

# »» Status report on SME succession: Planning steady at a high level

No. 241, 4 February 2019

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Some 227,000 owner-managers of SMEs are planning to hand over their business to a successor by the end of 2020. More than one third of these small and medium-sized enterprises (SMEs) – significantly more than before – have already successfully mastered the coming generational transition and found a successor. In other words: The current generation of SME owner-managers has become more aware of the need to plan for succession.

The KfW SME Panel has found that SMEs are generally paying more attention to the issue of succession. Owner-managers are better prepared and more of them have already found a solution than a year ago. External succession is becoming noticeably more important as a preferred variant.

Most succession planners have a sound earnings situation and strong equity base. Nevertheless, many pieces of the puzzle have to come together for succession to be successful. Having a sufficient run-up is crucial. But time is running out for some 36,000 enterprises. They are planning a management transfer within the next two years but have not yet adopted any measures whatsoever.

For many succession plans, the short supply of new emerging entrepreneurs remains the key constraint. The number of emerging business founders is too low – and has dropped even further in recent years.

## Succession management still very high on SMEs' agendas

Owner-managers of SMEs are keenly aware of the need to face the challenges of generational change. Never before have more business managers been weighing their options for withdrawing from their business in the future (Figure 1). This is a positive trend because when arrangements are made as early as possible, they secure investment and, hence, enterprises' sustainability and competitiveness.

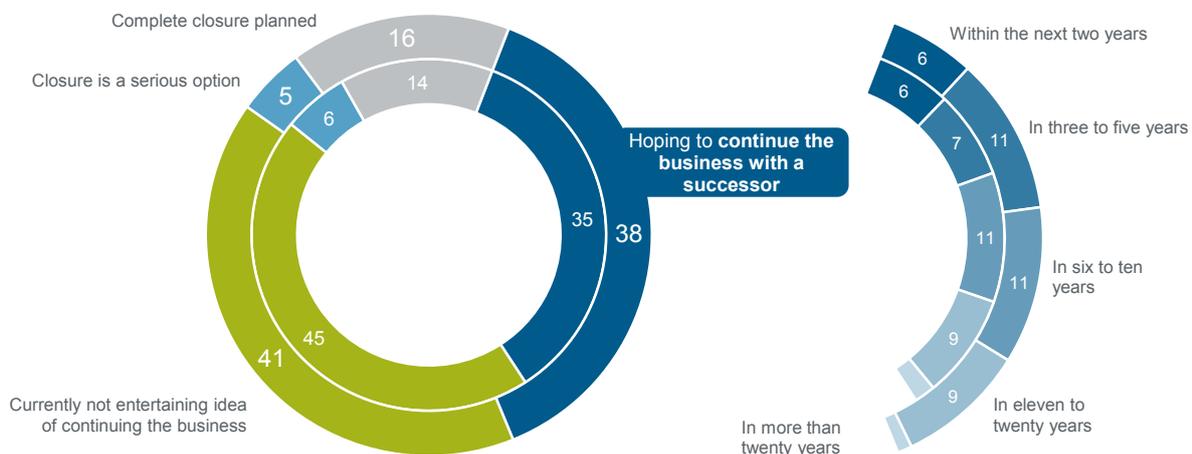
Among the contributors to this heightened awareness have been, not least, greater focus on the topic by economic policymakers, as well as regular and broader recent media reports.<sup>1</sup> The owner-managers of small and medium-sized enterprises in Germany are increasingly aware of the consequences of successful business succession management.

## Around 227,000 handovers are planned by the end of 2020

According to recent data collected by the KfW SME Panel,<sup>2</sup> around 6% of SME owner-managers plan to retire in the next two years alone and want their business to continue under a succession arrangement (Figure 1). Short-term plans remain stable on a high level (6% in 2017 as well). That means some 227,000 small and medium-sized entrepreneurs can generally imagine placing their business into the hands of a successor by the end of 2020.

