

MITTELSTANDSMONITOR 2008

DESPITE CYCLICAL SLOWDOWN, SME SECTOR STILL ROBUST

Annual report on cyclical and structural issues relating to
small and medium-sized enterprises – Executive summary

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Preface

In Germany – as in almost all industrialised countries – more than 99 percent of all businesses are small and medium-sized enterprises (SMEs). They produce almost half the corporate sector's gross value added. Their main qualitative feature is that owners and responsible management are identical. This sector includes small and micro enterprises – which *de facto* include all start-ups and most young enterprises – as well as larger enterprises with several hundred employees and a leading position in the world market. Through their diversity they ensure economic stability and form an integral part of a balanced enterprise size structure that facilitates structural change, promotes innovation and thus ultimately helps to boost growth and prosperity in an economy. Despite the enormous importance rightly attributed to small and medium-sized enterprises in the debate about economic and social policy, the economic situation of SMEs is not apparent from official statistics.

Only a small number of institutions have statistical databases of their own that allow them to make regular observations on issues concerning SMEs. However, reliable data and unbiased opinions (based on empirical evidence) are needed if the debate about key issues of economic life is to be conducted in an objective manner. For this reason Creditreform (Verband der Vereine Creditreform), IfM Bonn (Institut für Mittelstandsforschung), RWI Essen (Rheinisch-Westfälische Institut für Wirtschaftsforschung) and the Centre for European Economic Research (ZEW) have joined a KfW initiative to publish the *MittelstandsMonitor*, an annual report on cyclical and structural issues related to small and medium-sized enterprises. The basic idea is to collect and compare expert knowledge and present a concise version of the findings to the public. The primary objective is to conduct an impartial analysis on SME issues. The project partners' exclusive databases complement each other and provide a comprehensive empirical basis for the *MittelstandsMonitor*.

The assessment of the cyclical situation of small and medium-sized enterprises and the development of company start-ups and liquidations is a standard part of the report. Each year, it is supplemented by different topics relating to the SME sector that are of current economic interest. The 2008 edition focuses on the two subjects, that is, "Corporate research strategies – Are there any differences between SMEs and large enterprises?" and "Corporate succession at SMEs – Effects of the stages before and after transfer", respectively.

The project partners decided to entitle the *MittelstandsMonitor 2008* "**Despite cyclical slowdown, SME sector still robust**". Although the SME business climate has improved slightly compared with the 2006 average, a downward trend was perceived in the course of

2007. Support for the observation that the SME business climate had passed its peak also comes from the fact that business expectations are lagging far behind assessments of the current situation. Nonetheless, a robust cyclical situation can be assumed, particularly as a seven-year peak in SME investment propensity was recorded at the end of 2007 and the investment indicator was back above the long-term average for the first time since 2000. Likewise, the employment trend and employment plans indicate that the SME sector expects solid growth. In 2008 the real increase in GDP is expected to be 1½ percent in calendar adjusted terms, i.e. on a par with the potential rate. However, substantial risks when making these forecasts have to be considered. Risk might result from the impact of the confidence crisis in international financial markets on the global economy and the possible negative reactions of private consumer spending to the higher inflation rate (Chapter 1).

The development of start-up intensity from 2005 to 2006 depends on the data source consulted. According to the KfW Start-up Monitor and the start-up statistics compiled by IfM Bonn, start-up activity is declining, whereas the ZEW Start-up Panel sees start-up activity as remaining constant for Germany as a whole, with a slight increase in start-up activity in western Germany. Provisional calculations for 2007 point to a further decline in start-up activity. The lower start-up activity is due, on the one hand, to the tightening of the eligibility criteria for financial support from the Federal Employment Agency. The more restrictive conditions governing support are the result of combining the start-up subsidy (*Existenzgründungszuschuss*) and bridging money (*Überbrückungsgeld*) to form the new start-up subsidy (*Gründungszuschuss*). On the other hand, start-up intensity has slowed due to improvements in the cyclical situation. Because there are more dependent employment opportunities, fewer businesses are being set up as a way out of unemployment. There was a marked decrease in the number of liquidations and insolvencies in 2006 and, according to provisional figures, this development continued again in 2007. If start-up activity is viewed from the long-term perspective until 2020, the focus shifts to the issue of demographic change. As older age groups of the population are less inclined to set up in business, there will be a decrease in start-up activity. However, the decrease is estimated to be between 2 and 4 percent and is therefore moderate (Chapter 2).

