

MITTELSTANDSMONITOR 2003

SUMMARY

Annual report on cyclical and structural issues
relating to small and medium-sized enterprises.

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Purpose of the MittelstandsMonitor

In Germany more than 99% of all enterprises are SMEs. With the diversity of industries and size they represent they ensure economic stability, facilitate structural change, promote innovation and thus contribute to more growth and prosperity of a national economy. Nevertheless, the economic situation of the SME sector is not reflected in the official statistics. For this reason DtA, IfM Bonn, the Verband der Vereine Creditreform and ZEW have joined an initiative of KfW (KfW and DtA co-operate in the context of their new promotional initiative "Die Mittelstandsbank") to publish the MittelstandsMonitor, which is a joint annual report on cyclical and structural issues relating to small and medium-sized enterprises. The key idea is to collect and compare new expert findings in order to subsequently present them to the public in a concise form. The exclusive databases of the partners provide a comprehensive empirical basis for the MittelstandsMonitor. The assessment of the cyclical economic situation of small and medium-sized enterprises and the development of business start-ups and liquidations represent a regular element of the report. Further focal topics relating to SMEs will be added. This first edition is dedicated to the subjects of "SME Finance in Transition" and "Innovation – A Challenge for SMEs". The key results of the individual chapters are presented below.

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

Stabilisation but no far-reaching recovery after 3 years of decline

Against the background of the little dynamic – global and national – overall economic environment the SME business cycle has increasingly slowed down in the past three years. Given the pronounced domestic orientation of most SMEs, they were particularly hard hit by the weak domestic demand in Germany. On a yearly average, the key SME business cycle indicators of the participating institutions (KfW SME Business Cycle Indicator, Creditreform business climate indicator) fell to a several-year low in 2002. Western Germany recorded a serious economic slowdown. In turn, the cyclical situation in the eastern federal states remained relatively stable – though at the low level to which it had fallen already in 2002. The cyclical weakness affects all major economic sectors. The construction industry and retail trade are particularly hard hit, but the manufacturing industry, wholesale trade and the service industry are also severely affected by the slump.

In the wake of the cyclical decline the SME sector, below the bottom line, did not have any positive impact on the labour market in 2002. The share of companies which reduced employment was 16 per cent higher last year than the share of companies that created new jobs. Employment intentions for 2003 are marked by restraint and caution. At least the investors among SMEs want to continue to create new jobs, but even their employment planning (a projected increase of 8.3%) has recently been lagging half a percentage point behind the long-term average (8.8%). Even worse, only just over one fourth of SMEs is prepared to make investments at all. Thus, the investment propensity has roughly halved within only two years. The earnings situation also deteriorated further. Companies with declining earnings were in the majority in 2002.

The sentiments around the turn of the year and the outlook for 2003 are characterised by a high degree of uncertainty. Whereas the "hard" data on sales and earnings trends, but also the KfW SME Business Cycle Indicator, have recently shown first signs of stabilisation the sentiment-based indicators such as sales and earnings expectations turned gloomier. For the year 2003 the institutions assume that the SME business cycle will stabilise but will not gather any considerable momentum.

Chapter 2: Business fluctuation – a source of economic dynamics

Slump in business start-ups across all branches of industry, but still a positive balance of start-ups and liquidations

Business fluctuations, e.g. the change in the absolute number of companies as a result of start-ups and liquidations, have a considerable impact on the productivity of a national economy. Valid official statistics on start-ups and liquidations do not exist in Germany. For this reason we look at major aspects of business fluctuations by means of three complementary data sources.

Irrespective of whether we look at new company start-ups (companies as a sampling unit) or entrepreneurial start-ups (individuals setting up in business as a sampling unit) the number of start-ups has been declining since 1999. This development is expected to have continued in 2002. Major reasons for the decline are the unfavourable cyclical situation and the cyclical prospects which are not much better. On the contrary, part-time business start-ups show a high volatility. In 2001 their number increased over the previous year. In 2002, however, there was a decrease. The balance of start-ups and liquidations was also positive in 2002, though at a clearly lower level than in the last decade.

Qualitatively important contributions to the technological innovation of an economy are expected from the comparatively few high-tech start-ups. Despite the dampened cyclical environment, almost as many high-tech companies were founded in the year 2001 as in the

mid-1990s. However, it is rather disquieting that the start-up intensity in the high-tech industries in eastern Germany is clearly lower than in western Germany. An increase in high-tech start-ups would be desirable in order to accelerate the catch-up process in eastern Germany.

