German Venture Capital Barometer 4th Quarter 2022

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

VC sentiment in Germany cooled considerably at the end of the year

13 February 2023

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- Valuation adjustments weighed on market sentiment at the end of the year
- Investment climate is deteriorating as muted expectations weigh on investor appetite
- Sentiment around entry prices for new investments rose to ten-year high

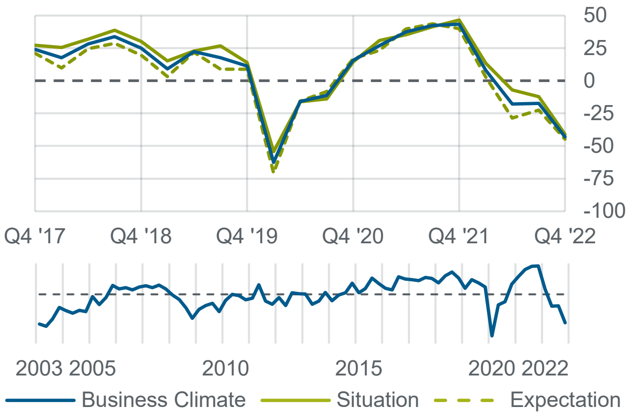
Mood turned frosty at the end of the year

Sentiment in the German venture capital market cooled off considerably towards the end of the year. After the downward slide in market sentiment stopped in late summer, confidence fell again in the final quarter. The business climate indicator of the early-stage segment nosedived 25.6 points to -42.9 balance points. With the exception of the unprecedented coronavirus shock in the first quarter of 2020, the only recent time sentiment was worse was 20 years ago. Assessments of the business situation and expectations both dropped. The indicator for the current business situation plunged by -28.9 points to -41.2 balance points, while the indicator for business expectations fell by -22.2 points to -44.7 balance points.

An eventful quarter that saw confidence slide

There appear to be different reasons for the drop in confidence, four of which stand out: It was the final quarter of the year, US investors became more cautious, FTX filed for Chapter 11 and the INVEST grant expired for the time being. With a view to valuation adjustments it is notable that the expectations component in the first three quarters was well below the situation component, which now followed suit to drop to the lower level in the final quarter. The negative development of enterprise values in the course of the year presumably led to more valuation adjustments in companies' annual statements. Furthermore, US investors in particular were more cautious about investing, which was evident from the VC deals concluded in the fourth quarter. This reduces investment opportunities for investors in Germany because US investors as well-capitalised syndication partners are missing. Besides, the insolvency of the FTX crypto exchange in November sent shockwaves through the tech scene that weighed on VC market sentiment around the world. It has probably made US investors even more reluctant to invest. Towards the end of the year the INVEST grant for venture capital as a form of public support for business angels also expired for the time being. It is probably the reason that the sentiment indicator on public funding fell noticeably. The grant is a strong investment incentive for business angels and therefore important for future deal flow of VC investors as well.

Development of VC business climate indicator



Key data of VC sentiment components

Values in balance points

	Q4/22	Δ Q3/22	Low	High
Business climate	-42.9	-25.6	-62.5	+43.3
Business situation	-41.2	-28.9	-58.3	+46.6
Business expectations	-44.7	-22.2	-70.8	+43.5
Fundraising	-46.1	-19.8	-70.1	+70.9
Entry evaluations	+34.2	+14.4	-53.5	+50.6
Exit opportunities	-63.9	-21.9	-75.4	+70.5
New investment	-8.1	-3.7	-72.5	+31.0
Dealflow quantity	+9.6	-0.8	-44.8	+33.4
Dealflow quality	+2.6	-6.4	-22.7	+29.0
Dealflow innovativeness	+11.2	+3.8	-47.6	+36.3
Taxation framework	+12.7	-6.3	-28.1	+35.4
Write-downs	-37.1	-21.0	-49.3	+29.0
Economy	-62.6	+17.8	-92.8	+74.8
Interest rates	-92.7	-17.0	-92.7	+38.7
Funding	-15.0	-29.4	-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

Fundraising climate continues to fall

The continuously rising interest rate level has caused the fundraising climate to cool off further. This reflects concerns that accessing capital may become more difficult. For one thing, further interest rate rises are making riskier asset classes increasingly unattractive for capital investors. For another, the stock market falls over the past year are leading to deviations in intended asset allocations in investment portfolios (denominator effect) and causing capital investors to shift more strongly to the now underweight classes or invest less in the future. The typically more interest rate-sensitive stock markets digested the new interest rate rises in the fourth quarter and even started the year with rising share prices. They are likely buoyed by the fact that the interest rate increases appear to be having an effect on lowering inflation and the economic outlook has brightened. Despite the steady performance of the public benchmarks, with share prices on the NASDAQ ending the year on a level that was already observable in the course of the year, investor sentiment about entry prices for new investments improved further in the final quarter, signalling lower valuations. The last time the indicator was better was ten years ago. The bargaining power in VC deals appears to continue to be shifting to investors.

