SME STUDIES OF THE 1990s:
The Question of Financing

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by
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Executive Summary

The paper presents an overview of various studies – commissioned by federal and provincial government and quasi-government bodies, as well as private entities, all of which examine the financing concerns of Canadian small and medium enterprises (SMEs).

The studies summarized and reported on here accept that financing is a significant concern for SMEs, but they vary in their approaches, emphases, and prescriptions. In addition, they recognize that financing is not the only important money-related problem faced by SMEs. The financing issue is exacerbated by heavy taxation, for instance, and cannot be separated from it in an examination of the Canadian SME environment. Information assymetries also play a role in causing financing difficulties.

Most studies address the question of debt financing, but while they agree that it is an issue of concern, they disagree on reasons and possible solutions. The issue is often presented as a failure of financial institutions to respond to SME loan requests, and, while that is clearly an element of the problem, it is more complex than that. One notable study by The Conference Board maintains that significantly more debt financing is available than is commonly accounted for, and that if SME owners and managers were aware of the alternatives available to them, they would be better prepared to finance their ventures. The CBA study suggests that banks and other financial institutions do a better job of servicing SMEs than "anecdotal" evidence presented before House Standing Committees would denote; but its study didn't appear to pay sufficient attention to differentiating between "established", traditional SMEs, and newer, knowledge-based ones.

Equity financing services a much smaller percentage of SMEs' capital needs, and while progress has been made in identifying and addressing the disclosure/prospectus costs associated with some aspects of accessing equity financing, there remain large areas that have not been well explored, particularly as far as a public policy role is concerned.

This examination of SME studies points to a number of key consistent findings about SMEs, and suggests a number of areas which would be worth examining further.

- Debt financing is significantly more important than equity financing in servicing SME capital requirements. On the other hand, successful SMEs are

careful, particularly in their early phases of growth, not to become overburdened by debt. Retained earnings are a critical source of early financing.

• Commercial loans from financial institutions are an important part of that debt financing, but there are significant other alternate sources of debt financing that a) may have the potential to play a yet larger role in servicing SME capital requirements, and b) that have not been sufficiently understood or studied.

• These alternate sources include leasing, which is frequently mentioned in studies as having significant potential which should be encouraged, and factoring, which has received much less emphasis.

• Wide consensus exists that financial institutions are not oriented to service knowledge-based SMEs effectively, nor did the CBA study indicate that significant changes had been made in the way loans are assessed. (Poor collateral value was cited as a key reason for loan turndown, particularly when the applicant is a brand-new business. This is a particular problem for knowledge-based SMEs, which do not tend to be tangible asset-based.)

• It evidently becomes important for SMEs to change their capital structure in order to grow beyond a certain size. In the beginning, retained earnings are particularly important, but the opportunity cost of relying on them becomes too great once the enterprise grows, and it becomes increasingly important for a successful SME to be able to rely more on equity financing.

• The Statistics Canada GSME study points out that the capital structure of successful SMEs appears to operate as described above, but that it is not known whether this is the most efficient way for them to operate, or whether they operate that way because they have adapted to the inefficiencies of the market.

• As the federal government's deficit priority eases, it may also, in the light of these considerations, be worthwhile to revisit the question of how to leave more retained earnings in the hands of small businesses, as suggested by multiple studies.

• As far as equity financing is concerned, it is apparent that the one of the biggest problems that exist – apart from the procedural costs of conforming to regulatory requirements, which is being addressed in various jurisdictions – is that of matching the potential investment dollars of "angel" investors with needy SMEs. This is especially important because it is investments of relatively small amounts of money – which are nonetheless critical to SMEs at a certain stage of their development – that the "angel" market serves. Nonetheless, informational assymetries are particularly onerous here, and none of the studies explicitly addresses this question.

• As the OSC study points out, the problems associated with obtaining equity capital – as detailed in the Queen's study and in *Taking Care of Small Business*, and as summarized on page 20 of this paper – leave room for further study. These include how to solve informational assymetry problems, what to do about the relatively high cost of due diligence for SMEs, and how to match "angels" successfully with needy SMEs.

• In addition, the question of why a distribution network for small offerings hasn't yet developed in Canada, and whether something could or should be done to encourage it, has yet to be explored.

Introduction

Through the course of the 1990s, a number of studies were completed, at the federal and provincial level, by public and private concerns, examining the state of small and medium enterprises (SMEs) in Canada, and, in particular, their financing.

It is the aim of this paper to summarize, compare, and contrast the various studies as they discuss SME financing, in order to provide the reader with a cogent understanding of a) where there is consensus; b) where and why there exist disagreements over approach; and c) where there are evident problems yet to be explored. This paper does not claim to be an exhaustive survey of the literature, but it does provide an overview of the state of understanding of SME financing issues.

A 1994 Statscan study confirmed the importance of SMEs to the Canadian economy:[1]

- SMEs contributed roughly 57 percent of total private sector gross GDP in 1992.

- The number of businesses in Canada increased by 30 percent over the last decade, and almost all of these were SMEs.

- Self-employment continues to grow, particularly in the services sector.

- SMEs are increasingly visible in the export market.

- Small businesses have been credited with employing almost half of all working Canadians.[2]

Given the obvious and growing importance of the SME sector to the health of the Canadian economy, a number of studies have been commissioned in recent years to investigate the environment in which SMEs prosper. The questions driving these studies are whether the tax and regulatory structure of the Canadian economy create an environment that encourages the growth and health of SMEs, and, following from this, whether there are public policy changes that could or should be made in order to enhance that environment.

