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STABILISATION IN THE SME SECTOR – BUT ECONOMIC RECOVERY FACED WITH CONSIDERABLE RISKS

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

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KfW Bankengruppe, Economic Department -
Palmengartenstrasse 5-9, 60325 Frankfurt am Main -
Phone +49 69 7431-0; Fax +49 69 7431-2944 -
www.kfw.de -

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Summary

Chapter 1: The Economic Situation of Small and Medium-sized Enterprises

- Business climate of SMEs was bad in 2009, yet no worse than in other, rather “normal”, economically weak years; SMEs profited from relatively stable domestic demand; signs of economic turnaround during the course of the year.
- SMEs as economic stabiliser in Germany: Business climate of big enterprises which were particularly hit by the collapsing exports and foreign trade fell to a new all-time low in 2009 and thereby fell considerably short of SMEs’ who managed to stabilise the overall economy.
- Business environment remains fragile: Expected real GDP-growth of 1 ½ % in 2010 is insufficient to quickly overcome the consequences of the crisis; business climate of SMEs will only marginally surpass the non-cyclical long-term average in 2010.

The global financial- and economic crisis culminated in a historical slump in real GDP in the winter half year 2008/2009, which levelled the upturn of the previous three years. Hence, in the entire year 2009, the GDP decreased by 5.0 % from spring onwards despite a politically stimulated economic turnaround. In light of this, the business climate of small and medium-sized enterprises (SMEs) has severely deteriorated for the second year running in 2009. The average annual business climate listed at approximately the same level as in the economically weak years 1993, 1996 and 2003, but – despite the far greatest slump in GDP in the history of the Federal Republic – still significantly above the all-time low of 2002.

The present-state-of-business indicator decreased as much as never before within a year and fell deep into negative territory in 2009 as a whole, having been predominantly positive in 2008. In contrast, business expectations deteriorated only moderately in the past year. However, due to the far more unfavourable base year 2008, this further marginal deterioration was sufficient to narrowly press business expectations to a new all-time low. As a result of the significantly smaller decrease of the expectations indicator in comparison to the state-of-business indicator, expectations in 2009 turned out to be a little more favourable than present-state-of-business verdicts for the first time since 2005 again. Such a constellation usually indicates an economic turnaround. Another promising factor is the upwards facing trend of the business climate curve during the fiscal year. However, the fact that the state-of-business indicator remained in negative balance until the end of the year illustrates that it is too soon to speak of a true normalisation. On the level of the five main economic sectors, it is noticeable that branches which are very involved in foreign trade (manufacturing sector, wholesale trade) are particularly affected by the recession, while the mood in domestic branches (building sector, retail trade, service providers) was considerably better in 2009. This diagnosis is also supported by the way SMEs regard their order and sales situation as well as their sales expectations.

Compared to big enterprises, SMEs rated their business climate – a record high – 12.5 points less negative in 2009, having continuously given worse evaluations from 2000 to 2008. The only time the interval was almost as large in favour of SMEs was in the recession year 1993. The hereby expressed stabilising effect of SMEs can easily be explained in view of the central forces of the downturn: Next to the severely diminished confidence in the finance sector, foreign trade was the main transmission channel by which recession impulses spread throughout the world and mutually intensified themselves in 2009. The simultaneous slump in demand of practically all trade partners meant that very world market oriented big enterprises were hit first and particularly hard by the worst global economic recession since the Second World War. Consequently, the climate in this segment fell to the lowest yearly average since 1991, the beginning of recording. In contrast, the crisis struck the usually far more domestic market oriented SMEs a little less hard, not least because the domestic demand turned out to be a lot more stable than the exports in 2009 thanks to political impulses. However, SMEs severely felt the massive recession too. The business climate of SMEs was therefore bad last year, yet it was no worse than in other, rather “normal”, economically weak years.

The negative earning position estimation weighs on the willingness to invest despite a continuous re-improvement of sales and profit expectations. The share of SMEs who at the end of 2009 were planning investments for the 1st half year 2010 fell, with 42.4 %, further below the long-term average (45.5 %), which it only managed to marginally surpass once since 2000 – in 2007. However, with a minus of nearly two percentage points relative to the end of 2008, the decrease in the willingness to invest kept within reasonable limits. This may indicate that, despite the weakness in demand, SMEs are unwilling to let their production facilities become obsolete and are at least planning investments in substitutes and rationalisation. The employment trend and the employment plans suggest that many SMEs are anxious to retain scarcely available specialists despite the burdens of the crisis.

