Finanzgruppe
Deutscher Sparkassen- und Giroverband

DIAGNOSE
MITTELSTAND

SME DIAGNOSIS

Current global challenges for SMEs
A stock-taking exercise

Winter 2018

Three out of four enterprises in Germany are customers of the Sparkassen-Finanzgruppe (Savings Banks Finance Group). Giving advice to and providing financing for small and medium-sized enterprises is part of the core business of Savings Banks and Landesbanken in Germany. To this end, they use their strengths: a thorough understanding of their customers and their specific circumstances, as well as full coverage of all of Germany’s regions.

SME Diagnosis 2018 is the eighteenth annual analysis conducted by the Deutscher Sparkassen- und Giroverband and provides representative data on the current status and future prospects of small and medium-sized enterprises in Germany.

CONTENTS

1 PREFACE

HELMUT SCHLEWEIS
President of the German Savings Banks Association

"The SME's resilience to crises is of major importance for the stability of Germany's economy."

Berlin, November 2018

Ladies and Gentlemen,

Germany derives its economic strength as well as its social stability from a balanced, decentralised structure. In Germany, many hidden champions do not have their headquarters in urban centres, but in the country's rural areas. Small and medium-sized enterprises account for the largest share of the total economic value added in Germany.

By and large, the financial position of SMEs has developed positively. Their turnover, efficiency and equity base have grown once again.

This is demonstrated by the latest S-SME Fitness Index – a detailed analysis of the Savings Banks' knowledge of SMEs. The Index is evidence of the solid financial robustness of small and medium-sized enterprises in Germany and predicts that SMEs will be in a good position to cope with future challenges as well.

The Savings Banks' store of knowledge about Germany's SMEs is unique. Three-quarters of all enterprises in Germany have business relationships with the Savings Banks Finance Group. As a result, Germany's 385 Savings Banks can review several thousands of balance sheets every year.

Savings Banks, Landesbanken and their partners within the Savings Banks Finance Group have fostered the success of Germany's SMEs for many generations because, due to the nationwide presence of Savings Banks, they are a reliable source of investment and operating loans. In addition, the commitment of Savings Banks is predominantly for medium-to-long term, which provides a high level of investment security. Small and medium-sized businesses also benefit from the Savings Banks' profound expertise in their sector, as this knowledge enables them to assess risks accurately and give informed advice on the businesses' future development. Savings Banks and their Finance Group therefore facilitate the business diversity that makes a significant contribution to our economy's resilience to crises.

> "SMEs benefit from the Savings Banks' sector expertise."

Enterprises – even smaller ones – have long been internationally networked, which makes them more susceptible to global trends such as punitive tariffs or currency fluctuations. Another risk factor is the high debt level of private households and enterprises in many of the countries that are supplied by German companies. A reversal in monetary policy can lead to financing difficulties, in particular in emerging markets.

This year's SME Diagnosis explores the question of what risks and opportunities small and medium-sized enterprises see for themselves. It examines potential economic developments and trends, surveys SME experts in the Savings Banks and analyses the internal balance sheet and P&L data of enterprises.

With this analysis, the Savings Banks' expertise as providers of finance for Germany's small and medium-sized enterprises is made available to the public at large. Owing to its SMEs, Germany is thriving. For this reason, the business community, society and policymakers need to know what developments are relevant for the SME sector and how the enterprises themselves are responding to the challenges.

54%

of SMEs see the trade war with the United States as the biggest global risk for their future development

39

thousand euros gross profit per employee

98%

of new loans taken out by mid-sized businesses are used to finance investments

39%

equity ratio in 2017

Equity ratio improved in 2017 (as a percentage)

14.1

↓

14.7

2 FITNESS INDEX

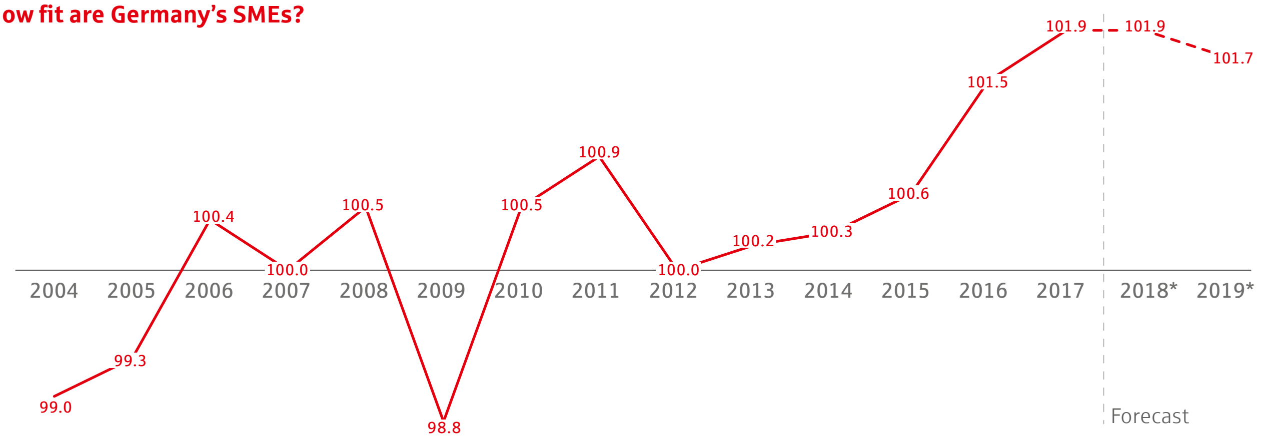
"Zukunft Mittelstand" 2018

"Zukunft Mittelstand" ("The Future of SMEs") is the title of a survey that forms the first part of this year's SME Diagnosis. The survey is based on an analysis of the key performance indicators of business clients and of the Savings Banks' loans to enterprises. In addition, we provide an assessment – based on the DSGV's sector forecast – of the potential future development of Germany's small and medium-sized enterprises. The S-SME Fitness Index assesses enterprises in terms of selected balance sheet and P&L figures and clusters them in four fitness components, i.e. performance, strength, resilience, and team spirit.

Key findings

- → The S-SME Fitness Index shows that the peak reached last year was once again surpassed this year, with a score of 101.9 points. The upward trend among Germany's SMEs has continued.
- → Along with the dynamic growth of revenues, profits also increased significantly once again. As a result, return on sales rose to 6 percent. This upswing is broadly spread across all sectors of the economy; however, the digital industry remains the fastest growing sector.
- → Since employee productivity continues to increase, rising personnel expenses have not led to a decline in profitability. This also explains why enterprises continue to recruit new employees.
- → SMEs are very confident about the future. This is also reflected by their large investments in fixed assets. At the same time, asset efficiency has reached a new maximum. The brisk investment activity has led to strong credit growth, demonstrating that the significant importance of bank loans has not declined for SMEs.
- → Due to the long-term financing structure, the strong equity base and the minor importance of interest expenses in the enterprises' cost structure, SMEs do not need to worry about a possible reversal in interest rates.
- → In our forecast, we predict that investment growth and return on sales will decline for the first time in 2019, albeit only very slightly. We therefore expect that the overall index will fall slightly in 2019, by 0.2 points to 101.7 points.

How fit are Germany's SMEs?



Average fitness 2004 to 2014 = 100; enterprises with a turnover of up to €250 million

*Forecast values for 2018 and 2019

Source: DSGV-Branchendienst

Powerhouse or couch potato: The S-SME Fitness Index measures the level of fitness of Germany's SMEs. What are the enterprises capable of achieving? How productive are the enterprises and their employees? And how well prepared are they for the future? Answers to these and other questions are provided by analysing selected KPIs that the DSGV's Branchendienst derives from approx. 300,000 anonymised balance sheets per year. The S-SME Fitness Index, which is compiled on the basis of these data, provides information on the current condition and sustainability of Germany's SMEs.

S-SME Fitness Index 2018 in detail

Performance:
Business and profits
How attractive are markets, and how successfully do enterprises operate in the markets?

How fast are enterprises growing?

→ **Turnover growth***

2017	2018	2019
6.3%	4.9%	5.3%

*Change in turnover vs. previous year

How profitable are enterprises?

→ **Return on sales***

2017	2018	2019
6.0%	6.0%	5.8%

*Operating result relative to turnover

Strength:
Investment and innovation
How much do enterprises invest, and and how innovative are they?

How much do enterprises invest?

→ **Investment growth***

2017	2018	2019
4.1%	3.6%	3.5%

*Fixed asset growth vs. previous year

How many euros in turnover are generated with one euro of fixed assets?

→ **Asset efficiency***

2017	2018	2019
€2.19	€2.21	€2.25

*Turnover relative to fixed assets

Resilience:
Stability and sustainability
How robust is the financing of enterprises, and how attractive are they for their owners?

How strong is the financial stability of enterprises?

→ **Equity ratio***

2017	2018	2019
39.0%	39.1%	39.5%

*Equity relative to the balance sheet total

How good is the return on capital?

→ **Return on equity***

2017	2018	2019
14.7%	14.7%	14.1%

*Operating result relative to equity

Team spirit:
Employees and their contribution
How productive are employees, and what is their contribution to the enterprises' success?

What is an invidual employee's contribution to the enterprise's success?

→ **Gross profit per employee***

2017	2018	2019
€39,100	€39,800	€40,400

*Turnover less cost of materials and personnel expenses relative to the number of employees

How many euros in turnover are generated with one euro of personnel expenses?

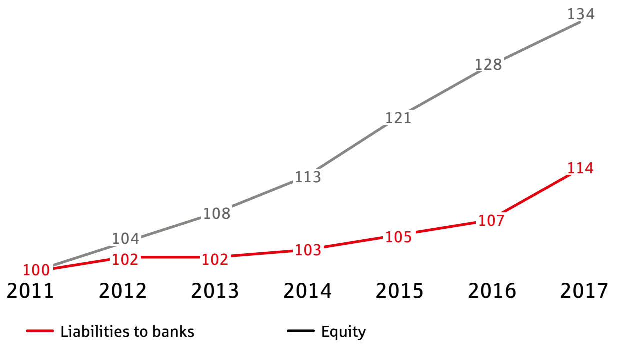
→ **Employee productivity***

2017	2018	2019
€4.18	€4.20	€4.20

*Turnover relative to personnel expenses

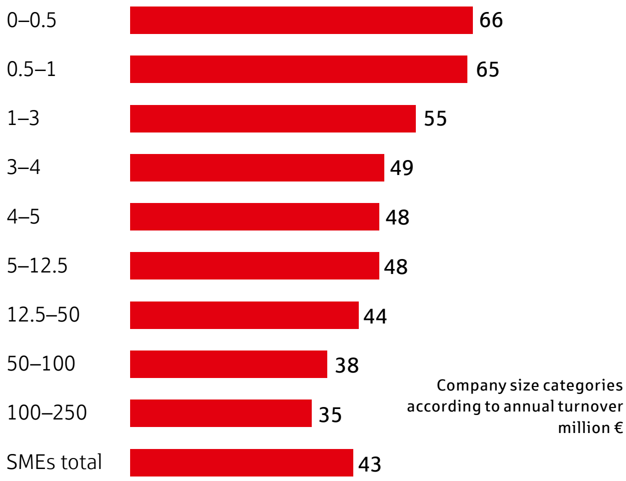
Focus: No need to fear a reversal in interest rates

Capital structure of SMEs (2011 = 100)



Source: DSGV-Branchendienst

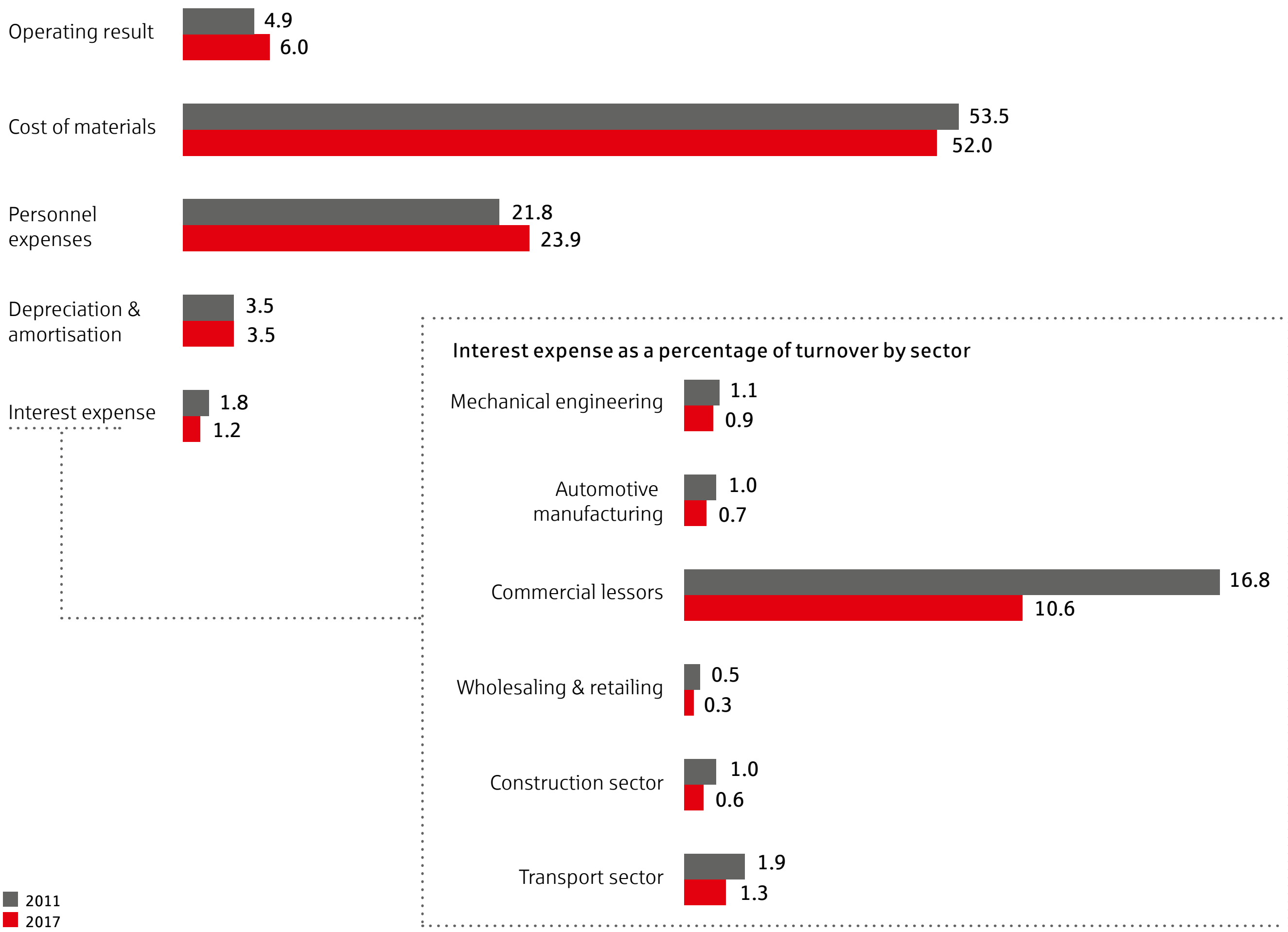
Percentage share of bank liabilities in debt