**Figure 1: Current key data on SME continuity in Germany**

Percentage shares in total SME sector; diagram on the right: Breakdown of 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. Not all results are therefore comparable with earlier relevant publications by KfW Research.

Source: KfW SME Panel 2017 and 2018.

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

The situation is similar in Germany's neighbouring countries. In spring 2018, an analysis of unclear successions in Switzerland concluded that around 13.4% of enterprises face unresolved succession situations within the next five years.<sup>3</sup> In Austria the responsible ministry estimated the succession potential among SMEs and sole traders in Austria between 2018 and 2027 to be around 29% (as at November 2018).<sup>4</sup> So Germany does not have a special status in any way.

**Succession planners' earnings situation and equity base**

The majority of enterprises whose owner-managers are getting ready for succession operate profitably:<sup>5</sup> In 2017, 87% of all succession planners achieved positive **profit margins** (SME sector overall: 91%)<sup>6</sup>. Around 13% of them suffered losses.

The average profit margin of all succession planners is 7.8% (SME sector overall: 7.2%). A stable and high profit margin attests to good earning power and is a key rating criterion for lenders in their lending decisions, for example.

A company's profit situation can also allow further conclusions to be drawn on the future viability of the underlying business model. Succession planners make an **annual profit** of EUR 113,000 (SME sector as a whole: EUR 105,000), although roughly half of these enterprises achieve an annual profit of not more than EUR 52,000 (SME sector as a whole: EUR 36,000).

Even the largest group of succession planners – **micro-enterprises** – appears to be in a good position: 85% of them generate positive returns and an average annual profit of EUR 63,000 (mean annual profit: EUR 40,000).

Enterprises' **equity ratio** also plays a role in assessing their financial robustness.<sup>7</sup> The equity base of enterprises planning their succession is excellent: 89% have a positive equity base (91% across the SME sector). Succession planners' average equity ratio was 32% in 2017 (31% across the SME sector).

They can definitely be said to have a strong equity base. This enhances their resilience in times of crisis, preserves their independence and gives them a high degree of flexibility to cope with a more difficult financing environment.<sup>8</sup>

Four in five of the short-term succession planners in the German SME sector are micro-enterprises<sup>9</sup> (with fewer than five employees) – representing 182,200 SMEs alone (table). A slightly higher number – 184,000 SMEs in total – belong to the services sector<sup>10</sup>. The construction sector has the lowest share of imminent successions in the next two years (4.1%).

The share of owner-managers planning their succession in the short term is more than twice as high in R&D-intensive manufacturing (9.6%) and large SMEs with 50 and more employees (9.4%).

**Solid profits, good equity base: SMEs are attractive for successors...**

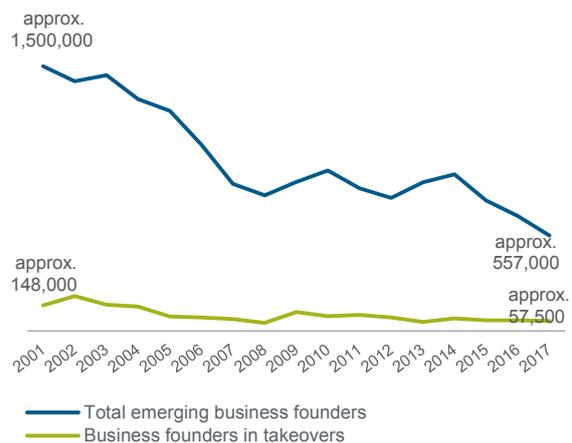
Not all management successions currently being considered by owner-managers will be completed. Many parts of the puzzle need to fit together, from the search for a successor and the general decision for or against a particular form of succession through the negotiation of a purchase price and payment terms to financing. By far not every existing owner-manager currently seeking succession will be able to do this.

