

# Focus on Economics

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## Succession planning in SME sector in full swing: Half a million hand-overs by 2017

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The average age of SME owners in Germany is constantly on the increase. As retirement age beckons, it becomes impossible to avoid crucial questions regarding the future of the business.

The KfW SME Panel reveals:

- (1) 580,000 SME owners are planning to hand over or sell their businesses between now and 2017. At least 4 million members of the working population will be affected.
- (2) Where owners seek to find a solution from outside their business, an "investment bottleneck" is often the result. Which means? Firm value as well as competitiveness decrease.
- (3) Where a business is handed over to other family members, this tends to be accompanied by noticeably higher levels of investment.

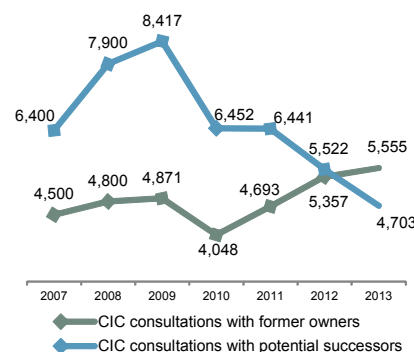
### There are over half a million business hand-overs on the horizon but demand is shrinking

Some 580,000 SME owners in Germany (i.e. around 16% of the entire SME sector) are planning to hand over or sell their businesses to successors by 2017 (Figure 1). These businesses currently employ at least 4 million people<sup>1</sup>.

And then there are those cases where, notwithstanding the fact that the owner will be stepping down as a result of his/her age, there are no plans to hand over the business. Instead, the business is to be closed, resulting in job upheaval for people working in these SMEs.

We do not know how many of the SMEs with a succession plan have already found a definite successor. In the case of family succession arrangements at least, there is a high probability that the issue will be receiving active consideration and that no direct efforts will, therefore, be

Figure 2: Chamber of Industry and Commerce consultations on succession planning 2007–2013



Source: DIKH (Association of German Chambers of Industry and Commerce) Report on Succession Planning 2014, P. 8.

underway to find a successor. The number of missing successors is therefore lower than the total number of businesses facing succession issues.

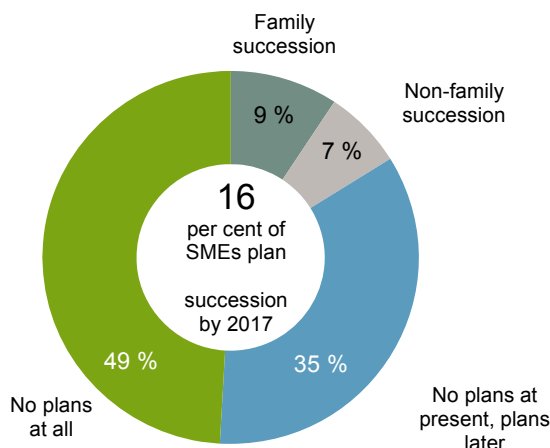
It is clear, however, that succession is becoming an increasingly important issue for the SME sector. More and more owners are planning their succession – but the number of people prepared to take on that role is declining (Figure 2).<sup>2</sup>

### Internal and external solutions more or less equally preferred

According to the KfW SME Panel<sup>3</sup>, 9% of SME owners currently hope to pass their business on to a family member by 2017. It can be assumed that in nine out of ten cases the business will be carried on by the children of the previous owner – mostly by sons.<sup>4</sup>

And the number of SME owners seeking to make succession arrangements outside their own family is not much lower (7%). The options available include selling to long-serving employees, selling to another company or selling to financial investors. However, there tends to be a preference, in virtually every segment of the SME sector, for arranging succession within the same family (Figure 3).