Source: DSGV-Branchendienst

SMEs are taking advantage of their strong earnings performance to continue to invest in their own businesses, which increases their capital base. However, this trend has not reduced the importance of bank loans because the use of loans has also grown steadily. In the period under review, the increase in bank loans was stronger than equity growth for the first time. Traditional bank loans – not equity – continue to be the most important source of financing for companies, in particular for small and medium-sized enterprises, the principal customers of Savings Banks. In enterprises with an annual turnover volume of up to one million euros, bank loans account for two-thirds of debt.

Cost and income as a percentage of turnover (all SMEs)



Source: DSGV-Branchendienst

The low interest level has had a positive impact on profitability. However, this effect is limited because, compared with the other cost categories, interest expense plays only a minor role in the cost structure. The ratio of interest expense to turnover currently amounts to only 1.2 percent, while it was still at 1.8 percent in 2011. Instead, the two key cost items for businesses are cost of materials and personnel expenses, which – when combined – amount to 76 percent of turnover. However, a breakdown by sector shows that there are significant differences. The real estate sector stands out in particular. While interest expense amounts to a large portion of the turnover of commercial lessors, this sector also benefits most from the lower level of interest rates. The ratio of interest expense to turnover is currently 6 percentage points lower than in 2011. The more solid financing structure, combined with higher equity investment, has also contributed to this lower ratio. However, an abrupt increase in interest rates would not lead to a dramatic decline in profits. Long-term loans account for 84 percent of the borrowed funds, medium-term loans account for 7 percent and short-term loans for only 9 percent. This means that, in the first year after a reversal in interest rates, an increase would affect only about one-fifth of the loan portfolio; in each of the two following years, one-eighth of the loans would be affected. Overall, it would take approximately eight years on average for a rise in interest rates to fully impact enterprises.

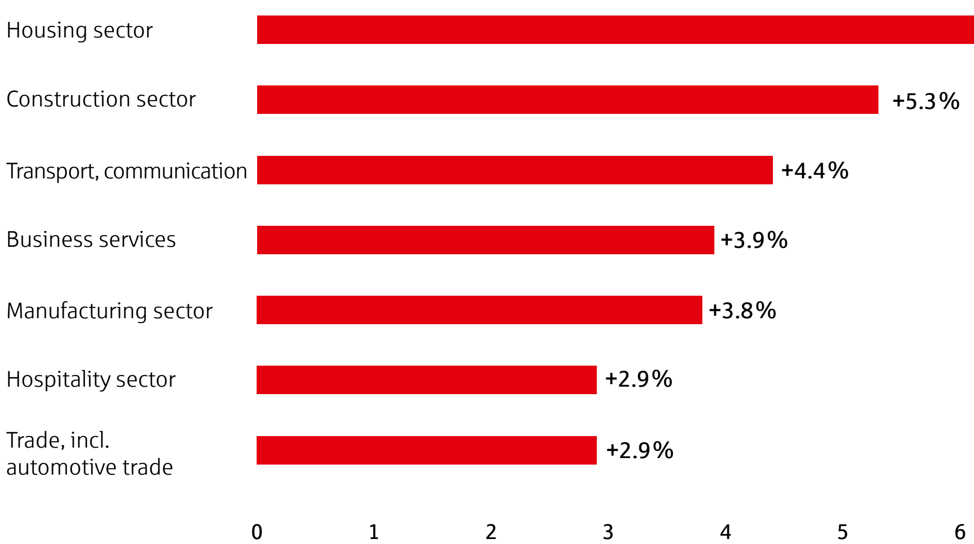
The latest key figures of Savings Banks 2018

The continuing importance of bank loans for small and medium-sized enterprises is also reflected in the Savings Banks' business performance in the first nine months of 2018. Loan commitments made to business enterprises reached a new record level of EUR 66.1 billion, which is evidence of the enterprises' brisk investment activity. Having increased by EUR 12.4 billion, the stocks of investment loans have now reached a new record high of EUR 287.8 billion. In addition, with deposits of over EUR 142 billion held with Savings Banks, the enterprises analysed have a high liquidity buffer. The continuing momentum of the booming real estate sector has led to an increase in commercial housing loans by EUR 6.2 billion to the current level of EUR 128.8 billion. Savings Banks therefore remain the undisputed market leader in business with small and medium-sized enterprises.

Continuing growth of loans to enterprises*

*Loan portfolio of Savings Banks in Germany as of 30 September 2018

Lending to selected sectors*



Deposits made by business enterprises**

* Year-to-date portfolio changes until the end of September 2018, business of Savings Banks
** Portfolio as of the end of September 2018, business of Savings Banks

Source: DSGV

S-SME Fitness Survey 2018

What are the concerns of Germany's SMEs? What are the current trends in terms of investment and financing? These and other topics were discussed by the Savings Banks' customer relationship managers in several hundred thousand interviews with Germany's small and medium-sized enterprises. Three-quarters of all enterprises in Germany have business relationships with the Savings Banks Finance Group. The S-SME Fitness Survey summarises the findings of the SME experts of all German Savings Banks. Insights from the market leader: succinct, up-to-date, pertinent.

Topical issue: No need to fear a reversal in interest rates

The ECB is expected to raise the key interest-rate for the first time next summer. After years of low interest rates, there is growing concern that it would be hard – if not impossible – for many enterprises to cope with an abrupt reversal in interest rates. We asked the enterprises what they were doing to prepare for a possible increase in interest rates.

Findings at a glance:

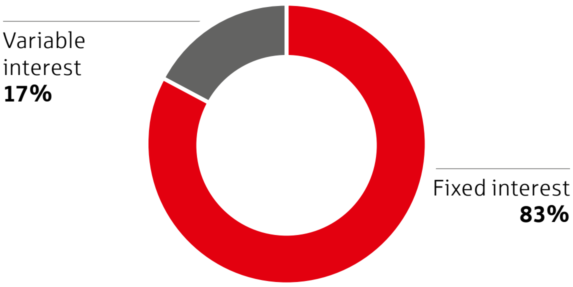
→ The enterprises interviewed have a very sound financing base. Over 80 percent of their loans have fixed interest rates and run over longer periods. A reversal in interest rates would therefore be slow to impact their balance sheets. Our survey shows that this financing trend has not changed in the current low-interest-rate environment. Hence, short-term market turmoil would have a delayed impact on the enterprises.

→ When enterprises take out loans, they do so within bounds and only in combination with equity. The additional funds raised are allocated, in roughly equal parts, to maintaining existing business and to investing in new business.

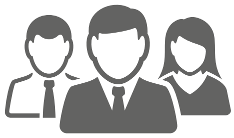
Question 1: Fixed or variable interest rates?

Do enterprises currently tend to give preference to variable interest rates that adapt to the market conditions and are particularly low in the current period of low interest rates? Or do they tend to prefer fixed interest rates that, in return, provide high planning reliability?

The figures
Current shares of fixed-interest and variable-interest loans to enterprises



Source: DSGV

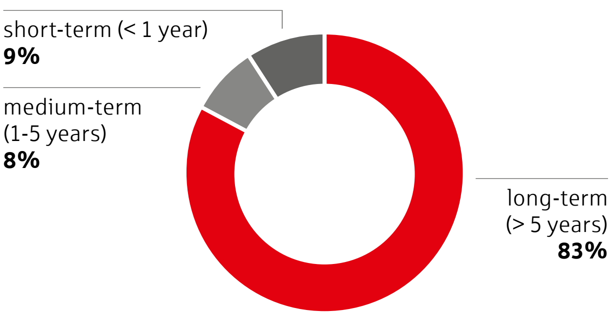


The experts' opinion
According to **95 percent** of the Savings Banks' financing experts, the enterprises are securing the current interest rate level, and the share of fixed-interest loans is growing or remains constant.

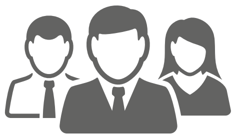
Question 2: Long-term or short-term loans?

The longer the term of a loan, the longer the period of time for which enterprises lock in the agreed interest rates. Do enterprises tend to choose long-term or short-term loans?

The figures
Current term structure of loans to enterprises



Source: DSGV

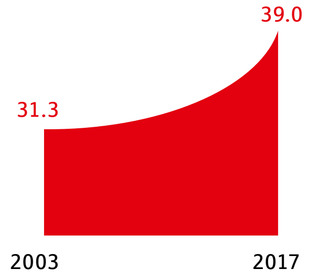


The experts' opinion
According to **31 percent** of the financing experts surveyed, enterprises currently tend to take out longer-term loans than in the past. According to **63 percent**, the terms of the loans will remain at the current level.

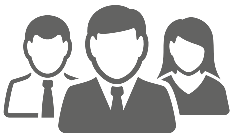
Question 3: Equity or debt financing?

There is a trend towards rising equity ratios. This will increase the enterprises' financial robustness and crisis resilience. Will this trend continue?

The figures
Equity ratio of enterprises



Source: DSGV-Branchendienst

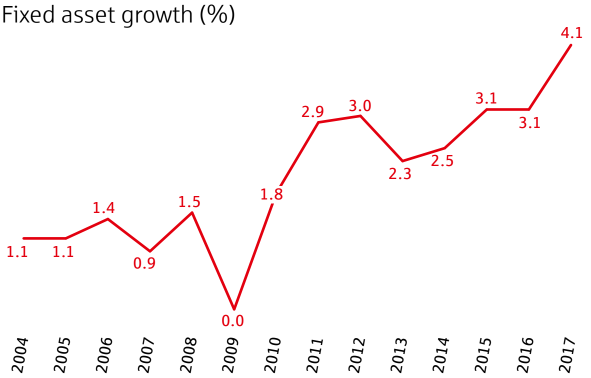


The experts' opinion
According to **59 percent,** the equity ratios of enterprises will continue to rise. According to **35 percent**, the ratios will remain at today's high level.

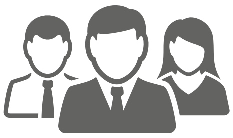
Question 4: Maintaining current assets or developing new business opportunities?

The fixed assets of the enterprises covered by the survey are growing from year to year. We have not identified an investment backlog among SMEs. There is no sign of asset erosion. What is currently the main purpose of loans taken out by enterprises?

The figures
Fixed asset growth (%)



Source: DSGV-Branchendienst



The experts' opinion
According to **98 percent** of the respondents, loans are used for investment purposes, with new investments outweighing replacement investments.

3 FOCUS THEME

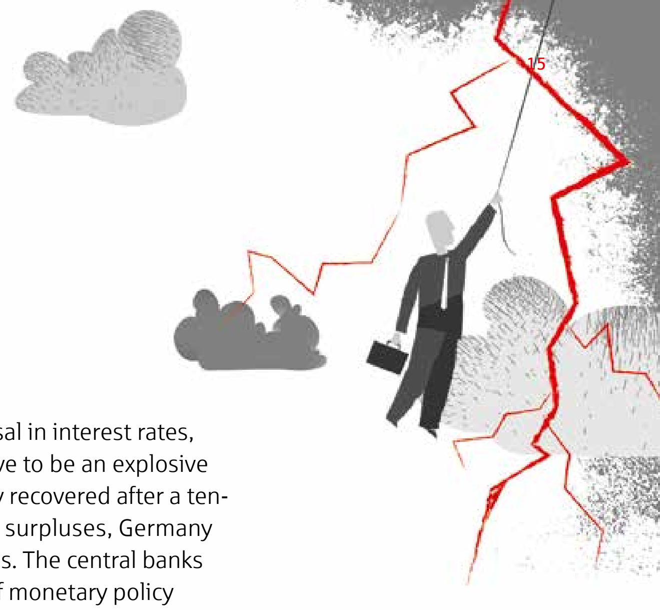
Current global challenges for SMEs

3.1 Introduction

Since the outbreak of the financial crisis in 2008, the interest in the "German Mittelstand" model has grown significantly. Business leaders, policymakers and representatives of associations want to know why small and medium-sized enterprises (SMEs) in Germany have a greater impact on the country's overall economic development than their counterparts of the same size in other countries. Many market observers have noted that Germany recovered very quickly from the economic slump in 2009. To a large extent, this was also due to the country's small and medium-sized enterprises, which account for the largest part of the value added and of the jobs in Germany. At the same time, the German SMEs' ties with partners in other countries have also increased, making them more vulnerable to global trends.