Of particular concern has been the question of financing: Do SMEs have adequate access to both debt and equity financing? What sorts of barriers stand in their way, and how might these be ameliorated? What is the role for governments and government programs in this process?

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[1] *Small Business in Canada: A Statistical Overview* (Ottawa: Industry Canada, December 1994).
[2] Yvon Gasse, "Importance of the Small and Medium-Sized Enterprise in the Canadian Economy ", *Journal of Small Business and Entrepreneurship*, Vol. 11, No. 3, April 1994, pp. 4-11.

It is upon these latter questions, as debated in the various studies commissioned in the mid-1990s, that this paper focuses.

The Federal Studies

Strategies for Success: A Profile of Growing Small and Medium-Sized Enterprises in Canada[3]

Released by Statistics Canada in February of 1994, *Strategies for Success* examined the strategies and performance of successful SMEs, in order to determine where they are successful and what distinguishes them from their less prosperous competitors.

The study found that successful SMEs (what Baldwin calls growing SMEs, or GSMEs) place a high value on good management practices and well-trained employees, pursue new markets with vigour, and innovate constantly with respect to products, practices, and management. What it also found, however, is that the capital structure of GSMEs changes over time.

Rather than focus on the cost of capital, as many SME studies do, the GSME study looked at how small firms structure their capital needs, and how these differ between those that are more and less successful.

Newer GSMEs rely heavily on retained earnings as a source of funds, but as they grow, they shift their emphasis to other forms of equity, such as paid-in-capital. Similarly, as firms grow, they move away from trade finance (accounts payable) to long- and short-term debt.

Importantly, however, GSMEs overall rely more on long-term than short-term capital. Most of the financing of an average GSME – 54.5 percent – consists of shareholders' equity (paid-in-capital and retained earnings) and long-term debt. Only 38.7% of its capital is provided by short-term debt and accounts payable.

This is an important finding because small firms are often depicted as poorly structured, insufficiently capitalized, and over-reliant on short-term debt.

Major sources of funding for a GSME are as follows: approximately 30 percent retained earnings; and roughly 25 percent each suppliers and financial institutions. Only 0.6% of financing comes from public equity markets, and 0.6% from venture capital firms. As GSMEs grow, there occurs a shift in emphasis from retained earnings to input from parent companies (where appropriate) and public equity markets.

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[3] By John Baldwin (Ottawa: Statistics Canada, February 1994).

As the study indicates, the successful move to alternate sources of funding – beyond a reliance on retained earnings – is critical to its prosperity and growth beyond a certain point. Firms that cannot make the shift in capital structure – that continue, for instance, to rely extensively on retained earnings, which have a high opportunity cost – will be severely hampered in their ability to grow.

The report did not offer public policy recommendations.

Financing the New Economy: Towards a Positive Conspiracy[4]

This report, the combined effort of private and public sector representatives, focused on the access to financing – and particularly debt financing – of knowledge-based SMES. The committee consisted of representatives from federal and provincial governments, and from universities and research institutes. Its report was released by Industry Canada in June 1994.

Key to the committee's perspective was the double understanding that, first, economic competition is increasingly driven by the innovative use of technology and international competition; and, second, that SMEs are a critical and growing part of the Canadian economy.

In consequence, the report concentrated on the particular challenges of knowledge-based SMEs – companies with mainly intangible assets, highly-skilled employees, and products and services that use advanced technology and have a short life expectancy – as they attempt to finance their businesses.

The challenge is particularly formidable because, in addition to the risks implied by SMEs generally, financial institutions have difficulty evaluating the viability of knowledge-based industries or securing their loans with tangible assets.

The committee was guided in its recommendations by the premise that government intervention should restrict itself to filling gaps in the marketplace, and should not compete with the private sector. It remained conscious of the fiscal inflexibility of federal and provincial governments in implementing change.

The issues identified on the side of lenders are primarily as follows:

- A lack of technical competence of lenders and investors to assess knowledge-based industries and their chances of success;

- High relative cost of due diligence for small businesses and a difficulty in financing ideas as opposed to tangible products;

- Financial institution tendency to deal with higher risk by refusing the loan outright;

- Export financing, frequently needed early, is frequently beyond the expertise of most lenders; and,

- Difficulty in coupling SMEs with informal investors (also called "angels").

[4] Final Report by Paul Toriel (Ottawa: Industry Canada, June 1994).

At the same time, many of the SMEs concerned lack experience and knowledge in presenting their companies to lenders or investors, are unwilling to reveal information about their technologies, and are concerned about losing control over their firms.

In the light of these considerations, the report's recommendations, most significantly:

- Encouraged financial institutions to develop the expertise to service knowledge-based SMEs;

- Encouraged financial institutions to find innovative ways to finance higher-risk ventures, even with higher pricing, and to adopt the Federal Business Development Bank (FBDB) "venture loan" concept;

- Urged that the FBDB expand its working capital loans through direct loans and guaranteeing the private sector working capital loans, and that FBDB expand its venture capital program, particularly for investments of less than $750,000;

- Urged that taxation – including the capital gains tax – be adjusted so as to encourage retention of profits by SMEs and to encourage investment in SMEs; and,

- Urged an increase in export information and financing for knowledge-based SMEs.

Taking Care of Small Business: Report of the Standing Committee on Industry[5]

The House Standing Committee on Industry studied the access to capital of SMEs during 1994 as well, and submitted its report in October of that year.

The committee's report was written from the perspective that access to financing is a significant problem for SMEs, but it is a problem with multiple causes. These include financial institutions, and particularly the banks, which have not done a good job of serving their small business customers; government, which has overburdened SMEs with taxes and regulatory burdens, and has been less concerned to build public policy around them than in many industrialized countries; and SMEs themselves, which often do not do a good job of understanding or answering investor/debt financier concerns.