In Germany only a small percentage of enterprises carry out research on a fairly regular basis; the ratio of average research and development expenditure to gross value added increases in line with the size of the enterprise. The clear majority of enterprises carry out applied research with a view to improving existing products and processes. By contrast, basic research inspired by practical problems is carried out by large enterprises in research-intensive sectors and small technology companies. There is a wide variety of corporate research strategies. The size of the enterprise, the sector context and the market

constellation all have impact upon the nature of the research strategy pursued. With regard to differences in research strategies, it can be seen that the extent to which research is firmly established at any enterprise increases with the size of the company. In addition, research at smaller enterprises focuses on a narrower geographical area while internationalisation is limited to a small number of very large businesses. Moreover, better financing opportunities and collateralisation place larger enterprises in a better position to define long-term research objectives (Chapter 3).

In the period from 2005 to 2009, it is estimated that one family business in six was or will be affected by the issue of company succession. Corporate successors have a fairly good idea of the difficulties and the complexity of the changeover. According to successors, the changes that they make to the enterprise have, on average, a positive effect on profitability and on the internal and external relations of the enterprise. The changes mainly involve removing investment bottlenecks and restructuring the company. If there is an investment bottleneck, it is presumably not least because the original owner no longer makes strategic decisions or investment owing to his/her limited planning horizon. The success of the generation change also depends on the size of the enterprise. Estimations by the successors themselves and an analysis of turnover development both show that larger enterprises develop better (Chapter 4).

The participating institutions: Creditreform, IfM Bonn, KfW, RWI, ZEW

Summary

Chapter 1: The economic situation of small and medium-sized enterprises

SME business climate passed its peak in 2007 but is still robust

Against the background of exceptionally strong GDP growth over the past two years, the average business climate in small and medium-sized enterprises again improved slightly in 2007 and thus reached a new high for the year as a whole. However, the minor increase in the climate is mainly due to the high carry-over of sentiment at the start of 2007 which had mainly developed in 2006. By contrast, both business expectations, which are lagging far behind assessments of the current situation, and the downward sub-annual trend in the two business climate components indicate that the SME business climate passed its peak in 2007. However, the climate was not poor. At the turn of the year 2007/2008, SMEs still had an exceptionally positive view of current business and orders, in particular. This is evidence of a robust business climate. For 2007 as a whole, the business climate gap between the SME sector and large enterprises was as small as in 2006. However, owing to a relative deterioration in the climate in the SME construction sector, the gap expanded noticeably in the course of 2007. Because economic activity slowed more in housing construction than in other parts of the construction sector, where smaller construction companies derive the lion's share of their turnover, these were particularly affected by the development.

The gap in sentiment between western and eastern Germany became noticeably smaller in the course of 2007; the lower sentiment in eastern Germany is essentially due to differences in the sector structure. A comparison of the five main economic sectors shows that manufacturing and service providers are in the most upbeat mood. However, retail trade, wholesale trade and construction industry are also still assessing the business climate and orders as above long-term average, meaning that the business climate in the SME sector is supported on a broad basis.

Driven by the favourable state of order books and the positive growth in earnings, over half the SMEs were prepared to make new investments at the end of 2007. For the first time since 2000, the investment indicator was higher than its long-term average. The seven-year high in investment propensity is a strong signal that SMEs basically expect solid growth, despite the drop in the climate. Employment and employment plans also point in the same direction. By the end of 2007, the share of enterprises with an increasing number of jobs was 16 percentage points above the share of firms reducing their workforce and thus only fell short of the record high achieved for Germany as a whole one year previously. Employment

expansion can be expected to continue in 2008. In December, just over 18 percent of SMEs were sure that they would increase their workforce in the first half of 2008; slightly more than 13 percent were intending to reduce the number of their employees. Compared with the previous year, there has been a marginal improvement in employment plans, which are positive on balance for the second time since the start of the time series.