At least in terms of earning power, profitability and financial robustness, the businesses that are ready for succession appear to be largely well-prepared (see Box 1). Most of the underlying business models should generally be viable.

**... but the pool of emerging entrepreneurs is becoming increasingly smaller**

This is where the main problem lies: The number of emerging business founders is too low and has dropped further in past years. While there were still some 1.5 million business founders in Germany in 2001, that number dropped to only 557,000 in 2017 – the lowest number ever (Figure 2).<sup>11</sup> The very strong labour market situation offers potential business founders an abundance of attractive employment opportunities.

**Figure 2: Start-ups in Germany**



Source: KfW Start-up Monitor.

At the same time, the number of new business founders who build on existing business structures has also declined. In 2017, only 57,500 people started a business by taking over an existing enterprise<sup>12</sup> – in 2001 it was 148,000 (a 61% decline). That is nowhere near enough to meet the demand.

**Table: SME owners' current withdrawal plans by segment**

Industry	Succession within the next two years strongly considered		Closure planned (All time frames)
	Share of all SMEs in segment in per cent	Share of SMEs	Share of all SMEs in segment in per cent
R&D-intensive manufacturing	9.6	4,200	9.1
Other manufacturing	8.1	16,600	18.5
Construction	4.1	14,900	26.3
Knowledge-intensive services	5.1	73,700	23.5
Other services	7.9	110,300	21.0
Trade	8.5	51,600	22.1
<b>Enterprise size by no. of employees</b>			
Micro-enterprises (under 5)	6.0	182,200	24.5
Small SMEs (5 to 9)	7.4	26,100	13.1
Medium SMEs (10 to 49)	8.8	25,100	4.2
Large SMEs (50 or more)	9.4	6,800	1.0
<b>Region</b>			
Eastern Germany	5.0	34,500	23.1
Western Germany	6.5	201,000	21.1
<b>Area of activity</b>			
Craft SMEs	6.4	66,200	24.8
Self-employed	5.4	58,100	26.3
<b>Total SMEs</b>	<b>6.0</b>	<b>227,000</b>	<b>21.3</b>

Note: Focus on successions planned in the short term (within the next two years). Closures comprise the categories 'definitive closure planned' and 'closure is a serious option'. No further differentiation is possible for reasons of robustness. Absolute figures are rounded. Because of diverse modes of calculation, the individual figures on segments do not add up to the 'SME total'. See endnotes 5 and 6 on class formation for enterprise size and economic sectors.

Source: KfW SME Panel 2018.

### Owner-managers are much better prepared and nearly two thirds already have a succession solution in place

The present owner-managers' heightened awareness is bearing fruit, particularly for short-term succession plans (within the coming two years) (Figure 3): A significantly higher share of present owner-managers has already finalised necessary negotiations – their share has grown by 6 to 36%. A further 26% of affected SMEs are conducting negotiations.

As a result, 62% of SMEs that are planning to complete their succession by the end of 2020 have already found a specific or potential successor. In other words: Around 141,000 enterprises are presumably 'off the market' – slightly more than the year before. Even so, more owner-managers are currently making specific succession plans as well. This is another indication of their heightened awareness.

### Time is running out for 36,000 SMEs – succession is rather unlikely

At the same time, the share of completely unprepared successions has fallen (-10 percentage points to 16%). Time is running out for these 36,000 SMEs. Their owner-managers

have either not even started the process or have merely collected information so far. It is very likely that their original succession plans will not be realised.

