Small businesses are key to economic growth. Recent studies by Industry Canada (Parsley and Dreessen, 2004) and other organizations have identified a small group of small and medium-sized enterprises (SMEs) that contributed disproportionately to the growth in Canadian employment. These high performers, often referred to as high-growth small and medium-sized enterprises (HGSMEs), were responsible for creating nearly 1 million net jobs out of a total of nearly 1.8 million net jobs in Canada between 1985 and 1999.

Other recent research (Fischer and Reuber, 2002) indicates that HGSMEs have great profit potential, but also potentially represent great financial risks. If HGSMEs are to continue as a principal engine of growth, it is important from a public policy perspective to understand the challenges and barriers they face in maintaining their growth. Using the most comprehensive database on small business financing, this profile on HGSMEs presents key characteristics, financing patterns and potential financial barriers for these high-performing firms.

Summary of Key Findings

• In 2001, 17 percent of all Canadian SMEs were considered HGSMEs; between 1985 and 1999, HGSMEs created roughly one out of two net jobs in Canada.

• In 2001, HGSMEs were
  • located in every region of the country, with a slightly higher concentration in Ontario (38 percent) and Quebec (24 percent);
  • found in all sectors of the Canadian economy, but were more concentrated in the manufacturing sector, professional services and knowledge-based industries; and
  • more likely to invest in research and development (R&D) than other SMEs (34 percent of HGSMEs invested in R&D activities compared with 25 percent for other SMEs).

• HGSMEs were more likely to request debt financing (21 percent versus 17 percent) and leasing (11 percent versus 6 percent) than other SMEs.

• In 2000, HGSMEs were more likely to use risk capital from angel investors or venture capitalists. They were nearly three times more likely to be financed by angel investors and over 22 times more likely to be financed by venture capitalists than other SMEs.

• After commercial loans and lines of credit (48 percent usage), HGSMEs were more likely to use trade credit from suppliers (43 percent) and the owner’s personal credit (38 percent), compared with other SMEs (49 percent, 38 percent and 33 percent, respectively).

Definitions

Small and medium-sized enterprises (SMEs) are defined as commercial (for-profit) firms with fewer than 500 employees and less than $50 million in annual revenues. Excluded are non-profit or government organizations, schools, hospitals, subsidiaries, cooperatives, and finance and leasing companies.

High-Growth SMEs (HGSMEs) are commercial firms with a cumulative sales increase of more than 50 percent over three years. High growth may also be defined by job creation or other financial variables; however, there appears to be no consensus among researchers on a standard definition of high growth and the adherence to a specific definition is mainly determined based upon the data available and the objectives pursued. In the following analysis, HGSMEs are compared with the profile and financing of all Other SMEs that did not have cumulative sales growth of more than 50 percent over three years.
In 2001, 17 percent of all Canadian SMEs (over 305,000 firms) were considered high growth, up from 12 percent in 2000. An earlier Industry Canada study (Parsley and Dreessen, 2004) found that hyper- and strong-growth firms\(^1\) (7 percent of all firms) were responsible for nearly 1 million of the nearly 1.8 million net jobs created between 1985 and 1999. While accounting for a small proportion of the SME population, HGSMEs make a considerable contribution to the Canadian economy.

**2001 Profile of High-Growth SMEs**

- 34 percent invested in R&D activities (compared with 25 percent for other SMEs)
- 12 percent exported their products and services outside Canada (similar to other SMEs), down from 18 percent in 2000
  - 91 percent exported products to the United States, 14 percent to Europe and 12 percent to Asia
- 37 percent are majority female-owned or half female-owned and 63 percent are majority male-owned (compared with 35 percent and 65 percent, respectively, for other SMEs)
- 78 percent have more than 10 years of management experience in their business’ industry (compared with 84 percent for other SMEs)
- 59 percent of owners have a post-secondary education (similar to other SMEs)
- 81 percent of owners built their business themselves (compared with 70 percent for other SMEs)


\(^1\) Although the *Growth Firms Project: Key Findings* study measured firms’ growth based on employment growth, SME FDI uses sales growth as the determining factor. This difference in growth criteria may lead to some conceptual differences in the findings of both studies.

