

# Germany's Driving Force in Corporate Real Estate Spells SME

## INTRODUCTION

BEOS Survey is an analytic series that reports quarterly on the latest in corporate real estate, also covering the related segments of industrial, manufacturing, and logistics real estate.

This issue of BEOS Survey takes a closer look at Germany's small and medium-sized enterprises (SME) in their role as the German economy's powerhouse, and as one of the country's largest demand groups for corporate real estate. To this end, we will analyse the function and significance of these mid-market companies for the German economy. Moving on, the survey will study the ways in which small and medium-sized enterprises handle the business property issue.

## HOW DO YOU DEFINE AN SME?

Standard definitions of SMEs in Germany include the approaches of the IfM Institute for SME Research in Bonn or the EU Commission that are applied by the Federal Ministry of Economic Affairs and Energy.<sup>1,2</sup> For the purposes of this BEOS Survey, the term SME shall refer to companies with 10 to 500 employees, and with an annual turnover of up to 50 million euros.<sup>1,2,3</sup>

		Social-security covered jobs			
acc. to EU	Turnover in euros	0 - 9	10 - 49	50 - 249	250 and more
	up to 2m	very small	small	medium	large
	more 2 and up to 10m				
	more than 10 and up to 50m				
	more than 50m				
acc. to IfM Bonn	Turnover	0 - 9	10 - 499	500 and more	
	less than 1m	small	medium	large	
	1m to just under 50m				
	50m and up				

Fig. 1: Company categorisation according to the IfM Bonn<sup>1</sup> and the EU<sup>2</sup> (source: IfM Bonn, 2013; EU, 2006)

Many small and medium-sized enterprises are family-owned businesses. These are textbook examples of

long-term corporate strategies and conservative, largely equity-financed business models. The approach is inspired above all by a family's identification with its business and the personal commitment that comes with it.<sup>4</sup>

Mid-market companies and family businesses are both generally credited with special attributes: a certain affinity to trend-setting technologies, export-driven production, international networking, close proximity to customers, and a historic rootedness within the region, long-term business policies and investments, sound financing models, crisis-resistance, and the promotion of young talent.<sup>1,2,3,4</sup>

## MID-MARKET COMPANIES – THE DRIVING FORCE OF GERMANY'S ECONOMY

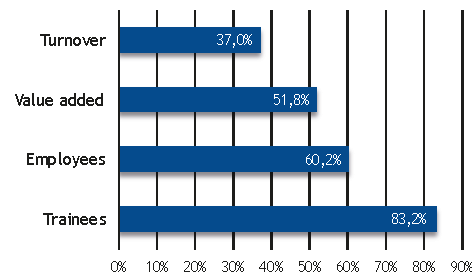


Fig. 2: Nationwide share of German SMEs, in percent, 2012<sup>3</sup> (source: BMWi, 2013)

In 2012, Germany's SME accounted for 37 % of the turnover, and an actual 51.8 % of the value added.<sup>3 4</sup> Yet it is in the area of employment that mid-market companies play a particularly prominent role. With a share of more than 80 % of the trainees, they contribute more than any other group to the promotion of young talent, and thus help to ensure the economy's continued competitiveness. Employment in general is clearly dominated by mid-market companies, which account for well over 60 % of all jobs in Germany. Traditionally, they are often rooted in a certain region, and fiercely loyal to their workforce. Which results in particularly stable employment relationships.

This is clearly suggested by a look at job growth and economic growth between the onset of the crisis in 2007 and the beginning stabilisation in 2010.<sup>1,3</sup> With a view to the gathering momentum of the German economy, the BVMW German Association for Small and Medium-Sized Businesses expects to see a substantial increase in economic output in 2014, and predicts the creation of around 250,000 new jobs (not including redundancies) in mid-market companies.<sup>5,6</sup>

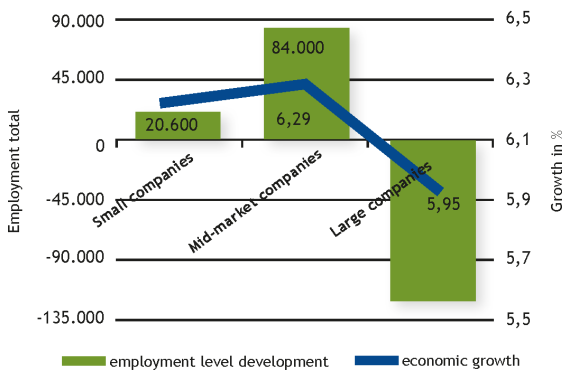


Fig. 3: Balance of the employment and economic output trends between 2007 and 2010 by category of enterprise<sup>3</sup> (source: GE Capital 2012)

The intense personal commitment of the senior executive level to the company results in a tendency to avoid short-lived trends, and to exercise prudence when adjusting the corporate strategy and exposure, while prioritising sustainability. That said, the relatively risk-averse business and employment policy does not stand in the way of an innovation- and export-driven orientation. In fact, the two coincide. For it is precisely the innovative strength of SMEs that ensures long-term economic stability, and with it a sustainable employment policy.

