

THE FINANCIAL SITUATION OF MITTELSTAND COMPANIES: AN OBSTACLE TO RECOVERY

Nearly eight years of sluggish domestic demand have plunged German small and medium-sized enterprises into a difficult financial situation, culminating in a record number of bankruptcies in 2003. The economic circumstances in which Mittelstand¹ (short for "kleine und mittlere Unternehmen", German for SME) operate is radically different from those of large businesses whenever activity is driven by foreign trade alone, as is the case at the moment. Given its weight in total value added and the number of people it employs, Mittelstand is decisive for the German economy. Today, Mittelstand financial situation is extremely fragile and any improvement is restricted by problems obtaining credit. As such, the pace of this economic recovery may be slower than in the past, with fewer jobs being created.

SMEs are crucial to the German economy

In 2000, Mittelstand (as defined by the *Institut für Mittelstandsforschung* in Bonn¹) liable for corporation tax covered 3.3 million enterprises and 20.1 million employees, i.e. 99.7% of enterprises liable for corporation tax, 69.7% of employment, 48.8% of value added of the private sector, 43.2% of taxable turnover and 83% of apprenticeships. At first glance, the weight of SME in the economy is the same in Germany as in France or the rest of the European Union (see *table below*: but the European definition is more restrictive and not suited to Germany where there are a number of "large" SME). However, the weight of SME's in the German economy is not caused by an over-representation of micro businesses, as is the case in France, or an over-representation of self-employed workers, as is the case in Southern Europe. Rather, it reflects the sheer number of small businesses and the volume of staff employed, as well as the level of value added and investment of medium-sized enterprises (in 1999, businesses in the non-construction industrial sector employing between 20 and 249 employees accounted for 38% of total investment, according to the IfM²).

BREAKDOWN OF NUMBER, STAFF AND VALUE ADDED OF BUSINESSES BY SIZE OF BUSINESS IN 2000*

Size of business (European definition ¹)	Germany**	France***	Italy	EU15
1-9 employees (micro)	Number: 81.4 Staff: 19.1 VA: 8.5	92.1 24.5 19.5	94.9 47.8 32.5	89.1 27.8 20.8
10-49 employees (small)	Number: 15.5 Staff: 22.5 VA: 16.4	6.7 21.2 19.1	4.5 21.9 23.4	9.1 21.9 19.9
50-249 employees (medium)	Number: 2.6 Staff: 19.5 VA: 20.6	1.1 16.6 16.9	0.5 12.5 16.6	1.5 17.1 19.0
Total SME	Number: 99.5 Staff: 61.0 VA: 45.5	99.8 62.3 55.5	99.9 82.2 72.6	99.7 66.9 59.7
More than 250 employees (large)	Number: 0.5 Staff: 39.0 VA: 54.5	0.2 37.7 44.5	0.1 17.8 27.4	0.3 33.1 40.3

* Sections D, F, G, H, I, K of the NACE (General Industrial Classification of Economic Activities within the European Communities) – D Manufacturing Industry; F Construction & Commerce; G Vehicle and Household Goods Repairs; H Hotels and Restaurants; I Financial Activities; K Real Estate, Rentals and Services to Businesses

** 1999 data, sections D, F, G of the NACE, VA excluding section G of the NACE, *** 1999 data. Source: Eurostat, structural business statistics

BREAKDOWN OF BUSINESSES BY LEGAL STATUS IN 2000

% of number (% of turnover)	Sole proprietorship (Einzelunternehmer)	Non-corporation		Corporation		Cooperative (Erwerbs- und Wirtschaftsgenossenschaften)	Company under public law	Miscellaneous
		OHG (partnership), GbR	KG (limited partnership), GmbH und Co. KG	AG, KGaA (limited partnership with share capital), bergrechtliche Gewerkschaften	GmbH (Ltd.)			
Small* (Turnover <1m)	75.3 (62.6)	9.1 (10.0)	1.9 (3.7)	0.1 (0.2)	12.1 (22.2)	0.1 (0.1)	0.2 (0.3)	1.3 (1.0)
Medium (1m < turnover <50m)	27.5 (15.4)	8.7 (7.3)	16.9 (27.9)	0.7 (1.6)	42.9 (43.0)	1.0 (1.6)	0.5 (0.7)	1.7 (2.6)
Large (Turnover >50m)	1.4 (0.6)	4.3 (4.6)	39.4 (23.1)	9.4 (34.8)	37.9 (30.5)	1.9 (1.3)	1.2 (0.8)	4.6 (4.2)

