

19 September 2008

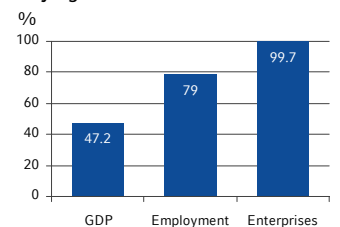
Spotlight

THE GERMAN MITTELSTAND

A class of its own

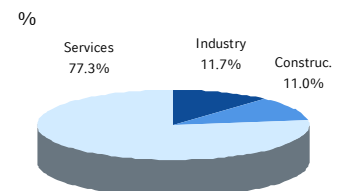
- The Mittelstand is of great importance to the German economy, accounting for almost half of value added and providing roughly 80% of all jobs. So it is with good reason that small and mid-sized enterprises (SMEs) are regarded as the backbone of the German economy and as an engine of growth and employment.
- One reason for the strength of the German Mittelstand is its combination of export and domestic business, with international business showing a marked increase in the past few years. Many SMEs, especially those from the industrial sector, are among the so-called export champions, i.e. they generate more than half their sales abroad.
- Despite the Mittelstand's importance to the economy as a whole, its specific structure plays little part in analyses of the business cycle. Even though the SME cycle runs largely parallel to that of large enterprises, it is generally less volatile. This holds out the prospect that medium-sized companies could show a more robust performance than large enterprises during the current downturn.
- Nevertheless, the economic setting will become far more difficult for Germany's many small and medium-sized businesses in the near future. The Mittelstand is also facing other major challenges. These include rising wages and input costs posing a central threat to SMEs, as they will probably find it harder than large companies to reap the benefits of advances in efficiency and to pass on higher costs to their customers. What's more, many medium-sized companies are likely to see their financing conditions deteriorate in the near future, which would be yet another burden on R&D, which is already very cost intensive. Finally, the issue of management succession is becoming increasingly important with a large number of companies facing management transfers in the next few years without having laid any succession plans.
- Increasing financing requirements and the often unresolved issue of management succession often make the larger SMEs attractive targets for financial investors. This creates fertile soil for Germany's still relatively small private equity market to grow, and to gradually close the gap on its counterparts in other countries.

Key figures on SMEs



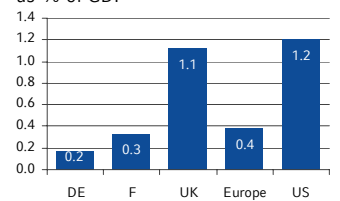
Source IfM, WestLB Research

SMEs and economic structure



Source IfM, WestLB Research

Private equity investment as % of GDP



Source BVK, WestLB Research

The German Mittelstand: a class of its own

The SME sector is deeply embedded in the German economy, to a greater extent than in almost any other country in Europe. The Mittelstand is viewed as an engine of growth and job creation, and is deemed to be the backbone of the German economy. The positive picture generally painted of the Mittelstand has been borne out in the past few months by reports such as “SMEs beat the big groups”, “Family-run companies more successful than manager-run companies” and “Financial markets crisis has little impact on SMEs”.

What are the defining features of the German Mittelstand sector that comprises small and mid-sized businesses? To what extent are they grasping the opportunities offered by globalisation? Where are they positioned in the business cycle? What short- and medium-term themes are influencing these small and mid-sized enterprises (SMEs)? This study looks into these questions. Our analysis shows that some SMEs differ significantly from large companies and to this extent are a class of their own. In times in which the economic setting and financial market environment are becoming increasingly difficult, the special structure of the SME sector could prove to be a stabilising factor for the German economy as a whole and could prevent a severe downturn. Nevertheless, the German Mittelstand will face some major challenges in the near future. Besides the financing aspect, these include the issue of management succession. This leads us to expect that the larger German Mittelstand companies will be an attractive segment for financial investors.

Some stylised facts

Quantitative and qualitative definition of the “Mittelstand” (SME) sector

There is no generally accepted definition of “Mittelstand” in Germany. The Institut für Mittelstandsforschung in Bonn (IfM) defines these companies, first, as “small and mid-sized enterprises” (SMEs) on the basis of quantitative criteria and, second, as family companies on the basis of qualitative components. The two terms are frequently used as synonyms. Even if this is normally correct in practice (but not always, as the takeover of the DAX company Continental by the family-owned company Schäffler shows), the definitions are still different. A business is generally classified in quantitative terms on the basis of revenue or employment numbers. By contrast, the family business definition is more qualitative and based on the ownership structure.

Definition of smaller and medium-sized enterprises

	Employees	Sales (€m)		Employees	Sales (€m)	Total assets (€m)
IfM			EU			
			Very small	< 10	≤ 2	≤ 3
Small	< 10	≤ 2	Small	< 50	≤ 10	≤ 10
Medium-sized	< 500	≤ 50	Medium	< 250	≤ 50	≤ 43
Large	> 500	> 50	Large	> 250	> 50	> 43

Source IfM, WestLB Research

Definitions of the IfM and European Commission

The IfM defines SMEs as businesses with fewer than 500 employees and annual revenues of less than €50m. According to a recommendation of the European Commission in 2003, a business in the EU is considered to be small or medium-sized if it has no more than 250 employees and if its annual revenues do not exceed €50m. In addition, these businesses

99.7% of all companies in Germany are SMEs

Combination of ownership and management sets family companies apart

The 30 largest family companies

No.	enterprise	sales (bn €)	employee (in k)
1	Schwarz Gr.	40,000	170.0
2	Aldi	32,000	200.0
3	Merckle Gr.	29,400	67.3
4	Haniel	25,892	58.4
5	Tengelmann	25,700	150.9
6	Bertelsmann	17,890	88.5
7	Otto Gr.	14,570	55.1
8	Boehringer	9,535	37.4
9	Heraeus H.	9,311	10.6
10	Tschibo	8,788	29.6
11	Marquard&B	8,473	3.7
12	INA-Schaeffler	8,000	60.0
13	Oetker	7,030	22.4
14	Adolf Würth	6,914	50.8
15	Schlecker	6,600	52.0
16	Rethmann Gr.	6,100	31.5
17	A.C. Toepfer	5,800	2.2
18	Röchling	5,350	26.7
19	Benteler	5,315	21.2
20	C&A Mode	5,211	32.0
21	Freudenberg	4,837	33.4
22	Helm	4,745	1.2
23	Globus Gr.	4,200	21.0
24	DM Drogerie	3,672	24.5
25	Voith	3,551	30.8
26	Knauf Gr.	3,550	18.5
27	Hella	3,071	24.2
28	Behr	3,052	18.1
29	B. Braun	3,026	31.0
30	Dachser	2,800	13.4

Source: Handelsblatt

have to be largely independent. Companies that are members of groups are not included in the SME category. According to the Commission's recommendation, independence means that no other company may have an interest of more than 25% in the SME in question.

According to the IfM's definition, SMEs account for 99.7% of all companies in Germany. The differences between the separate sectors regarding company size (SME ratio) are comparatively small. However, generally, the share of SMEs is lower in industry (including the energy sector) than in the construction and the service sectors, in which individual segments such as hotels and restaurants have SME ratios of nearly 100%.

A company's size plays no role in the qualitative definition of Mittelstand. This depends more on the combination of ownership and management. In other words the company is managed by an owner or a member of the family. For this reason, we refer in this connection to family companies.

Since management and owner decisions lie in a single pair of hands, these companies can be very flexible. In addition, the fact that family companies attach great importance to long-term business relationships, and that their goals tend to be medium- to long-term, can often have a positive effect. However, this same long-term approach can also lead to problems if companies cling on to the "tried and tested", and adjust too late or not at all to a changing environment. The very flat management hierarchy typical of family companies can also threaten a company's survival if management succession issues are not dealt with early enough.

Manager-controlled vs. owner-controlled companies

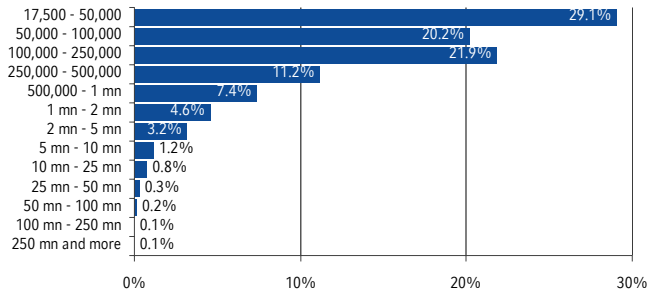
	%		
	LE	SME	
manager controlled	0.2%	4.7%	none family enterprise 4.9%
owner controlled	0.1%	95.0%	family enterprise 95.1%

Source IfM, WestLB Research

According to the IfM, 95.1% of companies in Germany are owner-run, i.e. family companies. Virtually all family companies are SMEs. Only 0.1% are large owner-run companies. This shows that it is with good reason that the terms family company and small and medium-sized enterprise are used as synonyms. At the same time, regardless of the definition it is clear that the Mittelstand sector plays a dominant role in the German economy. On the following page, we set out some key figures on SMEs, broken down by revenue, employment and sector structure. These figures are described in greater detail in the notes at the end of this study.

