



## SMALL BUSINESS

# Financing Profiles

SME Financing Data Initiative

January 2006

## Young Entrepreneurs

Canada's population is aging and a substantial number of today's entrepreneurs will soon be heading into retirement. To maintain economic growth and prosperity, it will become increasingly important that Canada's youth fill the entrepreneurial void left by the retiring baby-boom generation. Drawing on the comprehensive database of the SME Financing Data Initiative, this article provides a portrait of Canada's young entrepreneurs and examines the effect, if any, of the age of the owner on financing a small business.

**Summary of Key Findings:** Young entrepreneurs are found in all sectors of the economy, with a particularly high presence in knowledge-based industries (KBIs). Although most youth-owned businesses are considered small, as defined by the number of employees, there are relatively few youth involved in self-employment. Businesses owned by youth are more likely to be high-growth and are, for the most part, financially viable. Young entrepreneurs are more likely to identify access to financing as an obstacle to business growth than older entrepreneurs and they appear to have higher request rates for financing. Youth-owned small and medium-sized enterprises (SMEs) are also more likely to have their application refused, but face similar credit conditions as older entrepreneurs when financing is approved by lending institutions. This likely contributes to the higher than average usage of informal financing instruments, such as personal savings and love money, by young entrepreneurs.

### Definitions

This analysis classifies young entrepreneurs as business owners between the ages of 25 and 34 years. Youth-owned small and medium-sized enterprises (SMEs) are defined as those with at least 50 percent ownership by a young entrepreneur in a commercial business (for profit) with fewer than 500 employees and less than \$50 million in annual revenues.

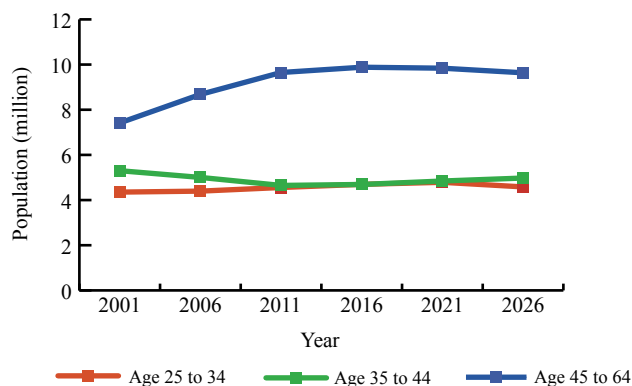
For comparative purposes, the profile and financing activity of young entrepreneurs is examined against SME owners in the 45 to 64 year age bracket. For brevity, this age group will be referred to as older SME owners.

Christine Carrington, Industry Canada

## CANADA'S AGING POPULATION

Canada's median age reached an all-time high of 38 years in 2001, representing the largest census-to-census increase in over a century (Statistics Canada, 2002). Based on Canadian population projections (see Figure 1), the population aged 45 to 64 will continue to rise steadily over the next decade, reaching more than 9.8 million by 2016. Several factors are contributing to this trend: the large post-World War II baby-boom generation, the long-term decline in fertility rates and the longer life expectancy of Canadians.

Figure 1  
Canadian Population Projections (2001–2026)\*



\* Figures represent the medium-growth projection and are based on 2000 population estimates.

Source: Statistics Canada, CANSIM, table 052-0001.

This demographic shift is already having a noticeable effect on Canada's labour force. The working population is increasingly comprised of older individuals: between 1991 and 2001, the percentage of workers aged 45 to 64 rose by 36 percent (Statistics

Canada, 2002). The Canadian Imperial Bank of Commerce (CIBC) reports that the number of firms run by entrepreneurs over the age of 55 (recently coined “seniorpreneurs”) is the fastest growing segment in the small business sector, having risen by 140 000 firms, or 30 percent, from 2001 to 2004 (Small Business, 2004). The CIBC also reports that more than 500 000 Canadian entrepreneurs (20 percent) are heading into retirement within the next five years, followed by an additional 30 percent by 2020 (CIBC World Markets, 2005). This will likely cause skills shortages in several industries (Statistics Canada, 2003). Hardest hit will be Saskatchewan, Atlantic Canada and Alberta, with the highest projected rates of small business owners retiring.