* Only businesses with taxable turnover of over EUR 16,617 are included. Source: IfM

This breakdown of Mittelstand reveals the existence of a substantial proportion of large SME, which are subject to regulatory and economic restrictions of corporations rather than those of sole proprietorships. These companies are important innovators. According to Eurostat's Flash Eurobarometre for 2001³, nearly 50% of privately-owned, medium-sized businesses in Germany (between 50 and 249 employees) generated over 10% of their turnover with new products or products that have been updated in the past two years – one of the highest rates in the European Union. For large enterprises, this figure is only 40% in Germany and 30% for the European Union. According to a 1999 IfM survey³, 10.4% of staff in businesses with less than 100 employees work in R&D, compared with 8% for businesses with a workforce of over 5,000.

SMEs are currently in a very sticky situation ...

Mittelstand financial situation deteriorated over the second half of the 1990s

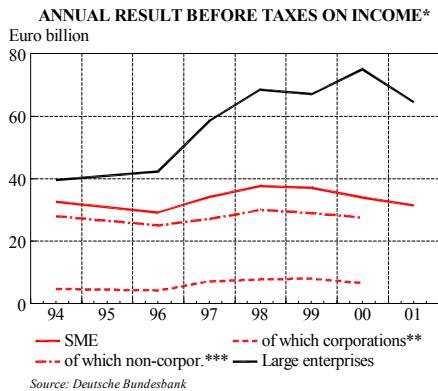
The difference between large-business and SME finances, which is common to all developed countries (large groups have more diverse sources of income and are more able to streamline costs via economies of scale, outsourcing and delocalisation) became all the more marked in Germany over the second half of the 1990s. Between 1994 and 2001, large groups' annual result before tax grew by 64%, while those of SMEs declined by 3%. In fact, only between 1997 and 1999 did SMEs register positive growth⁴. The widening of this gap reflects the weakness of the German economy since the mid-1990s. Only in 1998 and 1999 did domestic demand increase by more than 2%. And if the sudden slowdown therein since 2001 is anything to go by, the difference between SME and large businesses is surely even greater now.

¹ The definition of SME usually used in Germany is that of the *Institut für Mittelstandsforschung* in Bonn: small businesses have no more than nine employees and generate annual turnover of less than EUR 1m; medium-sized businesses have between 10 and 499 employees and generate annual turnover of between EUR 1m and EUR 50m. **European statistics** are divided into three categories: micro businesses with no more than nine employees; small businesses with between 10 and 49 employees, turnover of EUR 7m or balance sheet assets of EUR 5m; medium-sized businesses with between 50 and 249 employees, turnover of EUR 40m or balance sheet assets of EUR 27m. To be classed as a Mittelstand company in the strictest sense of the word, an enterprise must be independently managed. The European definition of this is that no more than 25% of an SME can be owned by a large enterprise.

² B Günterberg and H J Wolter, "Unternehmensgrößenstatistik 2001/2002", IfM Materialien No 157, Bonn 2003.

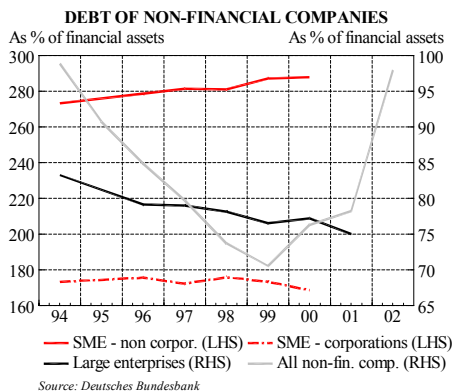
³ Manfred Schmiemann, "Enterprises in Europe – does size matter?", Eurostat 2002

⁴ "The economic situation of small and medium-sized enterprises in Germany", Deutsche Bundesbank, Monthly report October 2003. According to the Bundesbank, the difference between SME and large-business earnings is even greater due to the fact that, for partnerships and sole proprietorships, which account for a significant proportion of SME, the owner's personal income is included in turnover. Also, businesses that have filed for bankruptcy are not included in the statistics.



