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Tough climate for German SMEs: competition increases, the three 'I's promise success

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Germany's competitive position is under constant pressure. The climate is also tough for small to medium-sized enterprises (SMEs), as competition has picked up, pricing pressure is growing and greater flexibility is needed. Most of the competition for SMEs is found at home.

These companies rely on their existing strengths: Their main competitive edge comes from quality, service and reliability. Quality and efficiency are the most important strategic factors needed to survive in this market environment. Considerable effects can be generated through quality improvements in particular. A positive mindset with regard to globalisation also goes hand-in-hand with stronger growth.

Only few SMEs expect to see the competitive environment settle down by 2017. This bears risks for the 6 % of SMEs that see no competitive advantages for their company.

Reliance on companies

Companies' ability to perform in globalised markets determines the competitiveness and the wealth of an economy. In Germany, this is particularly reliant on SMEs. Like other European nations,¹ Germany has a large proportion of SMEs, which number some 3.8 million.

The KfW SME Panel provides information on the market environment and the competitiveness of the German 'Mittelstand'.²

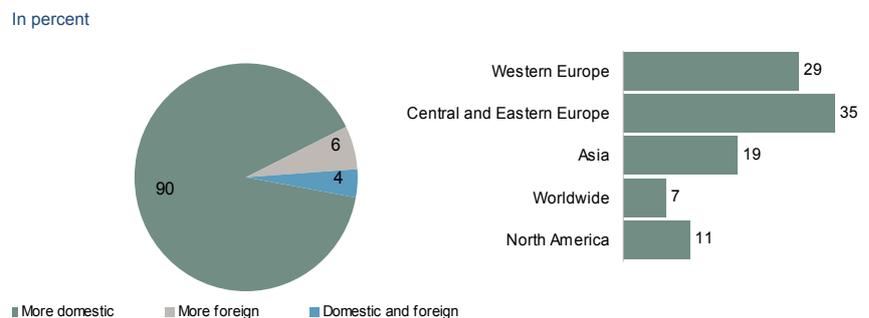
Competition picking up

Roughly two-thirds of SMEs (63 %) re-

port increasing competitive intensity in the last five years. A large majority (81 %) attribute this to domestic competition, which flies in the face of the constant progression of globalisation. Only a small proportion of SMEs feel more competition from abroad (13 %).

This can be traced back to the well-known strong focus on the home market

Figure 1: Where competitors of German SMEs are located ...



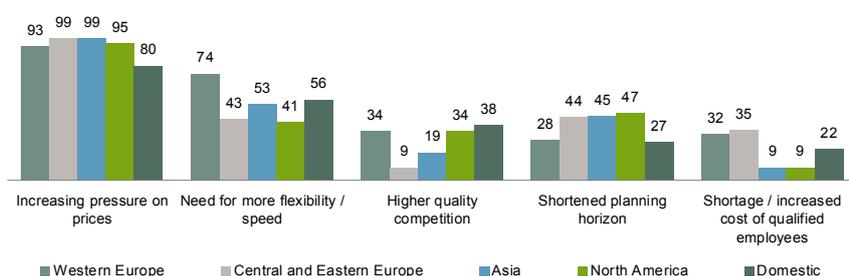
Source: KfW SME Panel 2012 – Special section "Competition and market environment".

Figure 2: Consequences of growing competitive intensity



Source: KfW SME Panel 2012 – Special section "Competition and market environment".

Figure 3: ... depending on the origin of the competitor?



Source: KfW SME Panel 2012 – Special section "Competition and market environment".

knowledge-intensive services and those operating in the R&D-intensive manufacturing industry are experiencing far less pricing pressure (-7 and -10 percentage points compared to SMEs on the whole), but the technological competition is growing heavily in these two groups (+3 and +14 percentage points). The construction industry is also striking: These SMEs see the consequences of more intense competition primarily in pricing pressure (93 %), shorter planning horizons⁴ (40 %) and the area of labour and supply costs (39 %).

Clear competitive advantages with quality, service and reliability

The quality of products and services, the service and consulting offers associated with these, and reliability in meeting delivery times and deadlines are the strategic success factors according to German SMEs; these enable them to establish and enhance their competitive edge (see Figure 4). The paramount significance of these three aspects is apparent in all SME segments.

As company size increases, so does the frequency with which competitive advantages are mentioned. Large SMEs in particular (50 or more employees or at least EUR 50 million in sales) mention the individual categories far more often. However, this is not always the case: There is virtually no difference between small and larger SMEs in the areas of consulting / service and in the uniqueness of products / services.

