

»» SME succession in Germany: 'Mittelstand' needs 152,000 successors by the end of 2021 – external investors wanted

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There has been a slight drop in the number of upcoming SME successions: Up to the end of 2021, each year some 76,000 SME owners intend to hand over their business to a suitable successor. One explanation for the current drop appears to be that there has been more interest in take-over start-ups recently. This reduces the number of open succession plans.

Owners appear to have become even more aware of the need to finalise company succession early. The share of successions already finalised has grown again. Nonetheless, time is running out for almost 32,000 SMEs. They plan to hand over their business within the next two years but have not yet taken any steps for a successful leadership transfer.

Family succession appears to be a model that has run its course. Instead, SMEs are developing a growing preference for a transfer to external buyers. The purchase prices envisioned by the owners are rising again. Potential buyers now need to budget an average purchase price of EUR 372,000 for a small or medium-sized enterprise.

Demographic change will increase the need for successors and make them more difficult to find. Already, more than 1.5 million owners are 55 years old or older. Over the next ten years, more successors will be needed than today. However, there are probably not enough new business founders moving up.

Company succession: the ultimate discipline

Passing a business on to the next generation has enormous implications. It is typically a major life event, both for the owner who is leaving the business and for the young successor who is taking over – and often a very emotional one. For neither of them is it routine and in most cases they cannot draw on previous personal experience. Insights into experiences of others are also hard to come by because most negotiations on succession arrangements are conducted secretly.

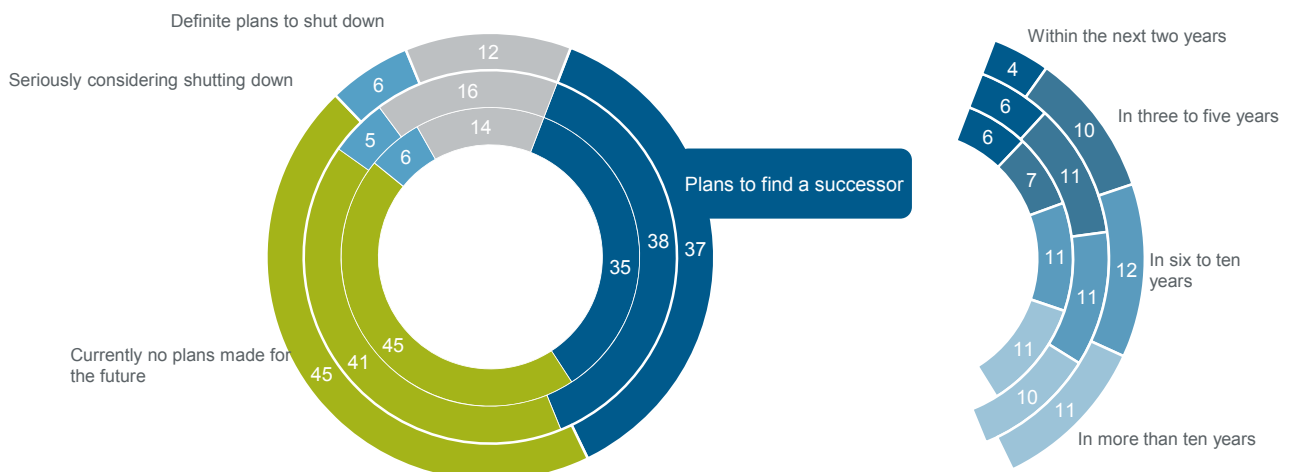
Reaching a compromise means putting together many pieces of the puzzle – a process that requires adequate preparation and information. The recent, noticeable broadening of the debate around the speciality of business succession is therefore all the more pleasing. Much has happened, especially in economic policy – at both federal and state level. The awareness of owners of small and medium-sized enterprises (SMEs) in Germany is also growing. Current data from the KfW SME Panel¹ on the status of SME successions indicate that the number of upcoming business successions has dropped slightly (Figure 1).

