In cooperation with the German Private Equity and Venture Capital Association and the Deutsche Börse Venture Network

VC sentiment improved slightly but remains very low

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– Situation assessments are slightly lower but expectations are much more optimistic
– Insolvency of Silicon Valley Bank weighs on market sentiment
– Sentiment around interest rate level in capital markets has hit a new record low

Business expectations are rising again

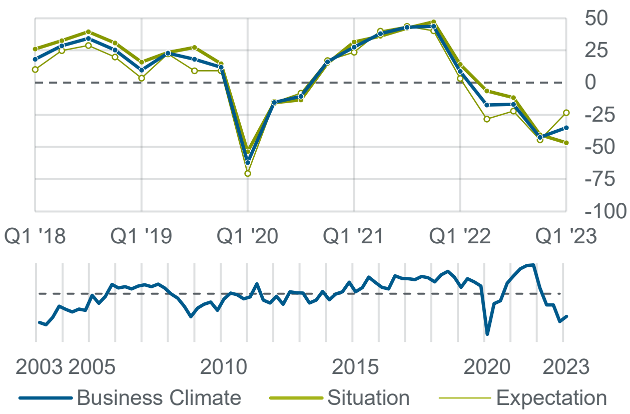
Business sentiment in the German venture capital market improved slightly in the first quarter of 2023. The sentiment indicator of the early-stage segment rose by 7.6 points to -34.9 balance points. However, this means sentiment remains on a very low level after plunging in the final quarter of 2022. While the current situation is regarded as having worsened, the increase is attributable to improved expectations. The indicator for the current business situation dropped by -6.1 points to -46.6 balance points, while the indicator for business expectations rose by +21.2 points to -23.2 balance points.

SVB insolvency is keeping sentiment low

The insolvency of Silicon Valley Bank left international VC markets in a state of shock for a whole weekend. Many start-ups and investors had to fear for their business and private capital. The doom and gloom that crept in for a while did not go away until the US administration lifted the cap of the federal deposit insurance for all the SVB's customer deposits. The feared massive distortions in the international VC markets failed to materialise and it seemed that the SVB insolvency was soon forgotten. Nevertheless, there is reason to believe that it weighed on German VC sentiment in the first quarter, which otherwise would likely have recovered more strongly. The moderate business activities of SVB's German branch are limited to venture debt. For now, it is safe to assume the supply of venture debt will be lower. This comes at the wrong time because in the current market phase with decreasing VC investments, start-ups are intent on stretching the period until the next VC financing round as much as possible. Many are also likely to want to use venture debt as bridge finance.

After the SVB insolvency there was brief speculation as to whether central banks would hit the pause button on interest rate rises for a while. But high inflation rates made new interest rate hikes necessary. That drove VC investor sentiment with respect to the interest rate level in the capital markets to a new record low (-100.5 points).

Development of VC business climate indicator



Key data of VC sentiment components

Values in balance points

	Q1/23	Δ Q4/22	Low	High
Business climate	-34.9	+7.6	-62.1	+43.7
Business situation	-46.6	-6.1	-57.7	+47.2
Business expectations	-23.2	+21.2	-70.5	+43.8
Fundraising	-45.0	+0.6	-69.6	+71.4
Entry valuations	+16.9	-17.1	-53.8	+50.4
Exit opportunities	-46.8	+16.6	-74.8	+71.1
New investment	+0.0	+8.1	-72.5	+31.0
Dealflow quantity	+5.1	-4.5	-44.8	+33.3
Dealflow quality	+15.6	+13.1	-22.9	+28.8
Dealflow innovativeness	+11.2	+0.2	-47.8	+36.2
Taxation / regulation	+8.0	-4.5	-28.2	+35.3
Depreciations	-34.3	+2.4	-48.9	+29.4
Economy	-53.2	+8.7	-92.1	+75.5
Interest rates	-100.5	-9.0	-100.5	+40.0
Public support	-0.8	+14.2	-58.1	+37.3

Colour scheme of sentiment indicator dots: values in the lowest tercile are marked 'red', in the medium tercile 'amber' and in the highest tercile 'green'. Indicator design may lead to deviations from previous publications.

Source: KfW Research, BVK and DBVN.

The rapid pace of the interest rate reversal brought great uncertainty

Further interest rate increases from central banks can be expected in the course of the year. The record low sentiment around interest rates is likely to be due not just to the interest rate level itself but rather to the speed at which it has shifted. Interest rates were already at this level in the years from 2006 leading up to the financial crisis, for example, but sentiment around interest rates at the time had dropped not more than half as low. The rapid interest rate reversal brought great uncertainty to the VC ecosystem. To be sure, there are now specific expectations regarding the trajectory of central banks' interest rate pathways but there is no way of predicting the further reactions of capital markets and investors to interest rate developments.

Fundraising sentiment remains very subdued

Since the interest rate reversal, the Nasdaq Composite Index has come down from its all-time high by as much as around 35%. That led to an overweight of alternative investments (such as venture capital) in institutional investors' portfolios, who are thus attempting to exit from those assets or invest less in the future. VC funds will therefore have difficulty acquiring new capital, which explains the bleak sentiment around fundraising.

Entry prices for new VC investments also appear to have dropped alongside the falling prices quoted on the Nasdaq, which are a benchmark for technology firms. Sentiment around entry valuations for new investments thus rose to a ten-year high even before the end of the final quarter of 2022. Stock prices rose again at the start of the year, sentiment fell again slightly at the same time but remains in the green, signalling good entry prices in a long-term comparison.