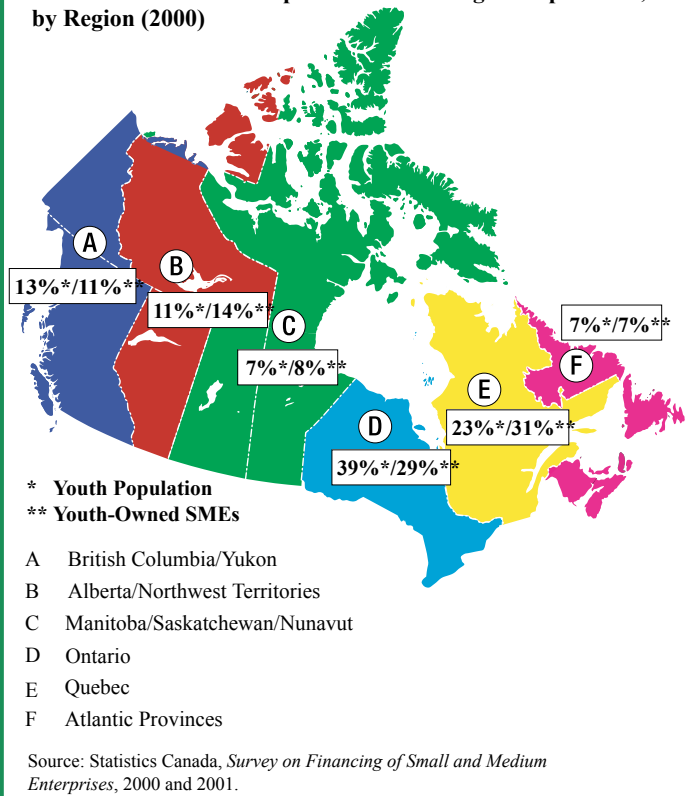
Further complicating the problem for the small business sector is the apparent lack of succession planning by older entrepreneurs. The Canadian Federation of Independent Business (CFIB) recently found that only one third of SME owners are planning for their future succession (CFIB Research, 2005). Furthermore, the majority of these plans are informal and not communicated to intended successors, which risks compromising a successful transition in ownership.

## ENTERING INTO ENTREPRENEURSHIP

It is widely recognized that small and medium-sized enterprises (SMEs) are engines of economic growth, productivity and job creation in Canada. Fostering entrepreneurial activity is therefore a priority of government. During a time when substantial numbers of entrepreneurs are exiting the market, encouraging Canada’s youth to become the next generation of business owners is particularly important.

In 2000, 124 000 of the 1.4 million SMEs in Canada (9 percent) were owned by young entrepreneurs. These firms brought in approximately \$44 billion in combined annual revenues during that year, accounting for 5 percent of the total revenue of all Canadian SMEs.

**Figure 2**  
Distribution of Youth Population and Young Entrepreneurs, by Region (2000)

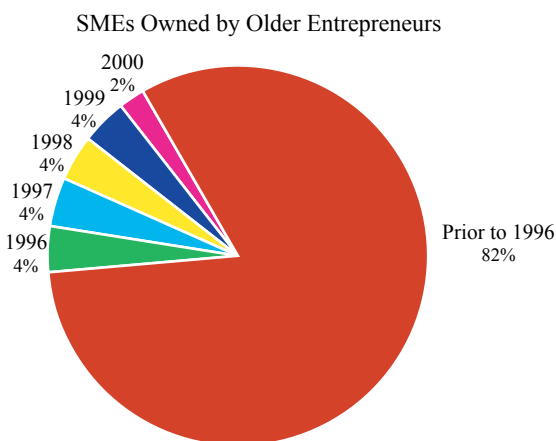
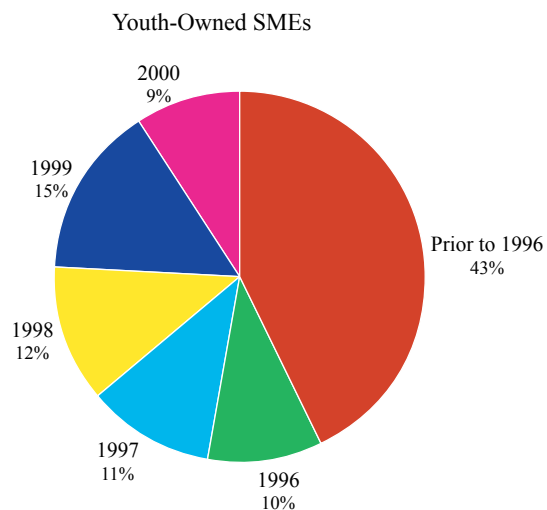


As illustrated in Figure 2, however, the proportion of youth-owned SMEs in Canada is lower than the proportion of youth in the overall population (9 percent versus 13 percent). This discrepancy is primarily due to the under-representation of young entrepreneurs in Ontario, where 39 percent of the population is under 35, but only 29 percent of SMEs are youth-owned. Throughout most other regions, the proportion of young entrepreneurs either matches or exceeds the population of youth.

