Special Report

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HIGHLIGHTS

- **For small and medium-sized businesses, the Great Recession was a horrible house guest – it arrived early and stayed late.**
- **SMEs lagged the recovery due to a high concentration in the hardest hit sectors and tight credit conditions that were made worse by having collateral tied to real estate. One in five SMEs borrow against residential real estate for business.**
- **Of the two influences, the mix of industry concentration seems to be the bigger issue holding SMEs back. Fortunately, the recovery is now broadening out beyond the manufacturing sector, allowing SMEs to grab hold.**
- **The prospects for SMEs should continue to brighten as the recovery extends this year and next, because the service sector will become increasingly engaged.**
- **With world growth increasingly driven by non-North American economies, some of the greatest sales growth potential will take place beyond domestic borders. SMEs have made noteable progress in some key emerging markets, a phenomenom that should continue in the years ahead.**

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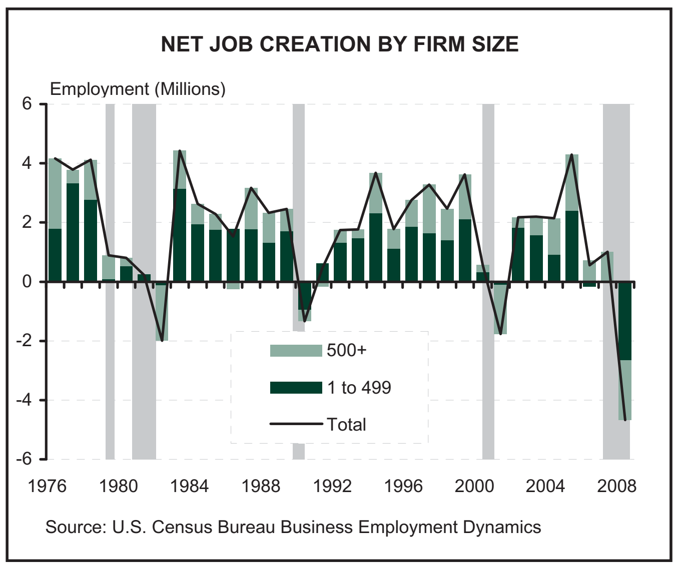
SMALL BUSINESSES WILL RECLAIM THE DRIVER'S SEAT BEHIND THE ECONOMIC ENGINE

Small and medium sized enterprises (SMEs) are an integral part of the U.S. economy. SMEs – classified as businesses that employ fewer than 500 people – make up more than 99% of all business establishments in America and are responsible for just under half of total employment. But, this understates their importance as an economic driver. Coming out of the last three recessions, 85% of the net job creation in the first two years of recovery took place in SMEs.

The Great Recession, however, was particularly damaging for small businesses across America due to their high presence in a number of heavily battered industries and greater reliance on real estate as collateral. The recovery, thus far, has generally favored larger sized firms through an improved ability to directly tap into capital markets and a strong manufacturing rebound – both of which are overly represented by large-sized firms. However, the tide will turn. The shape of this recovery will increasingly favor growth in the service sector, where SMEs have a unique advantage.

While the domestic economic recovery will provide good business opportunities, there is also enormous potential for SMEs to tap foreign markets. The world economy is increasingly being driven by non-North American countries. This leaves plenty of spoils to be gained by the SME that is adept enough to navigate products and services in the export market.



The Great Recession's impact on SMEs

The Great Recession was devastating to businesses both large and small, but it was especially hard on SMEs. For small and medium-sized firms, the recession was like a horrible house guest – it arrived early and stayed late. Of the 8.7 million jobs lost over the course of the recession, 60% were in SMEs. While employment amongst larger businesses continued to grow through 2007 and early 2008, SME employment peaked in 2006. This is in contrast to the 2001 and 1981 recessions, when employees within large businesses (500+ employees) bore the brunt of the pain.

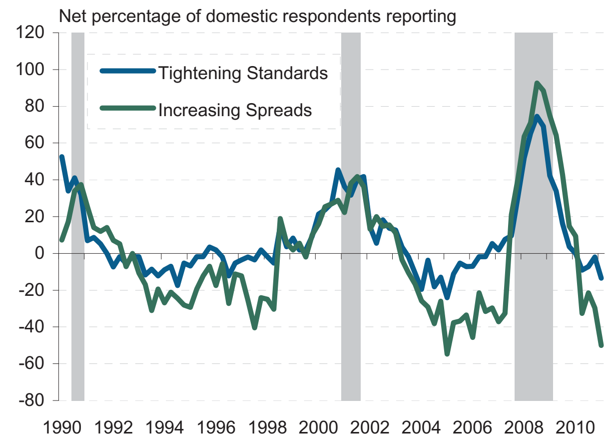
SMEs fared particularly poorly because they had a high concentration in industries that were among the hardest hit in the economy. By far, construction was the worst hit sector during the recession. From its peak in 2006, more than 2.2 million construction jobs were carved away – a drop of nearly 30%. Small and medium sized businesses make up over 85% of employment in the construction sector and accounted for 90% of those job losses.

