

»» Wave of successions in German SMEs: 240,000 successors wanted by 2019

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A wave of successions will sweep across Germany's small and medium-sized enterprise sector in the coming years. More than half a million owner-managers of SMEs plan to transfer ownership and control of their business by the year 2022. For some 100,000 enterprises, time is running out. They plan to wrap up their succession by the end of 2019 but have either not found a successor or have not yet started to look for one. This is the finding of a special analysis conducted by the KfW SME Panel.¹

The face of SMEs will change. Planned closures will also contribute to this. Giving up their business is an option for one in seven owners, for many it is the only option. Larger SMEs almost always favour succession but only half of micro-enterprises do. They are eight times more likely to prefer closing down.

Managing generational change is becoming increasingly challenging. There are not enough new business founders moving up who would be qualified to take over. At the same time, the need for successors is high and will grow. This is due, not least, to the fast ageing of owner-managers. Already, 1.4 million are aged 55 or over. One quarter of them will have passed the age of 70 by the time they plan to retire – one in ten will be almost 80. They retire six years later than the working population.

But not every region in Germany is equally affected. SMEs in Schleswig-Holstein, Thuringia and Baden-Württemberg have the highest share of older owner-managers. Succession is also a more critical issue there. The situation is different in Hamburg, Rhineland-Palatinate, Saarland and Mecklenburg-Western Pomerania, where far fewer management successions are imminent.

Unclear succession is an enormous barrier to investment. The nearer the time to transfer ownership and control approaches, the less owners are willing to invest. Ongoing negotiations are a further deterrent. Uncertainty is high but once the imminent succession is clarified, investments increase again by 40%. Family succession also promotes investment. Hence it is positive that more than half the owners want to see their business in the hands of a family member after they retire.

Generational change will hit SMEs by 2022

After its establishment, there is hardly a more profound event in the 'life of an enterprise' than managing a generational succession. Especially in Germany, the successful management of business transfer is becoming a growing challenge for the SME sector.² In the next two years alone, 236,000 owners of small and medium-sized enterprises (SMEs) plan to withdraw from their business and want to definitely place their operation into the hands of a successor (Figure 1). This applies to 6% of all SMEs in Germany by the end of 2019.

These enterprises are of considerable economic importance. In 2016 they employed 2 million workers (around 6.4% of the total SME workforce) and around 89,000 trainees and apprentices. Their turnover reached EUR 311 billion, a share of 7% of SMEs' total turnovers. Besides, these SMEs invested some EUR 9 billion in new plant and buildings, which represents around 5% of SME investment and just over 2% of all corporate investment in Germany. A further 275,000 SMEs plan to transfer control to a successor between 2020 and 2022 (another 7% of all SMEs in Germany).

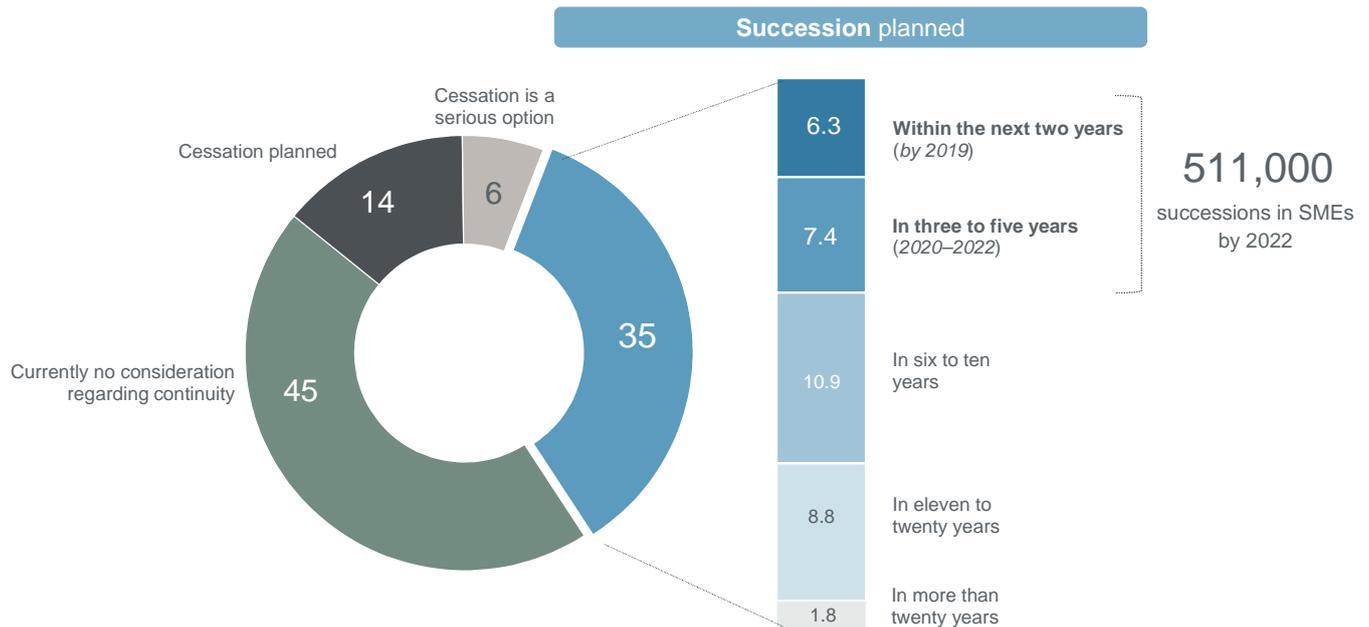
In the final analysis, a wave of successions will sweep across the German SME sector over the next five years, covering more than half a million business transfers (around 511,000 SMEs or 13.7% of all SMEs). The generational change will peak during the years 2023 to 2027. According to current figures, nearly 11% of business owners and sole traders plan to retire from the workforce during that period.