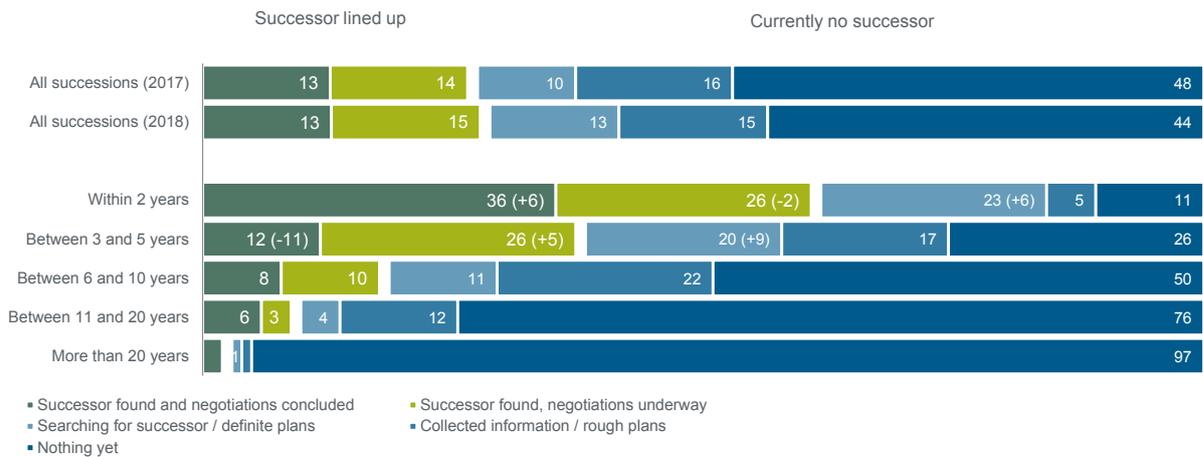
The reasons for their imminent failure are obvious: Transferring a business is a legally complex and long-term undertaking that requires careful preparation. Allowing sufficient lead-up time, making detailed preparations, choosing the right time and having realistic expectations are crucial factors for a successful business transfer. The Association of German Chambers of Industry and Commerce, for example, recommends that concrete planning and the search for a successor should begin no later than three years before the transfer. 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.

### Closing down is also an option

Besides the wish for orderly business succession, planned closure is the second large block in an enterprise's view of the future. After all, not every manager with specific retirement plans actually wants to continue their business.

**Figure 3: Status of preparations by planned withdrawal timeframe**

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



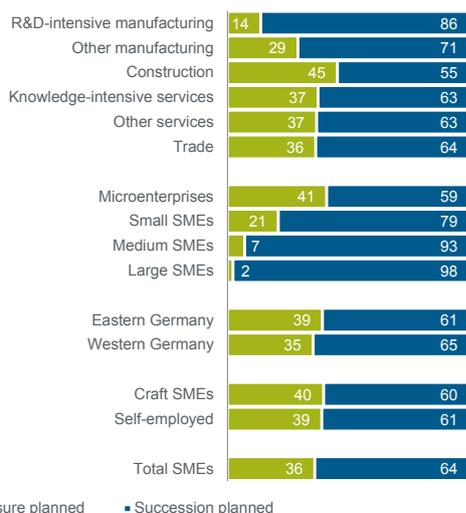
Source: KfW SME Panel 2017 and 2018.

Today, 16% of all owner-managers see closure as the only conceivable solution. At the most, 600,000 of the SME owners still in business today would leave the market voluntarily without a succession arrangement – assuming all SME owner-managers with closure plans actually implement them. For another 5% of SMEs, closure is at least an option being given serious consideration.<sup>13</sup>

While the public debate is heavily centred on the concept of succession, this element of the structural renewal of the SME sector is often forgotten. And yet, a closer look yields interesting insights (Figure 4).

**Figure 4: What is on owner-managers' minds when they think of retiring?**

Company proportions in per cent; only owner-managers currently entertaining ideas about the continuity of their business



Source: KfW SME Panel 2018.

If we narrow the focus down to those SMEs whose owner-managers are already thinking about the survival of their business, it is apparent that around one third favour shutting down. Planning for closure is therefore anything but unusual,

although it occurs with very different frequency across the SME segments. Shutting down is almost not an option for large SMEs in particular (2%). By contrast, 41% of owner-managers of micro-enterprises who are planning to retire are currently considering this solution. Thoughts of shutting down play much less of a role in manufacturing as well but nearly half the owner-managers of construction SMEs plan to give up their business in the future.

