

Competitiveness and Financing of German Medium-sized Businesses

Survey

Competitiveness, Trends in Markets and Financing, and
Attitudes towards Private Equity Investors

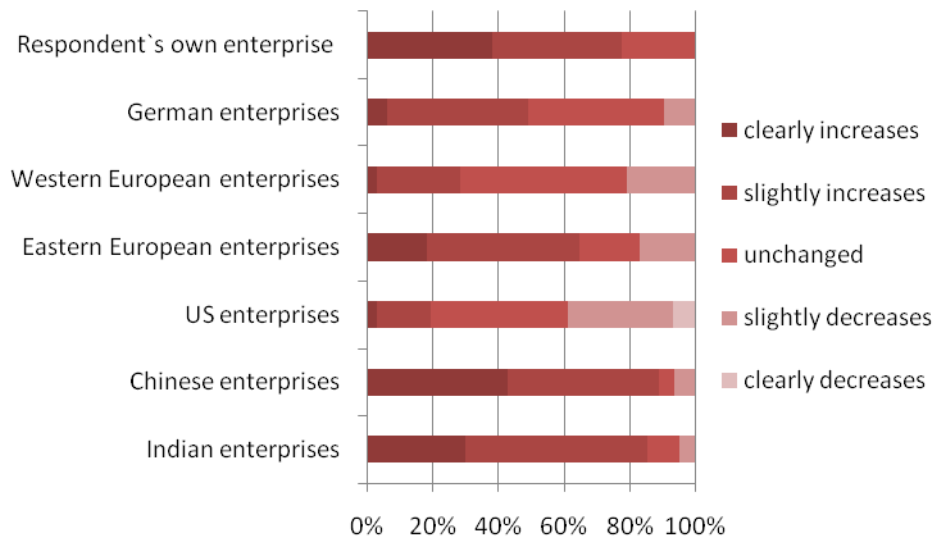
Survey of Entrepreneurs 2011:

German medium-sized businesses are on a par with Chinese companies, but market changes demand a significant amount of investment and capital.

German medium-sized businesses consider themselves well positioned for the future, expecting to improve their market position in the next five years. Of the 73 entrepreneurs from various sectors who took part in the survey conducted by the German professional magazine Markt und Mittelstand on behalf of the private equity firm Hannover Finanz, 38 per cent expect their company to be significantly more competitive by 2016 compared to the present. A further 40 per cent expect at least a slight improvement in their competitiveness.

The participants consider that only Chinese companies are likely to become even more competitive than their company itself. Indian companies are expected to gain in competitiveness as well, whereas US and Western European companies are seen as the main losers. German companies in general - excluding their own company - are also expected by the participants in the survey to improve only slightly in competitiveness.