Planning for business closure not uncommon

The public debate is heavily centred on succession but not every manager with specific retirement plans actually wants to continue their business. On the contrary: for one in seven owner-managers (14% or 545,000 SMEs), shutting down is currently the only option under consideration. A further 6% of business owners are at least giving closure serious thought (around 191,000 SMEs).³

Figure 1: Current key data on SME continuity in Germany

Share in total SMEs in per cent; column chart: Successions by timeline



Note: In the survey year 2017 (reporting year 2016), the collection of key variables on business succession was restructured and considerably expanded in the KfW SME Panel. Therefore, not all results are comparable with those of previous publications by KfW Research.

Source: KfW SME Panel 2017.

If all SME owners who have business closure plans follow through with them, there will be around 331,000 closures in the next five years. Thus, a maximum proportion of 9% of all SME owners doing business today will leave the market voluntarily without succession arrangements by 2022. These enterprises employ some 1.63 million workers in total.

The face of SMEs will change

Succession and closure are two sides of the same coin. Both are withdrawal options that are available to the owner. Both mean significant change for the enterprise population. The structural renewal that will take place in the SME sector between 2017 and 2022 can thus be expressed in a single figure: 842,000. This is the number of SME owners who will discontinue their business in the coming five years – with or without a successor. A number of unplanned business closures that is unknown and not reliably estimable can be added to this figure.

On the one hand, there is a lack of business founders moving up. Their numbers have been on the decline for years, dropping from 1.5 million in 2001 to just 672,000 in 2016⁴, which means that fewer people in Germany are starting a business than ever before. The absorption effect exerted by the dynamic labour market is currently too strong. The search for successors is additionally complicated by the fact that around three quarters of business founders would rather start from scratch than use existing structures. In 2016, only

around 154,000 people started a business by acquiring an interest in an existing enterprise or taking it over altogether.⁵ That is nowhere near enough to meet the need for qualified successors to current owner-managers.

Owner-managers usually take a single approach: family succession is the first choice

More than half of owners (54%) want to leave their business in the hands of a family member when they retire. Family succession thus dominates all segments as the most popular variant (Figure 2, left). Even so, 42% can imagine selling their business to an external buyer. Slightly fewer SME owners are considering handing over to an existing employee (25%) or co-owner (27%).

