

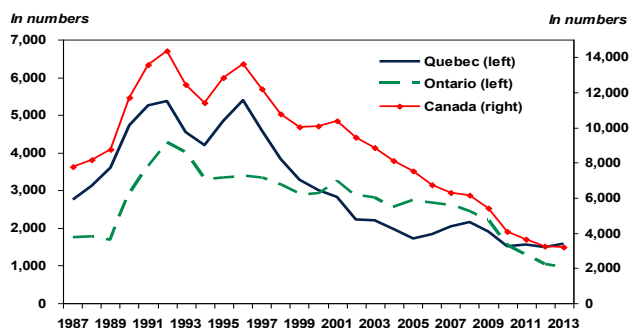
Business bankruptcies: Economic situation, knowledge gaps and differences

Business bankruptcies remain very high in Quebec, especially when compared to the situation in other Canadian provinces. Their numbers today are considerably lower than they were 20 years ago, however. Other than an economic downturn, a lack of management skills is one of the main reasons for these insolvencies, if the analyses offer any proof. The reasons given for this knowledge gap also shed light on potential solutions that are worth exploring. While entrepreneurs have little control over the bigger economic picture, their business knowledge is something that can surely be improved.

HEALTH CHECK

Quebec has made substantial strides since 1987 in terms of bankruptcies (graph 1). Since Quebec struggled through the 1990s, which began with a deep recession, fewer and fewer businesses in Quebec have filed for bankruptcy since the peak reached in 1996, with 5,399 bankruptcies. Bankruptcies have been on a slow downtrend since then until the recession episode in 2009, when the level of bankruptcies spiked at 2,157—less than half the peak recorded in 1996. In 2013, 1,591 businesses filed for bankruptcy.

Graph 1 – Overall, bankruptcies are declining



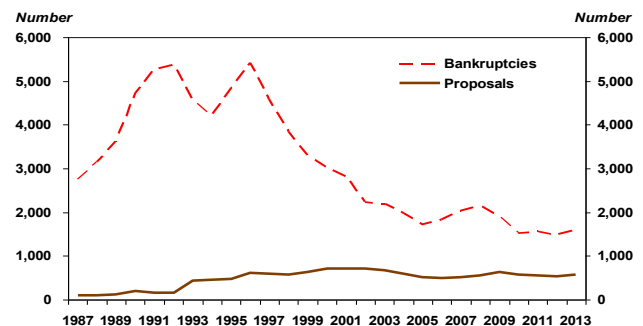
Sources: Office of the Superintendent of Bankruptcy Canada and Desjardins, Economic Studies

Quebec has suffered a greater share of bankruptcies than Ontario in the past three years, a phenomenon that had already been observed prior to the year 2000. That said, when viewed through the standpoint of assets and liabilities, bankruptcies in Ontario have outpaced those in Quebec by far for the past 20 years, with the exception of two periods: 1998 and 2013. Put briefly, Quebec may have more

bankruptcies, but the scale of the bankruptcy is smaller (table 1 on page 4).

How do we explain the steady decline over time in the number of bankruptcies in Canada, Ontario and in Quebec? According to Professor Janis Sarra from the Faculty of Law at the University of British Columbia in an empirical study on business bankruptcies and proposals between 2005 and 2008 in Canada: "...since the 1992 and 1997 amendments to the Bankruptcy and Insolvency (BIA), the public policy priority has been to try to rehabilitate insolvent businesses. One objective of the BIA reform in 1992 was to promote business proposals as an alternative to bankruptcy..."¹ As graph 2 clearly illustrates, business proposals have increased since 1992, but they appear to have levelled off for slightly more than the past 15 years.

Graph 2 – Quebec: Since 1992, bankruptcies have fallen while proposals have edged up



Sources: Office of the Superintendent of Bankruptcy Canada and Desjardins, Economic Studies

¹ Sarra, Janis, Failure to Capture the Brass Ring: An Empirical Study of Business Bankruptcies and Proposals under the Canadian Bankruptcy and Insolvency Act, Faculty of Law, University of British Columbia, April 2009, 116 pages.