For this reason, the focus theme of this year's SME Diagnosis is the question as to the possible effects that global economic trends can have on SMEs in Germany. For this purpose, we have analysed current global trends and movements as well as their potential effects on the business performance of SMEs. Furthermore, we have compared the findings obtained from this analysis with the assessments of our SME specialists in the Savings Banks with regard to the performance and the prospects of SMEs in Germany. These assessments are based not only on the professional expertise of the SME relationship managers, but also on a large number of personal meetings of the relationship managers with their business clients. In our assessments, we also took into consideration the findings of the analysis of our SME clients' balance sheet, P&L and credit data. The result gives a unique insight into the current position of Germany's SMEs as well as their opportunities and risks against the background of a dynamic global economic environment.

Germany's Savings Banks and Landesbanken have been a reliable financing partner for German SMEs for many years. We share similar values, such as the focus on long-term business relationships and strong regional roots. For more than 15 years, the German Savings Banks Association (DSGV) has dealt with the specific concerns of its SME clients within the framework of the SME Diagnosis.



3.2 Executive summary

The global economic climate is currently deteriorating. The upcoming reversal in interest rates, protectionist tendencies in world trade and high global debt levels may prove to be an explosive cocktail that could pose a risk for the global economy, which has not yet fully recovered after a ten-year period of low interest rates. With its persistently high current account surpluses, Germany is particularly vulnerable to a decline in global income and demand for goods. The central banks in Europe, Asia and the United States have only limited scope left in terms of monetary policy instruments to respond to another crisis, either in the financial markets or in the real economy. Initial effects of the reversal in interest rates in the United States can already be felt in emerging economies such as Turkey, Argentina or India. China is also facing major challenges because of the tariffs imposed by the United States.

When compared with other countries, Germany is in an exceptional position. A relatively low level of government debt, balanced budgets as well as low unemployment and inflation rates increase Germany`s resilience to the next global thunderstorm. The country's small and medium-sized enterprises can also look back over a number of very successful years. Robust turnover growth, increased equity ratios and rising capital expenditure are evidence of strength and confidence.

No two crises are alike. Recent global developments suggest that conditions in the real economy will generally tend to deteriorate, driven by protectionism and nationalism. This view is also shared by the majority of Germany's SMEs. Their overriding concern is that a further escalation of the trade conflict with the United States, as well as geopolitical tensions and the consequences of Brexit might adversely affect their future business performance. Rising energy and commodity prices also represent a burden on the enterprises.

The effects of an upcoming reversal in interest rates, which in any case is likely to go hand in hand with rising refinancing costs, are viewed less critically by SMEs. On the contrary: approx. 40 percent of the enterprises expect that financing conditions will continue to be favourable and are making increasing use of these conditions again to finance investments. However, although the enterprises do not anticipate in an abrupt reversal in interest rates, they tend to play it safe when it comes to interest-rate risks in the context of financing. Only close to one in five SME clients of Savings Banks rely on variable interest-rate loans for their financing needs.

This is also confirmed by studies conducted by the DSGV. The effects that an abrupt increase in interest rates would have on returns on sales and default probabilities of SMEs, for instance, would be manageable. This is an important finding because Germany's Savings Banks have significantly increased their market shares in the commercial lending business since the outbreak of the financial crisis in 2008 and today play an even more important role for the reliable credit supply of SMEs in Germany.

Low interest rates and an increasing number of regulatory requirements represent a burden for small and medium-sized credit institutions, which are by and large institutions funded by customer deposits. There is a risk that this tandem of regional banks and SMEs, which has been so successful in Germany in the past, may be weakened. Policymakers are therefore called upon to continue to develop measures such as those designed to adjust regulation in line with the size and risk of a credit institution.

3.3 The “German Mittelstand” model

In May 2017, the headline of the British newspaper “The Telegraph” read: “Secrets of growth: the power of Germany’s Mittelstand”. In a comparison between German and British SMEs, The Telegraph came to the conclusion that the German example offered lessons for British businesses and the government. In Germany, there was a well-trodden path for mid-sized firms to follow from the days of starting up to the time of business succession. As a result, mid-sized businesses had become the backbone of Germany’s economy and had helped the country to weather global economic storms. In Britain, there was no clear route for medium-sized enterprises, which were also often referred to as a “forgotten army”.

> In Germany, there is a well-trodden path for mid-sized firms to follow, from starting up the business through to the time of business succession.

In other countries, businesses are often set up with the objective of swift acquistion by investors.

However, the international interest in the German “Mittelstand model” is not limited to gathering information. According to Germany’s Federal Statistical Office, the number of small and medium-sized enterprises in Germany which are controlled by parent companies headquartered abroad increased by more than 20 percent in the period from 2009 to 2013. The motives of foreign investors for investing in German SMEs include strengthening customer proximity, benefiting from cutting-edge research, and concluding long-term supply agreements with key accounts, e.g. in the automotive industry.

The German “Mittelstand model” is based on a long-term approach ...

The success of Germany’s SMEs is based not only on the strong innovative capacity and adaptability of small and medium-sized enterprises. Start-ups elsewhere, in particular in Anglo-Saxon countries, are also extremely strong in this respect. Many of the large-scale companies, which are today’s market leaders in the fields of search engines, social media, or e-commerce, were established in the 1990s as small start-up ventures by outstanding entrepreneurs. Nevertheless, they remain the exception to the rule. Most business start-ups in the New Economy are established with the objective of an early acquisition by large-scale companies. In this respect, they differ considerably from the traditional model of Germany’s SMEs.

... and, through the business owner, maintains the link between ownership and responsibility.

The traditional model of the German mid-sized business is based on a long-term approach, in which ownership and the resulting responsibility are paramount. This is entirely in line with Article 14 of Germany’s Constitution, which reads: “Ownership of property comes with responsibility. Its use shall also serve the common good.” This is also reflected, for instance, in the definition of SMEs used by the Institut für Mittelstandsforschung in Bonn (Bonn Institute for SME Research). According to this definition, which focuses on the “unity of ownership and management”, large companies are also considered to be part of the SME segment, providing that up to two individuals hold at least 50 percent of the company’s shares and are members of the company’s management.

The history of Germany's SMEs has always been closely linked to the history of Germany itself. German sectionalism and recurring eruptions in society have characterised the development of Germany's SMEs as much as globalisation and digitalisation. This has shaped enterprises that are characterised, on the one hand, by close ties to their region and their employees and, on the other hand, by high-quality, competitive goods produced for the world market. These enterprises provide local training and employment opportunities and, at the same time, global sources of income.

Continuity over time has created regional links …

The traditional model of the German mid-sized business is based on a long-term approach, in which ownership and the resulting responsibility are paramount.

As a result of this pronounced dualism, the success of Germany's SMEs depends not only on political and social developments in Germany and in the various federal states but also on changes in the global environment.

… and has required global adjustments.

One local challenge for SMEs, for instance, is posed by the shortage of skilled labour, which is due, to some extent, to shortcomings in Germany's national educational policy. According to a survey conducted among the Savings Banks' SME relationship managers, the shortage of skilled labour currently poses the biggest risk to the future development of their clients. One example of a global challenge is the UK's planned exit from the European Union, which is also one of the top four issues cited by the Savings Banks' SME clients. Brexit – in particular if it is implemented without an agreement – will jeopardise existing trade relations of German SMEs and can therefore directly affect their turnover and profits.

Today, businesses are just as dependent on global developments as they are on national developments.

3.4 Developments in the financial markets since the outbreak of the financial crisis in 2018

Germany was hit by the financial crisis just as hard as other countries.

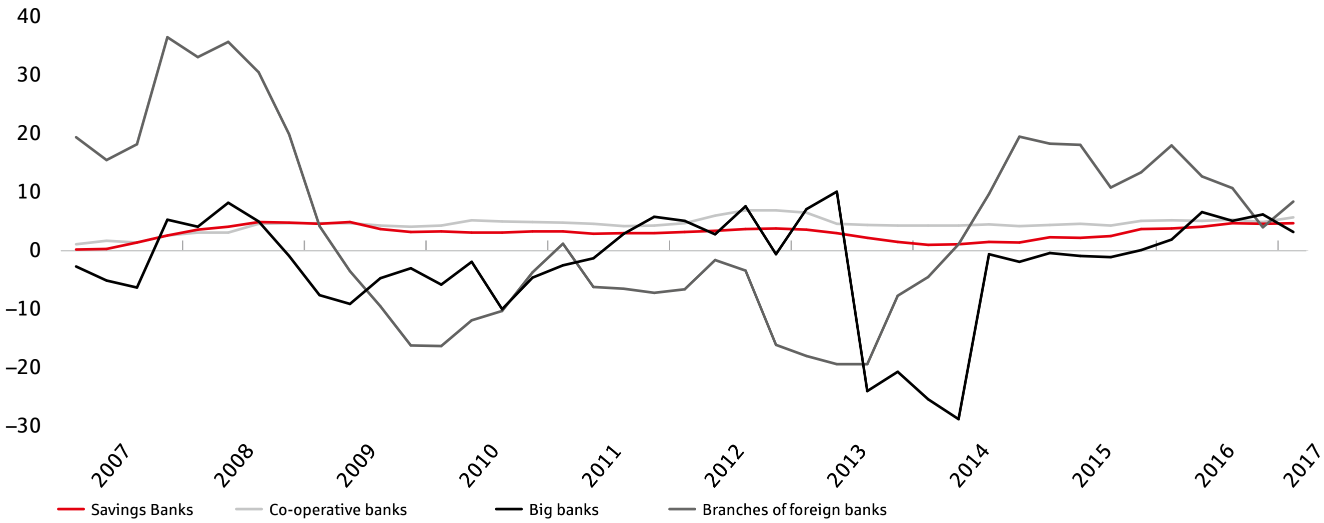
Almost exactly ten years ago, the financial crisis began in the United States with the insolvency of the investment bank Lehman Brothers. This resulted in turmoil in the financial markets, which in turn, led to a global recession in 2009. Many countries – first and foremost China – launched large-volume economic development programmes. At the same time, the central banks of the industrialised nations began to reduce their key interest rates.

However, largely due to regional banks and SMEs, Germany was able to overcome the crisis in the real economy as quickly as it did.

In Germany, economic output fell by nearly 6 percent in 2009, the steepest decline since the end of World War II. Aside from government support measures such as the environmental bonus granted for scrapping old cars and funding for short-time work, the reliable supply of credit to business enterprises, in particular SMEs, was a key reason why the crisis in Germany's real economy was overcome relatively rapidly. It was mainly Savings Banks and co-operative credit institutions that did not reduce their lending to enterprises and self-employed persons during the period of economic downturn. Big banks and branches of foreign banks showed a quite different response. Immediately after the onset of the crisis in early 2009, they began to reduce their new lending to business borrowers (G01).

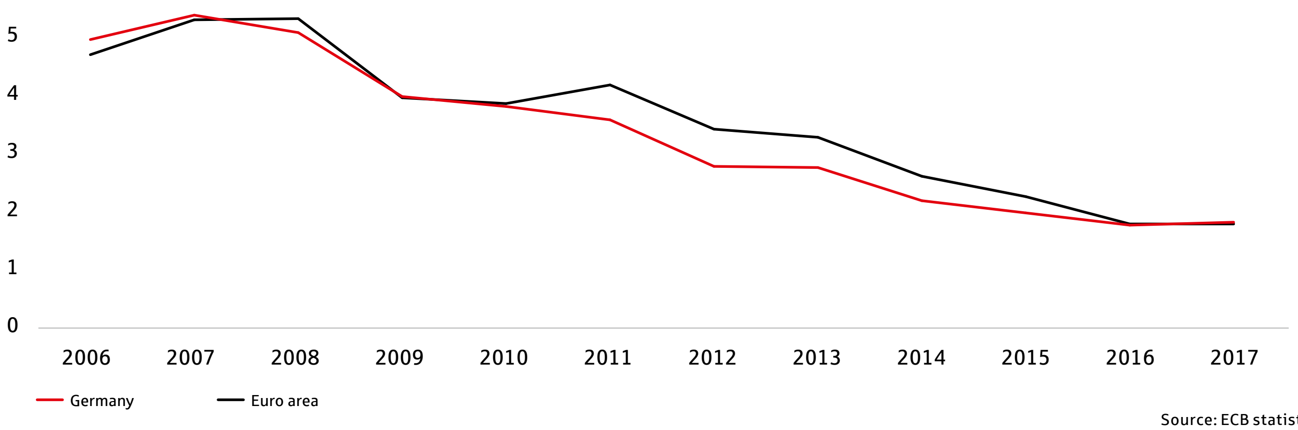
After the slashing of the leading short-term interest rates from 4.25 percent in July 2008 to a mere one percent in May 2009, the central banks in the euro area began in 2010 – and more so as of 2015 – to purchase securities. The purpose of these securities purchases was also reduce long-term interest rates, which have a major impact on the terms and conditions of loans to enterprises. There was a real risk of deflation, which, in the view of most economists, can run the risk of causing a vicious circle. The central banks sought to avert this risk by facilitating more favourable corporate and consumer loans.

