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Which Financing Options Can Support Germany's Mittelstand Today?

Whether for succession, transformation or expansion – only the right financing turns plans into reality. But which instruments are currently available, and which best suit particular objectives? An overview.

There is no question that corporate decision-makers in Germany face numerous challenges. Some are structural but have accelerated in recent years: bureaucracy, digital transformation, demographic change, and a shortage of skilled workers. More recently, additional challenges have emerged – from new tariff and trade barriers to sluggish economic growth – both domestically and in previously fast-growing markets such as China.

All the more notable, then, is the resilience with which Germany's Mittelstand (medium-sized companies) has been responding with creativity and a willingness to change, and with the courage to invest even in difficult times, thereby positioning themselves for the future.

Anyone pursuing new markets, technologies, or ownership changes needs strong (financing) partners. In recent years, banks have become markedly more risk-averse and thus more selective, making them less available as financing partners than before. Regulation has also made it harder for banks to finance important corporate investments in challenging times. Rising capital requirements in the wake of Basel IV, for example, are likely to prompt banks to pull back from financing certain sectors and credit-quality categories. As of early 2025, internal bank risk models for calculating capital requirements (risk-weighted assets) must be supplemented by the standardized approach. Under the standardized approach, the default risk weight is 100% if no external rating is available. In practice, this means banks must hold more equity capital.

At the same time, the range of alternative financing options has expanded. During the low-interest era, some finance leaders with strong credit profiles passed on these options. But with the shift to higher interest rates, even “classic” bank loans are no longer as inexpensive as they were before 2022. Which types of financing work best for which situations today? Not every instrument is equally suited to every financing task.

Below, we outline the most important solutions currently relevant for medium-sized companies, aligned with typical financing situations such as succession and transformation. In the process, certain instruments may also be “rediscovered” – mezzanine capital, for example.

A few important points to note first

Banks remain important financing partners – even in tough times. However, due to the regulatory requirements mentioned above, they are required to hold more capital against potential credit risks. When corporate balance sheets deteriorate broadly – as often happens in an economic downturn – they are compelled to adjust their lending. This can mean pulling back from certain lending commitments or tightening terms. Many medium-sized companies only notice these changes when a refinancing comes due or they want to expand their borrowing. At that point, some discover that tighter limits are being imposed, or that their established financing partner won’t renew or roll over existing lines. These difficulties can complicate important plans such as taking a larger equity stake or building a new product line. It’s therefore crucial for business owners to understand the current financing landscape and all available options at an early stage. That way, key projects stay on schedule without the numbers having to be reworked.

Against this backdrop, it makes sense to work with trusted partners to seek solutions – and to approach new financing partners as well. As a rule, the aim is to give lenders greater assurance by reducing their risk. Right now, however, it is hard for companies to post additional collateral based on their existing balance-sheet assets. In that case, it becomes necessary to broaden the existing toolkit of financing instruments. That toolkit is more diverse than ever: equipment leasing can help fund the modernization of manufacturing; factoring can quickly monetize trade receivables, strengthening working capital; mezzanine financing provides medium-term capital and, if structured appropriately, can be treated as equity from an economic perspective, improving balance-sheet ratios. And finally, equity financing – such as private equity – creates additional headroom for investment.

Banks often view such instruments – even if they do not offer them themselves – as a valuable complement, provided their own collateral remains unaffected. If existing banking partners and other financiers are involved in such considerations at an early stage, potential conflicts of interest can be identified in advance. The company can also benefit from the bank's network and relationships with other financiers.