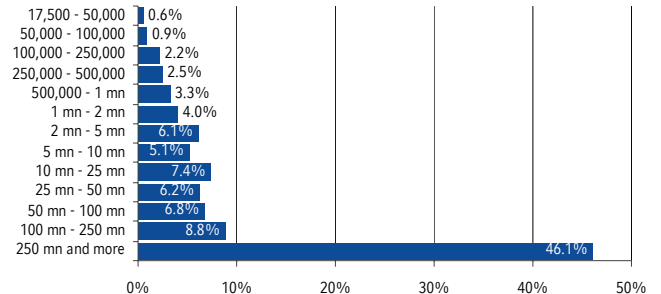
Selected key figures on SMEs

Number of businesses by revenue size
%, as of 2006



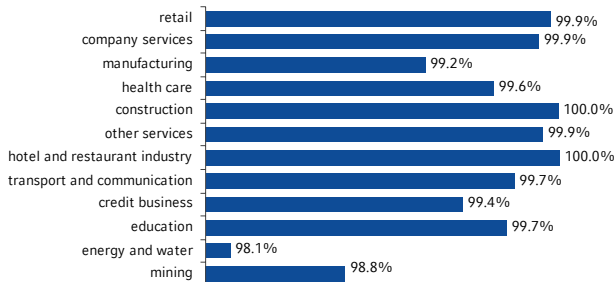
Source WestLB Research, IfM

Revenues of SMEs by revenue size class
%, as of 2006



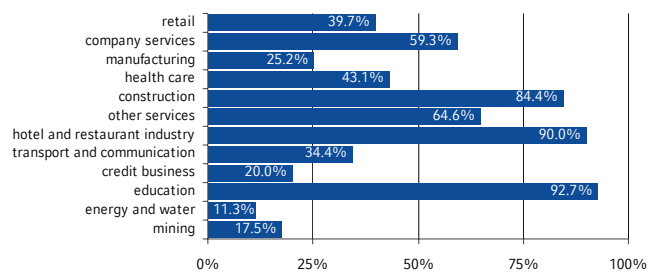
Source WestLB Research, IfM

Share of SMEs in economic sectors
%, As of 2006



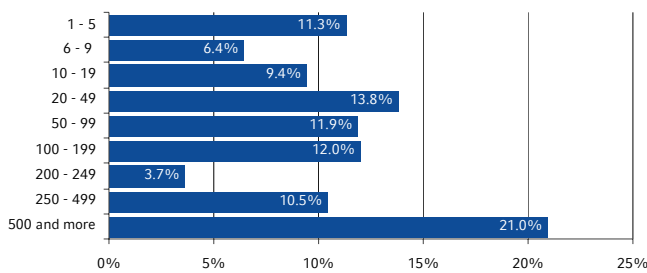
Source WestLB Research, IfM

Share of sales of SMEs in sectors
%, as of 2006



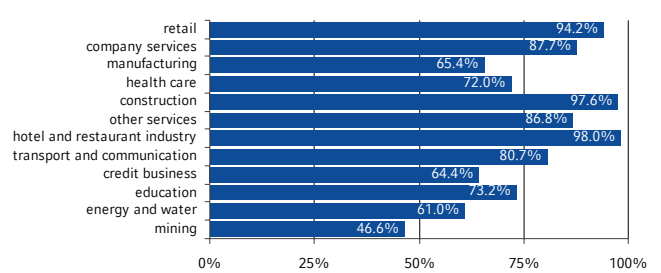
Source WestLB Research, IfM

Employees at SMEs by workforce size
%, as of 2007



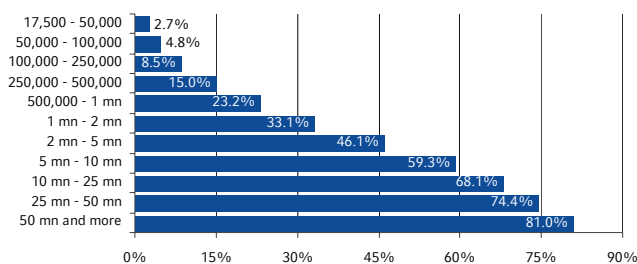
Source WestLB Research, Bundesagentur für Arbeit

Employment rate of SMEs by sector
%, as of 2006



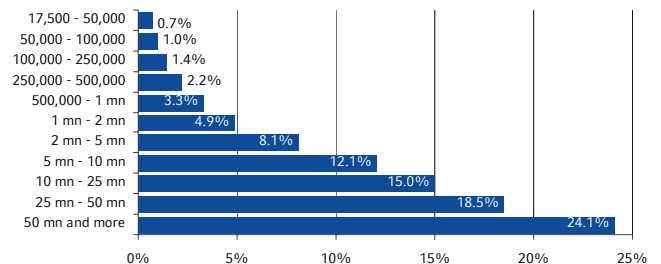
Source WestLB Research, IfM

Share of export companies by revenue size
%, as of 2005



Source WestLB Research, IfM

Export rate by revenue size category
%, as of 2005



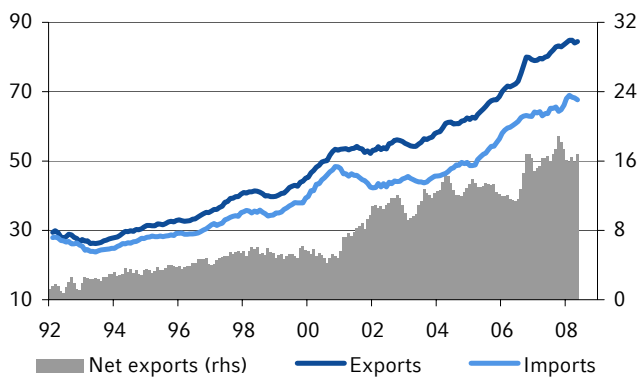
Source WestLB Research, IfM

Increasing international presence

SMEs' business has become increasingly international

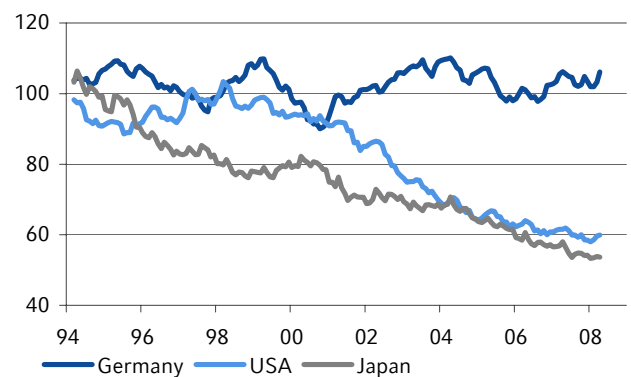
Export business has long been deemed to be the preserve of large companies. However, with large companies relocating their production plants abroad, the opening up of the markets in Central and Eastern Europe, rising costs in Germany (the cost of labour, taxes and levies) and the protracted phase of weakness in the domestic economy, SMEs too have stepped up their activities abroad.

Exports
in €bn



Source EcoWin, WestLB Research

Share of global trade volume
January 1994 = 100



Source EcoWin, WestLB Research

The strong performance of German companies in global markets

This has probably played a part in the accelerated pace at which German exports have expanded during the past few years; and this despite the fact that the euro has appreciated by around 80% since the beginning of 2002. Germany is the only industrialised country that has more or less managed to maintain its share of the global trade volume despite the rapid increase in emerging markets' trade flows.

Although 98% of exporting companies belong to the Mittelstand,...

The rapid expansion in Germany's exports coincides with a more than 20% increase in the number of exporting companies since the mid-1990s; this corresponds to 12% of the total number of companies in Germany. Some 98% of exporting companies are SMEs.