In this figure, *Mittelstand* refers to businesses with turnover of less than EUR 50m. * Annual profit before profit or loss transfers and pre-tax profits for businesses in the manufacturing, wholesale, retail and transport sectors. ** including cooperatives (*Genossenschaften*) and foundations (*Stiftungen*). *** partnerships (*Offene Handelsgesellschaft, Kapitalgesellschaften und Co, Gesellschaften bürgerlichen Rechts*) and sole proprietorships (*Einzelunternehmen*).

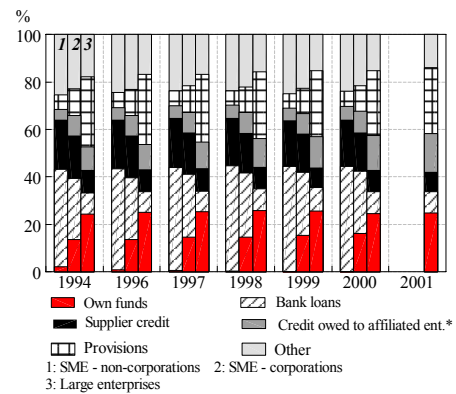
The deterioration of the *Mittelstand* financial position also appears in the liabilities side of the balance sheet: only at the beginning of the 2000s did debt fall slightly (at a time when financial difficulties no doubt required substantial deleveraging while commercial banks were restricting access to credit), while large enterprises enjoyed stronger growth in assets than liabilities at the end of the 1990s, thus enabling them to reverse the ratio. SME over-indebtedness (over 200% of financial assets compared with less than 80% for large enterprises) is above all attributable to sole proprietorships and partnerships⁵.



In this figure, *Mittelstand* refers to businesses with turnover of less than EUR 50m

The scale of *Mittelstand* debt is the side effect of its undercapitalisation: the percentage of own funds in balance sheets was just 7.5% in 2001, compared with 25% for large businesses. Even if we concentrate solely on SMEs classed as corporations, the lack of own funds is still blatant: 16% of liabilities. Furthermore, large businesses can borrow from subsidiaries (almost 15% of liabilities), while SMEs depend on suppliers (16% of liabilities for SMEs classed as corporations) and banks (26% for SMEs classed as corporations versus 9% for large enterprises).

LIABILITIES OF NON-FINANCIAL COMPANIES

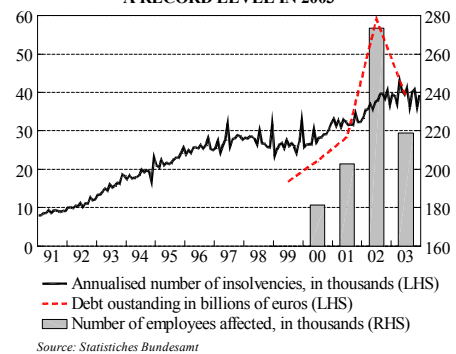


* Including liabilities vis-à-vis affiliated enterprises with which they are linked by virtue of participating interests as well as liabilities vis-à-vis partners. In this figure, *Mittelstand* refers to businesses with turnover of less than EUR 50m.
Source: Deutsche Bundesbank

2003, a gruelling year for *Mittelstand*...