This situation will likely change soon, however, as older business owners retire and younger business owners enter the market. In fact, since 1996, young entrepreneurs across Canada have been entering the SME marketplace at an average of approximately three times the rate per year of entrepreneurs over the age of 45. Figure 3 compares the two generations of SME owners based on the year their businesses first started selling products and/or services. Not surprisingly, SMEs owned by young entrepreneurs are far newer than businesses with older owners: 57 percent had been in operation for less than

five years, compared with 18 percent of firms from the older cohort.

**Figure 3**  
Year Businesses First Started Selling Products or Services (1996–2000)\*



\* Applicable to firms still in operation in 2001 and excluding firms that began operations but exited the market prior to 2001.

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

## PERCEIVED OBSTACLES TO GROWTH

Starting and establishing a new business in the highly competitive small business marketplace is a challenge for entrepreneurs of all ages. Research has shown that younger business owners may face additional barriers arising from inexperience, lack of a credit history with a financial institution and more modest asset bases upon which to draw (Frazer-Harrison, 2004).

Figure 4 ranks obstacles to business growth identified by Canadian entrepreneurs. Finding qualified labour,

access to financing and fluctuations in consumer demand are the top three barriers perceived by young entrepreneurs. Apart from the shortage of skilled labour, which appears to be a universal problem across Canada (McMullin, Cooke and Downie, 2004), older business owners identify different obstacles, ranking taxation levels and profitability among their three chief concerns.

**Figure 4**  
Perceived Obstacles to Business Growth and Development (2000)

### Young Entrepreneurs

Finding Qualified Labour	40%
Obtaining Financing	39%
Instability of Demand	25%
Levels of Taxation	23%
Low Profitability	19%
Government Regulations	19%
Equipment Renewal	13%
Managerial Skills	11%

### Older Business Owners

Levels of Taxation	40%
Finding Qualified Labour	38%
Low Profitability	34%
Instability of Demand	33%
Government Regulations	29%
Obtaining Financing	23%
Equipment Renewal	17%
Managerial Skills	6%

Source: Research Institute for SMEs, Université du Québec à Trois-Rivières. 2002. "Financing SMEs: Satisfaction, Access, Knowledge and Needs, 2001." Commissioned by Industry Canada.

## PROFILE

### LESS LIKELY SELF-EMPLOYED

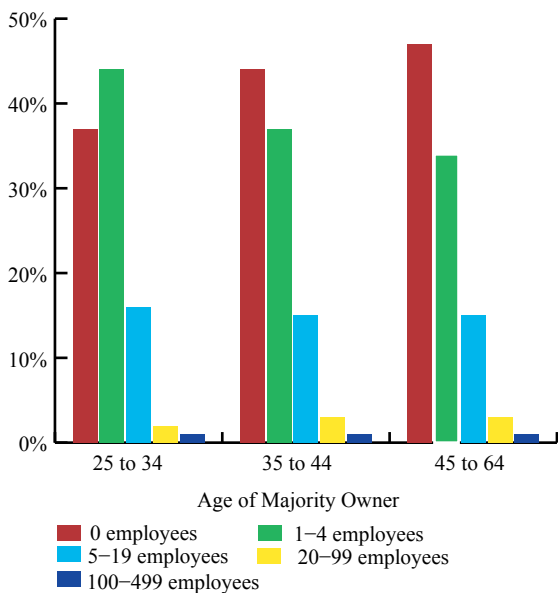
Similar to businesses owned by older entrepreneurs, the majority of youth-owned firms (81 percent) are micro-businesses, which employ fewer than five employees. Unlike older entrepreneurs, however, far fewer young entrepreneurs are engaged in self-employment. As Figure 5 illustrates, only 37 percent of youth-owned firms reported having no employees in 2000, compared with 47 percent of older entrepreneurs.

