market.

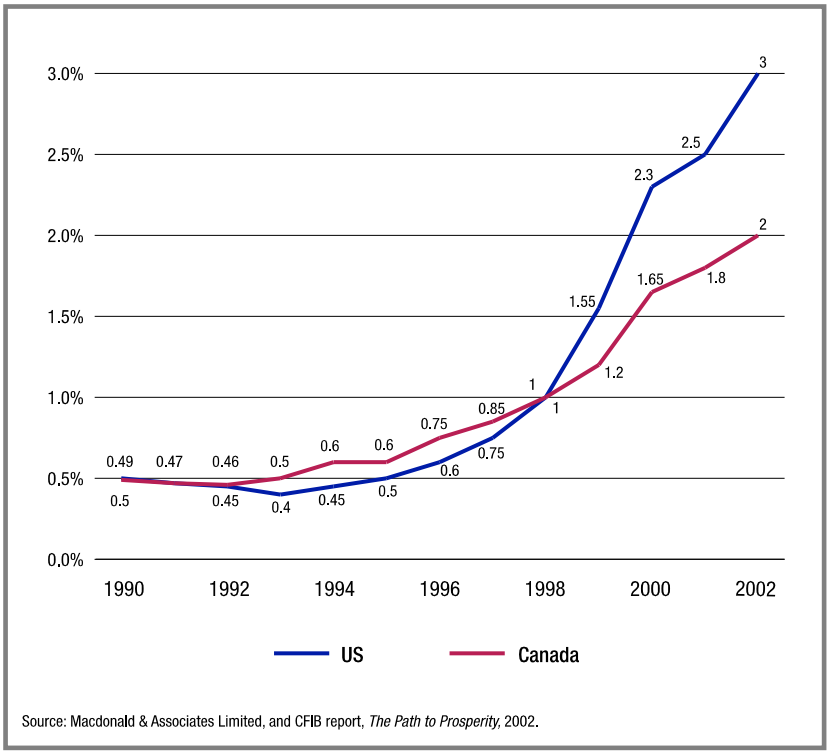
However, gaps between Canada and the US remain:

- Total capital under management (Figure 62), remains relatively smaller in Canada. The American market, which benefited earlier from the technology bubble, is larger, more sophisticated and more mature
- The low levels of institutional investment
- Canada has been more dependent on foreign investment, which tends to be volatile during periods of instability

Canada Total VC investments:
- $2.5 billion in 2002
- $3.8 billion in 2001
- $5.8 billion in 2000

US Total VC investments:
- C$32 billion in 2002
- C$61 billion in 2001
- C$159 billion in 2000

Figure 62
VC Under Management as a Percentage of GDP in Canada, 1996–2002



Source: Macdonald & Associates Limited, and CFIB report, *The Path to Prosperity*, 2002.

Canadian VC investments were more stable than US investments in 2001 and 2002
While Canadian VC investments declined by 35 percent between 2001 and 2002, VC investment levels in the US fell by nearly 50 percent over the same period. As a result, investment levels in the US in 2002 were comparable to those last seen in the pre-bubble year of 1998, when $21.6 billion (C$32.4 billion) was disbursed.

Important regional concentration of VC activity observed in the US

The regional concentration of VC investment is not unique to Canada. In fact, American VC activities are highly concentrated in Silicon Valley (California) and, to a lesser extent, the Boston area (Massachusetts). Over the last two decades, California and Massachusetts were the top two states in VC investments in high technology sectors, including information and communications technology and life sciences. More recently, as VC firms in California, New York and Massachusetts have diversified their investments, American venture capital has started to spread to Colorado, Maryland and North Carolina.

VC investments by state

California:
- C$14.2 billion in 2002 (45 percent)
- C$24.7 billion in 2001 (41 percent)

Massachusetts:
- C$3.6 billion in 2002 (11 percent)
- C$7.3 billion in 2001 (11 percent)

Texas:
- C$2 billion in 2002 (6 percent).
- C$5 billion in 2001 (8 percent)

4. INITIAL PUBLIC OFFERINGS (IPOS)

As mentioned earlier, firms typically go through various stages of financing during their life cycle. VC financing, which serves as a bridge between the informal financial sector and the public capital markets, is only a transitional phase in financing. VC will likely be more efficient in the presence of a strong informal capital market that screens, evaluates and finances new deals and strong formal capital market that provides good exit potentials, preferably through an IPO.[121] As research has found, an efficient IPO mechanism offers the prospects of a profitable exit for early-stage investors and therefore encourages investment in innovative, high-growth-potential firms.[122]

This section examines a recent SME Financing Data Initiative study on the performance of SMEs that issued IPOs in Canada between 1991 and 2000.[123] The study revealed the following:

- Public financing is a key stage in the development and growth of SMEs, especially that of knowledge-based SMEs. After raising capital stock exchanges, SMEs may have ongoing access to a regular source of capital. IPOs also provide an attractive exit for venture capitalists, who in turn provide equity capital to small and growing companies.
- Canada has an active IPO market, but one with marked weaknesses: Canadian IPOs tend to be smaller than American IPOs, many Canadian firms go public too early and their success and survival rates tend to be very low.

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121. In an initial public offering, a company raises capital by issuing shares to investors and subsequently becoming listed on a stock exchange. In these transactions, shares are sold to investors to provide equity capital to the company in return for company ownership.

122. Allan Riding, *Financing Entrepreneurial Firms: Legal and Regulatory Issues*. Research paper produced for the Task Force on the Future of the Canadian Financial Services Sector, 1998.

123. Cecile Carpentier, Maher Kooli, Jean-Marc Surêt, Université Laval, 2003. *Les Émissions Initiales au Canada: Statut, Anomalies et Dysfonctions.*

- IPOs in Canada tend be associated with high costs, which are especially onerous for smaller businesses. Moreover, Canadian IPOs tend to be under-priced, which seems to have a significant impact on SMEs' competitiveness.

IPOs in Canada: Size, Performance and Cost

4.1 Size

Canadian IPO market is comparable to US regional markets

Canadian IPOs tend to be very small transactions. Between 1996 and 2000, the average value of IPO transactions in Canada was $2.5 million; between 1995 and 1999 the average was $131 million in Germany, $74 million in France, $93 million in the UK and $84 million in the US Moreover, compared to the UK, France or Germany, Canada has had more small companies undertaking small transactions (in size and value). In fact, 90 percent of the companies that issued IPOs over the 1990–2000 period in Canada would have been considered too small (as measured by transaction value) to be covered under the American Securities and Exchange Commission regulations, or to be listed on national stock exchanges such as the NASDAQ or the New York Stock Exchange.

Different kinds of shares are offered in a typical IPO:

- ***Common shares,*** which are the most frequently offered, represent part ownership and voting rights. Common share owners may receive dividends, but only after preferred share owners. In the event of company liquidation, common share owners are the last to claim any of the company's asset
- ***Restricted voting shares*** are a class of common shares whose voting rights are limited
- ***Preferred shares*** grant a fixed dividend to their holders before any dividends are paid on common shares, and a stated dollar value per share in the event of company liquidation, but they don't usually come with a vote

The Timing of IPOs: "Hot" and "Cold" Markets

As indicated in Figure 62, companies tended to undertake IPOs in waves. The biggest waves were in 1993–1994 and 1996–1997, when the markets were particularly bullish, 1997 being the record year for this activity. Usually, companies choose to register an IPO at a time of "hot" market activity to maximize their share prices. Investors tend to be more interested in IPOs during bullish stock market periods. Unfortunately for companies, share under-pricing tends to be more of a problem during these periods as well.