SMEs are planning slightly fewer successions

In the next two years, 152,000 owners of small and medium-sized enterprises plan to withdraw from their business and place their business into the hands of a successor. This represents four per cent of all SMEs in Germany up to the end of 2021. The number of planned upcoming successions has

Figure 1: Current key data on business succession in the German SME sector

Percentage shares in total SME sector; diagram on the right: Breakdown of planned successions by timeline



Source: KfW SME Panel 2017–2019.

Note: This paper contains the opinion of the authors and does not necessarily represent the position of KfW.

thus decreased since previous surveys. In each of the past two years, some 6% of owners still responded that they were planning a transfer within that time horizon (approx. 227,000 to 240,000 businesses).

Business starters have recently shown greater interest in taking over existing SMEs

A look at the entrepreneurial dynamic at the current margin may reveal a possible source of the current decline.² In 2018, some 72,000 new entrepreneurs started a business by taking over an existing one. The number of those who are willing to build on existing business structures has thus grown by 24% year on year (2017: 58,000). That is the highest number in six years.

This may indicate that a higher than average number of planned successions have already taken place without complications as a result of growing demand by business starters. A gradual process of growing awareness may also be identified here, i.e., on the part of potential takeover entrepreneurs.³

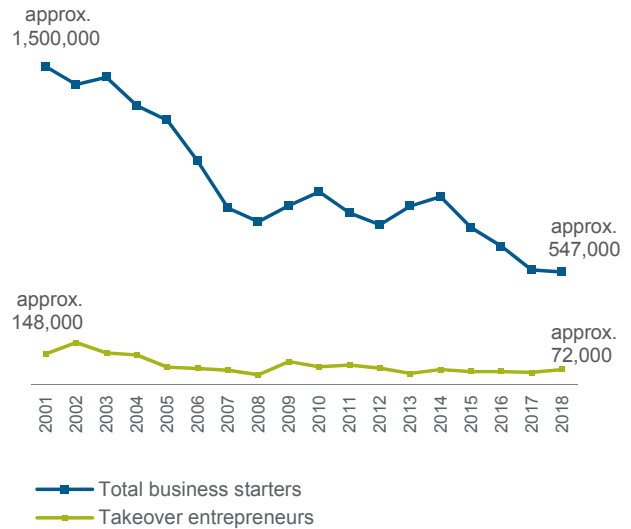
Despite the positive trend at the current margin, the limiting factor in business successions will continue to be a lack of numbers in the new generation of business starters (Figure 2). The appetite for entrepreneurship is generally weakening.⁴ The last figure was 547,000 business starters, a far cry from the 1.5 million seen in Germany in 2002. The pull effect of the record labour market's employment opportunities for potential business starters has been too strong.

Many owners are planning to shut down

Existing owners' withdrawal plans can also include shutting down entirely – another natural element of structural renewal in the business sector. Today, 12% of owners see closure as the only conceivable pathway after withdrawing from their business.⁵ At most, that would apply to around 450,000 currently active small and medium-sized entrepreneurs who are leaving the market of their own accord without any succession arrangements (of whom some 100,000 SMEs by the end

of 2021). But closure plans hardly play a role with growing company size. Business closures do not tend to be on the table in the manufacturing sector either.⁶

Figure 2: Business starters in Germany



Source: KfW Entrepreneurship Monitor.