The difficulties experienced by *Mittelstand* since the second half of the 1990s culminated in a record number of bankruptcies in 2002-2003. This figure continued to rise in 2003, mainly as a result of sole proprietors, small businesses and liberal professions going under (+11% on 2002). This followed the introduction of a new bankruptcy law on December 1st 2001 (§ 4a der *Insolvenzordnung*), which afforded this type of enterprise respite on the payment of administrative costs). In contrast, the number of bankruptcies amongst corporations with share capital (*AktienGesellschaft* and *Kommanditgesellschaft auf Aktien*) fell by nearly 20% after a previously unseen level of bankruptcies in 2002 among new technology businesses listed on the *Neuer Markt* (closed on June 5th 2003) and large corporates: 7 of the 10 largest European insolvencies concerned German companies in 2002 (Philipp Holzmann, Babcock Borsig, Kirch Media, Gontard&Metallbank, Peguform, Mühl, Fairchild Dornier).

**BUSINESS INSOLVENCIES REACHED
A RECORD LEVEL IN 2003**

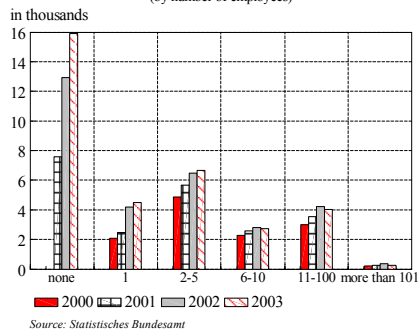


Bankruptcies for sectors A-K, M-O of *Klassifikation der Wirtschaftszweige (WZ 1993)*. As of 2001, including sole proprietors, small enterprises and liberal professions. As of January 1st 1999, creation of a single law for bankruptcies (replacing different regimes for East and West Germany), *Insolvenzordnung*, which allows GbR to file for bankruptcy.

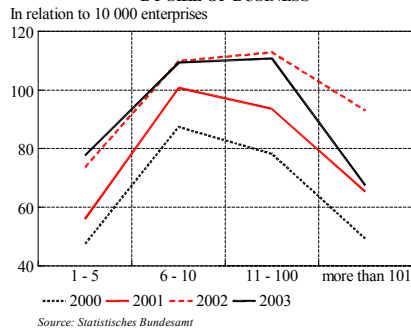
The rise in the number of bankruptcies in 2002-2003 (+16% then +4%) may seem less worrying than the figure for 1993 (+40%) but it has hit SMEs hard. Even putting aside the increase in the number of bankruptcies among artisans and other self-employed professionals, which is common to all eurozone countries and to be expected at this point in the cycle, statistics show that *Mittelstand* suffered a great deal in 2003: bankruptcies among medium-sized businesses (between 11 and 100 employees) did not stabilise and the increase in the number of bankruptcies among businesses that had been existing for more than eight years was of particular concern (+9% on 2002): for the first time ever, said businesses accounted for the majority of bankruptcies in 2003 (42% of the total).

⁵ "The economic situation of small and medium-sized enterprises in Germany", Deutsche Bundesbank, Monthly report October 2003. According to the Bundesbank, over-indebtedness must be viewed in context insofar as sole proprietorships and partnerships are encouraged to declare financial assets as private assets for tax reasons, and include personal loans in company liabilities as the interest is tax-deductible.

INSOLVENCIES BY SIZE OF BUSINESS (by number of employees)

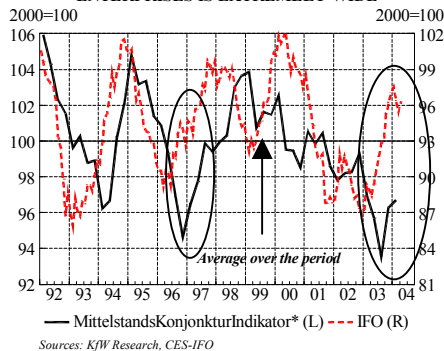


FREQUENCY OF INSOLVENCIES BY SIZE OF BUSINESS



...who will need time to recover

THE GAP BETWEEN SMEs AND LARGE ENTERPRISES IS EXTREMELY WIDE



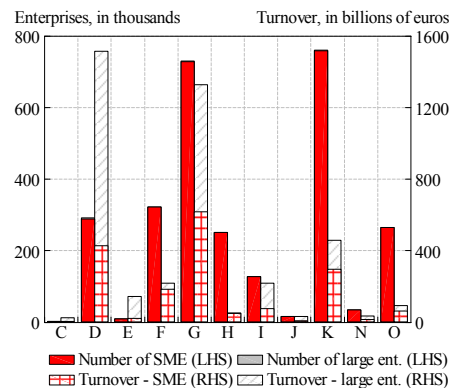
* Survey of businesses with turnover of less than EUR 50m and fewer than 500 employees applying to the KfW aid programme (2,000 applications per quarter)

