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Germany's Mittelstand – an endangered species?

Focus on business succession

Germany's *Mittelstand* (SME) businesses have a structural succession problem. A survey shows that less than one in every two businesses ready to be handed down are passed on to members of the owner families. For the foreseeable future, though, the much-touted succession gap is a myth, as attractive companies have no difficulty finding new owners these days. However, with non-family succession solutions on the increase, the successful German type of (family) business structure is under pressure.

Family businesses sing to a different song sheet. Endowed with abundant capital in the form of "relational trust", they are subject to social control prompting them to assume direct responsibility for the community. Being very flexible, they can respond comparatively quickly to the dynamic changes in their national and international environment.

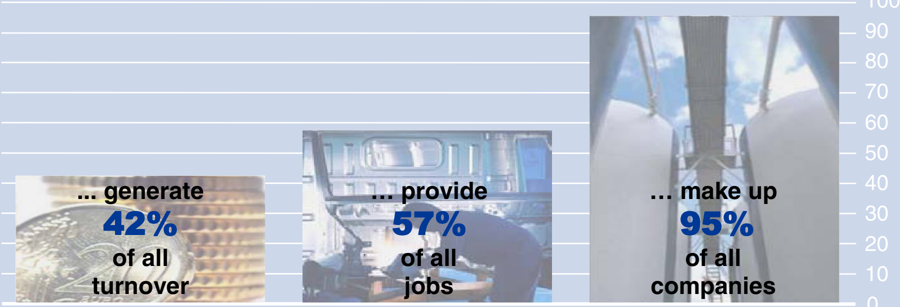
Germany needs more innovative family businesses. Fewer than 4% of Germans set up a company to capitalise on a business idea. The political (entrepreneurial) climate is chilly and the prospects dim. By 2050 the group of 30-39 year-old entrepreneurs will have shrunk by around 40%. More children and a more open-minded attitude to the immigration of business talent would brighten the outlook for the entrepreneurial landscape as a whole.

SME financing habits continue to change. *Mittelstand* businesses already adjusting their financing habits towards modern types of funding – driven not least by greater pressure to innovate – are better equipped for the future.

The future is bright for the *Mittelstand* on a long-term timeline. Going forward, creating innovative products will require a breadth of expertise that one company alone is often hardly capable of holding available. This will give rise to increased cooperation. In this setting, family businesses – with their flexibility and regional connectivity – will arguably stand to gain more than they lose. Efficiently managed generation change will help open them to new forms of cooperation.

How much longer?

Family businesses...



Sources: DB Research, IfM-Bonn

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If we would preserve what we have,
there is much we must change.
J. W. von Goethe

1. Introduction

Everybody is talking about them. They are everybody's darling. Globalisation has long since reached them – Germany's *Mittelstand* companies. More and more of these small and medium-sized enterprises, or SMEs, have operations abroad and have secured themselves niches with what are in some cases impressive world market shares. In no other country of a similar size in the world does the SME sector have such a strong export focus as in Germany. At a rapid pace and with promising prospects, German SMEs are slotting ever deeper into the globalised world. It is mainly owner-managed SMEs that constantly re-evaluate the basis of their tradition, track down cost-cutting potential, drive the development of innovative products and tap new growth markets. Even in their own backyard, *Mittelstand* firms are performing well again. The domestic economy has recently started to gather steam and many industries have found themselves a place in the sun again after difficult years. So much for the status quo.

But what about the future? For German SMEs this will be determined by two trends. First, for demographic reasons Germany will soon start to notice a shortage of young people looking to shape the business world as entrepreneurs and grasp the future in both hands. Today, more than 60% of entrepreneurs are younger than 40 and just under one-fifth older than 50. Extrapolating this age distribution, the number of entrepreneurs and successors is set to fall dramatically in the coming decades. Second, empirical research already shows a decline in young people's willingness to take over their parents' business. This gives rise to the obvious questions: What implications will the structural succession problem have on the business landscape? And what future can owner-managed SMEs look forward to?

Our study combines assessment of the current situation with a future scenario on the basis of which decision-makers can deduce possible options for action from where they stand individually. The paper begins with a condensed overview of structures and developments in the German SME sector. From this, recommended courses of action are derived with reference to the scenario analysis *Mittelstand* 2020.

Quantitative definition of SMEs

Type

IfM	Employees	Annual sales	Balance sheet total (€ m)
Small	<10	≤2	-
Medium-sized	<500	≤50	-
Large	*>500*	*>50*	-
EU*			
Micro	<10	≤2	≤3
Small	<50	≤10	≤10
Medium-sized	<250	≤50	≤43
Large	*>250*	*>50*	*>43*

* And one or more companies that do not meet the EU definition may not hold a stake of 25% or more in the company.

Source: IfM-Bonn 1

2. *Mittelstand*: Setting out its stall

2.1 *Mittelstand* vs. family business

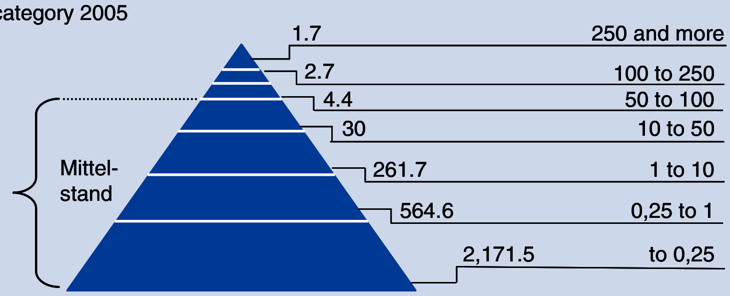
The problem is obvious – there is no legal definition of the term *Mittelstand*/SME[1]. In practice we usually resort to quantitative determinants such as the number of employees and/or annual sales to quantify the macroeconomic importance of SMEs.

[1] Neither the EU nor the US use the term *Mittelstand*. Instead, institutions there speak of micro, small and medium-sized enterprises (SMEs).

The Institute for SME Research – Institut für Mittelstandsforschung (IfM) in Bonn, for instance, classifies enterprises with less than 500 employees and annual sales of up to EUR 50 m as SMEs. The EU defines the term more narrowly, counting all businesses with less than 250 employees as SMEs. By the IfM definition SMEs make up 99.7% of all German companies. Or to put it another way, 99 out of every 100 German companies belong to the SME sector.[2]

Current company size structure

Companies by turnover size category 2005



Only companies liable to tax, with supplies and services of more than EUR 17,500

Source: Statistisches Bundesamt **2**

Real significance is one of quality

But the real significance of the SME sector lies not in its quantitative dimension. That measure obviously falls short of the mark, because no (payroll) statistic can say anything about whether a company belongs to the *Mittelstand* in terms of its attitude and behaviour. Instead, a (qualitative) definition will centre on the character of the entrepreneur, who is so deeply involved with the company that, at times, the business and businessperson can be described as one and the same. Entrepreneurs are distinguished by the courage to take on private business risk and the willingness to take personal responsibility for their actions. As a rule they assume management of, control over and responsibility for the company – their family business.

SMEs and family businesses (practically) identical

There is no universally valid definition of the term "family business" either. The IfM defines family businesses in the narrower sense as the unity of ownership and company management. The company is majority-owned by the family, and the direct influence of the family entrepreneur is felt throughout the company. Or more specifically, family businesses are owner-managed enterprises in which members of the owner family belong to the management. The IfM states that, of all companies in Germany, 95.1% are owner-managed. At the same time (almost) all owner-managed companies are SMEs in the quantitative dimension outlined above. Big owner-managed enterprises account for only a fraction (about 0.1%) of all family businesses.

Family businesses in the broader sense are often also called "owner enterprises", a definition geared solely to their ownership structure. Whether non-owner-managed or owner-managed, a family exercises majority control of the company (with more than 50% of the company shares) – irrespective of its legal form. This naturally also encompasses big family businesses with annual sales of EUR 50 m

[2] The author wishes to thank Prof. Dr. Frank Wallau (Institut für Mittelstandsforschung Bonn) for his valuable comments.

Family business in DE (in the narrower sense)

Big enterprises	Big enterprises managed by outside executives	Big owner-managed enterprises
	0.2%	0.1%
Smaller and medium-sized enterprises	Small and medium-sized enterprises managed by outside executives	Owner-managed smaller and medium-sized enterprises
	4.7%	95.0%
	Non-family businesses	Family businesses
	4.9%	**95.1%**

Source: IfM-Bonn 3

and more that no longer belong to the SME sector in terms of their size.

To sum up, family businesses play a pivotal role in Germany and, quantitatively speaking, almost all of them are *Mittelstand* companies. In the following we therefore use the terms *Mittelstand* companies/SMEs and family businesses synonymously.

2.2 Features of (successful) family businesses

In view of their ownership structure family businesses are often perceived as blueprints for success. Investigating the characteristic features of successful family businesses has become increasingly popular of late. As a rule this is confined exclusively to such traditional family business strengths as a focus on values, close ties with the local community, customer proximity, flat hierarchies, swift decision-making processes, long-term orientation or flexibility. But to assess family businesses properly a more nuanced view is required.[3]

— Owners of family businesses are typically very keen to hand the company down to their descendants. Research has shown that towards this end, if necessary they are prepared to tolerate lower returns to tide the business over critical periods.

— Essentially, abiding by tradition has a positive effect on the development of core competences and "relational trust". But if the basis of that tradition alters, clinging to old ways – however successful in the past – can become a problem. It is important here to find a balance between continuity and realignment.

Family businesses live out their corporate culture…

— Family businesses live out their corporate culture. They are successful partly because they often stick by their guns, and there is frequently no room for advice from outside. However, this attitude can rebound on them at times of crisis when adjustments in the basic game plan are precisely what are needed.

— Family businesses are family and business in one. In case of conflict – over the issue of company succession, for instance – this linkage can give rise to serious tensions.

— Family businesses assign family relationship patterns to their employees. The employee experiences a greater sense of purpose, leading to closer identification with the company. Of course, this sense of family community can also be detrimental to employees' careers where, for example, family members are placed in managerial positions with little or no regard for their professional suitability.

