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Trends in market: War in Ukraine is affecting investor expectations

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Author: Dr Georg Metzger, phone +49 69 7431-9717, georg.metzger@kfw.de

Two years after the coronavirus shock, sentiment in the German venture capital market dropped again in the first quarter of 2022. This was likely due to the inflation-induced accelerated interest rate turnaround and the greater economic uncertainty caused by the Ukraine war. The current downturn, however, began from a record-high level and is only around half as steep as during the coronavirus-induced decline in business sentiment in early 2020. Business confidence therefore remains in positive territory.

VC investors see a number of sectors becoming increasingly important in 2022. Above all, they anticipate that Greentech / climate tech, deeptech and cybersecurity will play a greater role. But investors are pessimistic about the e-commerce sector. In terms of deal volume, the e-commerce sector is by far the largest individual sector in Germany. A decreasing role of e-commerce can thus result in a potentially large deal volume being allocated to other sectors whose importance is growing.

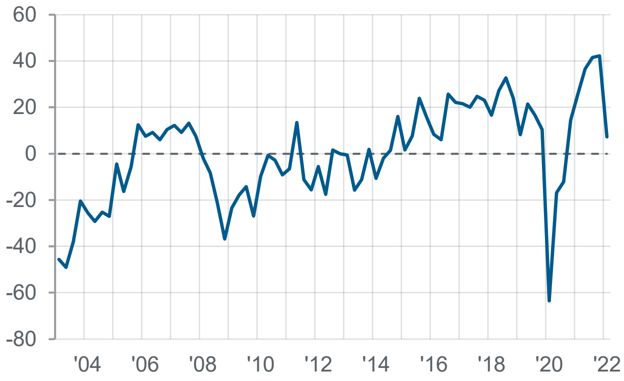
With regard to the challenges, VC investors regard higher geopolitical and economic uncertainty for 2022 as the most likely and most challenging scenario. The challenges associated with the faster pace of the interest rate turnaround, on the other hand, are being regarded as much less of a burden. One reason for this may be the time horizon. After all, these challenges might become a real burden especially in the medium term, in other words, after 2022.

The faster pace of the interest rate turnaround and the Ukraine war: VC sentiment has deteriorated considerably

Two years after the coronavirus shock, sentiment in the German venture capital market dropped again in the first quarter of 2022 (**Fehler! Verweisquelle konnte nicht gefunden werden.**). This was probably due to the inflation-induced accelerated interest rate turnaround and the greater economic uncertainty caused by the Ukraine war. However, the current trend differs from the coronavirus shock in two main aspects: First, the decline started from a record-high level and second, it is only roughly half as steep as it was then. The record confidence level that preceded the slump at the end of last year was also reflected in investment activity. Growing to more than EUR 15 billion, three times the volume of a good EUR 5 billion in 2020, the deal volume of 2021 was exceptional and is not likely to repeat itself anytime soon.

Figure 1: Two years after the coronavirus shock, confidence in the German venture capital market has dropped again

VC business sentiment (in balance points)



Source: German Venture Capital Barometer, 1st quarter 2022

The number of unicorns domiciled in Germany, that is, start-ups valued at more than USD 1 billion, doubled from 12 at the end of 2020 to 25 within a year. The German market was part of a development that took place internationally. Measured against economic output (GDP-weighted), Germany's deal volume caught up with that of France again last year and exceeded the EU average just slightly. By contrast, however, the gap to the important comparison markets in the UK and the US widened, where an even more significant upturn took place.[a]

The current sentiment downturn has most severely affected all indicators directly related to the interest rate turnaround, which has even picked up pace as a result of the higher energy prices due to the war. The interest environment and, consequently, the fundraising climate have thus deteriorated most sharply. This is also due to the fact that when interest rates rise, money tends to be withdrawn from the asset class VC, which will make fundraising more difficult. In the course of the tech stock correction on the share markets, the valuation indicator has also fallen because private markets normally follow public markets sooner or later. Falling entry valuations for new investments, by contrast, are bolstering investor confidence. Sentiment around the level of deal flow, investment appetite and exit opportunities, on the other hand, is hardly affected. This gives reason to hope that investment activity in German start-ups remains steady.

[a] Own calculations based on Preqin Pro (for deal volume), CB Insights (for unicorns) and IMF (for GDP-weighted).

Energy prices have increased and will possibly rise further, hitting the German economy hard. Start-ups are not immune to this either. But they are likely affected by supply chain disruptions and rising inflation to different degrees. This was the case already before the coronavirus crisis, which did not have any negative effects for most start-ups but posed major problems for tourism start-ups. Others such as delivery or collaboration start-ups, however, were able to benefit immensely. Thus, the impact of the war on energy supplies may equally become a booster for specific start-ups.

