

MITTELSTANDSMONITOR 2006

CYCLICAL UPTURN DESPITE ONGOING DIFFICULTIES

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

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Palmengartenstrasse 5-9, 60325 Frankfurt am Main

Phone +49 69 7431-0, Fax +49 69 7431-2944

info@kfw.de, www.kfw.de

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Palmengartenstraße 5-9, 60325 Frankfurt am Main, Germany
Phone +49 69 7431-0, Fax +49 69 7431-2944
info@kfw.de, www.kfw.de

About us

Responsible for the content:

Michael Bretz M.A., Head of economic research department,
Verband der Vereine Creditreform e. V., Neuss;
Dr. Norbert Irsch, First Vice President, Economic Department,
Chief Economist, KfW Bankengruppe, Frankfurt am Main;
Dr. Gunter Kayser, Scientific Direktor, IfM Bonn;
Dr. Bernhard Lageman, Division Chief „Entrepreneurship and
Enterprise Performance“, RWI Essen;
Dr. Georg Licht, Head of Department, Industrial Economics and International
Management, Centre for European Economic Research, ZEW Mannheim.

Authors:

Chapter 1:

Dr. Klaus Borger, KfW Bankengruppe, Frankfurt am Main;
Dipl.-Volksw. Micaela Kiener-Stuck, Creditreform, Neuss;

Chapter 2:

Dr. Michaela Niefert, ZEW, Mannheim;
Rechtsanwältin Anne Sahm, Creditreform, Neuss;
Dr. Philipp Tilleßen, KfW Bankengruppe, Frankfurt am Main;

Chapter 3:

Dipl.-Volksw. Wolfgang Dürig, RWI Essen;
Dipl.-Volksw. Jürgen Egel, ZEW, Mannheim;
Dr. Michaela Niefert, ZEW, Mannheim;

Chapter 4:

Dr. Dirk Engel, RWI Essen;
Dipl.-Volksw., M.A. Kai Kohlberger, Creditreform, Neuss;
Dr. Guido Paffenholz, IfM Bonn;
Dr. Dankwart Plattner, KfW Bankengruppe, Frankfurt am Main.

Coordination:

Dr. Dankwart Plattner (KfW Bankengruppe)

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Preface

In Germany, as in almost all industrialised countries, more than 99% of all enterprises are small or medium-sized (SMEs). They produce nearly half the enterprise sector's gross value added. Their main qualitative feature is that owners and responsible management are identical. Small and micro enterprises – which essentially include all start-ups and most young enterprises – belong to this sector as do 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 a national economy. Despite the enormous importance rightly attributed to small and medium-sized enterprises time and again in the debate about economic and social policy, the economic situation of SMEs is not apparent from the official statistics.

Only a few institutions possess sufficient statistical information bases of their own that would put them in a position 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-Westfälisches Institut für Wirtschaftsforschung) and the Centre for European Economic Research (ZEW) have joined a KfW initiative to publish the MittelstandsMonitor, which is a joint annual report on cyclical and structural aspects relating to small and medium-sized enterprises. The basic idea is to collect and compare new expert findings in order to subsequently present them to the public in a concise form. The prime objective is to conduct an analysis based strictly on objective facts. The partners' exclusive databases complement each other and 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 company start-ups and liquidations are a standard element of the report. This is supplemented each year by different topics relating to the small and medium-sized enterprise sector that are of current economic interest. The 2006 edition focuses on the subjects of "SMEs and professional qualifications" and "SME financing in the light of the financial market changes: difficulties, challenges and opportunities".

The project partners decided to entitle the MittelstandsMonitor 2006

"Cyclical upturn despite ongoing difficulties".

Their intention is to illustrate the clear benefit derived by small and medium-sized enterprises from the ongoing upturn in 2005. Due to its strong foundation, the favorable economic environment can be expected to persist in 2006. However, the current shortfall of output from its potential for small and medium-sized enterprises – a consequence of the persistently stagnating consumption in 2005 – has prevented them from having a positive impact on the labour market (Chapter 1).