Succession and shareholder changes

According to the KfW Succession Monitor – an annual survey on succession in SMEs – around 215,000 medium-sized companies will be looking for a successor by the end of 2025. By the end of 2028, roughly 532,000 of the total 3.84 million SMEs are aiming to arrange succession. However, there are now more entrepreneurs who are seriously considering – or actively planning – to shut down the business: 231,000 are seeing this as an option by the end of 2025. The reason: no successor can be found for their company. This, in turn, may be because the existing business model is outdated or important investments in the future have been neglected. In such cases, even a very low purchase price is too high for potential successors, because the necessary investments render an acquisition unattractive. There are, however, interesting options to address precisely this problem early on. But why are necessary adjustments and investments so often neglected? Usually, there are several reasons:

- The existing shareholder group lacked the impetus or insight that changes would be necessary to prepare for the future.

- The company's profitability was too weak to finance necessary measures from internal funds.
- The departure of one or more shareholders required significant payouts, constraining the financing capacity of the company and/or the remaining shareholders.

All three issues are solvable. Two key approaches are mezzanine and equity investments.

Mezzanine is making a comeback

Many financing advisers will recommend that – if the remaining shareholders cannot or do not wish to finance a shareholder's exit – another equity investor should be brought in. In doing so, the option of mezzanine financing is often overlooked. Mezzanine financing can fund, among other things, necessary investments or a shareholder's exit. For example, the managing directors (and co-shareholders) of *Votronic*, a leading manufacturer of electronics for motorhomes and special-purpose vehicles, were able to buy out their co-shareholder *VR Equitypartner* using mezzanine financing. They are now the sole owners.

The relatively long financing horizon – typically five to seven years – provides enough time to pay out the departing shareholder without overburdening the company. Mezzanine can also help when the designated successor from the company's management (or an external manager) lacks the necessary capital to finance the acquisition of shares and neither the bank nor the seller will grant a loan.

Depending on its structure, mezzanine can be classified on the balance sheet as equity or as debt. This is particularly attractive for shareholders who are reluctant to bring in a new shareholder. Thanks to mezzanine, the departing shareholder can be bought out without changing the ownership structure.

Although mezzanine capital has equity-like features, providers do not usually receive typical voting or control rights. At the same time, mezzanine is subordinated to traditional senior debt. This means the mezzanine financier takes on higher risk. Accordingly, this additional risk is offset by a higher interest rate, typically in the low double digits. The exact rate depends on the borrower's credit quality and the structure of the loan agreement. With custom ("individual") mezzanine, a tailored cost structure can be agreed – for example, combining a fixed rate with a performance-based variable rate. Terms can be adjusted based on metrics such as EBITDA performance or leverage. An "equity kicker" can reduce the cash interest burden: additional payments are agreed for a defined point in time (for example, in the event of a company sale) and are linked to enterprise value.

Companies should therefore not be put off by mezzanine's additional cost. Because of its variable features, the mezzanine provider shares the entrepreneurial risk; their return increases with the company's performance. Mezzanine – see "A few important notes before we begin" above – also increases the capital buffer for senior lenders. As their risk is reduced, they are more willing to expand credit lines or improve lending terms for senior loans. What matters is the total cost of financing – not just the cost of mezzanine capital.

Where private equity fits

Private equity is often used when, for example, no successor can be found within the family and there is a deliberate decision to bring a private equity firm – with its expertise and financial resources – into the shareholder group. This can give the existing shareholders access to the investor's network – seasoned advisers or other entrepreneurs from the portfolio. Private equity firms bring extensive experience, for instance in restructuring, further developing the business model, or opening up new markets.

Equity provided by financial investors – much like mezzanine capital – expands overall borrowing capacity. Because the capital cushion for lenders grows here as well, their risk decreases and lenders become more willing to finance and/or improve their terms. A key advantage of equity is that it carries no fixed costs, with the investor sharing the entrepreneurial risk alongside existing shareholders. However, they will only take on this risk if there is a realistic prospect of an adequate return. To achieve this, the investor has two levers: first, a regular share of profits proportional to their equity stake. Even more relevant is the second lever: increasing the company's value at the investor's exit. Hence financial investors have a strong interest in investing in profitable corporate growth.