Investment appetite has improved again slightly

The investment climate improved further in the first quarter of 2023. This is due to an improvement in the expectations component, as situation assessments deteriorated again slightly. The improved expectations suggest that German investors will step up their investment activities in the course of the year. That would also be important for the start-up ecosystem. After all, the development of investment activity is a signal for potential entrepreneurs. Already last year, fewer new start-ups were established because of the uncertain market environment and low investment activity. The less venture capital is invested, the less hope there is to be able to obtain venture capital even when needed and the more likely start-up businesses will not materialise. That would make renewed momentum in investment activity all the more important, including for VC investors' own deal flow.

Deal flow has weakened but quality remains high

VC investors' deal flow obviously weakened in the past year. The corresponding sentiment indicator fell sharply in the second quarter of 2022. Since then, it has hovered on a lower but still slightly above-average level in a long-term comparison. The lower number of business start-ups is a factor for the lower deal flow but so is the subdued demand behaviour of start-up entrepreneurs who responded to investors' restraint, which probably played a larger role. Many start-ups are attempting to use their existing capital to bridge the period up to the next financing round for as long as possible. Even if deal flow weakened, its quality remains high overall. That is not the case for the degree of innovation of deal flow which, although above-average, is now on a noticeably lower level since mid-2022. This may be because the market development has led to a stronger weighting of positive cash flows in the investment decision of VC investors, which is anticipated by start-ups that innovate but often exhibit negative cash flow, causing them to refrain from requesting finance.

Exit environment has improved slightly

After deteriorating sharply in the first quarter of 2023, the exit environment has stabilised and improved significantly. It remains subdued, although expectations about trade sales are improving slightly. However, the IPO window still appears to be firmly closed. Opportunities for secondary transactions also appear to be virtually non-existent.

Portfolio values remain under pressure

As expected, the decreased valuation level of public benchmarks has inevitably reached the VC portfolios, if with a delay. Sentiment around valuation adjustments fell sharply in last year's final quarter. This slump continued virtually unchanged in the first quarter of 2023. The pressure on valuation adjustments is likely to continue as a result of follow-on financings for start-ups that received their last financing round prior to 2022 at correspondingly high valuations.

Comments on the current trend

Dr Fritzi Köhler-Geib, Chief Economist of KfW

'VC sentiment improved slightly in the first quarter of 2023, although on a historically low level,' said Dr Fritzi Köhler-Geib, Chief Economist of KfW. 'The insolvency of Silicon Valley Bank is sure to have prevented a sharper sentiment upswing. In the end, a worrisome weekend was all that the directly affected start-ups and investors had to endure. They had taken a cluster risk which was ultimately borne by US taxpayers. The response of the US administration prevented major distortions in the international VC markets. In Germany, SVB mainly operates a venture debt business, so that a reduced supply must be expected here for now. Given that venture capital investments are decreasing and making venture debt more important as a form of bridging finance, this came at a very inopportune time. However, VC business expectations brightened significantly, so the market appears to believe that the worst is over. This is a good sign for start-ups that need fresh capital.'

Ulrike Hinrichs, Managing Director of the German Private Equity and Venture Capital Association (BVK)

'Even if the insolvency of Silicon Valley Bank weighed on sentiment at the start of the year, the moderate sentiment improvement and increased business expectations are a hopeful sign for the further course of the year', said Ulrike Hinrichs. 'Alongside continued lively investment activity, for start-up entrepreneurs this is good news that innovative business ideas will continue to find VC finance. And the current environment for valuations offers attractive entry opportunities for investors. The fundraising and exit climate, which are mainly suffering from the interest rate situation and the state of the economy, continue to be the biggest worries. If success stories become known here in the course of the year, however, sentiment should improve again.'

Calculation of the German Venture Capital Barometer

The **German Venture Capital Barometer** is based on a quarterly survey of the members of the German Private Equity and Venture Capital Association (Bundesverband Deutscher Kapitalbeteiligungsgesellschaften – BVK), the member investors of the Deutsche Börse Venture Network (since the 2nd quarter of 2021) and further private equity companies with registered offices in Germany. It reports the business climate in the German venture capital market on the basis of assessments provided by private equity firms with a focus on young companies. All sentiment indicators represent the average of the balance of situation assessments (share of 'good' minus share of 'bad') and the balance of expectations identified at the same time for the coming six months, normalised to their respective historical mean balance values as baseline level. As a result, the maximum or minimum value of the indicator may exceed or fall below +100 or -100 as the actual maximum or minimum. Because of the way the barometer is constructed, positive indicator values point to above-average sentiment and negative values to below-average sentiment.

The **German Private Equity and Venture Capital Association (BVK)** is the voice and the face of the private equity industry in Germany. The association is committed to improving conditions and facilitating access to private equity so that even more businesses in Germany can benefit from private equity. It has some 300 members. These include around 200 private equity companies and investors as well as some 100 consulting firms and service providers of the industry.

BVK
Bundesverband
Beteiligungskapital e.V.

The **Deutsche Börse Venture Network (DBVN)** was launched in 2015 and is now Europe's largest network for growth finance and 'Capital Market Readiness'. It focuses on providing efficient access to capital and has an extensive range of networking and training services. The network of more than 200 fast-growth businesses and more than 450 investors has already enabled 13 IPOs and numerous trade sales.

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