Sector trends: Ukraine war has consequences

Green tech / climate tech, deeptech and cybersecurity, in particular, are expected to grow in importance

VC investors see a number of sectors becoming increasingly important in 2022. Three quarters of investors (74%) expect green tech / climate tech to play a larger role and a good two thirds also see the sectors deeptech and cybersecurity starting to take off (68% each, Figure 2). Expectations may have been driven in part by the escalation of the war in Ukraine. Thus, the strong increases in energy prices have provided incentives for innovations in the area of energy efficiency and, thus, for investments in green tech / climate tech start-ups. Across Germany and around the world, new spring temperature records highlighted the need to take action on climate change.

The escalation of the war in Ukraine also illustrated the relevance of cybersecurity as Russia's cyberattacks also impacted Western Europe. In addition, a majority expect the sectors artificial intelligence (AI, 63%), clean tech (58%), foodtech / agtech and healthtech (53 and 52%) to grow in importance. There is no longer an absolute majority of investors who are optimistic for the sectors robotics/drones, biotech/life sciences, blockchain/crypto and space tech, to be sure, but more of them expect their relevance to increase than decrease or remain unchanged (50, 42 and 42, and 37%).

Most investors believe fintech and IoT will remain steady but expect e-commerce to lose importance

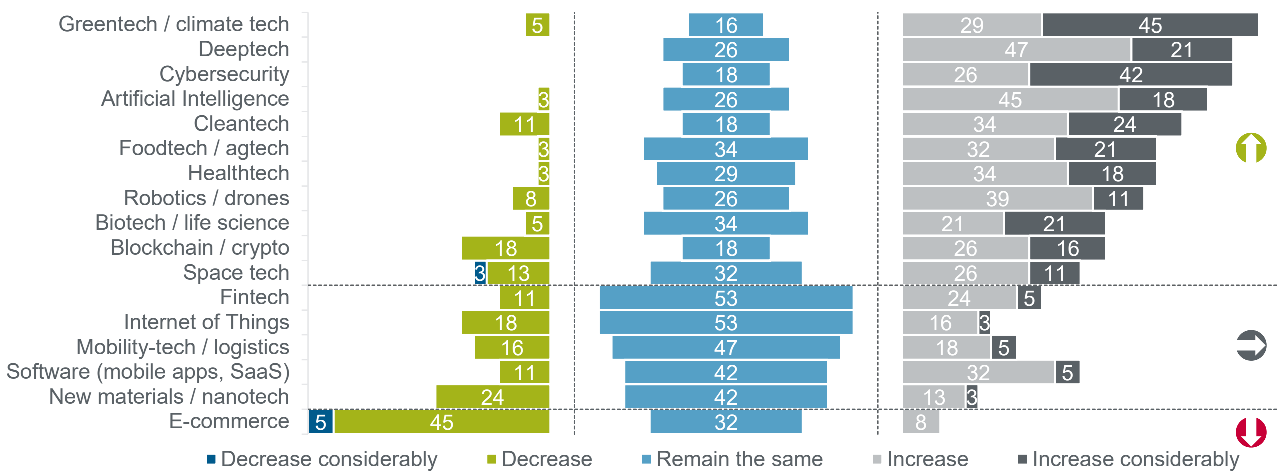
The majority of VC investors expect the sectors fintech and Internet of Things to remain on the same level of importance (53% each). They are also most likely to see the importance of mobility tech / logistics, software and new materials/nanotech as remaining steady (47, 42 and 42%). By contrast, investors are pessimistic about the e-commerce sector. Half of them believe it will lose importance.

Overall, the majority of VC investors are optimistic for most sectors. At first glance, this is not intuitive as increases and decreases in importance must ultimately balance each other out. Two aspects play a role in this regard: the intensity of the expected development and the baseline. The sectors green tech / climate tech and cybersecurity are most often seen as gaining in importance. Increases in importance are also expected relatively often for the sectors cleantech, deeptech, foodtech / agtech, biotech / life sciences, AI, healthtech and blockchain / crypto.

Only few investors see any sectors as declining sharply in importance. Nevertheless, the widespread pessimism about the e-commerce sector plays a major role for the overall assessment. In terms of deal volume, it is by far the largest individual sector in Germany. A decreasing importance of e-commerce can thus result in a potentially large deal volume being allocated to other sectors whose importance is growing. In some cases, capital flow could be considerable there, compared with investments previously undertaken in those sectors.