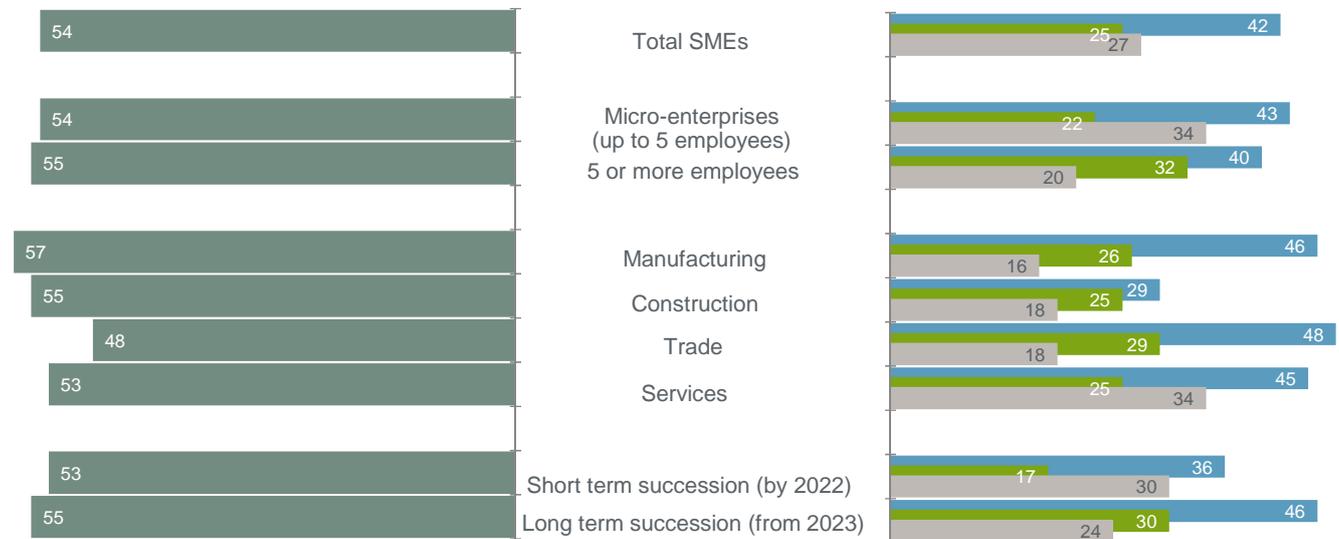
They appear to be largely set in their ways. Only two in ten SME owners even consider more than one succession option (23%). By contrast, 77% of SMEs have decided on a single form of succession. Among these less flexible enterprises, the explicit wish for family succession dominates – with around half committed to this pathway. A further one third focus exclusively on external buyers and roughly one in ten also consider an existing employee.

Nearly one in two SMEs with imminent ownership transfer still has no successor

Many enterprises are at risk of gradually running out of time. At the moment, 42% of enterprises are set to change owners

Figure 2: Which succession options are currently under consideration?

Shares of enterprises in per cent



Note: Multiple answers were possible. Analyses for the category 'employee' include only SMEs with employees. Analyses for the category 'co-owner' include only SMEs with several owners. Not including enterprises currently considering cessation of business. The number of responses under 'Other' was not illustrated but accounted for 3% of responses. These include setting up a foundation, for example.

Source: KfW SME Panel 2017.

by the end of 2019 but either have little in the way of specific succession plans or no plan at all (Figure 3). Their current owners have either not commenced the succession process, have merely collected information, or have at least entered the search phase. That could turn out to be a barrier to a successful transfer arrangement.

Transferring a business is a legally complex and long-term process that requires careful preparation. Emotions often put the brakes on this process. Owners are frequently too attached to their lifework and therefore tend to be reluctant to let go and embrace the associated processes. Allowing sufficient lead-up time, making specific preparations,

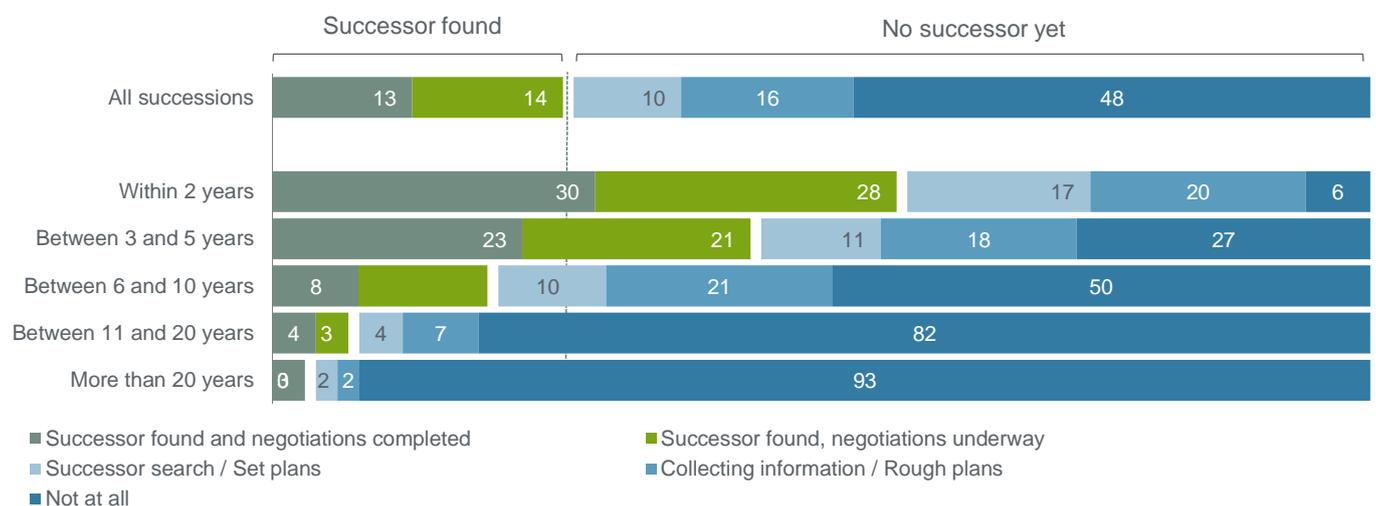
choosing the right timing and having realistic expectations are crucial factors for a successful business transfer.