## PROFILE COMPARISON

Characteristics	Young Entrepreneurs	Older Entrepreneurs
<b>Gender</b>	19% women, 67% men, 14% partnerships	14% women, 65% men, 21% partnerships
<b>Minority Status</b>	12% visible minority, 4% Aboriginal, 1% disabled	8% visible minority, 1% Aboriginal, 2% disabled
<b>Education</b>	75% with post-secondary	60% with post-secondary
<b>Managerial Experience</b>	78% have more than 5 years	93% have more than 5 years
<b>Home-based</b>	60% home-based	54% home-based
<b>Location</b>	71% urban-based, 29% rural-based	74% urban-based, 26% rural-based
<b>Export Activity</b>	7% export outside Canada	11% export outside Canada

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

**Figure 5**  
Distribution of Firms by Business Size in 2000

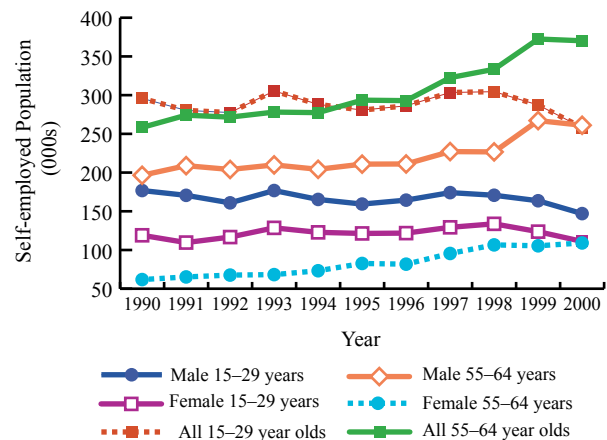


Source: Statistics Canada, *Survey on Financing of Small and Medium Enterprises*, 2000.

Figure 6 provides additional detail on self-employment trends among young entrepreneurs based upon Statistics Canada's *Labour Force Survey*.<sup>1</sup> There was a relatively stable trend of youth self-employment throughout much of the 1990s. Since 1998, however, self-employment levels among young entrepreneurs have been steadily declining for both men and women. By 2000, 147 000 young men and 111 000 young women were self-employed.

Meanwhile, the older cohort of 55- to 64-year-olds have experienced a steady rise in self-employment levels, reaching a peak at 373 000 in 1999. This trend is likely driven by workers exiting the paid labour force as they approach retirement and entering into self-employment. Throughout the past decade, self-employment has doubled in the professional services sector and more than trebled in the management and administration sector for this older cohort (Statistics Canada, *Labour Force Survey*, special order). Among older workers, it is primarily men who are engaged in self-employment, whereas the gender gap for the younger cohort is much smaller.

**Figure 6**  
Self-employment by Age and Gender (1990–2000),  
Monthly Average



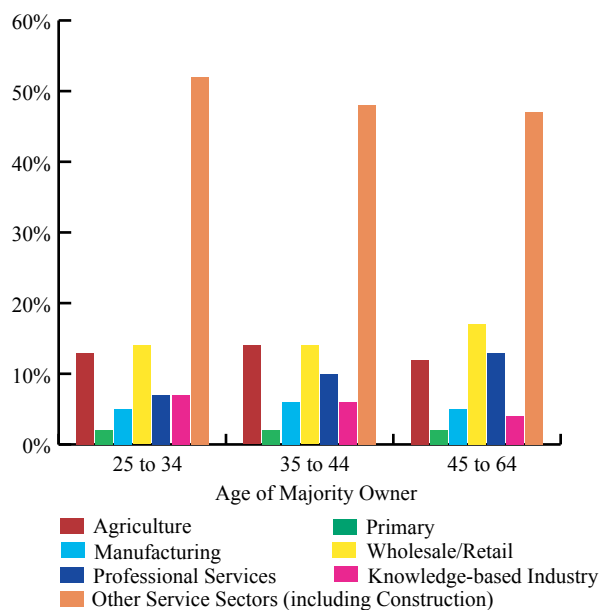
Source: Statistics Canada, *Labour Force Survey*, special order.

<sup>1</sup> Statistics Canada's *Labour Force Survey* considers the wider population of Canada's self-employed individuals of both incorporated businesses (with or without paid help) and unincorporated businesses (with or without paid help). This differs from the narrow definition of self-employed individuals used in the *Survey on Financing of Small and Medium Enterprises*, which considers only those business owners who are the sole operator of a business. Also excluded are unincorporated firms with less than \$30 000 in revenues, non-profit or government organizations, subsidiaries, co-operatives, and finance and leasing companies.