4.2 Survival rate

Canadian firms have low post-IPO survival rate

Very small issues by small or very small companies (under $1 million in net assets) with very short track records, have an extremely small chance of succeeding. Of the 153 companies with gross proceeds under $1 million that launched an IPO between 1991 and 1995:

- 53 percent were unsuccessful, either because they were written off, had negative net assets or ended up with net assets worth less than their transaction values

- 28 percent survived over five years and had a positive book return with net assets worth more than the proceeds of the IPO
- Only 6 percent survived over five years with net assets exceeding $10 million, and these could be considered real successes

Similarly, of the 95 companies with gross proceeds between $1 million and $5 million:

- 28 percent had either negative net assets or assets worth less than the gross proceeds
- 34 percent survived over five years and had a positive book return with net assets worth more than the proceeds of the IPO

Finally, of the 27 companies with gross proceeds between $5 million and $10 million:

- 40 percent had either negative net assets, or assets worth less than the gross proceeds
- 19 percent survived over five years and had a positive book return with net assets worth more than the proceeds of the IPO

Over the 1991–2000 period, more public companies disappeared from the Canadian stock exchanges than were added; the number of companies listed on Canadian stock exchanges declined by 5 percent, from 4342 to 4124, in spite of the 1891 IPOs.

4.3 IPO Cost

Going public is less expensive in Canada than in the US

The direct costs of issuing an IPO are determined by regulatory costs — including the preparation of a prospectus, the payment of fees and the work of various professionals — and the commission paid to an underwriter. Regulatory costs are more onerous for small firms than for larger ones. The commission paid to the underwriter is a percentage of revenues raised by the share offering.

Size being equal, the direct costs of issuing an IPO in Canada are lower than those in the US and, on average, the underwriter's commission is less in Canada than the US standard of 7 percent (Table 27). However, these costs remain burdensome, especially for SMEs.

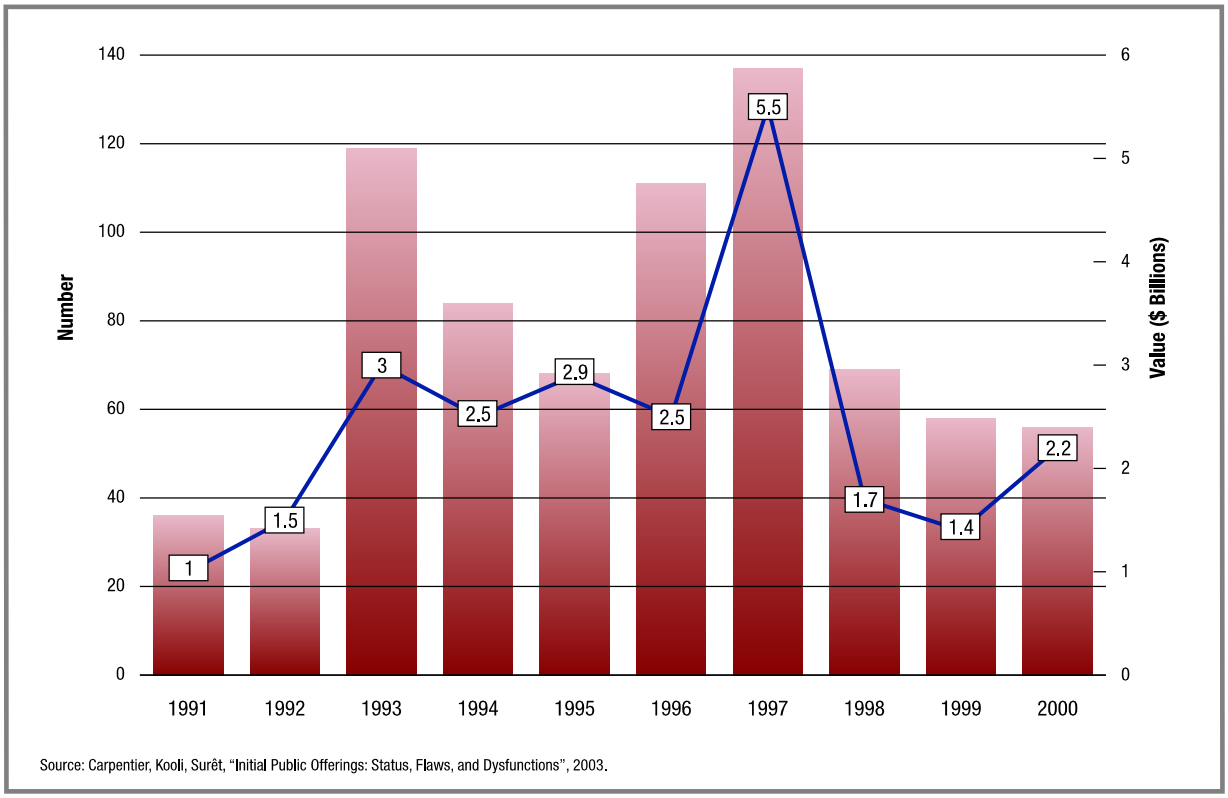
Paradoxialy, junior-capital-pool companies — for whom the IPO process is meant to be simplified and cheaper — actually pay a higher percentage of the transaction value to issue an IPO (23 percent) than do traditional SMEs of comparable size (16 percent).

Additional costs: the under-pricing of initial shares

The underpricing of initial share offerings constitutes an additional cost for all issuing companies, but one that becomes a serious matter for newly public SMEs. These costs affect, and perhaps determine, the ultimate success or failure of the company. Moreover, the smaller the company is when it goes public, the bigger the underpricing problem appears to be.

Figure 63

Number and Value of Canadian IPOs, 1991–2000



Source: Carpentier, Kooli, Surêt, "Initial Public Offerings: Status, Flaws, and Dysfunctions", 2003.

The problem in Canada may be due to the lack of competition between brokerage houses, particularly since 70 percent of industry revenues are earned by seven bank-owned firms, including all six of the largest banks. Other factors contribute to share under pricing, including:

Share underpricing occurs when the value of a company is underestimated as a reflection of the share price. According to recent research, initial shares are frequently under-priced. Moreover, underpricing tends to be more of a problem in a "hot" market than in a "cold" one. Ironically, more SMEs launch IPOs during hot markets in an attempt to maximize their share prices.

- the lack of hard negotiating skills or power among many SME managers, since the initial price is set by underwriters
- book-building, which is the method brokers use to calculate initial orders
- the unduly powerful influence of institutional investors

These factors are further explained in the attached box.

Table 27 — IPO Costs by Issue Size, 1997–1999

Size of Issue (U.S. $ Millions)	Number of IPOs	**BROKER COMPENSATION (%)**	Other Expenses (%)	Total Direct Costs (%)	Under Pricing (%)
CANADA					
1.0–9.9	53	**8.12%**	7.86%	15.98%	30.61%
10.0–49.9	49	**6.14%**	3.31%	9.45%	11.30%
50.0–99.9	10	**6.00%**	2.00%	8.00%	10.76%
100 and over	16	**5.53%**	1.75%	7.28%	8.88%
Average		**6.88%**	4.90%	11.78%	18.95%
Weighted average by size		**5.35%**	1.84%	7.19%	5.11%
UNITED STATES					
1.0–9.9	119	**9.29%**	8.70%	17.99%	9.05%
10.0–49.9	532	**6.93%**	3.70%	10.63%	26.15%
50.0–99.9	300	**6.88%**	2.12%	9.00%	55.57%
100 and over	237	**6.09%**	1.20%	7.29%	67.19%
Average		**7.00%**	3.30%	10.30%	37.50%
Weighted average by size		**5.79%**	1.43%	7.22%	38.38%

The direct costs of Canadian primary issues are from final prospectuses that were not available on the SEDAR until 1997. The direct costs of US primary issues are from final prospectuses available on the SEC site.