SMEs also have a dominant representation in the real estate industry, accounting for roughly two-thirds of all jobs in this sector. You don't have to be an economist to figure out that when demand dries up for construction activity, real estate services fare little better. The high representation of SMEs in wholesale trade offered another challenge. This industry, along with retail trade, began turning down in 2007, ahead of the official start of the recession.

However, no sector captures the unique nature of the Great Recession on SMEs more than the large catch-all services category. When it comes to data on smaller establishments, the U.S. Census Bureau provides only limited categories, so this one includes many industries, including professionals, information, tourism and health and educational services. In the past, this service category played an important stabilizing role for SMEs. It was the one sector that could be counted on for continued job growth…that is, up until the 2008-09 recession, when jobs declined for the first time in the history of the data series. Because the service category is the single largest source of SME employment at 42% of the total, job losses were an important factor behind the underperformance of SMEs during the recession. Jobs in the service sector buckled because this recession was like no other. As the below graph shows, the percentage of firms that were reporting depressed sales was of a magnitude that had never been experienced before, and clearly the pain was too much, even for sectors that were traditional strongholds.

Of course, the situation was made even more difficult by stringent credit standards. The potent combination of severely depressed sales and difficulty gaining access to credit naturally led to outsized job losses for SMEs.

CREDIT STANDARDS FOR SMALL BUSINESS



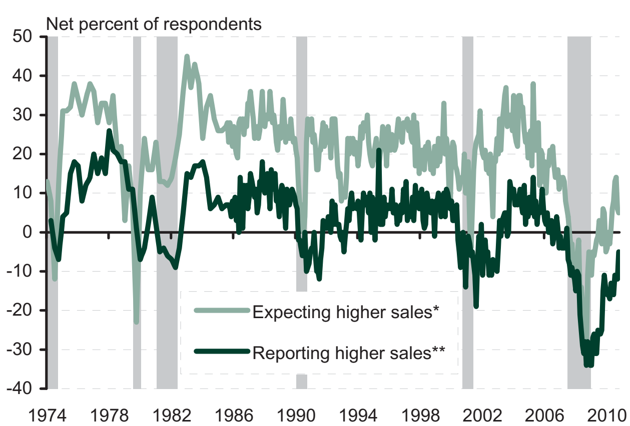
Source: Federal Reserve Senior Loan Officer Survey

The simple reality is that smaller establishments have less resources to weather economic storms, and they often lead the way in downturns. However, the Great Recession was the perfect storm. It battered SMEs early on, and then the weakness was concentrated in many small business dominated industries. Moreover, smaller firms had fewer financial options during this period of economic weakness.

Economic recovery still a challenge for SMEs

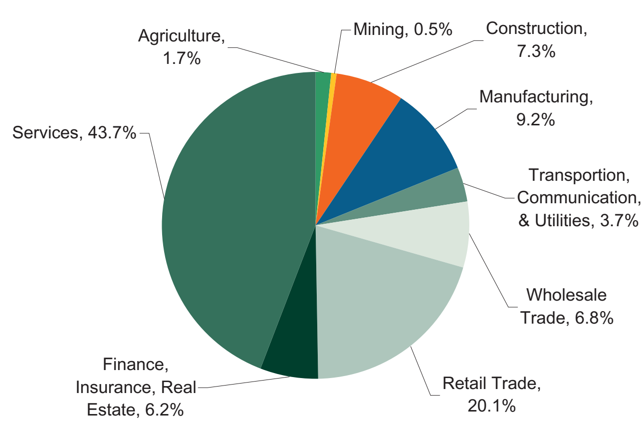
So, how are SMEs coping now? Unfortunately, the impact from weak demand for services and tightened credit conditions is lingering on small businesses. SMEs typically create and destroy about 3.5 times the amount of gross jobs as large businesses. The good news is that the number

SMALL BUSINESS SALES



*Over next six months. **Over last three months.
Source: NFIB

SHARE OF TOTAL EMPLOYMENT IN SMEs BY INDUSTRY



Source: U.S. Census Bureau, Business Employment Dynamics of SMEs laying-off workers either because of closures or downsizing has fallen since the recovery has set in. The bad news is that the birth of new companies and expansion of existing ones has remained sluggish.

