

German Mittelstand: what next?

By

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Small and medium-sized enterprises (Mittelstand) from the German-speaking region have made skilful use of the opportunities offered by developing markets. Thanks to successful business models, they have been able to achieve above-average growth in recent years and develop into niche market leaders (see Chart 1).

Five critical success factors have allowed the Mittelstand to build leading positions in global niche markets:

- Excellent product quality combined with a “Made in Germany” image;
- Innovative strength and technological leadership;
- Competitive organisation of the value chain;
- Efficient logistics with short delivery times;
- Above-average service offering.

The success of SMEs in niche markets should also be considered in the context of how larger markets have developed. In consumer electronics, for example, almost the entire Western industry has disappeared. Emerging Asian challengers – initially from Japan (Panasonic, Sony) and South Korea (LG, Samsung), then from China (Lenovo, Haier) – started by dislodging Western competitors from high-volume segments through lower costs. They then positioned themselves successfully in Premium Segments, often through acquisitions of Western companies that lacked strategic alternatives.

Could such changes also occur in those markets where the Mittelstand has become spoilt by success? To what extent are they genuine niche markets, offering little room for volume strategies, meaning that risks for the Mittelstand are low? In that case, is there sufficient growth potential for the niche market leaders?

These questions are strategically important for the future of many Mittelstand companies. To answer them, we need to take a brief look at what has happened in the past.

Until a few years ago, customer structures in developing markets could be described more or less as follows:

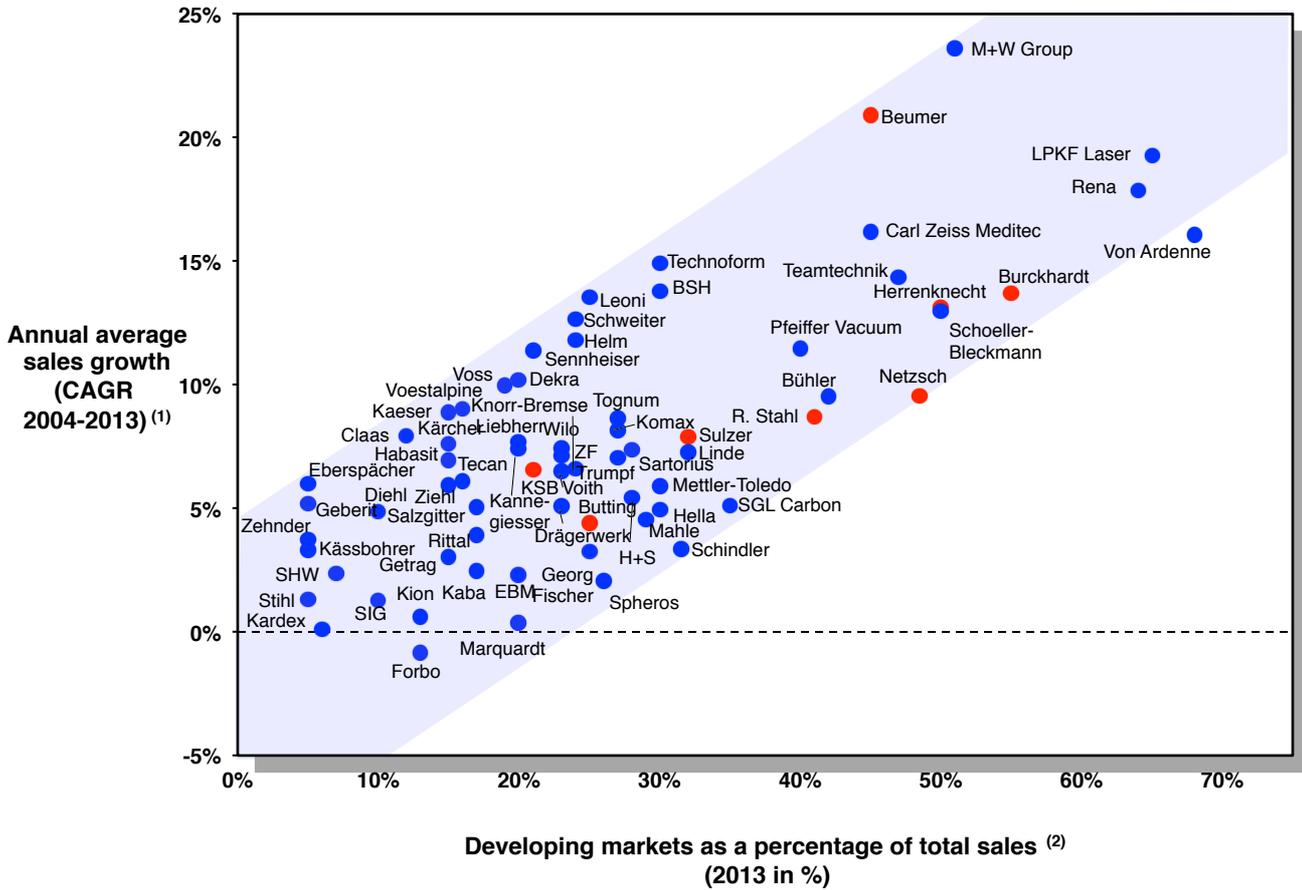
- Customers who are willing to pay a premium in the expectation of more reliable products and services;
- Customers with limited financial resources who focus on cheaper, local alternatives.