Figure 1: Green tech / climate tech, deeptech and cybersecurity are the three sectors expected to increase most in importance

How do you expect the importance of the following sectors and technological fields to change for investments in 2022? (shares in per cent)



In descending order by majority holdings. Difference to 100% attributable to 'Not sure' responses

Source: German Venture Capital Barometer, supplementary survey to the 1st quarter 2022

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. The primary focus of the barometer is on surveying business sentiment in the German venture capital market on the basis of assessments provided by private equity firms with a focus on young companies. In addition, investors are also asked supplementary questions on a range of topics of interest in irregular intervals. In the survey pertaining to the first quarter of 2022, the supplementary questions related to trends in the German VC market.

Uncertainty from inflation and the Ukraine war is a burden

The global flow of goods has stalled as a result of the coronavirus pandemic and many international supply chains have become so overstretched that they have broken. When supply shortages sparked strong increases in inflation rates, economic uncertainty rose to a record high already at the end of 2021 because the situation was without precedent. Not only did the escalation of the war in Ukraine at the end of February 2022 drive inflation up further; it pushed economic uncertainty to a new record level because of the unpredictability of events.

Very little is known about what is yet to come. Uncertainty hampers decision-making across the business community as a whole and thus among VC investors as well. Accordingly, VC investors expect geopolitical and economic uncertainty to remain elevated and problematic in 2022 (Figure 2). But VC investors also anticipate further challenges. Those that are most likely include:

– growing importance of ESG criteria,

– a higher interest level,

– higher capital needs of start-ups,

– more intense competition from foreign investors,

– reduced exit opportunities,

– falling share prices and

– a greater amount of untied funds (‘dry powder’).

However, these challenges do not burden all investors equally. Besides uncertainty, among the challenges most likely to materialise it is particularly the reduced exit opportunities, higher capital needs of start-ups and the growing importance of ESG criteria that are placing greater strain on investors.

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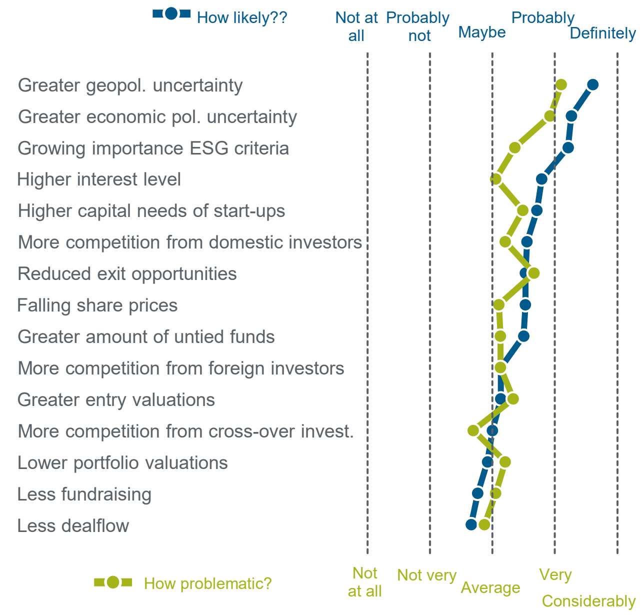
Figure 2: Higher risks and less favourable exit prospects are the greatest burden for VC investors

What challenges do you see in your field of business in the German market in 2022, and how will they affect your business activity? (average 5-point Likert scale)



Source: German Venture Capital Barometer, supplementary survey to the 1st quarter 2022

Central banks around the world have sped up the interest rate turnaround to rein in rising inflation. Investors therefore expect a higher interest rate level as well. However, VC investors do not see this as an above-average burden. Higher interest rates should tend to make alternative asset classes, one of which inevitably is venture capital, less attractive. New fundraising is therefore likely to become more difficult. Lower fundraising, however, is seen as less likely than average.

It is possible that the time horizon plays a role in the initially surprising overall assessment of interest rates and fundraising. Thus, these challenges might become a perceived burden only in the medium term, that is, after 2022. This may apply in the same way to the correlation between share markets and portfolio valuations. While lower prices in the share markets are being regarded as more likely than average, that does not apply to portfolio valuations. What could play a role here is that the valuation level of public markets manifests itself in private markets with a delay (‘stale pricing’).

VC investors see rather fewer problems on the demand side. Thus, they regard a lower deal flow, that is, a lower number of qualified start-ups eligible for VC financing, as less likely and burdensome than average. That may be an indication that the German start-up ecosystem is now on a solid foundation. Unlike 20 years ago, potential start-up entrepreneurs now have access to a significantly better support infrastructure with incubators, accelerators and seed financiers, which makes it unlikely for deal flow to dry up even in difficult market phases.