

## **Executive Summary**

### **Motivation**

- During the process of founding an enterprise, founders must make a number of strategic decisions in order for their new enterprise to successfully enter the market. Even after a successful start in the market, important strategic decisions have to be made to establish the enterprise sustainably in the market. Decisions made at any particular moment necessarily have consequences for future strategic decisions.
- Not all strategies that are chosen by young entrepreneurs are successful. In extreme cases, misguided strategic decisions can render the enterprise unviable and force it out of the market. Securing the survival of an enterprise can be regarded as the overriding goal and, therefore, as the main criterion of success.
- The present report on the results of the 2012 KfW/ZEW Start-up Panel examines strategic decisions in the areas of human resources and financial management. It also discusses aggregated closure rates of young enterprises and determinants of the individual likelihood of survival. A particular focus is on possible correlations between the strategic decisions on employment and financing on the one hand and the likelihood of survival on the other.

### **Employment trends and employee turnover**

- The immediate gross employment effect (GEE) from start-ups in 2011 was 416,000 full-time equivalent job positions, 59% of which were jobs for the founders themselves and 41% were jobs for employees. In 2009 the GEE reached nearly 520,000 jobs, the highest level of the past seven years. This high level could not be sustained in the subsequent years. Thus, in 2010 the GEE was already 31,500 jobs lower and dropped by a further 72,500 jobs from 2010 to 2011.
- The growth of one-year-old enterprises was just under 34% on average in 2011. Two-year-old enterprises continued the previous year's growth in the year 2011 but only at an average rate of 24%. The average strong growth in employment is generated by a minority of young enterprises (on average, 41% of enterprises). Most enterprises (59%), however, do not grow or actually contract.
- At the enterprise level, employee turnover already plays an important role in young enterprises. Employee turnover that is generated merely by replacing employees so that

the number of employees ultimately remains unchanged is referred to as churning. Churning causes costs, for example through the loss of expertise of employees who have left or from searching for and inducting new employees.

- If the new entrepreneurs have professional experience in the industry in which the young enterprise operates or previous experience from a management position held in another enterprise, this reduces the churning rate. In contrast, a poor financial situation (losses in the previous year or difficulties in obtaining debt capital) and a decline in employment are risk factors for increased churning. A possible explanation for this is that employees leave financially weak enterprises and proactively go to enterprises that have better future prospects.
- Business founders with little management experience should very carefully plan the recruitment of employees. This may enable them to prevent employees from leaving the enterprise after a short time and having to replace them at high cost.
- The management of young enterprises should take steps to retain their employees in due time to prevent high churning rates, particularly in difficult times. Otherwise their enterprises run the risk of losing more employees, who may be hard to replace, than would be necessary as a result of the crisis. The high costs of churning can aggravate the difficulties of the enterprise further and force it out of the market.

### **Financing behaviour of young enterprises**

- In young enterprises, injection of capital from outside, that is, funds of the proprietors or founders or debt capital, is very likely. Around 87% of enterprises founded in 2007 injected external funds in their first business year. Around 33% of new enterprises also use debt capital, or funds from third parties such as a short and long-term bank loans, promotional funds or loans from family or friends and other sources. Although the share of these funds was reduced by the fifth business year, it was still significant, at 33% external capital and 23% external financing by third parties.
- Financing decisions have longer-term impacts. Young enterprises that use external or debt capital in one business year use the respective funding type in the subsequent business year significantly more often. The decision whether to use external or debt capital in the year of establishment is also influenced by the characteristics of the founder. In the subsequent years, however, the founder's personal background and characteristics no longer play a direct role. They continue to have an indirect effect through the financing decisions made in the previous years, but in subsequent years it is

the business characteristics that are decisive for the financing decisions. A significant and stable determining factor is the turnover/cost ratio of the enterprise.