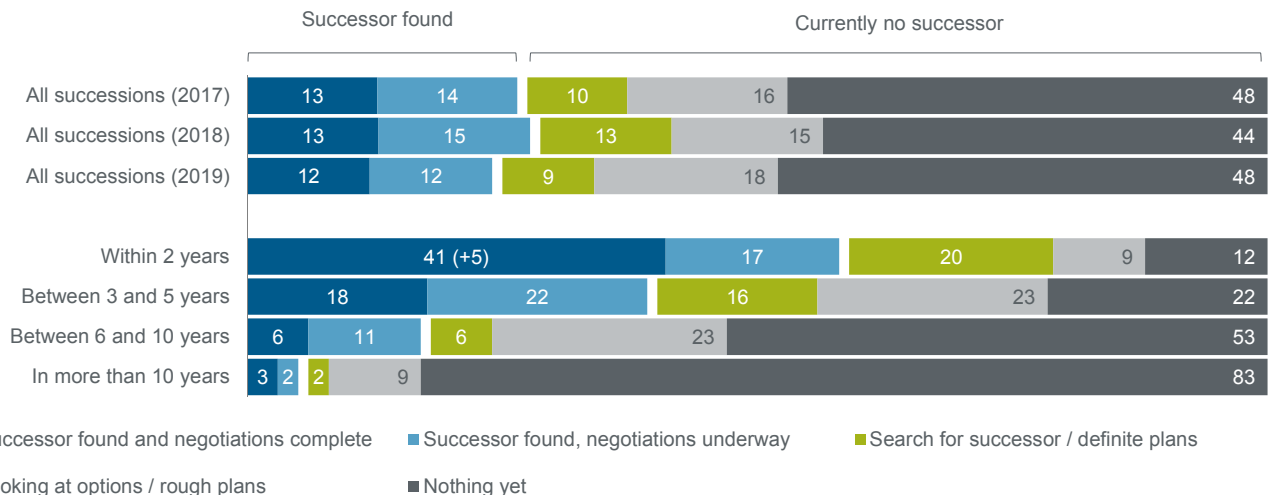
Awareness has grown further and more enterprises already have a succession plan

KfW Research has been accompanying the generational transition in the SME sector for quite some time now.⁷ What has become apparent is that SME owners have generally become more aware of the need to face the challenges of succession management.

A steadily growing number of owners have found and finalised a succession solution early – including in the current survey. Of those who are planning to hand over their business within a period of two years, 41% have already successfully completed their negotiations (Figure 3). In the preceding year, that share was 36% and two years before it was 30%.

Figure 3: Status of business succession preparations by planned withdrawal timeframe

Company proportions in per cent; values in brackets are year-on-year variations in percentage points.



This must be seen as a clear indication of heightened awareness on the part of owners and a giant step forward. Transferring a business is a legally complex and long-term undertaking that requires careful preparation. Allowing sufficient lead-up time, making detailed preparations, choosing the right time and having realistic expectations are crucial factors for a successful business transfer.

As at today, 62,000 of the 152,000 short-term succession plans are already completed, with the existing owners having finalised all necessary steps. A further 26,000 SMEs (17%) at least have their sights set on a specific successor and are conducting negotiations. These SMEs have a good chance of putting their planned succession in place by the end of 2021.

32,000 want a successor – but are completely unprepared

However, around 32,000 existing owners must face the prospect of unsuccessful business succession. These 21% of owners plan to hand over their business by the end of 2021 but have either not even started the process (12%) or have merely collected information so far (9%). Experience shows that this will not be sufficient and there is probably not enough time. It is no coincidence that the Association of German Chambers of Industry and Commerce (DIHK) recommends starting specific plans and searching for a successor no later than three years before the transfer.⁸

Has family succession run its course?

External investors are increasingly sought after

Company succession within the family, without a doubt the defining picture of generational business transition, is increasingly fading into the background (Figure 4). Only 44% of

owners currently considering succession would now like their business to pass into the hands of a family member. The previous clear preference for family business succession arrangements is thus gradually losing more and more ground in SMEs.⁹

