Intelligence MEMOS

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To: Canada's Policymakers

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Re: **Unpacking Canada's Persistent SME Growth Problem**

Only 2 percent of mid-sized Canadians firms grow into large companies with more than 500 employees, according to a 2016 Business Development Bank study. More recent data suggests that number has not budged.

Alongside weak firm growth, there has been a dearth of IPOs in Canada since the turn of the century, notwithstanding a 2021 bounce. This all leads to the fact that 90 percent of private sector employment in Canada is in SMEs, compared to only 47 percent in the US – a major contributor to the labour productivity gap between the two countries.

Canada, then, is not short on SMEs, but short on growing them into the kinds of firms we need to boost our lagging productivity. The C.D. Howe Institute has launched an SME Working Group aimed at finding whether the sources of private capital we do have are sufficient to help grow Canadian SMEs. To answer that question, this Memo surveys what we know from the literature on the relationship between business growth, capital, and policy.

The relationship between Canadian firm size and firm growth has a U-shaped pattern, meaning growth typically slows after a promising start, and firms must reach a particular threshold before growth can take off again. Moreover, the likelihood of scaling up decreases as firms age. In other words, it is not small that is important for growth, it is youth.

There is also significant state dependence for firm growth – firms currently in a state of high growth are much more likely to be in a high growth state later on (though, this varies with industry.)

On the financing front, a higher debt ratio (as a percentage of assets) weighs down firm growth and lessens the chance of scaling up. Strong liquidity often portends strong future growth. (Although we must be careful with the latter as sitting on too much cash can be a sign of weak opportunities to increase investment and growth.)

Overall, more patient long-term capital is required for investment in talent, infrastructure, and technology – all critical to creating high-growth long-lasting firms.

So, what do we know about capital availability in Canada? With respect to venture capitalists, domestic participants play a secondary role, with only a 30 percent market share in Q2 2022, with US funds accounting for most of the rest. There are almost no retail venture investors in three of the four biggest provincial markets in Canada: Ontario, BC, and Quebec. And, among domestic funds, federal and provincial government entities are the dominant players.

More generally, when it comes to the medium-size players we know aren't growing into large businesses, there are three tiers in the Canadian Growth Capital Market.

Tier 1 ($20 million plus investment) is largely made up of US private equity and growth equity funds, but increasingly supplemented by larger Canadian public pension funds and a small number of domestic growth equity funds. They are concentrated in the tech sector, including big US tech firms that often purchase Canadian mid-sized firms outright.

Tier 2 ($10-20 million) is increasingly populated by Canadian investors like bank-owned entities and domestic growth equity funds, and tend to be broader in the industries they invest in.

In Tier 3 ($2 million to $5 million range) we also see domestic investors, but we also see the strongest evidence of demand for growth capital outpacing supply.

As we look for ideas on how to give a capital boost to Canadian SMEs, we should keep in mind what the literature tells us, generally, about the relationship between firm growth and policy. At a cross-country level, the effects of policy on firm growth are nuanced. First, start-ups in volatile sectors and in sectors that exhibit higher growth dispersion are more exposed to national policies and framework conditions – i.e., their entry and growth performance appear to be more correlated to the policy environment – than those of start-ups in other sectors. This highlights the importance of promoting policies explicitly aimed at lowering risk, e.g. improving access to finance. And, second, start-ups are more exposed to the policy environment and the national framework conditions than incumbents.

We also need to look to other places that have seen success in the SME space. For example, Israel allows SMEs who have achieved a successful liquidity event (e.g. an IPO) to re-invest those proceeds at no capital gains tax into innovations within two years. This is the lay of the land as the C.D Howe Institute SME Working Group takes flight. We have begun exploring the conditions underpinning access to capital and firm growth, and our exploration will deepen this fall and into 2023, yielding what we aim to be actionable recommendations for decision-makers.

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