In 2008, real GDP growth will, however, flatten out perceptibly. The previous main drivers, exports and investments, are expected to support growth again in 2008, although there will probably be a decrease in the positive impetus that they contribute. By contrast, domestic growth forces will probably gain strength, mainly because the improvement in the labour market situation should stimulate private consumption. This will not be sufficient to maintain the high growth momentum with which Germany emerged in 2006 and 2007 from the previous long period of under-utilisation of production capacities. The participating institutions nonetheless consider that real growth of around 1¾ percent could be achieved in 2008. In calendar adjusted terms, this is the equivalent of an increase of around 1½ percent, putting the underlying cyclical momentum on a par with the potential rate. Hence the outlook – including the prospects of a continuation of the upward employment trend – is basically not bad, which should have a further positive or at least satisfactory impact on the business climate assessments by the SME sector.

Considerable risks are associated primarily with the crisis of confidence in the global financial markets. If the global economy were to lose more drive following the spillover of the crisis onto the global equity markets at the start of 2008, export growth would be far weaker than otherwise forecasted. Furthermore, the strong increases in the prices of energy and food could put pressure on consumers for longer than originally assumed, possibly rendering private consumption unable to fulfil the hopes that it would function as a major mainstay of growth.

Chapter 2: Corporate fluctuation – Current developments and effects of an ageing population

Decline in start-up figures since 2004 continues, but also fewer liquidations and insolvencies

Following the start-up boom in 2003 and 2004, there was an overall decrease in the start-up figures for 2005 and 2006. Its strength at the current edge varies, however, in different data sources – and hence for different start-up concepts. Whereas the start-up statistics compiled by IfM Bonn and the KfW Start-up Monitor show a decline in start-up intensity in both eastern and western Germany in 2006, the ZEW Start-up Panel even observed a slight increase in start-up intensity for western Germany. Provisional figures based on the IfM start-up statistics and the KfW Start-up Monitor indicate that start-up intensity will decline again in 2007. The slowdown in start-up activity is closely connected with both the tightening of the eligibility criteria for financial support from the Federal Employment Agency and the better cyclical situation. In mid-2006 the start-up subsidy (*Existenzgründungszuschuss*) and bridging money (*Überbrückungsgeld*) were combined to form the new start-up subsidy (*Gründungszuschuss*), which generally has more restrictive support criteria. At the same time, the improvement in the economic situation means that not only are fewer businesses being set up as a way out of unemployment, but there is also an increase in dependent employment opportunities, with the result that some potential new business founders decide to take a job rather than to go self-employed.

Following a slight increase in 2005, the number of liquidations decreased again in 2006. The number of corporate insolvencies has, however, been declining for some years and, according to provisional figures, this trend also continued in 2007. This is probably mainly due to the improvement in the economic situation. In contrast to start-up intensity, liquidation intensity has been decreasing for years. Overall, in the years following the “Ich-AG” start-up boom there has therefore been a positive start-up surplus, which is reflected in an increase in the number of enterprises in existence.

Increase in population ageing will have no more than a moderate impact on start-up activity until 2020

In the long term, demographic developments also affect the extent of start-up activity. Given an ongoing increase in life expectancy and low birth rates, the population figures and the age structure of the population of Germany will undergo a substantial change in the coming decades. The decline in start-up figures which is to be expected as a result is estimated to be about 2 to 4 percent until 2020 and is thus very moderate overall, although no account is

taken of adjustment reactions and other exogenous influences such as short-term cyclical fluctuations or changes in underlying institutional conditions.

As analyses at the individual level show, people aged 45 and older – and especially those who are 55 and over – are less inclined than younger people to set up in business; this is true on average as well as after deducting other factors determining start-up propensity such as the educational level or the previous employment status of the people concerned. On the other hand, the start-up projects of older people are no worse in terms of quality. In particular, measured in terms of the probability of the business lasting, older new business founders have no less chance of being successful than younger start-up entrepreneurs.