## YOUTH ACTIVE IN THE KNOWLEDGE-BASED ECONOMY

As shown in Figure 7, young entrepreneurs are found in every sector of the Canadian economy. In 2000, 20 percent of youth-owned SMEs operated in either goods-producing or primary sectors and 73 percent were in the service-based sector, which here includes wholesale/retail, professional services and the other service sector groupings. This distribution largely parallels the distribution in other age groups.

**Figure 7**  
Distribution of Firms by Industry Sector in 2000



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

Young entrepreneurs are unique for their proportionally higher presence in the knowledge-based economy. Seven percent of youth-owned SMEs operate in a knowledge-based industry compared with 4 percent of older business owners.

Young entrepreneurs also tend to be more engaged in research and development (R&D) activities. In 2000, 29 percent of youth-owned SMEs devoted part of

their investment expenditures to R&D, compared with 23 percent of SMEs owned by older entrepreneurs. In addition, 33 percent devoted their investment expenditure to technology acquisition and licensing costs compared with 26 percent of firms owned by older entrepreneurs.

## FINANCIAL PERFORMANCE OF YOUTH-OWNED SMEs

Figure 8 presents key financial information for the average youth-owned SME in 2000 compared with the average business owned by an older entrepreneur.

In 2000, the average net profit before taxes for young entrepreneurs was approximately half that of older entrepreneurs. Although important, lower profit levels alone do not necessarily indicate poor financial performance. For a more complete picture of financial performance, earnings must be measured against the assets and capital necessary to generate those earnings.

Three common measures of profitability used for this purpose are the rate of return on assets, the rate of return on equity and profit margins.<sup>2</sup>

The average youth-owned firm has

- slightly lower rates of return on assets (7 percent versus 10 percent among older entrepreneurs);
- lower rates of return on equity (19 percent versus 24 percent); and
- similar profit margins (7 percent versus 8 percent).

Under debt management, the average youth-owned SME had a debt-to-equity ratio of 1.7 compared with an average of 1.3 for other SMEs. Higher levels of debt-to-equity indicate a firm may not be able to cover interest and debt payments and increase the perception of risk associated with the business. In the short term, youth-owned SMEs are in line with the liquidity of other SMEs, with a ratio of current assets to short-term debt of 1.4 versus 1.5.<sup>3</sup>

<sup>2</sup> 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).

<sup>3</sup> 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.



**Figure 8**  
**Financial Statement Figures,\* 2000**

		Youth-Owned SMEs (average \$)	SMEs Owned by Older Entrepreneurs (average \$)
Revenues	Sales	376 000	622 000
	Total Revenue	389 000	645 000
Expenses		362 000	596 000
Net Profit (loss) Before Tax		26 000	49 000
Assets	Current	150 000	206 000
	Fixed	204 000	283 000
	Total	353 000	489 000
Liabilities		220 000	278 000
Equity	Owners'	78 000	123 000
	Total	133 000	211 000

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

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

Overall, these indicators suggest that youth-owned SMEs are not performing as well as firms owned by older entrepreneurs. Nevertheless, youth-owned SMEs are financially viable, particularly considering their shorter length of time in the marketplace and that many young entrepreneurs are still in the process of establishing themselves. The extent to which their financial performance is a reflection of sector and size is not yet clear.

## FINANCING

Past research on whether that youth face difficulties in accessing financing for their ventures has been primarily based on anecdotal evidence, which points to the lack of business and financial track records, workable business plans and business acumen, along with poor credit ratings or heavy student loan debts.

The following section examines financing activity, capital and debt structures of youth-owned SMEs in comparison with businesses owned by older entrepreneurs. Higher financing refusal rates and a likelihood of turning to informal sources of financing indicate that younger entrepreneurs may indeed be

experiencing more difficulty in accessing sufficient levels of capital for their businesses.

## ACTIVITY

As most businesses owned by young entrepreneurs are newer and still in the development stage, sufficient levels of capital are a critical component in fostering growth and expansion. Figure 9 presents an overview of the financing activity of youth-owned SMEs during 2000 compared with firms owned by older entrepreneurs. In 2000, young entrepreneurs exhibited significantly higher demand for debt, leasing and equity than firms owned by older entrepreneurs. Youth reported that financing was most often needed for working capital in the business, which is similar to reported financing needs of businesses run by other age groups. Accordingly, young entrepreneurs were most likely to apply for new lines of credit and term loans, often in amounts of less than \$100 000. (see “Credit Conditions for Young Entrepreneurs in 2000” text box for additional credit application details).