… but clinging to old ways can quickly spell doom

— Family businesses frequently benefit from flat hierarchies, which shorten decision-making channels. This benefits customers, suppliers and employees alike. But this unique feature can backfire if the principles of entrepreneurship are not passed on early enough to the next generation. If the successors are differently socialised, for example, and do not exemplify the corporate philosophy in personal practice, rapid decision-making processes can quickly prove disastrous.

[3] See also von Schlippe, A. et al. (2007). Familienunternehmen in Nordrhein-Westfalen. In Wirtschaftsbericht NRW. pp. 12-23; or Domayer, E. et al. (2005): Familienunternehmen – Auslaufmodell oder Erfolgstyp? Wiesbaden.

The 30 biggest family businesses in Germany

Company	Sales 2005 (EUR bn)	Em-ployees 2005
1 Schwarz Gr.	40,000	170,000
2 Aldi	32,000	200,000
3 Merckle Gr.	29,400	67,300
4 Haniel	25,892	58,444
5 Tengelmann	25,700	150,880
6 Bertelsmann	17,890	88,516
7 Otto Gr.	14,570	55,116
8 Boehringer	9,535	37,406
9 Heraeus H.	9,311	10,625
10 Tchibo	8,788	29,619
11 Marquard&B	8,473	3,707
12 INA-Schaeffler	8,000	60,000
13 Oetker	7,030	22,412
14 Adolf Würth	6,914	50,767
15 Schlecker	6,600	52,000
16 Rethmann Gr.	6,100	31,500
17 A. C.Toepfer	5,800	2,236
18 Röchling	5,350	26,700
19 Benteler	5,315	21,234
20 C&A Mode	5,211	32,000
21 Freudenberg	4,837	33,385
22 Helm	4,745	1,173
23 Globus Gr.	4,200	21,000
24 DM Drogerie	3,672	24,477
25 Voith	3,551	30,834
26 Knauf Gruppe	3,550	18,500
27 Hella	3,071	24,199
28 Behr	3,052	18,103
29 B. Braun	3,026	30,973
30 Dachser	2,800	13,400

Source: Handelsblatt 4

— Family businesses cultivate close ties with the region in which they operate. Their sense of community means that they are subject to social control prompting them to assume direct responsibility for public welfare. Of course this is also driven by the entrepreneurs' personal interests – for instance, when a commitment to public affairs enhances the company's standing.

2.3 Family business performance

Analysis of family businesses' performance is fraught with a host of data problems. The sources used refer to statistics that do not document the full spectrum of family businesses. There is a lack of resilient data on small and midsized family businesses. Even so, the data does suffice to indicate that as a rule big family businesses boast better sales trends than, say, listed corporations. Even on the capital markets family businesses are given good ratings. The international capital markets pay impressive tribute to this type of enterprise – which is all the more surprising inasmuch as capital markets in particular are said to focus on short-term (quarterly) targets, such as earnings, to the exclusion of all else.

But now to the research: The 50 biggest family-managed businesses outperformed the lead index DAX by an average of 6.8% p.a. over the past 15 years.[4] Another European-level study showed companies on which families exert significant influence outmatching their respective sectors by 8% p.a. on average since 1996.[5] In the US outperformance by family businesses is similarly marked.

German stock exchange operator Deutsche Börse now calculates a barometer of its own for listed family companies. It launched the stock exchange index GEX (German Entrepreneurial Index) on January 3, 2005 for young companies in which a family is the major shareholder. Since its 2005 launch the GEX has risen by 92% – the DAX by just 63%.[6]

The performance of non-listed family businesses has also been the subject of analysis. The 30 largest family firms posted significantly better sales growth than the leading 30 DAX companies. Sales at family-run businesses expanded almost twice as fast in the business year 2006 (9.7%) as at the DAX companies (5.5%). And recent research shows that the 500 biggest family businesses increased their workforce between 2003 and 2005 by about 10 percent, while the DAX companies shed labour.[7]

4 HypoVereinsbank (2004). Die Performance familiengeführter Unternehmen. Munich. In their study the analysts examined family businesses (1) in which the founder family holds a stake of at least 25%, giving it a blocking minority and (2) whose founders have a major influence on management of the company through seats on the board of managing directors or supervisory board.

5 Credit Suisse (2007). Unternehmen in Familienbesitz. Zurich. The analysts compared the performance of European shares in companies in which the founder family holds at least 10% of the capital with the performance of companies featuring a broad shareholder base.

6 The GEX contains owner-managed companies listed on the stock exchange for a maximum of ten years and belonging to the Prime Standard. Owner-managed means that managing directors, supervisory board members or their families own at least 25% of the voting rights. The number of companies in the GEX varies and is not set a priori. Any company satisfying the criteria is included. At present the index comprises around 120 stocks.

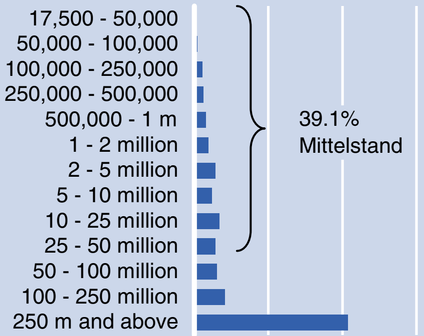
7 See Stiftung Familienunternehmen (2007): Die volkswirtschaftliche Bedeutung der Familienunternehmen. Stuttgart.

Performance by family businesses

Source: DB Research 5

Companies and their sales in Germany

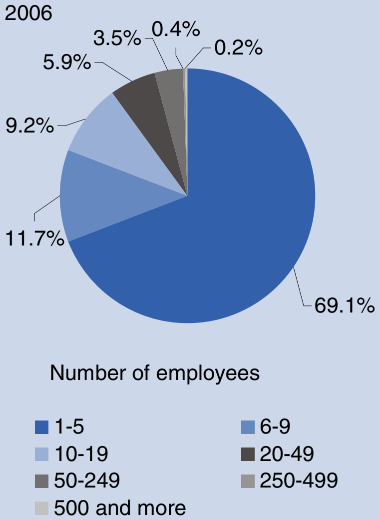
in 2005, by turnover size ranges, in EUR



Source: Federal Statistical Office 6

Businesses with employees liable to social ins. contributions

2006



Source: Fed. Labour Agency, special analysis by IfM, Bonn 7

3. Economic dimension and economic policy framework

3.1 Economic dimension

To establish their economic importance, the quantitative IfM definition of *Mittelstand* companies is used almost invariably in the relevant literature. This, of course, disregards companies that no longer fall within the quantitative frame, even though they are certainly *Mittelstand* companies by nature. The need for additional research is evident here.

Business ratios underscore great importance…

Even on the strength of the figures available, the macroeconomic weight of Germany's SME sector is without a doubt impressive. The data shows that the *Mittelstand* encompasses 99.7% of all businesses, roughly 70% of the total labour force, and around 80% of all training positions. All told, *Mittelstand* companies generate about 40% of all taxable turnover and almost 50% of overall gross domestic product. They account for about half of the corporate taxes paid in Germany. On the other hand, of course, it can be said that the 0.3% of companies that do not belong to the *Mittelstand* are responsible for (the other) half of gross economic output and make up (the other) half of the tax take. Yet this statistical number crunching aside, the importance of the *Mittelstand* sector in Germany is undisputed – it occupies a prominent position as a powerhouse of the German economy.

A word on the sectoral breakdown: Germany's SME sector comprises about 3 million businesses subject to turnover tax. Business-related services (mainly for companies) represent the largest group with more than 850,000 businesses, followed by the distributive trade (705,000). Then come the construction industry (320,000), other public and personal service providers (308,000), the manufacturing industry (275,000), the hotel and restaurant industry (245,000) and transport and telecommunications (127,000). Added to this are roughly 900,000 self-employed professionals.

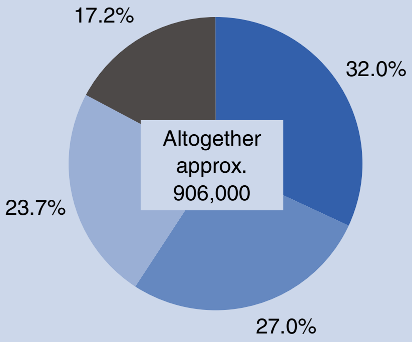
… also in terms of sales and employees…

90.1% of all businesses subject to turnover tax generate annual sales of less than EUR 1 million a year. 9.6% realise between EUR 1 and 50 m (chiefly in manufacturing). And roughly half of all businesses subject to turnover tax have annual sales of less than EUR 100,000. In other words, the German *Mittelstand* sector consists mainly of small companies.

Notwithstanding the dominance of smaller *Mittelstand* businesses, the number of companies with annual sales in excess of EUR 5 million has risen steadily over the past 10 years – by around 10% to more than 70,000 at present. The increase is due mainly to technological progress as SMEs active in growth industries such as nanotechnology, power engineering, telematics and bionics visibly ratchet up their sales. Ongoing globalisation is also strengthening SMEs' position as suppliers. In a quite formidable manner they are seizing the opportunities, in both quantitative and qualitative terms, that have arisen from the dissection of value chains, reduction in vertical integration and concentration on core competences – not only, but of course primarily for big companies.

Payroll figures approximately follow the breakdown in annual sales. Here, too, SMEs play the leading role, particularly the smaller firms.

Categories of liberal professions in Germany



- Healthcare professions 290,000
- Legal, business and tax consulting professions 245,000
- Liberal arts professions 215,000
- Technical and scientific professions 150,000

Source: Institut für freie Berufe, Berufsorganisation 2006 8

Company size by international comparison
Type, in %

	FR	DE	IT
Micro < 10 employees	93.0	88.0	95.6
Small < 50 employees	5.8	10.2	3.9
Medium-sized < 250 employees	1.0	1.5	0.4
Large > 250 employees	0.2	0.4	0.1
	GB	**EU-15**	**US**
Micro < 10 employees	89.3	92.4	94.0
Small < 50 employees	9.0	6.5	5.0
Medium-sized < 250 employees	1.4	0.9	1.0
Large > 250 employees	0.4	0.2	-

Source: European Commission (2003) 9

Roughly 80% of all businesses employ fewer than 10 workers liable to social insurance contributions. All in all, around 20 million people are employed in the *Mittelstand* sector. Analysis confirms that there is no such thing as the *Mittelstand* company – if at all, the term is generally taken to denote smaller firms.

