**When a lightweight defeats a heavyweight: a profile of Italian MSEs**

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*Keynote speech held at the 28th IMP Conference, Rome 13 September 2012*

Good morning, allow me to thank the organizers of this conference for inviting me. It is an honour to be here and a pleasure as well, not least because I studied Economics at Università Cattolica, although many years ago unfortunately.

My goal today is to introduce you to the main economic and financial features of Italian medium-sized companies. My possibilities of achieving this goal are greatly enhanced by the fact that I can rely on a quite unique database currently held at the Mediobanca Research Area. Some ten years ago we started a joint project with Unioncamere, the association of Italian chambers of commerce, to study what at that time was a quite neglected segment of the Italian industrial system.

It is quite simple to surmise why MSEs were so poorly considered at that time. They were seen as a temporary stage on the path leading from small companies to large companies. MSEs were not considered worthy of much attention, and were regarded as belonging to a grey area where firms are no longer small but not yet large. We had fortune on our side, in the sense that we were looking at what no-one else was studying at the time. Ten years of research and data collection have indeed shown that being “medium” constitutes a kind of steady state that allows many companies to achieve superior earnings performances, healthy financial structures and considerable ability to compete successfully in open international markets. Lean organization, strong segmentation of production processes along with a steady array of suppliers and partners and subsequent low capital consumption, great attention to products, in-depth knowledge of customers’ needs and close proximity with them in the after-sales market: all these are the main competitive factors that make MSEs a winning model, in Italy and other countries as well. In addition, family ownership, often seen as a limitation by scholars, has proved to be a significant point of strength. Especially when complemented by carefully-selected external managers, family ownership tends to be associated with short chains of control and hence quick decision-making processes.

Other scholars have devoted their energies to studying MSEs. Most of you will certainly have heard of a well-known book written by Simon and Zatta named “Hidden Champions”, that covers mainly German medium-sized and medium-large companies. From our point of view Italian MSEs have no desire to be hidden and in fact make their best efforts to gain visibility in
the international markets in which they operate. The real risk, we feel, is that such companies may be hidden in the national statistics, that too often speak of a stagnant, or worse still, declining Italian economy, thus preventing many observers from seeing that Italian manufacturing does still have a successful presence. Moreover, legal or regulatory definitions do not help in shedding light on MSEs, as they tend to muddle small and medium-sized companies.

*Slide 2. Italian MSEs: roots and current “identity card”*

To begin with, a brief historical recapitulation is required. In the mid-1970s in Italy, and in other countries as well, the model of the large company whose production processes were fully integrated and completely organized with a single large facility in order to pursue “internal economies of scale”, according to the Fordist paradigm, hit a crisis. Many reasons triggered this crisis: 1) the end of a period of low salaries, which until that point had been supported by the huge supply of labour leaving agricultural activities; 2) the rise of prices due to higher indexed salaries and the oil crisis; 3) the end of Italy’s role as a “late-comer” able to appropriate the more industrialized countries’ technological achievements during the years following the Second World War; 4) the demise of the large, state-owned companies, set up after the financial crisis of the 1930s and operating in high-tech sectors; 5) last, but not least, a silent revolution in the patterns of consumption, leading to a remarkable shift in the preference of consumers from mass, serial, non-differentiated products, to more sophisticated, customized, high-quality products. This change was triggered by the saturation of basic needs, and more generally, by the improvement of living conditions during the post second world war period (what we call the “Italian economic miracle”).

This type of new product could not be delivered by large firms with unskilled workers, accustomed to develop mass products with poor-quality contents. The result was the decline of the large companies, whose growth rates first dwindled to below those of the national GDP and eventually underwent a dramatic downsizing process.