Source: Carpentier, Kooli, Suret, 2003.

4.4 Conclusion

Determinants of Success and Failure of an IPO

- **Size:** companies whose transaction values are less than $10 million are less likely to be successful. As previously discussed, over a five-year period following the initial issue, companies of this size tend to lose half their value, once market fluctuations are accounted for.
- **Issue periods:** market cycles also play a role. Companies tend to under-perform if they launch their IPO during a "hot" market cycle.
- **Sector:** under-performance varies considerably from sector to sector. Financial services companies performed better than technology or natural resource-sector companies in the first five years after an IPO.
- **Analyst attention:** analyst interest is critical to a company's ability to raise equity capital and perform well in the market. According to the study, it is probable that analysts do not pay sufficient attention to SME IPOs in the belief that they are not sufficiently capitalized to interest institutional investors.
- **Institutional investors:** institutional investors can affect SME IPOs negatively, as they hold immense power in the process of negotiating the initial share price and, therefore, in affecting its under pricing. Moreover, empirical evidence shows that IPOs are oversubscribed to institutional investors, and that individual investors have problems obtaining securities at the offering price, which limits the amount of liquidity for small capitalisation securities, and can contribute to the lack of analyst and broker interest in small capitalisations, due to low transaction levels.
- **Book-building:** the method by which the underwriter establishes the initial share price seems to disadvantage SMEs. Underwriters and company managers present a "road show," which is the presentation of the company, its products or services, market, and perceived value, to institutional investors and interested brokers who will in turn sell the company's shares to individual investors. The underwriter then gauges investor interest and thereby establishes the demand curve for the company's shares. According to the study, book-building tends to favour institutional investors, who are inclined to dismiss SMEs.

Stock markets: unfriendly places for SMEs

The low survival rate of SMEs that use the IPO process signals major problems in the operation of the primary issues market. As noted above, only 6 percent of the smallest companies (under $1 million in transaction value) show the potential, after five or ten years, of growing into large businesses.

American results are similarly disappointing. Success rates have been very low for companies whose transaction value is between $1 million and $20 million (comparable to most Canadian IPOs) and which raise public funds through the Small Corporate Offering Registration (SCOR). Available data suggest that few of these companies grow sufficiently to issue shares on national exchanges such as the NASDAQ or NYSE.

In a dynamic risk capital market such as Canada's, there is a widespread belief that in an active market, venture-backed companies will naturally move from small to medium size before going public.

However, the study indicated that, while Canada has a very active risk capital market, firms tend to go public too early, perform poorly and have very low success rates (or survival rates). This situation signals a fundamental problem with respect to SMEs' readiness to undertake IPOs.

The dysfunctions in the small issues market (low survival rate, high costs, share underpricing and poor medium-term return) are symptomatic of problems encountered by small and medium-sized growing firms in their pre-IPO stage of financing. Empirical evidence suggests a need to expand the Canadian VC market's capacity to support more venture capital financing that would, in turn, support more IPOs. This would improve the VC market's capacity to cope with growth and would stimulate institutional investors' participation in the VC market. The result would be greater VC fund specialization and increased competition for investment deals, which could lead to higher company valuations, larger investments and more capital for IPOs. This should be supported, however, by measures that would allow IPOs to be deferred until businesses have a reasonable chance of survival. Ultimately, small Canadian firms could grow and exploit the full benefits of their innovations.

5. QUASI-EQUITY FINANCING

Quasi-equity financing (also known as mezzanine financing or sub-ordinated debt) is another form of financing frequently used by SMEs. It typically involves a mix of debt and equity financing, which allows investors to achieve gains through capital appreciation and interests on debt-repayment. Quasi-equity financing is often more attractive to companies with more limited growth potential and/or companies that prefer not to relinquish full or partial control of the business by selling shares.

The Canadian quasi-equity market is still relatively young and small. However, total quasi-equity investments grew by 77 percent, from $208 million invested in 347 companies in 1999, to $369 million invested in 583 companies in 2002. In 2002, the quasi-equity market remained vigorous, and a number of new mezzanine investors emerged in most Canadian regions, which may have contributed to increased activity, including:

- $369 million in total investments (compared with $292 million in 2001)
- 583 firms financed (compared with 550 in 2001)
- large deals ($5 million and over) captured $233 million, or 63 percent of all investments (compared with 51 percent in 2001)

According to some observers, recent market uncertainties may have encouraged industry players to focus their investments in well-established private companies in the mid-sized market.[124] Furthermore, fast-growing high technology firms may have decided to delay their exit, instead waiting for more favourable IPO conditions. These firms have created a greater demand for subdebt financing as an interim financing option. Investments in the $5 million and over bracket increased by 55 percent from 2001 to 2002, which could signal investors' appetites for larger investments.

124. See Glossary for definition.

Regional Perspective

In 2002, Ontario-based companies replaced Quebec-based firms as the primary recipients of quasi-equity investments, with $166 million (45 percent of total quasi-equity financing) invested in 182 firms. In 2001, Quebec firms attracted 27 percent of sub-debt investments. In terms of the number of financings, however, companies in Quebec were the most successful in attracting quasi-equity financings, with 277 firms financed (or 39 percent of the total). By contrast, the amount invested in Atlantic Canada decreased by 92 percent.

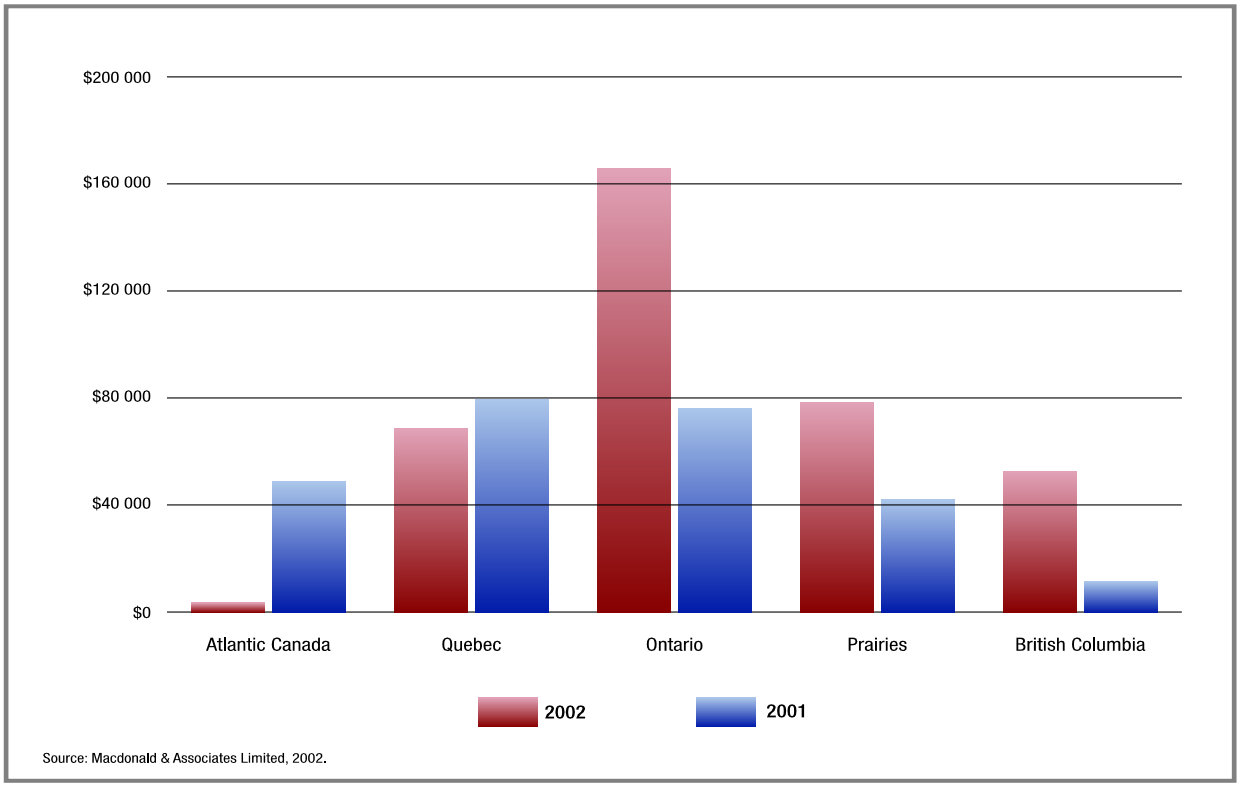
In 2002, quasi-equity investments reached:

- $166 million (45 percent of total) in Ontario, compared with $76 million (30 percent) in 2000
- $68 million (19 percent) in Quebec, compared with $79 million (27 percent) in 2001
- $53 million in British Columbia (14 percent), compared with $11 million (4 percent) in 2001
- $78 million in the Prairies (21 percent), compared with $42 million (16 percent) in 2001
- $3.5 million (0.9 percent) in Atlantic Canada, compared with $49 million (19 percent) in 2001

Investments flowed to:

- 182 firms in Ontario (compared with 196 in 2001)
- 227 firms in Quebec (compared with 211 in 2001)
- 75 firms in British Columbia (compared with 47 in 2001)
- 78 firms in the Prairies (compared with 108 in 2001)
- 20 firms in Atlantic Canada (compared with 23 in 2001)

Figure 64
Quasi-Equity Investment by Region, 2001–2002



Source: Macdonald & Associates Limited, 2002.

Investments were concentrated in the consumer products sector

As was the case in 2001, the Canadian quasi-equity industry focussed on expanding investments in mature mid-market sectors such as consumer products and services and manufacturing. In 2002:

- consumer products and services attracted $195 million (53 percent of total investments) to 366 companies
- manufacturing captured $67 million (18 percent) in 78 companies
- technology sectors captured the remainder of 21 percent (or $79 million), spread across information and communication technologies, with $50 million (13 percent) invested in 67 companies
- life sciences, with $29 million (8 percent) invested in 11 companies

Quasi-equity investments concentrated in large deals

Large quasi-equity financings ($5 million and over) accounted for $233 million (63 percent of total quasi-equity investments) in 21 companies in 2002, compared with $150 million invested in 9 firms in 2001, for 51 percent of total subdebt investments. Large deals averaged $11.1 million in 2002 compared with $11.5 million in 2001.

Mid-sized transactions ($1–5 million) provided 37 firms with $55 million, or 15 percent of total quasi-equity investments in 2002, compared with $52 million invested in 37 companies, for 18 percent of the total in 2001.The average deal size was $1.5 million in 2002, compared with $1.6 in 2001.

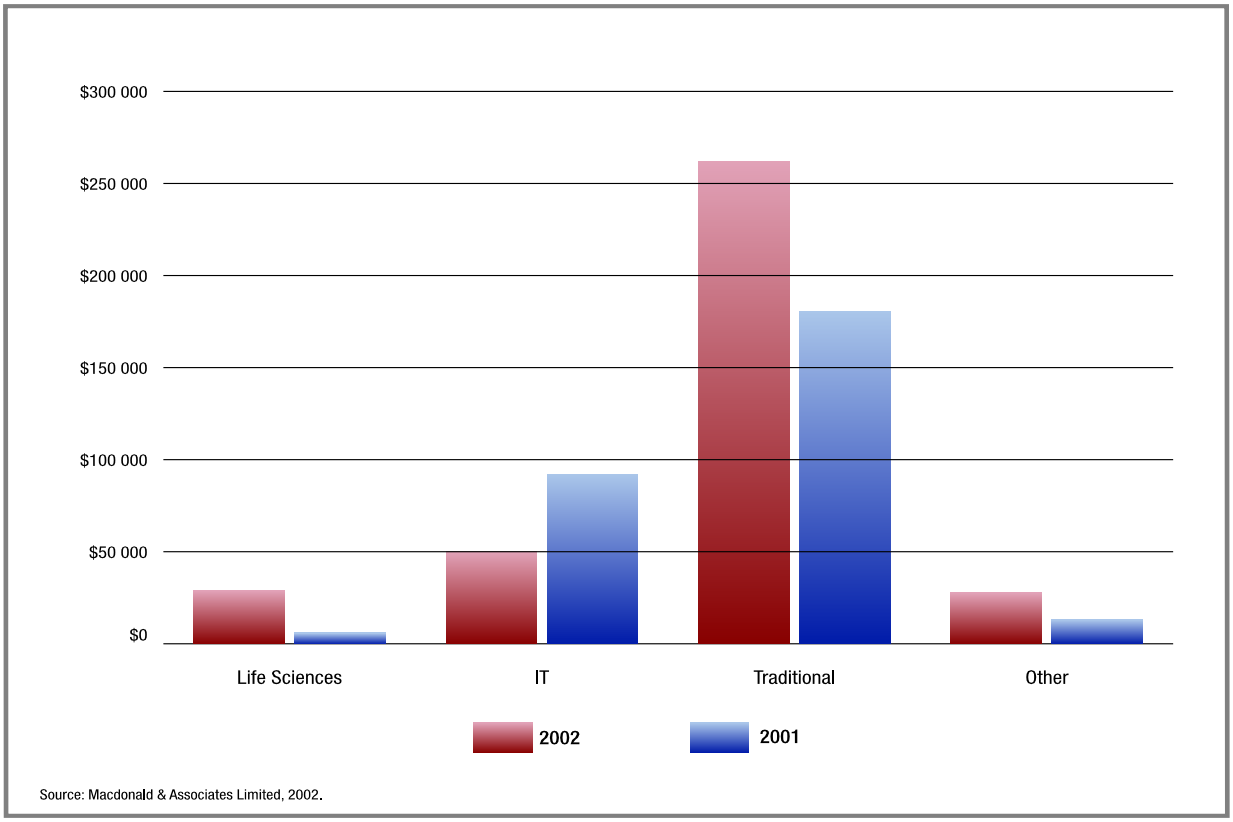
Small transactions ($1 million or less) continued to attract investors' interest, with investments totalling $81 million (22 percent of the total) distributed to 529 companies, or 90 percent of the companies that received quasi-equity funding in 2002. In 2001, these transactions accounted for $90, or 31 percent of the total, invested in 510 firms. As in past years, smaller-sized deals (under $500 000) captured the majority of quasi-equity investments in the under $1 million size category, with $63 million (or 78 percent) invested in 498 companies; in 2001 these companies attracted $66 million (73 percent) in 475 companies. In 2002, the average small financing in the under $500 000 category was $126 000, and the average under $1 million financing was $152 550.