When shareholders opt for a private equity firm, they should get to know their new partner. If the fundamentals have been outlined (possible price range, cultural and personal fit, a successful track record, and perhaps even extensive industry experience), several further points need to be clarified:

- ***Does the investor have the experience, network, and, where appropriate, in-house personnel to address specific weaknesses in the company?*** The most convincing evidence is how they have proceeded with other portfolio companies of comparable size, industry, and strategy.

- ***What constraints on our existing decision-making autonomy should we expect?*** Some investors will want to get actively involved in day-to-day operations, while others deliberately focus on strategic support and stay out of day-to-day operations.

- ***What is the investor's intended holding period?*** With private equity funds, the fund term typically limits the holding period to a few years. Others may have a similar time horizon for their investment but, thanks to "evergreen" structures, can be more flexible when market or company developments require it. This preserves the option to implement measures that may only pay off later – potentially with greater upside.

- ***How does the investor behave if things do not go according to plan?*** In recent years, the COVID-19 pandemic and the conflict in Ukraine have caused unexpected disruptions. Does the investor have the financial strength and know-how to support the company through such phases?

Many financial investors are interested in a close partnership with the company's senior executives. They therefore often offer attractive equity participation to previously employed managers. This can turn an employee into a shareholder, even if he initially lacks sufficient personal funds. Managing shareholders are sometimes offered a "rollover" (Rückbeteiligung), allowing them to sell a significant stake to the financial investor while retaining or re-investing an interest. Tying in key managers ensures continuity and can prepare the ground for a final succession arrangement. Together, the incumbent management and the new financial investor can make the necessary investments in the company, optimize the business model and cost structure, or make other important growth-driving decisions. This can enable the company to be sold later at a more attractive price and the succession to be completed.

For the entrepreneur, it is appealing to ring-fence personal wealth while remaining significantly invested. At first, this may sound expensive: you sell a significant stake at a relatively modest price and, before a later sale at a higher price, you own a smaller share. The crucial question, however, is whether the company would have been able to increase its value to that extent without the financial investor – or whether, with continued underinvestment or an outdated business model, its value might even have declined. The entrepreneur and the investor can negotiate an ownership split that is attractive to all parties.

Investing in transformation

As noted above, mezzanine and equity are both well suited for funding investments that facilitate a successful ownership succession. To give companies a viable path for the next generation, they need growth opportunities for the years ahead. Investing to address current issues also builds resilience to future uncertainties:

- ***Optimizing supply chains and mitigating trade uncertainties:*** Establishing new sites can help move closer to key existing customers, open up new markets, or take advantage of more favorable production conditions.

- ***Investments in digitalization and automation:*** To remain competitive even in high-wage locations, investments in modern machinery, software, and hardware are necessary – for example in modern manufacturing IT or automated procurement.

– ***Unlocking new growth opportunities:*** By expanding existing production capacities, a company can better meet rising customer demand or reduce dependence on suppliers by extending its value chain.

– ***Investments in sustainability and energy savings:*** Adjustments to an existing production setup typically better meet the requirements for climate-friendly manufacturing and reduce reliance on externally purchased energy.

New production sites and greater automation can also help counter the shortage of skilled labor. Becoming less dependent on individual markets means decoupling from specific economic cycles. Modernizing machinery or adding on-site renewable energy sources such as solar PV can lower energy costs – in other words, companies that don't take advantage of today's possibilities are hurting their future prospects. For medium-sized companies, however, after years of cyclical weakness, increased bureaucracy, and rising costs, it is difficult to fund the necessary investments in digitalization and transformation. Which financing instruments are suitable? As with succession (see above), mezzanine and external equity are again options – alongside other avenues such as machinery leasing.

Mezzanine

Mezzanine is once again an attractive financing option. Because bullet repayment at maturity is customary, longer payback periods don't strain liquidity. In addition, since the mezzanine term can be tailored, the financing can be aligned precisely with the investment requirement. With mezzanine financing, major transformation steps can be taken without overstretching the existing financing structure.