The good news in this crucial passage of the Italian economic history was that it became clearer and clearer that economies of scale could be achieved by the appropriate integration of a set of complementary and specialized firms, none of them necessarily large in size. Fortunately, the decline of the large companies was offset by the birth of smaller ones which began to populate the “district areas” of the Italian regions. District companies gave life to a felicitous alternative, at the same time representing a clear break with the large-company model. Complex production processes all integrated into one single, large facility established in order to exploit “internal” economies of scale and deliver mass products were no longer the rule; rather small companies, linked in networks or systems that split the production processes into several
phases and benefiting from “external” economies of scale. Large size was no longer a requirement but could be achieved in any case by considering the networks or systems of interconnected small companies as a whole. These “network” companies were involved in seemingly simple, low-tech productions, that would eventually evolve into what today is well known as “made in Italy” or rather “the Italian style”. Current Italian MSEs stem mainly from district firms, evolving towards more structured corporate arrangements and higher professional and managerial capabilities, in this way becoming leaders of the networks. They successfully integrated the locally-rooted, often informal or unspoken core knowledge, with innovations stemming from external, more formalized science-based knowledge. Current MSEs are system integrators of smaller firms. They have been able to achieve market leadership by locating themselves at the top of the quality ladder, thus making their products difficult to imitate, even if this benefit is nowadays becoming harder to defend, as emerging economies are climbing the quality ladder at a rapid pace, at the same time keeping their production cost at unattainable levels for western economies.

At the end of this quick summary, let me recap what our definition of MSEs is. There are two quantitative limits, referring both to annual sales and to total staff. In addition, an independent Italian ownership structure is required, so that companies controlled by non-Italian entities or belonging to large groups are dropped from the analysis. Indeed, it is clear that it would make no sense to study a company that meets the quantitative limits (sales and staff), but is managed by a large company by which it is fully consolidated.

Slide 3. Collapse of Fordism opens up new opportunities...

Two further slides serve to reiterate the above concepts. The red declining line shows the difference between the Italian GDP rate of growth (blue line) and that of the value added delivered by large companies (green line for state-owned and purple line for private ones). The time span here goes from the mid-1970s to the end of the last century.

Slide 4. ... taken by district-based enterpreneurs

Here again you have a clear picture of the reduction in labour force (upper graph) and value added (lower graph) faced by large companies system (blue line) and the simultaneous growth in district companies (red line). The time span here is from the years following the second world war, again to the end of the last century.

Slide 5. “What ancestors were thine?” MSEs and “district locations”

The link with old historical districts is in any case clear by inspecting the location of MSEs currently operating on Italian territories (red dots in this chart). Local communities supply a set
of professional skills and knowledge which even in a globalized world, still remains a crucial competitive asset for MSEs. Some 80% of the total population of MSEs is currently located in North-East Italy and in some of the regions of central Italy that hosted the Marshallian districts (Tuscany, the Marche and Umbria).

A small proportion of MSEs (just 10%) is found in North-West Italy, where a long tradition of large enterprises is rooted. Although small, this presence highlights the fact that districts are not the only seedbed of Italian MSEs. Several of them, indeed, were born outside district areas, as first-circle suppliers of LEs. When LEs in turn began to organize themselves according to lean production processes in order to address the decline in mass production, they relocated some of the more labour-intensive processes outside Italy in order to save costs, thus forcing MSEs to acquire new customers also often outside Italy. These MSEs were also able to position themselves in the higher value-added segments of the international value chain, at the same time preserving their networks of suppliers formed by locally-rooted small companies. Hence, even if they were less relevant in quantitative terms, “large enterprise” areas were a favourable ground for MSEs as well, and today we can say there is no substantial difference between MSEs as a result of their provenance (LEs or district area).

Finally, the presence of MSEs is truly negligible in Southern Italy, but here the poor legal environment kept global industrial activity at low levels.

**Slide 6. Local networks and globalized world**

One crucial question relates to the ability of MSEs to adapt their business model to the challenge of globalization. That is, how can a model that still remains deeply rooted in a local “atmosphere” coexist with the relocation of some production phases outside the country of origin. In fact in recent years, a good share of MSEs have been shifting certain operations abroad or engaging in international joint ventures in search of efficiency (cost savings), new markets (market-seeking), and also new knowledge. The share of non-Italian manufacturing subsidiaries to total subsidiaries has been increasing, reaching a level three times that at the start of the century; conversely, the share of domestic manufacturing subsidiaries decreased by 10% in the same period. In any case, the relocation process undergone by MSEs seems to have been cautious. On the one hand, it has almost stopped in recent years, possibly due to the crisis that has slowed investments, possibly to reconsideration of the usefulness of relocation, according to evidence of re-shoring noted recently in the western economies. In addition, even after the huge increase at the turn of the century, the share of non-Italian manufacturing subsidiaries is still below 14% of total manufacturing subsidiaries, which means that core production is still bound to Italy (low-left hand graph on this slide). Low-cost labour countries are chosen as the location only for labour-intensive and large-scale tasks, while high-value
added processes are retained in Italy. Conversely, the share of commercial subsidiaries located abroad now accounts for around half the total (low-right hand graph) so that the market-seeking purpose and the search for proximity with end-markets and customers seem to be the main driver for MSEs to move outside Italy.

