

# Focus on Economics

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## Investments: SMEs still in the black, large companies long since in the red

### Corporate Investments – Part A

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2014 will likely bring the turnaround: gross fixed capital formation by companies in Germany is rising for the first time in three years, and the main reason for this is the strong domestic economy.

This pleasing economic news obscures a structural phenomenon: companies are becoming less willing to invest. Corporate investment in 2013 is now only roughly 10% relative to gross domestic product (GDP), compared with approximately 15% in 1991, one year after reunification.

Corporate investment in Germany is also lower by international comparison. This is putting competitiveness and jobs on the line. Investments safeguard the future by renewing capital stock, expanding capacities, saving costs, increasing productivity or developing new business fields and technologies.

But does "less" also means "too little"? Especially since some developments indicate that future growth in industrialised countries may be less capital-intensive. But does that also apply to Germany? Taking a look at *net* investments is more unsettling than it is reassuring. Our KfW SME Panel reveals:

(i) Net investments made by large companies in Germany have been in the red by a total of EUR 100 billion since 2004.

(ii) Net investments made by SMEs amount to roughly EUR 350 billion and have been in the black since 2004, albeit on a declining trend. One reason

for this could be the fact that small and medium-sized enterprises (SMEs) are highly reliant on sentiment and domestic economic activity.

The objective should be that companies in Germany overall make real investments again and stop accumulating financial capital. This would have required an additional investment of at least EUR 55 billion in 2013.

### At least a cyclical recovery in corporate investments

The German economy has made a very robust start into the current year: GDP grew by 0.8% in the first quarter of 2014 compared with the previous quarter, faster than ever before in the last three years. Domestic demand, i. e. consumption and investments, was the only source of any positive stimulus. Construction investment

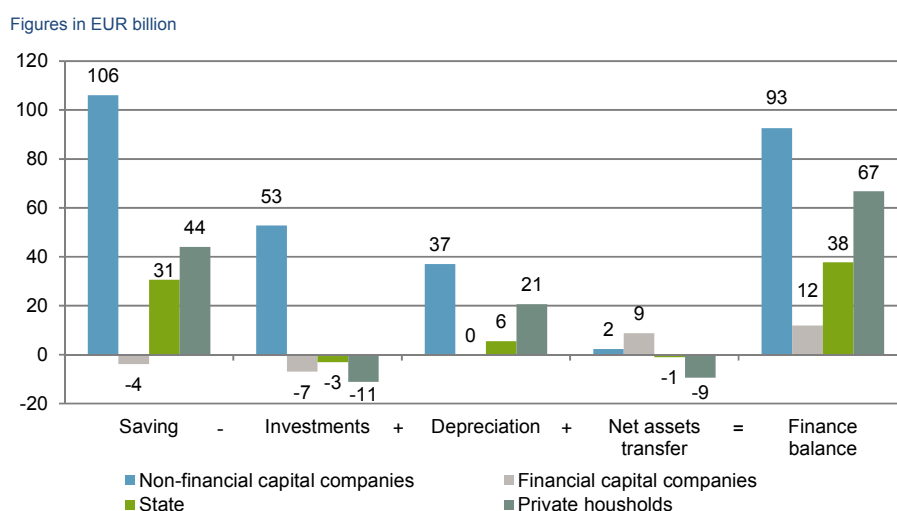
also benefited from the unusually mild winter. Foreign trade weighed down significantly on the quarterly growth, however, to the tune of 0.9 percentage points.

The negative contribution of net exports to growth, i.e. the balance of exports (+0.2%) and imports (+2.2%), can be attributed to the solid domestic economy. It pushed up imports, which also created demand for products from other Eurozone countries and supported their recovery; in 2013, nominal goods imports from these countries bucked the general trend by growing 1.4% (goods imports overall: -1.1%).

What is important for Germany as a business location is the fact that companies are making a significant contribution to reducing net exports. While companies in Germany have accumulated net financial assets over the last ten years (apart from 2008) and therefore financed foreign direct and portfolio investment too, we are possibly standing on the brink of a change in this respect (figure 1). Above all, private investment in equipment shows a clear upwards economic trend, from stagnating in the second quarter of 2013 to 2.9% quarterly growth in Q1 2014.

