

How the *Mittelstand* measures up

Dr Peter Horn and Axel Beeck report on current developments among Germany's vast pool of medium-sized private companies

For many decades, medium-sized German companies represented an important indicator of the economic situation and the growth of German industry. This role appears to have changed dramatically during the last two to three years. The lack of a successor in a family-owned company often used to be the main reason for the sale of a firm. Today, there are many other external factors which are more important.

Car component manufacturers

Members of ABN AMRO Intercontact have been advising a number of mandates from the car components industry in recent years by focusing mainly on steel processing and plastic parts production. In these areas, the typical German *Mittelstand* companies have been exposed to enormous pressure – rarely found in other industrial sectors – from two fronts.

The first is from key customers in the global automotive industry. These include direct domestic and international competitors, and the relatively strong international suppliers of systems. The second is the economic and financial pressure caused by factors such as economic cycles, raw materials, wages, currency, international networking, financial power and so on.

Car manufacturers have already given many component suppliers a tough time by demanding 20 to 30 per cent cost reductions, to be achieved within 12 to 18 months. Furthermore, the producers have decided to co-operate in future with only a limited number of so-called system suppliers (between 100 and 150 companies). Many of these have succeeded in changing from being simple producers of components to suppliers of systems and complete

units during the last ten to 15 years.

Following the increasing globalisation of the automotive industry, these system suppliers not only had to become international, but also had to accompany the big car producers in their expansion into regions underdeveloped so far by the automotive industry.

More and more financially strong system houses and suppliers are arriving in the German market from abroad. On the one hand, they can enjoy certain cost advantages due to the currency situation, and, on the other hand, they can aim at the fairly large slice of the German market where a small market share already represents a sizeable volume.

All these negative factors, already critical for the *Mittelstand* car components producers, were overshadowed in recent years by the economic recession, with the result that some of these firms had to close. Since many of them are also located in areas with a high unemployment rate, this development could lead to a critical macro-economic situation for some regions of Germany.

If these companies want to survive, they have to increase the added value of their products: for example, by offering new lines with improved technology in connection with the development of subsystems, or smaller units on the basis of the components produced so far.

Another way of survival can be found by entering strategic alliances, co-operations, stock swaps with other companies, or similar forms of restructuring, in order to create a group of companies with a critical mass and a critical volume. Presently, the critical sales volume is about DM200 to 300 million; it is likely that this volume will increase during the next three years to more than DM500 million.

In addition, there will continue to

be room for some companies in niche markets. However, the majority of car component producers will be endangered if they continue to stick to their present company policy and culture.

Tourism

Travel agencies and tour operators have also fallen victim to an increasing internationalisation of the leading suppliers. For Germany, the purchase of Thomas Cook in 1992 by Westdeutsche Landesbank was the beginning of a large number of takeovers. The last transaction in this sector two months ago was the takeover of ITS by the consumer goods distribution chain REWE.

The big-volume operators look like they are able to achieve satisfactory profits. Airlines and hotels demand from the tour operators and travel agencies, respectively, a minimum number of seats and rooms. Thus they try to pass on business risks to their customers. In case these quotas are not reached by the operator or agency, it is increasingly common that they will receive less favourable prices or might not even be listed as customers in future.

To illustrate this situation further, even a medium-sized tour operator, which is able to fill a 200-seat plane once per day during the main travel season, may not be large enough to reach a critical sales volume and hence obtain the most favourable conditions.

Furthermore, tour operators and travel agencies have to invest heavily in computer equipment and software in order to comply with the modern requirements of real time and on-line booking systems.

As a consequence, the German travel market will very soon be dominated by only five to six major chains each of tour operators and travel agencies.

Insurance

Even the insurance broker market, a niche market in Germany, has to face dramatic changes. In particular, the industrial insurance brokers have already lost ground and clients to larger houses with a clearly international orientation. Foreign brokers have started to create international networks over recent years and are able to advise their clients on a worldwide basis.

In the past, the personal relationship between client and broker was significant. But, due to the increasing globalisation of the insurance markets, this has become less important. In particular, the large corporations expect assistance from brokers in many parts of the world. Today, only a very small number of German brokers are able to offer this service.

Some large German corporations went one step further and established an in-house broker or, as in the case of Debis (Daimler-Benz), are buying out broker houses to turn them into in-house operators.

Of the top ten insurance brokers in Germany, only two have no foreign financial partner. The trend of foreign insurance brokers buying out medium-sized German companies in this field looks set to continue, particularly in view of the upcoming deregulation of the European insurance market. Not surprisingly, the Anglo-Saxon broker houses are the most active ones in searching for appropriate acquisition targets.

Fight for survival

The main concern for medium-sized German companies in future years will be how to survive rather than how to find a successor.

There is also a trend towards concentration in construction, environment, the media and pharmaceuticals.

Even an orientation towards niche markets does not guarantee survival, as the insurance broker firms show. Many large corporations are seeking new areas of activity, and are expanding from their traditional line of products and activities into new fields, as in the German telecommunications industry where Mannesmann, Veba, Thyssen and other companies are active and successful market leaders, having originally come from rather different industrial backgrounds.

Strategic alliances among medium-sized companies are able to reduce costs for the development of products, sales and marketing, purchasing and



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manpower. In view of the increasing internationalisation of markets, the selection of a partner is not limited by boundaries.

Today, partners do not have to be domestic companies: it is often more meaningful to liaise with a foreign partner in order to achieve a more global reach in the form of an international corporation. Also of interest are certain tax aspects whereby the headquarters of the partnership or holding company could be abroad for tax reasons. For instance, partnerships with companies from the Mediterranean area look rather attractive and will give German partners sizeable advantages in their production costs.

The experience of the last few years has shown that foreign companies, in particular from the Anglo-Saxon countries, as well as from France and Italy, are increasingly seeking partners for co-operation in Germany. In view of the peculiarities of German industry, these partners are interested in co-operations with *Mittelstand* companies and capital investment is not ruled out.

For medium-sized German companies, such co-operation provides an opportunity to exploit their knowledge of products and markets by distributing their products via the foreign partner in other international markets. In addition, the foreign company can bring in capital for further expansion of the business activities of the German partner.

A capital increase for the desired expansion or capital connection via stock swap with another medium-sized company can also be carried out by a financial investor. During the last



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five years, the number of investment companies in Germany has risen remarkably, leading to healthy competition for the best projects.

The *Mittelstand* company seeking additional capital today is lucky enough to have a number of choices which ultimately mean better financing conditions. Many investment firms, however, are avoiding turnaround situations and the medium-sized partner company has to be in good shape financially to be considered for a capital injection. Also interesting is the trend among German investment firms towards investing only in selected branches, thus creating small groups of companies with a critical volume and size.

In future, the typical German *Mittelstand* company has to become more flexible. This means being more open to contacts and discussions about co-operation, whatever form it might take. Of course, such mental flexibility also includes thinking about a possible sale – a thought which not too long ago was almost heretical in Germany.

The period of dramatic change and restructuring in Germany is not over yet and there will be many more takeovers, joint ventures, strategic alliances and co-operations to come. However, the *Mittelstand* companies have to present themselves in better shape and be alert for a suitable partner if they want to survive in this severe period of restructuring. □

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