KfW Research

German Venture Capital Barometer 3rd Quarter 2022

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

Sentiment in the German VC market is stabilising

27 October 2022

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- Situation assessments are slightly lower but expectations have lifted moderately
- Fundraising climate continues to fall
- Interest environment remains on a historically poor level despite reversal

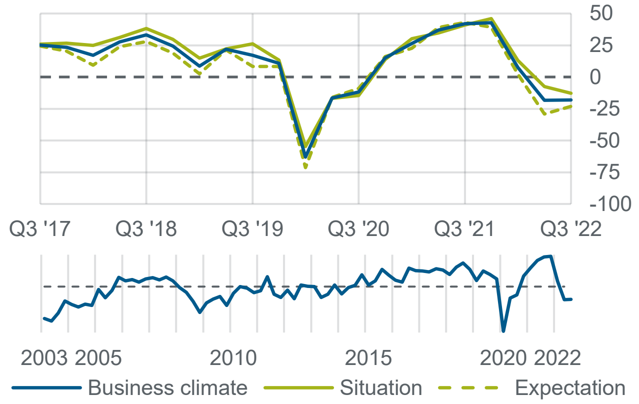
Large rate hikes no longer create shock waves

Sentiment in the German venture capital market stabilised in late summer. Market sentiment has thus stopped falling, although central banks again significantly raised key interest rates to fight inflation in the third quarter of 2022. The sentiment indicator of the early-stage segment remains virtually unchanged at -17.9 balance points (+0.3 points). Situation assessments and expectations have converged. The indicator for the current business situation is now moderately lower at -12.8 balance points (-5.3 points), while the indicator for business expectations rose slightly to -23.1 balance points (+6.0 points).

Aggressive fight against inflation is now priced in

Central banks around the world are raising their key interest rates to fight inflation. The Fed in particular is leading the charge. With key interest rate hikes totalling 1.5 percentage points up until June, it sent VC sentiment into a tailspin in the first half-year. With that, however, VC investors appear to have fully priced in the systematic fight against inflation. Sentiment has remained stable even though the Fed again lifted interest rates by another 1.5 percentage points and the ECB by 1.25 percentage points in the third quarter. VC investor sentiment towards interest rates was even buoyed slightly after falling to a record low. The stock markets reacted in a similar way. Technology share prices, which are more sensitive to interest rate changes than blue chips, came under pressure again on the NASDAQ as a result of the re-newed rate hikes but by the end of the quarter only dropped to the level already seen in June (after recovering in the interim). The write-down pressure on VC portfolios generated by the development of the public benchmarks has thus not grown further. The corresponding sentiment indicator actually improved slightly but nevertheless remains deep in the red. On the other hand, the fact that company valuations have not fallen further means that entry prices failed to drop even further, which is why the corresponding indicator hardly changed either.

Development of VC business climate indicator



Key data of VC sentiment components

Values in balance points

	Q3/22	Δ Q2/22	Low	High
Business climate	-17.9	+0.3	-63.0	+42.7
Business situation	-12.8	-5.3	-58.8	+46.1
Business expectations	-23.1	+6.0	-71.4	+43.0
Fundraising	-26.9	-9.1	-70.7	+70.3
Entry evaluations	+20.3	+1.6	-53.1	+51.0
Exit opportunities	-42.9	-1.6	-76.2	+69.7
New investment	-4.6	-0.2	-72.8	+30.8
Dealflow quantity	+10.5	+0.9	-44.7	+33.5
Dealflow quality	+9.1	-13.8	-22.7	+29.1
Dealflow innovativeness	+7.5	-11.1	-47.5	+36.5
Taxation framework	+19.1	+2.0	-27.9	+35.5
Write-downs	-16.6	+5.7	-49.8	+28.5
Economy	-81.2	-6.3	-93.6	+74.0
Interest rates	-76.8	+14.8	-91.6	+37.5
Funding	+14.2	-0.4	-58.3	+37.1

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.

Unlike the interest environment and valuation-related indicators, the fundraising environment became more challenging as a result of the most recent interest rate hikes. Situation assessments have now followed the negative development of expectations from the preceding quarters, although expectations did not deteriorate further in the third quarter. As interest rates for safe-haven investments are rising, talks with investors for VC funds engaged in fundraising appear to be becoming increasingly difficult. In this kind of environment, reliably providing public venture capital is likely to provide some certainty and contribute to mobilising private investors. The high inflation rates that made the aggressive interest rate reversal necessary are also driving the economic sentiment indicator deeper and deeper into the red. It has now been on ‘crisis level’ for the past three quarters, with levels similar to those recorded during the financial crisis and at the beginning of the coronavirus pandemic.