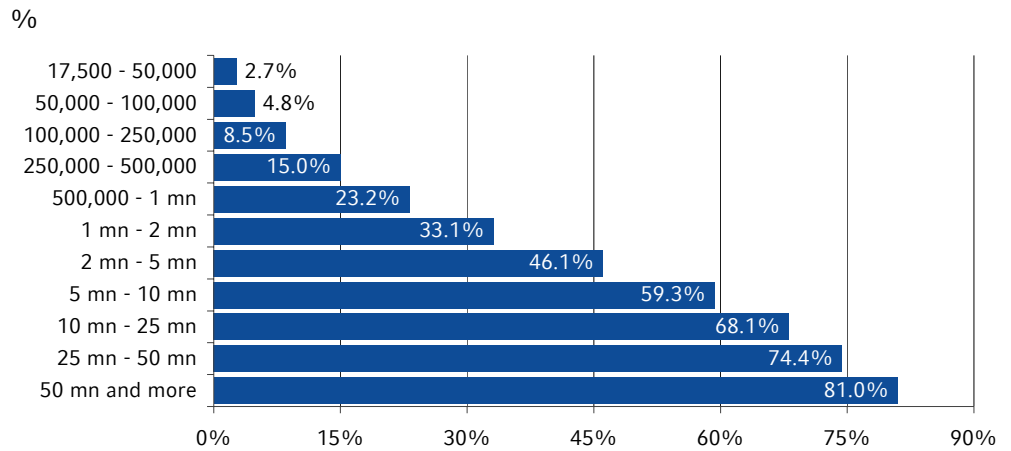
... there is nevertheless a positive connection between company size and the inclination to export

Nevertheless, there is clearly a positive correlation between company-size and the export business: far more exporting companies are to be found among the larger companies in each size class than among smaller companies. For example, 80% of large companies export goods and services whereas only one in three companies in the sales size-class from €1m to €2m is engaged in the export business.

Exports' contribution to total sales has increased

What is true of the number of businesses also applies to the volume of sales: export sales have increased appreciably since the mid-1990s. The contribution of export sales to total sales rises in line with company size: large companies account for almost 80% of total export sales. Exports account for around one-quarter of their overall sales.

Exporting companies by sales size-class



Source IfM, WestLB Research

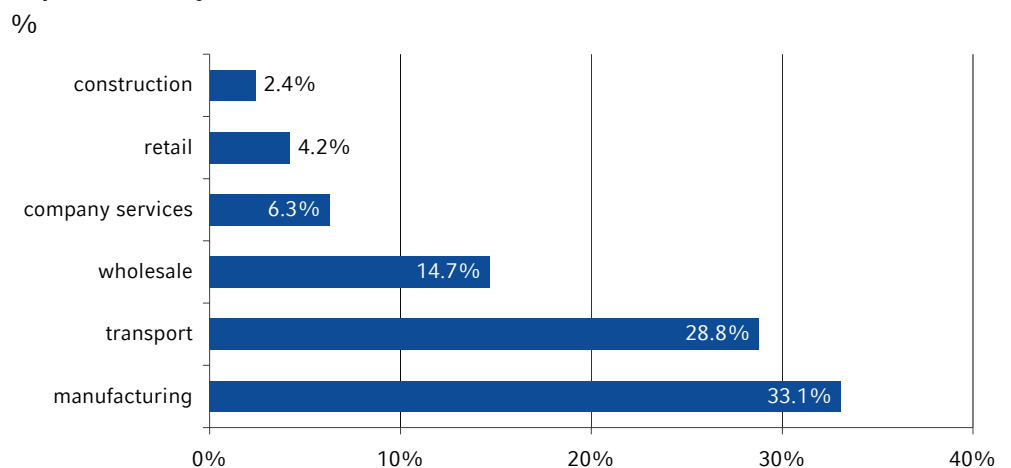
Industry has a large percentage of exporting companies

There is a particularly large number of exporting companies in the industrial sector. Virtually every second company from the mechanical engineering or chemicals industry is an exporter, but the number of exporting companies in the metal-working and automotive industries is also above average. These sectors generate large parts of their sales abroad. Within each individual sector the importance of the export business increases along with the size of the company. In the industrial sector virtually all companies with sales of €50m and more operate in markets outside Germany.

In industry many medium-sized companies are among the so-called export champions

The importance of the export business has continued to increase for German companies of all size categories since the data was collected in 2005. Within the industrial sector, for example, international sales as a percentage of total sales have increased by 5% since 2005. Various surveys indicate that Germany's Mittelstand has benefited from this. According to the Mittelstand panel of the Bundesverband der Deutschen Industrie (BDI) many medium-sized companies – especially in the industrial Mittelstand – are among the so-called export champions, i.e. exports account for over 50% of their total sales. They are even global market leaders in individual market segments. SMEs' exports are focused mainly on the old EU member states and the markets of Central and Eastern Europe. the relocation of production plant abroad plays far less of a role at many medium-sized companies than at larger companies.

Export ratios by sector



Source IfM, WestLB Research

Smaller SMEs still have a lot of scope to increase their export business

The 20 most successful family companies internationally

Nr.	enterprise	ratio*
1	Messer Group	100
2	Karl Meyer	95
3	Boehringer	92
4	Merck	91
5	Heraeus H.	90
6	Stihl Holding	88
7	SMS	87
8	Krones	85
9	Atlanta	83
10	Koenig & Bauer	83
11	Porsche	83
12	Glesecke & Devr.	81
13	Drägerwerk	80
14	Helm	80
15	Henkel	80
16	Wacker Chemie	80
17	Dürr	79
18	Franz Haniel	79
19	Voith	79
20	B. Braun	78

*) Export sales as % of total sales
Source: Impulse

However, these very positive results should not be allowed to conceal the fact that the smaller SMEs still do little international business. Although the BDI's SME panel says their export sales have increased considerably in the past few years, they are still a long way from matching the international sales of larger companies. Obstacles often encountered by SMEs when doing business abroad include the lack of the necessary minimum size, which is often seen as one of the main stumbling blocks for international business, as well as the difficulty of finding suitable distribution and business partners. Other hurdles may include institutional barriers or the management's and work force's lack of experience in foreign markets. Against this backdrop, the export opportunities that exist for SMEs are far from exhausted.

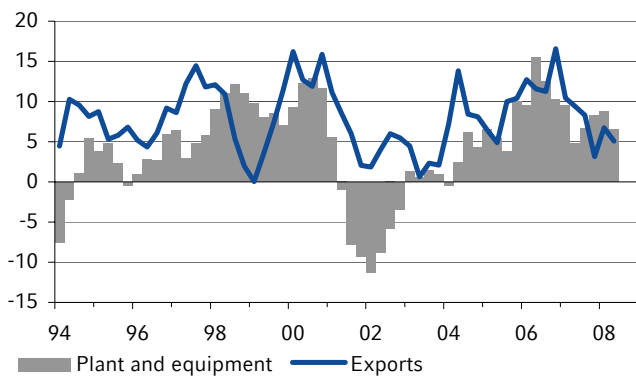
Looking at the level of internationalisation of the Mittelstand with regard to management form rather than company size, then the foreign business of large *family-run* companies' bears comparison with that of *manager-run* companies. Such family businesses are one of the driving forces behind German companies' success in world markets. In many cases, their export sales account for more than 50% of their total sales; at some companies this can be as high as over 80%. As widely as the business orientation of Germany's internationally successful family companies may differ, they share pronounced customer orientation and an ability to solve problems in a systematic manner. Another shared feature is their strict concentration on the company's traditional strengths. Core competences are virtually never outsourced, for example. Product specialisation and know-how are often combined with global marketing.

Despite their pronounced macroeconomic significance, SMEs play virtually no role in analysis of the business cycle

The significance of small and mid-sized enterprises for growth and employment in Germany is considerable. About 80% of employees work for an SME. According to the IfM's calculations, the *Mittelstand* sector accounted for 47% of value added in 2006. Nevertheless, its specific structure plays a comparatively minor role in analysis of the business cycle. Given its focus, it seems reasonable to assume that its position in the business cycle differs from that of large companies.

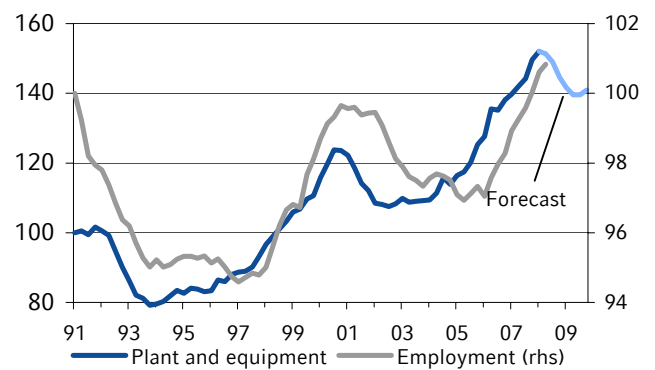
SMEs tend to be late-cycle businesses

Export and investment in plant and equipment
%, y/y



Source EcoWin, WestLB Research

Investment in plant and equipment and employment
1991 = 100



Source EcoWin, WestLB Research

Typical cyclical pattern

In Germany, the business cycle is extremely export-driven. Typically, an upturn starts from a pick-up in exports, which, through rising investment and employment, finally results in a pick-up in consumption demand. Accordingly, the trigger for a downturn is normally found in slowing exports.