... as well as by international standards

Smaller firms with fewer than 10 workers are also predominant (92%) in the European Union (EU-15).[8] The average European company employs 7 people. Differences in company sizes within Europe are due to structural, institutional and historical circumstances. And companies in countries with high GDP per capita are on average larger, whereas the average company size in countries with comparatively low per capita GDP tends to be smaller. SMEs in Greece, for instance, employ an average of 2 people, in Italy 4, Portugal 5, Spain 6, the Netherlands 12, the UK 11 and Germany 10. Across the water in the United States an average of 6 people work in an SME.

In Europe 66% of the total labour force is employed in the SME sector, against 33% in the US. This can be explained, firstly, by the fact that many micro enterprises in America are one-man businesses; secondly, brisk fluctuation in American business start-ups and closures means that more businesses are at the early stage and correspondingly small.

Active exporters

About 12% of all enterprises in Germany engage in export business. Roughly 98% of the approx. 350,000 German exporters are SMEs. In recent years the number of companies involved in export trade has risen steadily, particularly among smaller *Mittelstand* firms. SMEs do not therefore play an important role only on their home market – they also represent an important mainstay of the German export industry.

The bigger the enterprise, the higher the average export ratio of companies active on foreign markets tends to be. Export ratios at smaller businesses with annual sales of less than EUR 1 m range from 0.5% in construction to around 7% in the wholesale trade. In the medium-sized enterprise segment (sales of EUR 1-50 m) the spectrum runs from not quite 3% in construction to around 21% in manufacturing and almost 23% in transportation. Among the large enterprises, manufacturing is the heavyweight, driven by the automotive and mechanical engineering industries, both of which generate in excess of 50% of their sales on foreign markets.[9]

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[8] See European Commission (2003). SMEs in Europe. Brussels.
[9] See Deutsche Bundesbank (2006): Monthly Report December 2006. Frankfurt.

SME export ratio 2004
%

Sector	Total	>EUR 1 m	Mittelstand* EUR 1 to 50 m	Large enterprises EUR 50 m and above
Manufacturing	33.1	3.5	21.2	38.2
Construction	2.4	0.5	2.7	6.2
Wholesale trade and commission trade	14.7	7.3	13.9	15.5
Retail (incl. motor vehicles)	4.2	2.6	6.2	3.0
Transport (excl. Railways)	28.8	6.0	22.6	42.7
Business-related services	6.3	1.4	5.3	12.2
Total	**20.4**	**2.7**	**13.5**	**26.6**

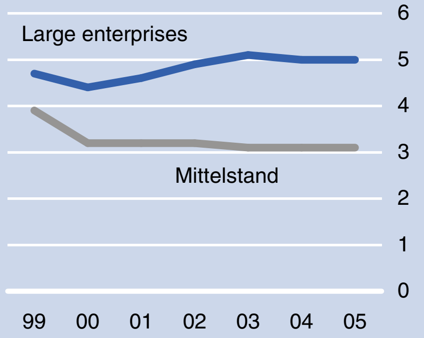
* By annual sales. Source: Deutsche Bundesbank (2006) **10**

Germany's strong focus on export business continues to be driven by its large enterprises, roughly 80% of which are active on foreign markets. Recently, however, export sales at SMEs have posted a comparatively strong upturn, with the *Mittelstand* sector registering significantly higher sales growth on foreign markets than large enterprises. Export sales by SMEs (with up to 500 employees) leaped by around 17% from 2004 to 2005, while large enterprises with more than 500 employees saw growth of only about 9%.

Industrial enterprises doing well abroad

The reasons for this good export performance are obvious: The opening up of markets in central and eastern Europe has visibly stimulated German SMEs' activities abroad. And as sub-contractors they often enter new sales markets in the wake of large firms. Roughly two-thirds of all exports by the *Mittelstand* sector head for EU countries.[10] The data also shows German industrial enterprises performing particularly well internationally. Many of them are "export champions" achieving export ratios of more than 50%. Other "hidden champions" that have focused on dynamic growth markets where they can play the product-quality card particularly effectively not infrequently capture world market shares of between fully 70 and 80%.[11]

Expenditure on innovation
Percentage of sales



Source: ZEW (2006) **11**

3.2 *Mittelstand* innovation intensity

SMEs as drivers of innovation?

Innovation and technological progress form the bedrock of business growth. Only those companies that square up to the challenges of technological progress can survive. Added to which, product life-cycles and innovation cycles have become ever shorter in recent years – also shortening the length of time available to earn the necessary funds to develop new products.

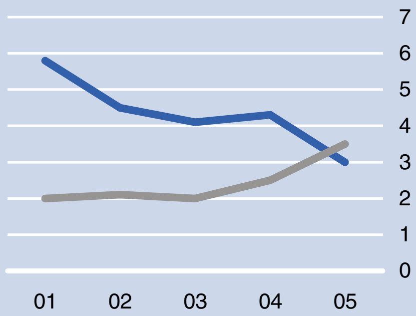
Almost all German *Mittelstand* businesses hold innovative strength in high esteem. In general SMEs are perceived as highly innovative, although recent data does put the *Mittelstand's* much-vaunted innovation role somewhat into perspective. There is authoritative evidence to suggest that innovation intensity has flagged at SMEs since the late 1990s. Large firms are becoming more research-active than small and medium-sized enterprises.[12]

The facts: Since 1999 innovation intensity has been declining at SME manufacturing firms. Whereas in 1999 SMEs were still spending 3.9% of their annual sales on innovation projects, by 2005

[10] See. KfW (2006): Die Globalisierung des Mittelstandes. Frankfurt.
[11] See BDI, Ernst & Young, IKB (2006): BDI-Mittelstandspanel. Berlin.
[12] See ZEW (2007). Innovationsverhalten der deutschen Wirtschaft. Mannheim.

SME innovation track record (manufacturing)

%



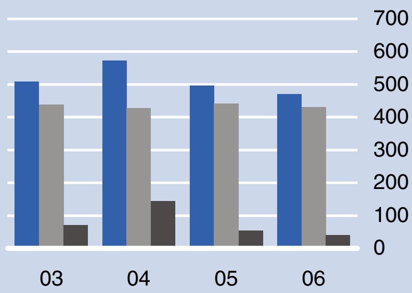
Share of sales with new-to-market products

Share of cost reductions through process innovation

Source: ZEW (2006) 12

Business start-ups and wind-ups in Germany

1999 - 2006 in '000



Start-up Wind-ups Balance

Source: IfM-Bonn 13

the figure had fallen to 3.1%. At large enterprises the ratio rose from 4.7% (1999) to 5.0% (2005). A similar trend is becoming apparent in knowledge-intensive services. Market success with newly introduced products is also unsatisfactory in the SME sector. In 2001 new-to-market products in manufacturing accounted for 5.8% of SME sales (4.6% at large firms), a figure that had fallen to 3.1% by 2005 – compared with an advance to 5% at large enterprises. However, success with process innovations (the proportion of cost reductions through process innovations) improved considerably, from 2% (2001) to 3.5% (2005). But even here, and for all their recent successes, SMEs can hardly match large firms' performance of 5% in 2005. It is interesting to note in this context, however, that SMEs involved in international trade undertake appreciably more innovative activity than businesses geared only to domestic markets.[13]

To summarise, the *Mittelstand* sector is spending far less on innovation than big enterprises. This will certainly have been partly due to sluggish earnings trends at many SMEs early in the decade, particularly since more and more is having to be spent on innovation. All the greater effort is now therefore required on the part of SMEs – and possibly also a rethink of their sometimes critical stance on selective cooperation with other companies.

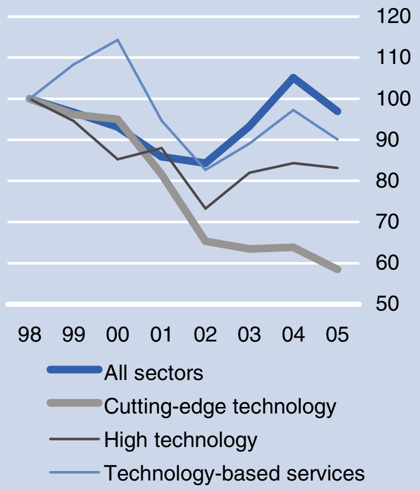
Start-up and wind-up statistics paint mixed picture

Each year in Germany some 500,000 new business start-ups are registered. This number compares with almost as many business closures year for year. On balance, therefore, there is regularly a slight start-up surplus. The data used to investigate start-up activity is gathered from business registration statistics. It suffers from a variety of problems, including the non-recording of liberal professions.

By way of analysis: Long-term, the number of business start-ups points downward, falling from 509,000 in 2003 to 471,000 in 2006. The fluctuations depend chiefly on the political framework conditions. For example, the increases in 2003 and 2004 stemmed mainly from start-ups motivated by unemployment, with business start-up grants (for one-man "Me Incs.") and "bridge-over" allowances acting as important incentives. With discontinuation of these two types of grant mid-2006 and fewer applications so far for the new start-up allowances, the number of new businesses set up in the past two years fell from 573,000 (2004) to around 470,000 (2006). Looking at the individual sectors, we see the general downtrend encompassing (practically) all main sectors. Hardest hit are the services sector and the construction industry in eastern Germany.

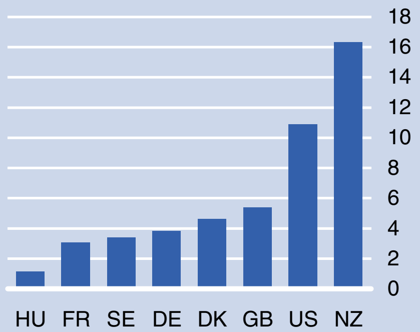
[13] On this subject see, for example, KfW, Creditreform, IfM, RWI, ZEW (2007). Mittelstandsmonitor 2007. Frankfurt.