For Germany there is no evidence of a self-supporting and sustainable upturn in 2010, despite the economic output rising again. The institutes participating in the MittelstandsMonitor expect real GDP to increase by about 1 ½ % this year, whereby half a percentage point stems from the statistical surplus already established in 2009. At the end of 2010 slightly more than a third of the crisis related GDP-slump would then be levelled, meaning that the effects of the historic recession are far from overcome. Under these circumstances the business climate verdicts of SMEs should tend to improve, yet they will only marginally surpass the non-cyclical zero base line in the yearly average.

Chapter 2: Business Turnover – Current Trends in the Start-up and Liquidation Activity

- After a decline from 2004 to 2008, 2009 is the first year where an increase in start-up activity can again be observed in Germany. This is presumably due to the worsened situation of the labour market.
- The number of business insolvencies due to over-indebtedness and (imminent) failure to pay jumped abruptly in the crisis year 2009.
- Voluntary closing downs of enterprises did, however, further decrease in 2009 again.

After the start-up activity has steadily decreased between 2004 and 2008, preliminary calculations for 2009 show a first rise again. For instance, the number of start-ups obliged to register their trade rose by 2.7 % compared to the prior year according to the start-up statistic of IfM Bonn in 2009. The KfW Start-up Monitor, which follows a broader concept of start-up activity and also includes part-time entrepreneurs and start-ups in liberal professions, shows an increase of even 15 %.

The previous boom years offered relatively good employment- and career possibilities for dependent employees. Thereby, self-employment lost part of its attractiveness compared to dependent employment (“push effects” decreased). This could not even be prevented by the inherently positive effect of a healthy economic environment on start-up activities (“pull effects” not strong enough). A decrease in the number of start-ups was the consequence. However, with begin of the economic crisis and a worsening of the labour market situation, the tide has turned. Start-ups with the aim of preventing unemployment or as an escape route from it are likely to have been the driving force behind the renewed rise of start-up activity in 2009. For instance, also the number of entries into support programs of the Federal Employment Office of Germany for start-ups escaping unemployment has significantly increased in the first half year 2009. Apparently, this more than compensated the direct negative influence of a reduced economic demand on the start-up activity.

In light of the expected rise in the number of unemployed during the course of the year, it is likely that the start-up activity will further increase in 2010. Hereby start-ups due to a lack of alternative employment opportunities (necessity-start-ups) will probably gain in significance compared to start-ups which are primarily motivated by a concrete business idea. The impulses for growth, employment and structural changes stemming from a rise of such start-ups are likely to be rather small.

The economic slump created a sudden jump in involuntary market exits as a result of over-indebtedness and (imminent) failure to pay. While the number of business insolvencies in 2008 remained at previous year’s level, it rose in 2009 for the first time since 2003 again by approximately 16 % to 34,300 cases. In contrast, the number of liquidations, which is regressive since 2005, has again decreased in 2009: The number of voluntary closing downs and

handovers of enterprises further decreased as the worse situation on the labour market resulted in fewer attractive opportunities to change from self-employment to dependent employment. Provided the economy only gradually recovers this year, it is likely that further enterprises will come under pressure, so that even more insolvencies are to be feared in 2010.

Chapter 3: Start-ups from Unemployment: Motivation, Projects and Contribution to Start-up Activities

- Start-ups from unemployment constitute a significant part of general start-up activities in Germany. Changes in the Federal Employment Office's (FEO's) support instruments severely affect the development of the number of start-ups.
- Not all start-ups from unemployment draw on FEO-subsidies. Conversely, a sizable amount of FEO-subsidy recipients does not describe themselves as formerly unemployed.
- Unemployed particularly often create start-ups due to a lack of employment alternatives and on average begin with smaller projects.

Start-ups from unemployment are of great importance for the general start-up activity in Germany. About one fifth of all founders were unemployed prior to moving into self-employment; among start-ups on a full-time basis even about 30 %. Accordingly, changes in the FEO's support instruments, which assist unemployed when taking on a self-employed activity, noticeably affect the total number of start-ups. For instance, the introduction of start-up subsidies in the years 2003 and 2004 sparked a start-up boom. After the (so-called) Hartz-IV-reforms came into effect in Germany in 2005, which also limited the access to the FEO's self-employment support again, the number of start-ups drastically declined.