Among the special fortes of mid-market companies is their aptitude for international networking and exporting. It is explained above all by the aforementioned corporate strategy parameters. Compared to other countries, Germany thus shows an unusually high density of companies whose innovative strength has made them the global market leader in their respective niche segments. Since these companies get not nearly as much media exposure as large corporate groups have, and are rarely in the public eye, they are known under the moniker “hidden champions.”<sup>4</sup>

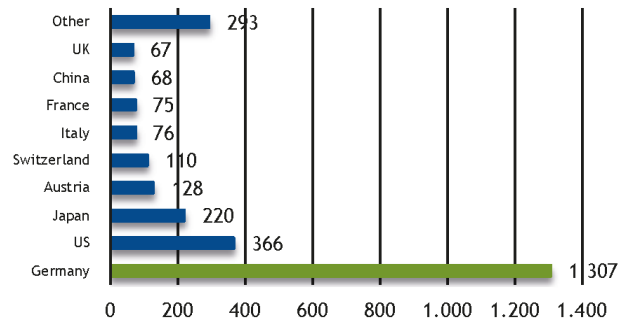


Fig. 4: Number of companies that are global market leaders in their niche segment: “Hidden Champions” in selected countries, as at 2012<sup>4</sup> (source: BMWi, 2012)

Many of these companies used their high-quality commodities to develop the global market as their outlet, generating a worldwide demand. The global demand for industrial goods made in Germany are in turn much more crisis resistant, especially whenever crises are limited to a certain region or country. The key importance of the export business for mid-market companies is confirmed by the stats: The export sales of Germany's SMEs rose by approximately 42 billion euros or well over 30 % between the years 2000 and 2010.<sup>4</sup>

The economic strength of German mid-market companies is striking when compared to Europe's other two large national economies, France and the United Kingdom. Both in terms of Export sales and in total employment figures or industrial employment, Germany is ahead of its reference countries, in some cases substantially so. Mid-market companies play a particularly dominant role in Germany's industrial sector. Industrial and manufacturing (especially automotive and mechanical engineering), followed by wholesale and retail trade count among the fastest-selling and most profitable SME segments.<sup>3,7</sup>

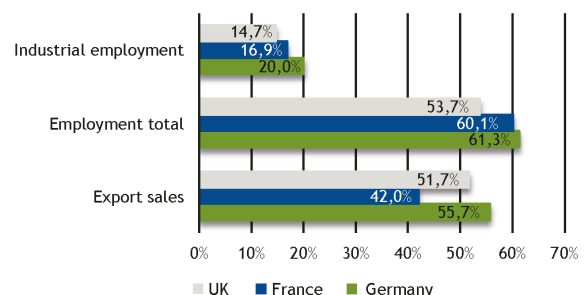


Fig. 5: Pro-rata shares of German SMEs in 2012, in percent<sup>3,4</sup> (source: GE Capital 2012; BMWi 2012)

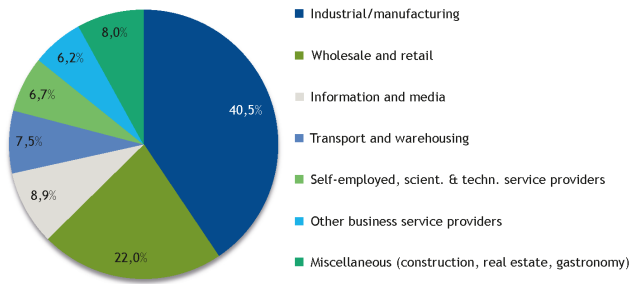


Fig. 6: Pro-rata share of the SME gross value added in 2012, by industry<sup>3</sup> (source: GE Capital 2012)

## SMES TEND TO OPERATE IN COMPANY-OWNED PROPERTIES

Mid-market companies usually use a blend of several floor area types to ensure smooth business operations. In addition to office accommodation for administrative purposes, they require production, storage and general purpose areas. High-tech companies, among others, also need research and development facilities. Retailers and industrials may require showrooms to present their merchandise. Also to be considered are special land requirements, access roads, transportation access and operating parameters (24-hour operation, emission constraints, et al.). Things are different with service providers: These tend to require office accommodation only, and are much more flexible in their site selection as a result.

The requirements thus identified are principally met by corporate properties: While differing in size, their sheer variety ensures that they provide whatever type of accommodation is needed for the smooth operation of a given business. And since mid-market companies account for 60 % of all jobs in Germany, they arguably generate the biggest demand potential for this property segment.<sup>3,4</sup>

### SAFER THROUGH OWNERSHIP?

The potential demand for lettable space is qualified, however, when you look at the ownership rate among mid-market companies. Eight out of ten own their business premises outright.<sup>8</sup> Especially production plants tend to be owned by the SMEs who use them, and the same is true for transport and warehousing space. As often as not, however, industrial properties that were built to purpose a long time ago no longer provide optimal layout structures. As a result of technical innovation and the concomitant in-

crease in efficiency, business premises are naturally subject to a continuously shifting requirements and adjustments. Company-owned properties can therefore hamper the adaptability of companies, whereas accommodation with more flexible structures would enhance it.<sup>9</sup>