Its most significant recommendations included the following:

- Government to increase its monitoring of financial institutions' lending practices via bank committee appearances and better statistics collection and publication, as well as an ombudsman to monitor and hear borrower grievances;

- Canadian banks to establish a code of conduct for lending procedures and a mediation process for borrower grievances;

- Federal assistance be given to SMEs in terms of:
    - a limited working capital guarantee for SME exporters;
    - changes in RRSP rules to allow SME owner/operators to invest in their own companies; and
    - a reduction in the capital gains tax;

- Financial institutions legislation be revised to enhance competition by:
    - removing capital requirements for trust and loan companies, replacing them with a prudent portfolio approach to commercial lending;
    - creating a class of banks that is not hindered by the 10 percent ownership restriction on Schedule I banks, and that would follow the same capital requirements as trust and loan companies;
    - remove limits on the size of foreign bank subsidiaries, and consider allowing these to branch directly into Canada;

- Provincial securities regulators be encouraged to simplify disclosure requirements for SMEs; and

[5] Ottawa: House of Commons, October 1994.

• Labour-Sponsored Venture Capital Corporations be compelled, by means of linked tax credits, to increase investments in SMEs.

Breaking Through Barriers: Forging Our Future[6]

The Small Business Working Committee was formed by The Honourable John Manley, Minister of Industry, and The Honourable Paul Martin, Minister of Finance, as a result of the February 1994 budget. Its members – drawn from the public and private sectors, including banks, SMEs, and large corporations – were commissioned to advise the government on what issues SMEs face in the Canadian economy, and what public policies would contribute to their sustained growth. *Breaking Through Barriers*, released in November 1994, is the Committee's report.

The position of this committee is, again, that SMEs are critical to the Canadian economy, accounting for roughly 40 percent of its total GDP, "more than a quarter of all sales, a third of all profits and a fifth of all assets",[7] as well as over half of private sector employment in the country.

The committee's report was intended to focus on the government debt, taxes, and regulation that contribute to the barriers that stand in the way of fully-realized potential for the SME sector.

Its recommendations were detailed, followed by an implementation plan. They are summarized as follows:

- The federal government must reduce profit-insensitive taxes, such as premiums on Unemployment Insurance and the Canada Pension Plan;

- Equity financing should be encouraged via tax incentives and measures to ensure that the Labour-Sponsored Venture Capital loans are effectively targeted at SMEs;

- Financial institutions should develop special units to evaluate SME loans, be innovative in developing new lending criteria for SMES, and develop innovative methods of making higher-risk loans;

- Government should encourage financial institutions to develop a code of conduct for SME lending, should require more and frequent reporting of SME loans, and should impose regulations on financial institutions if their response is inadequate;

- Government should encourage competition by re-examining BIS capital requirements for SME loans, and alter regulations that prevent credit unions from competing on an equal footing with other FIs;

- SME taxation should be altered as follows:

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[6] Small Business Working Committee (Ottawa: Government of Canada, November, 1994).
[7] *Ibid.*, Executive Summary.

- The Small Business Deduction (SBD) threshold, which reduces the federal tax rate on business income below $200,000, should be increased to $400,000;
- SME exporting should be encouraged via a refundable tax credit against foreign market R&D;
- Tax complexity and compliance costs should be reduced; and

- Government programs should be refocused in order to eliminate overlap and to fill financing gaps not covered by the private sector.

The committee's recommendations were made on the understanding that they could be implemented in total while retaining fiscal neutrality, as costs would be covered from the rationalization of existing programs.

Small Business: A Progress Report[8]

Small Business: A Progress Report was the 1995 federal Government's response to its own call for advice on improving the environment for SME growth.

The thrust of the report is that, with the Government's focus on deficit-reduction being paramount in its considerations, only those measures which had little or no impact on the public purse were introduced.

In this light, the following measures were implemented, among others:

Monitoring SME Lending:

- New bank lending data, published quarterly by the Bank of Canada, to provide better understanding of SME lending;

- Consultations with banks to produce a SME code of conduct and dispute resolution system.

Increased Financial Institutions Competition:

- Increased commercial lending powers for insurance and trust companies;

- Removal of the 12 percent ceiling on foreign bank assets.

Rationalization of Government Programs:

- Changes to SBLA to move to full cost-recovery and prevent banks from substituting these loans for conventional financing;

- Commitment to have FBDB continue to supplement private sector financing and operate on a cost-recovery basis.

Increasing Equity Availability:

- Maintenance of the $500,000 lifetime capital gains exemption;

- Establishment of the Canada Community Investment Plan to stimulate equity capital access to SMEs;

- Formation of Community Futures Development Corporations from merged Community Futures Committees and Business Development Centres, to help increase SME financing in small communities.

[8] Ottawa: Government of Canada, 1995.

Relieving Taxation and Regulatory Burden:

- Roll-back of Unemployment Premiums to 1993 levels for 1995 and 1996;

- Formation of joint private- and public-sector Forum on Paper Burden to reduce paper burden for SMEs and other businesses.

Increasing Export Financing for SMEs:

- Easing pre-shipment export financing for SMEs through a Canadian Commercial Corporation (CCC) line of credit;

- An Export Development Corporation (EDC) proposal to guarantee operating lines of credit against SMEs' foreign amounts receivable;

- EDC and bank partnership to improve medium-term financing for SME exporters.