If we are to believe the KfW *MittelstandsKonjunkturindikator* (MKI), the improvement in *Mittelstand* financial situation came later, and was much slighter, than the improvement in large-business finances (reflected in the IFO index). The KfW indicator is still well below its long-term average. The current situation is somewhat similar to that of 1996-97. At that time, the recovery was also driven by exports, benefiting large businesses first and foremost before gradually spreading to other parts of the production chain. Excluding any unforeseen circumstances that might put an end to the sharp increase in exports, the current recovery should therefore feed through to *Mittelstand*. However, as the economic gap between SME and large businesses is greater than it was in 1996-97, we may have to wait until 2005 before this happens. Indeed, although the earnings of large German businesses probably picked up in the second half of 2003 and should be sustained by robust foreign demand, the upturn in SME earnings will probably take much longer as the lack of any increase in household confidence and the slack labour market will hold back consumer spending, which is the main source of SME demand.

This economic gap between different types of business, which has not stopped widening since the second half of the 1990s, is partly due to the large number of SMEs in the construction sector (sector F of WZ 93): 11% of all SMEs and 10% of their turnover operate in the

construction sector, compared with 3% and 1% for large businesses. 26% of SMEs and 16% of their turnover operate in the real estate, rentals and services to businesses sector (sector K of WZ 93), compared with 10% and 7% for large businesses. Unfortunately, the construction sector has been in decline since the mid-1990s due to reunification-related overinvestment: these two sectors accounted for 22% of all bankruptcies over this period.

SECTOR BREAKDOWN BY SIZE OF BUSINESS IN 2000

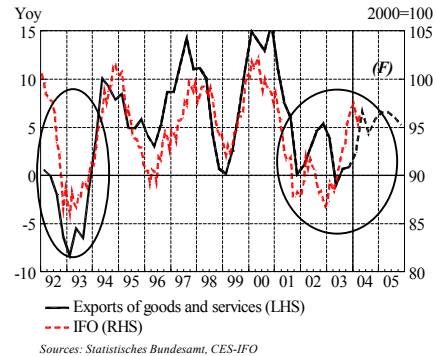


WZ 1993: C mining and extraction industry, D manufacturing industry, E electricity, G gas and water, F construction, G retail and wholesale sales, vehicle repairs and household goods, H hotels and restaurants, I transport, storage and communications, J financial intermediaries, K real estate services, rentals and services to businesses, N healthcare and social security, O other social services and services to households.

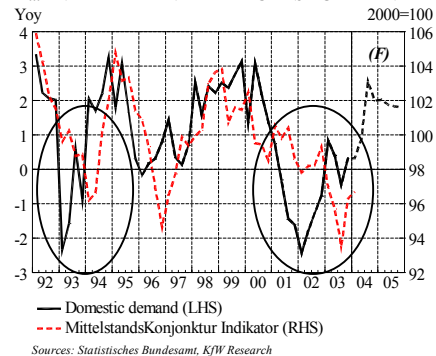
In this figure, *Mittelstand* refers to businesses with turnover of less than EUR 50m (only enterprises with taxable turnover of over EUR 16,617 are included) Source: Ifo

The growing difference between the situations for large businesses and SMEs is, more generally, due to the latter's dependence on the domestic market. In 1999, the proportion of exports in turnover for enterprises with turnover of over EUR 50m was 23.7%, versus 19.2% for those with turnover of between EUR 12.5m and EUR 50m and just 15.4% for those with turnover of between EUR 2.5m and EUR 12.5m.