Competition "right next door" and to the east

Nine out of ten SMEs currently see most of their competitors in their own domestic market (see Figure 1), meaning their rivals are right "next door". Only 6 % of companies report their competitors as being mostly abroad. This is the case for both smaller and larger SMEs. This is a reflection of the fact that German SMEs still have relatively few activities abroad compared with their international counterparts.

One new development is that Central and Eastern Europe are dominating the ranks of countries from which competing companies originate: This is where more than a third of the companies that mention foreign competitors (35 %) see their competition. This is even more the case for small SMEs, start-ups and small to medium-sized craft businesses (the latter actually find 84 % of their competitors in Central and Eastern Europe). Western Europe – the most important export and direct investment region for SMEs by far³ – ranks second in terms of locations of foreign competitors (29 %).

Noticeable pressure on prices

The growing competitive pressure has tangible consequences for nearly all companies (see Figure 2). Only 1 % of SMEs currently feel that they are evading the effects of the intense competition according to their own statements. The rising pricing pressure heads the rankings by far: Nearly every company with foreign competitors and 79 % of companies with rivals found mostly at home list this as a consequence.

Nearly half of SMEs list greater demand for flexibility and speed. Western European competitors in particular are a major driver here (see Figure 3).

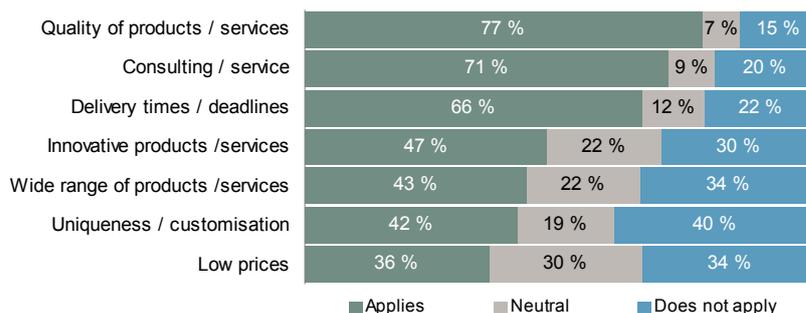
Quality competition is mentioned as the third most frequent effect – this is significantly more frequent from companies with domestic competition (+11 percentage points). Rivals from Central and Eastern Europe, in contrast, hardly give German SMEs any quality competition.

In cases where the competitive pressure is coming more from abroad, SMEs (slightly) more often face a shortage or increase in prices of resources (commodities, preliminary products, capital and labour).

The effects that SMEs see from growing competitive intensity vary depending on the size of the company and the sector in which it operates. Larger SMEs for example (at least ten employees) list each effect (slightly) more frequently than small SMEs. Companies offering

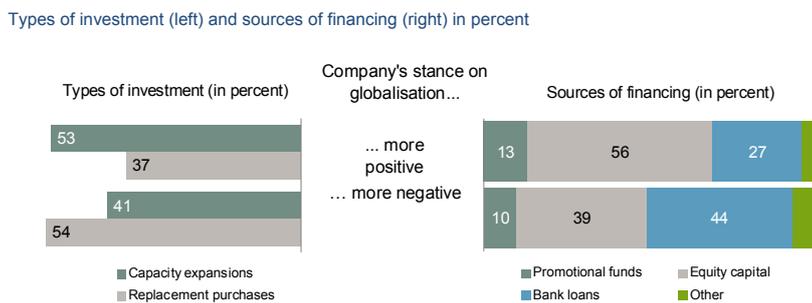
Figure 4: Competitive advantages of SMEs

Share of mentions in percent



Source: KfW SME Panel 2012 – Special section "Competition and market environment".

Figure 5: Perception of globalisation and investment behaviour



Notes: Sources of financing and types of investment as shares in investment volume, weighted with the number of employees and the investment volume. "Other" includes for example mezzanine and private equity.

Source: KfW SME Panel 2012 – Special section "Competition and market environment".

Six per cent see no competitive advantages

The competitiveness of 6 % of SMEs seems to be in jeopardy in the medium term. These SMEs do not consider themselves to have a competitive edge in any of the categories listed. These are small, domestic-oriented SMEs, which operate first and foremost in the services sector and have no R&D activities of their own. Given that the environment will continue to become more competitive in the future, some of the companies in this group are at greater risk of being pushed from the market. At best, they are oblivious to their own strengths. This stands in the way of them plotting a

successful strategic course.

R&D-intensive manufacturing industry stands out

The R&D-intensive manufacturing industry, which is extremely important for Germany's competitiveness,⁵ sets itself apart from the international competition in particular with the quality of its products and services according to its own statements. 87 % of these companies believe they have a competitive advantage here. A successful business model has been created here and this is combined with product-related consulting and other services (82 %).