For many niches in developing markets, this dual situation has in recent years led to a pyramid structure with three fundamentally different quality and price segments (see Chart 2):

- *Premium Segment*: with a market share of around 10-30% (of total market value), demand for higher-quality goods, features that satisfy international standards, imported components with (partly) local final assembly, dominated by the German Mittelstand.
- Core market segment or *Mid-Range Segment*: with around 30-40% of total market value, demand for product design similar to the Premium Segment, but with limited features, lower-quality components, mainly local sourcing and manufacture, 30-50%

- Chart 1 -

Niche market leaders from the D-A-CH region have benefited strongly from growth in developing markets



- CAVEAT -
 List of select industrial niche market leaders from the D-A-CH region in global markets. Data estimated if none published

● Companies that operate directly in developing markets
● Companies that benefit indirectly from growth in developing markets (oil and gas, mining sector, etc.)

(1) Excluding Bühler (2004-12), Herrenknecht (2005-12), Kannegiesser (2004-11), Rena (2007-12), Schott (2004-12), Sennheiser (2004-12), Wilo (2004-12), Burckhardt (2004-12), M+W Group (2009-12), Netzsch (2004-12), Teamtechnik (2006-12), VON ARDENNE (2004-12), Butting (2008-12), Spheros (2006-12), ZF Friedrichshafen (2004-12), MAHLE (2004-12), Voith (2005-13), Tognum (2006-12), Technoform (2005-12), Liebherr (2004-12), Eberspächer (2008-12), Helm (2004-12), KION (2006-13), Sonova (2004-12), Kässbohrer (2004-12), GETRAG (2004-12), Ziehl-Abegg (2006-12), BSH (2005-12), HELLA (2005-13), Diehl (2006-12), EBMPapst (2006-12), voestalpine (2004-12), EKATO (2008-12), Dekra (2004-12), Kaeser Kompressoren (2004-12), Marquardt (2008-12), SHW (2007-13), Voss Automotive (2005-12), Beumer (2004-12), Habasit (2004-12), SIG Combibloc (2008-12), Stihl (2006-13), Alfred Kärcher (2005-12);

(2) Emerging Asia including China, Latin America, Russia, Central Asia, Africa, Middle East.

Sources: Orbis, German Federal Gazette, annual reports, Bloomberg, Estin & Co analyses and estimates

lower prices compared with the Premium Segment, dominated by local manufacturers (or imports from e.g. South Korea or Taiwan);

- *Low-Cost segment*: with around 30-60% of total market value, demand for significantly lower-quality products, modest features and limited lifespan, prices 30-50% lower than the Mid-Range Segment and completely dominated by local manufacturers.

The rapid development of the Mid-Range Segment is normally led by local manufacturers and is based on the following four competitive factors:

- Lower production costs, initially due to a higher proportion of – and more efficient – local sourcing as well as greater product standardisation, followed by economies of scale resulting from market share gains;
- Simplified product design, derived from market leaders and innovators, but with limited features;
- Optimised local distribution network, thanks in part to more flexible methods, such as joint ventures with local distributors;
- Better support from local authorities as well as collaboration on product development.