In the 1990s some progress was achieved in Germany in making self-employment more firmly established in culture and society. These efforts have to be continued. Here, imparting and expanding specific knowledge on business start-ups is an important building block. It is also vital to further pursue this path on account of the demographic development, since due to the structural ageing of the German population start-up figures are expected to decline in the long run.

Chapter 3: SME Finance in Transition

Traditional financing patterns put to the test: Higher equity required in future

On average, German SMEs have a lower equity ratio than comparable enterprises in other European countries. Given the overall framework in Germany this equity ratio had been largely adequate for most companies for a long time. But in certain segments problems had already occurred before: for instance, in the areas of entrepreneurial start-ups, young technology-oriented companies in emerging high-tech industries and innovative as well as fast-growing companies. As a result of the structural change in the financial markets and the banking sector, the equity ratio will gain considerable importance for the financing conditions to be obtained. Thus, the SME sector in its entirety and diversity is faced with the necessity of far-reaching changes in its financial structure and has to improve its equity base.

Progress in information and communication technologies, deregulation and globalisation as well as higher yields requested by savers and investors constitute the main impetus for change in the financial markets. This even enhances the high competitive pressure in the German banking sector. Due to modern rating procedures it is possible to adjust the interest margin to the respective risk. As a result there is a stronger differentiation in loan terms for corporate borrowers depending on the companies' credit standing and the quality of the collateral provided. This development is even enhanced by "Basel II", which is however not the reason behind.

Many companies which due to their high risk have so far in fact been excluded from borrowing will in future have easier access to loans, however, they will have to accept risk-adjusted loan terms, which means higher interest rates. Especially in the event of smaller loan amounts, however, high appraisal and handling costs may further impede the access to loans. But most SMEs will have a broader range of financing instruments at their disposal than they had so far. In particular private equity financing will gain importance. Besides

internal financing, however, the classical bank loan will remain the most important financing instrument – for both start-ups and established companies.

The change in the financial markets also requires new promotional concepts. Besides innovative approaches such as global loans and securitisation, established instruments such as programme loans at favourable interest rates and equity finance also have to be developed further and to be complemented by advisory services tailored to the needs of specific target groups. And the SMEs' own initiative is also requested. Rating should be regarded as a chance in order to detect deficiencies. Also required are openness and transparency towards the banks as well as more professionalism from strategic planning to financial management.

Chapter 4: Innovation – A Challenge for SMEs

Targeted promotion of innovation and the elimination of obstacles to innovation remain the central tasks of structural policy

In terms of technological capability Germany still stays in a leading position among the industrialised countries but it is in danger of falling behind in the international comparison. Small and medium-sized enterprises have an important role to play in this innovation system. In addition to their huge importance for the diffusion of new technologies they also play a decisive role in the technological development through their own innovative activities.

Contrary to what is generally assumed the innovative activities of SMEs are not restricted to any specific age groups of companies: new products and production methods are rather developed and marketed by companies of any age and by no means only by young companies. With an increasing company size one can observe an increase both in innovative and R&D activities and in innovation success. Significant differences also exist with regard to the objectives pursued. While innovation projects of large companies rather aim at maintaining the market, small and medium-sized companies focus their innovative activities more on the search for and establishment of market niches.

Frequently SMEs do not fully exploit their innovative potential. Since part of the know-how produced in the context of the innovation process is available not only to the innovating company but also (free of charge) to other companies, especially small and medium-sized companies often invest less than would be desirable from a macro-economic point of view. Moreover, SMEs find it more difficult to finance innovation projects than large companies do.

Numerous SMEs are complaining about difficulties in actually implementing innovation projects. Frequently named difficulties are recruiting appropriate staff and financial constraints. The lack of equity is cited as a serious obstacle even more frequently than

insufficient access to borrowed capital. In addition, SMEs often face internal problems when implementing innovation projects, for instance organisational problems, insufficient use of external know-how and lack of knowledge on innovation management.

Thus, the central task of structural policy remains to better open up and develop the innovative potential of small and medium-sized companies. The targeted support of innovative activities of SMEs can help to accelerate economic growth and thus to safeguard jobs and create new ones.