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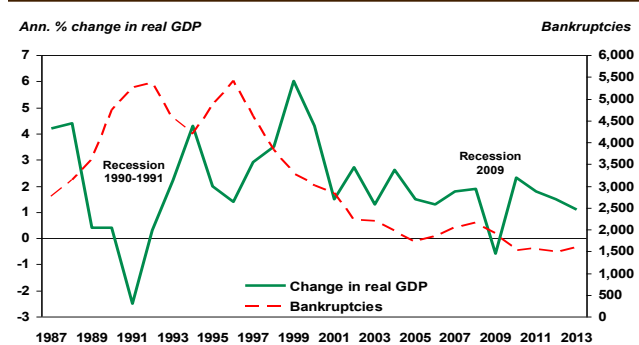
NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.

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BANKRUPTCIES AND RECESSION

As graph 1 shows, recessions have a highly variable impact on the rise in the number of business bankruptcies. That said, the most recent economic crisis did not do nearly the same damage as we saw in the 1990s. Graph 3 allows us to compare the change in Quebec’s real GDP against the number of bankruptcies. On one hand, we can observe that both recessions were quite different in scope, and on the other, businesses had a much more moderate reaction to the most recent recession.

Graph 3 – Quebec: The impact of a positive or negative economic environment is clear

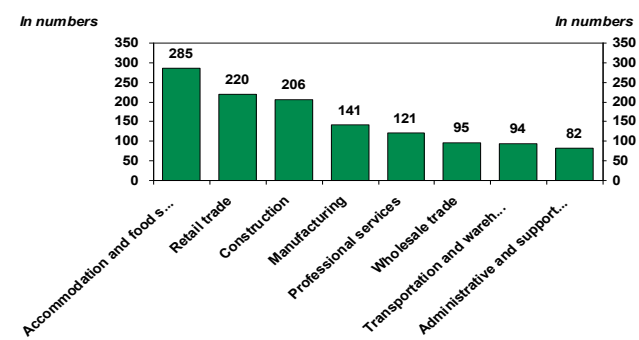


Sources: Office of the Superintendent of Bankruptcy Canada, Institut de la statistique du Québec and Desjardins, Economic Studies

A WIDE RANGE OF SECTORS AFFECTED

A snapshot of 2013 shows the ranking of the most heavily affected sectors, with accommodations and food services leading the number of businesses forced to file for bankruptcy (graph 4), followed by retail trade—embattled by fierce competition from the recent flood of mass-market trade banners from the United States—and by construction, the pace of which slowed somewhat last year.

Graph 4 – Quebec: Accommodation and food services topped the list in 2013



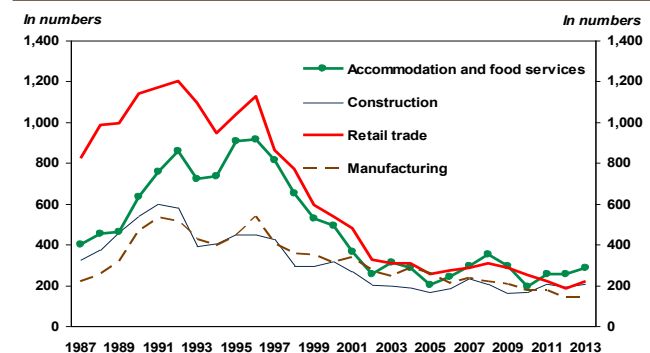
Sources: Office of the Superintendent of Bankruptcy Canada and Desjardins, Economic Studies

Manufacturing ranks fourth, which is not much of a surprise given the vigorous competition worldwide. However, the number of bankruptcies in this sector continues to trend downward, and could be pushed down even further by a weak Canadian dollar, the resurgence of the U.S. economy and the partial return of certain manufacturing activities to North America.

In 2013, the professional, scientific and technical services sector was hurt by the decline in the residential sector, the slowdown in the pace of large-scale infrastructure projects, the post-recession slowdown in mining activity and soft prices for metals.

A look back over the past 25 years shows that the accommodations and food services sector has not always topped the list. Graph 5 shows the dynamics in this sector over the past 27 years. We can see that the four most affected sectors have all seen bankruptcies decline over time. Retail trade, which long held the top spot on the list of the most impacted sectors, has recently been overtaken by accommodations and food services.