Development in start-up intensity
High-Tech sector, index: 1998 = 100



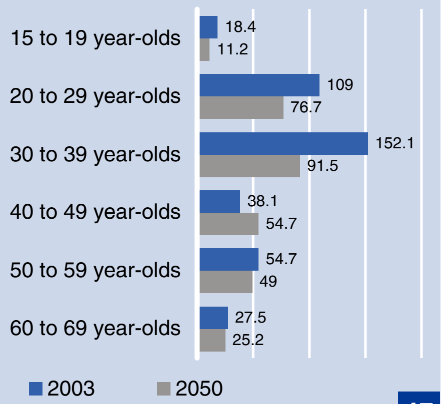
Source: ZEW **15**

Entrepreneurs
% of the population



Sources: DB Research, GEM (2005) **16**

Entrepreneurs are dying out
Number of entrepreneurs per age-group, in '000



Source: IW (2004) **17**

Start-up intensity in selected sectors 2000-2005
Start-ups per 10,000 potentially employable persons

Sectos	West Germany			East Germany		
	2000	2003	2005	2000	2003	2005
Manufacturing	2.6	2.6	2.6	2.5	2.5	2.2
Construction	4.5	6.0	5.5	9.0	10.3	7.8
Distributive trade	11.9	14.3	12.8	10.2	11.3	9.5
Services	27.2	29.9	29.0	25.9	27.7	23.5

Source: ZEW-Gründungspanel **14**

Corporate insolvencies (roughly 10% of dropouts) have gradually eased in recent years with the economic rebound. The downtrend persisted in 2006, dipping from not quite 37,000 insolvencies (2005) to below 31,000 (2006).

Brisk fluctuation in start-ups and dropouts is central to the evolution of competitive market structures. A dynamic start-up environment intensifies competition, and non-viable businesses are forced to exit the market. Fledgling companies tend to act as triggers for innovation. Admittedly, the bulk of business start-ups do not give rise to innovative products or new services. Many entrepreneurs who would, in different circumstances, have preferred traditional employment turn to entrepreneurial activity by force of necessity. Start-ups of this kind – with people out of work taking advantage of state incentivisation and immigrants opening shops or restaurants – are typically less innovative and unleash less growth and employment impetus.

It is therefore more interesting to concentrate on the opportunity-driven entrepreneurs who set out to realise their own business ideas. Relatively speaking, there are far fewer of these in Germany than, say, in the United States. Whereas almost 11% of US citizens pursue this strategy, the figure in Germany falls short of even the 4% mark.

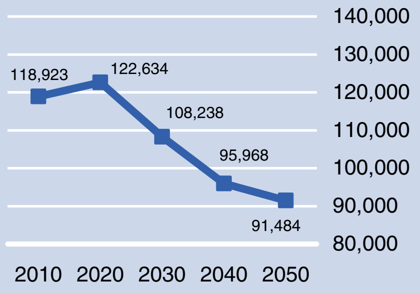
The situation is particularly problematic in the technology-intensive sectors of manufacturing and services. Both are generally perceived as the key engine of technological change in a society. But in these innovation-driven segments start-up intensity has flagged in recent years, seriously so in some cases. Technology-intensive services, for instance, failed to sustain their positive 2004 levels as their start-up activity in 2005 went into reverse. Entrepreneurial momentum has entered a particularly dramatic decline in cutting-edge technology, even running counter to the generally positive trend between 2002 and 2004.[14]

The business situation and state promotion programmes aside, a country's entrepreneurial activity essentially hinges on its entrepreneurship and, particularly in Germany, on demographic change. In Germany the decline in business start-ups through 2050 will be considerably steeper than population shrinkage. The group of 30 to 39 year-olds alone, which account for the majority of start-ups, will contract by around 40% through 2050. In the age bracket of 20 to 29 year-olds – the second major entrepreneurial group no less – the number of young entrepreneurs will plummet by 30%.

[14] See ZEW (2006). Gründungspanel. Mannheim.

Biggest group of entrepreneurs most endangered

Number of entrepreneurs in the 30 to 39 year-old age group



Source: IW (2004) **18**

3.3 Economic policy framework

There is a widely held preconception that globalisation robs national economic policy of its scope. Of course a country's economic policy cannot trigger a business boom at the touch of a button, but it can put important measures in place to create an institutional environment that will enhance (world) economic and business impetus. In other words, German SMEs can develop their capabilities to the full only if the business climate in Germany is right. Very important elements of this are reliability, continuity and confidence. However, analysis of the key locational factors, particularly with regard to regulatory density and tax and social legislation, reveals an ambivalent picture.

Regulatory density high

Germany's regulatory density is among the highest of any European country for the corporate sector. Nowhere else do regulations impact the hiring and firing of staff as severely as in Germany. The picture is similar with collective bargaining legislation. Across Europe, Germany has the second strongest tendency, after Austria, to association-level pay agreements and inflexible wage-setting systems. In contrast, there is broad freedom to set wages and salaries in the UK and Switzerland.[15] Being less able to escape this interference, German SMEs are far harder hit than large firms.

Licensing procedures in Germany also remain obstinately lengthy. They hamper the development of new products or delay the launch period for so long that competition and imitation leave hardly enough time to recoup the development costs on the market. By way of example, a comparison between setting up a company in Germany and Australia: In Germany it takes 24 days to set up a business and nine different agencies have to be consulted. In Australia the entrepreneur is issued with a company number via the internet. Using this, all further applications can be lodged with the Australian Taxation Office. After just two days (!) the entrepreneur can set about turning his ideas into new products speedily and with the minimum of red tape.[16]

Minimum wage as an example

The less the state intervenes in economic activity by regulation, the more SMEs' strengths come into play, and the succession process can also run more smoothly. But the projected reforms currently being debated hold out hardly any hope of deregulation – on the contrary. Take minimum wages as an example. Of course Germany needs to offer people better incentives and possibilities to work in the low-wage sector. But the minimum wages currently in the political limelight are not a helpful approach. If anything, their introduction reduces the chances of finding employment for the less skilled and (long-term) unemployed as labour costs do not reflect workers' productivity. It would be far more constructive, for example, to decouple high welfare costs from wages to create the proper incentives on both sides – for employers and employees – and give low-skilled workers a chance to find work again.

Promoting (further) labour market flexibilisation

The labour market has plainly become more flexible in recent years. Working life and weekly working hours have been lengthened, and for some time now workers have exercised wage restraint. This has

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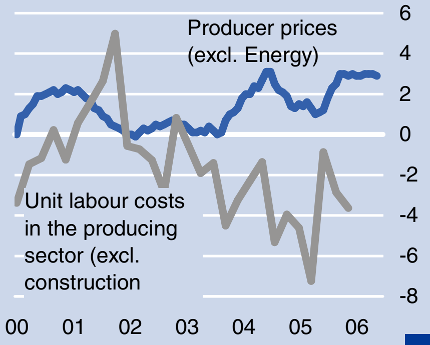
[15] See Stiftung Familienunternehmen (2006). Länderindex der Stiftung Familienunternehmen. Stuttgart.

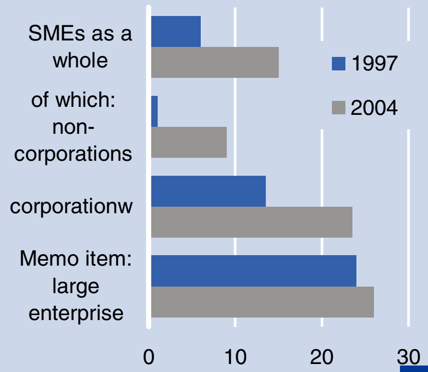
[16] See World Bank (2006). Doing Business in 2006. Creating Jobs. Washington.

Unit labour costs in reverse gear
% yoy



Source: Deutsche Bundesbank **19**

Equity ratio in the SME sector
Equity as % of balance sheet total



Source: Deutsche Bundesbank (2006) **20**

combined to depress unit labour costs and is now boosting corporate profitability and international competitiveness.

Increased flexibility and "bottom-up deregulation" through agreements on flexible working times at individual company level, for example, have also helped companies begin to create jobs again. This avenue needs to be pursued consistently. In an increasingly shifting (global) economic environment reform of collective pay agreements remains firmly on the agenda. Securing company "jobs pacts" by enshrining them in law and further easing protection against dismissal would be of particular benefit to the SMEs still deeply rooted in their domestic environment.

Equity base still a problem

A satisfactory equity ratio is the lynchpin of an effective investment and innovation strategy and for the assumption of entrepreneurial risk, given that self financing out of retained profits is still the major form of funding for the *Mittelstand*. State promotion programmes offer important business financing support for fledgling and small *Mittelstand* firms. But they cannot be a long-term solution.

Positive development in the equity ratio…

The equity ratio in Germany's *Mittelstand* has risen in latter years from 6% in 1997 to an average of 15% in 2004. Corporations' equity base broadened by ten percentage points to around 23%, while non-corporations notched up an eight-point rise to 9%. One of the reasons for non-corporations' meagre provision with equity is that in business partnerships the liable partners often withdraw profits that they then make available to the company again as external funds in the form of loans. Profits are often taken out of the business for tax reasons, and also because it tends to lower the liability risk.

The differences in the provision of equity vary considerably from sector to sector. The spectrum ranges from 6% in the construction industry and 6.5% in the retail trade to 21% in manufacturing and 21.5% in the wholesale trade. All told, *Mittelstand* businesses grew their stock of equity by 150% from 1997 to 2004. By way of comparison, large enterprises lifted their equity ratio over the same period by just 53%. Of course, there were blips in both directions. At a good tenth of SMEs, for instance, the equity ratio tops 70%. In contrast, micro enterprises with sales of up to EUR 1 million report a ratio of around 3%.[17]

… but capital resources remain a problem

In general the data confirms a strengthening of the equity base, particularly at small and medium-sized enterprises. Of course this is linked crucially to the positive earnings trend at many SMEs. Also, the debate on Basel II may have raised awareness of the relevance of maintaining an adequate equity buffer. But international comparison dramatically highlights the still relatively scant equity position at Germany's *Mittelstand* companies. In the United States the median equity ratio is just under 50%, in the Netherlands and France it stands at around 35%. While differences in international accounting, valuation and depreciation regulations do complicate comparison, they still cannot detract from German SMEs' weak equity situation.