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**Located in Every Region of the Country**

The regional distribution of HGSMEs reflects the regional economic structure of Canada. Although HGSMEs were located in every region of the country (see Figure 1), they were more concentrated in Ontario and Quebec. The combined share of HGSMEs in these provinces (62 percent) was slightly higher than other SMEs’ share (57 percent). An earlier report (Industry Canada, 2003) indicated that HGSMEs were more likely to be found in the manufacturing sector and knowledge-based industries than in other sectors of the economy in 2000. The concentration of manufacturing firms (67 percent of all manufacturing SMEs in Canada) and knowledge-based industries (65 percent of all knowledge-based SMEs in Canada) in Ontario and Quebec could help explain the higher concentration of HGSMEs in central Canada.
HGSMEs were found in every sector of the Canadian economy in 2001. As seen in Figure 2, however, HGSMEs tended to be somewhat more concentrated in manufacturing, professional services and knowledge-based industries, accounting for 24 percent of firms in both manufacturing and professional services and 19 percent of all knowledge-based firms. This may, in part, explain the higher expenditures in R&D among HGSMEs, as these three sectors have the highest percentage of SMEs engaged in R&D. In 2001, 43 percent of manufacturing firms, 37 percent of professional service firms and 47 percent of knowledge-based businesses invested in R&D.

Firms with more than five employees represented a higher proportion (26 percent) of HGSMEs compared with other SMEs (20 percent) in 2001. It might be assumed that these HGSMEs have higher revenues, assets and profits and a more extensive track record as larger firms tend to produce more in absolute terms and tend to be in operation for a longer period of time than smaller firms. However, this assumption is not supported by the data, which show the age distribution for HGSMEs was the same as for other SMEs in 2001 (78 percent having been in operation for more than five years). However, the combination of these factors (higher revenues, assets and profits) may mitigate lenders’ perceptions of risk: as will be seen below, HGSMEs appear to have no more difficulty accessing financing than other SMEs.

Although a recent study (Industry Canada, 2005) on small business goods exporters\(^2\) established that fewer than 2 percent of SMEs exported their goods in 2000, the *Survey on Financing of Small and Medium Enterprises, 2000, 2001* covers all sectors (services and goods).

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\(^2\) This estimate, produced from the Statistics Canada Exporter Registry, covers only small business goods exporters, whereas the *Survey on Financing of Small and Medium Enterprises, 2000, 2001* covers all sectors (services and goods).
Enterprises found that 18 percent of HGSMEs in all sectors (products and services) exported, compared with 9 percent for other SMEs during that year. The higher propensity of HGSMEs to focus on external markets may actually be underestimated because the survey did not test the extent to which these firms are integrated into larger firms’ supply chains (e.g. Bombardier and its suppliers or the automobile industry and its suppliers) that would then export worldwide. Additional research is required to fully understand the contribution of HGSMEs to the export market through larger firms’ supply chains.

### Higher Propensity to Invest in Research and Development Activities

Although more HGSMEs (34 percent) invested in research and development (R&D) activities in 2001 than other SMEs (25 percent), only a small proportion of them (2 percent in 2001 and 6 percent in 2000) were considered innovative firms, which was similar to the finding for other SMEs (2 percent in 2001).

### Stronger Financial Performance

Table 1 presents key financial amounts for the average HGSME in 2000, compared with averages for other SMEs. In 2000, HGSMEs demonstrated stronger financial performance than other SMEs in terms of size and profitability.

In 2000, the average HGSME was better positioned financially, with 18 percent greater assets than other SMEs, 72 percent greater revenues, 45 percent greater profits and 11 percent greater equity holdings.

Examining common profitability measures, HGSMEs again outperform other SMEs:

- Slightly higher rate of return on assets (13 percent versus 10 percent among other SMEs);
- Higher rate of return on equity (33 percent versus 24 percent); and
- Similar profit margins (8 percent versus 9 percent).

In terms of liquidity and debt management, the average HGSME had a similar debt-to-equity ratio as other SMEs (1.5 for HGSMEs and 1.4 for other SMEs). In the short term, HGSMEs have the same level of liquidity as other firms, with a ratio of current assets to short-term debt of 1.5.5