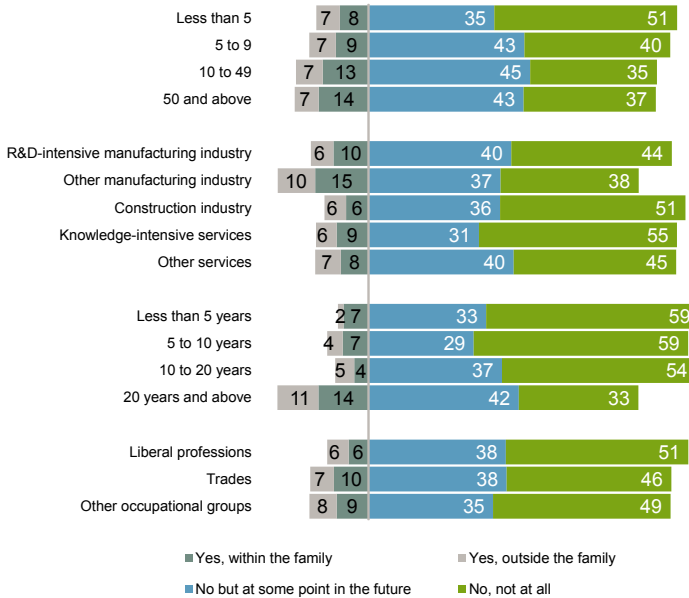
Figure 1: Succession planning in SMEs up to 2017



Source: KfW SME Panel 2014.

**Figure 3: Succession planning by segment**

Proportion of businesses in per cent; averages for each category from projected figures for 2011, 2012 and 2013



Note. Only companies making their first appearance in the database in each of the reporting years were taken into account. The relevant question relating to succession planning was put only to this group of companies.

Source: KfW SME Panel 2012–2014.

**Need for capital in the manufacturing industry makes succession planning more difficult**

Hand-over plans are especially common in companies involved in manufacturing (Figure 3). Food producers, wood product manufacturers and metal product manufacturers feature strongly in this segment. On average, one in every four (25%) SMEs involved in this segment has tried to find a successor at some point over the last three years. The DIHK also confirms this: no other sector has so many owners seeking to hand over their business to so few interested parties than the manufacturing industry (factor 4.6). The large amount of capital required is the most significant stumbling block in this sector.

**Planning begins as businesses get older**

It is no surprise that succession planning is a more urgent issue for older companies in particular. On average, 25% of SME owners whose business is at least 20 years old are already engaged in concrete succession planning (Figure 3).

is 13%.

But the length of time that the company has been actively trading is not the only significant factor when it comes to succession planning. There is a close correlation between the owner's age and concrete succession concerns (Figure 4).

With the exception of major listed corporations – where ownership and management are often in separate hands – SMEs tend to be closely identified with their owners (key terms: family businesses and solo entrepreneurs). In many cases, the business was founded by the current owner. Therefore, the older the business, the more likely it is that the owner will also be somewhat older. Once the owner reaches retirement age, finding a successor becomes even more important. Owners aged 60 and above are especially likely to be involved in succession planning. Hand-over or sale is a live issue for almost half of the businesses owned by people in this category.

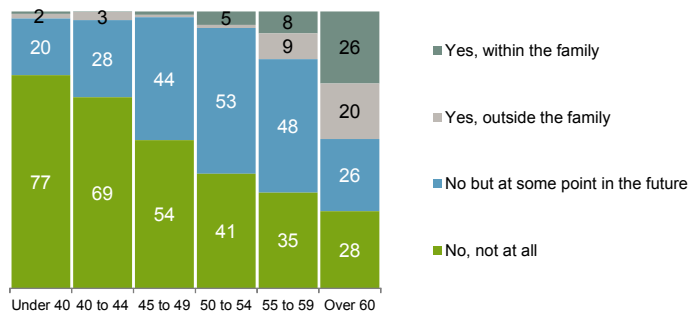
**Do hand-over businesses still invest?**

Earlier studies carried out by KfW Research<sup>5</sup> have revealed that SME owners feel a high degree of uncertainty prior to retiring from their businesses. In particular, they are concerned that potential successors might not value the future return to be gained from a specific investment quite so highly as they do themselves and that this could be reflected in the price paid for the business.