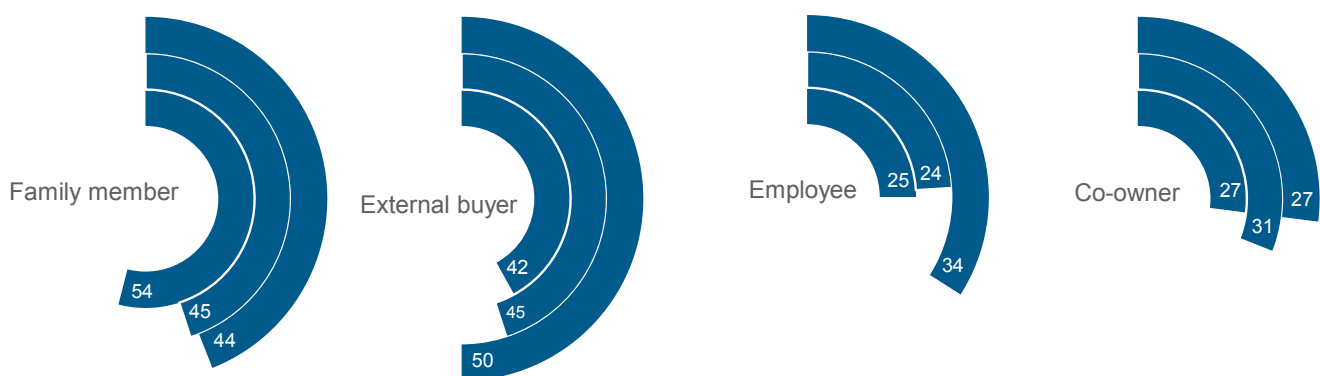
In contrast, preferences for alternative succession arrangements are increasing. Owners of SMEs are again considering external buyers more often (e.g. other companies, business starters or financial investors). One in two existing owners of an established SME (50%) can hence imagine an external buyer or investor as their successor.

SMEs: a worthwhile investment object?

Small and medium-sized enterprises can be an attractive option for external buyers. Potential buyers can build on a tried and tested business model (including a customer base, suppliers, orders booked, staff, expertise, etc.) which should be viable in the majority of cases. Almost 90% of companies planning for succession generate a positive profit margin¹⁰ averaging just under 8%. These SMEs earn an annual profit of around EUR 110,000 and 90% of them have a positive equity ratio¹¹ (mean value 32%). So it is safe to say that they have good earning power, a strong equity base and a solid financial position.

Figure 4: Succession variants currently being considered

Shares of enterprises in per cent

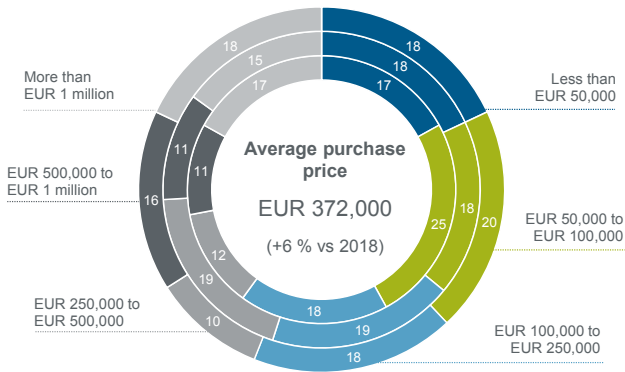


Note: Multiple answers were possible. Based on all SMEs considering succession (independently of the envisioned handover period). Analyses for the category 'employee' include only SMEs with employees. Analyses for the category 'co-owner' include only SMEs with several owners. Not including entrepreneurs currently considering closing their business. The number of responses under 'Other' are not shown. These include setting up a foundation, for example.

Source: KfW SME Panel 2017–2019.

Figure 5: Succession planners in the SME sector – purchase prices being asked

Percentages of companies; only companies whose owner-manager is planning succession within the next five years (by the end of 2024); only enterprises that have disclosed their purchase price.



Notes: The average purchase price is a rough estimate. See box at the end for details on how it was estimated and limits to interpretation.

Source: KfW SME Panel 2017–2019.

External sale comes with greater uncertainties

Although significantly more owners are considering selling their company to external buyers, not all of them will be successful. The key obstacle is that of ‘coming together for the first time’, which entails high transaction costs. Importantly, sellers lack experience and procedural knowledge. After all, a company succession is usually done only once.