Changes in portfolios of loans to enterprises and self-employed persons by banking group, as percent (quarterly figures) G01



Source: Deutsche Bundesbank, Banking Statistics

Interest rates of loans to enterprises in Germany and in the euro area G02



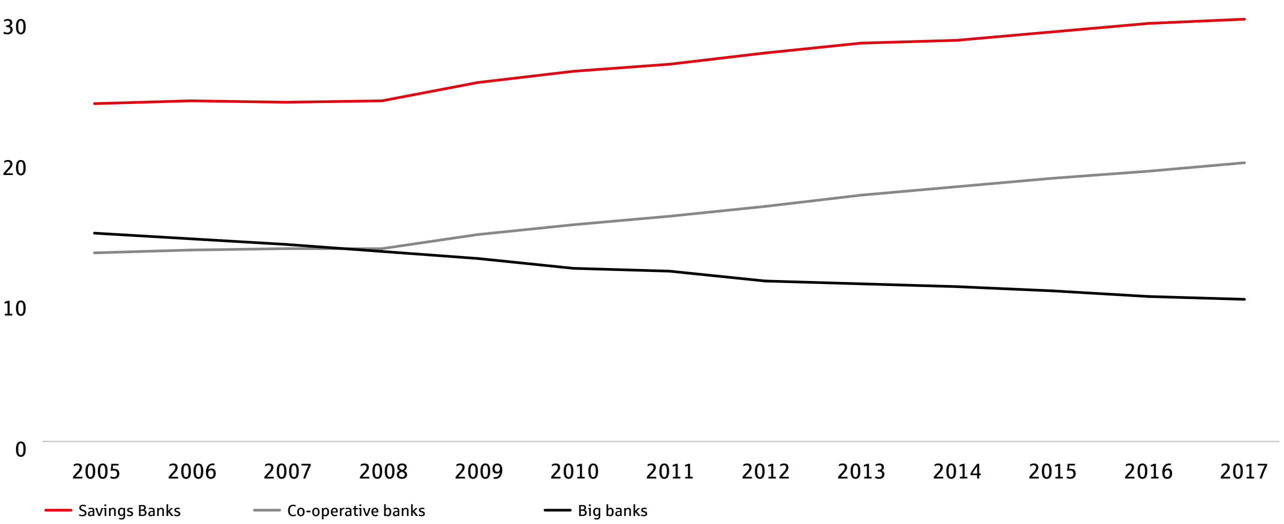
Source: ECB statistics

The interest rates of loans to enterprises have declined almost continuously since 2009. While in 2008 the average interest rate paid by enterprises in the euro area for loans with a term of more than five years and a volume of up to EUR 1 million amounted to 5.32 percent, the average interest rate in 2017 was only 1.79 percent. In Germany, the average interest rate fell from 5.08 percent to 1.82 percent (G02).

The financial crisis led not only to changes in the costs of loans to enterprises in Germany but also to a sustained structural change in the commercial lending market. The market shares of Savings Banks and co-operative banks increased significantly, from 37.8 percent in 2007 to 49.8 percent in 2017. In the same period, the market share of big banks fell from 14 percent to 10 percent (G03).

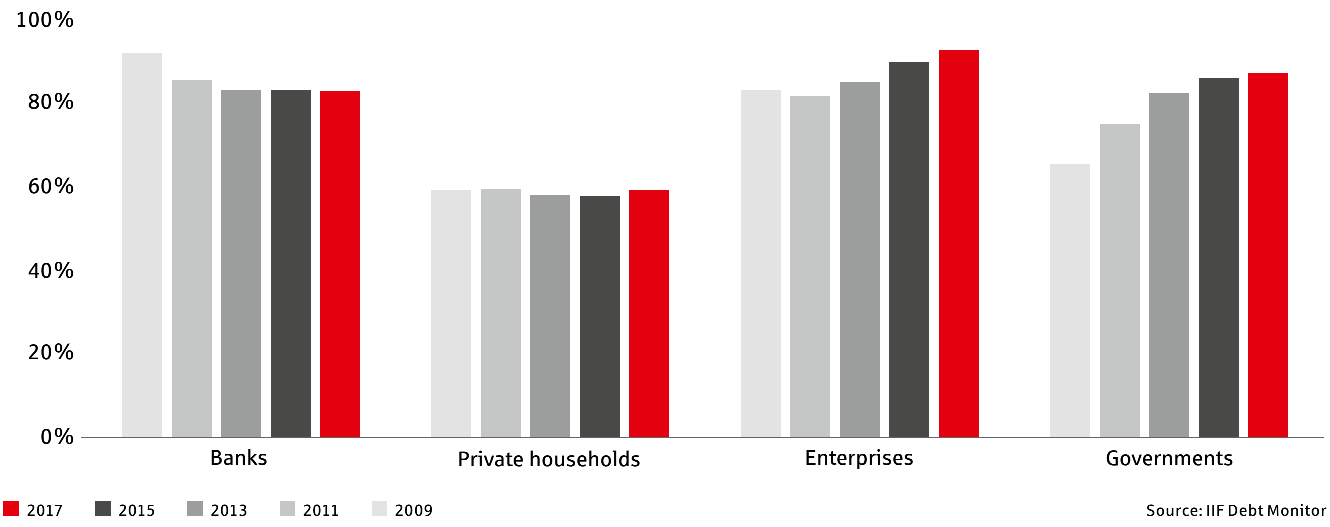
One effect of the financial crisis is that Savings Banks and co-operative banks have a far larger market share in commercial credit business today than they did ten years ago.

Percentage market shares of banking groups in loans to the "real economy" (including commercial housing loans; adjusted) G03



Source: Deutsche Bundesbank; own calculations

Global debt as a percentage of GDP, by sector G04



Source: IIF Debt Monitor

The central banks' expansionary monetary policy did not lead to the desired increase in loans to enterprises …

The expansionary monetary policy achieved the objective of avoiding a persistent crisis with negative growth and deflation. However, contrary to expectations, it did not lead to a sustainable increase in loans to enterprises and gross investments. Both loans to enterprises and gross investments stagnated in the euro area in the period from 2007 to 2017. Similar developments were also observed in the United States and in the UK The consequence of the financial crisis for the real economy was a decade of low growth. In the perod from 2008 to 2017, the economy of the euro area grew by only slightly more than 1 percent per year on average. To this day, the economic output of countries such as Italy and Greece has been lower than before the outbreak of the crisis in 2008. In this context, one can rightly speak of a lost decade.

In combination with the continuing low interest rates, governmental rescue and development measures led to a significant increase in public debt. In the period from 2008 to 2017, the government debt-to-GDP ratio in the euro area and in the United States rose from 70 and 60 percent, respectively, to over 100 percent of GDP. In China, where state-owned enterprises account for a large proportion of enterprise debt, the total debt of government and enterprises increased from approx. 130 to over 200 percent of GDP in the same period of time. Global public debt increased from approx. 65 to 87 percent of GDP in the period from 2009 to 2017 (G04).

To this day, the economic output of countries such as Italy and Greece has been lower than before the outbreak of the crisis in 2008. In this context, one can rightly speak of a lost decade.

This percentage increase represented loans of approx. USD 60 trillion in absolute terms. Because of the lack of investment opportunities in the real economy, a large part of these low-interest loans was used to buy existing assets such as equities, securities and real estate. In the past few years, the global inflation rates of these assets have been far higher than the price increases of consumer goods. The longer the period of low interest rates lasts, the higher the market valuations will be and the greater the risk of inflated prices and bubbles forming.

… instead, it led to a substantial increase in global public debt.

3.5 Recent global economic developments

Reversal in monetary policy – rising interest rates pose risk of higher refinancing costs

The United States is currently much more advanced in its real-economy and monetary-policy cycles than Europe or Japan. For this reason, the US central bank (Fed) began to increase its key interest rates as early as in 2015. The reasons for the Fed's decision were the sustained expansion of the US economy as well as low unemployment and inflation rates, close to the central bank's 2-percent target.

The US central bank began to increase interest rates as early as in 2015 …

Further increases in interest rates can be expected because the tax cuts initiated by President Trump add fuel to the fire of an already overheated mature upswing. In addition, efforts are being made in the United States to impose protectionist trade restrictions. If customs duties are imposed on a large number of imported goods – which is not appropriate to the current economic situation in the United States, either structurally or cyclically – this might generate additional pressure on prices. Inflation overshooting might prompt the Fed to boost interest rates even higher than currently expected by the market.

… and additional increases are foreseeable.

Further increases in interest rates can be expected because the tax cuts initiated by President Trump add fuel to the fire of an already overheated mature upswing.

There is a risk that – while it might stimulate growth and fuel inflation – the current mix of economic policy measures might prove to be a "flash in the pan". In this event, there is a risk that this development might come to an abrupt halt, triggered by the excessively fast speed of interest-rate hikes.

A reversal of monetary policy is also emerging in the euro area.

The situation is similar in the euro area. Supported by the ECB's extremely loose monetary policy, the euro area has also experienced an economic recovery and rising prices in recent years. So far, however, this development has been much less dynamic than in the United States, as demonstrated in particular by the unemployment rates in the southern European countries, which have remained significantly above pre-crisis levels for several years. Nevertheless, there is growing pressure on the ECB to not postpone the reversal in interest rates indefinitely. In Germany, where all the indicators that are relevant for monetary policy justify an increase in interest rates, the end of the securities purchase programme – which is planned for 2018 – is welcomed, and there are also growing calls for an increase in the key interest rate, which currently amounts to zero percent.

A sustained reversal of monetary policy – led by the United States – will probably first be felt in the markets for interest-bearing financial assets such as securities and loans. Subsequently, the refinancing costs for enterprises can be expected to increase. In addition, rising interest rates would have a direct impact on the prices of equities, real estate and other long-term investment items.

The effects will first become manifest in the asset markets, …

The low level of interest rates in the industrialised nations in the past ten years has led to an increase in foreign currency financing denominated in US dollars, Swiss francs or Japanese yen, in particular in emerging economies. Rising interest on these loans, combined with a depreciation of the emerging economies' domestic currencies, can lead to a sharp rise in charges for the debtor countries.

… in particular, however, in emerging economies.

Shadow banks such as investment funds and hedge funds involve the risk that their parallel investment behaviour might exacerbate negative price movement in the investment markets.

Signs of economic crises in Turkey and Argentina are a first indication.

Enterprises in emerging markets whose revenues are generated in local currency and countries with high refinancing needs in foreign currencies because of their current account deficits are particularly vulnerable. Initial consequences can already be observed in countries like Turkey and Argentina. The result would be rising default rates of enterprises, private households and government bonds in the countries concerned. In this event, substantial capital outflows can be expected, and the exchange rates of the emerging economies' currencies are likely to continue to depreciate.

However, the industrialised nations are also likely to be hard hit by further increases in interest rates because of the high level of private household debt.

In the industrialised nations, where private household debt is twice as high as in emerging economies, there is also a risk that growth stimuli will disappear if household demand is no longer supported by low-interest loans.

In addition, risks are posed in the financial sector, in particular by what is referred to as "shadow banks" such as asset management companies, investment funds and hedge funds. Their market shares have grown considerably since the financial crisis. At the same time, these financial market players are not subject to the strict rules that apply to banks. The specific risk posed by this sector is that, in the event of price turmoil, the majority of the players will show similar behaviour because of their parallel trading strategies, which can further exacerbate negative market movement.

US trade war, Brexit, and eurozone crisis – risks in the real economy challenge SMEs

One lesson learnt from the global economic crisis of the 1930s is that using devaluation or protectionism to gain advantages at the expense of other trading partners will lead to escalation on both sides and a deepening of the crisis. For this reason, the multilateral trade regime was established after the war under the leadership of the United States, with the World Trade Organisation (WTO) at the top. This was intended to prevent a repetition of the isolationist spirals.

The consensus on free world trade was terminated by the United States.

With its aggressive protectionist measures, the Trump administration wiped out the previous consensus, which poses a structural risk to the international division of labour and the associated efficiency and prosperity gains. This would, in all probability, lead to a decline in global trade flows, and hence, to a contraction of the economic output of all the trading partners. This, in turn, would have an adverse impact on global income and global purchasing power and consequently also on demand for goods. In this way, the trade war with the United States could lead to a downward economic spiral in the medium term. In the short term, customs duties on US imports may fuel inflation and thus accelerate the reversal in interest rates. This constellation would then be particularly dangerous.

Customs duties not only involve the risk that the global trade volume might decline …

The United States' threat to impose duties on imported cars was particularly serious from a German perspective. Trump selected cars as a category of goods of great symbolic significance. Such duties would indeed affect an important sector of the German economy and, indirectly, also Germany's SMEs via the supply chains.

… but they might also fuel inflation and consequently lead to an increase in interest rates that might be more pronounced than currently expected.