Slide 7. “What ancestors were thine?” MSEs and “district businesses”

The link between MSEs and districts is quite clear even by looking at their business specialization. The main activity is light mechanical engineering (37.9% % of the value added), personal and household goods (20.3%) and food and drinks (15.4%). All the activities that can be labelled as representative of “Italian style” account for around 61% of the total value added. This economic specialization is quite different from that of the large companies, which are mainly engaged in heavy mechanical industry (automotive and aerospace) and manufacture of metals, with “Italian style” productions accounting only for less than 35% of value added.

As already mentioned, a wide-ranging debate on the supposed decline of Italian manufacturing industry is currently taking place, in the press and among observers and scholars. From where we stand, should this be the case, the problem is with large companies, whose performance in Italy is poor, not with MSEs, which show earnings results and financial conditions that are quite positive and consistently better than those of large enterprises.

Slide 8. Great ability to cover international markets

I think you will agree with me on this latter point after viewing the next series of slides. Let me start with a long-run analysis of export sales. The blue line refers to Italian MSEs, the orange line to LEs. The picture is self-explanatory, and MSEs show a regular superior drift that leads them to accumulate 55% progress since the start of this millennium, compared to 27.3% shown by LEs. Let me now draw your attention to the years from 2000 to 2005, when the Euro appreciated significantly versus the USD. This caused a strong fall in the export capacity of all European companies, but MSEs were able to increase their exports in these years too, while LEs marked time and in 2005 were still below the value they started with in 2000. Even during the financial turmoil of the last years, MSEs were able to maintain this gap versus LEs. How can we explain this? It is due to the fact that MSEs act in market niches, producing customized goods that make the final buyer willing to pay a higher price to have a good he or she feels to be reliable, tailor-made and of high quality. In other words, the choice of the buyer is only marginally affected by the final price, and almost entirely driven by the intrinsic features of the good. By means of such virtually obsessive attention to product quality, MSEs are able to keep a tight grip on their customers, while at the same time maintaining high barriers against potential new entrants, and preserving their oligopolistic positions within niches. This in turn allows MSEs
to set “premium prices” which generate high profitability. By contrast, LEs still operate in mass markets and are completely exposed to the fierce competition from emerging low-labour cost economies. In mass markets price still remains an important driver of the final consumption choices and a rise in prices or a weakening of purchasing power are more likely to produce a huge shift towards cheaper products supplied by low labour-cost economies.

**Slide 9. Value added: two speeds**

Even this is not the whole story however. MSEs also show a superior capability to create value and so contribute to the wealth of countries. Here again the slide does not require too many explanation, and the evidence is even more striking than that previously seen with regard to exports. MSEs achieved an increase in value added during the period equal to 27.1%, while LEs saw a decline of around 8%. Let us focus once more on a specific time span from 2002 to 2005. These are called “zero-point growth years”, when Italian GDP saw only marginal increases. LEs suffered a dramatic slowdown in their capacity to generate wealth in these years, and in 2005 the level of value added was around 12 percentage points below the starting level. In contrast, MSEs were able to achieve a steady increase even in adverse macroeconomic conditions, thus offsetting the poor performance of LEs. The gap that opened up at the start of the millennium has never been closed, and the recent crisis has once again left LEs below the level of ten years ago.

Some observers have tried to reduce the importance of such results by asserting that the superior performance of MSEs is in any case of little assistance as they represent only a negligible share of the national economy. This is a serious mistake: we estimate that currently around 25-30% of the Italian manufacturing value added is generated by MSEs and their network of smaller suppliers, hence their contribution to the overall national wealth is anything but negligible. This as opposed to some 12% attributable to Italian LEs and a further 13% to foreign LEs.