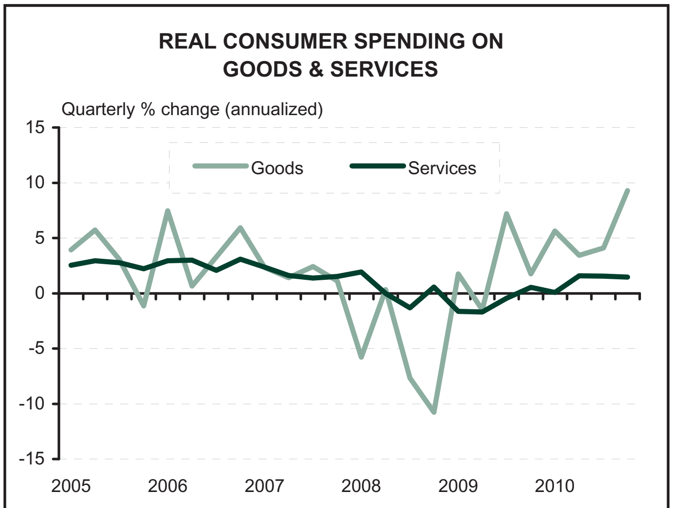
As the recovery has become longer in the tooth, access to credit has certainly improved for SMEs. However, a unique challenge remains. SMEs are often not large enough to directly tap into credit markets when more funds are needed, and so they rely primarily on collateral secured borrowing and commercial and industrial loans. Moreover, one in five small business owners borrow against residential real estate for business purposes. [1] With home prices having declined by over 30% and an estimated 27% of homeowners in negative equity position, access to this source of financing has diminished considerably. Naturally, this blocks an important financing vehicle for a number of entrepreneurs looking to start up a new company or expand existing operations.

However, the bigger influence dampening new hiring is that an overwhelming number of small businesses have reported weak sales in the recovery. The exception is in the manufacturing sector, which has roared back in part related to strong export demand and pent-up demand for big-ticket, interest-sensitive items like vehicles and electronics. Real spending on durable goods has rebounded by 19% since bottoming in December last year. But, SMEs have a relatively small representation in the manufacturing sector, and so many have not been able to capitalize on this good fortune. In contrast, it goes without saying that demand for construction activity remains depressed and, even more importantly, consumer demand for services has been excruciatingly slow to recover. In addition to reaching a bottom later than spending on durable items, since then, it has rebounded just 1.7%

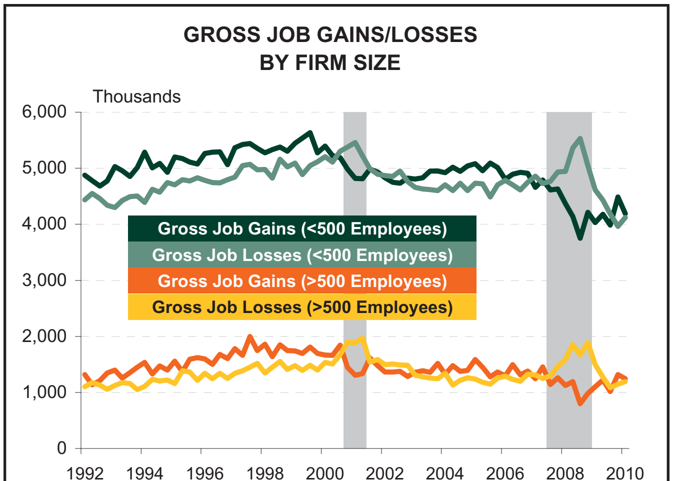
The continued challenges faced by SMEs explains much of the disappointing pace of the economic recovery over the last two years. Even though the recession officially ended in the second quarter of 2009, a recovery in the job market did not make an appearance until nine months later. And, even when jobs showed up to the party, it stumbled in – creating roughly one-third of the job gains one would have expected to see. It is not an overstatement to say that energizing the economic recovery depends crucially on the performance of SMEs.