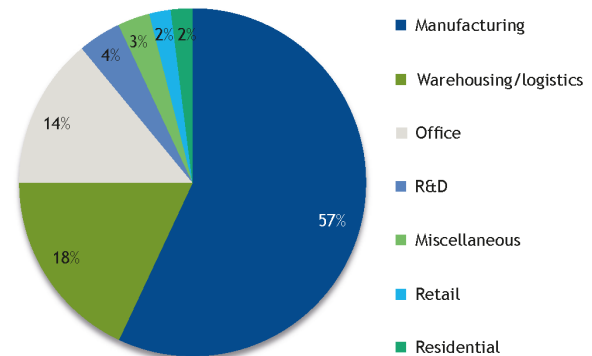


Fig. 7: Average pro-rata share of each floor area type in owner-occupied SME property portfolios<sup>8</sup> (source: EY 2008)

Yet many companies are reluctant to realign their property strategy, and to part with their building stock if necessary. Among the reasons most frequently cited to explain the affinity to property ownership are the independence from the real estate market or from landlords, the desire to safeguard in-house business structures and manufacturing processes, assumed cost disadvantages (rent), or the caveat that the quality could suffer as a result of inferior accommodation. Just as often, though, the scepticism is attributable to inflated estimates of the value of the company-owned properties, and to cluelessness concerning suitable disinvestment strategies.<sup>8</sup>

## SMES UNDERGOING TRANSFORMATION

Unlike in Germany, the percentage ownership in the Anglo-American countries is no more than 30 to 40 %. Major German corporates have already realised the perks of converting owner-occupied real estate into cash, and have lately lowered their percentage ownership down to around 50 % by bringing in a professional corporate real estate management (CREM).<sup>8</sup> Urged by analysts and shareholders to put their equity to more profitable use in their core business, listed companies have been particularly effective in reducing their ownership ratio.

Germany's SMEs are likely to experience an analogous mental shift. Between now and 2020, the senior

management of around 900,000 SMEs in Germany will experience a generational shift. Moving away from the traditional view of company-owned real estate as a safety and autonomy factor, even mid-market companies are more and more willing to embrace the trend toward CREM and leasing solutions.<sup>9,10</sup> The process is expedited by the increasingly professional approach that real estate industry players in Germany have been taking. The objective is to reduce the funds tied up, to increase flexibility, and to scale back the overhead.<sup>8,10</sup>

The generational shift, the generally enhanced transparency of Germany's real estate markets, and the improved quality of the building stock in the sector will combine to produce a mid- to long-term decline in the ownership rate. Harking back to BEOS Survey 05 (Industry 4.0), it is safe to say that ever shorter production cycles, among other factors, will necessitate increasingly flexible accommodation. Instead of raising a building corpus around their operational facilities at their own expense, mid-market companies will hire premises that are flexibly configured to accommodate a variety of different use types and business-critical installations.<sup>10</sup> This type of accommodation is highly versatile, letting its occupiers respond in any of various ways to changed parameters in a business environment where adaptability is increasingly important to maintain competitive edge. Here, the landlord's is limited to installing the use-specific tenant fit-out, e.g. whenever special mechanical services requirements come into play.

## THE LOCATION ISSUE

The emergent trend among mid-market companies suggests rising demand for lettable area in corporate properties. Given the local rootedness of many mid-market companies, however, this creates a new set of issues: Especially companies in southern Germany are domiciled in remote areas that lack a local real estate market.<sup>7</sup> In the absence of both demand and liquidity, selling properties is obviously much harder than it is on established markets. The situation of remote locations will deteriorate even further in the years after 2020 in the wake of the demographic change and the attendant shortage in skilled labour. Long-term, the re-urbanisation trend will expand to include corporates, too. These will be compelled to move closer to the urban centres in order to remain attractive employers and to be able to offer an ur-

ban infrastructure. In doing so, they will prefer to be close to corporate clusters of similar character.

A key advantage in this context is the steady environmental load reduction especially in the manufacturing industry, which opens up new options when it comes to site selection. Efficient production will no longer depend on whether or not a specifically zoned trading estate (land utilisation plan acronym "GE") or industrial area ("GI") is available. Rather, companies may move into more central locations within a given conurbation. In many cities and regions, especially in central locations, the number of plots available for owner occupation is dwindling, though.<sup>10</sup> The tendency to rent is therefore driven by necessity because property ownership has become much harder and costlier. At the same time, it is preferable because there is a larger supply to choose from. But renting has also become easier because the market has become more professional lately.

## CONCLUSION

The aspects discussed highlight the great potential that mid-market companies have as target group for corporate real estate: The high level of employment presupposes a corresponding floor-space volume, while the risk-averse, long-term horizon is conducive to sustainable cash flows. What companies of this type need is a certain floor space mix and accommodation with flexible floor plans. Emergent trends such as Industry 4.0, the generational shift, professional CREM, and re-urbanisation increase the dormant potential of corporate real estate for mid-market companies even further. For providers, the situation implies great opportunities as rising demand coincides with a relatively limited supply.<sup>10</sup>

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### CREDITS

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