Founders, who by their own account were unemployed prior to their start-up and founders, who drew on FEO-subsidies for their start-up do not represent identical groups in the realm of start-up activities. On the one hand, not all previously unemployed (by their own account) founders draw on FEO-subsidies. On the other hand, many founders who drew on FEO-subsidies assisting self-employment do not describe themselves as formerly unemployed, even though the access to start-up support and entry money is tied to a registered unemployment status. Presumably, these were in particular founders who were only registered as unemployed very briefly and in fact began directly from a prior engagement. Hence, a share of FEO-subsidies probably benefits people, who in the aftermath of terminating their employment register as unemployed in order to draw on start-up support for a self-employment which they already planned while they were still employed.

With regard to the motivation for a start-up, previously unemployed founders clearly distinguish themselves from other founders: While they predominantly go into self employment due to a lack of employment alternatives (65 %), the share of these so-called necessity-start-ups only constitutes about 40 % of total start-ups. Moreover, unemployed people tend to begin with smaller projects, so that the macroeconomic effects on growth and employment should be smaller than with other start-ups. The survival chances of projects from previously unemployed founders are not per se lower, however. Rather, the survival probability is determined by other individual- and project inherent characteristics which may correspond to

the status of unemployment. This is particularly true for the motivation of a necessity-start-up, which has a distinct negative influence on the probability of survival and which is far more common among previously unemployed founders than among the totality of founders and also among founders drawing on FEO-funds.

The frequently voiced concern that the FEO assists with its support-programs start-ups of businesses which have a high probability of soon closing down again cannot be confirmed as such. Rather, requiring financial resources and thereby also making use of FEO-funds goes along with a higher probability of projects surviving the first critical business years. However, it seemingly cannot be ruled out that unemployment insurance contributions also support people's step into self-employment who are not really in danger of unemployment and who are not part of the actual target group of labour market policies. The disadvantage of a possible abuse of FEO-support-funds is accompanied by the advantage of reaching a high number of unemployed who are willing to create a start-up enterprise with relatively low bureaucratic costs. If the support-recipients' length of unemployment can efficiently be reduced, this will also relieve the social security systems. Studies which examine in how far start-up support and entry money fulfil these expectations are still pending at this moment in time.

Since it is generally desirable from a labour market and social policy perspective, if previously unemployed people become self-employed, they should not be faced with disadvantaged access to start-up support programs. Additional support possibilities towards the FEO's start-up support and entry money are provided by the promotion-banks, which, as a matter of principle, are open to all people willing to create a start-up enterprise, irrespective of their employment status. The specific pre-conditions and needs of the particularly small-scale funding requirements of previously unemployed founders, which may be connected to a greater need of consultation, ought to be considered when shaping promotion programs. After all, the aim should be that formerly unemployed start-up entrepreneurs are not wrongfully disadvantaged in the credit access.

Chapter 4: Availability of Required Skilled and Management Staff in Small and Medium-sized Enterprises

- No general lack of specialists, but despite economic crisis still shortages of skilled and management staff.
- Small and medium-sized enterprises (SMEs) are not per se less attractive employers. They perform better than big enterprises with regard to immaterial working conditions, but are inferior with regard to material working conditions.
- Enterprises which present themselves as attractive employers perform considerably better with regard to efficient recruitment.

A general lack of highly skilled staff in the sense of a comprehensive labour shortage, which concerns a wide variety of qualifications, has not existed in recent years in Germany. Nonetheless, it was possible to observe quite severe shortages in some distinctive regions and professions. The economic crisis, which deepened in autumn 2008, has led to a certain relief in this context. However, a survey among enterprises in autumn 2009 has shown that enterprises are, of course, also looking for employees in economically difficult times (about 50 %) and that approximately one third of all enterprises searching for personnel encountered difficulties filling vacant positions, especially positions for skilled and management staff.

In light of major demographic trends in Germany, it can be expected that recruitment problems will intensify even independent of cyclical influences from 2015 and at the latest from 2020 when the baby-boom generation reaches retirement age. According to the projections, it is especially in the realm of highly skilled where severe shortages are hereby to be expected.