In 2017, the United States accounted for close to 9 percent of Germany's total exports of goods. This volume of exports would be exposed, directly and indirectly, to the adverse effects of US protectionism. In addition, there may also be third-round effects. If a protectionist race of isolationism does damage to the global economy as a whole, this would adversely affect growth and demand from third countries.

The same applies if other suppliers that are barred from the US market were to divert their production volumes to the European Union. Chinese steel production would be a case in point. Steel overcapacity in China might be shifted to the European Union, which would compromise German exports.

However, there are also many unresolved problems in the euro area. Along with the need to reposition the institutions and their rules of operation, the persistently high government debt levels in some Member States pose a challenge for the euro area's future stability. Although the euro area's aggregated government debt ratio has not continued to increase in recent years, there are still differences from country to country, which in some case are substantial. The debt-to-GDP ratios of countries like Finland, Germany and the Netherlands range between 60 and 70 percent. In some other countries – including large Member States like Italy, France and Spain – the debt-to-GDP ratios are far above 100 percent. In the event of a crisis, this might lead to shortages in cross-border flows of liquidity, capital and goods within the internal market.

Member States in the euro area with high government debt are particularly vulnerable.

Another risk is smouldering at Europe's northren periphery: the planned exit of the UK from the European Union (EU). If the UK leaves the European Union without clear agreements, the chief economists of the Savings Banks Finance Group expect growth to decline by up to two percentage points in the United Kingdom and by up to half a percentage point in the euro area, including Germany.

A resurgence of the euro crisis cannot be ruled out in this case.

3.6 Potential effects on German SMEs and their own-assessments

For Germany, the main risk is a drop in exports to the euro area.

Trade war

The global developments described above can have a variety of effects on the business performance and earnings of Germany's SMEs. The biggest risk is a fall in exports due to Germany's high dependence on exports. By comparison: in 2009, the year of the crisis, exports dropped by 14.3 percent (adjusted for inflation).

In addition to large-scale enterprises, many larger SMEs would also be affected.

Large-scale enterprises account for the bulk of Germany's exports. According to the German Federal Statistical Office, SMEs accounted for 17 percent of the export volume in 2017. According to a recent survey conducted by the Reconstruction Loan Corporation (Kreditanstalt für Wiederaufbau – KfW), 27 percent of Germany's SMEs (i.e. 780,000 enterprises) generated revenues abroad in 2017, which was 10 percent more than in the previous year. The SMEs' propensity to export is positively correlated with the size of the enterprises. Nearly 40 percent of the medium-sized SMEs exported goods to foreign countries.

In the current complex situation, declining exports could be triggered by many factors. Protectionist and nationalistic aspirations could also lead to reductions in foreign trade within Europe. In addition, German export surpluses in the euro area are currently supported by the assumption of risk by government and the build-up of Target2 balances at the Deutsche Bundesbank. If this policy was reversed, the customers' purchasing power and ability to pay in crisis-ridden countries would diminish.

For many suppliers from Central and Eastern Europe, for instance, Germany can be seen as the "Gateway to the World".

However, even if these instruments continued to be available, demand for German goods would decrease from partner countries slipping into recession, as experienced in the period from 2010 to 2012. At that time, the rapidly growing newly industrialised countries offset the decline in demand from Southern Europe. Should a future crisis go hand in hand with a largely synchronous recession in large parts of the global economy, it would be more difficult to compensate for the drop in demand.

Unlike the period from 2010 to 2012, declining demand from the euro area …

Germany's economy is also closely linked with its European trading partners when it comes to imports. German manufacturing companies, for instance, purchase a large proportion of the value added in production in the form of advance services and semi-finished goods. With this in mind, Germany (figuratively: "the Port of Hamburg") can indeed be seen as the "Gateway to the World" for many suppliers from Central and Eastern Europe.

… could not be offset by increasing demand from emerging economies.

It is questionable whether this high level of integration could be maintained if protectionist and nationalistic tendencies generally increased. If the level of integration decreased, this would probably lead to negative implications for the efficiency of the division of labour and specialisation in Europe. The resulting upsurge in costs and prices could create additional inflationary pressures.

The German Savings Banks' SME clients are aware of the global risks

During their meetings with the Savings Banks' SME relationship managers, more than half of the SME clients stated that they see protectionism and an associated intensification of the trade war with the United States as a risk to future global economic development. Among the SME clients who currently see the future global economic situation as predominantly negative, more than 90 percent feel threatened by the trade policy pursued by the United States. Consequently, more than 80 percent of these SME clients primarily fear a slump in sales. The Savings Banks' SME clients see trading opportunities mainly in China and in other aspiring emerging markets like India.

While most of the small and medium-sized enterprises are pessimistic with a view to the global economy, SME decision-makers continue to be optimistic with regard to the development of the domestic economy. More than 40 percent of the enterprises look back over a financial year in which their financial position improved in terms of orders, turnover and earnings. This is also reflected by the DSGV's S-SME Fitness Index 2018. For financial year 2017, this index reached a new record high with a score of 101.9 points (2016: 101.5 points). The experts of the DSGV's Branchendienst and 84 percent of the Savings Banks's SME clients assume that the high index level will also be maintained in 2018. For financial year 2019, the DSGV expects that, for the first time, the index will decline slightly to 101.7 points.

In this context, it is particularly encouraging that investment opportunities and low refinancing costs are currently perceived as the biggest opportunity for the development of the enterprises' business. This is also reflected by the SME clients' balance sheet figures. Fixed assets grew by 4.1 percent in 2017, following 3.0 percent in 2016. It was particularly encouraging that the IT sector reported the highest increase in investments with a growth rate of approx. 11 percent.

More than 90 percent of our SME clients see the shortage of skilled labour and the political environment as risks for the successful future development of their enterprises. A similar view is held by the International-Monetary Fund (IMF), which, during its annual consultations with the DSGV, drew attention to the high intensity of regulation and the continuing negative trend in new business registrations in Germany.

A survey conducted by the DSGV last year on the topic of business taxes also showed that the biggest problem for small and medium-sized enterprises was not the level of taxes, but the complexity of tax law.

SME clients do not feel threatened by a possible increase in interest rates.

Reversal in interest rates

Only one out of ten SME clients of the Savings Banks currently sees rising interest rates or more difficult access to borrowed capital as a risk. Although increasingly indicators support a reversal in interest rates in the euro area, nearly 40 percent of the enterprises perceive the continuing low interest rates as an opportunity for global economic development.

However, this does not prevent the Savings Banks' SME clients from playing it safe and taking advantage of the current low level of interest rates in order to lock in their interest expenditure over the long term. Approx. 95 percent of SME clients are currently requesting loans with the same or longer terms. Something similar applies to risk management. The two hedging instruments cited most frequently are fixed-term loans and interest-rate swaps. Only about one-fifth of the enterprises are interested in loans with variable interest rates.

Nevertheless, they continue to finance investments with long-term fixed-rate loans.

Although, from a macroeconomic perspective, there is a great deal of evidence which suggests that interest rates and refinancing costs will increase in the near future, there are also a number of good arguments for believing that such an increase in interest rates would pose only a minor problem for Germany's SMEs.

Their high profitability enabled SMEs to increase their equity ratio from 29 percent to 39 percent of balance sheet total in the period from 2004 to 2017. It is particularly positive that all sectors participate equally in this trend. Even sectors that used to be less well capitalised in the past – such as construction or hospitality – today finance roughly one-quarter of their business with equity.

Due to a higher equity base and long-term fixed-rate loans, increases in interest rates would only have a limited impact on SMEs.

However, this trend has not reduced the importance of bank loans because the use of loans has also grown steadily. On the balance sheets of enterprises, liabilities to banks grew by approx. 6 percent in 2017, while equity increased by "only" slightly more than 4.5 percent. Traditional bank loans are the most important source of financing, in particular for small and medium-sized enterprises. In enterprises with an annual turnover volume of up to one million euros, bank loans account for two-thirds of debt.

Although loans have grown at an above-average rate, SMEs have much lower debt today than during the period of higher interest rates before the outbreak of the financial crisis. The decreasing debt ratio, combined with the low level of interest rates, has had a positive impact on the enterprises' profitability. In 2017, their interest expense amounted to only about 1.2 percent of turnover, while it was still at 1.8 percent in 2011. On the other hand, the aggregated expenditure for materials and personnel, taken together, amounts to approx. three-quarters of turnover. Hence, an increase in interest rates would not have significant effects on the profitability of SMEs.

A study conducted by the DSGV's Branchendienst in March 2018 came to the conclusion that, if interest rates increased abruptly by two percentage points, the enterprises' return on sales would decrease only from 6.0 to 5.9 percent in the first year. This is due, among other things, to the fact that 83 percent of the Savings Banks' loans to enterprises are fixed-rate loans with an average term of six years. This means that it would take six years for an increase in interest rates to have full impact on the P&L accounts of SMEs. In the 2-percent scenario, returns could then be expected to fall by approx. 10 percent to 5.5 percent.

Default rates among the Savings Banks' SME clients would also increase only slightly.

A second consequence of a reversal in interest rates and the associated macroeconomic effects would be surcharges to the credit risk premiums. Banks and Savings Banks assess the probability of customers defaulting and calculate a customer-specific credit risk premium on this basis. In times of rising interest rates and falling earnings, default probabilities and risk premiums usually increase.

The importance of loan financing for SMEs in Europe

Enterprises primarily acquire debt in two different ways: either they take out loans from banks, or they issue financial instruments such as securities or bonds in the money and capital markets.

Sustainable and reliable access to bank loans plays a particularly important role for SMEs. On the one hand, bank loans provide a price advantage for SMEs at the transaction level, compared with capital market financing. For small and medium-sized enterprises, external ratings, statutory disclosure requirements and placement costs are more cost-intensive than for large-scale enterprises because of the high share of fixed costs. On the other hand, regional banks such as Savings Banks often have better credit information about their SME clients than capital market investors. This enables the financing banks to carry out a higher-quality risk assessment than capital market players. This reduction of information asymmetries provides price advantages for customers and leads to greater efficiency in terms of the macroeconomic distribution of financial resources. In addition, bond issues on the capital market are not an option for many enterprises because of minimum volumes.

While a direct comparison between the costs of bank loans to commercial borrowers and capital market financing shows that bonds tend to provide a price advantage, it must be borne in mind that these figures do not include the bond issuing costs. Furthermore, G06 shows that capital market financing was associated with higher costs and greater volatility during the financial crisis of 2008/2009.

However, in addition to pricing aspects, the geographical availability of financing resources also plays an important role when small and medium-sized enterprises take financing decisions. In Germany, far more than 1,000 regional credit institutions that are oriented to the real economy provide nationwide access to financial services, for both retail and business clients. Germany's Savings Banks see this as their public service mission, which is enshrined in the legislation of Germany's federal states. Without Savings Banks, many enterprises would therefore not be able to operate in structurally weak regions.

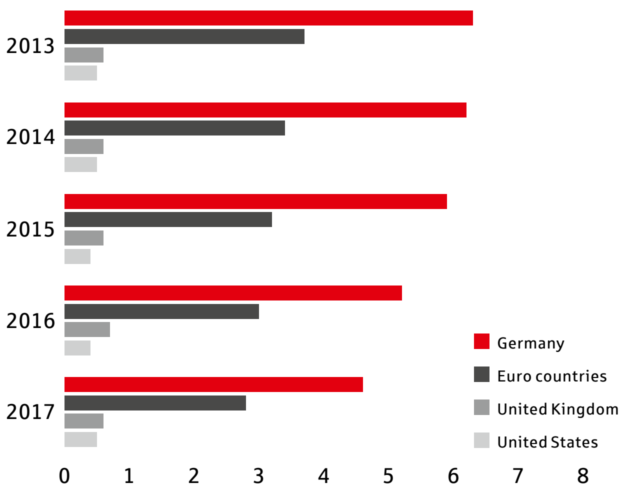
This structural particularity of Germany is also reflected by the ratio of loan-based to capital-market-based financing of enterprises. In 2017, this ratio was just below 5:1 in Germany, which was much higher than in the euro area. In Anglo-Saxon countries such as the UK and the United States, on the other hand, enterprises use bonds rather than bank loans for financing purposes (G07).

This is due to a significant shortage of regional banks, in particular in the UK 74 percent of the British banks, for instance, have their headquarters in London. By comparison, only 7.1 percent of German banks were headquartered in Frankfurt/Main in 2015.[1] A survey conducted among British SMEs showed that half of all small and medium-sized enterprises in the UK have problems in obtaining credit. In the view of the SMEs interviewed, the main problem was the banks' lack of SME expertise.[2] In contrast, only close to 15 percent of Germany's SMEs currently believe that access to credit is difficult.[3]

Lending rates versus capital market rates G06

Source: Datastream, ECB, own calculations

Ratio of loan to bond financing in various countries (2013 to 2017) G07



Source: ECB Statistical Warehouse, United Kingdom Office of National Statistics, Federal Reserve Economic Data, own calculations

[1] Franz Flögel and Stefan Gärtner, The Banking Systems of Germany, the UK and Spain from a spatial perspective: The UK Case, Discussion Paper 17/03.
[2] Close Brothers, Banking on Growth: Closing the SME funding gap Understanding the changing needs of Britain's SMEs, November 2016.
[3] Source: Kreditanstalt für Wiederaufbau, 2018, Sentiment in the credit market remains good, Survey among E nterprises, page 3 (enterprises with an annual turnover of up to €50 million).