The large number of start-ups in recent years is largely attributable to start-ups by unemployed people. Their number decreased somewhat in 2005 as the subsidy criteria were tightened. There were fewer company insolvencies in 2005 but a marked increase in private insolvencies, which meant an overall increase in the number of insolvencies. The large number of insolvencies is probably also related to the boom in start-ups by unemployed people in recent years. The macroeconomic impact of the latest wave of start-ups is generally to be viewed with a critical eye – especially with regard to its small effect on employment. Moreover, the sectors of the economy that are crucial to growth and technological progress are benefiting from the increase in start-up figures only to a disproportionately small extent (Chapter 2).

Well-trained employees are required to ensure the economy's competitiveness and to strengthen the drivers of growth. The dual vocational training system is considered a good way of combining practical training periods within a company and theoretical studies at a vocational training centre and hence an effective means of equipping trainees for their chosen profession. It makes a significant contribution to a low level of youth unemployment by international comparison. In the past 10 years, however, the image of the predominant advantages of the dual system has become a little tarnished. It is therefore appropriate to ask whether the dual system needs to be overhauled. Various approaches to the reform debate are presented in Chapter 3. The authors argue against replacing the dual training system by training modules but expect greater flexibility to be derived from concentrating on "loosely defined core professions". The economic incentives to take on trainees could be reinforced, for example, if vocational training institutions, inter-company training centres and training establishments were to coordinate their activities in such a way as to better meet business requirements. In the field of further training, the authors call for the public sector to support measures to improve further training opportunities for employees of small and medium-sized enterprises.

The change in the financial markets, which began in the mid-1990s, affected corporate finance as well. Banks take greater account of the borrower's individual creditworthiness not only in loan decisions but also when determining their loan conditions. They therefore require enterprises to be more transparent, to document their plans more extensively and to supply

more forward-looking qualitative data. The shift in the financial markets brings small and medium-sized enterprises face to face with the need to strengthen their equity base, in particular, and to diversify their sources of financing. Opportunities and conditions for raising external equity and quasi-equity financing are discussed in Chapter 4.

The participating institutions

Chapter 1: Cyclical position of small and medium-sized enterprises

Upswing for SMEs

Against the backdrop of the moderate recovery of the Germany economy, the mood in the SME sector has improved so markedly after a hesitant start that the historical average of business climate and order books – the yardstick for the normal cyclical situation – was narrowly exceeded in 2005 as a whole for the first time for five years. Especially since last summer, SMEs are experiencing a greater upswing and in the final quarter of the year the business climate even reached a level last seen in the autumn of boom year 2000. The improvement in the climate in the course of the year is attributable to both elements, although the assessments of the situation were revised upward more strongly than the expectations. In cyclical terms, SMEs caught back up with large companies almost completely in 2005.

The upswing not only picked up speed last year; its basis also became broader. Incoming orders and the business climate increased in both parts of Germany although only among the SMEs in western Germany were they above average. The manufacturing industry was in the lead along with the wholesale trade and the service industry, with little difference in the relative ranking of these three main sectors of the economy. The two strongly domestically oriented sectors, the retail trade and the construction industry, are still in the cyclical doldrums although they have made a clear recovery.

Driven by the upward trend in sales and income, the SMEs' willingness to invest increased for the third year in succession: just under 38% of the SMEs were recently planning new projects. Although that is the highest figure since 2001, it is below the long-term average (46%). The comparatively restrained propensity to invest suggests that SMEs still have sufficient capacity reserves, which may be drawn upon initially to meet additional demand before further investment needs to be made to expand production facilities. The production potential is still far from fully exploited, which probably also explains why SMEs did not have a positive impact on the labour market in 2005. However, the downswing has almost come to a halt.

Recent forecasts indicate that an average calendar-adjusted real growth of 1.8% can be expected in 2006. Since German unification the cyclical pace has been significantly higher on two occasions only – in post-recession year 1994 (2.7%) and at the peak of the new economy boom in 2000 (3.5%). This increase in optimism was triggered by the new dynamism for growth in the second half of 2005, which is continuing into 2006, but government economic policy decisions are also likely to stimulate the domestic economy in 2006. The general economic situation is set to generate a self-sustaining recovery through

such an initial impetus. The current situation – which is characterised by considerable capacity reserves, long-standing weak domestic demand, sustained restraint in wage development and successful rationalisation and rehabilitation measures throughout the entire business sector coupled with a marked improvement in financial structures, the earnings situation and corporate competitiveness – is such that no overheating is expected in the foreseeable future. The macroeconomic conditions expected in 2006, which imply a strengthening of domestic demand and persistently lively foreign business, are better than they have been in a long time. The participating institutions therefore expect that in 2006 SMEs – and indeed the economy as a whole – will have their best year since 2000.