Large companies are usually more sensitive to the business cycle than small and medium-sized enterprises

Initially, it is the large companies that profit from this traditional cyclical pattern; they are more export-oriented than small and mid-sized firms. The *Mittelstand* sector comes into its own later during the cycle, when the external stimuli weaken and domestic demand assumes the role of the economic engine. Conversely, this means that small and medium-sized firms do relatively well during the downturn while large enterprises are already feeling the effects of the flagging economy.

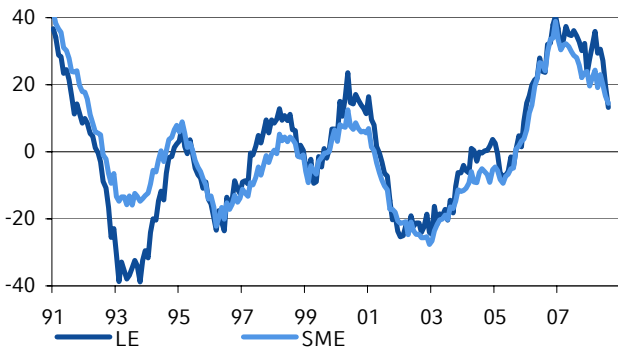
SMEs normally prosper later in the business cycle

The structure of the economy also points to SMEs doing better later in the cycle. Among individual economic sectors, industry is undoubtedly the most cyclical, which is attributable to the high proportion of international sales and capital goods production. By contrast, the development of the service sector is much less volatile. Even if SMEs dominate the economy across all sectors, the share of large companies in industry is higher than in the service sector.

Earlier studies point to the late cycle nature of SMEs

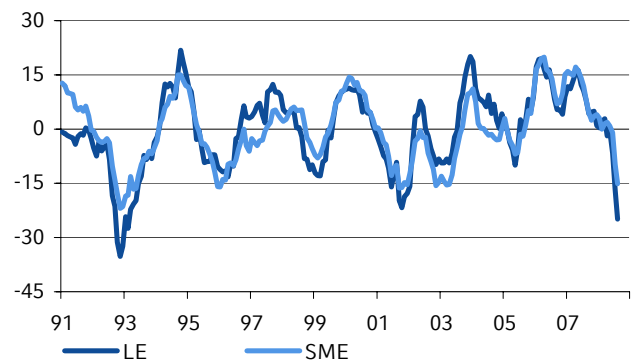
Studies carried out by KfW for earlier business cycles have demonstrated that small and mid-sized companies normally lag behind in the business cycle and that their economic position can differ considerably from that of the large companies. The traditional pattern is confirmed: a pick-up in foreign demand is first felt by large industrial companies. They are then normally followed by mid-sized and small industrial businesses, which are more export-oriented than similarly sized service providers and construction companies.

KfW-ifo business situation
Balance



Source KfW, WestLB Research

KfW-ifo business expectations
Balance



Source KfW, WestLB Research

There is no evidence for this lag at the moment, but there is a high correlation between the ifo indices

However, the ifo Business Climate Index published by the KfW for SMEs shows no lag relative to the business climate at large enterprises for the period since 1991. Both indicators – and this also applies to the two sub-indices “business situation” and “business expectations” – are highly correlated with each other. Although the SME index does tend to lag slightly behind that for large enterprises, the highest correlation (correlation coefficient = 0.90) exists in the current period.

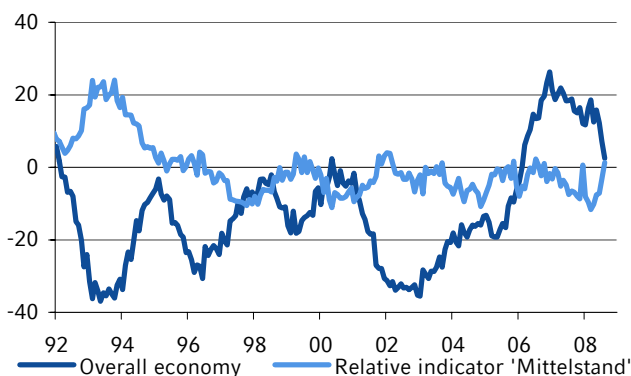
Synchronism is possibly due to SMEs' increasing international orientation

Narrowing the observation period down to the time since 2001 to today does not change this result fundamentally. However, the correlation between the two indices has increased (correlation coefficient = 0.97). This could reflect the growing internationalisation of *Mittelstand* firms, whose business cycle is increasingly driven by exports. However, it could possibly also be because the ifo-Institut survey contains a disproportionately large number of larger medium-sized companies. Their orientation differs less from that of large companies than does that of smaller firms.

The amplitudes of both indicators are different

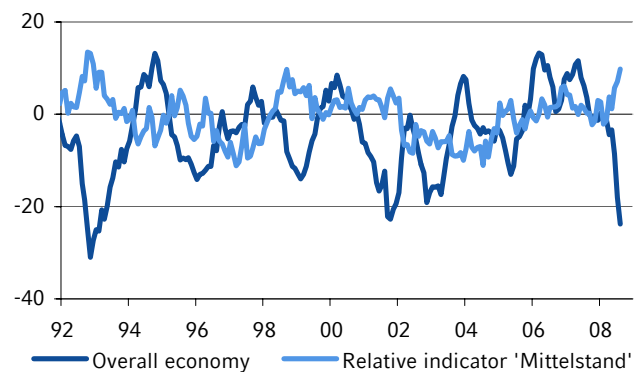
Although statistically it is not possible to identify any lag between the SME cycle and that of large enterprises, the amplitudes of the two indicators are different. This immediately becomes clear if one compares the ifo business climate index for the economy as a whole with the so-called Mittelstand indicator. The relative Mittelstand indicator measures the difference between SMEs' assessments of the business climate, situation and expectations, and those of large enterprises. The indicator takes on positive (negative) values when SMEs are more optimistic (pessimistic) than large enterprises.

KfW-ifo business situation Balance



Source EcoWin, KfW, WestLB Research

KfW-ifo business expectations Balance



Source EcoWin, KfW, WestLB Research

Positive assessment of the current business position

The ifo business climate index remained robust both for SMEs and large companies well into the spring. As in other surveys, most of the mid-sized businesses surveyed rated the current situation as good. By comparison, the assessments of large companies were even better. This is shown in the chart by the SME indicator for the business situation lower than zero. Recently, i.e. in August, the SMEs' assessment of the current business situation was somewhat better than that of large enterprises.

Economic expectations among SMEs are holding up better

Looking ahead to future business prospects, SMEs were less optimistic than in the previous year. However, as expected, they were less sceptical than large companies. The corresponding SME indicator for business expectations is accordingly greater than zero. Even when the business climate deteriorated across all businesses in the summer months, the decline for SMEs was smaller than for large companies, whose expectations well and truly collapsed. At the moment, the difference is greater than it has been since autumn 1998, i.e. during the Asian and Russian crisis.

The specific structure of the Mittelstand apparently functions as a sort of cushion during a downturn, preventing the business cycle from falling too severely. Conversely, it has a certain braking effect during an upturn. In other words, business cycle fluctuations would be greater here in Germany if the economy were not so oriented to the SME segment.

Growth is likely to slow in Germany

If these statements hold true for the near future, the SME sector will enjoy a more favourable environment than their larger counterparts. The business cycle in Germany has peaked and is weakening. The slowdown in global growth momentum and the appreciation of the euro are dampening demand for products made in Germany and are putting the brakes on export growth. A more sceptical outlook for international earnings, tighter profit margins and more difficult financing conditions is making companies less willing to invest. At best, private consumption is likely to revive only slightly in the near future, but such a trend would tend to benefit SMEs more than large enterprises.