<table>
<thead>
<tr>
<th>Financial Statement Figures in 2000*</th>
<th>High-Growth SMEs</th>
<th>Other SMEs</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenues</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>933 000</td>
<td>535 000</td>
</tr>
<tr>
<td>Total Revenue</td>
<td>961 000</td>
<td>559 000</td>
</tr>
<tr>
<td><strong>Expenses</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>887 000</td>
<td>599 000</td>
</tr>
<tr>
<td><strong>Net Profit (loss) Before Tax</strong></td>
<td>74 000</td>
<td>51 000</td>
</tr>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>300 000</td>
<td>198 000</td>
</tr>
<tr>
<td>Fixed</td>
<td>282 000</td>
<td>293 000</td>
</tr>
<tr>
<td>Total</td>
<td>582 000</td>
<td>492 000</td>
</tr>
<tr>
<td><strong>Liabilities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>197 000</td>
<td>128 000</td>
</tr>
<tr>
<td>Long-Term</td>
<td>156 000</td>
<td>157 000</td>
</tr>
<tr>
<td>Total</td>
<td>353 000</td>
<td>285 000</td>
</tr>
<tr>
<td><strong>Equity</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Owner’s Equity</td>
<td>110 000</td>
<td>126 000</td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>119 000</td>
<td>78 000</td>
</tr>
<tr>
<td>Total</td>
<td>229 000</td>
<td>207 000</td>
</tr>
</tbody>
</table>

* Figures may not add up exactly due to rounding and the absence of some income statement or balance sheet data.


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3 Innovative firms are firms that invest more than 20 percent of their total investment expenditures in R&D.

4 The rate of return on assets measures a firm’s performance in using assets to generate earnings independent of the financing of those assets, whereas the rate of return on equity measures a firm’s performance in using assets to generate earnings but also considers the financing of those assets using the DuPont method of calculation (Gaber, Davidson, Stickney and Weil. *Financial Accounting*, Dryden).

5 Current ratio is a measure of a company’s current assets to its short-term debt. A current ratio of 1.0 means that a company could survive for one year, even if it made no sales. Overall, the higher the ratio, the more liquid the company is.
FINANCING ACTIVITY

MORE LIKELY TO MAKE A REQUEST FOR FINANCING

As Table 2 illustrates, HGSMEs were more likely to make a request for debt financing than other SMEs. Chartered banks played a central role in the financing of HGSMEs, receiving 67 percent of requests for debt financing compared with 23 percent received by credit unions and caisses populaires. With only 10 percent of the requests for debt financing, Crown corporations and other institutions played marginal roles in financing HGSMEs.

HGSMEs, like most other SMEs, did not shop around to obtain financing in 2001; eight times out of ten, HGSMEs approached their regular financial institutions when they sought debt financing.

MORE LIKELY TO REQUEST LEASING

HGSMEs appeared to be more inclined to request leasing than other SMEs. Close to 11 percent of HGSMEs requested some form of leasing agreement in 2001, compared with only 6 percent of other SMEs. Despite this difference, HGSMEs saw lower levels of approval in 2001, with 90 percent and 96 percent approval rates for HGSMEs and all other SMEs respectively.

MORE LIKELY TO REQUEST EQUITY FINANCING

Although HGSMEs have great profit potential, they also potentially represent great financial risks (Brigham et al., 1991). High sales growth imposes financial pressures on HGSMEs by creating the need for new employees, space, marketing, distribution and production equipment. HGSMEs are usually too small to become publicly traded companies, and they require major inflows of risk capital to sustain growth. HGSMEs can use debt financing or equity to finance the acquisition of new assets, but they must maintain a reasonable balance between these two financing instruments. In 2001, only one percent of HGSMEs requested equity financing, similar to that of all other SMEs. However, earlier studies (Industry Canada, 2002b, 2003) found that HGSMEs were nearly three times more likely to be financed by angel investors and over 22 times more likely to be financed by venture capitalists than other SMEs. They also demonstrated that HGSMEs used debt and equity financing more than other SMEs.

HGSMEs Financing Activity

- HGSMEs use a broad range of financing instruments and are more likely than other SMEs to use external financing.
- In 2001, 21 percent of HGSMEs requested debt financing compared with 17 percent of other SMEs and were nearly as likely to be approved (80 percent of HGSMEs were approved compared with 83 percent of other SMEs).
- HGSMEs had higher use of alternative external financing, such as trade credit (45 percent) and leasing (20 percent), than other SMEs.
- Internal resources, such as owners’ personal savings (for 36 percent of HGSMEs) and retained earnings (for 34 percent of HGSMEs), played a more important role for these firms than for other SMEs.

Table 2: Financing Request and Approval Rates in 2001

<table>
<thead>
<tr>
<th>Type of Financing</th>
<th>Rate</th>
<th>High-Growth SMEs (%)</th>
<th>Other SMEs (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt Financing</td>
<td>Request</td>
<td>21</td>
<td>17</td>
</tr>
<tr>
<td></td>
<td>Approval</td>
<td>80</td>
<td>83</td>
</tr>
<tr>
<td>Lease Financing</td>
<td>Request</td>
<td>11</td>
<td>6</td>
</tr>
<tr>
<td></td>
<td>Approval</td>
<td>90</td>
<td>96</td>
</tr>
<tr>
<td>Equity Financing</td>
<td>Request</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>Approval*</td>
<td>43</td>
<td>74</td>
</tr>
<tr>
<td>Government Financing</td>
<td>Request</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td></td>
<td>Approval</td>
<td>71</td>
<td>54</td>
</tr>
</tbody>
</table>

* Data are less statistically reliable due to lower frequency of response.