Savings Banks play a more important role for SME financing today than ten years ago.

A calcuation of Sparkassen Rating- und -Risikosysteme (Savings Banks' Rating and Risk Systems) concludes that, under the stress scenario described above, an abrupt increase in interest rates by two percentage points would lead to only slightly higher default rates among SME customers. The number of SME clients with payment difficulties would increase by approx. 4 to 6 percent. In view of the currently very low percentage of non-performing loans, an increase in this order of magnitude would be quite manageable for the Savings Banks Finance Group.

This is a very important finding because the developments during the financial crisis in 2008 and 2009 had shown that efficient Savings Banks and other banks play a prominent role in ensuring a continuing supply of credit, and hence, in ensuring the resilience of the real economy. It was mainly owing to Savings Banks and co-operative banks that a credit crunch was avoided in Germany during the financial crisis.

Policymakers need to ensure that regional banks will not be unduly burdened by new regulation and low interest rates.

As demonstrated above, the market share has grown as has the importance of medium-sized regional banks such as Savings Banks and co-operative banks for SME financing. Today, SMEs rely on a stable relationship with their local bank, more so than ten years ago. For this reason, it is of great significance that the particularities of regional credit institutions that are focused on the real economy are taken into account in terms of the political and regulatory environment. First and foremost, regulatory requirements should be facilitated and simplified for medium-sized, less complex credit institutions to fit in a “Small and Simple Banking Box” as requested by the DSGV for a long time now. A first step in this direction has recently been taken by the Swiss Financial Market Supervisory Authority with the regime it launched for small banks.

Germany's scope for fiscal policy measures is greater than that of other countries.

Potential fiscal countermeasures

In addition to a stable supply of credit, fiscal policy measures can also help enterprises to survive economic slumps. In 2009, at the peak of the crisis, the effects of the crisis were cushioned in particular by the temporary extension of short-time work benefits and the introduction of a bonus for exchanging used cars.

As described above, government debt has significantly increased worldwide as a result of the crisis. This considerably restricts the ability of many governments to finance additional stimulus programmes by borrowing funds in the event of another downturn. In this respect, Germany is in a special position because it is the only large country in the euro area that has kept its debt ratio constant since the outbreak of the financial crisis. In 2017, Germany's government debt-to-GDP ratio amounted to approx. 70 percent, which was far below the ratio of the euro area and the United States (just above 100 percent of GDP) (G05).

In the event of a global economic downturn and a decline in exports, this scope should be used in a focused manner.

This development was due to the fact that the government had achieved and maintained a balanced budget for several years. The German government therefore has the financial scope to counter an economic slowdown by adopting additional fiscal policy measures, as in 2009. However, it is not clear how quickly the government could actually implement measures designed to support market demand for goods and whether the categories of goods supported in this way would make up for a sudden drop in demand from abroad.

In any case, fiscal policy will play a more important role in the next economic downturn than during the last slump in 2009. This is due to the fact that, compared with the 2009 crisis, the European Central Bank would have far less latitude in monetary policy. Reducing interest rates to an even lower negative level would make it more attractive to hold cash. Extending the bond buying programme once again would drastically increase the risk that credit might be misallocated and that price bubbles might emerge.

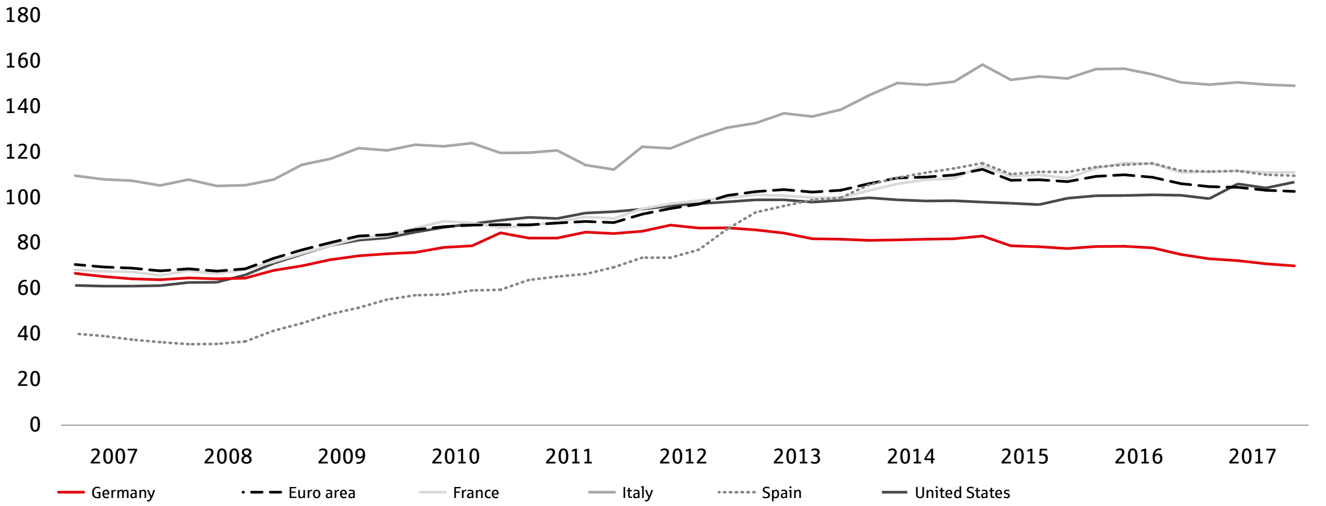
In the event of a protracted decline in exports, major structural changes would be necessary for Germany and Germany's SMEs.

Small and medium-sized enterprises have very limited scope to circumvent punitive tariffs on exports by moving their production to another country. Hence, only about 6 percent of the Savings Banks' SME customers are planning additional foreign investments. If exports decline, it is important for SMEs that the government introduces programmes specifically designed to stimulate domestic demand. A protracted decline in exports would call for a major structural change in Germany's economy.

A second target of public investments should be the expansion of the digital infrastructure and an increase in IT investments. According to the IMF, Germany ranks far behind other OECD countries such as Switzerland, the United States and South Korea in both fields. On the other hand, in 2017, Savings Banks registered the strongest turnover growth for SMEs in the digital sector; this, of course, comes as no surprise. Topics such as the "Internet of Things", Industry 4.0, alternative drives and autonomous driving will drive this sector's turnover growth for a long time to come. It is all the more important that public investments should be more focused on expanding broadband networks in rural areas.

These changes should be addressed by investing in the future.

Ratio of public debt to gross domestic product, large euro area countries and United States G05



Source: IIF Debt Monitor

4 SURVEY AMONG THE SAVINGS BANKS' EXPERTS

The survey conducted among the Savings Banks' experts complements the S-SME Fitness Index and the focus theme of the SME Diagnosis. For the purpose of the survey, a total of 330 of our customer relationship managers for business clients were interviewed nationwide in the period from August to September 2018. These experts not only have very extensive knowledge of the sector of small and medium-sized enterprises, but they also regularly meet for discussions with their SME clients. This enables them to provide a professionally sound and up-to-date assessment of the business performance, views and plans of their more than 2 million business clients.

SMEs are aware of global risks

Nearly half of the SMEs have been able to improve their business performance in the past twelve months because of a positive economic environment combined with favourable financing terms. Despite slightly less-positive expectations for the future, the Savings Banks' experts believe that the vast majority of their customers will be able to maintain their strong performance in the next twelve months.

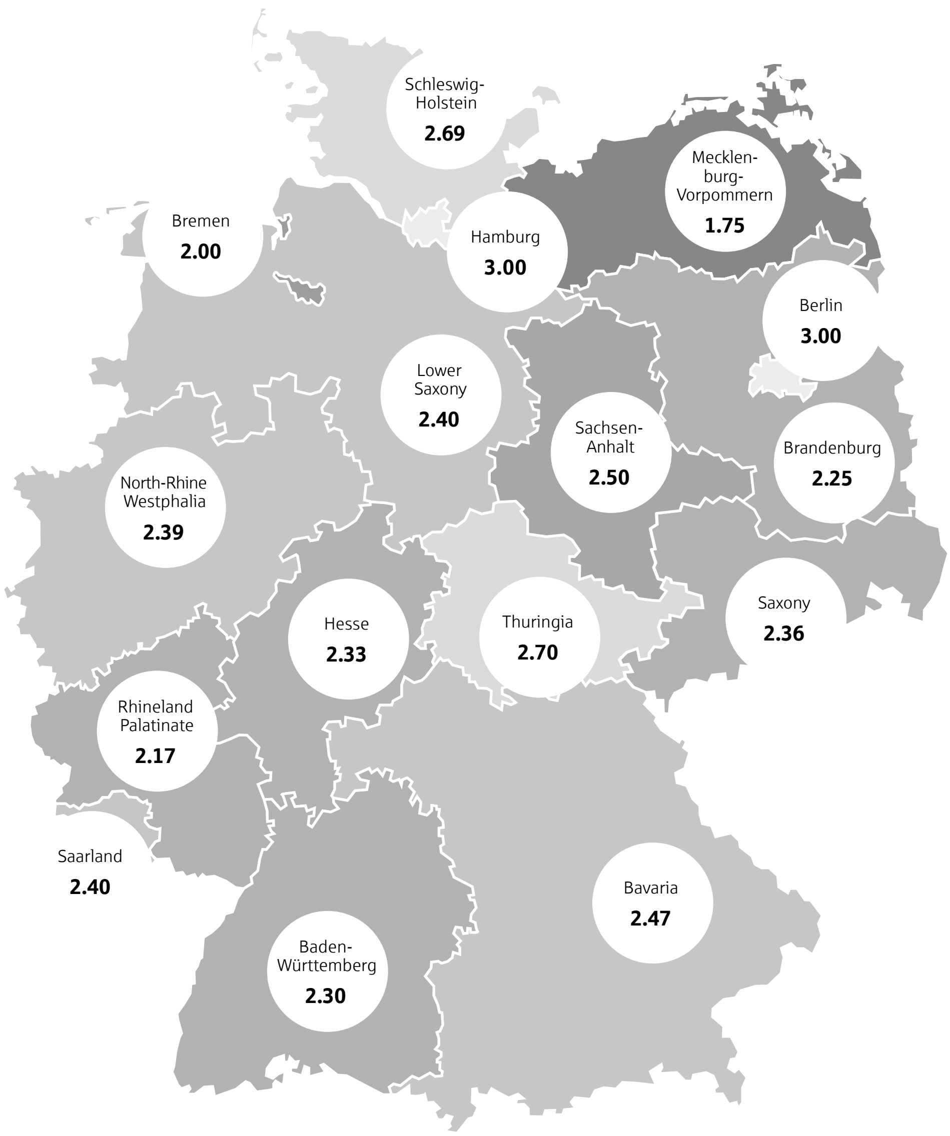
However, slightly over half of the SME clients consider the global economic environment as predominantly negative. The trade war with the United States, increasing prices of raw materials, geopolitical tensions, and the risks associated with Brexit are cited as particularly adverse factors. The majority of the Savings Banks' SME customers do not see an upcoming reversal in interest rates as a threat. Nevertheless, they are taking precautions and continue to finance their investments conservatively with longer-term fixed-rate loans, or they use derivatives to hedge against rising interest rates.

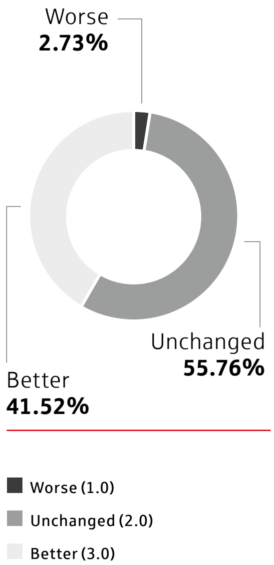
Part 1: Current business performance, outlook and economic environment in Germany

Question 1: How do you assess the current business performance (orders, turnover, earnings) of your SME clients compared with the previous year?

Choice of answers: better, worse, unchanged

According to the Savings Banks' financing experts, the business performance improved for 42 percent of the SME clients last year. While this figure is lower than in the previous year (52.5 percent), it is much higher than in 2016 (30.5 percent). In 2017, SME clients increased both their turnover and their profits. The return on sales achieved by mid-sized business clients in this period of time amounted to 6 percent.