**Slide 10. Industrial margins: we have no competition**

If absolute quantities (exports or value added) have shown a better trend for MSEs over the last ten years, the evidence is no different by relative measures of performance. If we look at the ratio between the industrial margin and value added, the picture is clear once again. MSEs’ profitability is always superior (there is no point of contact between the two lines in this slide), and their path is even smoother over time, as MSEs are only slightly affected by macroeconomic conditions. Conversely, large firms show a very volatile pattern, with periods of strong weakness when the macroeconomic scenario is adverse.
Slide 11. The bottom line: MSEs still smoother but LEs closer

If we move down the profit and loss account of the companies to reach the bottom line (that is, the net result), something seems to change, and MSEs lose some of their luster. The lines keep their shape, but there is a shift that brings them close and overlapping.

What changed from the previous evidence based on industrial margins?

There are two main reasons.

Slide 12. LEs: manufacturing firms or financial holdings?

LEs in some senses resemble financial holding companies more than manufacturing companies, as they manage a huge amount of cash and liquid assets. In addition, they are organized into complex groups, with many subsidiaries often located outside Italy that pay dividends subject to favourable tax burdens. The result is that LEs may benefit from a considerable amount of financial revenues that overcome financial charges. The opposite is true for MSEs that borrow only in order to finance net working capital, and thus have a negative financial balance.

Slide 13. An enemy of Italian MSEs: the tax burden

Italian MSEs have to face a heavier tax burden than LEs, with a gap that in recent years has been around seven percentage points. Taxation on Italian MSEs is also less favourable in comparison with MSEs located in other European countries, with a gap reaching 15 percentage points in some cases.


But financial aspects matter too, and from this point of view as well MSEs emerge as being better structured. MSEs have a light structure, and the decentralization of production processes along the network of suppliers and partners reduces the need for fixed assets and therefore capital in order to finance them. A simplified structure of the financial statement reveals other significant points of strength for MSEs, especially when compared with LEs. Let us focus on the left-hand side of this slide where data on MSEs are represented. The upper block shows the composition of assets, the lower block the composition of borrowings plus net worth. The same description holds for LEs on the right-hand side of the slide. There are three main points of strength in MSEs: 1) net tangible worth covers all tangible fixed assets (the violet square is larger than the green one), so MSEs in the aggregate do not need to borrow in order to finance their long-term investments; this means that MSEs enjoy an entirely satisfactory level of financial independence; 2) current assets are almost double the level of current borrowings, thus ensuring full coverage of short-term debt with short-term assets (the red square is larger
than the blue one); 3) as a consequence of the above features, MSEs enjoy a favourable mismatch whereby some amount of long-term borrowings covers a share of short-term assets, a highly desirable state of affairs. It is easy to see that none of these features is detectable in LEs, which by contrast have a sizeable proportion of liquid assets, which are thus deducted from industrial investments and kept in order to compensate poor industrial margins, as seen above, generating high financial revenues.

*Slide 15. Nominal labor productivity and competitiveness*

Let me close my presentation with a quick snapshot of productivity. In the first upper table the nominal (or apparent) labour productivity is plotted. It is calculated as net value added per employee, and MSEs show a better profile over almost the whole time span covered. But MSEs show a lower labour cost (about 20% less), so the ratio between labour cost and value added, the key for competitiveness, is by far better for MSEs than for LEs.

*Slide 16. MSEs: Higher productivity without downsizing*

This is even more striking considering that MSEs have been able to retain high competitiveness while increasing their labour force at the same time (11.2% more since the start of millennium), while LEs have undergone a dramatic process of downsizing (down 18%).

*Slide 17. Easy question: do MSEs need to grow and become large? Let’s dismiss the myth of large size!*

One final question. Many scholars and observers claim that Italian companies need to grow, as a sort of “one-size-fits-all” rule able to solve all the problems of the alleged Italian decline in one go. We feel that for Italian MSEs this is not the case. Three reasons support this answer: 1) the mid size is a winning size that allows companies to reach a balance between lean structure and efficient coverage of market niches; bigness itself is an empty concept when detached from the size of the market niche the company is willing to operate on; 2) MSEs are often organized in networks or systems of companies, a heritage of the districts. MSEs may be relatively small when isolated, but achieve efficient size when considered as a system; 3) growth is a dangerous task. As shown in this final slide, the most probable outcome of a growth process is to lose independence (56%), or, worse still, default. Larger size means to magnify the probability of default by nine times, which remains at very low levels (0.8%) when medium size is preserved.
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Rome, 13 September 2012

Italian MSEs: roots and current “identity card”

- US and Europe were spurring steady growth in the late 1940s to the 1960s and large enterprises (LEs) then lived a “golden age”. Their production processes were fully integrated in big plants pursuing “internal” economies of scale. The passwords were: mass production and mass marketing to satisfy a mass demand.