The Government did *not* implement the following recommendations, among others:

- For prudential reasons, capital requirements and other rules were not relaxed for trust companies and banks;

- For fiscal reasons, capital gains taxes were not reduced;

- For fiscal reasons, proposals to allow for RRSP investment in non-arm's-length business were not implemented;

- On the grounds that they already exist, no further incentives or punishments were administered to ensure that Labour-Sponsored Venture Capital Corporations meet their SME investment requirements. (On the other hand, changes have subsequently been made – such as measures included in the Federal and Ontario 1997 budgets to encourage LSVCC investment in SMEs and to make Community Small Business Funds eligible investments for Labour Sponsored Investments Funds – which do follow the suggestions of earlier studies.)

- For fiscal reasons, the threshold below which the Small Business Deduction applies was not increased to $400,000 from $200,000, as proposed.

Provincial Studies

Many provincial studies, including the recent *Small Business Growth and Employment in British Columbia,*[9] *The State of Small Business and Entrepreneurship in Atlantic Canada*,[10] and *Les PME au Québec: État de la situation 1994*[11] concentrate on a description of the state of the SME sector in the province. They tend to rely on federal studies for a discussion of SME financing.

There are some exceptions, however, as considered below.

Reforming the Regulatory Framework for Small Business in Ontario[12]

This report reviews the state of federal and provincial regulations affecting small business, as these are outlined in the federal studies described above. It briefly surveys the federal studies, and notes some Ontario measures to promote small business. These include:

- An innovation tax credit of 10 percent, introduced in 1994 on all research and development activities for Canadian-controlled SMEs;
- An advisory program assisting SME growth with advice, working capital, special projects funding and wage subsidies;
- A program to simplify the business registration process;
- Reforms to provincial financial services regulations aimed at providing greater SME access to credit unions and trust and loan companies;
- A Community Economic Development Act creating community investment share corporations and community loan funds to encourage investment in SMEs across the province.

[9] British Columbia Ministry of Small Business, Tourism and Culture, 1996.
[10] Atlantic Canada Opportunities Agency, 1994.
[11] Ministère de l'Industrie, du Commerce, de la Science et de la Technologie, 1995.
[12] Carolyn Stobo (Toronto: Ontario Legislative Library, 1995).

Banking on Knowledge: Status Report 1994[13]

Banking on Knowledge is the final report of a study of Quebec's Conseil de la science et de la technologie, aimed at promoting the creation and growth of technology-based SMEs. The report takes a holistic approach to its subject, arguing that large and small businesses, universities, financial institutions, and government all have a significant role to play in creating a supportive environment for technology-based SMEs. Its recommendations are aimed at all of these players. Significantly in terms of financing, they include the following:

- A confidential bank of names of informal "angel" investors should be prepared to help connect investors and appropriate small entrepreneurs;

- Governments should continue to not tax the first $500,000 of capital gains on investments devoted to the creation and growth of technology-based SMEs;

- Venture capital companies should invest more start-up capital in small businesses, and should acquire the technical knowledge to invest in technology-based industries by forming partnerships with firms that have such knowledge;

- Financial institutions should find ways of evaluating knowledge- and technology-based firms, and innovative ways of financing them, by developing associations with organizations that have the requisite technical knowledge to adequately evaluate proposals, and by setting up teams devoted to assessing and advising young knowledge-based firms;

- The Government of Quebec should simplify and rationalize its programs, and continue to fund those that emphasize technology-based firms, such as the Program to Support Strategic Employment and the 40 percent scientific research tax credit.

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[13] Québec: Conseil de la Science et de la Technologie, 1994.

Ontario Securities Commission Task Force on Small Business Financing: Final Report[14]

The October 1996 report of the OSC Task Force on Small Business Financing was the culmination of two years of work in which the OSC wrestled with the regulatory barriers complicating access to equity capital for SMEs. Complex rules governing prospectus preparation and disclosure meant astronomical costs for small firms contemplating the public equity markets, and the Task Force's aim was to preserve the credibility and prudential requirements of the process while simplifying it where justified for small firms.[15]

In the course of doing so, the Task Force considered sources of SME equity capital to a degree not covered by most other reports on SME financing, and which is worth recapping here.

The equity capital market consists of a number of distinct segments:

• **"Love Money"** is the entrepreneurs' personal savings in addition to those of friends, family, and close business associates. It is the major source of start-up capital for SMEs.

• **Trade financing** – the credit and investment of suppliers and customers – is a key part of financing new SMEs.

• As new firms begin to grow, they then use the informal venture capital, or **"angel"**, market. Drawing on the results of a 1993 study by Alan Riding and associates of Carleton University, a number of significant points can be made about "angels".[16]

"Angel" investors are highly educated, experienced in small business themselves, and wealthy. They look for, and use, investment opportunities primarily through personal contacts, business associates, and personal research, and are extremely thorough in their "due diligence" research on potential investments. They invest in less than 3 percent of opportunities they examine.

They invest an average of $100,000 annually, sometimes in chunks as small as $10,000 and sometimes contributing towards an investment demand of $500,000. They hold their investments for approximately six years, during which time they

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[14] Toronto: Ontario Securities Commission, October 1996.

[15] Related reforms have been implemented in British Columbia, and were being considered in Nova Scotia, Quebec, and Manitoba.

[16] A. Riding, P. Dal Cin, L. Duxbury, G. Haines, R. Safrata, "Informal Investors in Canada: The Identification of Salient Characteristics", Report Submitted to the Federal Department of Industry, Science and Technology (Canada) and to the Ministry of Economic Development and Trade (Ontario), May 23, 1993, and quoted in *Task Force on Small Business Financing*, p. 30.

participate in management of the enterprise or ensure that they have a thorough knowledge of the enterprise and its business details.