Chapter 2: Business fluctuation – current start-up trends

The turnaround in start-up dynamics which began in 2003 continued in 2004. As in the previous year, the increase in start-up intensity can be attributed to the growing number of business start-ups by unemployed people. In 2005, however, these declined again somewhat owing to a tightening of the subsidy criteria. In 2004 there was a slight decrease in the number of company insolvencies for the first time since 2000. The downward trend gained strength in 2005. By contrast, there was a further marked increase in private insolvencies, leading to an overall increase in insolvencies. Liquidation figures point in the same direction. Rising start-up and liquidation figures imply an increase in business fluctuation.

The start-ups by unemployed people are presumably responsible for the relatively high fluctuation. These occur primarily in less capital-intensive sectors with low market entry barriers such as building crafts and company-related services. Only a comparatively small proportion of unemployed business founders employ staff. As for them the “escape route”, i.e. the desire to find a way out of being unemployed, is more important than the “opportunity” aspect, i.e. the expectation of making a lot of money through the enterprise, they endeavour to keep the investment risk low.

The economic impact of the latest start-up boom is therefore probably best viewed with a critical eye. Start-ups by unemployed people generate hardly any additional employment effects. They increase competitive pressure in less capital-intensive sectors, which are already characterised by a high degree of fluctuation. The sectors of the economy that are crucial to growth and technological progress are benefiting from the increase in start-up figures only to a disproportionately small extent. By international comparison – and as an average across all sectors – start-up dynamism in these sectors in Germany seems to be below average.

Given this development, consideration needs to be given to focusing on promoting start-ups that are innovative and hence contribute to more growth and employment. With regard to the promotion of start-ups by unemployed people, one aim needs to be a more thorough examination of the viability of the founder’s business concept and a reduction in windfall effects. Another possibility would be to provide support on the basis of a grant that has to be repaid (at least in part).

Chapter 3: SMEs and professional qualification

The dual vocational training system is still highly acclaimed outside Germany. It is considered a good way of combining practical periods of training within a company and theoretical studies at a vocational training centre, an effective means of equipping trainees for their chosen profession. The dual initial training system is also proving its worth from the point of view of integration. School-leavers are ensured a swift and smooth transition into working life. In Germany the dual system makes a significant contribution to the level of youth unemployment, which is low by international comparison.

Only around one-fifth of all enterprises (23.4%) are involved in providing training under the dual system. Of these, 57% employ fewer than 9 people. Around 30% are in the category of enterprises employing 10-49 people. Small and medium-sized enterprises thus play a vital part in professional training, especially in the field of trade and commerce.

In the past 10 years, however, the image of the predominant advantages of the dual system has become a little tarnished. The proportion of young people opting to train under the dual system has decreased. Instead, college-based training programmes are proving more attractive. At the same time, enterprises have become less willing to take on new trainees. There are a number of reasons for this trend. For example, more recent business strategies which focus more intensively on cutting costs are having a negative impact on the willingness to provide training, particularly in medium-sized and larger enterprises. Numerous official and formal requirements are also hindering training provision.

Every now and then, this system of vocational training is called into question as part of the debate on reform. The thinking is that training modules or providing training blocks that are appropriate to the specific situation would ensure not only that employee qualifications and the skills needed are brought more quickly into line but also that the rigidity of existing training regulations are circumvented. However, such a departure from the current system of vocational training is accompanied by major risks. Many people derive meaning and identity from their profession. Modules cannot replace this aspect of professional life. Moreover, particularly on the labour market, professions and their designation act as signals – at least simplifying communication about the level of qualifications and skills. Criticism of the vocational training concept is sparked by institutional issues, namely the tediousness of adapting job descriptions to changed conditions in business practice and the rigidity of professional definitions. Concentrating on “loosely defined core professions” should lead to greater flexibility while safeguarding the advantages of the principle behind the dual training scheme.