Outlook for SMEs

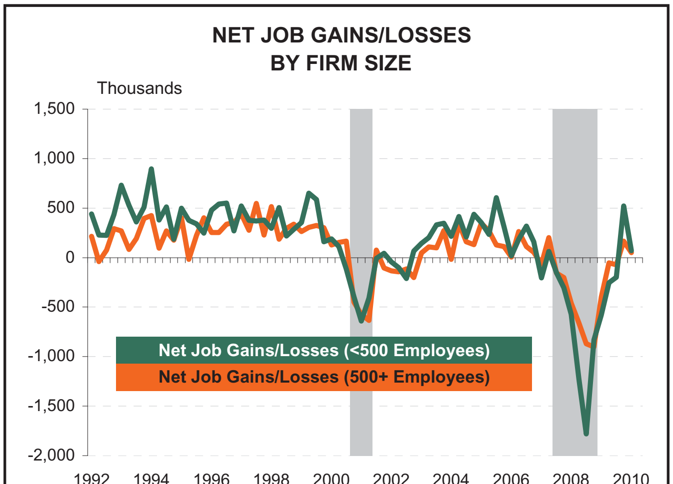
While the above analysis is sobering, progress on the points raised offers hope for the outlook. In the second and third quarters of 2010, SMEs began to reinstate their status



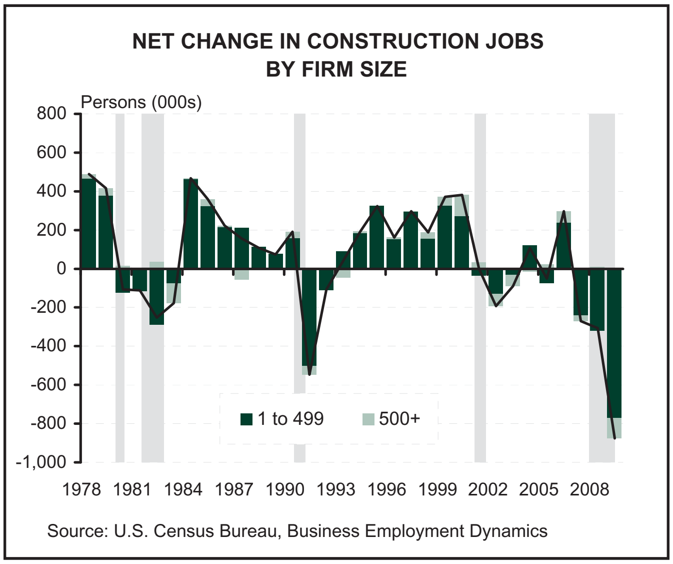
Source: Bureau of Economic Analysis



Source: BLS, Business Employment Dynamics



Source: U.S. Bureau of Labor Statistics: Business Employment Dynamics



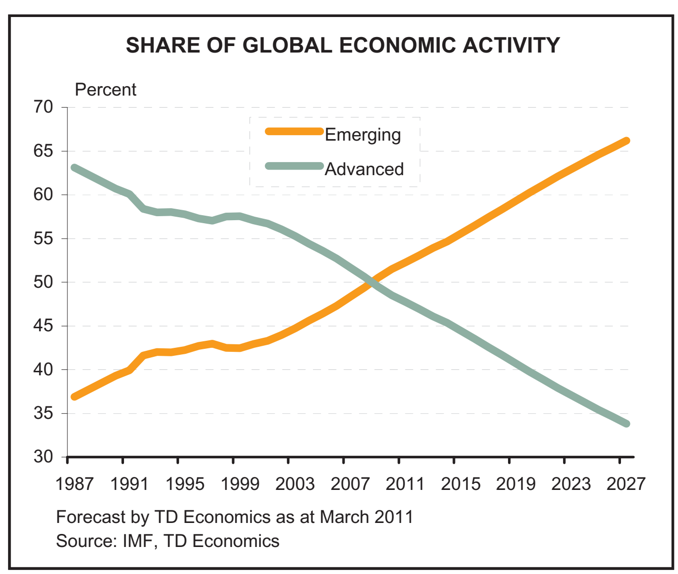
as a dominant hiring source, accounting for 60% or more of national net job gains. The gains are now occurring due to both fewer companies disappearing from the economic landscape, as well as more companies starting up or expanding. Although we only have SME data at this disaggregated level to the third quarter of 2010, we know from the national non-farm monthly payroll figures that hiring momentum within the service sector accelerated noticeably in 2011, where the majority of SMEs reside. By extension, this is a good sign that business activity and sales have picked up enough to prompt an increase in hiring activity. Looking at consumer spending patterns, there has definitely been an acceleration in spending on services since the end of last year. With domestic demand gaining strength, opportunities for new firms to start up and take advantage of the economic recovery should continue to rise.