The bigger the company, the more likely it is to be concerned with succession planning. The reason for this is that there is a clear correlation between age and size. Only 3% of SMEs that are less than five years old have ten or more employees; however, in the case of established SMEs that have been operating for 20 years or more, the corresponding figure

**Figure 4: Succession planning by age of owner**

Proportion of businesses in per cent; averages for each category from projected figures for 2011, 2012 and 2013

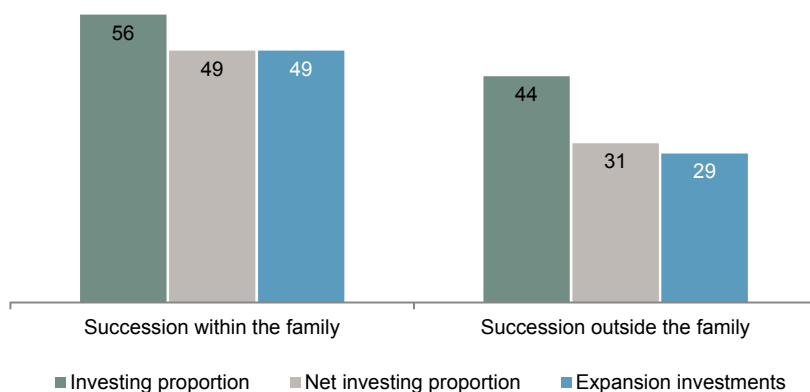


Note. Only companies making their first appearance in the dataset in each of the studied years were taken into account. The relevant question relating to succession planning was put only to this group of companies.

Source: KfW SME Panel 2012–2014.

**Figure 5: Investment behaviour by type of succession**

Proportion of businesses in per cent; averages for each category from projected figures for 2011, 2012 and 2013



Note. Only companies making their first appearance in the dataset in each of the reporting years were taken into account. The relevant question relating to succession planning was put only to this group of companies.

Source: KfW SME Panel 2012–2014.

Unless this insecurity can be resolved, it can lead owners to refrain from making investments as they approach the sale or hand-over of their business.

In this regard, our data shows that the intended method of succession is important in determining the owner's investment behaviour.

#### External succession puts a dampener on ...

Investment is only halted where the business is to be handed over or sold to someone from outside the owner's family circle (Figure 5).

On average, the proportion of SMEs carrying out investment, the proportion of SMEs with positive net investments and the proportion of expansion-orientated investments as a subset of investments as a whole have been substantially lower over the last three years. Clearly, SME owners are holding back.

This self-imposed restraint can have consequences. The value of the business falls; capital stock value losses due to depreciation are no longer – or insufficiently – compensated for by new investment. The longer the period of restraint, the greater the risk that profitability and competitiveness will suffer. This, in turn, can deter potential successors or reduce the sale price that can be achieved. It is the start of a vicious circle.

In a worst-case scenario, the very survival of the business – and the jobs associated with it – would be put at risk.

#### Family hand-overs are advantageous ...

It has a noticeably positive effect on his/her investment behaviour when an SME owner intends to hand his/her business over to a family member rather than to someone from outside the family circle. The proportion of investing SMEs (+12%), the proportion of net investing SMEs (+20%) and the proportion of expansion-orientated investments (+16%) are all considerably higher than when the business is to be passed on to a non-family member.

Evidently, owners are more willing to invest in the business, even when they are older, if they know the business will remain in the hands of a family member. It can be assumed, in these circumstances, that owners are persuaded by a much greater "emotional obligation" to hand over a properly functioning business. In order to ensure the preservation of the company, investment decisions in these scenarios are presumably based more on the principle of maximising *longer term profit*.<sup>6</sup>

#### ... and have a demonstrably positive effect on investment

Are results distorted by factors such as the sector to which SMEs belong? In the

case of family hand-overs, there could conceivably be a greater preponderance of SMEs that are structurally more inclined to make higher levels of investment (e.g. larger companies or SMEs in the manufacturing industry that require more intensive R&D input).