• Slightly larger SMEs – those which have completed initial product development and marketing – can tap into the **formal venture capital market**. This level of investment also includes risk capital funds capitalized by such institutional sources as banks, governments, pension funds, life insurance companies, and large corporations. Investments tend to be larger than in the "angel" market.

• The **institutional private placement market** does **not** usually invest in SMEs directly. Rather, this market is available to SMEs through the work of professional fund managers in the formal venture capital market.

• Finally, SMEs may tap into the **public equity markets,** where a prospectus is required.

The Task Force Report relied on the work of a study by Jeffrey MacIntosh of Queen's University,[17] in addition to *Taking Care of Small Business*, in defining the difficulties SMEs have in raising equity capital.

These are:

• An apparent lack of available capital at the low end of the market ($50,000 to $1,000,000);

• A significant "informational assymmetry" at work – where SME insiders know a lot about their own businesses, and investors know a lot about financing alternatives, but they don't have an efficient way of sharing information;

• High relative costs of small public equity transactions, because of the fixed costs of meeting "due diligence" needs – prospectus and disclosure requirements – relative to the amounts of money needed;

• A concern that SMEs may not generate the high returns required by investors, particularly in view of the "due diligence" effort required on their part;

• An unwillingness on the part of entrepreneurs to share ownership or managerial control with investors.

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[17] Jeffrey MacIntosh, "Legal and Institutional Barriers to Financing Innovative Enterprises in Canada", (Kingston: Government and Competitiveness School of Policy Studies, Queen's University, October, 1994).

Significantly, the Task Force also ascribed SME equity problems to the lack of a developed distribution network for small offerings in Canada. There is not yet in Canada, in contrast to the United States, a network of dealers specializing in small-scale financing.

The Task Force recognized that a comprehensive analysis of the problems of obtaining equity capital for SMEs, and the potential solutions to those problems, is beyond the scope of its mandate. It concentrated, therefore, on reforming legislative and regulatory requirements in the securities markets.

The thrust of the Task Force's recommendations is to radically simplify the process – and therefore the cost – for SMEs of accessing public equity markets. Prospectus and registration requirements, in particular, are eliminated or simplified in particular situations.

In addition, the Task Force suggests that, in certain situations, SMEs should be able to advertise in order to raise equity capital without requiring prospectus-like disclosure.

The Task Force also addresses the issue of investment matching services, which attempt to link "angels" with capital-desirous SMEs. The Task Force was not concerned about eliminating a costly registration requirement for services that involve accredited investors, but was concerned about services that act as "market intermediaries" between "unsophisticated", non-accredited investors and small firms. It suggested that these might be exempted from registration requirements on a case-by-case basis, as a blanket exemption for them was deemed to be too risky.

Improving Access to Capital for Small and Medium-Sized Business in Manitoba: Report of the Manitoba Task Force on Capital Markets:[18]

This 1994 report confronted the broad picture of access to equity capital, and it offered a wide range of observations and recommendations, in addition to simplification of securities regulations.

Among other issues, the report emphasized the importance of matching "angel" investors with entrepreneurs. It noted that a federal Government attempt – the Canadian Opportunities Investment Network (COIN) – had not been successful because of its "cumbersome process, database-driven nature, inadequate evaluation and screening elements, lack of experienced matchmakers, and the large proportion of costs going to middle persons."[19] It suggested that a more successful model might be broker-formulated and run by active, experienced deal-makers.

It also suggested, among other things:

- The creation of Junior Capital Pools such as exist in Alberta and the United States, to allow SMEs without assets to raise capital by selling low-cost shares to the public; in addition to Junior Capital Pools where investors invest in a management team rather than a business *per se*;

- A provincial small business lending program; and

- An investment fund operating along the lines of the Ontario Lead Investment Fund (OLIF), B.C. Focus, or the Canada Investment Fund: the Manitoba Pooled Investment Fund.

[18] Winnipeg: Manitoba Task Force on Capital Markets, 1994.
[19] *Ibid.*, p. 18.

Other Studies

Small and Medium Sized Business in Canada: Their Perspectives of Financial Institutions and Access to Financing;[20] *Small and Medium Sized Businesses in Canada: An Ongoing Perspective of Their Needs, Expectations and Satisfaction with Financial Institutions*[21]

These studies, commissioned by the Canadian Bankers Association and performed by Thompson Lightstone & Company Limited, were released in April 1996 and June 1997 respectively. The first surveyed 1,809 SMEs across Canada, augmented in various sectors for a total of 2,615 telephone interviews, in order to establish the nature of their loan experiences and attitudes toward financial institutions. In addition, 750 account managers from the major banks were interviewed in order to determine key reasons for loan turndowns. The second study involved 2,519 telephone interviews, and interviews with 1,080 account managers. It largely confirmed the findings of the initial study, which are summarized below.

The findings run counter to the conclusions of various other studies on the performance of financial institutions with respect to SME lending. The CBA study found, among other things, that:

- Only one in three of the SMEs surveyed requested financial institution financing in the previous year. Most of those that did were larger ($1million to $50 million in annual sales, a group which represents 19 percent of the companies surveyed); involved in primary industries (fishing, logging, mining), manufacturing, or transportation/communications; and/or buying into an already existing business.

- Most – 79 percent – of SME financing requests to financial institutions during the previous 12 months were approved in full (73 percent) or in part (6 percent). Another 6 percent were still pending; 15 percent were turned down.

- Most SMEs surveyed – 72 percent – reported being satisfied with their main financing institution.