Relatively robust performance to be expected by the Mittelstand

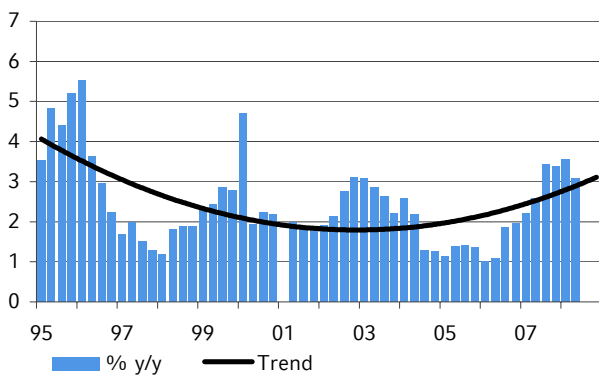
Conclusion: Even if the economy in Germany – as in other countries – weakens in the near future, small and mid-sized businesses are likely to put in a more robust performance than large companies. This should benefit the overall economy in Germany. However, the relative robustness of the Mittelstand in the business cycle should not be allowed to distract attention from the prospect that the economic environment will become far more difficult in the near future. In addition, the German Mittelstand will face more major challenges in the short and medium term.

Rise in wages and input costs is a burden

Decline in unit labour costs as a result of restructuring and modernisation measures

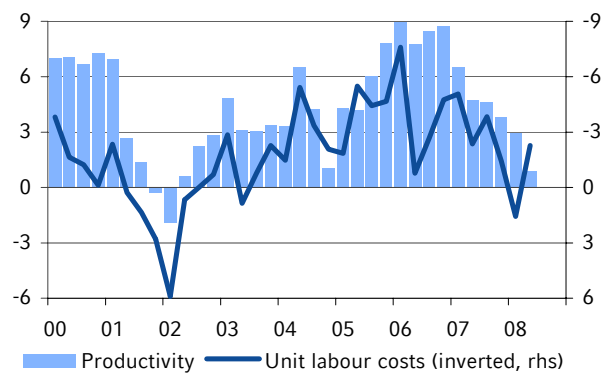
Wage policy in Germany has been moderate in recent years. Nevertheless, labour costs – both for SMEs and for large companies – remain very high internationally. However, this has not represented a major problem in terms of profitability and competitiveness, as long as high labour costs have been cushioned by corresponding productivity gains. Unit labour costs have fallen noticeably, largely as a result of far-reaching restructuring and modernisation measures.

Collective wages in industry
%, y/y



Source EcoWin, WestLB Research

Productivity and unit labour costs in industry
%, y/y



Source EcoWin, WestLB Research

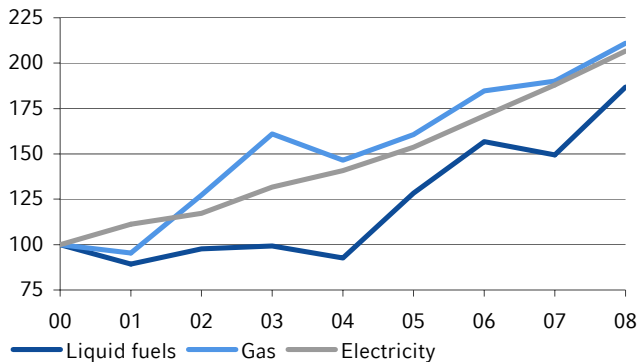
Labour costs will increasingly be viewed more critically

Meanwhile, though, the issue of labour costs is likely to be viewed more critically – for two reasons. First, this year’s collective wage settlements across all sectors of the economy have been considerably higher than expected. While smaller businesses are less tied to these settlements than larger companies, they will presumably still have to pay higher wage costs given the lack of skilled labour. Second, productivity gains initially slow during a downturn. As a result, an increase in unit labour costs is usually inevitable.

Drastic rises in the prices of energy and other raw materials

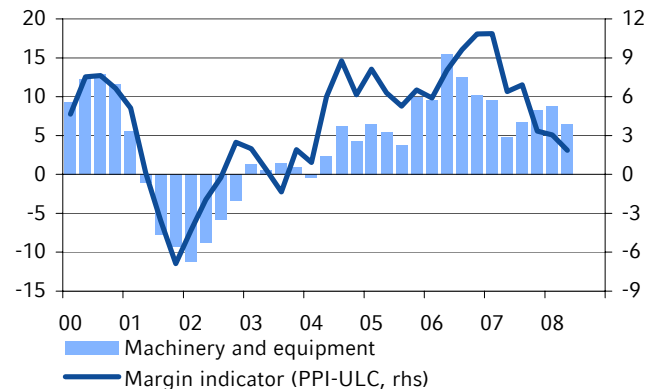
This development is hitting companies at precisely the wrong time, as costs have also come under pressure from other quarters. Energy has recently become drastically more expensive in the wake of the marked rise in crude oil prices; gas and electricity prices have now more than doubled since the start of this decade. The price of heating oil has risen by slightly more than 80%.

Energy prices in industry 2000 = 100



Source Federal Ministry for the Economy and Technology, WestLB Research

Profit margin and investments %, y/y



Source EcoWin, WestLB Research

Cost aspects in focus

Even if the most recent drop in crude oil prices continues, prices in the downstream energy markets will initially continue to rise. It must not be forgotten that prices of other commodities have increased considerably. This takes account of the firm euro cushioning the rise in commodity prices, which are normally calculated in dollars. Against this background, it is hardly surprising that according to surveys companies are focusing increasingly on costs – whether they relate to labour, energy or raw materials. Both SMEs and large companies are likely to be similarly affected by this, and by the pressure to adjust.

Companies are likely to step up cost-cutting measures

In the current economic situation, and given the broad extent of cost increases, it is likely to prove difficult for companies to fully pass on higher costs to their customers. They will therefore often be forced to bear some of the cost increases themselves at the expense of their profit margins. All past experience shows that increased pressure on margins will dampen the willingness to invest. In addition, it is likely that business strategies in the near future will become dominated by cost-cutting measures, with the focus on personnel savings. SMEs are likely to find it harder than large companies to increase efficiency and pass on higher costs.

Unemployment will probably increase in 2009

Unemployment will probably continue falling this year, but we expect the situation in the employment market to deteriorate at the latest at the beginning of 2009. In the light of the acute lack of skilled human resources, companies will probably avoid laying off large numbers of qualified employees. As a result, the brunt of downsizing will presumably be borne by the less qualified, by “mini-jobbers” and those employed by temporary employment firms.

The Mittelstand innovation engine is not yet running smoothly

Investment and innovation are drivers of growth and employment

Investment and innovation are the drivers of growth and employment. They are supremely important to the economy not only in the short term. In addition, they determine an economy's medium- and long-term growth opportunities. The market successes of companies and their long-term ability to survive depend increasingly on the extent to which they are able address these processes. An additional challenge is that product life and innovation cycles have shortened in recent years. For innovative companies, this means that the payback period for funds used to develop new products has shortened.

More innovation at larger companies

In general, SMEs are considered to be very innovative. In fact, however, the degree of innovativeness rises sharply in line with company size. For example, large companies accounted for over 87% of R&D expenditure in 2006, with small and medium-sized businesses accounting for just under 13%. In industry, large companies' share of such expenditure is much higher at 93.5%. The ratios regarding employees in R&D are similarly high. If one considers the trends over time, it is clear that – despite all the emphasis on the significance and promotion of R&D – the ratios have hardly shifted in favour of SMEs.

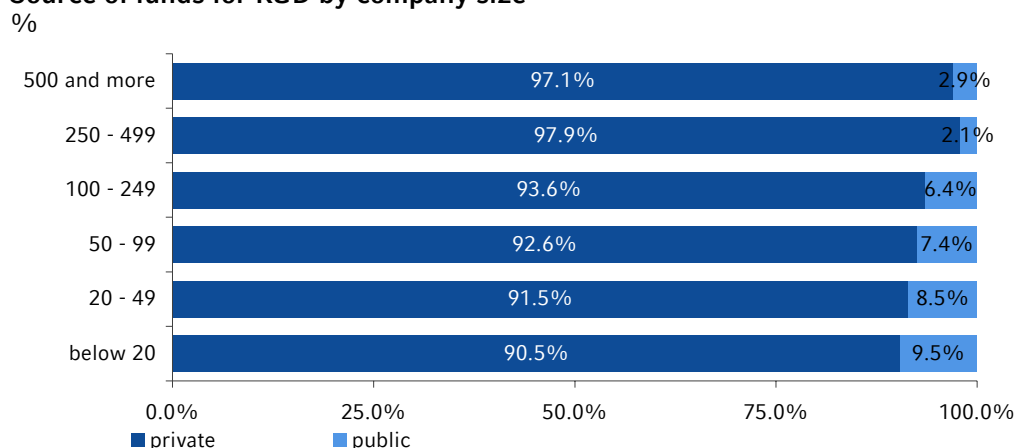
More innovation at internationally oriented companies

Within the *Mittelstand* sector, R&D activities tend to be found more in larger businesses. A very interesting finding is that international mid-sized businesses are generally involved in much more innovation activity than companies that focus on the domestic market.