Development of Competitiveness until 2016



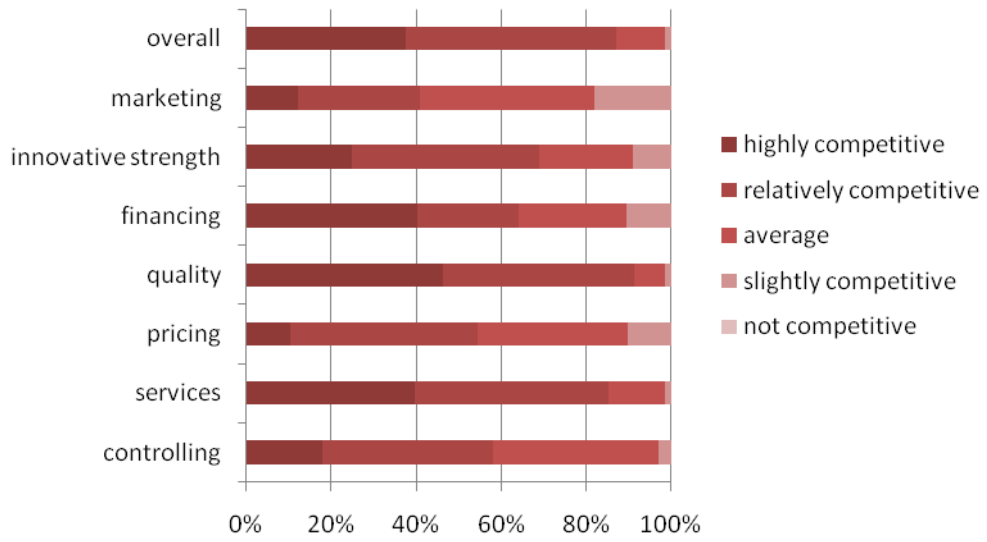
n=73

Source: "Markt und Mittelstand" Research

Even today, the companies surveyed consider themselves well positioned in most areas, with above-average competitiveness especially in the fields of product quality, services and innovation. Weaknesses, however, are identified in the areas of marketing and pricing. In the field of financing, the answers suggest a certain polarization: two out of five companies assess themselves as highly competitive in this category, but almost the same number of businesses regard themselves as merely average or below.

Companies that are international or national market leaders set themselves apart from their competitors: In the fields of quality, innovation, controlling and pricing, they are much stronger. Again, the companies surveyed considered themselves more competitive in the various fields than German companies in general. Only the fields of innovation and quality stand out from the rather undistinguished overall impression.

Divisional Competitiveness



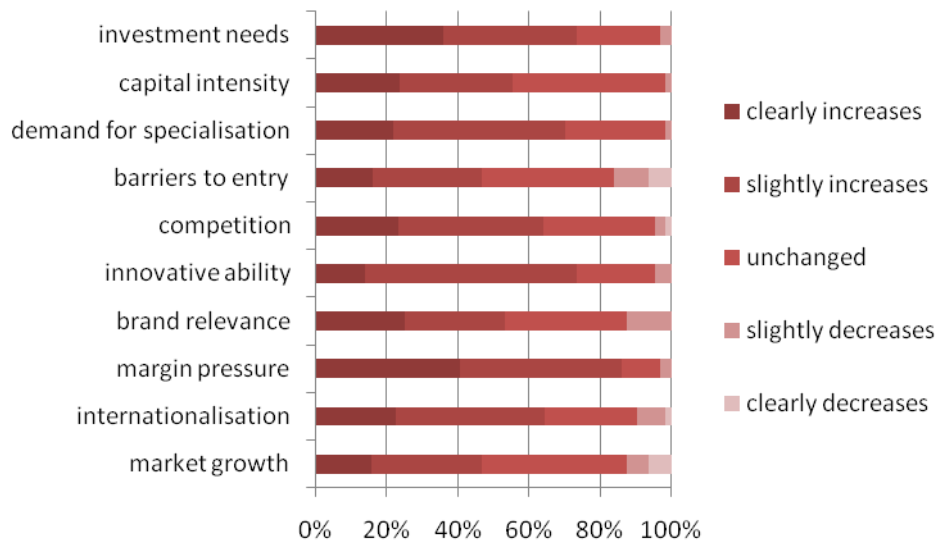
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Source: "Markt und Mittelstand" Research

To improve their competitiveness as expected, and to generate growth, the companies will have to adapt to changing market conditions and rising challenges in the coming five years. Almost 90 per cent of the participants in this survey expect increasing pressure on margins, and just under half of them assume that the increase will be substantial. After the years of reticence during the global economic and financial crisis, the need for investments is expected to grow significantly in the five years ahead.

The nature of the business polled has no effect on the market changes expected. No matter whether the company is a specialist or allrounder, an innovator or late adopter, a quality leader or price leader, they all expect rising pressure on margins to be the most significant change. It is however interesting that specialists, innovators and quality leaders expect the changes to be considerably more serious than their respective counterparts do.