- At the mid of 1970s in Italy LEs fell into a deep crisis and their production model was shaken into its roots. Many macroeconomic and social factors played a role for this. It became clear that economies of scale could be achieved by the appropriate integration of a set of complementary and specialized firms, none of them necessarily large in size.

- It was the return of the Marshallian Industrial District (MIDs) whose twin pillars are: “external economies” (external to the firm, but internal to the district) and “industrial atmosphere”, i.e. a set of shared cognitive, moral and behavioural attitudes deeply rooted in a local, naturally or historically bounded, socio-cultural and institutional context.

- MIDs are the seedbeds of current MSEs that have evolved from district firms. They keep a deep link with local places, but have successfully integrated the locally rooted core knowledge with innovations stemming from external science-based knowledge.

According to Mediobanca-Unioncamere definition, MSEs have to meet:
- Annual sales between 15 and 330 € millions;
- Total staff between 50 and 499 employees;
- Independent Italian ownership structure.
Collapse of Fordism opens up new opportunities...

GDP and value added, base 1974=100; percentage differences (right-hand axis)

Source: Becattini G., Coltorti F. [2004], Aree di grande impresa ed aree distrettuali nello sviluppo post-bellico dell'Italia: un’esplorazione preliminare, in “Rivista Italiana degli Economisti”, n. 1

... taken by district-based entrepreneurs

Percentage share of manufacturing staff and value added by industry

Source: Becattini G., Coltorti F. [2004], Aree di grande impresa ed aree distrettuali nello sviluppo post-bellico dell'Italia: un’esplorazione preliminare, in “Rivista Italiana degli Economisti”, n. 1
“What ancestors were thine?”

MSEs and “district locations”

Local networks and globalized world

No index of the ratio of Italian/foreign manufacturing subsidiaries to total manufacturing subsidiaries
"What ancestors were thine?" MSEs and "district businesses"

**Italian MSEs**
- Food and drinks: 13.7%
- Personal and household goods: 5.1%
- Mechanical engineering: 1.9%
- Paper, printing and publishing: 5.7%
- Chemicals and pharmaceuticals: 20.3%
- Manufacture of metals: 37.9%
- Other: 15.4%

**Large Italian groups**
- Food and drinks: 9.83%
- Personal and household goods: 6.4%
- Mechanical engineering: 1.5%
- Paper, printing and publishing: 10.7%
- Chemicals and pharmaceuticals: 9.8%
- Manufacture of metals: 73.0%

**Great ability to cover international markets**

Index no. of sales for exports, 2000 = 100

**Exchange rate €/Usd**

- **2000-2010**
  - MSEs: +55.0% (4.5% year average)
  - LEs: +27.3% (2.4% year average)

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Value added: two speeds
Index no. of value added, 2000=100

2000-2010
MSEs: +27.1% (2.4% year average)
LEs: -8.4% (-0.9% year average)

Industrial margins: we have no competition
Net operating margin (ebit) as a percentage of value added
The bottom line: MSEs still smoother but LEs closer

Net result as a percentage of value added

LEs: manufacturing firms or financial holdings?

Financial net revenues (+) or charges (-) as a percentage of value added
An enemy of Italian MSEs: the tax burden

Tax rate in %

"Lean production" means "lean finance"

Percentage composition of sources and investments
Nominal labor productivity and competitiveness
Net value added per employee in € thousands and labour cost as a percentage of net value added

MSEs: Higher productivity without downsizing
Index no. of staff, 2000=100
Easy question: do MSEs need to grow and become large?
Let’s dismiss the myth of large size!
What happen to MSEs that overcame upper bounds

- Still independent 36.5%
- Taken over by Italian companies 36.2%
- Taken over by foreign companies 20.1%
- Defaulted 7.2%

Average MSEs default rate: 0.8%

Thank you for attention
Further information at www.mbres.it