Fifty-eight per cent of SMEs that are due to change owners in the next two years have already found a successor. Around half of these enterprises have already completed their negotiations successfully while the other half are in targeted negotiations. That means 137,000 SMEs have already been 'married off' while the remaining 99,000 currently have no succession solution.

Owner-managers who want to keep their business in the family have already made much more progress (Figure 4).

Figure 3: Status of preparations by planned withdrawal timeframe

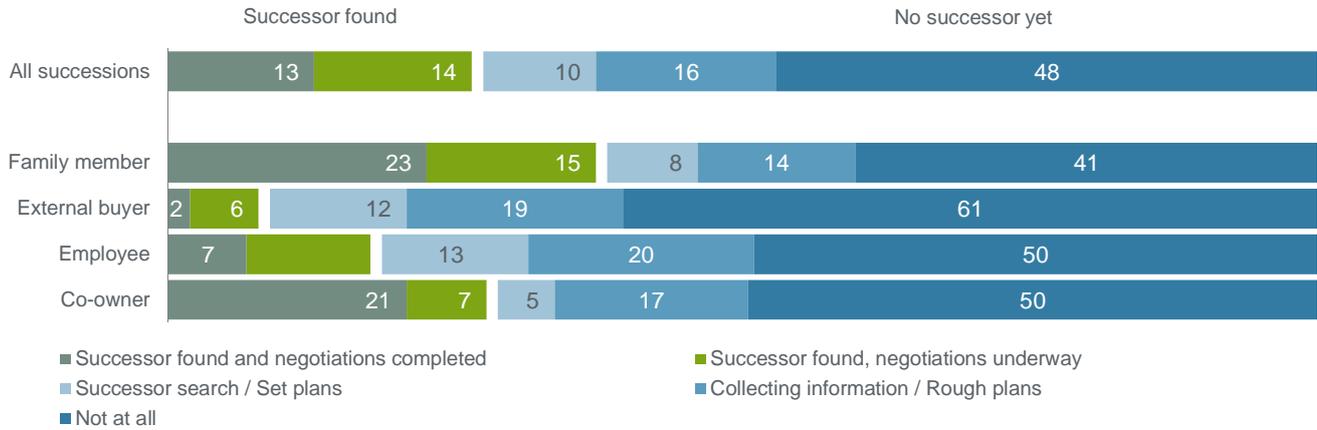
Shares of enterprises in per cent



Source: KfW SME Panel 2017.

Figure 4: Status of preparations by planned succession variant

Shares of enterprises in per cent



Source: KfW SME Panel 2017.

Irrespective of when they plan to retire, 38% of them have already designated a successor from within the family. Entrusting the business to the children thus simplifies and speeds up the transition process considerably. Owners who intend to hand over or sell their enterprise to a current co-owner also appear to be clear about their decision at an early stage. For 28% of them, the choice is already made. Not so for owners planning an external sale, however: only 8% of them have already found a successor. They have a particularly low degree of planning certainty.

Large SMEs and manufacturers favour succession – micro-enterprises eight times more likely to close shop

Succession or cessation? The answer clearly depends on size⁶ (Figure 5). For large SMEs with 50 or more employees, closing down hardly appears to be an option. A mere 5% of owners are considering this at the moment, while micro-enterprises with fewer than five employees are eight times more likely to close, at 41%. The succession situation is a mirror image of this: While nearly all large SMEs opt for succession when their owner retires, this is an option to fall back on for just over half of all micro-enterprises.

Company owners in retail, construction and the services sector have quite similar plans. Just over half to two thirds of enterprises in these segments want a successor. In manufacturing, by contrast, the share of succession planners exceeds three quarters.