The aspects of innovative products / ser-

vices (71 % or +24 percentage points versus SMEs overall) and uniqueness (63 % or +21 percentage points) are also deemed more important than average. Some of the less important factors are low prices and a wide range of offerings (-9 and -4 percentage points, respectively). This paints a clear picture of the unknown global market leaders, also called the "hidden champions". These are often found in the R&D-intensive manufacturing industry and are niche specialists with high-quality, technologically complex products.

Growth is strong when the stance toward globalisation is positive

A positive stance toward globalisation goes hand-in-hand with growth. SMEs that put the opportunities of globalisation at the forefront show stronger growth in sales (+48 %) and employment (+77 %) than those with a negative prevailing attitude. They also feature higher labour productivity (+25 %) and are more profitable (return on sales +2 percentage points).

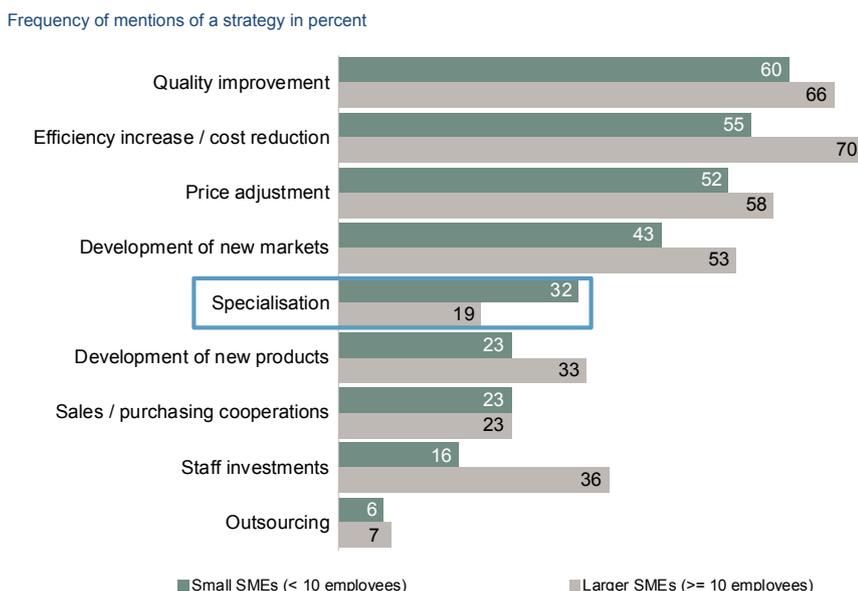
Proponents of globalisation have much greater risk appetite. This is reflected in both the investment and financing behaviour (see Figure 5). A much greater willingness to use own funds for financing purposes means a strong focus on capacity expansion (for example to tap into new or expand existing sales and procurement markets). These SMEs play an active role in countering the increased pressure to act and compete and this is clearly paying off.

SMEs focus on quality and efficiency

SMEs are pushing back when it comes to dealing with greater competitive intensity. Competitive strategies are consistently based on existing competitive advantages (see Figure 6). Quality improvements take top priority. Companies are almost as quick to mention measures aimed at improving efficiency and cutting costs.⁶ Price adjustments and tapping into new markets are also important strategic options.

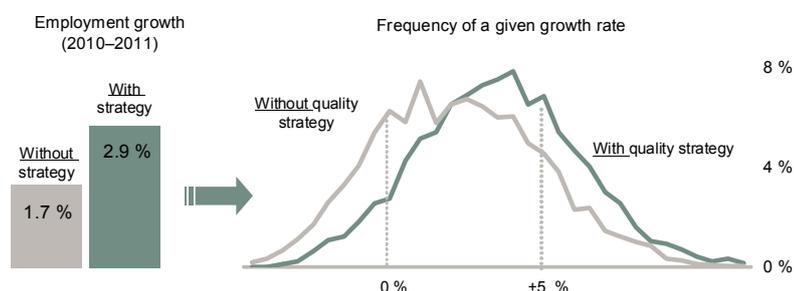
Larger SMEs (at least ten employees) list nearly every competitive strategy more often than small SMEs (fewer than ten employees). The generally greater

Figure 6: What are the important strategies for SMEs?



Source: KfW SME Panel 2012 – Special section "Competition and market environment".

Figure 7: Quality improvement and employment growth – visible relation across the entire range of SMEs



Notes: Estimated figures for employment growth considering relevant company characteristics (e. g. size, age, sector and innovation activities) and other competitive strategies. Growth in full-time equivalent employees. The illustration on the right shows the distribution function of the estimated employment growth, differentiated by "quality improvement" strategy.

Source: KfW SME Panel 2012 – Special section "Competition and market environment".

room to manoeuvre of larger companies comes into play here. One exception is the strategy of specialising in just a few products or services. This plays a bigger role for smaller companies given that it is their only strategy. They rely much more heavily on a focussed company policy and less on diversification.