- Key reasons for loan turndown are a) a perceived weak ability to service debt/cash flow; and b) a limited guarantor/security strength, or poor collateral value.

[20] Thompson Lightstone & Company (Toronto: Canadian Bankers Association, 1996).
[21] Thompson Lightstone & Company (Toronto: Canadian Bankers Association, 1997).

• Therefore, the following businesses face higher turndown probabilities: "young businesses, SMEs with lower sales volumes, low net worth applicants,...businesses requesting increases/expansions and new financing" as well as applicants in the accommodation, food and beverage, and real estate sectors.[22]

• The higher turndown rates for women appear to be due to the fact that they tend to head smaller, newer businesses in precisely those sectors that face higher turndown probabilities, and is not related to their gender.

The second study noted that the banks' Codes of Conduct requires that applicants who are declined loans be provided with a) reasons for the bank's decision, b) the requirements for reconsideration, and c) available information on alternative sources of finding. However, when surveyed, only 40 percent of SMEs whose requests were refused reported having been given information on reconsideration requirements, and only 5 percent said they were given information on alternative sources of financing.

Furthermore, although all the major banks have had ombudsmen in place since 1995 to deal with SME complaints, the 1997 CBA study found that fewer than one in five of the SME major bank customers is aware of the ombudsmen's existence.

A number of factors should be noted about the CBA study when considering its results:

• The average age of the SMEs surveyed was 13.5 years, and the average length of the relationship with a financial institution of those surveyed was 10.8 years.

• SMEs were broken down for consideration into a number of sector (SIC) categories. These did not specifically consider the "knowledge" or "high-technology, low traditional asset" firms targeted in some other studies.

• And finally, the first study attempted to contact new businesses that had been turned down for start-up loans, but was not successful in finding a sufficient number of these. Therefore, the position of such applicants was not considered in the survey. The second study did not indicate whether a similar attempt was made.

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[22] *Ibid.*, p. 17.

Alternative Sources of Debt Financing For Small and Medium-Sized Enterprises[23]

This Conference Board of Canada study argues that traditional measurements of the availability of debt financing for SMEs underestimate the amount – and therefore the potential – of financing available because they ignore huge portions of the market. It examines alternative sources of financing such as lease contracts and other asset-based financing (much of which is not calculated by Statistics Canada data because it occurs off-balance-sheet), non-residential mortgages, factoring of receivables, and credit cards. Once these are taken into account, the study suggests that, rather than being $120 billion, the market for commercial loans is actually $246.7 billion.

Among the significant points are the following:

• Factoring – the financing of operations through the sale of accounts receivable to a third party – is common in the United States and Europe, where it serves a useful financing service particularly to early-stage small businesses, but is still rare in Canada.

• Foreign banks make 17% of their commercial loans, including non-residential mortgages, to SMEs;

• 90 percent of business debt financing (including non-residential mortgages) of caisses populaires and credit unions is SME lending;

• Trust companies make 32 percent of total commercial loans, 58 percent of non-residential mortgages, and 20 percent of lease contracts to SMEs;

• 10.7 percent of life insurance company-provided non-residential mortgages are SME mortgages. The life companies also invest indirectly in SMEs via venture capital and other investment firms;

• Roughly 35 percent of all asset-based financing (which includes leasing, secured loans on assets or conditional sales of assets) is to SMEs; and

• Credit card business lending was estimated at $55 billion in 1994.

Importantly, the study indicates that as these alternatives are under-emphasized and their impact is not well-understood, SMEs do not take full advantage of them as financing vehicles.