The analysis of reasons, which, from the employers' point of view, were responsible for the inability to fill vacant positions for skilled and management staff between autumn 2008 and autumn 2009 does not only indicate that a lack of (appropriate) applicants was the cause, but also that the incentives offered by enterprises were not always sufficient to convince applicants – in particular for highly skilled or executive positions – to join the searching enterprise.

A differentiated empirical analysis with the data of the socio-economic panel (SOEP) illustrates that SMEs do not generally offer a worse working environment than big enterprises. Especially small enterprises with less than 20 employees perform as well and in some aspects even better than large enterprises, according to an evaluation of working conditions by employees. If SMEs have advantages compared to big enterprises, they generally lie in the realm of immaterial incentives (e.g. working atmosphere, involvement in decision making). In the realm of material incentives (in particular higher salaries), the advantages lie with big enterprises. These results hold, independent of the qualification level of the evaluating employees.

On the basis of the survey among enterprises it was possible to find indications that personnel-searching enterprises could reduce the occurrences of recruitment problems with specific material and immaterial incentives. In particular small enterprises with up to 20 employees who offer exactly those categories of immaterial incentives in which they – according to the evaluation of employees – outperform their bigger counterparts can strongly reduce their recruitment problems for management staff.

As a conclusion, the recommendation can be derived that SMEs, who in light of the imminent demographic trends and the thereby occurring shortages of specialised and executive staff aim to increase their attractiveness as employer, should predominantly focus on the configuration of immaterial incentives and reduce possible deficits in the realm of personal development opportunities. Moreover, SMEs should not neglect the question of appropriate communication methods and increasingly select ways which enable them to convincingly communicate a satisfactory working environment to external parties. These methods include, for instance, making early contact with appropriate executive staff, handing out industry-internships with interesting, practically applicable tasks or implementing targeted measures of human resource marketing.

Chapter 5: Financing Innovations in Small and Medium-sized Enterprises

- Small and medium-sized enterprises (SMEs) predominantly finance innovative projects – in comparison to “common” investment projects – from internal resources.
- While bank credits only play a minor role in financing innovations due to their restricted risk tolerance, venture capital – which is a particularly appropriate source of finance for innovations – is insufficiently available.
- A lack of external financing resources has a negative effect on the innovation activity of SMEs.

Unlike investments, innovation projects by SMEs are predominantly financed from internal resources. Consequently, when it comes to funding innovations internal means dominate with 71 % of the utilised quantity, while in the realm of general investments this share merely amounts to 48 %. Only 12 % of innovation expenditures are financed by bank credits.

The rather high importance of internal funds when it comes to financing innovative projects empirically certifies the result, derived by economic theory, that asymmetric information between the management of an enterprise and external financiers is a key problem of innovation financing. As a consequence, credit financing often proves to be unfavourable for innovative projects. This particularly affects highly-innovative enterprises which are of special importance for the structural change and international competitiveness of Germany. In fact, the empirical results show that in particular those highly innovative enterprises, which produce market novelties and which are characterized by a high R&D-intensity (measured as the share of R&D-expenditures of annual turnover), can barely draw on bank credits.

Venture capital – as a particularly appropriate funding source for innovations – unfortunately is also only available on a small scale. Merely 2 % of SMEs' innovation expenditures are financed like this. Venture capital financing is strongly focussed on young, highly innovative enterprises, which often have not yet reached break-even.

With the aid of grants 7 % of innovation expenditures are financed. The importance of grants rises with increasing technology-orientation of an enterprise, meaning that they predominantly benefit those enterprises which put great effort into innovation activities. Moreover, SMEs from the new laender draw considerably more on bonuses and grants than their counterparts from the old laender.

A lack of external funding sources and, accompanied by that, a strong dependence on internal financing power negatively affects the enterprises' innovation activity: For instance, internal means are restricted, so that overall less innovation projects can be realised. This also means that innovation behaviour needs to be severely adjusted to the current economic situation. If innovation activity is reduced in economically difficult phases, enterprises run the risk of irrevocably losing important know-how through personnel brain drain. In addition, long-

term innovation projects will often be too small dimensioned to still be financed during a changing profit situation, or there will, in total, be fewer implementations of long-term innovation projects and instead more short-term development projects. This will result in less and less fundamental novelties being generated.