Role of the Business Development Bank of Canada (BDC)

The BDC is the largest provider of quasi-equity financing in Canada, and tends to focus on transactions under $1 million, carrying on its leadership role in this deal size category. In 2002, BDC:

- invested $107 million in 523 companies
- was responsible for $72 million (89 percent) of the industry's total investments in the small deal bracket (under $1 million)
- was regionally diversified, investing across the country
- dedicated 88 percent of its investments to traditional sectors

Figure 65
Quasi-Equity Investment by Sector, 2001–2002



Source: Macdonald & Associates Limited, 2002.

CONCLUSION

On a relative basis, the Canadian economy has enjoyed virtually the same level of risk capital and VC activity as the American economy. Nonetheless, some relative regional VC investment gaps exist, notably in the Prairies and, to a lesser extent, in the Atlantic provinces. These gaps, which will require further examination, may be explained by the nature and operation of VC investment processes and by the structure of regional economic activity. The low survival rate of small businesses involved in IPOs also needs to be further explored, as this tendency could potentially hinder the Canadian economy's development and growth. A number of questions will need to be addressed in light of the findings highlighted above, notably:

- What effect does the poor performance of Canadian small issues have on market liquidity?
- Should there be a focus on facilitating pre-IPO financing?
- What alternatives can be found to allow IPOs to be deferred until businesses have a reasonable chance to ensure their survival?

APPENDIX: SME FINANCING DATA INITIATIVE — STAKEHOLDER CONSULTATIONS, FALL 2002

In the fall of 2002, Industry Canada, Statistics Canada and the Department of Finance Canada consulted with stakeholders in Toronto and Ottawa on a series of questions related to the implementation and improvement of the SME Financing Data Initiative (SME FDI), which was launched in 2000. The objective was to engage stakeholders in the resolution of two issues that remained outstanding from the first round of consultations in 2000:

1. Develop measures to link authorization size to employment size for client businesses as an approach to resolving this issue;
2. Develop a revised definition of knowledge-based industries (KBI) based on the North American Industrial Classification System (NAICS) codes.

During the consultations, the SME FDI partners proposed:

- a practical approach to link authorization size of loans to employment size of firms by number of employees; and
- a revised KBI definition, based on the methodology used in 1996, which made the fewest possible changes to the current definition of KBIs.

Based on a series of questions from SME FDI partners, stakeholders were invited to provide written comments on the proposed approach, including:

- What legal/technical issues need to be addressed?
- What other compliance issues need to be considered?
- Are there alternative approaches?
- When should the link between employment size and authorization size be implemented?
- Are there sectors that fall outside the boundaries of the converted Standard Industrial Classification (SIC) codes from Tiers I and II that should be included in NAICS (e.g. advanced materials that were not included previously because the industries in question made up very small portions of a large number of SIC codes)? If so, on what criteria?

Linking Authorization Size to Employment Size of Firms (By Number of Employees)

Issue

Through the *Survey of Suppliers of Business Financing*, Statistics Canada collects and publishes data from Canadian financial institutions on the amount of financing supplied to businesses by authorization size of loans and leases. Since 2000, Industry Canada has used authorization size as a proxy measure to report on SME financing to the Industry Committee on the state of SME

financing. However, 2000 data from the (demand-side) *Survey on Financing of Small and Medium-sized Enterprises* show that the average debt authorized for medium-sized businesses (100 to 499 employees) was over $1.5 million. For smaller businesses, this average ranged from $64 000 for businesses with fewer than five employees to over $600 000 for businesses with between 20 and 99 employees. These results illustrate the risk of using a proxy measure — the average authorization for a medium-sized business in 2000 was well above the proxy threshold. Also, Statistics Canada found considerable variation between the average amounts authorized for businesses with fewer or more employees. These findings indicate that a sound assessment of the state of SME financing will require solid employment size estimates for several employment size categories.

Proposed Approach: A Supplement to the Survey of Suppliers of Business Financing (SSBF)

During the last round of consultations (2000–2001), financial institutions indicated that they could not provide reliable data on employment size from their own database. In the proposed approach, Statistics Canada would select a sample of suppliers (banks, credit unions, leasing companies) and ask them to provide information (name, address, telephone, CCRA number, authorization size, amount outstanding) about a random sample of their business clients. Statistics Canada would then use this information to link each business to the Statistics Canada Business Register to obtain an estimate of employment that would then be combined with the authorization size and supplier type information to create a model of employment size by authorization size, by supplier type. This model would distribute all authorizations reported by suppliers to the size of the firms to which they likely were given.

Stakeholder Reaction:

1. **Privacy and confidentiality of information**: Stakeholders raised a number of legal implications, including privacy and confidentiality concerns regarding potential legal breaches, notably with the *Personal Information Protection and Electronic Document Act,* the *Bank Act* and the *Statistics Act*, under the purview of Industry Canada, Finance Canada and Statistics Canada, respectively.

   Action: To alleviate stakeholders' legal concerns and stimulate an informed debate, the SME FDI partners requested formal legal opinions. According to the various counsels, the privacy and confidentiality issues raised by stakeholders are not well-founded and should not hinder the implementation of the partners' proposed approach. The SME FDI partners will propose a realistic action plan for the implementation of the approach, and discuss it with private sector stakeholders.

2. **Using the demand survey**: Stakeholders suggested adding questions to the *Survey on Financing of Small and Medium-Sized Enterprises* to identify the amount of liabilities and total number of employees, which would allow an assessment of the relationship between authorizations and employment size.

Action: Although using the demand survey to ask small and medium-sized businesses about their liabilities and employees seems to be a reasonably promising method, this approach holds a number of challenges that must be considered prior to implementation. The SME FDI partners are currently examining the advantages and disadvantages of using the demand survey as well as its likelihood of providing positive results within the five-year implementation period, scheduled to end in 2005.

DEFINITION OF KNOWLEDGE-BASED INDUSTRIES

Issue

The definition of knowledge-based industry (KBI) must be modernized, based on the North American Industrial Classification System 1997 (NAICS-97) used by chartered banks to report to the Industry Committee on lending activities.

Background

In 1997, Industry Canada, the Business Development Bank of Canada (BDC) and the Canadian Bankers Association (CBA) developed a standard KBI definition in response to the Industry Committee's request. The definition was based on Statistics Canada's Standard Industrial Classification 1980 (SIC-80). Since the development of this definition, the BDC and the CBA have used it extensively to report on their volume of lending to KBIs.

All parties recognized in 1997 that this definition was handicapped because of the limitations linked to the age of SIC-80 — for example, several critical sectors of the new economy were not covered in this industrial classification. In 1998, however, the successor to SIC-80, called the North American Industrial Classification System (NAICS-97), was finally adopted. This system, which was implemented under the North American Free Trade Agreement (NAFTA), reflects the current economic and industrial structure and has the added advantage of being the standard for the all of North America. In 2000, Industry Canada reviewed the definition of KBI to convert it from SIC-based groupings to NAICS. However, this conversion was rather mechanical and did not consider stakeholders' views.

Commercial banks have yet to adopt the new NAICS-based definition and continue to use the original 1997 definition of KBIs. They advised in the fall 2002 that their SIC-based reporting systems met their needs and that they did not see any benefit in changing their database to NAICS. As a result, when Statistics Canada requests information from the banks on their lending and other financing activities by industry, they provide their data using the old definition. Statistics Canada then converts them into NAICS, but since many businesses are likely not classified properly, the results are unreliable.