Graph 5 – Quebec: Accommodation and food services conceded the top spot to retail trade



Sources: Office of the Superintendent of Bankruptcy Canada and Desjardins, Economic Studies

Bankruptcies in the accommodations and food services sector are not surprising for anyone with any knowledge of this economic activity. Many entrepreneurs try to make their way in the restaurant business without having a strong grasp of the trade and they run the risk of having to close up shop quickly. According to the Association des restaurateurs du Québec, only 15.3% of restaurants survive beyond nine years, and more than 71% of restaurants close their doors after five years of being in business.²

² Association des restaurateurs du Québec, <http://www.restaurateurs.ca/>

THE REASONS FOR BUSINESS BANKRUPTCIES

There is a lack of in-depth studies on business bankruptcies in Canada and in Quebec. However, the study conducted by Statistics Canada in 1997³ for Industry Canada and the 2009 study by Professor Janis Sarra from the University of British Columbia drew similar conclusions in some respects. There is no one single reason why businesses fail. As seen earlier, economic conditions and especially recessions have a substantial impact on a business's ability to stay in business.

Management weaknesses are a consistent factor in both studies (table 2). Statistics Canada concluded that almost half of all business bankruptcies in Canada are largely attributable to internal factors within the business. Management failings were highlighted and substantial shortcomings in the area of financial management were also formally identified as causes. Three specific problems in this area were flagged: an unbalanced capital structure, an inability to manage working capital and undercapitalization. The study in fact states that “the underlying factor contributing to financial difficulties is management failure rather than external factors associated with imperfect capital markets.”

More recently, Professor Sarra studied 6,000 insolvency cases (bankruptcies and business proposals) in Canada from 2005 to 2008. Her study, submitted in 2009, had an initial finding consistent with the Statistics Canada study: poor management is the key variable in the insolvency equation. Professor Sarra also analyzed businesses based on their legal structure: incorporated businesses (or partnerships in Quebec), sole proprietorships and corporations. Management topped the list in all three categories (table 2 on page 4).

In general, undercapitalization is the second cause of business insolvencies. In the case of sole proprietorships, businesses suffer from insufficient capital. For the other two structures, a lack of capital just when the business needs to expand or change direction is the main reason why these businesses fail.⁴

Overextension of credit or over-indebtedness is another major cause of insolvency, with credit card debt playing a large role in small business bankruptcies. Despite the 10-year period separating both studies, both studies show similarities in their findings.

³ Statistics Canada, *Failing Concerns: Business Bankruptcies in Canada*, 1997, 72 pages. Catalogue no. CS61-525E.

⁴ For more information on SMEs in Quebec and equity financing, see Desjardins, *Economic Studies, For a more entrepreneurial and prosperous Quebec*, 2014, p. 55 (full report in French only)

MORE BANKRUPTCIES IN QUEBEC

As we have seen, Quebec has the highest number of bankruptcies of all the Canadian provinces. No studies exist that are comparable to the studies on Canada as a whole that apply to Quebec and explain the variance with the other provinces. However, a few organizations and analysts have opinions on the matter.

For the Fondation de l'entrepreneuriat, the lack of support for Quebec's entrepreneurs is behind this situation. Inconsistencies in government programs and an insufficient number of mentors in Quebec were flagged as reasons. In their opinion, financing is not at issue.

For the Canadian Federation of Independent Business, a group comprising mostly SMEs, the high cost of regulatory compliance and the high tax rate—federal and provincial—for Quebec's SMEs explain the situation.

Analysts posit that Quebec's higher ratio of smaller businesses compared to Ontario could be one explanation, meaning that smaller businesses are, by extension, more fragile.

Of all the sectors, the food services sector has generated the most documentation. Quebec stands apart from the other provinces in the higher percentage of independent restaurant owners vs. larger restaurant chains—at 72%—compared to 64% in the rest of Canada. This suggests that an affiliation with a network with a head office and well established business practices for inventory management, traffic, employees, financial ratios, etc., that offers support to managers under a well-known banner are markers that limit spur-of-the-moment decision-making.

FINDING SOLUTIONS WITHIN THE REASONS

Pinpointing the specific causes that push businesses to file for bankruptcy is difficult to do. However, the studies conducted in Canada and the observations of the organizations who work with entrepreneurs show that bankruptcies in Quebec are the result of a confluence of factors: financial circumstances that are at times more difficult, knowledge gaps and differences with other regions in Canada. The reasons advanced in the studies and by those working close to the action offer just as many solutions that are worth exploring. But based on what is happening elsewhere in Canada, Quebec has to roll up its sleeves.