The accumulation of monetary assets is increasingly giving way to investments in

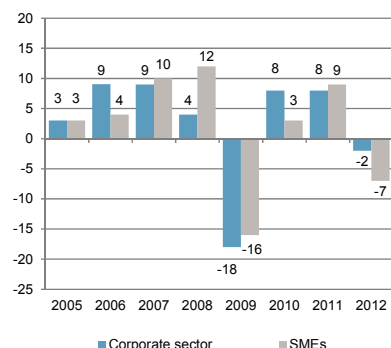
Figure 1: Elements of financing balance, trend from 1999 to 2007



Source: Destatis, KfW Research calculations.

**Figure 2: Annual growth rates for gross fixed capital formation**

Figures in percent



Sources: KfW SME Panel 2005–2013, Destatis, KfW Research calculations.

equipment. In future, companies should ideally become net borrowers again to finance real economic investment in Germany, as was the norm until 2003. This is positive for Germany as a place to do business.

**Warning signs in the SME sector**

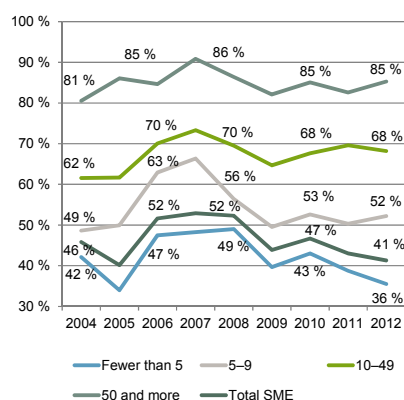
Corporate investments are a key driving force behind future economic growth and prosperity in Germany. That said, a look at the figures reveals that investment patterns throughout the entire corporate sector have been subdued in recent years (figure 2). Following the sharp decline in investments in 2009 due to the economic and financial crisis, companies are still reluctant to invest in new machinery and equipment.

The willingness to invest has fallen sharply among SMEs in recent years (figure 3). While 53% of companies were ready to invest in 2007, this ratio sank to just 41% in 2012, and this applies to almost every SME segment. Only the upper mid-sized companies with industrial and international operations have been able to keep their level more or less constant for years.

What is also worrying is the growing structural gap in willingness to invest, i. e. the difference between small and large SMEs in their propensity to invest. Sitting at 49 percentage points, this gap is wider than it has ever been since 2005.

**Figure 3: Share of SMEs investing**

Size classes by FTE employees



Source: KfW SME Panel 2005–2013.

**SMEs: net investments always in the black...**

But are things really so bad with corporate investments in Germany? A closer look at the data for small and medium-sized enterprises (SMEs) shows that there is (still) no general investment weakness in this corporate segment. SME investment intensity, for example – a measure of the average size of investment projects – has been pretty much constant since 2004 at approximately EUR 8,000 per employee.<sup>1</sup>

**Table: Investment volumes, depreciation and net investments in the corporate sector between 2005 and 2012**

Figures in EUR billion

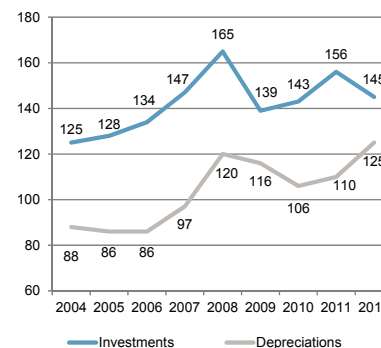
	2004	2005	2006	2007	2008	2009	2010	2011	2012
<b>SMEs (companies with annual turnover up to EUR 500 million)</b>									
Investments	125	128	134	147	165	139	143	156	145
Depreciation	88	86	86	97	120	116	106	110	125
Net investments	+37	+42	+48	+50	+45	+23	+37	+46	+20
<i>Investment coverage (in %)</i>	142	149	156	152	137	119	134	142	116
<b>Large companies (companies with annual turnover above EUR 500 million)</b>									
Investments	107	112	127	137	130	104	118	124	130
Depreciation	127	131	135	133	119	128	140	141	132
Net investments	-20	-20	-8	+4	+11	-24	-22	-17	-2
<i>Investment coverage (in %)</i>	84	85	94	103	110	81	85	88	99

Note: The investment volume and the amount of depreciation are calculated as described in the box. Investment coverage describes the ratio of the investment volume to depreciation.

Sources: KfW SME Panel 2005–2013, Destatis, KfW Research calculations.

**Figure 4: SME investments / depreciation**

Figures in EUR billion



Note: The investment volume and the amount of depreciation are calculated as described in the box.

Source: KfW SME Panel 2005–2013.