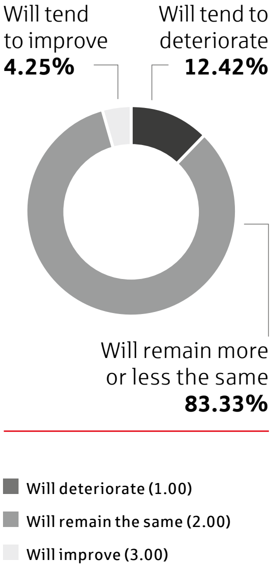


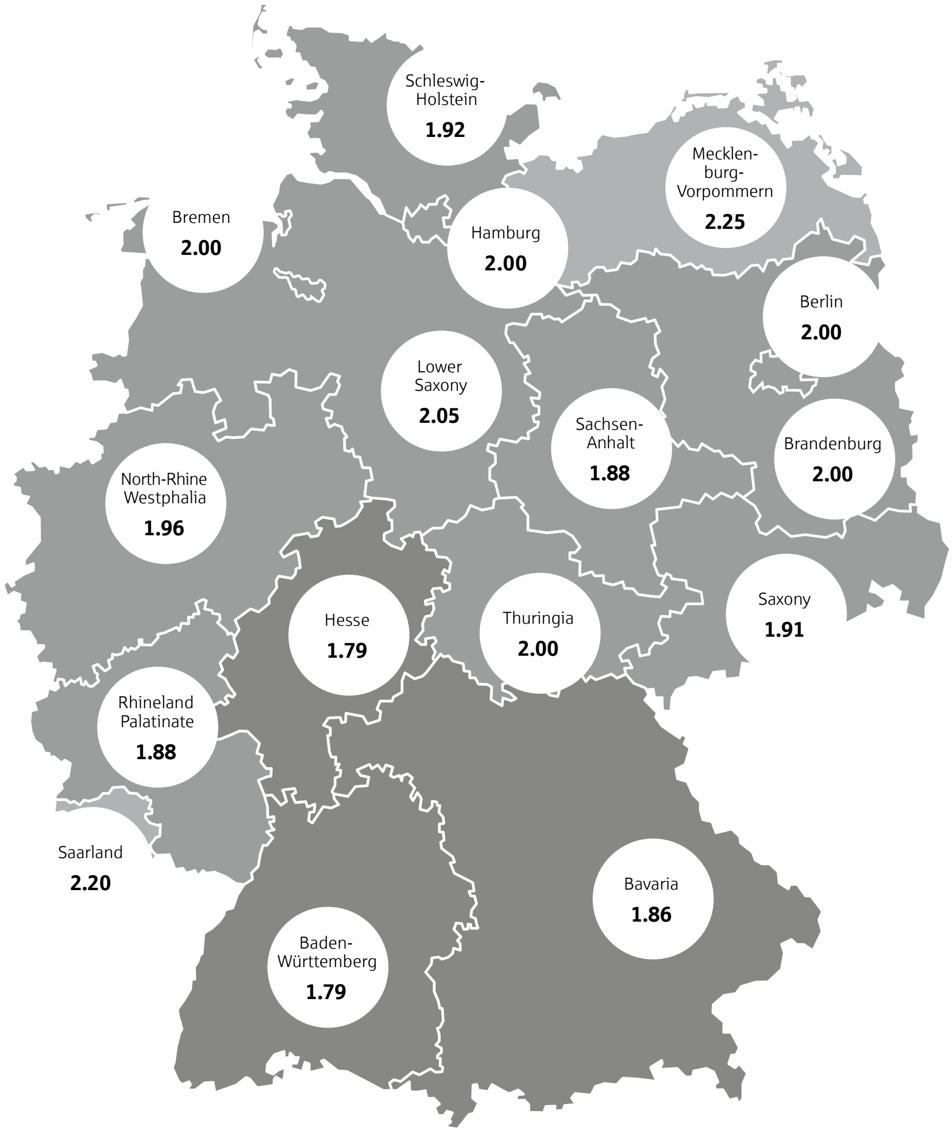


Question 2: On average, do your SME clients expect that their business performance will:

Choice of answers: remain more or less the same, tend to improve, tend to deteriorate

According to the respondents, the SMEs' business expectations for the next twelve months have significantly deteriorated. While 14.3 percent expected an improvement last year, this applied to only 4.5 percent in the current survey. The respondents assume that 83.7 percent of the enterprises (2017: 83 percent) will be able to maintain their business performance over the next twelve months. However, because of the very strong performance of SME clients in the past few years – the DSGV's S-SME Fitness Index reached a new record high of 101.9 points – the latest survey results can still be seen as very positive. The experts assume that, in the next twelve months, nearly 90 percent of the SME clients will be able to maintain or even surpass their solid performance of 2017.

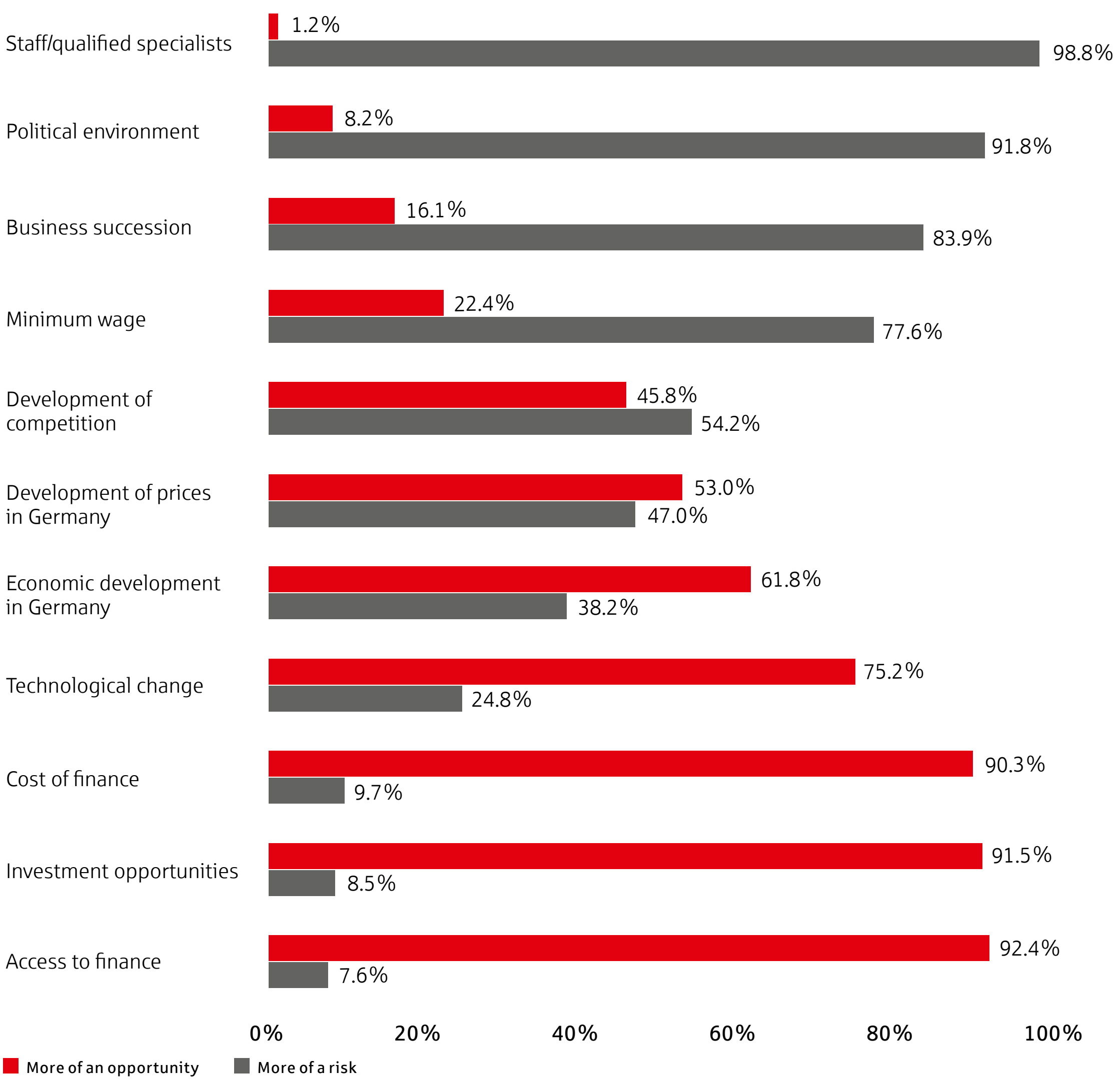




Question 3: How do the majority of your SME clients assess the following factors with a view to the future development of their enterprises?

The shortage of skilled labour (98.4 percent) and the political environment (91.3 percent) are currently perceived as the biggest risks for the future development of their enterprises. This is in line with earlier DSGV surveys (shortage of skilled labour: 83 percent) and a recent survey conducted by the Darmstad Technical University among larger mid-sized industrial enterprises. In this survey, only 26 percent of the respondents stated that they were satisfied with the German government's current economic and SME policies.

SME clients see factors such as access to finance (92.4 percent) and the low cost of finance (90.3 percent) are seen as an opportunity for their future development. The majority of the enterprises told the Savings Banks' experts that they perceived the economic development in Germany (61.8 percent) and the associated investment opportunities (91.5 percent) as an opportunity for the future development of their enterprises.



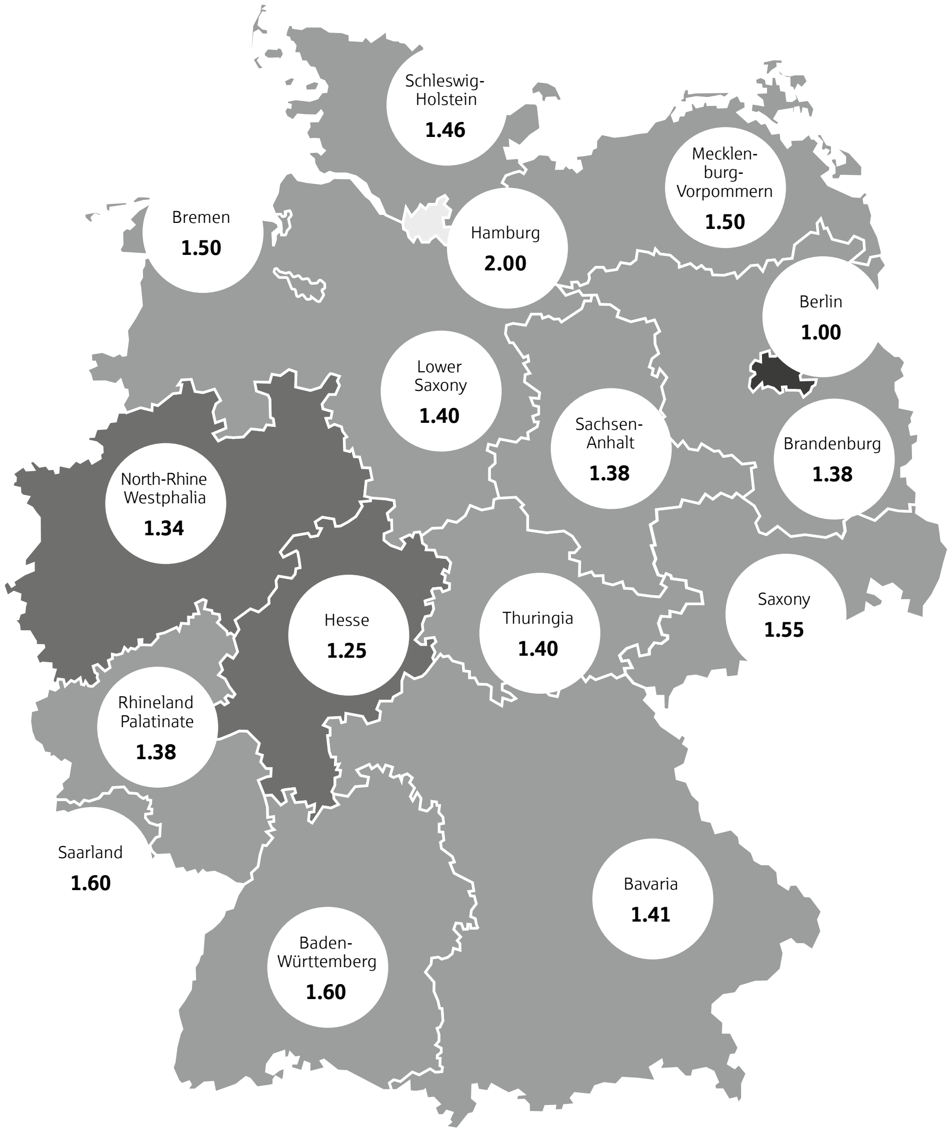
Part 2: Current global economic environment and effects on business performance

Question 4: How do the majority of your SME clients assess future global economic development?

Choice of answers: mainly negative, mainly positive

According to the experts interviewed, the Savings Banks' SME clients have a more critical attitude towards future global economic development than towards the future economic development in Germany. 58.7 percent perceive global economic developments as mainly negative. In question 5, the experts were asked what adverse global factors had led to this negative assessment.