Joëlle Noreau
 Senior Economist

Table 1 – Evolution of bankruptcies in Canada from 2000 to 2013

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|--------------------------------|--------|--------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| Canada | 10,060 | 10,399 | 9,463 | 8,849 | 8,136 | 7,537 | 6,747 | 6,293 | 6,164 | 5,420 | 4,072 | 3,643 | 3,236 | 3,187 |
| Newfoundland | 120 | 104 | 80 | 59 | 56 | 56 | 45 | 52 | 39 | 33 | 21 | 24 | 15 | 21 |
| Nova Scotia | 352 | 403 | 312 | 277 | 255 | 277 | 241 | 206 | 162 | 146 | 138 | 95 | 86 | 84 |
| Prince Edward Island | 26 | 33 | 36 | 36 | 39 | 41 | 41 | 32 | 14 | 27 | 16 | 15 | 13 | 18 |
| New Brunswick | 226 | 256 | 237 | 218 | 207 | 203 | 193 | 151 | 196 | 101 | 70 | 43 | 53 | 64 |
| Quebec | 3,017 | 2,822 | 2,225 | 2,197 | 1,968 | 1,714 | 1,834 | 2,035 | 2,157 | 1,894 | 1,520 | 1,569 | 1,488 | 1,591 |
| Ontario | 2,925 | 3,260 | 2,875 | 2,794 | 2,558 | 2,730 | 2,671 | 2,585 | 2,437 | 2,208 | 1,533 | 1,276 | 1,042 | 958 |
| Manitoba | 253 | 300 | 249 | 243 | 178 | 149 | 160 | 102 | 103 | 65 | 68 | 60 | 36 | 55 |
| Saskatchewan | 437 | 412 | 338 | 379 | 368 | 374 | 301 | 204 | 150 | 161 | 99 | 104 | 79 | 68 |
| Alberta | 1,712 | 1,700 | 1,994 | 1,640 | 1,570 | 1,195 | 666 | 449 | 447 | 405 | 378 | 264 | 230 | 137 |
| British Columbia | 980 | 1,098 | 1,108 | 1,002 | 923 | 786 | 587 | 470 | 454 | 380 | 229 | 192 | 192 | 189 |
| Territories, Yukon and Nunavut | 12 | 11 | 9 | 4 | 14 | 12 | 8 | 7 | 5 | 0 | 0 | 1 | 1 | 2 |

Source: Office of the Superintendent of Bankruptcy Canada

Table 2 – Bankruptcies and insolvencies in Canada: the key factors

| Source | Incorporated businesses | Sole proprietorships | Partnerships |
|---|---|--|---|
| Dr. Janis Sarra UBC - Faculty of Law Examined 6,000 cases from 2005 to 2008 (study completed in 2009) | Management weaknesses Low business volume Excessive debt Economic downturn | Poor business and money management Over-indebtedness Undercapitalization Economic downturn Failure to pay taxes | Same causes as for sole proprietorships, with an emphasis on: Undercapitalization Over-indebtedness |
| | Consistent factor - In all cases: mismanagement | | |
| | Second most recurrent factor - Undercapitalization | | |
| | Third most recurrent factor - Over-indebtedness or overextension of credit | | |
| | Credit card debt played a major role in small business bankruptcies. | | |
| Statistics Canada 1997 | Almost 50% of bankruptcies in Canada are primarily due to shortcomings in business management rather than issues that are out of the owners' control: - Shortcomings in business management - Lack of opportunities for their product Bankruptcies are primarily due to managers' lack of experience Financial management represents a major shortcoming, with 3 problems cited most often: - Unbalanced capital structure - Inability to manage working capital - Undercapitalization | | |

Sources: *Failure to Capture the Brass Ring: An Empirical Study of Business Bankruptcies and Proposals under the Canadian Bankruptcy and Insolvency Act*, Statistics Canada, *Business Bankruptcies in Canada*, 1997, 72 pages. No. 61-525-XIE in the catalogue and Desjardins, Economic Studies.