Particularly as a means of encouraging SMEs to become more involved in professional training, it makes sense to resort to measures that boost the economic incentive to take on trainees. This could be achieved, for example, through an agreement between vocational training institutions, inter-company training centres and training establishments that is better geared to business requirements. Trimming back the number of regulations governing job descriptions and allowing a range of specialisations and extensions to develop around a core profession would give training establishments greater freedom when designing training syllabuses. Collective training programmes could become a key feature of the efforts to improve the training ratios. This would also enable highly specialised small and medium-sized enterprises to join forces with others to provide training courses covering specific professional fields.

The ratio of supply to demand in the market for trainee positions has taken an unfavourable turn in recent years, i.e. at the end of the year regular recourse needs to be made to appeals and image campaigns calling on enterprises to create additional trainee positions to accommodate young people who are still without an apprenticeship. Although these annual campaigns have been moderately successful in plugging the gaps in the provision of apprenticeships in the past, public debate has not given sufficient place to the underlying causes of the mismatch between the number of apprenticeships available and the number demanded. It is therefore time to ask whether the dual system needs to be overhauled. This is even more pertinent because demographic considerations alone indicate that SMEs, in particular, will soon be faced with a more acute shortage of skilled workers. To take account of the rising knowledge intensity of products and production, ongoing staff training is absolutely vital but is not implemented nearly enough. SMEs, in particular, find it difficult to provide their staff with adequate further training opportunities, which means that they are still a long way off from the frequently propagated concept of "life-long learning". Measures to improve the number of further training opportunities available to staff at SMEs should be supported by the public sector. The shortfalls in the number of new academics with a technical background could be mitigated by ensuring that holders of technically oriented jobs update and broaden their knowledge by attending academic further training measures. One of the key tasks of universities and, in particular, technical universities should be to provide relevant further training courses for both academics and non-academics.

Chapter 4: SME financing in the light of the changing financial markets: difficulties, challenges and opportunities

SME financing in Germany is based traditionally on two pillars – internal financing from retained earnings and depreciation and bank loans. The product of underlying institutional conditions which favour borrowing and the efforts of SME managers to avoid reducing their decision-making power by taking on new partners, this specific financing culture still predominates today. However, it is being increasingly complemented and supplemented by investment and mezzanine financing.

The financial markets began to change in the mid-1990s, prompting banks to alter their lending behaviour. The change is characterised by the greater account being taken of credit risk and by improvements to banks' risk management practices. This requires enterprises to become more transparent, to document their projects more extensively and generally to supply more forward-looking qualitative data. For the SMEs in Germany, which have tended to be rather "uncommunicative", this is a significant change.

SMEs usually notice the change in the financial markets when encountering obstacles in applying for loan financing. The difficulties are not limited to the more demanding requirements of business transparency; not infrequently they also extend to the denial of credit – especially in the case of small enterprises. The decline in the volume of credit granted by banks and savings banks to enterprises and self-employed people has given rise to public concern about the credit supply for SMEs in particular. Empirical analyses cite cyclical (demand-related) reasons and the banks' reluctance to grant loans as the cause. At least in recent times, demand-side, i.e. cyclical, effects seem to be dominating the development.

Further empirical findings stress the need for SMEs to place their financing on a broader basis and, in particular, to strengthen their equity base. This not only improves their financial structure but also gives them better access to external financing. This perception is meeting with increasing resonance among SMEs. Medium-sized enterprises, in particular, have improved their equity ratio and their credit rating. However, further efforts are needed and many enterprises are planning to strengthen their equity base further.

SMEs basically have several ways of procuring equity capital from external sources. They can acquire real equity via the stock market and private equity companies. Mezzanine capital – a cross between debt capital and equity capital – is a further option.

If it can be accounted for as equity capital on the balance sheet, it reinforces the equity base directly. Otherwise, provided that its specific features permit, it can be classified in the

context of a structured balance sheet analysis or a rating as quasi-equity capital. However, not every form of financing is equally suitable and available for every enterprise or every financing need. Mezzanine capital is a serious investment financing option primarily for established SMEs with a steady cash flow.

The change in the financial markets has shifted the parameters of corporate financing in Germany. It gives small and medium-sized enterprises access to financing instruments that were previously available to large corporations only. Not only has the demand for new, previously unused instruments increased, there has been a major upturn in supply, too. The market is in a state of change and the end is not yet in sight.