Availability of financial resources determines R&D expenditure

The fact that the level of research at SMEs is comparatively low is probably linked mainly to the availability of financial resources, especially as the amount of spending required for innovations keeps on increasing. As the resources available to larger companies are much greater, the above results do not come as a surprise. Nor should it be a surprise that the share of public funds for mid-sized firms plays a much greater role in their research activities than it does for large companies.

Source of funds for R&D by company size



Source IfM, WestLB Research

Besides using state assistance, companies with limited resources can cooperate with other firms to enhance the efficiency of their R&D operations. Various surveys come to the conclusion that SMEs do indeed enter into research alliances despite having plenty of reservations. However, these arrangements fall far short of making good the shortcomings. Research cooperation agreements are more widespread among large companies, which in any event have more resources at their disposal, than among SMEs.

Financing conditions are deteriorating

Traditional financing sources for SMEs

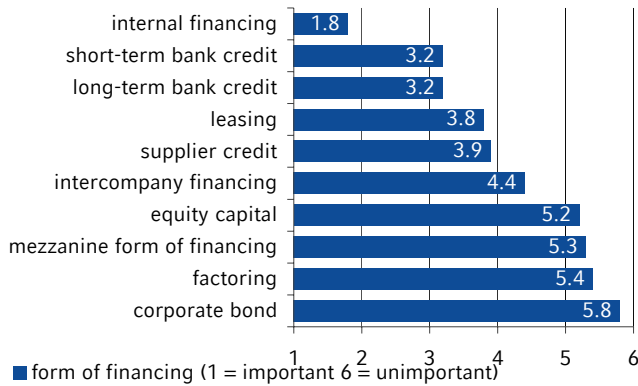
Traditionally, the financing of small and mid-sized businesses based on two pillars: internal financing and bank borrowing, the former remaining the more important source of funding. About one-half of all SMEs finance investments or R&D expenditure from their own or retained funds. If they use outside financing opportunities, traditional bank lending dominates. Other significant sources of financing are leasing and supplier credit. By contrast, private equity capital and mixed forms combining equity and debt capital, such as mezzanine finance, are an option for relatively few companies. One of the main problems of the SME segment is its relatively thin equity capitalisation.

Rise in equity ratio

Various studies conducted by KfW and Creditreform show that the equity ratio has risen since the start of this decade. However, this basically positive result must be put in context. For one thing, it is mainly large mid-sized companies that have managed to improve their equity base. Moreover, the ratio has deteriorated in 2008, and internationally it remains very low.

The importance of sources of financing

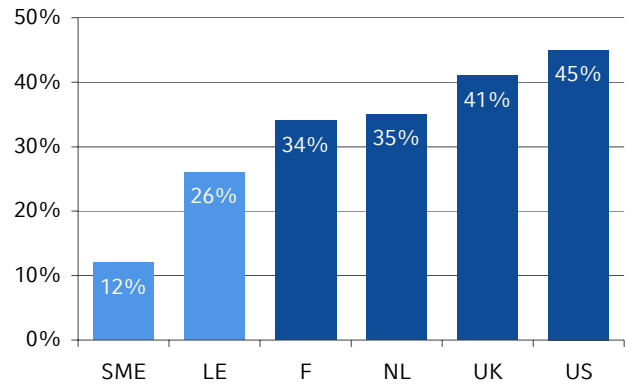
Rank points



Source KfW, WestLB Research

International comparison of equity ratios

%, as of 2005



Source IfM, WestLB Research

Financing conditions improved up to the outbreak of the financial markets crisis

Financing conditions for small and mid-sized businesses improved up to the outbreak of the financial markets crisis that originated in the US housing market. Surveys carried out by the KfW conclude that the share of businesses for which borrowing has been difficult or become more difficult has gradually declined. At the same time, the number of companies reporting that borrowing had become noticeably easier has fallen. This finding is seen as evidence that the good economic situation had made it easier to obtain loans, and that increasing numbers of businesses had adjusted to meet the stricter requirements of the financial markets.

Small businesses find it more difficult to obtain loans

Financing conditions have also improved for smaller companies in recent years, but this does not alter the fact that they still find it considerably harder to obtain loans than larger companies do. For example, in the case of businesses with annual revenues of less than €1m, the share of those with difficult financing conditions is about four times as high as for large companies (annual revenues more than €50m). This shows that small businesses still have more problems in adapting to changed conditions. The percentage of small firms that have obtained absolutely no loans is also markedly higher.

Credit rating is crucial in lending

A company's credit rating plays a crucial role when it comes to lending. However, many businesses still underestimate the assessments carried out by their bank (internal rating) or by rating agencies (external rating). According to the results of the KfW survey, nearly one-quarter of the firms did not even know whether they had a rating, or how high or low their rating was.

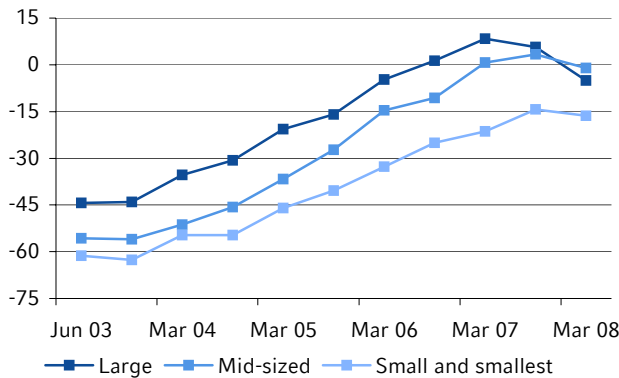
Large companies are better informed about ratings

The lack of information on ratings is largely due to the companies themselves. Nearly three-quarters of businesses surveyed by the KfW stated that they had not obtained information about their ratings. There are also huge differences between companies with regard to rating criteria. The survey showed that large companies are much better informed than small companies about the requirements of their house bank.

Financing conditions have been somewhat more difficult since the start of the financial markets crisis

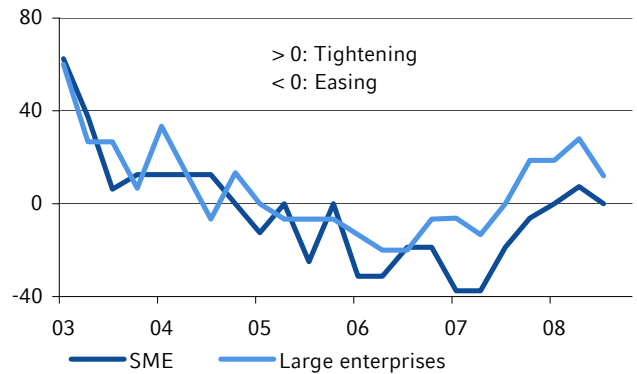
Financing conditions for SMEs have not yet deteriorated significantly since the start of the financial markets crisis. Several surveys have come to this conclusion. For example, in the KfW's current business survey, the share of companies reporting difficult borrowing conditions has risen only slightly. However, the trend towards easier lending observed in earlier surveys has not continued.

ifo credit climate according to company size
Balance



Source ifo, WestLB Research

Expected development in credit standards
Balance



Source EcoWin, WestLB Research

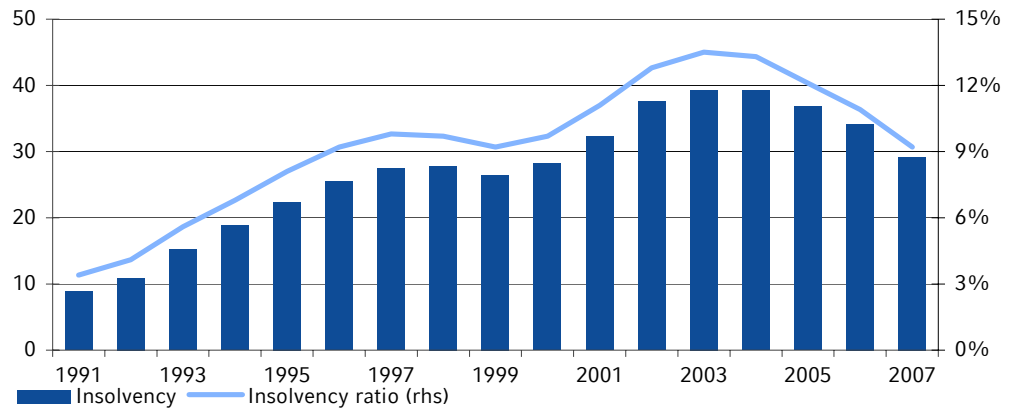
According to the ifo-Institut the credit climate has deteriorated only slightly

The ifo Institute too concluded in its business survey that lending conditions in industry, the construction sector and in retail have worsened only slightly. Interestingly, it is larger industrial companies that have reported that their house banks were more reluctant to lend. For the first time, their ratings of lending practices were more pessimistic than those of mid-sized firms. Given the turbulence of financial markets, which worsened markedly in the first few months of this year, this deterioration is only moderate in the opinion of the ifo Institute and can be attributed to the slowdown in the economy.