Investment climate is deteriorating

The appetite for new investment slipped into the red in the final quarter. This is mainly due to a steep drop in the expectations component, while situation assessments remained steady. The bleak expectations may have to do with the investment activity that could be observed in the final quarter. According to current data, deal volume fell by 40% on the previous quarter – a development mainly resulting from US investors exercising restraint. Deal volume of German investors, on the other hand, remained steady. US investors' activity has fallen particularly sharply in the scale-up stage. After all, in the past there have been only few large deals without US investor participation. Syndication opportunities are reduced here as a result. The bleaker expectations about investors' own appetite for new engagements may have something to do with the fact that it is uncertain how long US investors will continue to exercise restraint. In the medium term, however, the prospects for investment activity remain good because the capital available for investment has grown further in spite of the adverse macroeconomic environment. But it is uncertain when these funds will be called for investments. What is also still unclear is how the number of start-ups will continue to develop. Even if only few start-ups actually receive VC, the current decline in investment activity may weigh on future start-up activity. Thus, dwindling prospects for receiving VC finance may reduce the motivation to establish a start-up. The drop in the number of new start-ups already observed in the past year is in line with this but may also be an effect of the massive rise in economic uncertainty caused by the Ukraine war.

Deal flow indicators are largely steady

VC investors' assessments of deal flow strength had fallen considerably in the second quarter but have since continued on that level on the border between boom and normality. The lower number of business start-ups has contributed to shaping the trend of this indicator but it is more likely that the changed demand behaviour of start-ups looking for follow-up finance has been instrumental for its progression. Start-ups have responded to the shift in the focus of investors' investment decision from growth indicators to cash flow indicators. Accordingly, many start-ups are working to reduce their costs and get by with available capital for longer. As a result, the frequency of financing rounds is falling. Start-ups with highly innovative products, technologies or business models, however, often have structurally negative cash flow. They have few options for extending the runway and are then dependent on new capital. Requests for finance from such start-ups may have increased again in the fourth quarter, which would explain the rising indicator for the degree of innovation of deal flow on the one hand and the falling indicator for quality on the other hand – which investors are now associating more closely with positive cash flow.

Exit environment continues to deteriorate – and approaching record low

After the temporary break in the preceding quarter, the record-fast decline in the exit climate is continuing. It has fallen so steeply that the previous low of the first quarter of 2009 is almost within reach. Despite the steady stock market performance, IPO sentiment in particular became more frosty. If the positive start to the year in the stock markets continues, however, investors may see an IPO window opening and use it for exits. Sentiment towards trade sales also turned slightly more negative again. The decline is attributable to a deterioration in the situations component – a trend that contrasts with the increased number of start-ups acquired by strategic investors in the fourth quarter. The dissatisfaction is likely attributable to diminished exit proceeds because exit valuations, too, obviously fall in the course of the market's development.

Comments on the current trend

Dr Fritzi Köhler-Geib,
Chief Economist of KfW

'VC sentiment dropped yet again in the fourth quarter of 2022', said Fritzi Köhler-Geib, Chief Economist of KfW. 'As companies prepared their annual accounts, the valuation adjustments that became neces-sary because of the way the year panned out came into focus again with companies' annual accounts and weighed on sentiment. The reluctance of US investors also weighed negatively. This underscores the need to do even more in the scale-up stage in order to reduce dependence on US investors in that area. The good medium-term outlook for VC investment activity brightens the start of the year 2023. The amounts of investment capital which young funds in particular can still receive from their investors has risen further despite the adverse macroeco-nomic environment. Fortunately, the INVEST grant, an important investment incentive for Business Angels, had a fast relaunch.'

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

'Towards the end of the year, a perfect storm developed from the most varied factors and pushed venture capital sentiment further downwards. Combined with the further worsening economic outlook, this is weighing on venture capitalists' investment appetite. The retreat of international investors, especially from the US, is also making large financing rounds a challenge. This underscores yet again that a well-capitalised domestic scene with a strong German investor base is needed to make the German market more robust and more resilient in times of crisis. We need to join forces with market stakeholders and policymakers to achieve this, even when the fundraising situation is rated extremely critically. The fact that considerable capital remains available for investments in the funds is cause for optimism. After all, a number of new venture capital funds were set up in 2022 despite the difficult 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
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 busi nesses and more than 450 investors has already enabled 13 IPOs and numerous trade sales.

Deutsche Börse
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