THE IFO INDEX IS DRIVEN BY EXPORTS...



... AND THE MKI INDEX BY DOMESTIC DEMAND



The IFO index reacts quickly to any change in the rate of exports (pick-up in 1997 and end of 2003, decline in world trade in late 2001), whereas it takes a sustained increase in domestic demand for the *MittelstandsKonjunkturindikator* to reap the benefits (as it did in 1993, 1997 or, to a lesser extent, 2003).

...and will struggle to recover given the difficulty in obtaining credit...

Unlike large enterprises, who enjoy higher own funds and who can obtain loans from subsidiaries, SMEs are highly dependent on external financing, the main source of which is short-to-medium-term bank loans (under five years). Commercial banks (such as Commerzbank and HVB group for larger commercial banks) have an almost equal footing on this segment of the market as public banks (mostly Sparkassen).

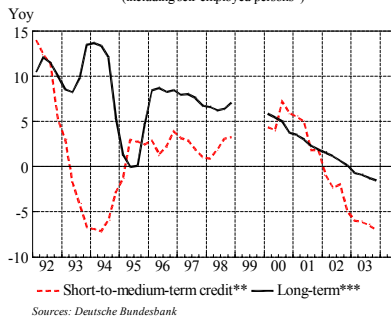
THE CREDIT MARKET IN 2002

Share of credit owed to... as %	Enterprises excl. self-employed persons (incl. financial intermediaries, excl. MFIs)			Sole prop.	Households (including non-profit institutions)	
	Total	Under 5 yrs	Over 5 yrs		Total	Housing loans
Commercial banks	29	43	21	23	26	22
Public-sector banks	42	39	42	39	35	34
Credit cooperatives	10	12	8	23	19	17
Mortgage banks (RealKreditinstitute)	14	4	20	11	9	11
Building and loan associations (Bausparkassen)	0	0	0	2	10	13
Banks with special functions	6	2	9	2	2	3

Source: Deutsche Bundesbank

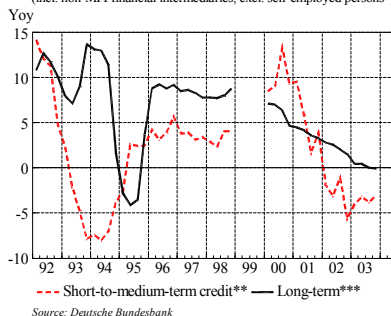
Outstanding short- and medium-term corporate credit has yet to pick up. The rate of decline is hardly the same as during the 1993 recession.

MFIs LOANS TO NON-FINANCIAL COMPANIES (including self-employed persons*)



Sources: Deutsche Bundesbank

MFIs LOANS TO NON-FINANCIAL COMPANIES (incl. non-MFI financial intermediaries, excl. self-employed persons*)



Source: Deutsche Bundesbank

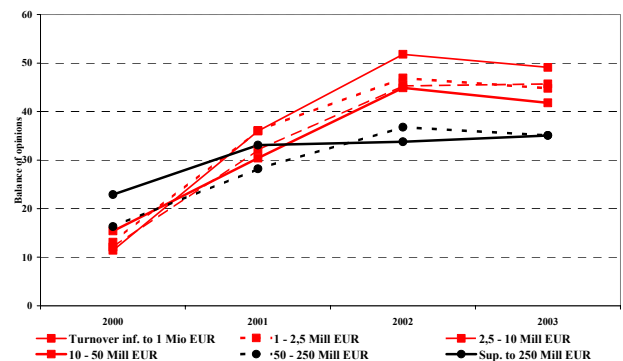
* Self-employed persons (Wirtschaftlich selbständige Privatpersonen): unwaged artisans, self-employed professionals and, as of 1999, shopkeepers. Self-employed persons represent around 1/3 of outstanding IMF loans to businesses, compared with less than 5% for financial intermediaries excluding IMF. ** Maturity of less than four years until 1998, 5 years after. *** Maturity of over four years until 1998, 5 years after. The break in 1999 is due to the change in the definition of Monetary and Financial Institutions (MFI) as a result of entry into the EMU.