Tax jungle hardly tackled

German tax system ever more complex

Taxpayers in Germany have to abide by 118 laws, 87 regulations, 5,000 instructions, 96,000 administrative rules and a host of rulings by the Federal Finance Court and other courts. The number of tax

[17] See Deutsche Bundesbank (2006). Monthly Report December 2006. Frankfurt.

lawsuits before German fiscal courts alone exploded from roughly 13,000 in 1970 to more than 73,000 in 2004, according to the fiscal courts' annual reports. This compares with 4,000 lawsuits before the US fiscal courts in 2004 and just 400 in Japan.

The facts impressively underscore that, next to the high nominal tax rate on corporations and business partnerships, the complexity of the German tax system is the greatest deterrent to setting up a business there. Owing to their scant personnel and financial capacities SMEs are particularly dependent on a transparent, uncomplicated and comparatively light-load tax system.

2008 tax reform more of a whimper than a bang

So to come straight to the point, even if the tax reform envisaged will on balance make Germany a more attractive place in which to do business, there is still a long way to go before the investment climate brightens permanently for the *Mittelstand* sector. What is more, the long-awaited "bang" was more of a whimper: German tax legislation is still among the most complicated in the world.

As regards the reform, German corporations are subject to high nominal tax rates by international standards. Corporation tax, solidarity surcharge and local business tax (with local authorities assessing local business tax at an average rate of 400%), add up to a nominal rate of 38.7%. The planned overhaul of company taxation coming into force at the beginning of 2008 will significantly improve the tax load to not quite 30% (including local business tax). But particularly for *Mittelstand* businesses, aside from the tax load at the corporate level the personal income tax burden on owners of (shares in) business partnerships is also most important, given that most SME companies operate as partnerships (about 83%).

The projected reform schedules a new rate of taxation on retained profits at business partnerships. Profits ploughed back into the business will initially be taxed at 28.25% (plus solidarity surcharge). If withdrawn at a later date, these profits will attract tax at a rate of 25% (plus solidarity surcharge). All told, this brings the tax load, applying the top rate of taxation, up to 48.29%. At present profits from business partnerships attract top taxation of 45.68%. Even the tax burden on non-retained profits increases, owing to the wealth tax and solidarity surcharge, to round about 47.5%.[18]

To summarise, it is doubtful whether business partnerships will be able to take any notable advantage of the new relief on retained profits. Basically, the privilege will presumably only be of interest to larger partnerships that have the potential to retain substantial earnings at long term. On the other hand, it is not clear to what extent smaller partnerships will be able to benefit from the improved depreciation facilities (the so-called "investment deduction").

Tax considerations are also important when it comes to company succession. Handing over businesses within the family should not be made more difficult by the imposition of added fiscal burdens and the liquidity problems to which this may give rise. Further relief is also necessary in the revision of inheritance tax.

Inheritance tax reform needed that will secure the future for businesses

With very few exceptions, business partnerships are directly affected by inheritance tax as the assets brought into the business are taxed directly and not the capital contributed (e.g. in the form of equities) by the investor. To foot the tax bill, the funds required generally have to be withdrawn from the company's assets. This can lead to liquidity problems that may throw the business's continued existence into doubt.

Already, company succession is given preferential tax treatment over other assets. To facilitate business handovers a tax allowance of EUR 225,000 and a 35% valuation discount are granted. This applies to one-man businesses and partnerships as well as to substantial interests (more than 25%) in corporations. The main thrust of the new proposals is towards tax deferment for privileged assets, staggered over ten years. If the business continues to operate beyond this time frame the tax debt is wiped out entirely. Continuation of the business is subject to certain conditions, such as job preservation, in pursuit of economic policy objectives and to avoid tax stratagems. In principle, measures designed to keep a business up and running are to be welcomed. But as always, the devil is in the detail. Matters are made more complex and the extent to which the regulations hit the mark is questionable.

Economically speaking, there are good reasons for and against inheritance tax. But the most powerful arguments against its abolition are of a distributional and fiscal nature. Following the Federal Constitutional Court ruling it is to be hoped that a reform will substantially facilitate business transfers from an inheritance tax angle.

[18] See, for instance, B. Kessler, W. et al. (2007). Unternehmenssteuerreform 2008: Die geplanten Änderungen im Überblick. In Betriebs-Berater, pp. 523-534; or ZEW (2007). Steuerreform 2008: Gewinner und Verlierer im deutschen Mittelstand. Mannheim.

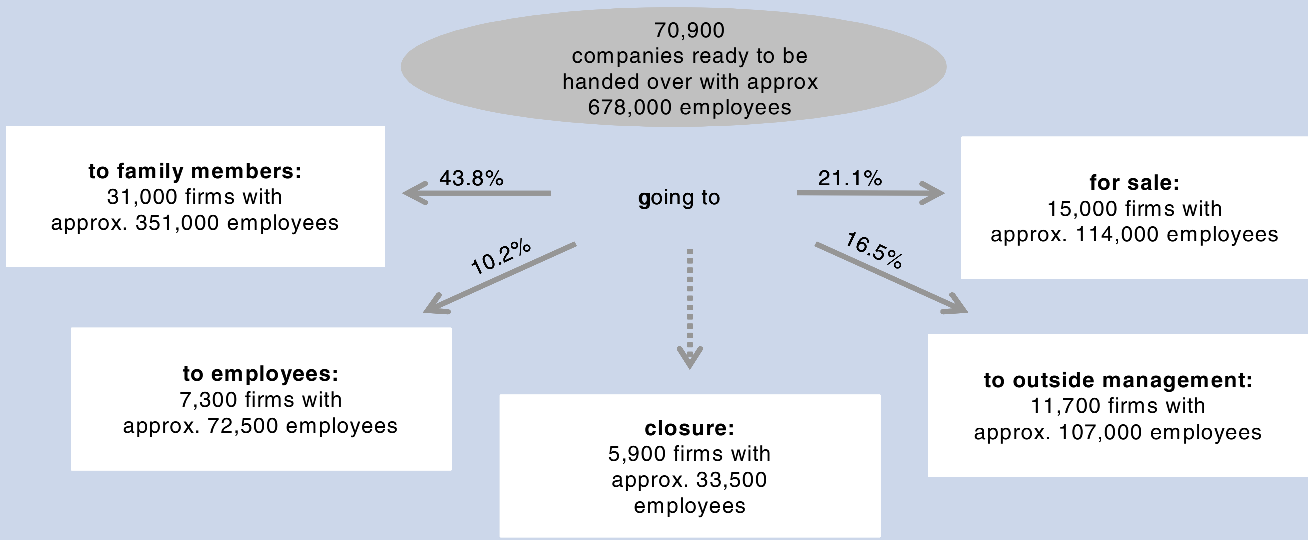
4. Company succession

4.1 A variety of succession solutions

The issue of company succession is gathering momentum in public debate. And quite rightly so since not even one in every two businesses ready to be handed down are now likely to be passed on to members of the owner families. There are not enough children willing or able to take over. The succession problem has implications beyond the company itself, as unresolved difficulties with succession put countless jobs at risk year for year. This adds a macroeconomic dimension to the issue.

Facts first: Around 70,000 family businesses a year are affected by upcoming handovers.[19] Succession from within the family is no longer the rule.[20] Nowadays scarcely 44% plan to pass on the business to a family member. Roughly 10% of respondents are planning to hand the business over to members of staff.

Succession solutions in German family businesses, 2005



Source: IfM-Bonn 21

Almost one family business an hour closes in Germany when the owner steps down. Admittedly, this mainly affects smaller firms that are often no longer going concerns.[21]

Owners sell one in every five *Mittelstand* businesses

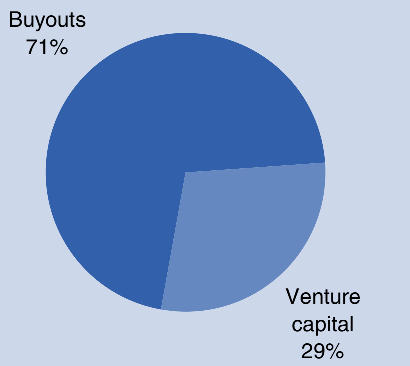
About 21% of businesses are reckoning on sale – to financial investors or strategic buyers, among others. Financial investors regard the acquisition of part or all of a business as an investment to be sold on at a profit in the short, medium or long term. Strategic buyers (e.g. competitors) seek to strengthen their competitive

[19] See IfM (2006). Nachfolgelösungen in deutschen Familienunternehmen. Bonn. IfM projection based on the latest 2002 turnover tax statistics and additional data sources, businesses with sales in excess of EUR 50,000 only.

[20] See, for example, IW (2006). Unternehmensnachfolge. Cologne; or Institut für Mittelstandsforschung Mannheim (2004). Generationswechsel in mittelständischen Unternehmen. p. 31. Karlsruhe.

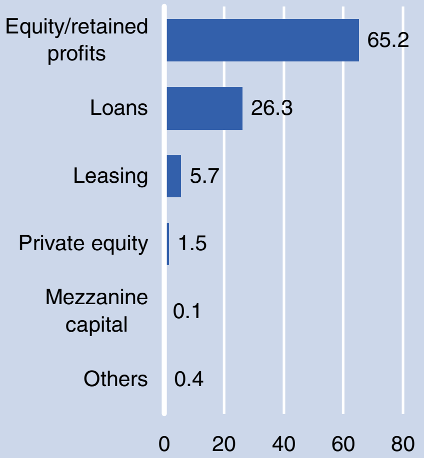
[21] The succession solutions "going public with an IPO" and "setting up a foundation" are negligible factors in the Mittelstand sector in terms of their frequency.