Expected Market Changes until 2016



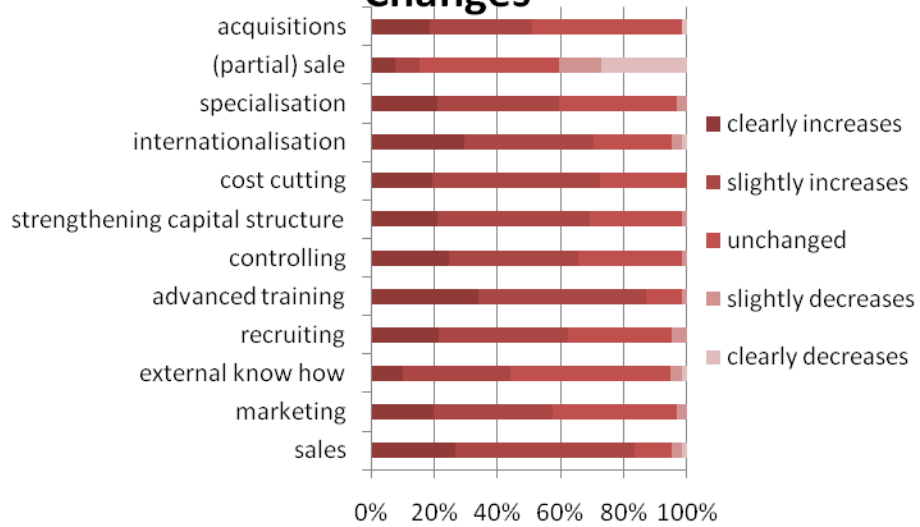
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Source: "Markt und Mittelstand" Research

As the businesses face the need to adjust to the challenges and market changes ahead, there is however no clear strategy as a reaction to the rising pressure on margins and need for investment. Instead, the companies are planning a broad range of activities. A third of the participants in the survey plan to stress internationalisation, another third want to improve the advanced training of the workforce. 20 percent plan major improvements in each of the fields of specialisation, controlling and sales. All in all, an increase in activities is planned in every area covered by the survey.

The companies expecting a very strong increase in their competitiveness by 2016 also demonstrate a higher level of commitment. They are planning above-average improvements in internationalisation, specialisation and cost-cutting, and want to hire more employees. About 40 percent of them plan to significantly strengthen and broaden their sales and marketing.

Reaction to expected Market Changes



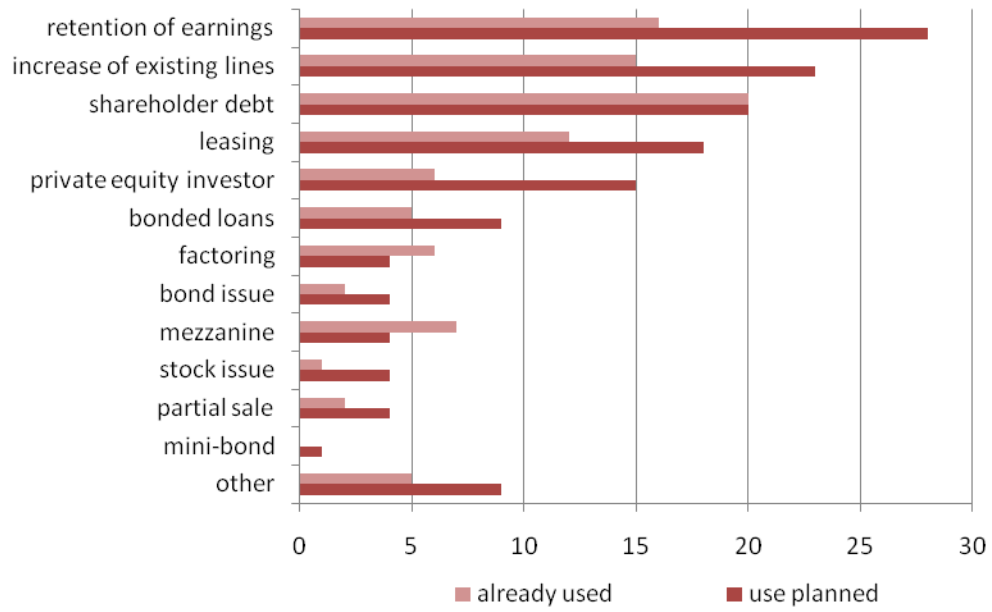
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Source: "Markt und Mittelstand" Research

For almost a third of the companies, modernisation and enlargement of production capacities is the biggest investment project within the next five years. Furthermore, 22 per cent want to invest in the expansion of their distribution network; 19 per cent want to invest in external growth via M&A; and 15 per cent want to invest in the expansion of their own production facilities. More than two thirds of the companies surveyed expect an additional capital requirement of at least EUR 1 million to finance growth projects and changes as planned. Almost 30 per cent even expect additional capital needs to be EUR 10 million and above.

Their capital requirements are planned to be financed first and foremost by the retention of earnings and the increase of existing credit lines. Shareholder loans also remain a popular method among medium-sized businesses. But more and more medium-sized companies are willing to make use of alternative financing methods such as leasing or issuing bonded loans. Remarkably, in the light of the existing financing structure, about 20 percent of the enterprises questioned are considering taking a private equity investor on board.