Investment activity on a high level despite uncertainty

Investor appetite for new engagements did not decline further after slipping in the second quarter. The indicator stabilised just slightly below the long-term mean level. Its decline in the second quarter had already indicated that reduced investment activity was to be expected in the third quarter. Based on current data, deal volume was indeed smaller in the third quarter 2022 than in each of the two preceding quarters. However, the volume achieved remains on a level rarely seen in any quarter prior to the exceptional year 2021. The stabilising investment appetite indicator is a good predictor that the fourth quarter should see solid investment activity as well.

It will likely take some time for the cooling fundraising environment to translate into consistently reduced investment activity. After all, the very good fundraising environment of recent years has led to the accumulation of a great deal of ‘dry powder’, that is funds pledged by fund investors that can still be drawn down for investment purposes. For German VC funds alone, free funds are currently estimated to be in the medium single digit billions. Of the deal volume invested in Germany, 20 to 30% typically comes from German VC investors. The existing free funds are therefore likely to be a strong support for the VC offering for German start-ups at least for the next one to two years. How much the cooling fundraising environment will translate into reduced investment activity in the ensuing period will depend not only on the further development of the macroeconomic conditions but also on how easily private capital can be mobilised through the structural provision of public VC.

Exit environment remains weak

The exit environment is currently being regarded as dismal. Falling from its record high in the first half, it has deteriorated faster and more strongly than ever. The exit environment stabilised on this level in the third quarter. With respect to the various exit channels, the discrepancy between the exit environment and exit activity widened, however. Whereas the IPO environment stabilised with the stock markets, sentiment towards trade sales deteriorated yet again. There have been only three quarters with lower levels since 2003. The indicator for the current situation has followed the preceding negative trend of the indicator for expectations. Expectations, in turn, have not deteriorated further. Still, the development in the number of registered acquisitions of VC-funded companies is not in line with the poor sentiment. There has been above-average acquisition activity in the third quarter. One obvious explanation continues to be that the negative assessment of the environment has to do with the lower valuations, meaning that despite strong acquisition activity, investors are currently unable to obtain the hoped-for exit proceeds.

Deal flow indicators are still hovering in the green

After VC investors’ deal flow appears to have weakened in the previous quarter, valuations of quality and degree of innovation are now declining amid virtually unchanged demand. But all three indicators are still in the green, their historically highest tercile. Reports on investors’ reluctance to invest probably contributed to the apparent decline in deal flow, as start-ups are likely to have refrained from requesting finance as a result. In addition, many investors are known to have rebalanced their investment decision and are now more mindful of profitability and cash flow achieved. Start-ups with highly innovative products, technologies or business models often have structurally negative cash flow. Because of the decreasing prospects for success, it is possible that these start-ups in particular are disproportionately more reluctant to request finance, which would explain the declining degree of innovation of deal flow.

Comments on the current trend

Dr Fritzi Köhler-Geib,
Chief Economist of KfW

‘VC sentiment stabilised in the third quarter of 2022 despite further strong key interest rate increases. The interest rate moves were apparently expected by VC investors and already priced in with the sentiment decline in the previous quarter. The central banks’ announcement of their intention to systematically fight inflation has thus shaped the formation of expectations’, said Dr Fritzi Köhler-Geib, Chief Economist of KfW. ‘However, the fundraising environment has further deteriorated. The increase of ‘risk-free’ interest rates is therefore becoming more problematic for VC funds in the fundraising phase and will weigh on the VC offering for start-ups in two or three years. The successive launch of the individual components of the German government’s Future Fund will therefore come at exactly the right time to provide some certainty in this environment.’

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

‘The continuation of the downturn in sentiment was not unexpected in view of the economic and political conditions. Fortunately, the more muted sentiment among VC funds has not had an equally abrupt impact on their investment activity. Investments were robust in the first half-year. As a result of the successful fundraising years 2020 and 2021, companies still have considerable resources at their disposal with which to bring existing investments through the current difficult period and to seize the opportunities currently on offer. This is supported by high deal-flow quality and lower entry valuations. The exit situation gives more cause for concern. Successful sales at attractive valuations are likely to be difficult in the current environment.’

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, adjusted by their respective historical mean balance values. 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 Venture Capital Association** is the voice in 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 Deutscher Kapitalbeteiligungsgesellschaften 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.

Deutsche Börse Venture Network