**Figure 9**  
**Financing Request and Approval Rates (2000)**

		Youth-Owned SMEs	SMEs Owned by Older Entrepreneurs
Type of Financing		%	
Debt Financing	Request Rate	37	20
	Approval Rate	78	82
Lease Financing	Request Rate	14	8
	Approval Rate	97	99
Equity Financing	Request Rate	3	2
	Approval Rate*	80	82

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

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

Young entrepreneurs are slightly more likely to have their applications rejected by financial institutions. In 2000, 78 percent of their credit applications were approved compared with 82 percent for older

business owners. Fewer years dealing with a financial institution (66 percent of youth have been dealing with a financial provider for less than 7 years) and a lack of a solid credit history may contribute to a lower approval rating. A relative deficiency in assets to pledge as security for financing may also be a factor, yet fewer youth-owned SMEs were required to pledge assets as collateral than SMEs owned by older entrepreneurs. Further research is required to uncover the actual causes for lower financing approval rates among younger entrepreneurs.

Following the pattern found with older entrepreneurs, the majority of young entrepreneurs requested debt financing from chartered banks (64 percent versus 66 percent for older SME owners), followed by credit unions or caisses populaires (21 percent versus 20 percent). Of those youth that did not apply for financing in 2000, most (89 percent) reported it was because their business did not need it. Seven percent of youth avoided applying for financing because they thought their application would be rejected by their financial provider, a concern shared by only 4 percent of older entrepreneurs.

#### **Credit Conditions for Young Entrepreneurs in 2000**

- The most requested forms of debt were new lines of credit (35%) and term loans (31%).
- Youth, on average, requested new lines of credit for \$30 000 and were authorized for \$28 000 (\$118 000 requested and \$112 000 authorized for older entrepreneurs).
- For term loans, the average request was for \$88 000 with \$82 000 authorized (\$129 000 requested and \$129 000 authorized for older entrepreneurs).
- 30% of young entrepreneurs requesting financing were required to pledge personal assets as security (40% for older entrepreneurs).
- 37% of young entrepreneurs were required to pledge business assets (42% for older entrepreneurs).
- Business financial statements, formal applications and personal financial statements were the most common documents requested by the credit supplier

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

## **CAPITAL STRUCTURE**

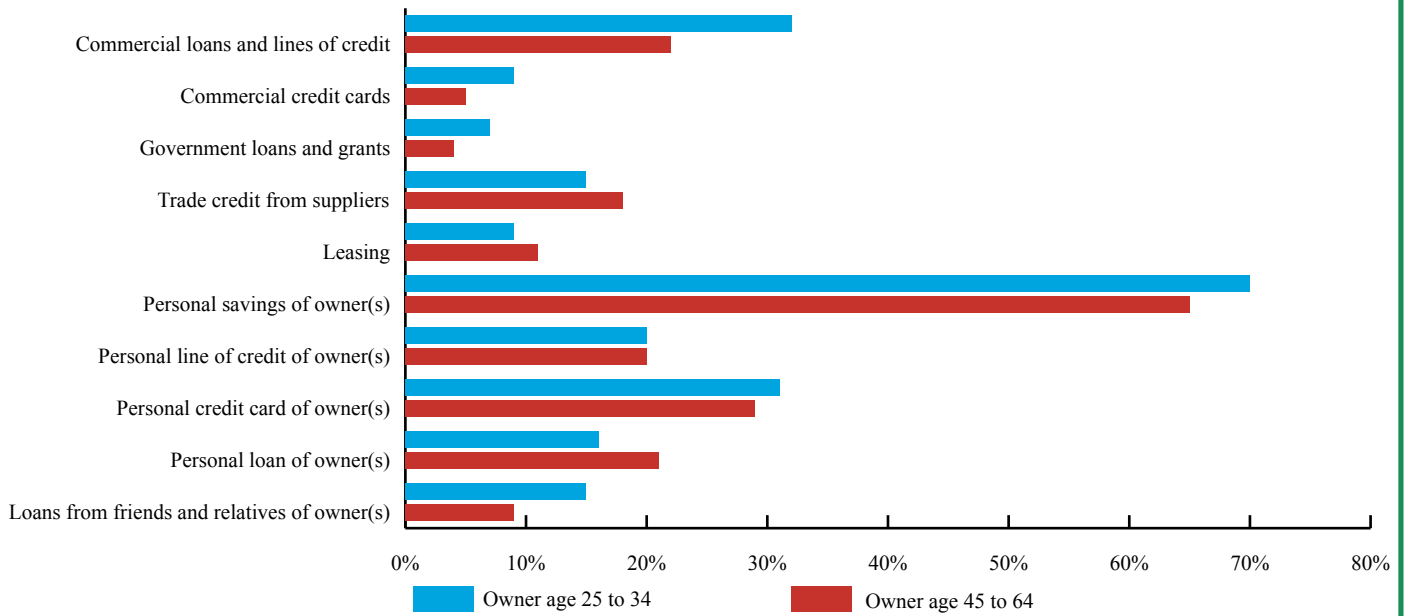
Figures 10 and 11 list the top ten sources of financing used by young entrepreneurs compared with older business owners during start-up and during established operation in 2000.