Need for successors will remain high as owners age: 1.4 million of them are 55 or older

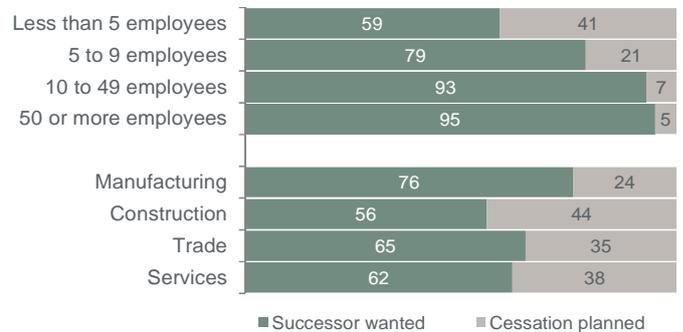
The need for successors will remain high. There is a significantly higher number of SMEs with older owners today than just a few years ago. Demographic change has already left a deep imprint (Figure 6). At the same time, SME owners have generally been ageing faster than the German population as a whole.⁷

In 2016, 39% of all business owners were already aged 55 or older. For comparison: In 2002 that share was still 20%. This means that more than one third of all business

managers – or some 1.4 million SME bosses – have reached an age at which economically active people entertain thoughts about retirement. The average age of business owners is currently around 51 years (2002: 45 years) and the average age of all owners considering succession is already 59 years. The age of owners facing imminent succession is a high 67 years.

Figure 5: Succession or cessation by segment

In per cent, only SMEs with responses



Source: KfW SME Panel 2017.

Not ready to retire – one in ten owner-managers are 77 years old when they step down

SME bosses also remain active significantly longer than the average population. The average retirement age in Germany is currently 61.7 years.⁸ Business owners and self-employed persons work more than six years longer before retiring. On average, an owner-manager will be around 68 years old when they retire.

Two further key figures illustrate how urgently successors are needed. One quarter of business owners will have reached the age of 72 or older by the time they plan to retire. One in ten owners will even be 77 years or older when they leave their firm. This is irrespective of whether they opt for succession or cessation. There are also very few sectoral differences.

Children are the only variable that does make a difference.

Business owners with no children plan to retire much earlier. The average age is then 64.8 years and rises to 66.7 years where underage children live in the household. Owners with children of legal age want to stay in business the longest. Their planned retirement age averages 69.1 years – more than four years above that of childless owners.

Figure 6: Age of SME owner-managers

Percentages of enterprises by age band



Notes: The count includes only those enterprises that were newly entered in the dataset in the respective survey year. Regular survey respondents were excluded because the age of owners increases by definition. No data are available on the age of business owners for the year 2003.

Source: KfW SME Panel 2017

Challenges of ageing are even greater in some places

The ageing of SME owner-managers and imminent successions are not an equally pressing problem in all regions of Germany. In fact, there are surprisingly large differences (Figure 7). The consequences of demographic change are more severe in Schleswig-Holstein. Nearly half the owner-managers (46%) are 55 years old or older in this state. As illustrated by the KfW Start-up Monitor, this is also because Schleswig-Holstein is the only federal state in which the motivation to start a business is higher in older persons (aged 41 to 50 years) than younger ones.⁹ The share of older owner-managers is also relatively high in Thuringia (44%) and Baden-Württemberg (41%).

These states are therefore facing particular structural challenges. Succession processes have to be initiated more frequently than average here. In Schleswig-Holstein, 21% of owner-managers plan to transfer or sell the business to a successor within a three-year timeframe (either to a family or non-family member). That is by far the highest proportion of all federal states, closely followed by Thuringia, Hesse and Baden-Württemberg (17% each). The situation appears to be different in Hamburg, Rhineland-Palatinate, Saarland and Mecklenburg-Western Pomerania. The shares of SME owner-managers seeking a successor in the short term are below average. Founders who are willing to take over a

business will find Hamburg to be particularly challenging as only 4% of SMEs there are preparing for succession.

Succession as a barrier to investment: the sooner owners retire, the less they invest

On aggregate, enterprises whose owner-managers have succession plans invest roughly as much as all SMEs on average in Germany (around EUR 7,500 per FTE employee). Although this finding may appear surprising at first glance, the reason for it is obvious. It depends on the timescale!

The nearer the time of the planned succession or sale approaches, the less likely the enterprise carries out investment projects. If the succession is planned to take place in the next five years, the willingness to invest averages around 41%. If the planned succession is more than five years in the future, the willingness to invest averages 56% – a significantly higher rate. Furthermore, owners planning to discontinue the business hardly invest at all (willingness to invest: 30%).

The importance of the timescale becomes particularly clear if we look at investment volume per full-time equivalent (FTE) employee (Figure 8) – a suitable measure to account for the correlation between enterprise size and investment volume. SMEs scheduled for succession far in the future (in 11 to 20 years) invest EUR 7,900, an amount nearly identical to that of all SMEs (2016: EUR 7,954). SMEs scheduled for imminent succession (within the next two years) have a low investment intensity of EUR 5,700.