The high planning uncertainty is also reflected in the fact that owners looking for an external buyer are much less prepared. Just under 1% of them have already found a successor and only 4% are in specific negotiations. In contrast, 90% have not even begun their rough planning or are still searching.

Business succession platforms are a valuable tool that make it easier for stakeholders to come together and to reduce information asymmetries between the parties (see box on next-change, Germany’s largest business succession platform).

The proportion of entrepreneurs who can imagine handing over their business to a current employee has also increased (plus ten percentage points to 34%). In this type of succession, one or more managers take over the company or the company is taken over by employees. This development, too, appears to offset the structurally declining relevance of family-internal generational change.

The business succession platform next-change



next-change is a business succession platform that has been operating online since 2006. Its purpose is to bring entrepreneurs who are interested in a succession arrangement together with emerging business founders. Succession planners and business founders interested in a takeover can create anonymised advertisements or re-search the existing database. next-change focuses on succession processes outside the family.

Advertisements are created with support from a regional partner (e.g. a chambers of skilled crafts, chambers of industry and commerce or savings banks). The regional partners are tasked with providing quality assurance and coordinating the process of bringing the parties together. The regional partner is selected during the preparation of the advertisement.

As at January 2018, the site registered 6,565 advertisements from existing owners who want their business to pass on to a successor. Some 500 to 600 new advertisements are added each month. Around one quarter of the businesses registered for succession (24%) generate an annual turnover of not more than EUR 250,000 and more than half of them have no more than ten employees (55%).

Next-change is an initiative of the Federal Ministry of Economic Affairs and Energy, KfW Group, the Association of German Chambers of Industry and Commerce, the German Confederation of Skilled Crafts, the Federal Association of German Cooperative Banks and the German Savings Banks and Giro Association in collaboration with the partners of the ‘next’ initiative.

Purchase prices are rising again: owners now ask 6 per cent more for their company on average

Many challenges must be overcome on the pathway to successful business succession. One of the most formidable barriers to success is finding a purchase price that is acceptable to both seller and buyer alike, that is, minimising deviations in ideas about purchase price on either side.¹² In monitoring the status of SME succession, KfW Research surveys existing owners’ price expectations (see box at the end for details on how they are estimated and limits to interpretation).¹³

The most recent analysis of intended purchase prices now shows a year-on-year increase of 6%. Where a seller specifically envisions a succession within the next five years (by the end of 2024), in 2019 a potential buyer would have to budget an average price of EUR 372,000 to purchase the company (2018: EUR 351,000).

Turnover multiplier is increasing in parallel

The comparison of annual turnovers and envisaged purchase prices also suggests that existing owners are valuing their companies higher on average. The turnover multiplier¹⁴ increased from 90% in 2018 to now 110%. In other words: On average, succession planners in the SME sector define their purchase price as annual turnover multiplied by a factor of 1.1, significantly more than in the previous year (2018: 89%).

This multiplier can provide negotiating partners with an initial starting point for determining the underlying company value. However, this is a rough approximation for all SME succession planners (irrespective of the time leading up to the planned succession). Individual valuations vary greatly and segment-specific ranges are broad.¹⁵ It also needs to be added that there is no generally recognised method for determining the purchase price of an SME. What is decisive in many cases is the company's operating income, for example, or future earning power (particularly as measured in EBIT).

Vast majority of SMEs still have reasonable ideas about purchase price

Despite all 'price increases': A detailed view of the class distribution shows a marked shift towards rather lower purchase prices for SMEs. Thus, nearly one in five SME companies rate their current value at not more than EUR 50,000 (18%). More than half estimate the current purchase price at not more than EUR 250,000 (56%). The median is thus significantly lower: Half of all owners of SMEs estimate their company's purchase price at not more than EUR 175,000.