Private Equity in Germany
PE investment, 2006



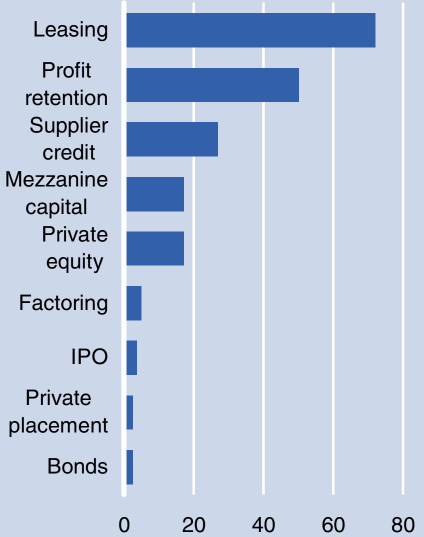
Source: BVK **22**

Major sources of investment financing
%



Source: MIND (2006) **23**

Sources of financing for innovative companies
%



Source: Compamedia (2007) **24**

position through the business transfer. An acquisition may, of course, also appeal to suppliers and customers as, say, a means of increasing product and sales potential.

Private equity funds are assuming greater prominence in the succession option “sale”, especially for larger SMEs. Private equity is the term used to denote interests acquired by financial investors, mostly in non-listed companies. Investments to finance fledgling companies are known as venture capital, takeovers of established companies as buyouts (typically with majority shareholdings).

Roughly 29% of total private equity investment in Germany in 2006 took the form of venture capital, while buyouts made up about 71%. Although part of the broader heading Private Equity, venture capital is of little relevance to succession solutions. Buyouts, on the other hand, are one of the typical transfer models, even though they are of comparatively little importance on the succession market. In 2006 EUR 3.6 bn was invested in 970 companies, of which the German Private Equity and Venture Capital Association (BVK) estimates that a mere 60 (!) were organised as succession solutions. This compares with the 70,000 firms a year lined up for takeover.[22]

Buyouts are divided into management buyouts (MBO) and management buy-ins (MBI). In the latter case, executives from outside the company acquire the business. In an MBO the company is bought up by executives from within it. MBOs are more frequent than MBIs. Both types of company acquisition are commonly financed with the aid of private equity funds, as the (new) management seldom has sufficient private resources to finance the entire transaction. A company takeover financed mainly with external funds is called a leveraged buyout (LBO).

4.2 Accompanying financing solutions

The enormous importance of successful business handovers is undisputed in terms of Germany’s position as a business location. The young, generally well-qualified successors inject fresh ideas and as a rule reposition the business in the corporate lifecycle. There are a large number of modern financing instruments available to SMEs to ensure that in the process, and in subsequent day-to-day business dealings, they are not constrained by their financial resources.

As regards the sources of funding, equity financing is still the avenue most often used by *Mittelstand* companies. About two-thirds of SMEs finance their investment from internally generated funds or retained profits. When they turn to external financing, the traditional loan is still the benchmark, with roughly a quarter of businesses taking recourse to bank loans for their capital expenditure. Private equity and hybrid forms of equity and external funding, such as mezzanine capital, represent a significant option for only 1.5% and 0.1% of businesses respectively.

While external funding (notably bank loans, and also public support programmes) will continue to play a prominent part, particularly for smaller SMEs, bank loans look set to decline further in importance for larger *Mittelstand* firms in an increasingly innovation-driven environment. For them, different financing tools, including already familiar capital market-based instruments, will shape the financing landscape (i.a. private equity, mezzanine, and securitisation). Innovation-savvy *Mittelstand* businesses are already looking to more

[22] See BVK (2007). Statistics for the Year 2006. Berlin.

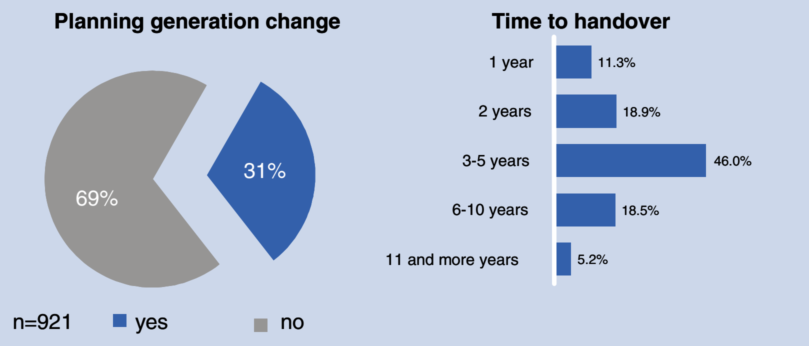
innovative sources of funding. A study shows innovative *Mittelstand* companies attaching similar importance to leasing (72%) as to bank loans. Alongside profit retention (50%) and supplier credit (approx. 27%) companies are increasingly turning to mezzanine capital (17%) and private equity (17%).[23]

Classical private equity companies are emerging more prominently to help solve financing issues when the succession process makes restructuring necessary. As a rule PE companies provide private equity in the form of capital contributions, either as dormant holdings, nominal capital or share capital.[24] About a quarter of SMEs with between 20 and 250 employees say they basically have an open mind on raising private equity. A good third of smaller SMEs with up to 10 employees are in favour of private equity.[25]

4.3 Implications for the corporate landscape

The number of companies seeking a successor in the future will rise substantially in the coming years for demographic reasons. According to the BDI-Mittelstandspanel, of the roughly 90,000 industrial family businesses in Germany alone almost a third (31%) are currently engaged with the forthcoming company transfer. For about 21,000 companies a handover is on the agenda in the coming five years.[26]

Period to generation change



Source: IfM-Bonn (2006) **25**

Family succession on an international comparison

Succession issues are addressed differently from country to country, as various studies by Stavrou (1999), Rose and Colli (1999) and Howorth and Ali (2001) show. The following gives a brief overview of selected findings.

Stavrou finds that European successors are more likely to want to enter the family business the earlier they come in the order of birth. In the Far East it is the other way round. The later they come in the order of succession the likelier they are to succeed to the business. Basically, the greater the commitment to the family business in the past, the more chance there is of family succession. This delivers empirical evidence of the need for early involvement. And what is more, potential successors from Europe and the Far East (but not from the US) show considerable interest in taking over a family business that is already being managed in the second generation.

In another study Rose and Colli examined the succession problems of family businesses in the UK and Italy. They discovered that in both countries family businesses play a similarly important role early on. In Italy family businesses are not simply confined in the main to small and medium-sized enterprises; a comparatively large number of big firms are also family owned. In Britain succession from within the company has generally remained the norm. Primarily, however, this means the transfer to longstanding employees; successors from the founder families are second in line.

The research by Howorth and Ali compares Anglo-American customs with Portugal. The authors establish that in Portuguese entrepreneurial families daughters, even though better qualified than sons, stand less chance of taking over their parents' business. Sons, meanwhile, often enter the firm with a low level of education and little work experience (outside the family business). As a rule the daughters' better education is explained by poor earnings prospects in the family business. They therefore acquire qualifications for the Portuguese jobs market – even though training in Portugal is considered less important than in other European countries. In the Anglo-American area many entrepreneurs fear a loss of status and respect when they hand their business over. While this is also a concern in Portugal, it weighs less heavily since older people are generally treated with more respect there than younger ones. In both cultures there is practically no preparation for the transitional phase.

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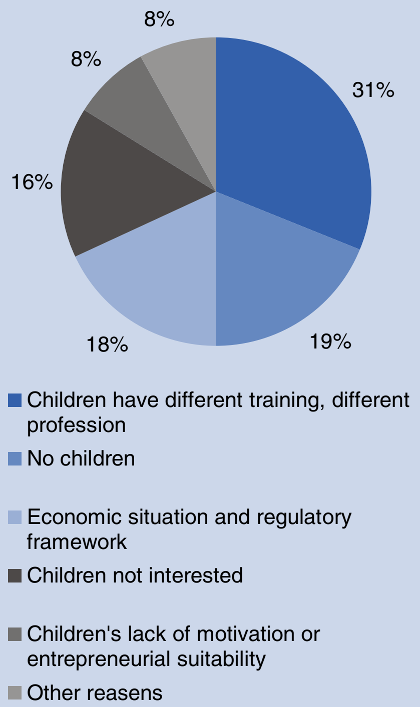
23 See Compamedia (2007). The study commissioned by the business magazine Wirtschaftswoche is available to the author. Compamedia surveyed 82 companies that have taken part in recent years in TOP 100 competitions for Mittelstand businesses.

24 There are many different ways of cooperating with private equity companies. As a rule financial investors have an exit strategy with a roughly five-year timeline. As well as putting up capital they often also make their management expertise available to the business. Of course, the investors' short-term focus can create operating and strategic business tensions with family businesses' long-range strategies. Recently, even large family businesses have begun investing in German SME funds.

25 See DIHK The German Chambers of Industry and Commerce (2007). DIHK-Umfrage zum Beteiligungskapital. Berlin.

26 See BDI (2006). BDI-Mittelstandspanel. Berlin. More than 1,000 small and medium-sized industrial enterprises took part in the survey. It may be assumed that the findings can safely be transposed to the bulk of family businesses in Germany.

Why no family successor?

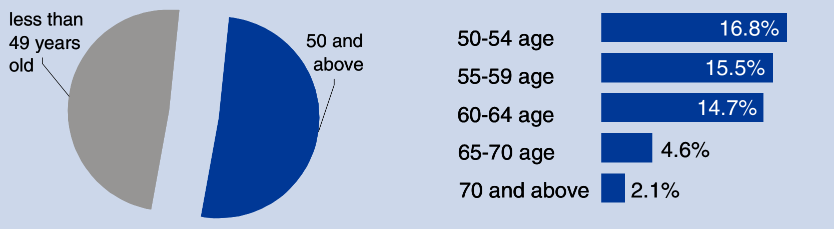


Source: Hessen Agentur (2006) 26

There is broad consensus in literature on the subject that for many entrepreneurs the succession issue is taboo.[27] At present about half the 50 to 59 year-old entrepreneurs have not yet decided what is to happen when they step down.[28] This is often due to family entrepreneurs' reluctance to address the problem of succession in good time. There are many reasons for this, some of them very personal. As a result of the attitude outlined, the average handover age of 66 is considerably higher than in other EU countries. This is presumably also one reason why family businesses in Germany tend not to obtain the best possible selling price – as is the case, say, in America. Research delivers evidence of this, albeit only indirectly. In almost 27% of handovers generation change is compelled by unforeseeable events, without the proper preparations having been made (e.g. due to the owner's illness or death).[29]

On average over-50 year-olds at the helm

Age structure of managing directors in %



Sources: BDI, Ernst & Young (2003) 27

Having to hand the company over at short term is all the more problematic in that more than half of all family businesses do not have a family member sufficiently motivated or suitably qualified to take on management of the firm. Yet in principle keeping the business in the family is more highly regarded than making a good sale. As a general rule ethical considerations such as the business's continued independent operation, the preservation of its good reputation and securing jobs are to the fore in a company transfer.