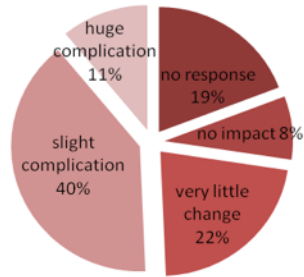
Means of Finance



n=73

Source: "Markt und Mittelstand" Research

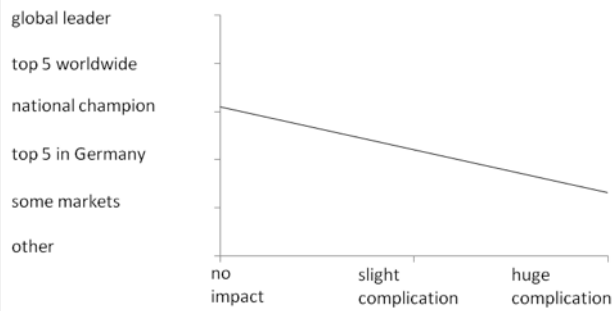
Expected Impact of Basle III on the Ease of Borrowing Capital



n=73

Source: "Markt und Mittelstand" Research

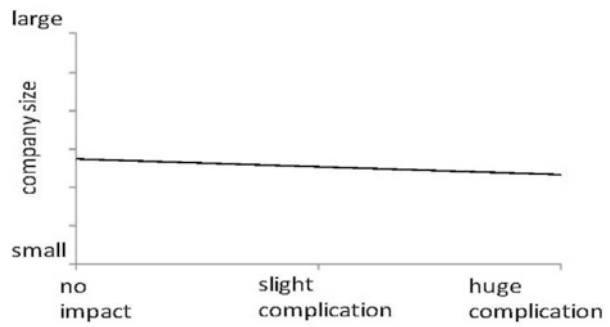
The Good Ones go into the Pot ...