The naysayers may point to the latest NFIB small business survey for April, which showed optimism among small firms had deteriorated slightly. However, there are three interesting observations from that survey. First, there was a notable increase in the number of firms reporting an improvement in actual sales, supporting the view we outlined in the previous paragraph. Second, although the expectation for higher sales over the next three months was lower than it was at the start of the year, it was definitely showing a level of optimism that was comparable or higher than the second and third quarters of 2010, when SMEs were already accounting for the majority of job gains in the economy. And third, fewer firms were reporting adverse profit trends alongside a greater number of respondents passing along higher prices to consumers or expecting to do so within the next three months. This is not something that would be feasible or sustainable in a weak demand market, and is an indirect measure of confidence. SMEs must be starting to feel that the demand environment has firmed up sufficiently to absorb the higher prices. Putting the pieces together, when it comes to confidence surveys, it's always a good ideato watch what they do, and not just what they say.

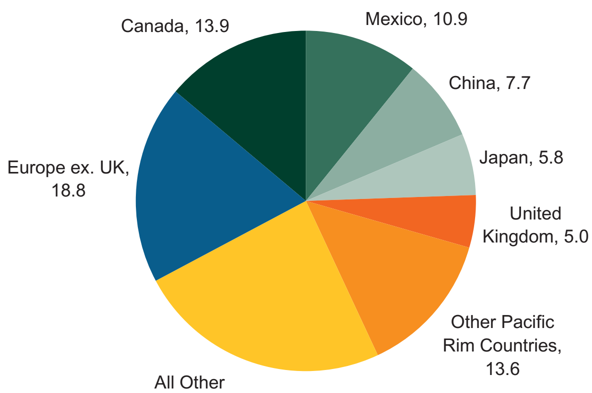
What about the heavily battered construction sector where many small businesses congregate? In this area we have little good news to offer for the near term. It will definitely continue to struggle over the next year, as we write in our report, "*Setting the Stage for a U.S. Housing Recovery*." However, looking beyond that time period, there are a number of reasons for guarded optimism. As labor market conditions improve, population growth and pent-up demand among young people will drive up household formations. Moreover, given the extent of the losses already experienced and the diminished size of the industry, the worst declines in the construction sector are already in the rear-view mirror. Thus, those small businesses that remain must certainly be the fittest of the pack. Underlying demographic requirements and depreciation of the housing stock mean that housing starts should gradually move up to roughly 1.6 million annually over the next several years – an increase of almost 300% from their current rock-bottom levels. Opportunities in the sector will start out slow, but steadily gain momentum with each passing year.

Looking beyond our borders

The main conclusion is that a firmer domestic economy will raise economic prospects for small and medium sized businesses, but this masks the fact that an SME that is adept enough to navigate products and services in an export

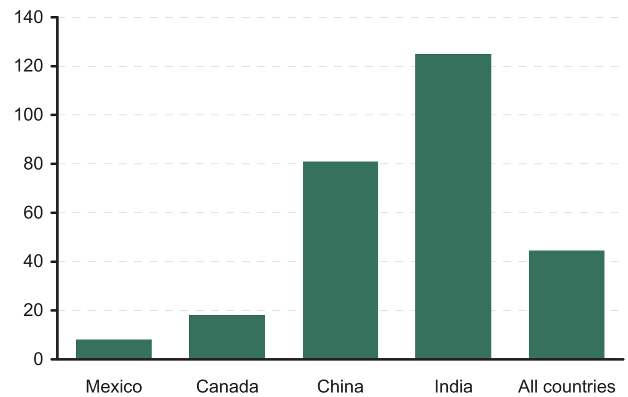


SME MERCHANDISE EXPORTS BY REGION, 2009



Source: U.S. International Trade Commission Business Register

GROWTH IN SME MERCHANDISE EXPORTS, 2004-2009



Source: U.S. International Trade Commission Business Register

market faces a number of unique advantages over the firm that solely focuses on servicing the domestic market. First, growth in world demand is becoming increasingly diverse and driven by non-North American countries. Emerging-market economies already make up 50% of the world economy and, in the next decade, that share will rise to 60%. Second, just like we are taught to diversify our investment portfolio to avoid swings in any single market or industry, the same logic can be applied to business sales. Nothing demonstrates this more than the recent recession episode. While it is characterized as a "Great Recession" in America and the worst of its kind in seven decades, some markets were able to sidestep it all together – like China – while others experienced a far milder version – like Canada, Brazil and India. Comparing performances, while total nominal goods exports are about 5% above their pre-recession peak, exports to Pacific Rim countries are up 18%, and those to China are up 45% .