Not unlike business owners of other age groups, young entrepreneurs primarily finance the cost of starting up their business through their own personal savings, as well as other informal methods such as their personal credit instruments and “love money” from friends and relatives. However, SMEs owned by youth also report using formal sources of commercial credit to a greater extent than older entrepreneurs. During business start-up, 32 percent of young entrepreneurs used commercial loans or lines of credit compared with 22 percent of older entrepreneurs. Although this is consistent with the higher than average financing request rates seen among youth-owned SMEs in Figure 9, it conflicts with past anecdotal evidence claiming that younger entrepreneurs were unable to access formal financing instruments during early stages of business development.

Young entrepreneurs also make slightly higher use of government programs than older business owners. Seven percent of start-up youth-owned SMEs (see Figure 10) and 11 percent of established youth-owned SMEs (see Figure 11) used government programs as a source of capital.

As businesses mature, ongoing capital requirements become financed increasingly through formal financing instruments obtained from financial institutions (e.g. commercial credit, trade credit from suppliers, leasing, etc.). This is illustrated in Figure 11 for both youth-owned SMEs and businesses owned by older entrepreneurs. However, younger entrepreneurs also continue to use informal financing sources beyond the start-up stage to a far greater extent than older entrepreneurs. Nearly half (44 percent) of young entrepreneurs report using personal savings to finance ongoing operations compared with 34 percent of older entrepreneurs, and there is similarly high usage

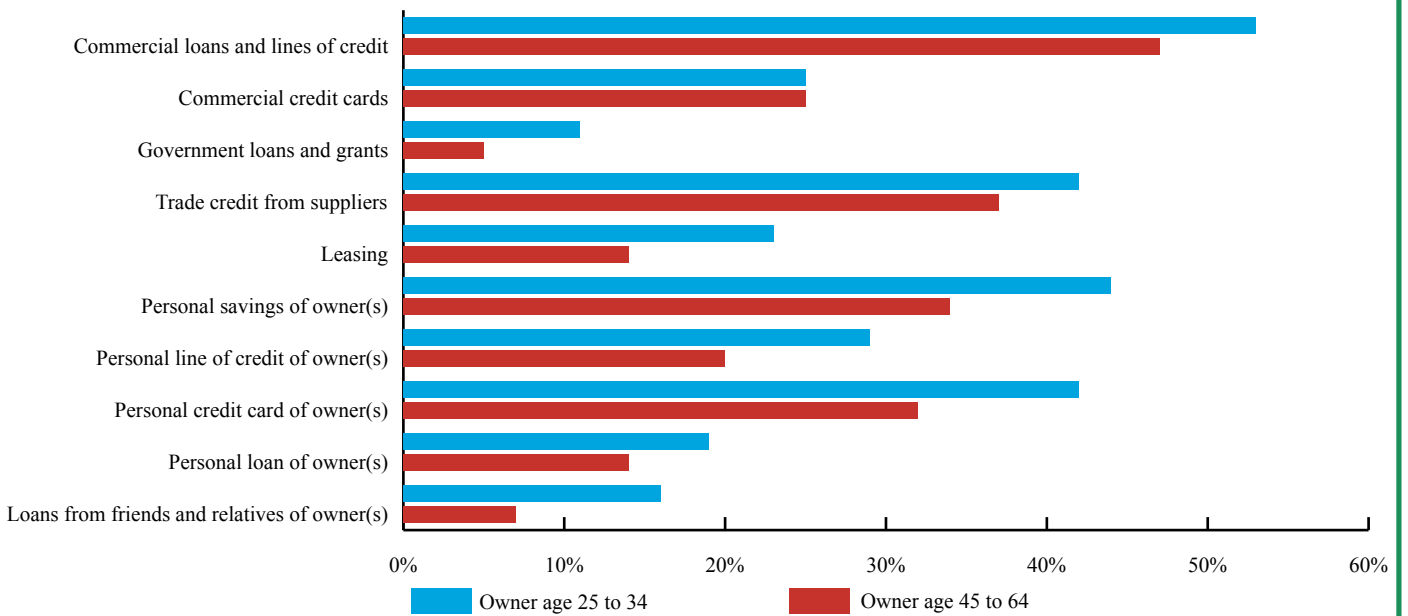
**Figure 10**  
**Top Ten Sources of Financing Used During Start-up\***



