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

VC business climate weakens again: Bad mood at the turn of the year

12 February 2024

Author: Dr Georg Metzger, phone +49 69 7431-9717, georg.metzger@kfw.de
Press contact: Wolfram Schweickhardt, phone: +49 69 7431 1778, wolfram.schweickhardt@kfw.de

- Despite falling, expectations remain much more optimistic than situation assessments
- Exit environment suffered a setback as expectations slumped again
- Satisfaction with entry valuations remains high but so does write-down pressure

Subdued sentiment at the end of the year

VC business sentiment fell again slightly in the final quarter of 2023. The mood in the German venture capital market thus remained subdued at the end of 2023, although it was better than after the slump experienced up to the end of 2022 as a result of the interest rate turnaround. The sentiment indicator of the early-stage segment fell by 8.1 points to -27.4 balance points. Both subcomponents – situation assessments and business expectations – deteriorated, although expectations remain significantly more optimistic than assessments of the current business situation. The indicator for the current business situation shed 7.3 points, dropping to -39.2 balance points, while the indicator for business expectations fell by 8.9 points to -15.5 balance points.

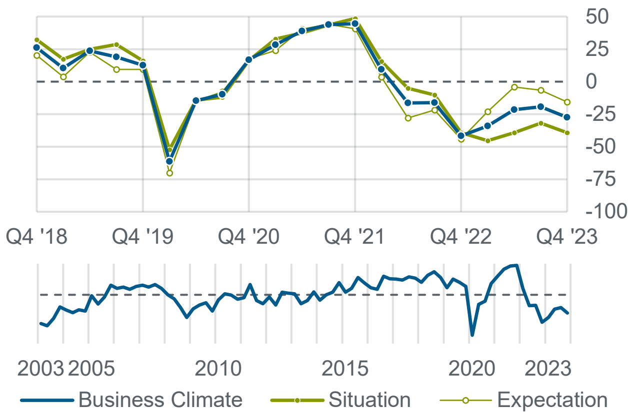
Fundraising climate has hardly changed

Since it nosedived in 2022, the fundraising climate in the German VC market has hardly changed, so the mood at the end of 2023 continued to be frosty (-39.5). In the second quarter, however, a wide gap opened up between the current business situation and expectations because situation assessments plunged yet again while expectations became much more optimistic. To be sure, the higher expectations have not yet been fulfilled and have fallen again in the meantime. But a larger gap and, thus, hope for rapid improvement of the fundraising climate remains.

Exit environment has suffered a setback

The frosty fundraising climate has to do not just with the rapid and hard interest rate reversal but also with lower exit proceeds, which resulted in rather scant return flows for fund investors and hence, lack of reinvestment. Driven by much more optimistic expectations, the negative sentiment around exits appeared to improve slowly before the end of the third quarter. But the risk of a setback associated with this overhang of expectations became reality in the final quarter. Expectations remained unfulfilled, their level dropped again substantially and, as situation assessments also deteriorated, the exit environment hit an annual low (-55.5).

Development of venture capital sentiment indicator



Key data of venture capital sentiment components

Values in balance points

	Q4/23	Δ Q3/23	Low	High
Business climate	-27.4	-8.1	-61.2	+44.5
Business situation	-39.2	-7.3	-56.4	+48.6
Bus. expectations	-15.5	-8.9	-70.2	+44.1
Fundraising	-39.5	-1.2	-68.1	+72.9
Entry valuations	+20.3	-1.3	-54.7	+49.4
Exit opportunities	-55.5	-19.7	-73.1	+72.9
New investment	-1.3	+4.7	-72.1	+31.4
Dealflow quantity	+15.9	+5.6	-45.3	+32.9
Dealflow quality	+7.0	+4.8	-23.0	+28.7
DF innovativeness	+3.1	+2.9	-47.9	+36.0
Taxation / regulation	+13.5	+4.3	-28.4	+35.0
Depreciations	-28.6	-6.7	-48.0	+30.3
Economy	-58.0	-8.7	-90.0	+77.6
Interest rates	-79.2	-1.1	-103.5	+43.2
Public support	+1.6	+4.0	-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.

There appear to be disappointed expectations particularly around exits via secondaries and IPOs. Expectations about these exit channels outpaced the actual situation since the beginning of the year but have now been corrected. As a result, the IPO climate dropped to a near all-time low. Market observers had actually expected the IPO window to open up in the final quarter. But despite new record highs in the stock markets, multiple IPOs were cancelled on short notice or postponed. The drop in expectations, however, indicates that VC investors are anticipating a lull in IPOs for 2024 as well. By comparison, sentiment around exits via trade sales is improving again. The environment for acquisitions has brightened for the fifth consecutive quarter. Here, situation assessments are lagging behind the outpacing expectations. Overall, however, in a historic comparison, sentiment continues to be poor here as well. But based on the numbers, 2023 was a good year, with a similar number of exits via trade sales as in 2022.