- The start-up motive has a significant impact on financing behaviour. Opportunity-orientated founders who want to explicitly implement a business idea tend to depend more strongly on the use of external or debt capital because they are more strongly orientated to growth. Enterprises founded by people who primarily want to work as their own bosses, on the other hand, are less likely to use external or debt capital.
- The turnover/cost ratio is an important parameter because a higher turnover/cost ratio of an enterprise not only makes it less reliant on external and debt capital but also reduces the occurrence of financing difficulties in the year of its establishment. This is important because financing difficulties in one business year make financing problems more likely in the subsequent year as well.
- There is no guarantee that enterprises will have access to funds from providers of external capital, which is why entrepreneurs should carefully prepare their search for external financing by third parties. Even if only 15% of the start-up cohort of 2007 reported financing problems with external providers of capital, nearly half of these young enterprises (44%) will also have difficulties with third-party providers of capital in the subsequent year. This shows that there is a certain degree of regularity in the occurrence of financing difficulties. Financial planning should therefore take high priority.
- In the first business years, an enterprise usually does not sustain itself from its own resources. The decisions on investing equity and borrowing have a longer-term impact and are therefore too serious to be taken in an ad-hoc manner. Moreover, the financing of the enterprise must be aligned with the business idea.

### **The survival of young enterprises**

- Young enterprises are considered to be more at risk of closure than older enterprises. After five business years, some 40% of start-up companies from any particular year are no longer in the market.
- The most recent financial crisis has had different impacts on the start-up cohorts. The older the start-ups were, the lower was the increase in closure rates. This means that the 2009 crisis has made closure significantly more likely for young start-ups than for older ones.

- The business founders' industry experience is of high importance for survival once the enterprise was founded, but this effect becomes weaker as the enterprise become older and, thus, as the founders gain experience – even those who were novices at the start.
- The risk of closure is higher in cases where founders possess entrepreneurial experience already before starting the enterprises surveyed here. To what extent this indicates a higher risk propensity of experienced founders or whether they have not learned enough from previous experience cannot be answered here.
- Not surprisingly, financing difficulties negatively impact on the survival of young enterprises. In contrast, the use of debt capital to finance business activity does not appear to indicate a higher risk of closure.
- R&D activities have no impact on the risk of closure in the first four business years but significantly increase the likelihood of survival in the subsequent year. Enterprises that conduct R&D activities lay the groundwork for a renewed product offer and thereby secure their continued survival in the market.
- For enterprises in their fourth year, the risk of leaving the market increases as the number of employees rises. Some enterprises may have chosen an excessively risky growth strategy and have grown "too fast". When they encounter difficulties, employees cause fixed costs, at least in the short term, that cannot be easily lowered.
- Risks also arise from high employee turnover. For young enterprises the risk of closure rises with increasing churning rates. High employee turnover may, however, also indicate problems among the employees or between the management and employees, or that employees choose to leave the enterprise because of difficulties in the enterprise to look for a more secure job.

### **The KfW/ZEW Start-up Panel**

- The KfW/ZEW Start-up Panel provides the first database for Germany that monitors start-up companies from the moment they are founded across several years and at the same time provides a broad range of specific information about the entrepreneurs and their start-ups. In particular, the unique analysis potential of the Panel is to incorporate a time dimension into the analyses. These analyses include the identification of differences that become apparent as an enterprise grows older and analyses of start-ups repeatedly interviewed over time about trends that have so far occurred in their life cycle.

- The whole survey population forms the Mannheim Enterprise Panel, which is based on business start-up data captured by the credit agency Creditreform. The survey covers new enterprises which are either listed in the commercial register, have resorted to debt capital, business loans or similar resources for their foundation, or are otherwise actively integrated into the economic process (so-called economically active start-ups). The KfW/ZEW Start-up Panel provides a representative view of this important segment of start-up enterprises.
- Each year, around 6,000 newly established and young enterprises are surveyed for the KfW/ZEW Start-Up Panel. The fifth survey wave which was conducted from April to July 2012 included start-ups from the years 2005-2011. The sample comprised both young enterprises from the 2005-2010 cohorts which had already participated in the survey in previous years and start-ups from the years 2009-2011 which were surveyed for the first time.