The average valuation of the intended purchase prices has thus increased for the second consecutive year – after +2% in 2018. The median, however, has remained constant for the third consecutive year. The current increase in average valuations is primarily attributable to the growth in the value class between EUR 500,000 and EUR 1 million (+5 percentage points). There are significantly more owners of SMEs that place their company in this value class.

Almost one in two are approaching the age of retirement

The need for succession is high and is set to increase further. The number of enterprises with older owners has been growing continuously for quite some time and is far above previously customary values (Figure 6). Currently, 44% are aged 55 and over. In 2002 that share was only 20%. This means that nearly half of all business managers have now reached an age at which working people entertain thoughts about their retirement. Expressed in absolute figures, that is just over 1.5 million business owners.

At the same time, the share of young owners (under the age of 40) has halved from 28% to now 14% during the same period. This very clearly demonstrates the consequence of an excessively low number of young entrepreneurs moving up.

Demographics will make succession more difficult in future

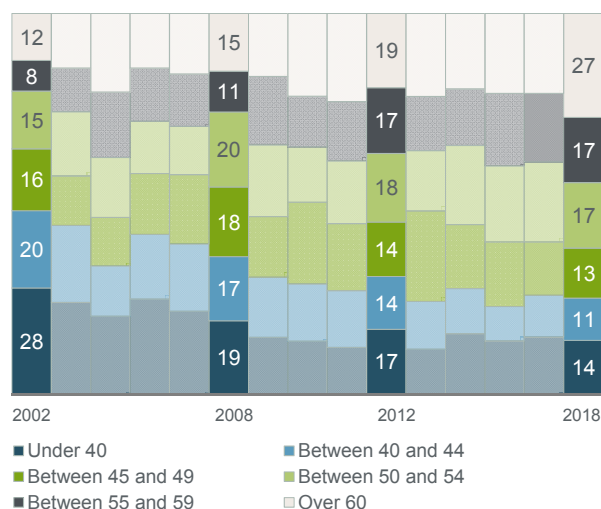
Demographic change has already had a significant impact. At the same time, SME owners have aged faster than the German population as a whole.¹⁶ The average age of an SME business owner is currently around 52 years – seven years higher than in 2002 (45 years).

In those companies that are planning succession soon, i.e. within the next two years, the owners even average 67 years. For comparison: The average retirement age in Germany is currently around 62 years. Already SME bosses and self-employed persons continue to work significantly longer than the average population.

The average age structure of SME owners will continue to increase and there will be more older owners. This will become particularly obvious between 2025 and 2035. That is when the baby boomer generation retires from the workforce. The younger cohorts, however, are less populated and the number of potential succession candidates is declining. In other words: The demographic situation will see a growing number of owners facing a shrinking number of potential successors.

Figure 6: Age of SME owners

Percentages of enterprises by age band



Notes: The count includes only those enterprises that were newly entered in the dataset in the survey year. Regular survey participants are excluded because the owners' age increased by definition. No data are available on the age of business owners for the years 2003 and 2017.

Source: KfW SME Panel 2003–2019.

The KfW SME Panel

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

With a database of 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 17th wave was conducted in the period from 11 February 2019 to 21 June 2019.

To estimate the purchase prices, the information provided

by the owners from the value class allocation was translated to numerical values. In order to arrive at these values, the relevant median class value was set. For example, a value of EUR 25,000 was assumed for the value class 'less than EUR 50,000'. In an initial allocation to the highest value class 'more than EUR 1 million', a cautious approach was chosen by setting precisely his minimum class threshold as the envisioned purchase price.

As it is unknown whether there is equal distribution within the individual value classes, the stated average values therefore represent approximations with a tendency towards underestimation.

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

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¹ For details on the annual analysis of the structure and development of the SME sector in Germany, see the current annual report: Schwartz, M. (2019), **KfW SME Panel 2019: After a record year, dark clouds are gathering**, KfW Research.

² Cf. Metzger, G. (2019), **KfW Entrepreneurship Monitor 2019: Entrepreneurial activity in Germany has stabilised. Has the downturn just slowed, or is it over?** KfW Research.