Price pressure is likely to ease but lower valuations continue to weigh on portfolios

The fact that the environment for acquisitions remains poor nonetheless can likely be explained by the valuation level, which collapsed after the interest rate turnaround, enabling significantly lower exit proceeds than expected despite many exits. With a view to valuations, however, we may have passed a turning point, which would then enable higher exit proceeds again as well. Since slipping briefly to a low at the end of 2022, the share prices on the NASDAQ have increased again substantially, with the index gaining nearly 50% in 2023. The positive development of the prominent benchmark index is likely to take the pressure off prices. Still, the valuations of VC investors' portfolios are likely to remain under pressure. After all, not all start-ups that were able to finalise financing rounds at very high valuations seen in the boom year 2021 have yet required follow-up financing. It remains to be seen whether all of them will be able to obtain follow-up finance and if so, at what valuation. As a result, sentiment around valuation adjustments remains poor (-28.6). At any rate, corrections appear to have been made again to many valuations in the final quarter because situation assessments deteriorated significantly. Expectations also decreased but remain optimistic.

A ray of light: Investment appetite is growing

So far, the general rebound in valuation levels has not impacted much on the mood around entry valuations for new commitments. To be sure, the level of satisfaction slipped minimally for the second straight quarter, but it remains on a very high level (+20.3). This suggests that entry valuations for new commitments are still being seen as attractive. It is possible that the time has come for many VC investors to invest more again. Thus, the investment environment improved significantly in the final quarter and is now just barely below its historic average (-1.3). To be sure, the investment environment continues on a level that is driven by expectations, as expectations fuelling the appetite for investment in new commitments are much higher with a view to the next six months than current situation assessments. However, the latter has improved for the second consecutive quarter and therefore recovered again from its low after the interest rate turnaround.

Higher investment appetite meets with stronger deal flow

The deal flow environment improved overall in the final quarter. The indicators for the level, quality and innovativeness of deal flow all increased. Assessments of deal flow levels had dipped sharply after the start of 2022, presumably because start-ups adapted to the diminished investment appetite of VC investors and conserved their existing funds without submitting new funding applications. Since the beginning of 2023, start-ups appear to have gradually become less cautious. In addition to those start-ups that now require follow-up finance since the latest round, those start-ups that have so far funded themselves temporarily via bootstrapping are also likely to increasingly sense a financing opportunity. As a result of the most recent increase, the indicator is now back on a very high level (+15.9). The indicators for quality and innovativeness of deal flow have also improved moderately and are now moving on or towards their upper levels again (+7.1 and +3.1).

Comments on the current trend

Dr Fritzi Köhler-Geib,
Chief Economist of KfW

“The recovery of business sentiment in the German VC market has stagnated, so investor confidence remained subdued towards the end of 2023”, said Fritzi Köhler-Geib, Chief Economist of KfW. “The war in the Middle East and concerns over a possible escalation have weighed on the recovery at least temporarily, which was to be expected. In the course of the year, however, investor confidence improved significantly from its brief drop, which had been caused by the interest rate turnaround. Sentiment continues to be subdued as an expression of great dissatisfaction with fundraising and exits. On the investment side, however, things are looking up. To be sure, much less VC was invested in Germany in 2023 than in the course of the boom of 2021. But investment is on the level of the previous years and, thus, higher than investor sentiment would imply. The good news for start-ups is that after dropping briefly, VC investors' appetite for new commitments already rebounded again in the past two quarters. Access to VC could therefore become easier again for start-ups than it has been for a good one and a half years.”

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

“Market activity and sentiment of venture capital companies are still taking a wait-and-see attitude”, summarised Ulrike Hinrichs, Managing Director of the German Private Equity and Venture Capital Association (BVK). “Economic and political conditions continue to stand in the way of a sustained sentiment upswing. The exit situation and fundraising environment are further key stumbling blocks. However, the expected interest rate reductions in the course of the year could cut the knot. The valuation level for new investments is attractive, and demand for capital is high. The financing rounds around the turn of the year, some of which were very large, give hope. They highlight the growing investment appetite of venture capital companies and the return of confidence.”

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.

Deutsche Börse Venture Network