The lack of a revised KBI definition based on the NAICS could compromise the capacity of the federal government to understand the impact of KBI enterprises in the Canadian economy. This definition gap will increase in the future with the introduction of a new industrial classification system in 2007. At that time the industrial classification system should allow international comparison between Canada, the US, Mexico, the European Community and the United Nations statistical system. The introduction of these new systems will require a deeper revision of the KBI definition.

Proposed Approach

In the fall of 2002, a joint public-private sector consultative group was proposed to discuss the revision of the KBI definition. It was proposed that the group make minimal changes to the current SIC-based definition to reach an agreement on a revised KBI definition. While a limited number of stakeholders expressed interest, the BDC was enthusiastic about participating in such a group.

Next Steps

In the short term, Industry Canada will consult with Statistics Canada to update the present NAICS-based definition of KBI. Such work will cover inter alia, the inclusion of advanced industrial materials and Internet-related activities into the definition. The CBA and the BDC will be invited to participate in the proceedings should they be interested.

Table 28 — Amount of Commercial Debt Authorized and Outstanding by Authorizations as of December 31, 2000

	Domestic banks	Other banks	Credit unions and caisses populaires	Finance companies	Portfolio managers, venture capital companies, financial funds	Insurance companies	Leasing companies	Total - all suppliers
LESS THAN $25 000								
Amounts authorized ($ millions)	2 693.1	101.6	2 107.5	992.2	7.4	81.2	14.6	5 997.6
Amounts outstanding ($ millions)	1 382.6	71.8	1 203.3	324.7	5.6	5.2	11.5	3 004.7
Number of clients (thousands)	367.0	11.5	204.4	130.1	0.9	10.9	5.2	730.0
$25 000–$49 999								
Amounts authorized ($ millions)	3 987.2	278.8	2627.8	1 106.2	11.4	122.7	194.3	8 328.4
Amounts outstanding ($millions)	2 434.1	240.9	1 634.9	545.5	8.1	16.4	150.2	5 030.1
Number of clients (thousands)	114.8	8.0	76.6	31.2	0.3	3.5	5.5	239.9
$50 000–$99 999								
Amounts authorized ($ millions)	8 208.1	331.0	4 238.0	2 913.3	36.7	168.6	7.6	15 903.3
Amounts outstanding ($ millions)	5 279.4	248.7	2 804.5	1 632.1	30.3	47.3	7.3	10 049.6
Number of clients (thousands)	121.4	4.7	61.7	42.4	0.5	2.4	0.1	233.2
$100 000–$249 999								
Amounts authorized ($ millions)	18 155.8	1 125.0	7 751.5	8 601.8	152.2	470.3	25.1	36 281.7
Amounts outstanding ($ millions)	12 314.6	864.1	5 390.6	4 863.8	129.8	126.4	21.6	23 710.9
Number of clients (thousands)	118.0	7.1	50.9	59.1	1.0	3.0	0.2	239.3
$250 000–$499 999								
Amounts authorized ($ millions)	17 333.1	1 441.9	4 604.5	10 587.9	186.1	522.2	4.1	34 679.8
Amounts outstanding ($ millions)	11 778.4	1 097.7	3 250.0	6 343.4	155.6	318.0	2.4	22 945.5
Number of clients (thousands)	50.0	4.0	13.7	29.9	0.6	1.5	0.0	99.7

Continued . . .

Table 28 — Amount of Commercial Debt Authorized and Outstanding by Authorizations as of December 31, 2000

	Domestic banks	Other banks	Credit unions and caisses populaires	Finance companies	Portfolio managers, venture capital companies, financial funds	Insurance companies	Leasing companies	Total - all suppliers
$500 000–$999 999								
Amounts authorized ($ millions)	20 161.4	1 932.9	3 493.1	9 522.4	367.7	1 377.5	8.4	36 863.4
Amounts outstanding ($ millions)	13 305.0	1 425.4	2 419.0	6 352.8	280.7	1 054.2	7.1	24 844.2
Number of clients (thousands)	29.1	2.7	5.2	13.2	0.5	1.9	0.0	52.6
SUBTOTAL OF SMEs								
Amounts authorized ($ millions)	70 538.7	5 211.2	24 822.4	33 723.8	761.5	2742.5	254.1	13 8054.2
Amounts outstanding ($ millions)	46 494.1	3 948.6	16 702.3	20 062.3	610.1	2742.5	200.1	89 585.0
Number of clients (thousands)	800.3	38	412.5	305.9	3.8	23.2	22.0	1 594.7
$1 000 000–$4 999 999								
Amounts authorized ($ millions)	57 108.6	7 735.9	5 594.6	14 622.0	3 379.9	22 191.6	63.6	110 696.2
Amounts outstanding ($ millions)	35 572.2	4 900.9	3 634.5	9 799.7	2 497.4	16 509.0	50.4	72 964.1
Number of clients (thousands)	27.3	3.5	3.0	7.0	1.2	8.8	0.0	50.8
$5 000 000 AND MORE								
Amounts authorized ($ millions)	467 157.0	64 915.1	5 599.1	11 449.2	7 407.3	42 825.0	848.2	600 200.9
Amounts outstanding ($ millions)	125 213.0	29 797.3	3 419.1	7 090.9	5 184.9	33 237.9	777.9	204 721.0
Number of clients (thousands)	10.3	2.5	0.3	0.6	0.4	2.7	0.0	16.8
TOTAL – ALL CLIENTS								
Amounts authorized ($ millions)	594 804.3	77 862.2	36 016.1	59 795.0	1 1548.7	67 759.1	1 165.9	848 951.3
Amounts outstanding ($ millions)	207 279.3	38 646.8	23 755.9	36 952.9	8 292.4	51 314.4	1 028.4	367 270.1
Number of clients (thousands)	837.9	44.0	415.8	313.5	5.4	34.7	11.0	1 662.3

Source: Statistics Canada, *Survey of Suppliers of Business Financing, 2000.*

Table 29 — Amount of Commercial Debt Authorized and Outstanding by Industry as of December 31, 2000

2000			
	Amounts authorized ($ millions)	Amounts outstanding ($ millions)	Number of clients (thousands)
Agriculture, forestry, fishing	55 295.3	36 159.4	341.2
Mining, oil, gas extraction	61 383.6	23 245.4	31.7
Utilities	24 758	10 405.7	12.5
Construction	40 742.5	20 145.8	133.4
Manufacturing	124 090.5	53 677	122.7
Wholesale trade	36 857.3	17 324.3	49.7
Retail trade	56 858.2	30 106.9	160.6
Transportation, warehousing	41 404.7	18 620.1	73.6
Information, culture	25 464.9	10 019.4	32.5
Finance, insurance	135 527.5	32 001.3	153.8
Real estate, rental, leasing	62 501.8	43 647.3	107.9
Professional, scientific, technical	17 673.8	8 353.1	69.2
Education, health	20 046.3	10 037.1	57.6
Entertainment, accommodation	36 540.8	21 107.6	95.5
Knowledge-based industries	58 922.0	24 514.3	63.7
All other industries, unknown	109 806.5	32 419.8	220.3
Total — all industries	848 951.7	367 270.2	1 662.2

Source: Statistics Canada, *Survey of Suppliers of Business Financing, 2000*.