Econometric analyses can help us in this regard. These support the contention that the type of succession influences investment behaviour. Taking numerous relevant business characteristics into consideration, it can be shown that there is a *statistically significant positive effect* on two out of three investment behaviour indicators where the intention is to pass a business on to a family member.<sup>7</sup> The probability that any investment will occur is nine percentage points higher. The probability that expansion investment will be made is as much as 13 percentage points higher.

However, no statistically significant correlation for the net investor indicator can be found.

#### Summary

Demographic changes are hitting the SME sector. More than 1.3 million owners are already 55 years of age or older.<sup>8</sup> It can be assumed that the ageing process will have a negative effect on SME competitiveness in the medium term, as it slows down both investment and innovation – as our study shows.<sup>9</sup> Effects of changes to the demand side, with a declining, ageing and more ethnically diverse population are not yet considered.

The numbers clearly show that demographic changes will inevitably and increasingly alter the structure of the SME sector in the years ahead. Over half a million SMEs will be looking for a successor between now and 2017 and they will be doing so at a time when there is a shortage of entrepreneurs ready to take up the reins. Not enough entrepreneurs are waiting in the wings – either in total or in the context of succession planning.

Non-family successors have to be considered. However, our studies reveal that significantly less investment goes into SMEs prior to an external hand-over, storing up risks for the hand-over process itself and for the long-term viability

of the business.

As well as undertaking the search for a successor at an early stage (the "next-change" business exchange which operates throughout Germany is a good place to start), owners seeking to hand over their business should also concern themselves with the specifics of the succession arrangements. Experience shows that owners often begin the process of finding a successor too late. Planning really needs to start at least three years beforehand.<sup>10</sup> In many cases, owners are likely to have a strong emotional attachment to the business.<sup>11</sup>

It is not clear how much this influences their ability to set a realistic selling price. It is not inconceivable that they might be somewhat over-ambitious in this regard and this could deter potential buyers.

And, of course, the very complexity of the hand-over process can cause delays. By definition, the parties often have no practical knowledge of the legal or taxation aspects of the transaction.

Taxation matters are especially significant in the case of family hand-overs. Research suggests<sup>12</sup> that family hand-overs result in a fall in investment levels

because inheritance tax or restrictive tax law produces a higher burden of taxation – in other words, when the original owner is subject to over-regulation in deciding how to hand over his/her business.

Given this backdrop, the new inheritance tax arrangements that are due to be introduced by the end of June 2016 are keenly awaited. Exemption regulations will be of particular interest to SME owners. ■

### The KfW SME Panel

The *KfW SME Panel* (KfW-Mittelstandspanel) has been conducted since 2003 as a recurring postal survey of small and medium-sized enterprises in Germany. The basic population used for the KfW SME Panel includes all private-sector companies from all industries with annual turnovers of up to EUR 500 million.

The KfW SME Panel sample is designed in such a way that it can generate representative, reliable and very precise statements. With a database of up to 15,000 companies per year, the KfW SME Panel is the **only representative survey of the German SME sector** and thus the most important source of data on issues relevant to the SME sector.

**Information** relating to **succession planning** is collected only in the year of first inclusion in the dataset. This question is not posed repeatedly to the relevant enterprises in the following years. Details relating to a total of 2,161 companies were taken into account for the 2013 reporting year (data collection in 2014). Clearly, this results in a lower number of cases compared to the dataset as a whole. In order to still be able to present meaningful and, in particular, reliable results even though the number of cases is lower than the overall dataset, the analyses in this article are usually based on a summary of various waves of the KfW SME Panel. The most recent survey (12<sup>th</sup> wave) was conducted in the period from 1<sup>st</sup> February 2014 to 30<sup>th</sup> May 2014.