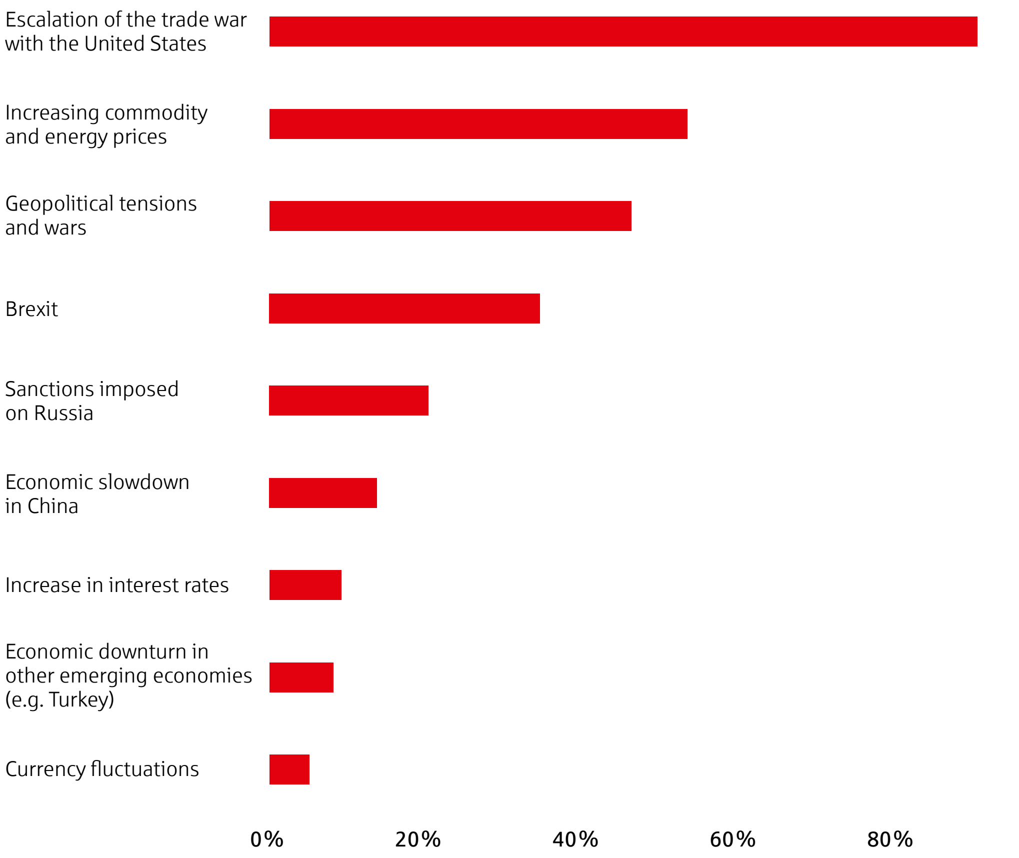
Mainly negative (1.00)
Mainly positive (2.00)



Question 5: In the opinion of your SME clients, which factors will have the strongest adverse impact on future global economic development?

Question was asked if the answer to question 4 was "mainly negative"

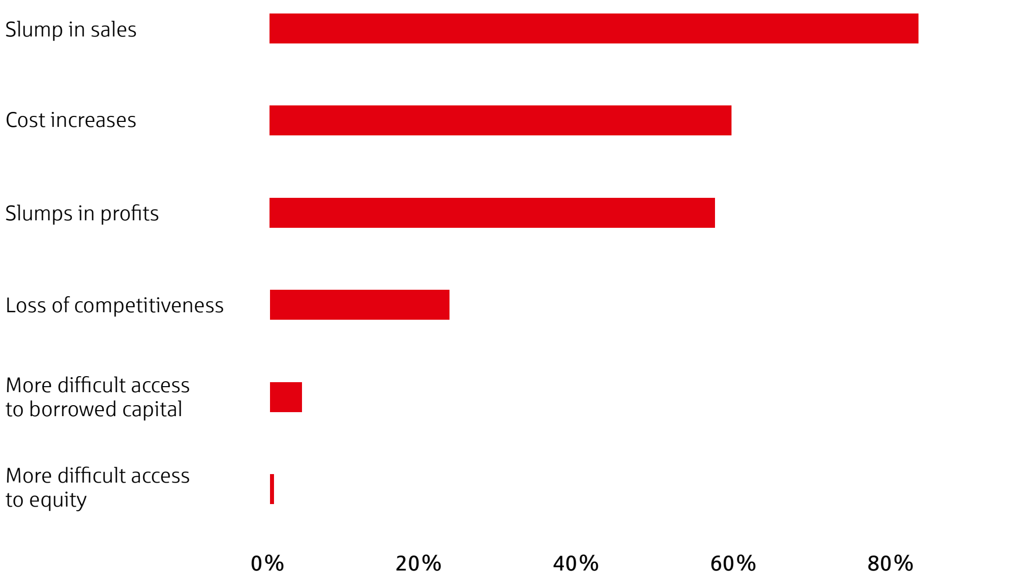
According to the experts interviewed, their SME clients believe that the trade war with the United States (90.8 percent), rising commodity and energy prices (53.6 percent), and geopolitical tensions and wars (46.4 percent) are the most important adverse factors that will affect future global economic development. The answers clearly demonstrate that SME clients are very aware of current global challenges.



Question 6: When you speak with your SME clients about a slow-down in the global economy, what effects on the business performance of their enterprises do they cite most frequently?

Question was asked if the answer to question 4 was “mainly negative”

The direct effect of a global economic slowdown cited most frequently by SMEs in their conversations with the Savings Banks’ experts is a slump in sales (83.2 percent). Cost increases (59.2 percent), which rank second, are primarily related to the risk of rising customs duties and commodity prices.

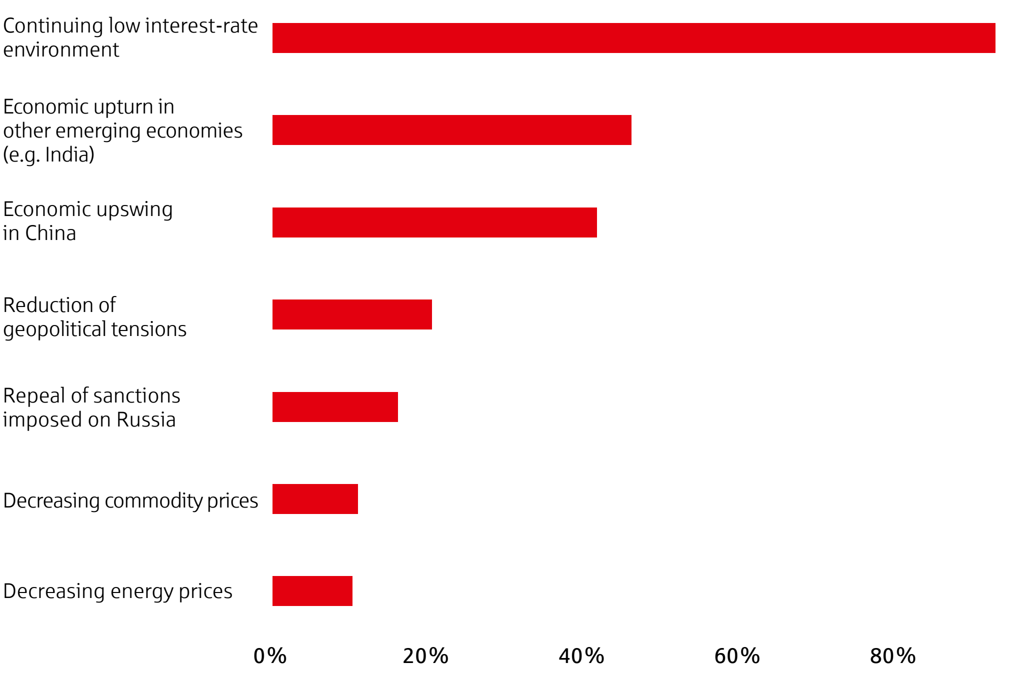


Question 7: What factors support a positive global economic outlook in the view of your SME clients?

Question was asked if the answer to question 4 was "mainly positive"

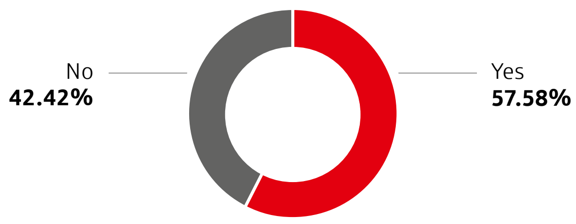
Small and medium-sized enterprises primarily see the continuing favourable financing terms (92.70 percent) as a positive factor in the current global economic environment. In 2017, Germany ranked third within the euro area with interest on loans to enterprises amounting to 1,82 percent, following France (1.57 percent) and Belgium (1.81 percent).

Despite the escalating trade conflict between the United States and China, 41.7 percent of SMEs continue to expect a sustained upswing in China. Nearly 46 percent also look to other emerging economies like India, hoping that their development will provide a positive impetus for the global economy.



Question 8: Do the majority of your SME clients assume that global economic development will directly affect their own enterprises?

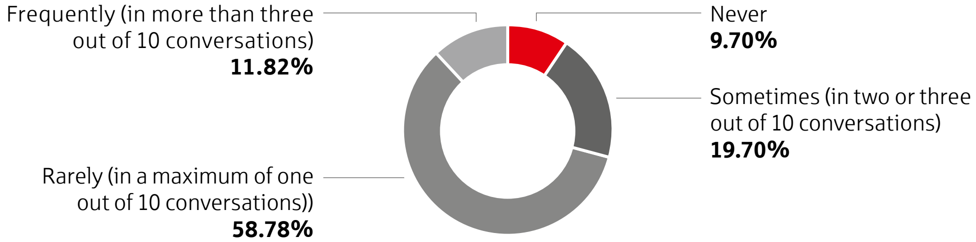
Overall, more than half (57.6 percent) of the SME clients assume that global economic development will directly affect their own enterprises. Since only around 10 percent of the Savings Banks' experts interviewed advise enterprises with an export ratio of more than 30 percent of turnover, the figures clearly demonstrate that global economic developments are also an issue for SMEs with medium or low export sales.



Part 3: Recent developments in financial risk management

Question 9: How often do your SME clients ask you about the use of financial instruments to mitigate interest-rate or price risks?

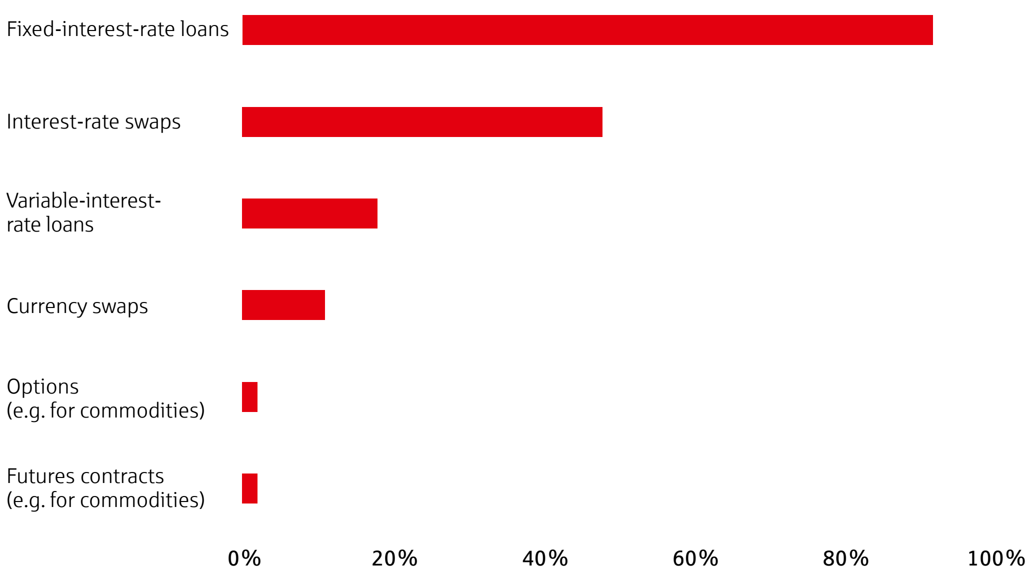
Only 11.8 percent of the SME experts are frequently asked by their clients about hedging interest rate risks. This reflects the view – which still prevails among SME clients – that significant interest rate increases are not expected in the foreseeable future. However, it should be borne in mind that, currently, approx. 83 percent of the Savings Banks' loans to enterprises are already fixed-rate loans with an average term of six years.



Question 10: When you speak with your SME clients about the use of financial instruments to mitigate interest-rate or price risks, what products are discussed most frequently?

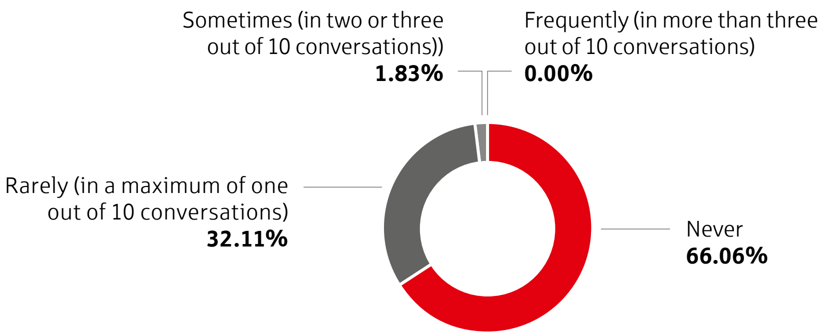
You can choose up to two products.

For SME clients, fixed-rate loans continue to be the most popular instrument to hedge against interest-rate risks. In 91.9 percent of cases in which the Savings Banks' experts discuss interest-rate hedging transactions with their SME clients, they refer to the use of fixed-rate loans. Nearly half of the SME clients (47.7 percent) are also interested in the use of interest-rate swaps, which are a more cost-effective and flexible instrument for managing interest-rate risks. Nearly one out of five SME clients (18.1 percent) has considered taking out variable-interest-rate loans, which enable enterprises to continue to benefit from low or decreasing short-term interest rates.



Question 11: How often do your SME clients ask you about the use of capital-market-based financing instruments such as SME bonds or peer-to-peer financing?

In only about 3 percent of their meetings with SME clients, the Savings Banks' experts are asked about the use of capital-market-based financing instruments such as peer-to-peer financing. This demonstrates that interest in traditional bank loans is unabated, in particular among small and medium-sized enterprises. For SMEs, the transaction costs of a bank loan are much more favourable than the costs of capital-market-based financing. Neither external ratings nor cost-intensive placements are necessary for SMEs to take out a bank loan.



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