CAPITAL STRUCTURE

More Likely to Accept Equity Financing

In 2001, 60 percent of HGSMEs were incorporated, 33 percent were sole proprietors and the remaining 7 percent were limited partnerships. The legal status of HGSMEs may have implications for the use of external equity financing by HGSMEs. As seen in Table 3, there are some striking differences in the owners’ equity structure between incorporated HGSMEs and other incorporated SMEs. In 2000, external investors played an important role in financing incorporated HGSMEs, accounting for 38 percent of HGSMEs’ capital compared with 11 percent for other incorporated SMEs. While informal investors (friends, relatives and employees) represented a small proportion (4 percent) of equity financing of incorporated HGSMEs, venture capitalists and other external investors supplied 34 percent of the total equity of incorporated HGSMEs (compared with 10 percent for other incorporated SMEs). This suggests that these firms are more “venture-capital (VC) investor-ready” than other incorporated SMEs. A report from Industry Canada (2002a) identified six characteristics of venture-capital-financed firms: high-growth orientation, high rates of return on equity, strong management teams, high R&D spending, international orientation and flexible ownership structures. As discussed earlier, HGSMEs have demonstrated most of these characteristics.

It appears that, unlike incorporated HGSMEs, limited partnerships and sole proprietorships, which account for half of high-growth firms, are unlikely to attract a large amount of external risk capital. Because sole proprietorships cannot by nature issue shares, they cannot share ownership with outside investors; likewise, the ownership restrictions on typical partnerships are not attractive to outside investors. The implications for the growth potential of nearly half of the firms that have consistently accounted for disproportionate job creation, innovation, R&D expenditures and exports are unclear. However, without outside risk capital, these firms may stop growing or be vulnerable to loss of market share. More research is needed to determine the impact of ownership structure on the future growth of such firms.

Retained earnings and owners’ equity play different roles in the equity structure of HGSMEs compared with other SMEs (see Table 1). For example, retained earnings (52 percent) played a central role, along with owners’ equity (48 percent), in the equity structure of HGSMEs. In contrast, other SMEs use more owners’ equity (61 percent) than retained earnings (38 percent) in financing their business through equity. Higher retained earnings by HGSMEs may be related to the higher profitability of these firms.

Table 3
Distribution of Owners’ Equity Among Privately Owned SME Corporations in 2000

<table>
<thead>
<tr>
<th>Investors</th>
<th>HGSMEs</th>
<th>Other SMEs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internal investors</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Business managers</td>
<td>56.5</td>
<td>84.2</td>
</tr>
<tr>
<td>Parent company</td>
<td>1.2</td>
<td>1.5</td>
</tr>
<tr>
<td>Employees of the business</td>
<td>0.7</td>
<td>0.2</td>
</tr>
<tr>
<td>Friends or relatives</td>
<td>3.6</td>
<td>2.7</td>
</tr>
<tr>
<td>External investors</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Angels</td>
<td>4.5</td>
<td>1.4</td>
</tr>
<tr>
<td>Venture capital</td>
<td>5.1</td>
<td>0.2</td>
</tr>
<tr>
<td>Other</td>
<td>28.5</td>
<td>9.8</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>


Sources of Financing

HGSMEs Use a Broad Range of Financing Instruments and are More Likely to Use External Financing

The use of different financial instruments within a firm’s capital structure and the distribution of the firm’s equity tend to reflect its financing strategy for growth and expansion. As Figure 4 shows, both HGSMEs and other SMEs used a broad range of financing instruments in 2000.
More Likely to Use Trade Credit and Leasing

After commercial loans and lines of credit, HGSMEs were more inclined to use trade credit and leasing to finance their activities than other SMEs, as shown in Figure 4. In addition, internal resources such as personal credit cards (38 percent versus 33 percent) and owners’ personal savings (36 percent versus 34 percent) played a more important role for HGSMEs than for other SMEs in 2000. HGSMEs’ greater capacity to rely on internal sources of financing could be explained by their higher profitability (see Table 1).