<sup>1</sup> The 2013 figures are in line with those for the previous two years. The proportion in 2011 was 14% (approx. 530,000 companies) and in 2012 15% (approx. 540,000 companies). 95% confidence intervals were also calculated for 2013. The interval for the proportion of SME owners who were seeking to find a successor from within their own family ranged from 8 to 11%. The interval for the proportion of SME owners who were seeking to find a successor from outside their own family ranged from 6 to 8%. Based on the two upper and lower values, this means that between 497,000 and 669,000 SME owners are planning to hand over or sell their businesses to successors by 2017.

<sup>2</sup> Association of German Chambers of Industry and Commerce (DIHK) (2014), Good Successors – Bottleneck among the SMEs, DIHK Report on Corporate Succession in 2014, Association of German Chambers of Industry and Commerce, Berlin.

<sup>3</sup> For the latest figures see Schwartz, M. (2014), KfW SME Panel 2014: SMEs feeling the impact of weak growth in Europe, and bracing for harder times ahead, KfW Economic Research, Frankfurt am Main. For detailed information on relevant SME indicators, see also the tables section of KfW SME Panel 2014, available via the following link: <https://www.kfw.de/KfW-Konzern/KfW-Research/KfW-Mittelstandspanel.html> (only available in German).

<sup>4</sup> Moog, P.; Kay, R.; Schlömer-Laufen, N. and S. Schlepphorst (2012), Business succession in Germany – current trends, IfM-Materialien No. 216, Institut für Mittelstandsforschung, Bonn.

<sup>5</sup> Haunschild, L.; Tchouvakhina, M. and A. Werner (2010), Unternehmensnachfolge im Mittelstand: Investitionsverhalten, Finanzierung und Unternehmensentwicklung, KfW Research, Standpunkt No. 5 July 2010, Frankfurt am Main (only available in German).

<sup>6</sup> cf. for example James, H. S. (1999), Owner as Manager, Extended Horizons and the Family Firm, *International Journal of the Economics of Business*, Vol. 6 (1), P. 41–55.

<sup>7</sup> Pooled probit estimates using the three yearly tranches available (2011–2013). Once again, only companies making their first appearance in the dataset in each of the surveyed years were taken into account. Explanatory variables taken into account in the regression analyses included size of business, age of business, business sector classification, legal form and R&D activities carried out.

<sup>8</sup> Gerstenberger, J. and M. Schwartz (2014), Mittelstand altert im Zeitraffer, *Economics in Brief* No. 63, KfW Economic Research, Frankfurt am Main (only available in German).

<sup>9</sup> Schwartz, M. and J. Gerstenberger (2015), Ageing of German SME owners is putting a dampener on investment, Focus on Economics No. 85, KfW Economic Research, Frankfurt am Main. – Zimmermann, V. (2013) Have the old still got what it takes? Differences in the innovative output of young and old entrepreneurs, Focus on Economics No. 33, KfW Economic Research, Frankfurt am Main.

<sup>10</sup> Association of German Chambers of Industry and Commerce (DIHK) (2014), Good Successors – Bottleneck among the SMEs, DIHK Report on Corporate Succession in 2014, Association of German Chambers of Industry and Commerce, Berlin.

<sup>11</sup> Pochop, S. and S. Besecke (2012), Unternehmensnachfolge und Rating: Zur Berücksichtigung und Relevanz der Nachfolgeregelung bei der Kreditvergabe, Flensburger Hefte zu Unternehmertum und Mittelstand, No. 1, Flensburg (only available in German).

<sup>12</sup> According to Tsoutsoura, M. et al (2014), The Effect of Succession Taxes on Family Firm Investment: Evidence from a Natural Experiment, Journal of Finance, awaiting publication. – Ellul, A.; Pagano, M. and Fausto Panunzi (2012), Inheritance Law and Investment in Family Firms, American Economic Review, Vol. 100 (December 2010), P. 2414–2450.