Willingness of SMEs to invest did hit a low in 2012, but this will only result in a pressing problem if new investments by companies do not cover the simultaneous loss of value in the capital stock. However, there is still no sign of any asset erosion due to negative net investments (figure 4).

Over the KfW SME Panel's entire survey period, SMEs' net investments have always been in the black. Since 2004, investment in *new machinery and equipment* has exceeded depreciation in small and

medium-sized companies by an aggregate EUR 349 billion.

**... but investment coverage is gradually declining**

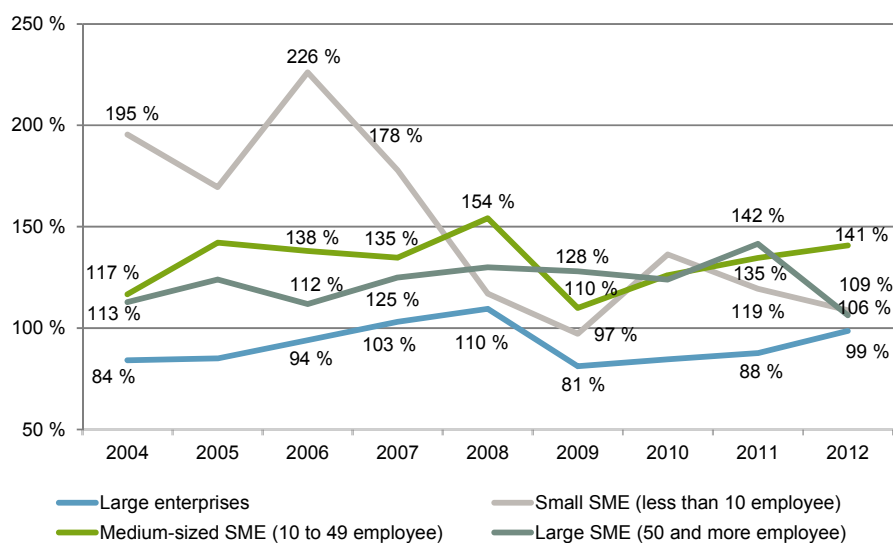
At the same time, however, we must not ignore the trend in investment coverage since 2006 (table). The investment coverage reflects the relationship between new investments and depreciation. It reveals whether the investments in a year will suffice to maintain the given capacities of the company or the value of its capital stock. Since peaking in 2006 at 156%, this figure has since fallen to 116% in 2012.

Parallel to this, we see a continuous rise in SMEs with negative net investments: totalling 50% in 2006, this percentage rose to 56% in 2012. The structural investor gap referred to above is reflected here again: micro SMEs (with fewer than five employees) and small SMEs (5 to 9 employees) produce shares of 56 and 60% and are higher (often significantly) than larger SMEs with figures of 53% (10 to 49 employees) and 49% (50 or more employees).

The latest figures thus clearly show a negative trend, and especially with smaller SMEs there is real cause for concern (figure 5). Nonetheless, German SME capital remains intact.

**Graph 5: Investment coverage between 2005 and 2012 by size class**

Figures in percent



Note: Investment coverage describes the ratio of the investment volume to depreciation.

Sources: KfW SME Panel 2005–2013, Destatis, KfW Research calculations.

**Large companies: loss in value for almost nine years in succession**

The situation is somewhat different for the roughly 1,700 large companies in Germany (annual turnover of more than EUR 500 million). In only two years of the period surveyed did new investments exceed the concurrent loss in value through depreciation (2007 and 2008) – and even then the investment coverage was only barely in the black at 103 and 110% (figure 5 and Table).

This means that large companies overall are not maintaining their capital stock in Germany. The resultant limitation of production opportunities and failure to adapt production processes to state-of-the-art technology could cast doubt on companies' future performance capacities and mean they surrender growth potential (on foreign markets too).<sup>4</sup>

Other studies – conducted by the German Savings Banks Association (DSGV), for example – arrive at a similar conclu-

**Recording investments and depreciation in the corporate sector**

To determine the absolute volumes of net investments in SMEs and in the German corporate sector as a whole, first of all the data in the KfW SME Panel<sup>2</sup> was linked with investment data for the entire corporate sector, as provided by the Federal Statistical Office<sup>3</sup>.