Private equity

An alternative or complement to mezzanine is equity. New shareholders may be another company or a financial investor. Using a "buy-and-build" strategy – that is, the targeted acquisition of one or more other companies – the existing strengths of a business can be expanded with new products, capabilities, locations, or customers.

Machinery leasing and other options

For years, "alternative" financing instruments such as leasing and factoring have seen rising demand. However, these depend heavily on the company's specific situation and the investment objective. Leasing helps spread costs compared to a one-off investment. That said, the lessor will also want to hedge its risks. As a rule, lessors typically finance assets that have residual value and are marketable, such as vehicles and machinery. The company's creditworthiness is another important factor in securing leasing finance. Factoring, in turn, is only viable if there is a steady and sufficient volume of receivables from creditworthy customers. Companies should be aware that factoring is not a short-term financing solution.

Private debt – debt financing provided by funds, insurers, and others as an alternative to bank or capital-market borrowing – has also become increasingly widespread. Usually more expensive than traditional bank loans, private debt offers greater flexibility. If a bank declines financing, for example for credit or other risk concerns, this instrument can help fund acquisitions or other investments.

Stronger together

When selecting the "right" financing solution, consider the following:

- Do terms such as tenor, security/collateral, pricing, repayment schedule, in formation and consent rights, and related covenants, suit both the financing purpose and your company's interests?
- How flexible is the instrument if plans change – what are the triggers and consequences?
- How does the instrument fit into the overall financing structure?

This brings us back to a statement at the start of this text: "Banks – even when they do not offer such instruments themselves – often see them as a valuable complement."This is especially true for the *Genossenschaftliche Finanzgruppe* (*GFG*), as illustrated by *Votronic*, mentioned above: At the end of 2017, the two founders of this medium-sized specialist in electronics for special-purpose vehicles and recreational vehicles discussed a potential succession solution with their local *Volksbank Lauterbach Schlitz eG*. Two interested managers lacked the necessary equity to purchase the company. The *Volksbank* put them in touch with *GFG*'s investment company *VR Equitypartner*. In the end, the founders opted for an integrated *GFG* solution: *VREP* took a stake in *Votronic*, *Volksbank Lauterbach Schlitz* supported the acquisition financing, and it has since become *Votronic*'s main bank. The two managers first became co-owners and, as of early 2025, are now the sole owners. Management, shareholders, and banks worked together to ensure that *Votronic* has developed very well since 2017 despite major challenges. Thanks to strong profitability and a conservative financing structure, the company was able to weather even sharp swings in demand. This success story began with a conversation at the *Volksbank*.

Votronic isn't the only example of effective collaboration among a bank, a company, and an investor. *Heizungsdiscount24*, *HERO Textil*, and *Schmidt + Bartl* also implemented successful succession solutions with cooperative banks and *VREP* as equity and mezzanine financiers – leading their companies into the future.

The *Genossenschaftliche Finanzgruppe* has bundled its succession expertise in a *Nachfolge Kompetenz Center* (*KCN*), the group's dedicated center of excellence for succession. The central players are *VR Equitypartner*, with strong experience executing corporate successions via equity and mezzanine solutions; *DZ BANK Corporate Finance*, with its M&A advisory expertise; and *DZ PRIVATBANK* for all matters relating to wealth management. This way, entrepreneurs can, if they wish, access all solutions for succession and its financing in one place – delivered by different specialists. Notably, succession isn't treated as "done" at handover, but as an investment in the company's future.

Resume

With the right (financing) partners and carefully chosen instruments, Mittelstand firms can address major entrepreneurial projects such as succession or transformation – even in difficult times.

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About the author:

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Christian Futterlieb studied Business Administration at the University of Mannheim. Since autumn 2023, he has been a member of the Senate of Economy Europe, which is dedicated to the integration and further development of the European Union as an economic and peace community.