This nose-dive in lending (the picture is a little less shocking if we exclude self-employed persons) seems excessive in proportion to the slowdown in growth between 2001 and 2003 (on average, GDP has stagnated compared with a contraction of 1.1% in 1993), which suggests that the fall in credit is due to lower supply. This theory is supported by the fact that the reduction is largely attributable to

commercial banks, whose outstanding loans to enterprises have been negative in year-on-year terms since the end of 2001, while credit issued by public-sector banks did not become negative until the end of 2003. However, the results of surveys on conditions to access to bank loans are ambiguous. The ECB's bank lending survey does not reveal any significant difference between financing conditions (as reported by the strategy departments of large German banks) for SME and those for German businesses as a whole or the rest of the eurozone. Furthermore, banks have shown a clear tendency to ease corporate lending conditions since the fourth quarter of 2002.

Surveys of SMEs paint a very different picture.

SMEs ARE STILL HAVING TROUBLE ACCESSING CREDIT



% of businesses who consider that bank loans are harder to obtain than they were the previous year. Survey of 4,600 enterprises in 24 sub sectors.

Source: Unternehmensfinanzierung, KfW Research

KfW surveys show that financing conditions, which strongly deteriorated between 2000 and 2002, have barely improved since. In particular, the proportion of businesses with turnover of between EUR 10m and EUR 50m who feel that lending conditions have tightened is still 10 percentage points higher than for businesses with turnover of over EUR 50m. This restriction has a particularly hard impact on medium-sized enterprises, who would be more likely to take advantage of the current improvement in foreign demand than small enterprises and especially micro businesses.

Without going so far as to talk of a credit crunch⁶ affecting all businesses, banks are probably now being very selective in which SMEs they lend to, and this is highly detrimental to businesses in a banking system dominated by the *Hausbank* (the business enters into a long-term relationship with one main bank which has access to privileged information). Hence, at a macroeconomic level, we have credit rationing, i.e. a reduction in the amount available without an increase in interest rates. This is confirmed by the *Unternehmensfinanzierung* for 2003/2004 (most SMEs attribute the shortage of available credit to a stricter analysis of finances and higher collateral requirements rather than higher interest rates, whereas few large businesses alluded to the constraint of collateral).

⁶ "The development of bank lending to the private sector", Deutsche Bundesbank, Monthly Bulletin October 2002 and "The slowdown in German bank lending - revisited", Dr. Thorsten Polleit, in "Droht eine Kreditklemme in Deutschland - was sagen die Daten?", KfW-Workshop October 2003. Both consider that the majority of the reduction in banking credit issued to businesses is due to fluctuations in long-term demand for credit. However, Hiltrud Nehls and Torsten Schmidt, "Credit crunch in Germany?", RWI discussion paper n°6, 2003, conclude that there is a credit crunch (defined as a restriction in credit supply that is not in line with market interest rates and the profitability of investment projects) with interruptions since 2001. This rationing of demand for credit is explained by the fall in bank profits due to the equity market slump, with the policies of the four leading commercial banks being particularly restrictive. The authors believe that the renewed pick-up of equity markets will help to stop this rationing of demand for credit.

This situation, which he considers “dramatic”, led the *KfW* chairman, Hans W. Reich, to vehemently criticise banks’ lending policy. However, the improvement in commercial banks’ earnings should gradually put an end to this. Also worth mentioning is that the switch to the new regulatory ratios defined by Basel II in 2006, for which German banks are more prepared than other eurozone banks⁷. This will require the establishment of credit ratings specific to SME; these will measure risk more accurately than in the past but also enable a better differentiation between return on investment projects within *Mittelstand* as well as leading to greater transparency in banks’ financial decision making (according to *Unternehmensfinanzierung 2003*, 70% of businesses surveyed know the rating criteria of their bank and, among companies who know their rating, three quarters agree with it).