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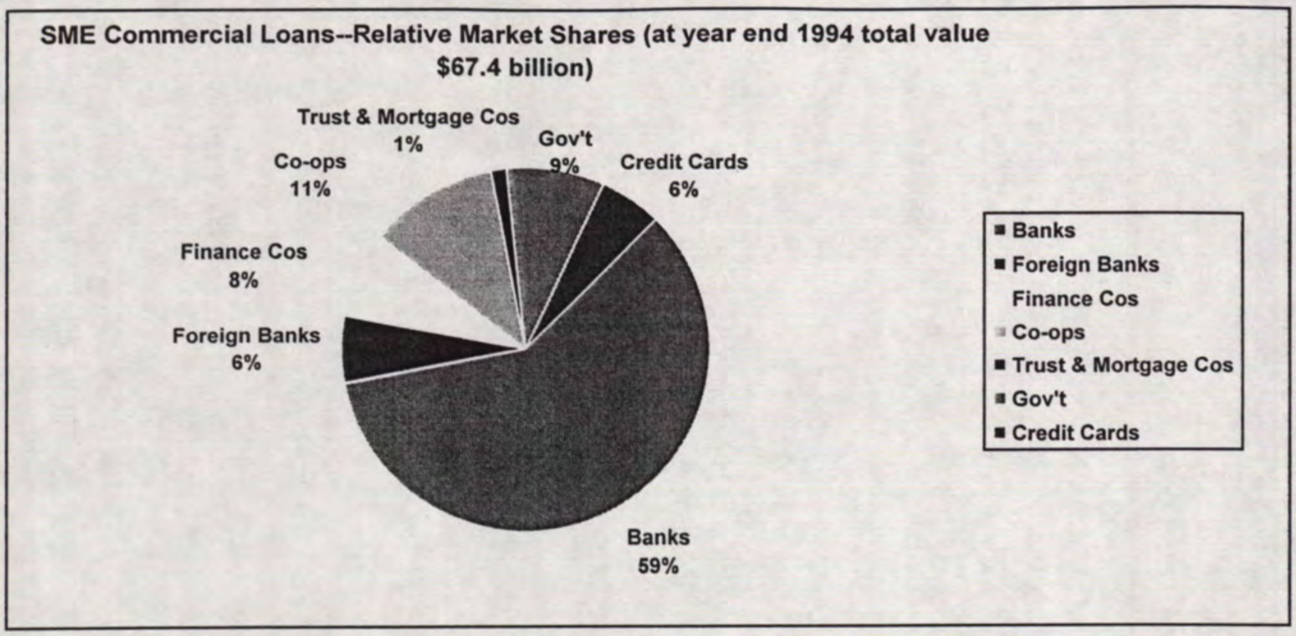
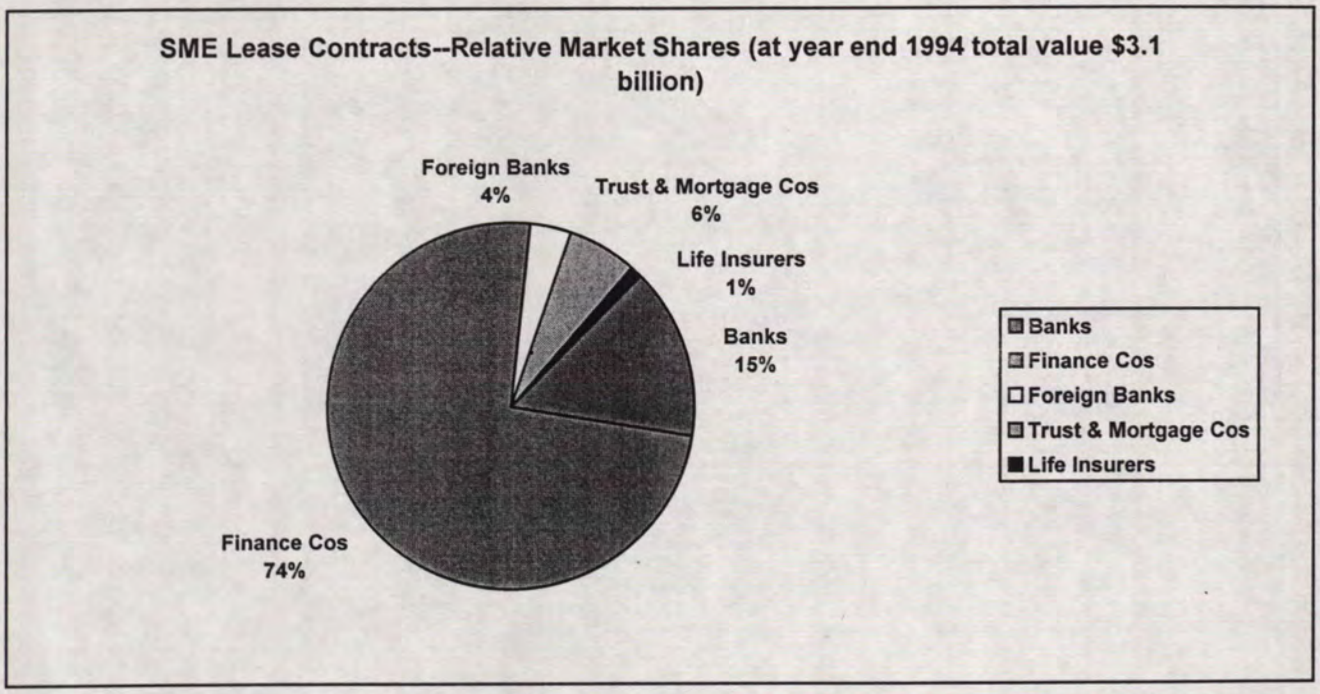
[23] Carolyn Conner, (Ottawa: The Conference Board of Canada, March 1995).



The Conference Board of Canada, 1995 [24]



The Conference Board of Canada, 1995[25]

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[24] *Ibid.*, p. 29.
[25] *Ibid.*, p. 30.

Consensus and Differences

The studies summarized and reported on here all touch on various aspects of the financing of SMEs. It is widely accepted that SMEs are an important, and increasingly important, segment of the Canadian economy. It is accepted that it is good public policy, therefore, to create an environment which sustains and encourages the growth of SMEs.

It is also understood that most SMEs are extremely small, that they are often very vulnerable to anything from an economic downturn to mismanagement, and that the SME market is consequently a highly risky one.

The studies all accept that financing is a significant concern for SMEs, although they focus on different aspects of it. Nor do they maintain that financing is the only important money-related problem faced by SMEs. It is recognized, for instance, that information assymetries play a significant role in causing financing difficulties. Moreover, it is widely accepted that financing concerns walk hand-in-hand with heavy taxation; indeed, that the financing issue is exacerbated by, and cannot be separated from, the taxation issue if one is examining the Canadian SME environment.

Furthermore, it has been a fact of recent Canadian economic history that governments' room to manoeuvre with respect to public policy is severely constrained by its need to bring the deficit under control. In difficult fiscal times when social programs are being curtailed and health care budgets have been visibly evaporating, increasing public spending on small business has not been easily justifiable.

To some extent, clear policy directions are difficult to determine because of disagreements in analysis and prescriptions.

The various studies agree that there are problems with small business financing but they don't agree on what these are, in part because they concentrate on different aspects of the financing question, and in part because the art of measuring adequacy is not a science.

On the question of debt financing, The Conference Board study, for instance, maintains that significantly more debt financing is available than is commonly accounted for, and that if SME owners and managers were aware of the alternatives available to them, they would be better prepared to finance their ventures. The CBA's position is that banks and other financial institutions do a better job of servicing SMEs than "anecdotal" evidence presented before House Standing Committees would denote; but its study didn't appear to pay sufficient attention to differentiating between "established", traditional SMEs, and newer, knowledge-based ones.