Table 30 — Debt Authorized and Outstanding by Province as of December 31, 2000

2000			
	Amounts authorized ($ millions)	Amounts outstanding ($ millions)	Number of clients (thousands)
Newfoundland and Labrador	5 574.6	3 250.8	13.4
Prince Edward Island	2 047.2	1 253.0	8.0
Nova Scotia	10 110.6	6 084.1	26.5
New Brunswick	8 347.9	5 095.1	33.1
Quebec	147 285.4	74 204.4	486.8
Ontario	474 835.8	160 640.6	510.6
Manitoba	19 045.9	11 103.9	81.0
Saskatchewan	18 780.2	11 512.6	159.8
Alberta	86 426.8	47 349.1	166.2
British Columbia	74 784.5	45 789.8	166.7
Yukon	690.1	396.4	1.4
Northwest Territories	639.0	384.9	1.3
Nunavut	337.2	166.7	0.6
Canada	848 951.6	367 269.7	1662.5

Source: Statistics Canada, *Survey of Suppliers of Business Financing, 2000.*

Table 31 — Amount of Lease Financing Authorized and Outstanding by Authorizations as of December 31, 2000

	Domestic banks	Finance companies	Leasing companies	All other suppliers	Total all suppliers
LESS THAN $25 000					
Amounts authorized ($ millions)	11.5	1 555.4	1 580.4	160.9	3 308.2
Amounts outstanding ($ millions)	9.6	798.1	1 137.0	114.3	2 059.0
Number of clients (thousands)	0.9	154.1	243.1	18.8	416.9
$25 000–$49 999					
Amounts authorized ($ millions)	36.1	2 801.9	780.4	95.1	3 713.5
Amounts outstanding ($ millions)	29.5	816.1	536.7	73.4	1 455.7
Number of clients (thousands)	1.0	80.1	22.2	2.7	106.0
$50 000–$99 999					
Amounts authorized ($ millions)	118.9	701.4	518.6	77.4	1 416.3
Amounts outstanding ($ millions)	94.9	461.2	391.4	58.0	1 005.5
Number of clients (thousands)	1.6	8.9	7.6	1.1	19.2
$100 000–$249 999					
Amounts authorized ($ millions)	393.8	313.7	2.5	134.1	1 587.1
Amounts outstanding ($ millions)	477.2	399.5	3.0	96.8	1 222.6
Number of clients (thousands)	582.0	412.6	3.8	0.8	10.1
$250 000–$499 999					
Amounts authorized ($ millions)	510.6	554.3	283.7	102.0	1 450.6
Amounts outstanding ($ millions)	410.6	451.5	208.3	79.6	1 150.0
Number of clients (thousands)	1.5	1.6	0.8	0.3	4.2
$500 000–$999 999					
Amounts authorized ($ millions)	663.1	807.4	255.7	98.8	1 825.0
Amounts outstanding ($ millions)	529.9	635.6	189.7	82.7	1 437.9
Number of clients (thousands)	1.0	1.1	0.4	0.1	2.6

Continued . . .

Table 31 — Amount of Lease Financing Authorized and Outstanding by Authorizations as of December 31, 2000

	Domestic banks	Finance companies	Leasing companies	All other suppliers	Total all suppliers
$1 000 000–$4 999 999					
Amounts authorized ($ millions)	1 753.8	1 990.1	678.1	340.7	4 762.7
Amounts outstanding ($ millions)	1 391.2	1 474.7	512.3	299.9	3 678.1
Number of clients (thousands)	0.9	0.9	0.3	0.2	2.3
$5 000 000 AND MORE					
Amounts authorized ($ millions)	4 084.2	3 631.8	617.8	954.7	9 288.5
Amounts outstanding ($ millions)	3 404.2	2 703.4	473.9	869.5	7 451.0
Number of clients (thousands)	0.6	0.0	0.0	0.0	0.6
TOTAL — ALL CLIENTS					
Amounts authorized ($ millions)	7 572.0	12 519.5	5 296.7	1 963.7	27 351.9
Amounts outstanding ($ millions)	6 183.6	7 740.1	3 861.9	1 674.2	19 459.8
Number of clients (thousands)	10.0	249.7	278.2	24.0	561.9

Source: Statistics Canada, *Survey of Suppliers of Business Financing, 2000.*

Table 32 — Amount of Lease Financing Authorized and Outstanding by Industry as of December 31, 2000

2000			
	Amounts authorized ($ millions)	Amounts outstanding ($ millions)	Number of clients (thousands)
Agriculture, forestry, fishing	1 054.2	799.2	10.5
Mining, oil, gas extraction	988.3	713.8	10.0
Utilities	210.1	166.7	1.1
Construction	1 604.3	11 82.2	19.6
Manufacturing	4 625.2	3 726.4	45.8
Wholesale trade	811.9	587.4	24.4
Retail trade	1 228.3	913.1	22.2
Transportation, warehousing	11 019.5	7 213.7	257.3
Information, culture	306.3	243.8	8.7
Finance, insurance	406.0	275.6	11.9
Real estate, rental, leasing	357.1	271.9	6.0
Professional, scientific, technical	1 283.3	891.8	62.6
Education, health	698.6	489.6	17.9
Entertainment, accommodation	1070.1	846.1	6.2
Knowledge-based industries	2 436.8	1 935.5	46.7
All other industries, unknown	1 688.7	1 138.6	57.9
Total - all industries	27 351.9	19 459.9	562.1

Source: Statistics Canada, *Survey of Suppliers of Business Financing, 2000.*

Table 33 — Amount of Lease Financing Authorized and Outstanding by Province as of December 31, 2000

	2000		
	Amounts authorized ($ millions)	Amounts outstanding ($ millions)	Number of clients (thousands)
Newfoundland and Labrador	413.0	254.8	7.4
Prince Edward Island	112.3	73.8	1.5
Nova Scotia	453.2	288.0	10.9
New Brunswick	459.3	263.5	12.0
Quebec	5 510.0	3 962.9	118.8
Ontario	11 587.2	8 466.8	233.3
Manitoba	980.8	662.5	19.6
Saskatchewan	972.7	664.7	17.4
Alberta	3 515.6	2 448.2	68.6
British Columbia	3 162.3	2 260.3	69.6
Yukon	123.4	73.1	0.8
Northwest Territories	38.2	21.9	1.1
Nunavut	2.8	2.2	0.0
Unknown	20.9	17.4	0.9
Canada	27 351.7	19 460.1	561.9

Source: Statistics Canada, *Survey of Suppliers of Business Financing, 2000*.

Table 34 — Loss Rates (%) on Commercial Debt, by Authorization Categories, of Financial Suppliers in 2000

	Domestic banks	Other banks	Credit unions and caisses populaires	Finance companies	Portfolio managers, venture capital companies, financial funds	Insurance companies	Leasing companies	Total - all suppliers
LESS THAN $25 000	1.08	3.34	2.99	0.59	X	x	x	1.79
$25 000–$49 999	0.75	1.29	2.13	1.10	x	x	x	1.28
$50 000–$99 999	0.84	0.68	1.96	0.96	x	x	x	1.19
$100 000–$249 999	0.70	0.46	1.31	0.56	x	x	x	0.84
$250 000–$499 999	0.37	0.47	0.93	0.58	3.53	2.40	x	0.55
$500 000–$999 999	0.23	0.76	0.79	0.51	x	x	x	0.45
SUB-TOTAL OF SMEs	**0.51**	**0.69**	**1.47**	**0.93**	**26.23**	**6.51**	**1.20**	**0.75**
$1 000 000 - $4 999 999	0.13	1.38	0.80	x	x	x	x	0.40
$5 000 000 AND MORE	0.35	0.77	0.51	x	x	x	x	0.40
TOTAL – ALL CLIENTS	**0.35**	**0.8**	**1.23**	**0.50**	**1.93**	**0.20**	**0.23**	**0.49**

Note: An "x" refers to estimates supplied to meet the confidentiality requirements of the *Statistics Act* and/or for low data quality reasons.