The volumes of investment and depreciation among **SMEs** are assessed as part of the KfW SME Panel. The KfW SME Panel has been conducted since 2003 as a recurring postal survey of small and medium-sized enterprises in Germany with an annual turnover of up to EUR 500 million. The population does not include the public sector, banks or non-profit organisations. With data based on up to 15,000 companies a year, the KfW SME Panel is the only representative survey in the German SME sector. The KfW SME Panel provides an opportunity to make projections for micro-companies with fewer than five employees too. The KfW SME Panel sample is designed in such a way that it can generate representative, reliable data that is as precise as possible.

**Total corporate investment** is calculated by adjusting gross fixed capital formation for public-sector investment and residential construction investment. Depreciation in the corporate sector is calculated in a similar way. The underlying data is taken from Subject-matter series 18, Series 1.4 (last updated: March 2014) at the Federal Statistical Office.

The investment and depreciation volumes of **large companies** (with annual turnover of more than EUR 500 million) are calculated by deducting the volumes determined for SMEs from the relevant figures for the entire corporate sector.

sion based on the verifiably ageing capital stock in companies.<sup>5</sup>

## Understanding why, and quickly

There could be many possible reasons for a decline in the capital stock of large companies in Germany. Potential causes include:

- Uncertainty regarding future developments on the labour market and the implications for costs (minimum wage, pension package),
- Low level of public-sector investment (lower than almost every other industrialised country) holding back complementary private investments,
- Declining attractiveness of Germany as a place to do business,
- Uncertainty regarding future burdens caused by the energy turnaround,
- Excessively low economic growth,
- Production close to sales markets without currency risks,
- High dividend expectations from management and shareholders,
- Interest margins to other countries,

- Demographic change in Germany,
- Intelligent production with reduced space and equipment requirements,
- Structural change towards more services,

to name but a few. The loss of capital stock will become a problem if it leads to the loss of necessary jobs. This is why more research must be conducted on the reasons with a view to elaborating the right economic policy.

## Summary: the next five years are crucial

Although we cannot yet assume that there is any fundamental investment weakness among German companies, the latest trend in SMEs' net investments should at least be taken as a warning sign.

We have to better understand why large companies are reducing their capital stock. While counter-measures cannot yet be specified owing to the lack of precise information on the causes, additional public investments are required. As a rule, these stimulate corporate investments. At any rate, public infrastructure,

housing and recreational opportunities play an important role in positive assessments of business locations.<sup>6</sup> Making greater use of financing scope and flexibility can help here according to the International Monetary Fund – especially in view of the current interest rate.<sup>7</sup>

It is also possible for companies to invest "more", and with interest rates very low in most cases, this would surely be profitable too. The ongoing implementation of the energy turnaround and reactions to the impending shortage of skilled labour due to demographic change (modernisation of workplaces, for example) are only two huge opportunities to use investment as a means for preparing Germany as a place to do business in the future. This is a question of future competitiveness, jobs and income.

Weak investment performance? Not in all firm categories. Reluctance to invest? Yes – and this is measurable. We will focus on some of the causes in the next part of our series on corporate investment. ■

<sup>1</sup> The full-time equivalent employees of a company were used for the calculation. The number of FTEs is calculated by taking the number of full-time employees (including proprietors) and adding the number of part-time employees multiplied by a factor of 0.5. Trainees are not taken into account. A sector comparison of investment intensity also shows that the differences between 2012 and 2004 are mostly small. Only companies operating in the R&D intensive manufacturing sector currently display a lower investment intensity. Cf. Schwartz, M. (2013), List of tables for KfW SME Panel 2013, KfW Economic Research, Frankfurt am Main.

<sup>2</sup> Schwartz, M. (2013), KfW SME Panel 2013. Solid overall impression despite sand in the works, KfW Economic Research, Frankfurt am Main.

<sup>3</sup> Cf. Federal Statistical Office (2014), Subject-matter series 18, Series 1.4, National Accounts. Last updated: 5 March 2014, Wiesbaden.

<sup>4</sup> Zeuner, J. (2013), Investing for the Future, Focus on Economics No. 21, KfW Economic Research, Frankfurt am Main.

<sup>5</sup> German Savings Banks Association (DSGV) (2014), SME Diagnosis 2014. The investment recovery must come. Berlin.

<sup>6</sup> Zimmerman, V. (2014), Business Survey 2014: Financially strong, energy-conscious and location-sensitive, KfW Economic Research, Frankfurt am Main.

<sup>7</sup> Cf. Concluding Statement of the Article IV Consultations of the International Monetary Fund (IMF) on Germany: <http://www.imf.org/external/np/ms/2014/051914.htm>.