**Alternative succession variants are gaining ground: More SMEs are looking for external buyers...**

Slightly less than half the present owner-managers with succession plans in place would like their business to pass into the hands of a family member (Figure 5). An equally high percentage – 45% – are considering an external buyer (e.g. a start-up entrepreneur, another business or a financial investor). A year ago there was still a clear preference for family-internal succession arrangements but now both variants are equally common.

This may reflect that the 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 generally more difficult (with children choosing other career pathways and more couples without any children, for example), which shifts the focus more on external succession considerations.

But particularly in external arrangements, where existing owner-managers and potential successors do not know each other, information asymmetries are pronounced and the transaction costs of a successful transfer are high. Existing owner-managers lack contacts, are not well networked and lack experience and knowledge of processes. After all, a company succession is usually done only once. Business succession platforms are an attempt to 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 exchange).

**The business succession platform next-change**

next-change is a company transfer exchange that has been operating as an online platform 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 research the existing database. next-change focuses on family-internal succession processes. Its use is free of charge.

Advertisements are created with support from a regional partner (e.g. a chambers of skilled crafts, chambers of industry and commerce or savings banks). These 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.

In January 2018, the site registered 6,565 advertisements from existing owner-managers who want to pass their business 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 up to 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. [www.next-change.org](http://www.next-change.org)

**... but are less well prepared**

Figure 6 shows that the succession process is generally fraught with more uncertainty when it involves an external sale. Although it has recently become more popular, this

approach is very difficult to plan. Only 2% of existing owner-managers have already found a successor and concluded their negotiations. A further 8% are at least conducting negotiations.

Nine in ten owner-managers who are planning to sell their business are still looking for a buyer or have not even started their preliminary planning. As a result, the chances of their wish for an external buyer coming true are slim.

Where the succession is intended to remain within the family, owner-managers are more advanced in the process. The successor from within the family has already been chosen in 42% of cases. The transfer or sale of the business to a co-owner also appears to accelerate the handover process. In this variant, 25% of existing owners are already clear about the succession. Both arrangements benefit from the fact that the potential successor either knows the business or is already working in it. Information asymmetries are fewer.

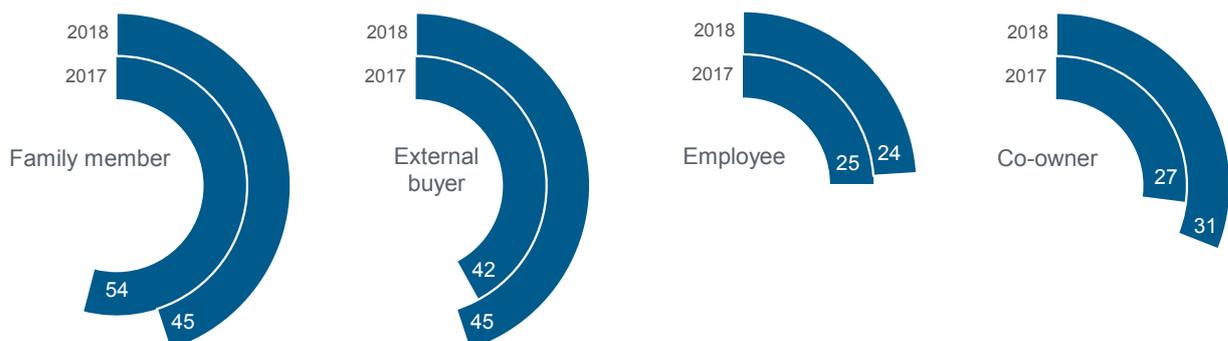
**Conclusion: the trend is pointing upward**

Awareness appears to have grown among SMEs for the need to face the challenges of succession in a timely manner, as demonstrated by this status report of KfW Research. Other indicators are also showing positive signs. For example, more existing owner-managers than ever before have recently sought specific advice from the chambers of industry and commerce.<sup>14</sup> At the same time, more SMEs than ever before have an 'emergency kit' (a compilation of all documents and powers of attorney that are important for a successor).