Why is this so? The imminent transfer of ownership, coupled with the owner-manager's generally high age (Figure 9) reduces their propensity to invest. That is understandable. On the one hand, existing owners of SMEs contemplating retirement are uncertain as to whether a potential successor rates the future profit of an investment equally highly and factors it into the purchase price accordingly. On the other hand, many mature-aged business owners believe investments have an excessively long payback period. Having reached a high age, they have a strong desire to avoid long-term financial obligations.¹⁰

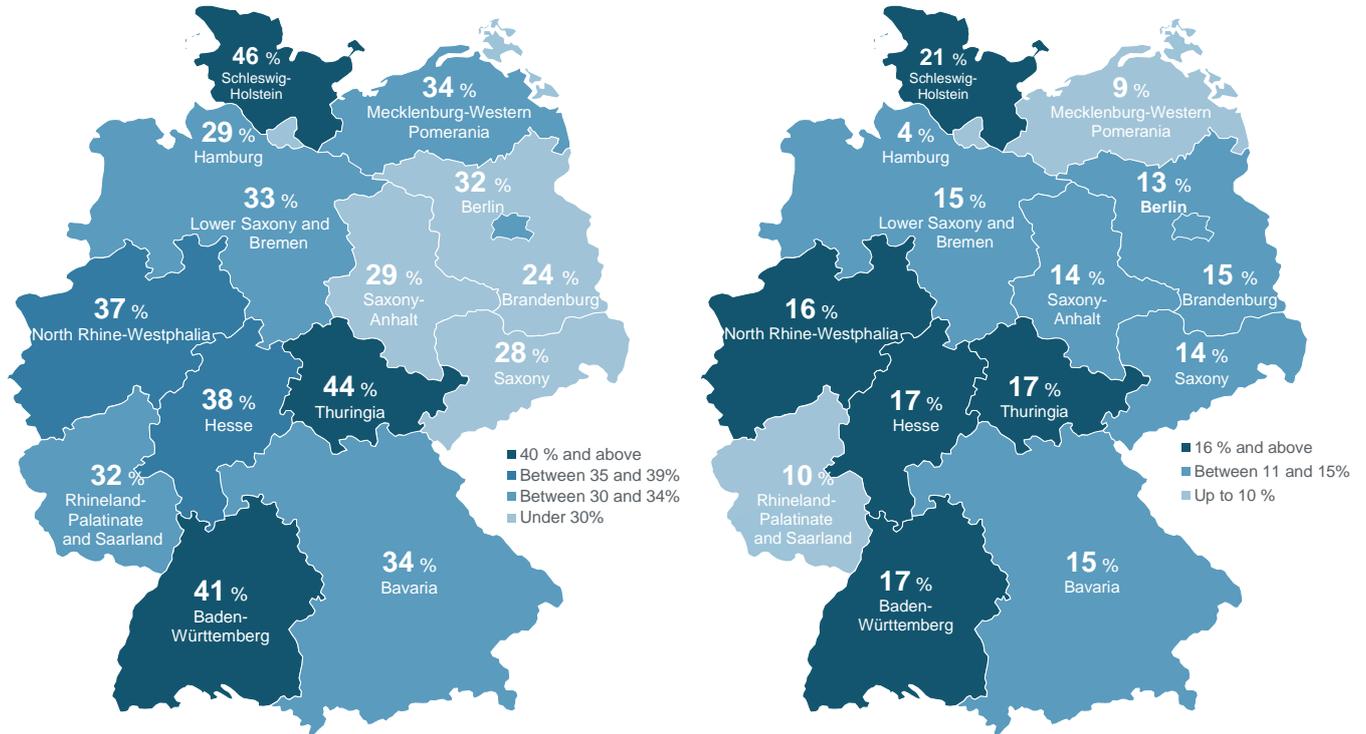
Keeping it in the family provides impetus

The type of successor an entrepreneur wants plays a decisive role for investment activity. Where the plan involves transferring the business to an external buyer, a current employee or co-owner, investment intensity is lower than the average of all SMEs with succession plans (between EUR 6,600 and EUR 7,000 per FTE employee).

This is entirely different when the enterprise stays in the family. Investment intensity then actually rises to some EUR 8,500. When the business stays in the family, the investment behaviour is hence significantly more committed than when it is sold to a non-family member. Current owner-managers appear to be more willing to invest in their business even at a more advanced age when they know it will be looked after by a family member.

Figure 7: Percentages of owner-managers over the age of 55 and SMEs with succession plans by federal state

Left: Percentage of owner-managers of all SMEs aged 55 or above (average 2012–2016) / Right: percentage of SMEs planning succession within three years (average 2011–2015)



Notes: Age of owner-managers (left side) mapped on the basis of a representative regional survey of the 2012–2016 waves of the KfW SME Panel. The count includes only those enterprises that were newly entered in the dataset in the respective survey year. Regular survey respondents were excluded because the age of owners increases by definition. Company succession (right side) mapped on the basis of a representative regional survey of the 2011–2015 waves of the KfW SME Panel. The current wave of the year 2016 cannot be considered here because the data collection methodology was modified. Rhineland-Palatinate / Saarland and Lower Saxony / Bremen were combined for reasons of robustness.