The perception of a growing lack of interest on the part of family members is borne out by regional surveys in Hesse. Almost half the family businesses polled said the children were simply not interested or were pursuing a different professional career. 8% of respondents regarded a lack of motivation or suitability for entrepreneurship as the key reason. Fully 18% of family businesses cite the present "economic situation and regulatory framework".[30] In principle, of course, family members should only take over a business if they are at least as suitable as people outside the family – extrafamilial succession solutions are certainly not to be dismissed out of hand. Basically, a well prepared sale has positive implications for entrepreneurs themselves (one being that it frees up funds for retirement) and for the economy as a whole (by preserving jobs, for example).

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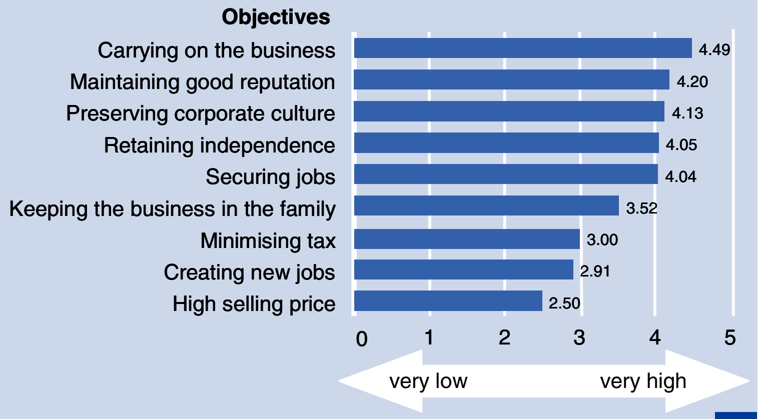
27 See e.g. Berghoff, H. (2003): Abschied vom klassischen Mittelstand. In Berghahn, V. et al. (Editor): Die deutsche Wirtschaftselite im 20. Jahrhundert, pp. 93-113 or Brost, H. et al. (2005): Unternehmensnachfolge im Mittelstand. Frankfurt.

28 See Impulse & S-Finanzgruppe (2004): MIND – Mittelstand in Deutschland. Berlin.

29 See IfM (2006). Unternehmensübertragungen 2005 nach Übertragungsursache und Beschäftigung. Bonn.

30 See Hessen Agentur GmbH (2006). Hessischer Mittelstandsbericht 2006. Wiesbaden. The agency interviewed 1,428 SME family businesses.

Business succession motives



Source: IfM Bonn 2006 28

High sales price not an issue

Succession gap is a chimera

To summarise, it is obvious that Germany is not suffering from a succession gap. It is true that in the long term demographic trends will overshadow the issue of succession, too – but hardly at present. On the contrary, the commonly cited prevailing succession gap is a chimera, as attractive companies have little difficulty finding new owners through MBIs, MBOs or sale to financial investors or strategic buyers. All in all, roughly 92% of businesses are carried on by family or non-family members. And the approximately 6,000 companies that are not passed on when the owner retires can hardly be taken as proof of a succession gap. Typically these businesses are of the less economically viable kind.

(Family) business structure in danger of disappearing

Were Germany to have more children or be more creative with regard to the immigration of business talent, a succession gap need not open up in the long run either; but at present there is no sign of a trend in this direction. Even so, the *Mittelstand* is not an endangered species in quantitative terms – there are still entrepreneurs to take up the baton, albeit in dwindling numbers. But the proliferation of non-family succession solutions does signal the demise of the special German-style (family) business structure so successful in the past. This would have socio-political consequences, as the unique features of Mittelstand businesses would gradually fade. And secondly, the qualitative structural change could hardly come at a worse time for many owner-manager families themselves, given the extremely propitious outlook for many family businesses precisely in the long term.

5. *Mittelstand* 2020

Expedition Deutschland

It is obvious that social and economic systems are constantly changing. But the pace, depth and breadth of this change varies considerably over time, and the general direction cannot always be forecast reliably on a longer timeline. In a comprehensive scenario analysis Deutsche Bank Research has therefore examined possible paths and developed four pictures of the future for Germany's economy and society in 2020.[31] Analysis of a series of long-range trends showed a trend towards the scenario "Expedition Deutschland" to be the most plausible (see box "Germany 2020"). From this analysis we can filter out implications for Germany's Mittelstand and its succession issues.

[31] See Hofmann, J., Rollwagen, I. and Schneider, S. (2007). Germany 2020 – New challenges for a land on expedition. Deutsche Bank Research. Frankfurt am Main.

5.1 Project "Germany 2020"

*Germany faces historic economic, social and political decisions. To make the right decisions, we first need to have consistent pictures of the future as a basis. Deutsche Bank Research has therefore sketched out what paths of development are conceivable for German business and society in the future based on an innovative scenario analysis – and which picture of the future is the most plausible.[1] The core elements of this **"Expedition Deutschland" scenario** for 2020 are (formulated from a 2020 perspective):*

***In 2020, the "project economy" delivers 15% of value creation** in Germany (in 2007 the figure was about 2%). The "project economy" refers to usually temporary, extraordinarily collaborative and often global processes of value creation. For many companies this type of cooperation is now – in many cases – the most efficient way to do business. This is because product lifecycles have shortened further; the breadth and depth of the knowledge and skills needed to develop and market successful products have increased rapidly; successful products are increasingly the result of convergence between differing fields of technology and knowledge, and many companies and research facilities are even more highly specialised in 2020 than in 2007.*

Consequently they collaborate ever more frequently on joint projects, often in the form of legally and organisationally independent project companies. They delegate specialised staff or organisational units to work on these projects, invest capital or provide know-how and networks. Businesses can thus respond flexibly to the distinctly higher demands that global markets now make of expertise and speed while sharing the costs and risks. They are often, but by no means invariably, successful with this approach. Even in 2020 collaboration causes a lot of personal and strategic friction. Mature, highly standardised information technologies now help alleviate this technical friction.

The project economy is closely intertwined with the traditional way of doing business. Even in 2020 many companies still bring their products to market on a go-it-alone basis. But often the same companies cooperate in other markets – innovation-intensive ones, for instance – in a project-centric way. German Mittelstand businesses in particular benefit from the project economy, where they can turn their specialisation edge and organisational flexibility to advantage – and are additionally boosted by a renewed surge in start-up activity.

***Open innovation processes helped in clearing the hurdles to new markets**. In 2020, Germany has caught up with its competitors in markets for cutting-edge technology and knowledge-intensive services. Innovation is now Germany's core competence and "Created in Germany" first choice, particularly in Asia and the Middle East. This success was due not least to collaborative innovation and intelligent sharing and exchanging of knowledge and intellectual property. The project economy approach to work proved efficient precisely in the early innovative and hence especially knowledge-intensive stages of value creation. What is more, many German corporates (and their local and international project companies) have benefited in recent years from having more closely integrated the generation of "sovereign customers" into their processes. These customers are well networked through interactive forums and have up to date knowledge of prices and qualities in the areas that interest them.*

By contrast, many business investments in long-term research and development have fallen by the wayside by 2020. They are often poorly suited to the more short-lived value-added patterns of today.

***Knowledge is traded on efficient markets in 2020.** Knowledge of customers, markets and many other issues is now far more efficiently valued and traded than in 2007. The operators of such knowledge-based services are prospering. Intellectual property has become a commonly used asset class, and investors can choose from a wide range of theme-based patent funds, copyright securitisation and the like. Moreover, intellectual capital has swung into the focus of company valuations. These days, as well as traditional balance sheet ratios the capital market also takes interest in a company's research efficiency, education and training budget and cooperation rating.*

The young and seasoned minds that house this intellectual capital benefit in 2020 from efficient learning markets. Private operators of learning services prosper. Also, the public universities and other educational facilities have become more efficient following a wave of consolidation. Furthermore, they are more strongly involved in the market for modular education and training.

***The state is reducing its intervention and becoming a smart regulator** along with its citizens and firms. On the one hand legitimation problems have motivated the state and still tight fiscal constraints have compelled it to cede part of its mandate to others. On the other, the regulatory issues have become increasingly complex. More than ever before, the state needs to tap the knowledge of citizens and companies to be able to set suitable framework conditions.*

Regulatory regimes that emerge in this way are more intelligently geared to the needs of business and society. They are more transparent for people and companies alike and ease the struggle into new markets. In general though, too, the state's abandonment of parts of its mandate has resulted in social transfers now coming with strings attached. In addition, more and more social services (e.g. long-term care) are organised on a private basis. Germany has become a "stakeholder society" based on reciprocal action.

***German society forms a new middle class by 2020 but the lower periphery falls behind.** The middle class celebrates its comeback. The new opportunities for upward social mobility and the higher risk of social decline, both the consequence of increasingly global and volatile value creation, have clearly shown the middle class the value of knowledge. Many Germans with a mid-range income therefore invest heavily in education – and thus gain qualifications for the demanding, but at the same time well-paying jobs in the project economy.*

Well-educated older people also benefit as they are intelligently integrated in the working world in 2020. By contrast, low earners have only limited access to the new learning markets, and young and old alike often have to fear for their livelihoods. International competition has an even more incisive impact on this group than on others. Many low earners are compelled to organise themselves in self-help networks, and many have lost their faith in politicians.

Given the structural changes outlined on the way to "Expedition Deutschland" we expect German GDP to grow at an average rate of 1.5% per year through 2020. From a 2007 perspective these changes pave the way to exceptional opportunities for business, society and politics, but they also harbour substantial risks.

