

German VC market: Business sentiment continues to recover

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- Situation assessment rises slightly as business confidence keeps improving
- Fundraising climate has hardly changed: expectations much better than situation assessments
- Frosty exit climate is slowly thawing

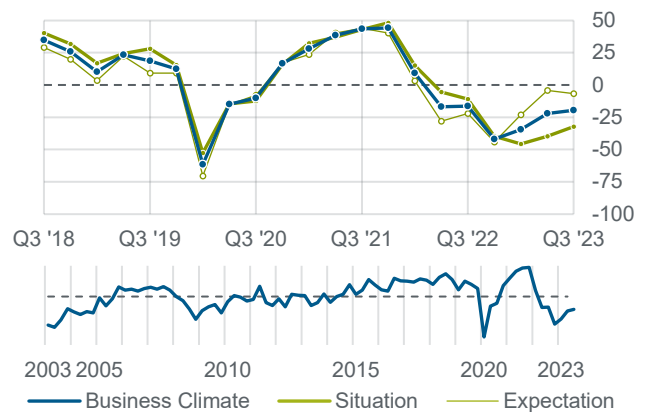
Situation assessments are gradually catching up with forward-looking expectations

Business sentiment in the German venture capital market continued to improve in the late summer of 2023. The sentiment indicator of the early-stage segment rose by 2.4 points to -19.6 balance points, trending slightly higher than in the previous quarter. Situation assessments slightly converged on expectations, which continue to be significantly more optimistic. The indicator for the current business situation rose by 7.3 points to -32.4 balance points, while the indicator for business expectations dipped slightly to -6.8 balance points (-2.5 points).

Hoping for a better future

Despite the slight improvement in situation assessments and the moderate drop in expectations, market actors have a much more positive view of the future than of the current situation. The development in the third quarter, however, gives cause for hope that the more optimistic expectations gradually come true and the business situation in the German VC market continues to improve. But because of the high overhang of expectations, the risk of setbacks remains high. As was already the case in the second quarter, there is also relative optimism about the expected development in the months ahead with respect to other important market factors. This applies to fundraising, exits and investment appetite alike. The gap between the situation and expectations component for the fundraising climate continues to be the widest. At -59.8 balance points, the fundraising situation remains just above its previous low, while fundraising expectations stood at -17.8 balance points, indicating continued hope for significant improvement. Exit expectations sat at -15.1 balance points (+27.3 points) in the third quarter, strongly diverging from current situation assessments, which stood at -57.8 balance points. Driven by more optimistic expectations, the frosty exit climate appears to be slowly thawing. However, the optimism is not budding at the same rate for all exit pathways. While the expectations indicators for exits via IPOs and trade sales rose only moderately (by +12.5 and +11.7 points), the indicator for secondaries increased substantially (by +31.4 points).

Development of venture capital sentiment indicator



Key data of venture capital sentiment components

Values in balance points

	Q3/23	Δ Q2/23	Low	High
Business climate	-19,6	+2,4	-61,6	+44,2
Business situation	-32,4	+7,3	-56,8	+48,1
Bus. expectations	-6,8	-2,5	-70,4	+43,9
Fundraising	-38,8	+0,3	-68,6	+72,4
Entry valuations	+21,9	-9,2	-54,4	+49,7
Exit opportunities	-36,4	+16,5	-73,7	+72,2
New investment	-6,0	+2,1	-72,2	+31,4
Dealflow quantity	+10,5	+3,0	-45,1	+33,1
Dealflow quality	+2,3	-0,3	-23,0	+28,8
DF innovativeness	+0,2	-8,6	-47,9	+36,1
Taxation / regulation	+9,3	+10,9	-28,3	+35,2
Depreciations	-22,3	+0,6	-48,3	+30,0
Economy	-50,0	+13,8	-90,7	+76,9
Interest rates	-79,1	+25,3	-104,4	+42,2
Public support	-2,4	-5,0	-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.

In relation to exit opportunities via secondaries, not only did expectations rise but the current situation was also rated significantly more positively than in the previous quarter. It appears that market conditions are now configured in a way that amid given valuations and prospects, potential sellers and buyers of existing start-up participations are more likely to come together. For one thing, more sellers are presumably accepting the reduced valuations as the 'new normal' and tolerating higher markdowns and for another they can generate urgently needed return flows for their investors, for example, which probably flowed more scantily in the past months. At the same time, buyers are finding more attractive entry opportunities to attractive start-ups. Overall, VC investors are very satisfied with the level of entry valuations for new commitments despite the current drop.

Comments on the current trend

Dr Fritzi Köhler-Geib,
Chief Economist of KfW

'The mood in the German VC market remains on a path of recovery, even if it improved only slightly in the late summer', said Fritzi Köhler-Geib, Chief Economist of KfW. 'You might call it a period of thaw, if near the freezing point. This is because current sentiment remains very subdued despite improvements. Expectations, however, are brighter despite a minor drop. The more optimistic expectations should actually give cause for hope that business confidence will continue to improve. However, the war in the Middle East and the risk of economic fallout in the event of an escalation are likely weighing on sentiment. German investors have little exposure in Israel but a further trouble spot worsens economic uncertainty nonetheless and will at least partly offset possible positive effects such as the pause in central banks' interest rate increases.'

Willingness to invest has not (yet) quite returned

The satisfaction with entry valuations has not yet translated into higher investment appetite, however. The indicator for the current investment climate continued below its long-term average for the third straight quarter, while the expectations indicator remained above its long-term average. In other words, VC investors are anticipating growing investment appetite but are still reluctant to actively invest. It seems as if the market was waiting for a starting signal to start moving.

The restraint does not appear to be caused by lack of demand for VC. After all, the deal flow indicators are above their long-term averages – even if investors' satisfaction with the quality of deal flow could be better. Investors might take their foot off the brake once the Fed and ECB take an extended pause in interest rate hikes. With inflation figures trending downward, the end of the cycles of interest rate rises is foreseeable – and already evident in rising sentiment around interest rates but the uncertainty about it can still be felt.

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

'Optimism is slowly returning. At the moment, however, there is a lack of inspiring triggers to transform the gradual recovery into a sentiment upswing and, ultimately, into growing investment. As for overall economic performance, everyone has their eyes on interest-rate policy and economic signals. With a view to the German VC market, we expect the market launch of the Growth Fund to provide impetus that will surely improve the fundraising environment. We hope the Financing for the Future Act will provide a real boost but only if it is adopted as proposed in the government's draft. Critical elements are the elimination of turnover tax on management fees and improvements to employee equity participations. Investors and start-ups expect the coalition partners not to backpedal on this.'

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.

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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