In the coming years, the contribution of start-ups to growth and employment will therefore only marginally decrease as a result of population ageing. In the years after 2020, however, depopulation will accelerate and will also be associated with a stronger decrease in start-up figures. In any case, steps must be taken to ensure that, even if there is an overall reduction in start-up activity and a change in the composition of the population interested in setting up in business, the step into self-employment remains an attractive proposition. It is thus important that access to appropriate financing remains open and forms of financing and start-up advice to be adjusted to the needs of the specific target groups so that they still have the desired macroeconomic impact.

Setting up “limited companies” past its peak

An examination of the development of corporate start-ups and closures with the legal form of *private company limited by shares – limited companies* for short – addresses another aspect of the current economic debate. A limited company is, under British law, very similar to a German GmbH (*Gesellschaft mit beschränkter Haftung*), the major difference being that only one pound sterling is required as the initial share capital. In addition, it takes very little time to enter the limited company in the commercial register in contrast to establishing a GmbH.

Creditreform data allow an initial assessment to be made of the importance of limited companies for start-up activity in Germany. According to direction-giving judgements by the European Court of Justice, there was a marked increase in the number of new limited companies set up from 2003 onwards; as the total number of limited companies set up over the years until September 2007 are around 23,000. Only a small percentage of new business entrepreneurs opt for this legal form. The peak of limited company establishment activity in 2006 has now been passed and fewer were set up in 2007. Moreover, in contrast to the downward trend in company closures in recent years, there has been a sharp increase in the

number of closures of limited companies. New limited companies can therefore be seen to have a short lifespan in Germany.

The rapid end of the boom in limited company start-ups may first be due to the initial underestimation of the constraints under British company law. Secondly, however, the limited company might have a negative image, which stems from the opportunity for personal exemption from liability without the need to raise a minimum capital. This is presumably what encouraged many start-up entrepreneurs to go self-employed although their business concepts were not quite mature and/or their business was set up on a comparatively weak financial basis. Third, the German legislator decided to make the GmbH internationally competitive and to authorise a sub-form of the GmbH – a “business company” (*Unternehmergeellschaft*) – which requires no registered liability capital when it is set up. It is inexpensive, quick and uncomplicated to establish. Given expectations that it will be possible to set up “business companies” from mid-2008, it may well be that far fewer start-up entrepreneurs already decided to adopt the legal form of a limited company in 2007.

Chapter 3: Corporate research strategies – Are there any differences between SMEs and large enterprises?

If the potential of small and medium-sized enterprises for research and development is to be pursued further, particularly with regard to the Barcelona objective of an increase in R&D expenditure to 3 percent of GDP, more knowledge about differences in the profiles and strategies of small and large enterprises carrying out research needs to be gained. What is apparent is that only a small percentage of all enterprises carry out research on a more or less continuous basis and that research activities are initiated to a considerable extent by the sector context and are encouraged by specific market constellations. Hence most is spent on business R&D, for example, in the four sectors of electronics, mechanical engineering, motor vehicle manufacturing and the chemical industry including pharmaceutical industry. In those sectors competition between enterprises is influenced to a substantial extent by research to find original innovations and to develop them. As the official statistics show, average research intensity increases with the size of the enterprise.

Few enterprises carry out basic research, and if they do so it is only to the extent that it has direct practical applications. These enterprises are mainly large companies in research intensive sectors. However, also small technology enterprises (in biotechnology, for example) carry out basic and applied research in order to develop new products. However, the clear majority of enterprises, including most SMEs, carry out applied research to improve existing products and processes incrementally. However, many large enterprises and larger SMEs also pursue the objective of developing new products and processes.

Enterprises' research strategies, defined as the basic pattern of behaviour which characterises corporate research and development activities over the long term, vary considerably. Relevant differences can be found for every component of the strategy, e.g. regarding decisions whether to acquire internal or external knowledge, management and controlling, the extent to which research is firmly established at the enterprise and the integration of R&D into the company's value added processes. At the same time, there also are a number of systematic differences. The larger the enterprise, the more firmly established research is at that company. In large enterprises, R&D is subject to formal controlling. Relatively little use is, however, made of other formal management mechanisms at the enterprises and, here too, there is a decrease from large to small enterprises.