Even when there is consensus, for instance on the point that small business is hampered by high and profit-insensitive taxes, following the policy prescriptions has not proven to be easy. The federal government's hands have been tied by its fiscal restraint priorities, such that it could not follow some of the advice it requisitioned in its own studies. For example, capital gains taxes could not be lowered for fiscal reasons, and the suggestion that RRSPs be permitted to be invested back in non-arm's-length small businesses was rejected largely for the same reason.

Equity financing services a much smaller percentage of SMEs' capital needs, and while progress has been made in identifying and addressing the disclosure/prospectus costs associated with some aspects of accessing equity financing, there remain large areas that have not been well explored, particularly as far as a public policy role is concerned.

This examination of SME studies points to a number of key consistent findings about SMEs, and suggests a number of areas which would be worth exploring.

- Debt financing is significantly more important than equity financing in servicing SME capital requirements. On the other hand, successful SMEs are careful, particularly in their early phases, not to become overburdened by debt. Retained earnings are a critical source of early financing.

- Commercial loans from financial institutions are an important part of that debt financing, but there are significant other alternate sources of debt financing that a) may have the potential to play a yet larger role in servicing SME capital requirements, and b) that have not been sufficiently understood or studied.

- These alternate sources include leasing, which is frequently mentioned in studies as having significant potential which should be encouraged, and factoring, which has received much less emphasis.

- Wide consensus exists that financial institutions are not oriented to service knowledge-based SMEs effectively, nor did the CBA study indicate that significant changes had been made in the way loans are assessed. (Poor collateral value was cited as a key reason for loan turndown, particularly when the applicant is a brand-new business. This is a particular problem for knowledge-based SMEs, which do not tend to be tangible asset-based.)

- It evidently becomes important for SMEs to change their capital structure in order to grow beyond a certain size. In the beginning, retained earnings are particularly important, but the opportunity cost of relying on them becomes too great once the enterprise grows, and it becomes increasingly important for a successful SME to be able to rely more on equity financing.

• The Statistics Canada GSME study points out that the capital structure of successful SMEs appears to operate as described above, but that it is not known whether this is the most efficient way for them to operate, or whether they operate that way because they have adapted to the inefficiencies of the market.

• As the federal government's deficit priority eases, it may also, in the light of these considerations, be worthwhile to revisit the question of how to leave more retained earnings in the hands of small businesses, as suggested by multiple studies.

• As far as equity financing is concerned, it is apparent that the one of the biggest problems that exist – apart from the procedural costs of conforming to regulatory requirements, which is being addressed in various jurisdictions – is that of matching the potential investment dollars of "angel" investors with needy SMEs. This is especially important because it is investments of relatively small amounts of money – which are nonetheless critical to SMEs at a certain stage of their development – that the "angel" market serves. Nonetheless, informational assymetries are particularly onerous here, and none of the studies explicitly addresses this question.

• As the OSC study points out, the problems associated with obtaining equity capital – as detailed in the Queen's study and in *Taking Care of Small Business*, and as summarized on page 20 of this paper – leave room for further study. These include how to solve informational assymetry problems, what to do about the relatively high cost of due diligence for SMEs, and how to match "angels" successfully with needy SMEs.

• In addition, the question of why a distribution network for small offerings hasn't yet developed in Canada, and whether something could or should be done to encourage it, has yet to be explored.

SME Financing: A Study Matrix

Study	Emphasis:			
	Debt Financing	Equity Financing	Taxation	Other Notes
Strategies for Success, Baldwin/StatsCan, February 1994	X	X		SME Capital Structure
Financing the New Economy, Industry Canada, June 1994	X	X	X	Knowledge-Based SMEs
Taking Care of Business, House Industry Cttee., October 1994	X	X	X	Financial Institutions Competition
Breaking Through Barriers, Small Business Working Cttee., November 1994	X	X	X	Emphasis on Government Role, especially reducing tax and debt burden
Small Business: A Progress Report, Government of Canada, 1995	X	X	X	Government response to earlier reports
S.B. Growth & Employment in B.C., B.C. Government, 1996				The state of small business in British Columbia
The State of S. B. and Entrepreneurship in Atlantic Canada, Atlantic Canada Opportunities Agency, 1994				Examines SMEs in Atlantic Canada in light of GSME study

Study	Emphasis:			
	Debt Financing	Equity Financing	Taxation	Other Notes
Reforming the Regulatory Framework for S.B. in Ontario, Stobo/Ontario Government, 1995				Reiterates federal studies; lists Ontario reforms
Banking on Knowledge, Québec Conseil de la Science, 1994	X	X	X	Holistic approach to encouraging Quebec's knowledge-based SMEs
OSC Task Force on SB Financing, Ontario Securities Commission, 1996		X		Reforming & simplifying regulatory barriers to access to equity financing
Improving Access to Capital for SME Business in Manitoba, Manitoba Task Force on Capital Markets, 1994		X		Broad approach to improving SME equity financing in Manitoba
Small & Medium Sized Business in Canada: Their Perspectives of Financial Institutions & Access to Financing, and follow-up, Canadian Bankers Association, 1996 & 1997	X			CBA-commissioned study of SME perspectives of financial institutions' lending

Study	Emphasis:			
	Debt Financing	Equity Financing	Taxation	Other Notes
Alternative Sources of Debt Financing for Small & Medium-Sized Enterprises, Conference Board of Canada, 1995	X			Stresses importance of under-studied and under-emphasized alternative sources of debt financing

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