Source: Statistics Canada, *Survey of Suppliers of Business Financing, 2000*.

GLOSSARY OF TERMS

Angel Investors: A high net worth individual active in venture financing, typically participating at an early stage of growth.

Capital Lease: A lease that meets one or more of the following criteria, meaning it is classified as a purchase by the lessee: the lease term is greater than 75 percent of the property's estimated economic life; the lease contains an option to purchase the property for less than fair market value; ownership of the property is transferred to the lessee at the end of the lease term; or the present value of the lease payments exceeds 90 percent of the fair market value of the property.

Churn Rate: Percentage of SMEs that enter and exit the marketplace annually.

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).

Conditional Sales Contract: Credit that allows the vendor of the asset to retain legal title until the purchaser has made full payment.

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

Crown Corporation: A corporation that was established by a country's government.

Current Assets: A balance sheet item that equals the sum of cash and cash equivalents, accounts receivable, inventory, marketable securities, prepaid expenses, and other assets that could be converted to cash in less than one year. A company's creditors will often be interested in how much that company has in current assets, since these assets can be easily liquidated in case the company goes bankrupt. In addition, current assets are important to most companies as a source of funds for day-to-day operations.

Debt: A financial obligation to a lender; the amount of debt and interest payable is agreed upon over a designated period.

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

Debt to Equity Ratio: A measure of a company's leverage, calculated by dividing long-term debt by common shareholders' equity, usually using the data from the previous fiscal year. Sometimes, long-term debt plus preferred shareholder's equity is divided by common shareholders' equity, since preferred stock can be viewed as a form of debt. A company with a higher debt/equity ratio can offer greater returns to shareholders but is riskier.

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

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

Domestic Banks: Includes the six large domestic banks and several smaller ones as defined by the Office of the Superintendent of Financial Institutions.

Entrepreneur: An individual who starts his/her own business.

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

Equity Financing: Any form or financing that is 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.

Finance Companies: Includes enterprises that provide financing to businesses, often for the purchase of goods and services, but do not accept deposits. Debt financing is commonly provided, however, companies that purchase accounts receivable or provide both debt and lease financing are also included here. Examples include the acceptance companies of vehicle and equipment manufactures, factoring companies and most government business enterprises. Enterprises providing only lease financing are usually classified as leasing companies.

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

Financial Leverage: Is a measure of the ability of a firm to service its debts and arises when a firm finances part of its business with securities that entail fixed financing charges.

Financial Market Imperfection or Gap: Exists where groups of businesses are systematically denied access to financing they ought to, on objective criteria, be accessing.

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.

Fixed Assets: A long-term, tangible asset held for business use and not expected to be converted to cash in the current or upcoming fiscal year, such as manufacturing equipment, real estate and furniture.

Follow-On Financing: A supplementary round of financing in an existing portfolio company that builds on the original financing, generally in line with business growth and development. Venture-backed firms are often engaged in multiple follow-on deals. Typically, a venture-backed company receives cumulative rounds of financing to facilitate its progression from one stage of development to the next.

High-Growth SMEs (GSMEs): Cumulative sales growth rates of 50 percent or more over a three-year period, covering the years 1997–2000, and is applicable to all Canadian SMEs from the self-employed up to firms with fewer than 500 employees.

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

Informal Investors: An individual who invests personal capital directly in a business owned by others. Investors include friends, family and business angels.

Initial Public Offering (IPO): The first sale of stock by a company to the public.

Institutional Investors: Includes pension funds and insurance companies such as Quebec's Caisses des dépôts et placements, Ontario Municipal Employees Retirement System, and the Ontario Teachers Pension Plan. Through the late 1980s and the first half of the 1990s, pension funds were unwilling to consider VC investments as part of their portfolio.

Insurance Companies: Includes life, health, property, and casualty insurers and re-insurers.

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.

Labour-Sponsored Venture Capital Corporations (LSVCCs): 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.

Leasing Companies: Includes enterprises providing lease financing, usually for vehicles or equipment.

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.

Long-term Debt to Equity Ratio: A measure of the financial leverage of a firm (the ability of a firm to service its borrowings). This ratio does not include current liabilities (short-term debt such as accounts payable) because it is assumed that this debt will be paid off through inventory rollover and through receivables and is therefore not a reliable measure of the creditworthiness of a firm.

Love Money: Financing extended by close friends and family. Lending is usually based on the relationship between individuals rather than on a formalized risk assessment.

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

Medium-Sized Enterprise: A firm with 100–499 employees.

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.

Micro-enterprise: A firm with one to four employees.

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 Lease: A lease for which the lessee acquires the property for only a small portion of its useful life. An operating lease is commonly used to acquire equipment on a short-term basis. Any lease that is not a capital lease is an operating lease.

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

Other Banks: Includes foreign banks, trust companies and all other deposit-accepting institutions except credit unions and caisses populaires.

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

Personal and Business Guarantees: Promise made by an entrepreneur that obligates him/her to personally repay debts his/her corporation defaults on.

Portfolio Managers, Venture Capital Companies and Financial Funds: Includes enterprises typically engaged in managing pools of assets. Examples include mutual fund companies, investment advisors, venture capital companies, labour-sponsored venture capital funds, mutual funds and segregated funds.

Quasi-Equity: A specialized form of private equity, characterized chiefly by use of subordinated debt, or preferred stock with an equity kicker.

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.

Recession: Two consecutive quarters of declining GDP.

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

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

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

Risk Capitial: Funds made available for start-up firms and small businesses with exceptional growth potential. Managerial and technical expertise are often also provided.

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 kilometre. 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 fewer than 1500 POCs. Additionally, a post office that does not have a letter carrier associated with it can be deemed a rural office.

Secured Loans: A loan backed by assets belonging to the borrower in order to decrease the risk assumed by the lender. The assets may be forfeited to the lender if the borrower fails to make the necessary payments.

Slow-Growth Stage: The stage at which a business' sales increase slowly.

Small and Medium-Sized Enterprises: Demand-side survey: Firms with less than 500 employees and less than $50 million in annual revenues. Supply-side survey: less than $1 million in authorization.

Sole Proprietorship: A business structure in which an individual and his/her company are considered a single entity for tax and liability purposes. A sole proprietorship is a company that is not registered with the state as a limited liability company or corporation. The owner does not pay income tax separately for the company, but he/she reports business income or losses on his/her individual income tax return. The owner is inseparable from the sole proprietorship, so he/she is liable for any business debts.

Stages of Development:

- **Early Stages of Development**

  Seed Stage: A developing business entity that has not yet established commercial operations and needs financing for research and product development.

  Start-up Stage: A business in the earliest phase of established operations that needs capital for product development, initial marketing and other goals.

  Other Early Stage: A firm that has begun initial marketing and related development and needs financing to achieve full commercial production and sales.

- **Later Stages of Development**

  Expansion Stage: An established or near-established company that needs capital to expand its productive capacity, marketing and sales.

  Acquisition/Buyout Stage: An established or near-established firm that needs financing to acquire all or a portion of another business entity for growth purposes, such as an Acquistion for Expansion Financing.

  Turnaround Stage: An established or near-established company that needs capital to address a temporary situation of financial or operational distress.

  Other Stage: Includes Secondary Purchase, or the sale of portfolio assets among investors, and working capital.

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

Term: 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.

Trade Credit: A company's open account arrangements with its vendors.

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 kilometre. Also, a post office with letter carriers assigned to it is considered urban.

Venture Capital: Risk capital invested by VC firms in privately held companies, 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.

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.

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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