Lastly, more than ever before, SMEs along with other American firms have seen a considerable improvement in their global competitiveness over the past decade. Since 2002, the dollar has depreciated by a hefty 26% against its collective trading partners. Currencies are notoriously volatile and the greenback could certainly claw back some of those losses, but broader fundamentals point to a dollar that will not return to its former glory. This offers a prime opportunity for enterprises to gain a foothold in foreign markets in order to expand sales.

Making neighbors with the world

The insatiable appetite and importance of emerging markets has not gone unnoticed by SMEs. There's no getting around the fact that proximity and long standing relationships make Canada and Mexico the primary export markets for SMEs. But, they also have their sights pinned on a number of developing economies. For instance, China makes up over 7% of SME merchandise exports. This may seem like a small share on the surface, but it has been steadily rising. Over the 2004 to 2009 period, exports to all countries by SMEs grew by over 30%, but to China, the pace had doubled. Likewise, growth to India grew by an even faster 120%.

However, this is only part of the equation. We traditionally think of the manufacturing sector, and merchandise in general, as the key driver of exports – and this is very much true for large firms where exports represent 84% of sectoral activity. [2] But, in the world of SMEs, service trade actually plays a larger role – just as it does with their presence in the domestic economy. There is also an indirect way of playing the global economy: SMEs can focus on increasing sales and services to an American company with significant export exposure. Examples include providing services such as accounting, advertising, consulting and legal advice. Looking at the whole trade package, the U.S. International Trade Commission (USITC) estimated that total employment supported by value-added SME exports came to 4 million jobs in 2007. For the entire export industry (including large firms), it was 9.2 million.

Nothing worth having comes easy

Of course, entering the export market is easier said than done. There are a number of challenges that uniquely impact an SME. In a study conducted by the USITC, the top three impediments for manufacturing SMEs were identified as obtaining financing, high tariffs, and transportation/shipping costs.[3] In contrast, the top three for service firms were language/culture, foreign sales not sufficiently profitable, and financing. These are not the same challenges faced by large firms, where issues are mainly around foreign regulations and taxation. But, there was one critical finding that came out the study. As SMEs export more, their perception of the severity of impediments tends to decline. This likely speaks to the simple notion that practice makes perfect. As firms become more experienced in navigating through some of the headwinds, gain a foothold in foreign markets, recruit the appropriate talent and services, they likewise become more successful at the business of exporting.

The bottom line is that an ever increasing share of global growth is externally driven, and this isn't a trend that is going to end. The evidence indicates that SMEs certainly appreciate this notion and are trying to tap into this growth. Although they have relatively low overall export exposure to a number of high-growth markets, the trend is on the upswing and will likely continue to grow with time.

Conclusion

The American economic engine relies heavily on small and medium sized businesses. Traditionally SMEs are the first in and the first out of recessions – reflecting their vulnerability to economic downturns, as well as their nimbleness to change quickly and take advantage of a recovery. This time around, however, they were first in and last out due to the SME industry mix which did not work in their favor, both in terms of job and sales opportunities. And, it also didn't help that with financial purse strings already pulled tight, SMEs rely disproportionately on residential real estate as collateral for business operations.

Fortunately, there are growing signs of improvement on a number of fronts. Sales have begun to turn upward and job growth in services has picked up considerably in recent months. While the housing market will continue to pose a challenge for SMEs – both in terms of businesses operating within the sector, as well as the impact of home prices on SME financing – the worst should already be in the past.

Looking beyond the U.S. business cycle, the increasing global nature of economic growth should not be overlooked. Some SMEs are already seizing on these opportunities by gaining a foothold in high-growth countries in emerging Asia, but certainly the potential to expand further exists.

All told, the last several years have been a trial by fire for many SMEs. But, the resiliency of small and medium sized businesses has been a key strength of America's economy. The next few years will mark a new phase for the U.S. economy, characterized by accelerated job growth and increased opportunities for small and medium sized businesses.

Endnotes

1 Schweitzer, Mark E. & Scott A. Shane. "The Effect of Falling Home Prices on Small Business Borrowing." Economic Commentary, Cleveland Federal Reserve, Number 2010-18, December 20, 2010. Retrieved from: http://www.clevelandfed.org/research/commentary/2010/2010-18.pdf

2 Small and Medium-sized Enterprises: Characteristics and Performance, United States International Trade Commission, November 2010

3 Ibid