Similar Credit Conditions for HGSMEs as for Other SMEs in 2001

HGSMEs seeking debt financing had to meet conditions from financial institutions comparable to those for other SMEs.

- Financial institution response time: It took less than five days for the majority of HGSMEs (55 percent) to get an answer from their financial institutions regarding a request for debt financing. However, a significant portion of HGSMEs (38 percent) faced much longer delays, waiting more than 10 days. The reasons for differences in waiting periods are unclear at this time.

- Collateral requirements: The majority of HGSMEs that sought debt financing did not need to provide personal (77 percent) or business collateral (62 percent) to guarantee their financing.

- Documentation requirements: Seventy-six percent of HGSMEs that sought debt financing were asked by their financial institutions to provide documentation to support their requests; 88 percent of them had to provide business financial statements. However, few HGSMEs were asked for business plans (7 percent compared with 20 percent for other SMEs). This significant difference may be attributable to the fact that there are a significantly higher number of established firms in the HGSME group (start-up firms are usually asked for business plans).
SUMMARY AND DISCUSSION

HGSMEs were identified as key contributors to job creation in Canada, despite accounting for a small proportion of the SME population. Slightly more concentrated in central Canada and in manufacturing, service and knowledge-based industries, HGSMEs were located in all regions of the country and all sectors of the Canadian economy. In 2001, these firms had a higher propensity to invest in research and development activities compared with other SMEs. Finally, HGSMEs had higher levels of assets, revenues and equity, and were more profitable than other SMEs. HGSMEs were similar to other SMEs in terms of liquidity and debt service capacity.

Although HGSMEs have great profit potential, they also potentially represent great risks. This analysis has shown that lenders’ perception of risk may be mitigated by other factors, such as higher levels of revenues, assets and profits, because HGSMEs appear better able to access financing than other SMEs. The financial analysis of HGSMEs also revealed that they used a broad range of instruments to finance their activities and tended to be larger than other SMEs. HGSMEs used commercial credit, trade credit and owners’ personal financial resources (personal savings and personal credit) to support operations more than other SMEs. However, like other SMEs, HGSMEs identified chartered banks as their main provider of debt financing; the terms and conditions attached to the financing were similar for both groups. Leasing and government financing programs were identified as popular complements to debt financing among HGSMEs, but equity was not. Personal resources of the owners and investors related to the business (actual shareholders, partners, friends and family) also played an important role in financing HGSMEs.

Of all HGSMEs that requested debt in 2001
• 38 percent requested a new term loan, 27 percent requested a new line of credit and 10 percent requested a mortgage compared with 35 percent, 31 percent and 16 percent, respectively, for other SMEs
• 55 percent received an answer from their financial institution in less than five days (compared with 48 percent for other SMEs)
• 23 percent were asked to provide personal collateral (compared with 41 percent for other SMEs)
• 38 percent had to provide business collateral (compared with 43 percent for other SMEs)
• 76 percent had to provide documentation (compared with 81 percent for other SMEs)
  • 88 percent had to provide business financial statements (compared with 73 percent for other SMEs)
  • 30 percent had to provide personal financial statements (compared with 27 percent for other SMEs)
  • 7 percent had to provide a business plan (compared with 20 percent for other SMEs).
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Available at www.sme-fdi.gc.ca

Data Initiative.

Data Initiative.


Industry Canada.

Statistics Canada, CANSIM, Table 282-0008 and Catalogue No. 71F0004XCB.
SME Financing Data Initiative

Small Business Financing Profiles is an ongoing series of articles on specific segments of the marketplace and a component of Industry Canada’s reporting efforts on SME financing. Other profile articles have examined Canada’s women entrepreneurs, visible minority entrepreneurs and young entrepreneurs.

Consistent with recommendations in 1999 from the Task Force on the Future of the Canadian Financial Services Sector, the SME Financing Data Initiative is a comprehensive data collection program on SME financing in Canada. In partnership with Statistics Canada and Finance Canada, Industry Canada reports on the supply of, and demand for, small and medium-sized business financing to provide a complete picture of SME financing.

As part of the initiative, Statistics Canada administers a series of national surveys on small and medium-sized enterprises (Survey on Financing of Small and Medium Enterprises) and financial providers (Survey of Suppliers of Business Financing). Industry Canada supplements these surveys with additional research into niche areas of SME financing.

For further information on the SME Financing Data Initiative and access to statistical findings and reports, visit www.sme-fdi.gc.ca. For information regarding the methodology of the Survey on Financing of Small and Medium Enterprises, visit Statistics Canada’s website at www.statcan.ca.

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