n=73

Source: "Markt und Mittelstand" Research

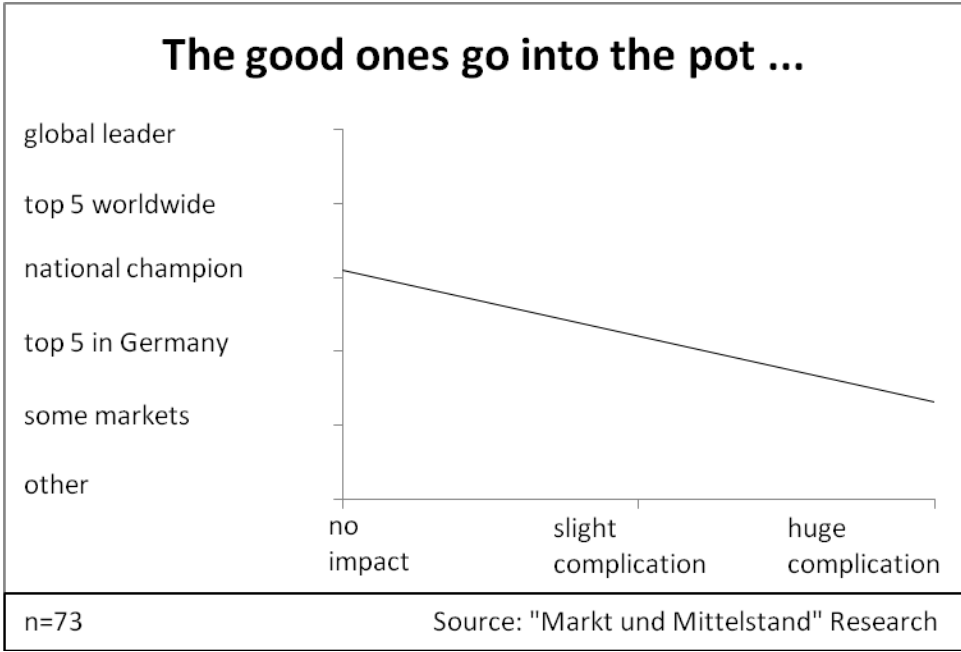
Size not critical



n=73

Source: "Markt und Mittelstand"-Research

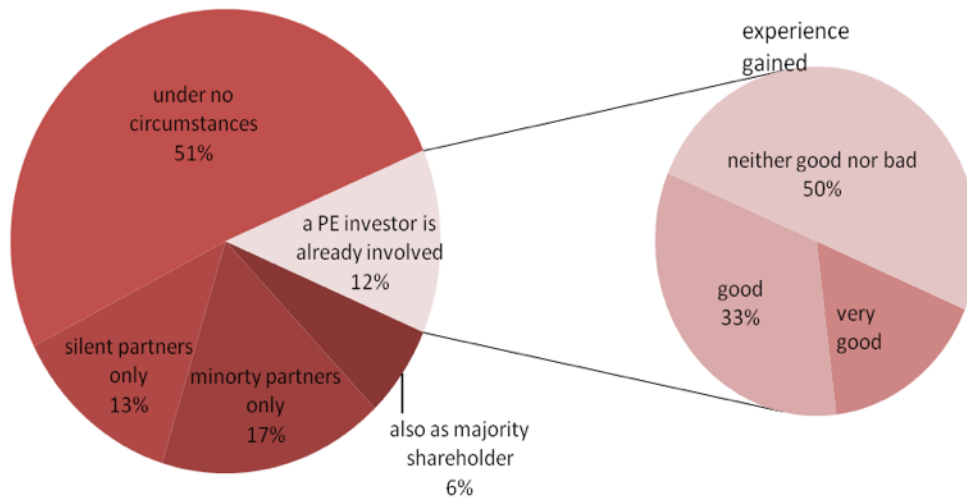
The majority of the companies fear that the increased equity requirements for banks (Basle III) will have a negative impact on the ease of borrowing capital. Yet, only about 10 per cent expect significant complications.



As to the financing mix, private equity investors are becoming increasingly attractive to the participants in the survey. Around half of the entrepreneurs questioned can fundamentally envisage working with a private equity investor or are already doing so. However, a certain amount of caution remains: 30 percent of the companies can imagine a private equity investor as a minority shareholder or silent partner. 6 percent can also envisage a private equity investor holding the majority of their shares. 12 percent of the participants are already cooperating with a private equity investor, and their experiences are predominantly favourable.

When seeking an investor, the medium-sized businesses polled are thoroughly conscious of the differences between private equity firms. The time horizon is the most important selection criterion, followed by sectoral expertise and the investor's tradition and track record. The nationality of the private equity firm, in contrast, is hardly of any significance. Companies mainly expect the professional investors to help them with financing. Two thirds of the participants absolutely expect support in this field. While companies may be willing to accept support from a private equity investor in the areas of strategy, human resources and controlling at least under some circumstances, they are reluctant to hand over operational responsibility.

Co-operation with Private Equity Investors



n=47

Source: "Markt und Mittelstand" Research

Summary

The results of the survey show that German medium-sized businesses expect significant market changes within the next five years. In particular, the companies surveyed assume there will be increasing pressure on margins as well as rising investment needs. If they are nevertheless to strengthen their competitiveness in these surroundings, they will have to, and are planning to, expand their activities significantly in all fields.

For that purpose, the majority of the participants anticipate an increase in their capital requirements of at least EUR 1 million. Many even expect a need for additional funds in the amount of EUR 10 million and above. The most important single project in the current recovery phase is the modernisation and enlargement of production capacities, closely followed by the expansion of the distribution network and M&A activities. Cash flow, bank loans and loans from shareholders remain the most favoured means of financing. The anticipated obstacles to credit access resulting from the increased equity requirements of banks (Basle III), and the amount of funds required, are however making it necessary to seek alternative sources of financing. Together with leasing and bonded loans, significantly more medium-sized businesses than in the past are considering the involvement of private equity investors. The companies look to those investors above all for support in financing.

Around half of the companies surveyed can fundamentally imagine working with a private equity investor or are already doing so. In spite of this development and although those who have already gained experience with private equity investors predominantly rate the cooperation as favourable, medium-sized companies are still uncertain with respect to private equity. Participation by a private equity investor as a silent partner or minority shareholder therefore remains the preferred mode. Furthermore, the companies surveyed expect an appropriate time horizon for that participation and are keen to keep control of their operational activities.

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