At the same time niche market leaders from the German speaking region also succeeded in achieving strong growth rates of more than 10% p.a. in developing markets as a result of growing local demand, market share gains through consolidation of the Premium Segment and, in some cases, substitution of the Low-Cost Segment.

However, with growth in demand remaining weak in saturated markets and stronger challengers emerging from developing markets, it will be increasingly difficult for the Mittelstand companies to maintain current growth rates in the future.

The threat emanating from the rapidly developing Mid-Range Segment and from leading (Asian) competitors needs to be understood on two levels:

- Consolidation of developing markets;
- Positioning of Asian Mid-Range competitors in the Premium Segment.

Consolidation of developing markets

The larger the “niche” of the relevant industrial goods market, and the more it is characterised by economies of scale, the more likely it is that a strong Mid-Range Segment will develop and be consolidated by (Asian) cost leaders. Although many niche leaders are still the largest competitors overall, the rapid growth of the Mid-Range Segment in many markets plays into the hands of Asian manufacturers, which are able to further reduce their costs through economies of scale and win market share. The more the Mid-Range Segment is consolidated, the harder it becomes for the Mittelstand companies then to gain a foothold in this segment and achieve growth in developing markets, especially since in many cases they are still in the process of adapting their business model and repositioning takes considerable time (see Chart 3).

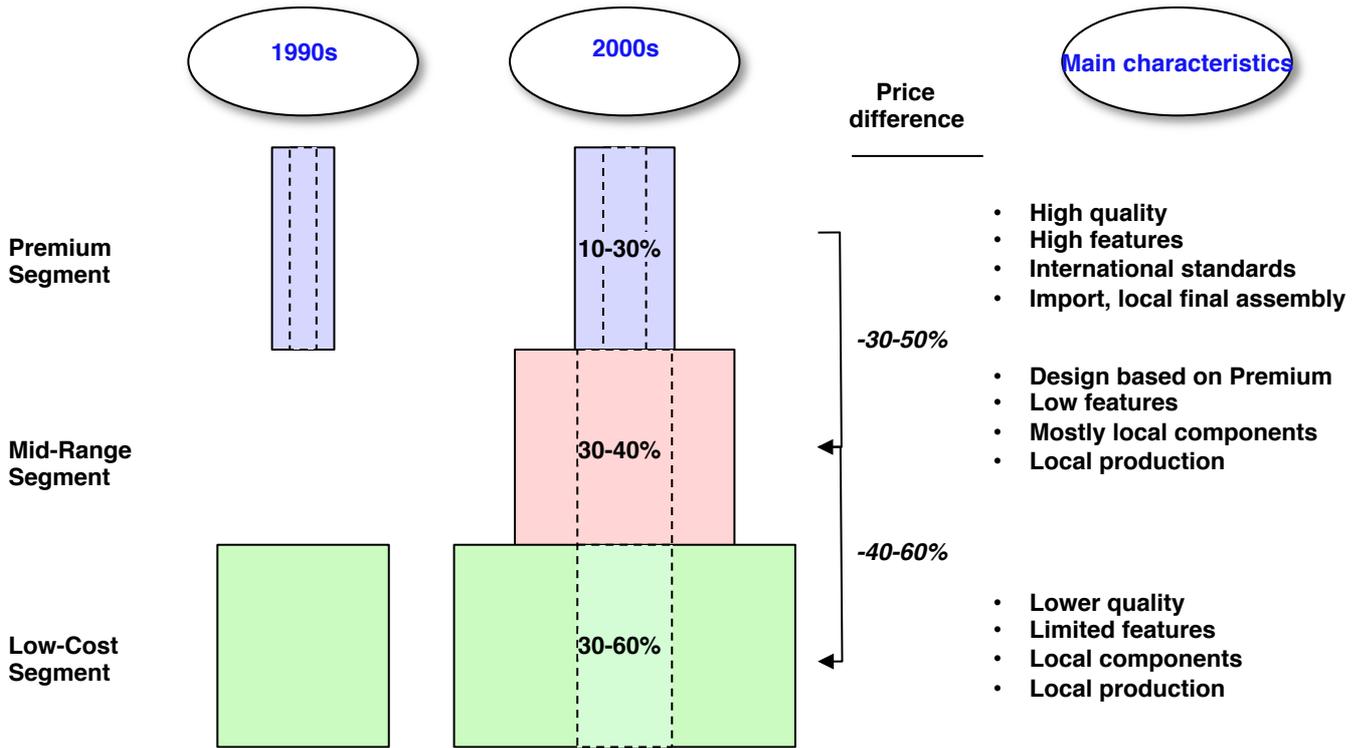
Positioning of Asian Mid-Range competitors in the Premium Segment