³ For more on takeover entrepreneurs in general, see Metzger, G. (2016), **Transfer-planning entrepreneurs outnumber takeover entrepreneurs 3 to 1**, Focus on Economics No. 133, KfW Research.

⁴ Cf. Metzger, G. (2019), **Wunsch nach beruflicher Selbständigkeit nimmt ab, Lichtblick durch Jüngere** (*The drive for self-employment is slowing, younger entrepreneurs are a silver lining* – in German only), Focus on Economics No. 261, KfW Research.

⁵ In a further 6% of SMEs, closure is currently a withdrawal option that is at least receiving serious consideration (irrespective of the time envisioned up to the owner's withdrawal). This group of owners is not being regarded as succession planners here. For one thing, the analyses would be fraught with problems of definition that make statements difficult. For another, it 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.

⁶ Cf. the corresponding sections on pages 3 and 4 in Schwartz, M (2019), **Status report on SME succession: Planning steady at a high level**, Focus on Economics No. 241, KfW Research.

⁷ In order to account for the growing importance of the issue, the collection of relevant data was restructured and expanded significantly in the context of the KfW SME Panel in 2017. For initial findings resulting from this modification, see: Schwartz, M. (2018), **Wave of successions in German SMEs: 240,000 successors wanted by 2019**, Focus on Economics No. 197, KfW Research. – Schwartz, M (2019), **Status report on SME succession: Planning steady at a high level**, Focus on Economics No. 241, KfW Research. Analyses from previous publications cannot be compared one-to-one with the data presented here. For the history 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.

⁸ DIHK (2018), DIHK Report on company succession 2017: Unternehmensnachfolge 2018 – Große Herausforderungen, aber auch Lichtblicke (*Company succession 2018 – major challenges, but rays of light, too* – our title translation, in German only), Berlin.

⁹ This may reflect the fact that preference for family succession arrangements is declining as a result of structural changes. Future observations will show whether this is the case. What is also conceivable is that in-family generational transfer is becoming more difficult in general (with changing career preferences among children and more childless couples, for example), causing the focus to shift more towards external succession considerations.

¹⁰ Profit margin is defined as the ratio of pre-tax profit to turnover. The figure shows the mean values of profit margin weighted against turnover.

¹¹ The equity ratio is defined as the ratio of equity to balance sheet total. The figure shows the mean values of the equity ratio weighted against the balance sheet total. The calculations apply only to enterprises required to draw up balance sheets.

¹² Emotions are also a barrier in many cases. Many owners are too attached to their lifework and therefore tend to be reluctant to let go and embrace the associated processes.

¹³ Cf. Schwartz, M. (2019), **Kaufpreise bei Nachfolge im Mittelstand** (*Purchase prices in SME business successions* – in German only), Focus on Economics No. 251, KfW Research.

¹⁴ In order to determine the average value of the turnover multiplier referred to in the text, the empirically identified turnovers and fitted company values were used based on median class values. As companies that generate relatively low turnovers (such as very young businesses) tend to apply very high and unrealistic multipliers, the turnover multiplier was limited to the value of ten in the calculation. The limits to interpretation in calculating company values mentioned in the box should also be noted.

¹⁵ For example, the expert opinions of the FINANCE multipliers demonstrate a significant range of turnover multipliers in the segment of small caps (annual turnover of less than EUR 50 million). The lower threshold of the valuation range is a value of roughly 0.5 (construction and crafts segment) and the highest value is 2.0 (pharmaceuticals segment). These multipliers are based on quarterly market assessments by experts of M&A consulting firms and investment banks. Multiplier corridors are surveyed and averaged for 16 industries.

¹⁶ Gerstenberger, J. and Schwartz, M. (2014), **Mittelstand altert im Zeitraffer** (*SMEs are ageing in fast motion* – in German only), Economics in Brief No. 63, KfW Research.