For the R&D rate targeted by the EU, an important factor is whether the research activities take place in Germany, Eastern Europe, Asia or elsewhere. It is therefore interesting to consider differences regarding the geographical distribution of the R&D as they relate to the

size of the enterprise. At SMEs, R&D activities are on average very strongly concentrated – generally on one location. Several locations are the exception and occur, for example, if this is needed because of customer contacts or the necessary production-related development. The internationalisation of R&D activities that has become apparent in recent years is very strongly restricted to a few very large international concerns.

Small enterprises naturally have a smaller research and development budget than large companies. This frequently limits their opportunities to carry out basic research with uncertain outcomes. They therefore try to edge forward into new areas of knowledge or specialise in particular niches. Larger enterprises tend to be in a better position to define long-term research objectives and to explore fundamentally new areas of knowledge. In this respect the different degrees of risk propensity are less important than the financing opportunities.

Our findings clearly show that the role of R&D activities at SMEs, including technological advancement, needs to be viewed very strongly in their systemic context. R&D projects should therefore be positioned along the industrial value added chain, while at the same time taking account of the interdependence between the R&D activities of SME and larger enterprises. The innovative ability of SMEs in motor vehicle manufacturing in the supply chain, for example, affects the competitiveness of the entire sector. In the pharmaceuticals industry there is also a close link between biotechnology firms and large pharmaceutical companies. The latter often take the results of the biotechnology companies' R&D activities on board and assume responsibility for clinical tests and the market launch. At the same time, the close exchange of views with research at universities, other higher education institutions and research organisations is very important not only for large enterprises but also for technology-oriented SMEs.

Chapter 4: Corporate succession at SMEs – Effects of the stages before and after transfer

In the period from 2005 to 2009, it is estimated that one in every six family enterprises in Germany was or will be affected by the issue of succession. With the preparation and implementation of the corporate transfer, family enterprises fairly frequently enter an unstable stage in their life as many original owners put off strategic business decisions because of the pending transfer to their successor. The presumed investment bottleneck affects the development of company turnover not only in the period prior to the transfer but also in the post-transfer period. The successor generally catches up with neglected investments but it nonetheless takes some time before this turnaround in the enterprise concerned is also reflected in positive developments in turnover and profit.

Empirical support for these presumed impacts of the stages before and after transfer was provided by a written survey among corporate successors in Bavaria. Although the successors assessed the degree of difficulty and the complexity of the generation change relatively well before taking over the enterprise, their actual experience of the succession process differed from their expectations on one or two points – albeit not to any great extent. The volume of capital needed, for example, was larger than expected. Most successors admitted that after taking over the enterprise they first had to remove the investment bottleneck and restructure the company. This could be interpreted as a consequence of the investments neglected by the previous owner in the period prior to the company transfer.

The changes made after succession are seen by the successors in the survey as having, on average, a positive impact on the company's profitability as well as on its internal and external relations. Negative impacts of the company transfer occurred only in relation to the financial strength of some enterprises. Successors at large enterprises give a significantly more positive assessment of the success of their takeover than successors at small enterprises, indicating that how enterprises develop in the post-succession period depends on the size of the enterprise.

Similarly to the assessment made by the successors themselves, the analysis of the economic development of enterprises at which the management changed during a generation change shows that the success of a generation change is heavily dependent on the size of the enterprise. The analyses of turnover figures before and after the company transfer yield the following results. First, medium-sized enterprises with a change of generational ownership achieve a stronger increase in turnover both in the stage prior to the company transfer and after the company transfer than smaller enterprises. Second, the development of turn-

over at the company transfers surveyed differed from that at enterprises with no change of managing director. Whereas business continuation at medium-sized enterprises fared far better than for the sector as a whole, the result for smaller company transfers was precisely the opposite.