Source: KfW SME Panel 2012–2017, KfW SME Atlas 2018 (forthcoming).

Figure 8: Investment behaviour in 2016 by timeline up to planned succession

Investment volume in EUR per full-time equivalent employee



Source: KfW SME Panel 2017.

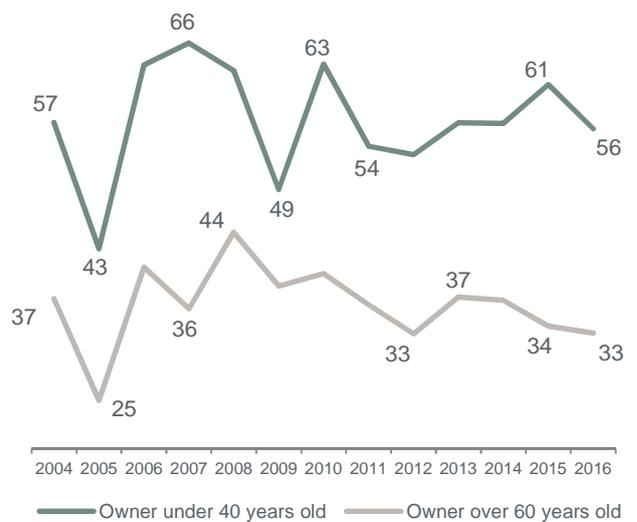
This presumably reflects the significantly higher ‘emotional duty’ to hand over a functioning enterprise. To secure the survival of the enterprise, investment decisions in these scenarios are more often made with the aim of maximising profit in the long term.¹¹

Succession clarity increases investment by 40 per cent

It is crucial to reduce or, in the best of cases, completely eliminate uncertainty for the owner-manager. That encourages investment even when succession is imminent. A delay or failure to transfer or sell the enterprise to the next generation of business owners puts pressure on capital formation and hence competitiveness and ultimately on jobs.

Figure 9: Investment activity by age of owner-manager

Percentage of investing enterprises



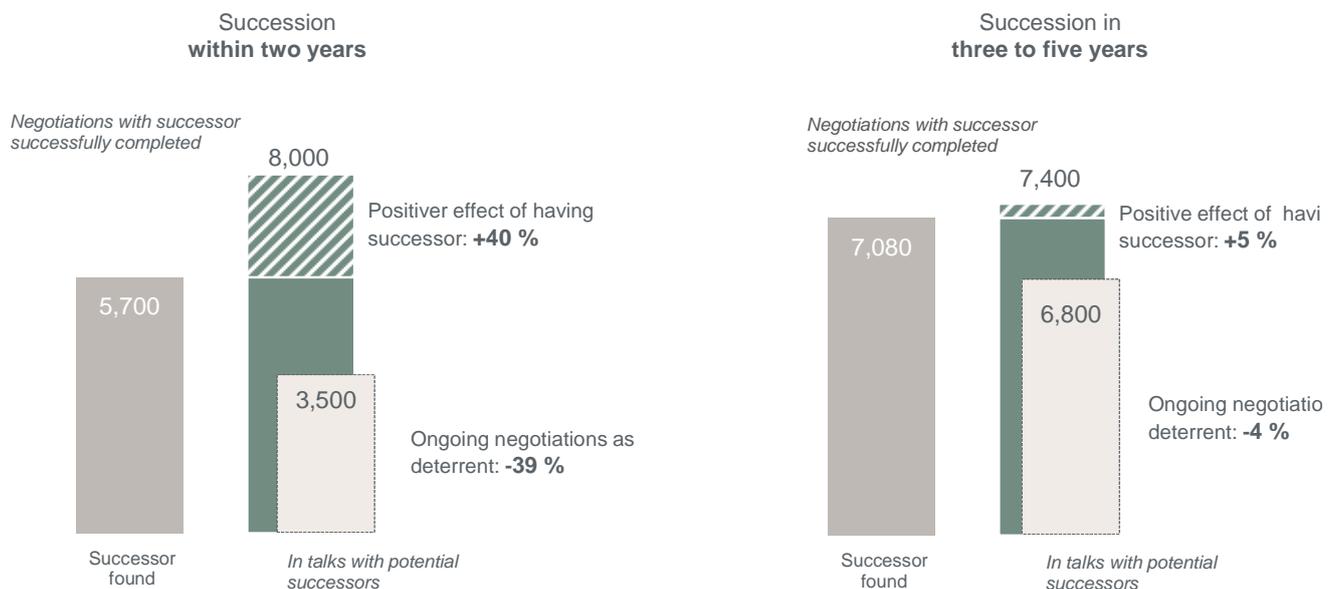
Source: KfW SME Panel 2005–2017.