Access to loans will probably become more difficult

The opinion of the companies is that financing conditions are overall relatively robust. We find this surprising, given the results of the Bank Lending Survey, which show that banks have tightened their lending standards. Against this background, it is possible that lending will become more difficult after all. Reasons pointing in that direction include the fact that the financial markets crisis is not yet over and that banks are currently hardly willing to shoulder additional credit risk, given their already considerable needs to make write-downs in some cases. In addition, we consider it highly likely that relatively stable financing conditions of late have benefited at least to some extent from earlier statements and that new business will accordingly become more difficult in the future.

Insolvencies and insolvency rates
'000s and %



Source IfM, WestLB Research

Risk of increasing number of corporate insolvencies

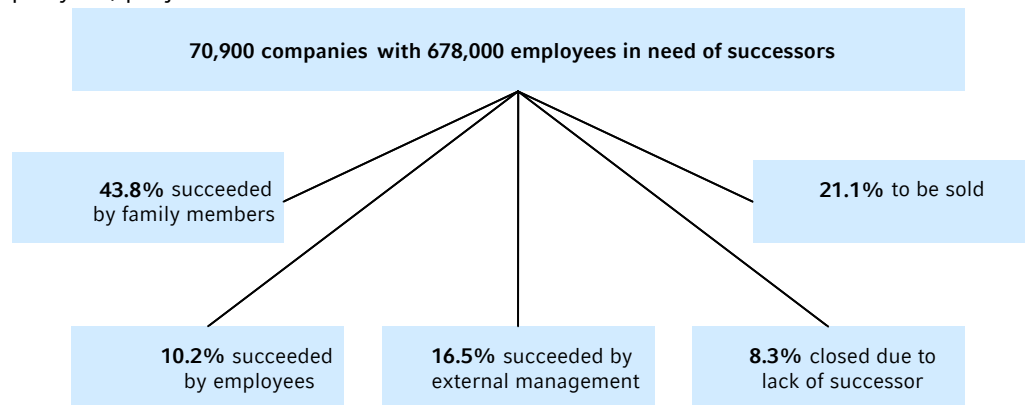
As the economy slows the number of insolvencies, i.e. the number of companies being wound up due to insolvency, will increase, having fallen to its lowest level since 2000. This would predominantly affect small and very small firms. Companies with sales of less than €500,000 account for around two thirds of all insolvencies; companies with sales of up to €5m account for as much as almost 96% of all insolvencies.

Urgent need for successors

About 71,000 business successions a year up to 2010

Besides financing, succession too will be one of the key challenges facing SMEs in the coming years. According to the IfM's calculations, some 71,000 family businesses a year with nearly 680,000 employees will require new managements in the near future. More than three-quarters of the upcoming succession solutions relate to small companies.

Succession solutions in family companies
per year, projected to 2010



Source IfM, WestLB Research

Often no successor in the family

In many family enterprises, there is simply no internal successor because of a lack of children. As a result, the IfM calculates that not even one-half of the upcoming transfers will be within families (44%). About 10% of the businesses will be transferred to an employee and 16.5% to an external manager. Slightly more than 8% will find no successor at all and will have to close. This in itself costs some 34,000 jobs a year.

About one-fifth of the family businesses that will have to be transferred will be sold

No less than one-fifth of businesses that will have to be transferred will be sold to financial or strategic investors. While the former normally view their acquisition as an investment that they plan to sell in the short, medium or long term, strategic investors often attempt to improve their own competitive position through acquisitions. Acquiring a company may also be an option for suppliers or customers looking, for example, to expand product or sales potential.

Private equity funds are showing increasing interest

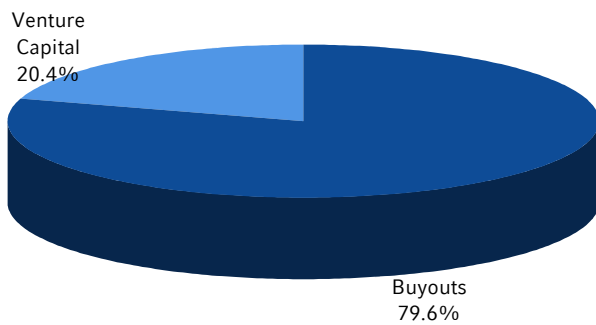
Acquisitions of large mid-sized businesses have become more significant especially for private equity funds. With regard to investment by financial investors a distinction is made between:

- Venture capital: investments to fund young companies; and
- Buyouts: investment in or full-scale acquisition of established businesses.

Buyouts dominate private equity investments

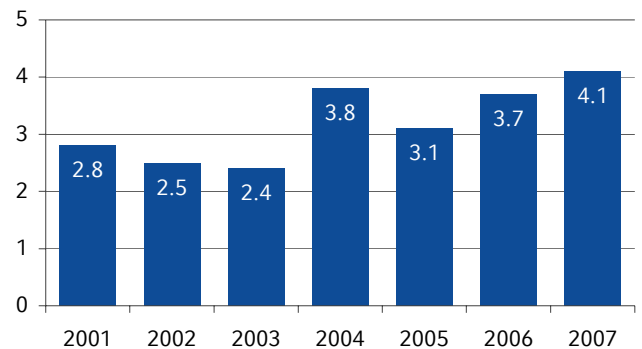
Last year, a total of €4.2bn (2006: €3.6bn) was invested in nearly 1,100 companies. As in previous years, buyouts (79.6%), which are one of the typical acquisition models, stand out. Venture capital accounted for 20.4%. The sectors with the highest capital inflows were consumer goods, engineering, and information technology production.

Private equity
%, as of 2007



Source BVK, WestLB Research

Capital invested in private equity
€bn



Source BVK, WestLB Research

Private equity in Germany is a relatively small segment compared to other countries

Despite considerable growth last year, the German private equity market is relatively small in international terms and has plenty of catching up to do. As a percentage of GDP, the capital invested in private equity in Germany amounts to just one-sixth of the corresponding amount in the US. Germany also lags well behind other European countries. However, given the numerous successions in the coming years, the private equity market is likely to gain in significance.

Notes: the German Mittelstand at a glance

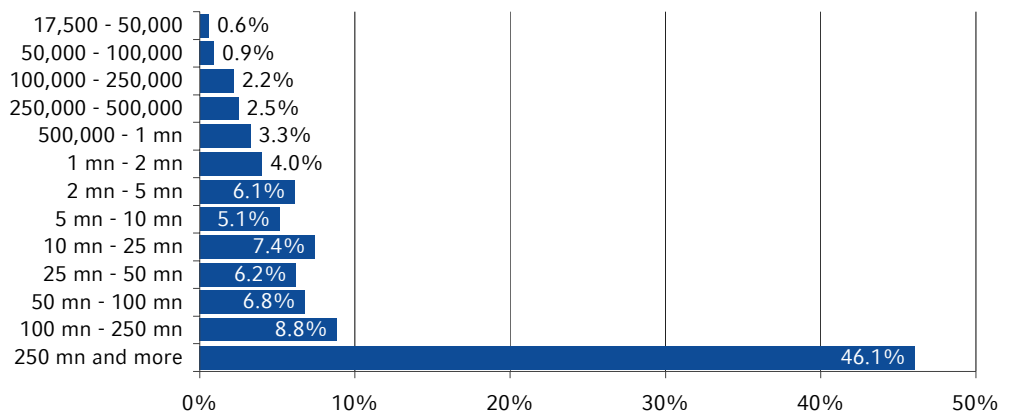
Key figures on the Mittelstand

SMEs account for 40% of all sales

According to corporate tax statistics for 2006, 89.8% of companies in Germany returned annual sales of less than €1m; a further 9.9% of companies reported sales of between €1m and 50m. Accordingly, only 0.3% of all companies are large enterprises; these, however, accounted for around 60% of total sales. In other words, small and medium-sized firms were responsible for roughly 40% of all sales.