Experience in larger markets has shown that challengers in developing markets are successful not just in pursuing volume strategies but also in capturing Premium Segments. The ability to do the same thing in niche markets depends on many factors:

- Technological gap between the niche leaders and (Asian) Mid-Range firms;
- Presence of other, true barriers to entry, which operate more strongly in combination than individually;
- The (Asian) challengers’ financial strength and their interest in the Premium Segment, which ultimately depends on the size of the niche as a whole as well as that of the respective Mid-Range Segment and the degree of consolidation.

**- Chart 2 -
Pyramid structure of developing markets**

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Source: Estin & Co analyses

Depending on how they assess the risks and opportunities associated with their position in the current niche, the German Mittelstand companies have different strategic options open to them, which they need to focus on in order to respond to potential obstacles to future growth.

If a niche market is relatively small, global and therefore genuine, and if Asian Mid-Range competitors cannot easily enter the Premium Segment market, then apart from expanding or defending market share in the current countries, German Mittelstand companies have two basic options for future growth.

- Expanding geographically into Premium Segments in other (often smaller) developing markets;
- Diversifying into Premium Segments for related products and services.

Expanding geographically into Premium Segments in other developing markets

Many niche market leaders initially focused, with good reason, on large developing markets such as China and India, thus neglecting the “next wave” of smaller markets. Taken together, these countries have a certain amount of potential, but individually they are dwarfed by the markets just mentioned. So the question is: when and to what extent should consideration be given to smaller developing markets? This depends on current and future size, the share of the Premium Segment, barriers/costs to entry and the strength of local competition. The risks associated with this option are relatively small, apart from the danger of fragmentation and over-stretching of management resources, combined with the likelihood of potentially relatively low growth potential overall.

Diversifying into Premium Segments for related products and services

This option essentially involves diversification of products and services in growth markets, without this necessarily having to be accomplished in saturated markets as well.

The advantage is that growth can be achieved in the attractive Premium Segment without necessary needing to develop a new business model. However, the following questions have to be considered when it comes to diversification:

- Are there attractive alternatives to the current Premium Segment?
- To what extent are these related to current products and services?
- Why weren't they considered earlier (in saturated markets)?
- What are the barriers to entry and risks in these new markets?
- What expertise does the company have to develop these markets?
- Are there any acquisition opportunities?

If the niche is relatively large and offers strong growth potential for at least the Mid-Range Segment, there is a risk that competitors will start by growing strongly in large developing markets, such as those in Asia, and then subsequently target saturated markets with lower prices. In addition to the first two options, market entry into the Mid-Range Segment must also be considered as a potential option.