The Solution: complete succession arrangements as early as possible. Once the succession is clear the level of investment rises again, considerably.

The effect of clear succession is most pronounced where an

Figure 10: Investment intensity by stage of succession planning

Investment volume in EUR per full-time equivalent employee; all data representative of the year 2016.



Guide (left): Enterprises currently reporting their intention to arrange for succession in the next two years invested an average EUR 5,700 per FTE employee in 2016. Where enterprises in this group are currently in negotiations with a potential successor, they invest an average EUR 3,500 per FTE employee. Enterprises that have already found a successor and completed their negotiations invested an average EUR 8,000 per FTE employee.

Source: KfW SME Panel 2017.

enterprise needs to change ownership within the next two years (Figure 10 left): Investment intensity in this group rises significantly as soon as succession is secured. Capital expenditure per employee (measured in FTEs) then rises by EUR 2,300 to EUR 8,000. This means that the effect of secured succession encourages owner-managers to invest an additional 40% in their business.

If, however, the negotiations with a potential successor are currently ongoing, the existing owner-manager's reluctance to invest increases once again. Investment intensity is then 39% lower (EUR 3,500) and on a level comparable to a planned closure. The patterns outlined here are also evident in successions that are planned for a later point in time (Figure 10, right). However, the effects are then significantly less pronounced. ■

Database: The KfW SME Panel

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

With data based on up to 15,000 companies a year, the KfW SME Panel is the only representative survey of the German SME sector, making it the most important source of data on issues relevant to the SME sector. The main survey of the 15th wave was conducted in the period from 13 February 2017 to 23 June 2017.

Further information and the current annual report can be obtained at: www.kfw-mittelstandspanel.de

¹ For the current edition of the KfW SME Panel, see Schwartz, M. (2017): KfW SME Panel 2017. Germany's domestic economy continues to break records – sectoral transformation poses new challenges, KfW Research.

² KfW Research has been accompanying this transformation process in the SME sector for quite some time. In order to account for the growing importance of this issue, the collection of relevant data was restructured and expanded significantly in the context of the KfW SME Panel in 2017. Therefore, not all results reported in this analysis are comparable with those of previous publications. On this topic, see also e.g. Leifels, A. (2016), Ageing boosts SMEs' need for successors – 620,000 business transitions by 2018, Focus on Economics No. 132, KfW Research – Schwartz, M. and Gerstenberger, J. (2015), Succession planning in SME sector in full swing: Half a million hand-overs by 2017, Focus on Economics No. 91, KfW Economic Research.

³ The group of business owners for whom subsequent closure is currently at least a serious option is not regarded as succession planners in the remainder of the analysis. For one thing, the analyses would be fraught with problems of definition that make statements difficult. For another, focuses primarily on enterprises and owners for whom succession is at least very likely to become relevant. The analyses relating to the group of succession planners therefore exclude this segment of business owners.

⁴ Metzger, G. (2017), KfW Start-up Monitor 2017: Record employment with side-effects: Fewer start-ups than ever, KfW Research.

⁵ For a detailed analysis of start-ups by acquisitions in Germany cf. Metzger, G. (2016), Transfer-planning entrepreneurs outnumber takeover entrepreneurs 3 to 1, Focus on Economics No. 133, KfW Research.

⁶ The calculation of the number of employees is based on the concept of full-time equivalent employees (FTEs). FTE employees are calculated from the number of full-time employees (including business owners) plus the number of part-time employees multiplied by the factor 0.5. Apprentices are not included.

⁷ Gerstenberger, J. and Schwartz, M. (2014), Mittelstand altert im Zeitraffer, Economics in Brief No. 63, KfW Economic Research (in German only).

⁸ Deutsche Rentenversicherung, Eurostat. (Found at Statista)

⁹ Cf. Metzger, G. (2015): Are start-ups the same throughout Germany? Hardly! A comparison of German states, Focus on Economics No. 111, KfW Research.

¹⁰ Schwartz, M. and Gerstenberger, J. (2015), Ageing in SMEs is putting a damper on investments, Focus on Economics No. 85, KfW Economic Research – Gerstenberger, J. and Schwartz, M. (2014), Uncertainty hampers SMEs' investment, a secure framework is necessary, Focus on Economics No. 66, KfW Economic Research (both in German only).

¹¹ Cf. e.g. 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.