One striking difference in importance is also found in the investments in personnel measures: This strategy is more than twice as important for large SMEs. This presumably reflects preparations and activities relating to the expected shortage of qualified employees in the future. It can likewise be assumed that large SMEs invest more in inhouse education and training measures (for example language courses for employees as part of an internationalisation strategy).

While market development and product development currently still rank somewhere in the middle of competitive strategies, they are poised to become

much more important in the medium term. With companies expecting to see competition pick up until 2017, the importance of these strategies will grow by around 50 % (in the case of market development) and by as much as around 100 % if new products are developed.

Quality pays off – performance benefits

Quality and growth are closely correlated (see Figure 7). The employment growth rate between 2010 and 2011 was 2.9 % on average for SMEs that listed quality improvements as an important company strategy. The companies that did not list this "only" increased their staff numbers by 1.7 %. The advantage of the quality-oriented SME is thereby seen in the long term as well.⁷ Possible objections that a few SMEs with very heavy growth could distort the analysis are baseless. On the contrary: Along the entire spectrum of employment growth among SMEs, fewer are tending to show low levels of growth and more are experiencing more rapid

growth – the frequency distribution has seen a visible shift to the right. This type of correlation cannot be found for any of the other competitive strategies.

Promoting investment, innovation and internationalisation

The climate is tough for SMEs, yet competition is also a supporting pillar when it comes to modernisation and thus the sustainability of a country. Competition is hardly expected to abate in the future either. Especially given that new markets continue to be opened up in the course of globalisation. Competition from abroad is picking up.

For this reason, three factors are essential: Companies will have to be aware of the significance of clear strategies. These must be formulated, implemented with resolve and tracked in a sustainable way. As our results show, a strong focus on quality aspects can strengthen a company's competitiveness. Openness to competition is also advisable, even on a global scale. This may just drive a company's own performance.

To follow these recommendations and keep up in the rat-race, innovation and the conscious, consistent pursuit of international activities will be necessary.⁸ Innovation, internationalisation and, in this context of course, investment will (have to) be stronger pillars of a small to medium-sized company's competitiveness in future. It all depends on these three big 'I's.

Countries employing suitable measures to focus their policies on the three 'I's will strengthen the competitiveness of their SME base. ■

¹ Nearly every European country is made up of more than 99 % SMEs. The key structural characteristics of German SMEs lie in their diversity (for example with regard to the size and sector structure). For further details: Tchouvakhina, M. and M. Schwartz (2013), Diversity is crucial: how the SME sector in Germany compares with others in Europe, Focus on Economics No. 24, KfW Economic Research, Frankfurt am Main.

² As a result of the link to the KfW SME Panel, the special analyses presented here also give a representative look at the competitive situation of SMEs (across all sizes and sectors). For basic methodical aspects, see Schwartz, M. (2012), Strong performance – increasing risks. KfW SME Panel 2012, KfW Economic Research, Frankfurt am Main. Results of the current wave will be released in autumn 2013.

³ See Brutscher, P., Raschen, M., Schwartz, M. and V. Zimmermann (2012): Internationalisation in Germany's SME sector – Step by Step to global presence. KfW Research, KfW Group, Frankfurt am Main.

⁴ This is meant as a reduction of the period in which an SME can plan (for a project, sales strategy, etc.), triggered by a (more) rapidly changing overall environment. Crucial factors here are the entry of new/additional competitors, new technological developments, or in general if the basic information from the original plan changes significantly.

⁵ These companies are not only very productive (factor of 1.3 vs. SMEs on the whole), have high rates of innovation (factor of 1.9) and are especially active abroad (factor of 3.3). They are also responsible for 18 % of the workforce and 28 % of all investments. See also Tchouvakhina, M. und M. Schwartz (2013); Diversity is crucial: how the SME sector in Germany compares with others in Europe, Focus on Economics No. 24, KfW Economic Research, Frankfurt am Main.

⁶ The focus of German SMEs, therefore, corresponds to that of larger companies, as another current study shows. See Roland Berger (2013), Restructuring study 2013, Düsseldorf.

⁷ An analysis for the period 2009 to 2012 was performed using the preliminary data for 2012. This also confirms the correlation: Companies listing quality improvements as an important competitive strategy feature higher growth in employment (5.5 % compared to 3.0 %).

⁸ The same can be said for Germany: The fact that SMEs are carrying out less R&D activities over the past years is problematic on the one hand; the lagging degree of internationalisation compared to other countries is also deemed critical. Regarding the first aspect, see Zimmermann, V. (2013): The innovation motor in SMEs is sputtering, Focus on Economics No. 13, KfW Research, KfW Group, Frankfurt am Main.