Market entry into Mid-Range Segments in developing markets

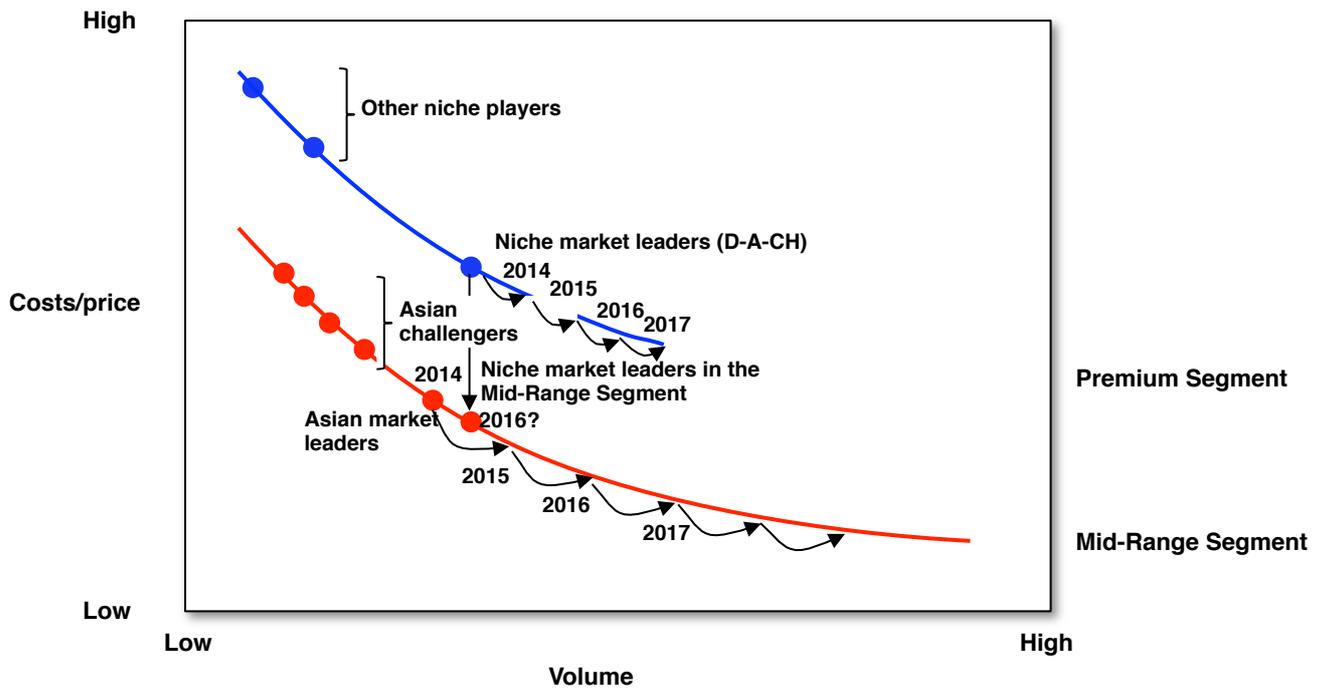
This option involves a focused attack on local competitors in the Mid-Range Segment in developing markets. If successful, there is a prospect of strong future growth with attractive margins, while eliminating strategic bottlenecks in one fell swoop. However, the risks are considerable, primarily because Western niche market leaders are not (or are no longer) well acquainted with the business model necessary to accomplish this.

Time is also pressing: the further that local competitors progress, the greater their cost advantages and the higher the hurdles that need to be overcome in order to catch up.

- Chart 3 -

Competition dynamics: Niche market leaders from D-A-CH region are in a tight spot

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- 2014: Niche market leaders from the D-A-CH region dominate the Premium Segment and, in absolute terms, are (still) larger than Asian challengers in the Mid-Range Segment
- Situation in 3-5 years: by the time niche market leaders are positioned in the Mid-Range Segment, Asian challengers may have already developed into market leaders and begun to consolidate the market as a result of economies of scale

Source: Estin & Co analyses

The development of a successful Mid-Range business model requires expertise on at least six levels:

- Product design: development of a modified design with reduced features;
- Sourcing and production: establishment of a competitive local organisation;
- Brand: development of either a dual-brand strategy or adaptation of product lines with a single brand;
- Price strategy: positioning of the respective brand(s) to match the segment;
- Sales and service organisation: development of a modified organisation for the Mid-Range segment, taking into account the important role of local dealers in developing markets;
- Management: establishment of a specific organisation for the Mid-Range Segment, with the advantage of local origin.

Given the organisational and cultural challenges associated with developing a new business model, acquisitions or joint ventures should be considered for this option.

After a long period of success, the German Mittelstand now faces important strategic decisions. Competitors from developing markets have caught up in niche markets as well, and are about to conquer them. If SMEs are unable to find answers, their future growth will be greatly reduced, and they will fail to generate value. The risk then is that they will be left with only one option: sale of the business to the (Asian) competitor. Especially in family-run businesses, this is not a goal worth considering, and important decisions must be taken now. Wait and see is not an option.

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Estin & Co is an international strategy consultancy based in Paris, London, Zurich and Shanghai. The firm assists the management of major European, North American and Asian groups in defining their growth strategies, as well as private equity funds in analysing and improving the value of their investments.