...despite public aid

Aware of the financial difficulties facing SMEs, the government has introduced support measures to help them. As part of the Agenda 2010, the *Initiative pro Mittelstand* includes:

- the creation of a special bank for SME credit, the *Mittelstandsbank*, through the merger of the section of *KfW* working in this area and the *Deutsche Ausgleichsbank* on July 1st 2003 (in 2003, it provided EUR 9bn in preferential-rate loans to businesses with turnover of less than EUR 500m);
- as part of the *Initiative Finanzstandort Deutschland*, *Mittelstandsbank*'s March 1st 2004 launch of a mezzanine loan programme (*Unternehmerkapital*), which is underwritten by the *KfW* and does not require the borrower to put up any collateral. Commerzbank and DZ Bank are already involved;
- an attempt to encourage banks to lend to SMEs: *KfW* has launched *Mittelstand* credit portfolio securitisation programmes (*PROMISE* in 2000 and 2001; *True Sale Initiative* at the end of 2003 with securitisation from a credit pool set up by 13 banks).

As of this year, *Mittelstand* will benefit from stable social security contributions, which is important as labour costs account for a greater proportion of spending than they do for large businesses (22% of all costs in 2001, compared with 14% for large businesses), as well as a relaxation of the law on redundancies for companies with less than 10 employees (previously five).

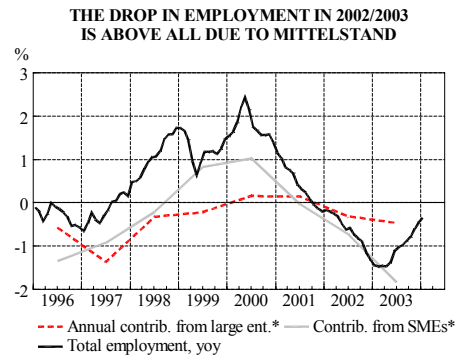
Measures to encourage individual entrepreneurs and artisans were also approved in 2003: as part of the tax cuts introduced on January 1st 2004, an increase in the tax threshold for SME to EUR 350,000 of turnover and EUR 30,000 in profit; aid for the unemployed in setting up their own businesses (*Ich AG*), though this only reduced unemployment by 72,500 last year; lowering the number of disciplines in which professional certificate (*Meisterbrief*) is required from 94 to 41; simplification of administrative procedures in starting up a business.

A situation weighing on investment and employment

As SMEs account for a significant percentage of investment, the lack of improvement in their profits and the difficulty with which they are

⁷ The association of savings banks has developed a standardised rating system for SMEs, which all savings banks started to use in 2002/2003: Peter Konesny, Deutscher Sparkassen- und Giroverband “Basel II and the savings bank sector” workshop at the CIRAC, May 12th 2004

faced in obtaining credit will limit capital expenditure growth, further weighing on the faltering German recovery⁸.



* calculated on the basis of partial data on employees required to pay social security contributions on June 30th each year (i.e., for June 30th last year, 27 million jobs of a total of 38.2 million). In this figure, *Mittelstand* refers to businesses with less than 500 employees.

More than any other type of company, *Mittelstand* shape employment trends: they caused the improvement in 1999 and 2000 and the contraction in 2002 and 2003. This is more due to the fall in staff numbers at medium-sized enterprises than bankruptcies of sole proprietors.



The absence of any real improvement in *Mittelstand* profits will hold back the employment recovery. Although the *KfW* indicator on SME hiring intentions has been above its long-term average since February, SMEs are unlikely to risk recruiting new staff at a time when the outlook for demand is uncertain (it should be noted that this indicator is calculated on the basis of enterprises preparing an investment project with *KfW* and who are therefore expanding. Furthermore, it is possible that this increase is merely a correction of the sharp, and perhaps excessive, fall of late 2003).

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⁸ According to the *KfW*'s 2003 *Unternehmensfinanzierung*, of all businesses with an investment project, 65% of those with turnover of between EUR 2.5m and EUR 10m have asked for a loan to finance it. This figure goes down to 56% for businesses with turnover of between EUR 10m and EUR 50m and to 39% for those with turnover of over EUR 50m.