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

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

**Figure 11**  
**Top Ten Sources of Financing in 2000\***



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

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



of the owner's credit instruments and love money among youth-owned SMEs. Elevated overall usage of informal financing instruments is consistent with financing data collected on newer firms, particularly those experiencing higher growth (Industry Canada, 2003). The extent to which high usage of informal sources is also reflective of youth being unable to access formal credit instruments is unclear and requires additional research.

## DEBT STRUCTURE

Young entrepreneurs owed a combined total of \$25 billion in debt in 2000. The distribution of debt by source is shown in Figure 12. Consistent with entrepreneurs of other age groups, the largest single source of debt for young entrepreneurs is chartered banks, with a 26-percent share of youth debt, followed by trade credit owing to suppliers, with a 25-percent share.

**Figure 12**  
**Allocation of Debt by Source, 2000**

Type of Supplier	Youth-Owned SMEs	SMEs Owned by Older Entrepreneurs
	%	
Chartered Banks	26	28
Credit Unions/ Caisses populaires	6	6
Credit Cards	1	1
Government Programs	8	5
Leases	1	1
Loans from Individuals	21	17
Trade Credit from Suppliers	25	20
Other	12	22
Total Debt	100	100

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

Two notable differences for young entrepreneurs are the higher than average proportions of debt owed to private individuals (accounting for 21 percent of youth debt) and government financing programs (accounting for 8 percent). Of the debt owed in the form of individual loans

- 65 percent was owed to other business owners;
- 25 percent was owed to relatives;
- 6 percent was owed to friends; and
- 14 percent was owed to other individuals.

## RISK CAPITAL

Risk capital, which encompasses forms of early-stage equity financing such as angel investment and formal venture capital, can be an important source of financing, particularly for technology-driven or high-growth potential firms. Risk capital can offer these firms the substantial amounts of capital necessary for their expansion, but the owner must be willing to hand over a share of the business in return.

Few young entrepreneurs, as with other age groups, seek equity financing. In 2000, only 3 percent of SMEs owned by youth applied for equity financing, of which 80 percent acquired it. However, young entrepreneurs are more willing to share equity in their firm to obtain capital in order to grow, expand or refinance. Of young entrepreneurs currently in a majority position within the business, 49 percent say they are willing to share more equity to raise capital compared with 31 percent of older entrepreneurs.

## SUMMARY AND DISCUSSION

Canada's population of young entrepreneurs will become increasingly important over the coming decade as the large baby-boom generation enters retirement. Young entrepreneurs are located throughout Canada and operate in all sectors of the economy, with somewhat higher concentrations in the knowledge-based sectors.

A significant obstacle perceived by young entrepreneurs is access to sufficient levels of financing for their businesses, although few empirical studies have examined financing barriers faced by youth-owned SMEs (Heidrick and Nicol, 2002). SME Financing Data Initiative research points to a few factors that may complicate access to financing for younger entrepreneurs:

- their firms appear riskier because they are newer (i.e. have less credit history), more concentrated in knowledge-based industries (which often have fewer tangible assets to pledge as collateral), and often higher growth (which has been associated with higher financial risk);

- their firms are small and less established in their sector of operation;
- although financially viable, their firms do not perform as well as businesses owned by older entrepreneurs; and
- they have fewer years of management experience.

Ironically, many of these factors also increase the capital needs of youth-owned SMEs. As newer, fast-growing businesses, youth-owned SMEs have significantly higher request rates for all forms of financing. At the same time, young entrepreneurs are slightly more likely to have their application refused by a financial institution. Perhaps as a result, youth-owned SMEs finance their operations through informal financing methods more often than firms owned by older entrepreneurs. Additional research is needed to understand the extent to which lack of a career or credit history, underdeveloped business networks, lower asset holdings to use for collateral, or large student debt loans are also contributing to financing difficulties for young entrepreneurs.

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## 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 and visible minority 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](http://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](http://www.statcan.ca).

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