Annual sales by size category

% share



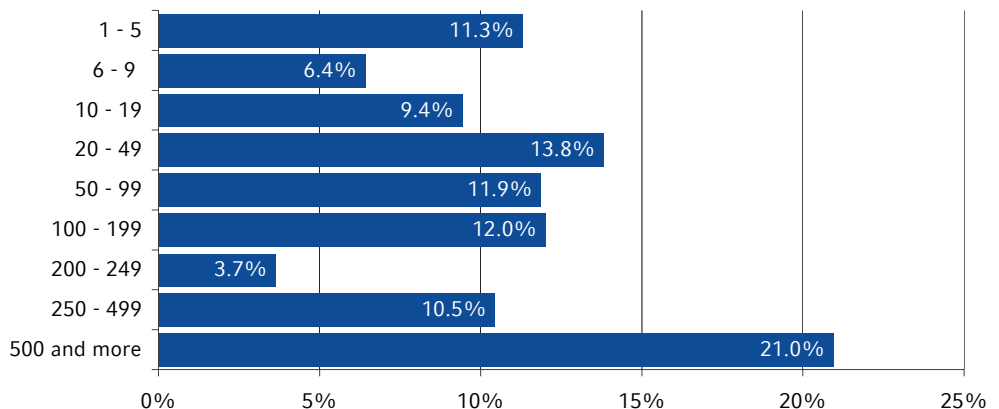
Source Ifm, WestLB Research

SMEs employ 80% of the German workforce and provide 83% of all apprenticeships

Employment statistics for 2007 show that 96% of all businesses employ fewer than 50 persons; around 4% have more than 50 and fewer than 500 employees. Only 0.3% of all companies have more than 500 employees, but this small share nevertheless employs around 20% of all social security contributors. Consequently, around 80% of the work force is employed by the SME segment. The apprenticeship situation is similar. According to the Bundesagentur für Arbeit (Federal Labour Agency), 83% of apprenticeships are provided by small and medium-sized firms.

Number of employed by size category

%



Source Federal Labour Agency, WestLB Research

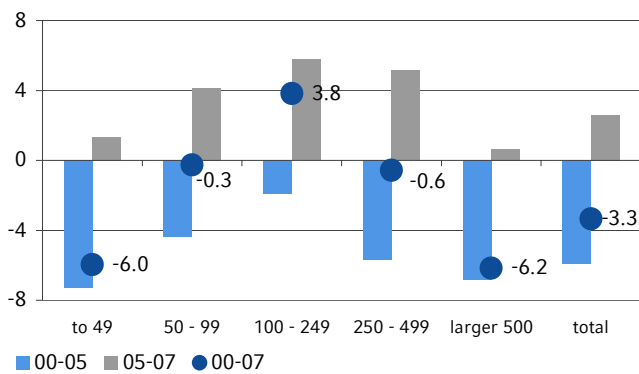
Larger medium-sized companies are the engine of employment

As far as the trend of employment is concerned, companies with between 100 and 250 employees have performed best: on balance, they have increased the number of jobs they provide since 2000. During the phase of restructuring between 2001 and 2005 they shed

comparatively few jobs. Both smaller and larger companies did far less well, by contrast. Although employment has increased here in the wake of the general economic upturn since 2005, it has not done so enough to make up for the previous restructuring-induced redundancies. In the light of these results, the widespread claim that the Mittelstand is the engine driving employment in Germany needs to be qualified to a certain extent: in the past few years, it has been the larger medium-sized enterprises that have been the main engine of job creation.

Employment growth by headcount

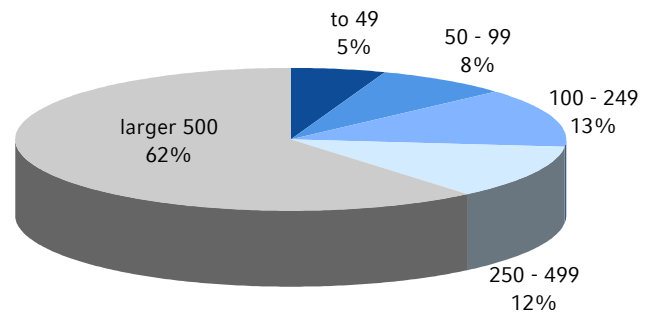
Average % change



Source Federal Labour Agency, WestLB Research

Industrial value added by headcount

as % of total value added



Source Federal Statistical Office, WestLB Research

According to calculations carried out by the IfM, the Mittelstand contributed approximately 50% of value added in 2006. The contribution to value added in the industrial sector, at around 40%, is far lower than in the construction industry or in the service sector.

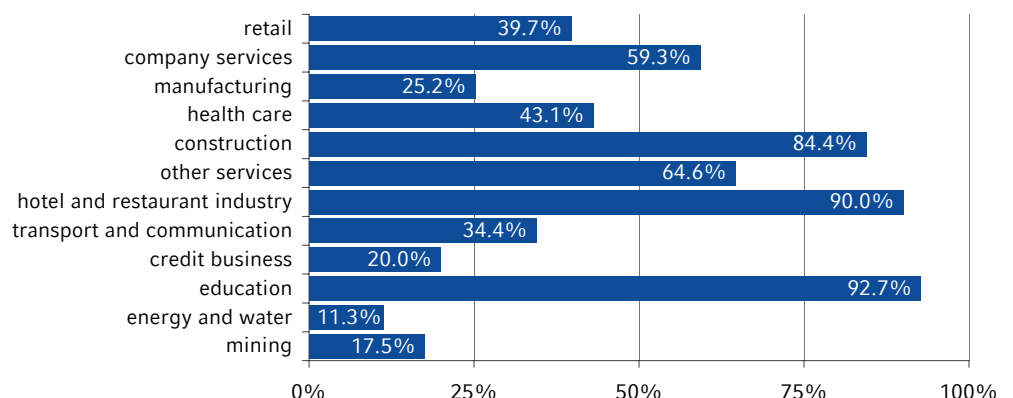
Mittelstand and the sectors

[SMEs in the construction and catering industries and the education sector account for a large percentage of sector sales](#)

While differences with regard to company size are limited within the various sectors of the economy, contributions to sector sales paint a different picture: 98.2% of SMEs in the power industry account for only slightly more than one tenth of total sales in the sector. They make similarly small contributions to sector sales in the manufacturing and banking industries. By contrast, SMEs in the construction industry, the catering trade and the education segment account for the bulk of sector sales.

SMEs' contributions to sector sales

%



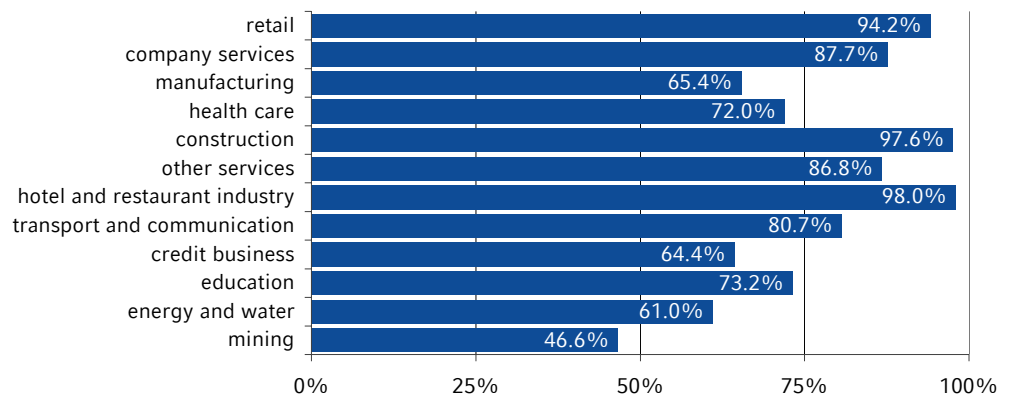
Source IfM, WestLB Research

Medium-sized companies in the manufacturing or banking industry create fewer jobs

With regard to the share of employment, the discrepancy between SMEs on the one hand and large enterprises on the other is less pronounced. Medium-sized businesses in all sectors other than mining account for more than 60% of jobs. SMEs in the manufacturing industry, the energy sector and banking employ comparatively few persons. In the construction and catering sectors and the retail trade, which tends to be dominated by large enterprises as regards sales, SMEs account for extremely high percentages of jobs in their respective segments.

SMEs' share of employment by sector

%



Source Ifm, WestLB Research

Typical SME sectors

Conclusion: Although SMEs account for a very high percentage of companies in all sectors of the economy, the sales and employment data shows major differences. Typical SME sectors are, accordingly, the construction industry and the catering trade. By contrast, manufacturing industry, the energy and water sector and banking tend to be the preserve of larger companies.

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