These developments are to be welcomed because the pressure will remain high. A growing proportion of existing owner-managers are approaching the age of retirement. So as the cohort of baby boomers retires from professional life, their departure will leave a void on SMEs' executive floors.<sup>15</sup> Not least, the businesses facing imminent succession have great significance for the overall economy. In 2017, these SMEs provided employment for 1.98 million workers and 76,000 trainees and apprentices. They invested EUR 9.3 billion, which was roughly 2.4% of all business

**Figure 5: Succession variants currently being considered**

Shares of enterprises in per cent

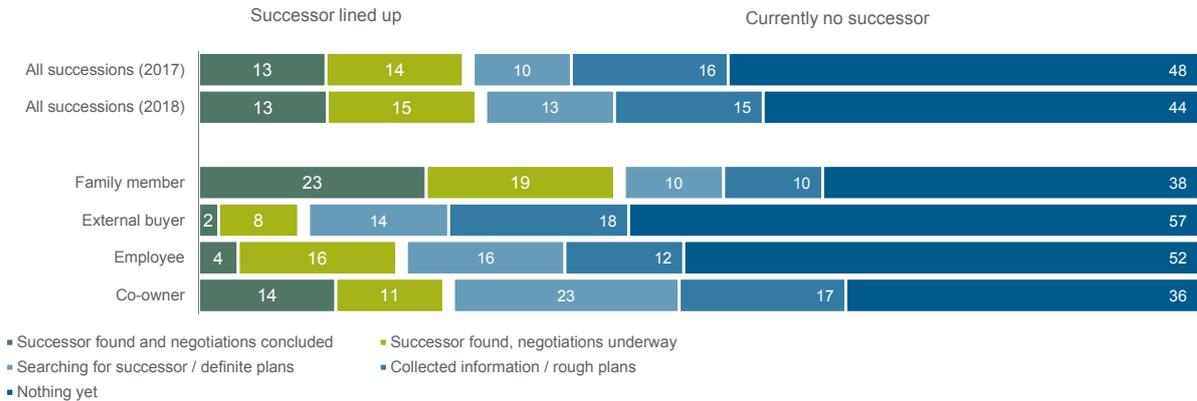


Note: Multiple answers were possible. Based on all SMEs considering succession (independently of the envisioned handover period). Analyses for the category 'employee' include only SMEs with employees. Analyses for the category 'co-owner' include only SMEs with several owners. Not including enterprises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

Source: KfW SME Panel 2017 and 2018.

**Figure 6: Status of preparations by planned succession variant**

Shares of enterprises in per cent



Note: Multiple responses on the succession variant were possible.

Source: KfW SME Panel 2018.

investment in Germany, and they accounted for around 6% of overall turnover in the SME sector (EUR 283 billion). The business successions already secured are therefore all the more pleasing.

Most of all, a secured succession constitutes an enormous lever for investment. Analyses by KfW Research have shown that the closer the date of transfer draws, the less willing enterprises planning succession are to invest.<sup>16</sup> This is because of the existing owner-manager’s uncertainty. It is questionable whether a potential successor will consider the future returns of an investment in the purchase price. Besides, from the owner-managers’ point of view – who are often of a high age – many investments take too long to pay off, so they shy away from the financial obligation. An early succession arrangement provides certainty and allows investment to rise again. This helps businesses remain competitive in the long term. ■

**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 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 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 16th wave was conducted in the period from 12 February 2018 to 22 June 2018.

Further information and the current annual report can be obtained [here](#).