Jan Hofmann, Ingo Rollwagen und Stefan Schneider (2007). Germany 2020 – New challenges for a land on expedition. Current Issues. Deutsche Bank Research, forthcoming; German version at www.expeditiondeutschland.de

5.2 The shape of Germany's *Mittelstand* to come

The future lies with the project economy

The keyword for the future is project economy. It refers to usually temporary, extremely collaborative and often global processes of value creation. Companies will increasingly have to respond to the more exacting demands of their environment – particularly amid the rise of the emerging markets – with new, flexible forms of co-operation.[32] This is because producing and successfully marketing innovative products will call for a breadth of skills and knowledge that one single company is but seldom able to provide – and especially not at the speed with which markets clamour for the next product generation. The rapid increase in complexity and convergence between differing fields of knowledge makes collaboration in many areas, particularly R&D and other innovation processes, absolutely vital.

Rosy outlook for many SMEs

This environment makes the outlook rosy for many SMEs, particularly the midsized among them. Above all, this is due to their marked flexibility; big corporations that tend to be more rigid in their organisational structures and processes are likely to benefit comparatively less. Many project economy stakeholders will also be SMEs because this business size gives them sufficient opportunity to diversify their risk in spite of their strong specialisation (different teams in the company can work in parallel on entirely different projects).

Finally, *Mittelstand* companies' organically evolved, often regionally rooted networking stands them in good stead in the project economy. These networks are sustained by the personal continuity of management. As a rule owner-managers enjoy closer ties with their business associates, customers, products and staff than hired executives.

The project economy is accompanied by a number of other structural changes, the most important of which are:

— The convergence of technologies that will increasingly form the basis of innovation will make it easier for *Mittelstand* firms in the project economy to move into innovative technology fields and markets, because as a rule no *Mittelstand* company will be able to satisfy the appetite for knowledge by future innovative sectors on a go-it-alone basis.

— The particularly broad spectrum of technological niche competences in the *Mittelstand* segment provides a sheer unending repertoire in the project economy for recombination into new "modular products". One example is energy-conscious building, with combinations of smart home, solar energy and insulation solutions.

— Moving forward, intellectual property will not only be an immensely important production factor, but also a widely used investment product on the capital market (patent funds, patent securitisation etc.). SMEs can tap into the new sources of financing to fund innovation without surrendering control of the company itself to the relevant investors. As a rule the projects will be legally and organisationally independent special purpose

Project Economy lowers transaction costs and strengthens the market

Whether business transactions are conducted on the market or within a firm is critically determined by the transaction costs incurred. Information costs, bargaining costs and enforcement costs are summarized under transaction costs. Contracts with the market are always transformed into contracts within the firm when this saves costs. This substitution takes place until the transaction costs that arise within the firm reach the level of the transaction costs on the open market.

According to this approach, developed by Ronald Coase, transaction costs fall the higher the number of transactions. Transaction cost-cutters in the project economy, besides the number of projects, are digitisation, e.g. through database networking, or the development of virtual collaborative environments. Further factors lowering transaction costs are trade in valued knowledge (information costs), the interest in establishing standards and, in the context of bargaining and enforcement costs, smart co-regulation in particular.

The temporary nature of the projects reduces project stakeholders' mutual dependence and hence the incentive to secure quasi rents through opportunistic behaviour. The incentive to behave opportunistically is further reduced for the project stakeholders by the considerable importance attached to reputation as specific capital in the project economy. High reputation, in turn, lowers the information and bargaining costs and thus benefits the project economy.

Sources: Ronald Coase 1937, DB Research

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32 Collaboration is already a clearly evident trend, also at SMEs. In 2005, 36% of SMEs that engage in research participated in joint R&D projects together with other companies and partners from the world of science (including research facilities and universities). Roughly three-fifths of these companies (60.7%) cooperated in a network with more than one partner. See Maass et al. (2006). FuE-Kooperationen von KMU – Interne und externe Erfolgsfaktoren aus organisationsökonomischer Sicht. Bonn.

vehicles. Consequently, the capital market will exercise control only over the project, not over the SMEs involved in the project themselves. The project economy therefore offers SMEs a field for experimentation with (new) capital market-based forms of finance.

— The increasing systematic valuation of intangible capital will open up new opportunities for SMEs, enabling them to present their own knowledge potential more transparently (e.g. to potential employees, customers or partner companies). This will enhance the company's value and image. There are already a number of initiatives in Germany and other countries aimed at standardising and disseminating so-called "knowledge balance sheets".

Avenues of succession

— Family members
— Employees
— Sale
— External management
— Closure of the firm because there is no successor

5.3 Implications for business succession

Given the structural change still to be mastered, the successful route to the project economy will certainly involve many challenges, of both a political and business nature. One pivotal area is succession. In the following, selected implications for business success in the project economy scenario are sketched out.

Family members benefit most in succession stakes

— Personal relationships of trust that have evolved over time between companies are vital to a successful project economy. Too much fluctuation in management puts many *Mittelstand* businesses in the project economy at risk of losing one of their key advantages. This is particularly true of the succession avenues "external management" and "sale". Where the company is passed on within the family, the loss of trust can be (almost) entirely made up by the company's usually cross-generational alignment.

Testbed for new financing instruments…

— Moving forward, SMEs will find a growing spectrum of instruments with which to finance the handover phase. For one, the traditional prominence of bank loans will give way to more strongly capital market-based financing tools that are already available today. Also, new instruments focusing above all on the intellectual property of the company seeking capital will broaden the range. Successful generation change can encourage a more open-minded attitude towards new types of financing – and new forms of collaboration as well. However, because of their longstanding, close ties with the owner, business successors from within the family are often even more strongly in the grip of traditional financing habits than external successors. But particularly for them, the project economy could turn out to be a good testbed for new approaches to financing. If the successors have a stake in a legally independent project they might turn to the capital market as a means of financing – gaining experience with new types of financing in the process for subsequent investment by their own company.

— The new financial tools will strengthen the "sale" option as a succession avenue. New types of funding in general and foreign investors' growing interest in innovative German companies in particular will broaden the spectrum of potential buyers. Private equity funds, for example, can be expected to switch their search from the traditional field of undervalued companies (set for saturation in the future) to the high-growth sector of innovative businesses.

— In the project economy new (profit participation) schemes will be applied as an element of staff remuneration. Models of this kind inspire an entrepreneurial mindset among employees, which in turn better qualifies them as potential company successors. Owners can build up employees over the long term, involving them early on in the trust relationships that have evolved with other companies – although, of course, not to the same extent as with family succession.

… and new participation models

— In the project economy professional networks will facilitate the search for successors. They open up access to suitably qualified candidates at many levels of responsibility (strengthening the "external management" avenue).

6. Conclusion: Ten recommended courses of action to boost *Mittelstand* growth

For business decision-makers…

1. As knowledge develops more rapidly, so greater specialisation becomes imperative. The central areas of learning will increasingly concentrate on market- and industry-specific knowledge. Companies therefore need to provide continuous and flexible training for their employees. For entrepreneurs this implies constantly moving forward and never confining themselves to what they learned earlier in life. They must always challenge the keystones of tradition, be receptive to know-how from outside and basically be willing to delegate authority.
2. Given the increasingly rapid pace of knowledge production, temporary cooperation between companies will be an important element going forward. In this environment the typical characteristics of family businesses mean the outlook for them is basically good. SMEs are therefore well advised to keep raising their flexibility and networking bonus. Timely and efficiently organised generation change encourages a more open-minded attitude to new forms of cooperation.
3. *Mittelstand* companies today not infrequently have inhibitions about engaging with rivals. The owner's sole power to make decisions often stands in the way of proper cross-company collaboration. But cooperation need not mean having to surrender the advantages of flexibility and autonomy. Only by working together can many SMEs achieve the critical mass vital to the viability of many (innovation) projects.
4. Standards will be more important in the future. We are already seeing a clear trend towards standardisation. This makes it all the more important for companies not just to recognise standards, but also to play an active part in the development of new standards. In the process they can benchmark their own strengths.
5. The importance of bank loans is poised for further decline. SMEs will have to address new financing concepts, as external financing – a particularly popular option in Germany – is not very suitable for risky (innovation) projects. SMEs that are already adjusting their financing habits towards state-of-the-art vehicles are thus particularly well ranged.

… and the political powers that be

6. The signals being sent out in political debate are that tax and labour market reforms will remain a work in progress over the medium or indeed long term. For a change in policy Germany lacks the commitment of informed business and academic figures; what is more, there are hardly any parliamentarians with much free market sympathy. Measures building sustained economic growth have (too) few supporters and are therefore

adopted (too) seldom. The picture is different in other countries (e.g. USA). Entrepreneurs should therefore more actively support lateral entrants into politics from among their midst.

7. Cooperation with financial investors providing capital and know-how will be more important than ever in future. The Private Equity Act scheduled for the end of 2007 is a chance to put attractive regulatory conditions in place. This is particularly pertinent with regard to the tax environment, where the individual investor and not the investment vehicle as such should be liable to taxation. Nor should financial investors be subjected to excessive transparency requirements.
8. It is obvious that Germany has a structural entrepreneurship problem. The country needs more innovative family businesses. Ownership and risk, as two sides of the same coin, and the way in which the owner's economic destiny is bound up with that of the company create a unique "culture of private enterprise". It is vital to instil the spirit of enterprise early on and significantly improve the environment for business start-ups. Streamlining licensing procedures for start-ups and strengthening the venture capital market would be important places to start.
9. Given the exponential growth in the knowledge base and the ageing of the population, Germany's arguably most important source of value creation lies in education. The Mittelstand sector needs "bright minds" wanting to seize the initiative with new ideas. Politicians must therefore invest more in the future, focusing public spending on education and research. Companies urgently require better scope to develop with a competitive training environment. One aspect of this is a more open-minded attitude towards skilled immigrants and those willing to acquire skills, and greater efforts to integrate the immigrants already living here.
10. Germany's future rests on innovation. Germany possesses excellent basic research facilities, but as a rule the results produced by academic research are too far removed from business implementation maturity. Germany does not lack ideas, but they are often realised abroad. Besides significantly raising the number of science and engineering graduates, it is therefore also important to establish greater interdisciplinary skills in schools and universities. We need young people who are interested in different disciplines and will later have a grasp of the value chain in its entirety in their research.

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