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<sup>1</sup> KfW Research has been accompanying the generational change process in the SME sector for 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. 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 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.

<sup>2</sup> For the current edition of the KfW SME Panel, see Schwartz, M. (2018): **KfW SME Panel 2018: No sign of letting up: SMEs are on a path of growth in Germany and abroad**, KfW Research.

<sup>3</sup> Bisnode D&B (2018), **Nachfolge-Studie KMU Schweiz 2018: Analyse der Unternehmungen mit einer offenen Nachfolge (Succession study on SMEs in Switzerland in 2018: analysis of enterprises with unclear succession situations – our title translation, in German only)**, 9 April 2018. Bisnode D&B Schweiz AG, Urdorf.

<sup>4</sup> Federal Ministry for Digital and Economic Affairs (BMDW) (2018), **SME Report 2018: Bericht über die Situation der kleinen und mittleren Unternehmen der österreichischen Wirtschaft (Report on the situation of small and medium-sized enterprises of the Austrian economy – our title translation, in German only)**, Vienna.

<sup>5</sup> 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.

<sup>6</sup> The reference values for the SME sector as a whole were taken from the KfW SME Panel 2018.

<sup>7</sup> The equity ratio is defined as the quotient of equity and the 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.

<sup>8</sup> Gerstenberger, J. (2018), Hohe Eigenkapitalquoten im Mittelstand: KMU schätzen ihre Unabhängigkeit (High equity ratios: SMEs value their independence – in German only), Focus on Economics No. 206, KfW Research.

<sup>9</sup> Enterprises are classified into employment size classes according to the number of full-time equivalent employees (FTEs). Rather than employee numbers (the enterprise's headcount), this definition depicts actual demand for labour. 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. This results in the following differentiation: micro-enterprises (fewer than 5 FTE employees), small SMEs (5 to 9 employees), medium SMEs (10 to 49 employees), large SMEs (50 and more employees). Unless otherwise stated, this article assigns enterprises to employee size classes according to this classification.

<sup>10</sup> Research- and development-intensive (R&D intensive) manufacturing is defined as those manufacturing sub-sectors whose average research and development intensity (R&D intensity: ratio of R&D expenses to turnover) is higher than 3.5%. The definition is based on what is known as the NIW/ISI list of research-intensive industries and services, which in turn follows the Federal Statistical Office's 'Classification of Economic Activities (WZ 2008)'. Engineering, medical technology, instrumentation and control technology, vehicles, pharmaceuticals and office equipment are of particular quantitative importance. Knowledge-intensive services comprise service sub-sectors with an above-average share of university graduates in total employment, or services with a strong focus on technology. These include, for example, architecture and engineering firms, law firms, tax and management consultancies, data processing and telecommunication services. The definition is also based on what is known as the NIW/ISI list of research-intensive industries and services. Other manufacturing is primarily represented by the food industry, wood processing, manufacture of metal products and other manufacturing not further specified. Other services includes a relatively high number of retail and wholesale firms. It also includes, among other things, businesses in the fields of nursing, education and training, culture and sport.

<sup>11</sup> Metzger, G. (2018), **KfW Start-up Monitor 2018 – Start-up activity remains in a trough but growth, innovation and digitalisation are gaining importance**, KfW Research.

<sup>12</sup> A further 69,000 business founders started up by acquiring an interest in an existing business in 2017.

<sup>13</sup> The group of business owners for whom closure is currently at least a serious option is not regarded as succession planners in this analysis. 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.

<sup>14</sup> DIHK (2018), DIHK-Report zur Unternehmensnachfolge 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.

<sup>15</sup> Leifels, A. (2016), **Ageing boosts SMEs' need for successors – 620,000 business transitions by 2018**, Focus on Economics No. 132, KfW Research

<sup>16</sup> Schwartz, M. (2018), **Wave of successions in German SMEs: 240,000 successors wanted by 2019**, Focus on Economics No. 197, KfW Research