KfW Research

German Venture Capital Barometer 2nd quarter 2022

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

Mood on German VC market turns frostier – sentiment signal turned red

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- VC business sentiment is once more considerably cooler
- Fundraising indicator drops sharply – second steepest decline since coronavirus shock
- Confidence about interest rate levels in capital markets at all-time low

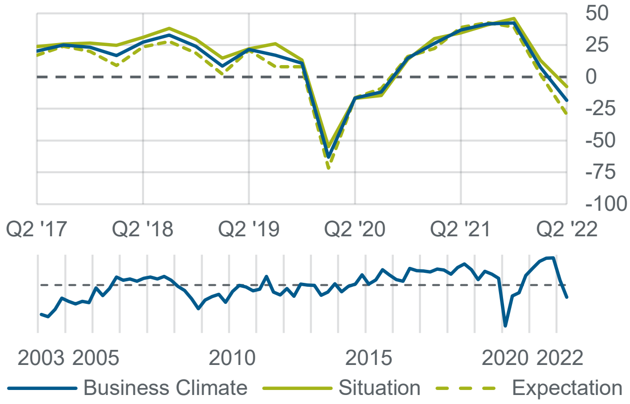
Sharp interest rate turnaround has spoiled the mood for the VC market

The inflation-induced announcement of an increase in base rates caused business confidence on the German VC market to buckle in the first quarter of 2022. A historic interest rate increase by the Fed in the US and expectations of a tighter course by the ECB caused sentiment to continue nosediving in the second quarter. The business climate indicator in the early phase segment dropped by 26.0 points to -18.5 balance points. This has cast an even darker shadow on business expectations than on situation assessments. The indicator for current situation assessments fell to -7.6 balance points (-20.6) while the business expectations indicator lost 31.4 points to stand at -29.4 balance points.

Interest rate outlook weighs on company valuations

In June the Fed surprised the markets with the sharpest increase in benchmark interest rates in nearly 30 years. Shortly thereafter, further large rate hikes were already under consideration. The interest rate increase by the ECB, too, was already being flagged. These prospects drove the interest rate level in the capital markets upward, with the Fed and ECB introducing further rate increases in the third quarter at the end of July. That depressed to an all-time low the interest rate expectations among VC investors, who had gotten accustomed to the low interest rate environment of the past years. At the same time, write-down pressure increased further. The reaction of the central banks has also put a further dampener on tech stock prices in the share markets. Though, their development is not reflected one-to-one in the VC portfolio movements. Nevertheless, falling prices will gradually impact on the valuations of new financing rounds – beginning in later-phase scale-ups, which are most readily comparable to publicly listed companies, as some prominent examples have shown in recent weeks. Accordingly, the confidence indicator on write-downs has lost considerable ground. Falling company valuations, on the other hand, are once more leading to more favourable entry points. Against this backdrop, the indicator for entry valuations has made clear gains.

Development of VC business climate indicator



Key data of VC sentiment components

Values in balance points

	Q2/22	∆ vs. Q1/22	High	Low
Business climate	-18.5	-26.0	+42.5	-63.3
Business situation	-7.6	-20.6	+45.9	-59.0
Business expectations	-29.4	-31.4	+42.7	-71.7
Fundraising	-18.2	-51.5	+69.9	-71.0
Entry evaluations	+19.0	+48.0	+51.3	-52.8
Exit opportunities	-41.8	-54.3	+69.2	-76.8
thereoff: Trade-Sales	-52.0	-47.4	+52.3	-95.6
Secondaries	-27.1	-32.5	+52.7	-60.7
IPOs	-42.8	-30.3	+94.5	-56.8
New investment	-4.5	-21.0	+30.7	-72.9
Dealflow quantity	+9.8	-23.9	+33.7	-44.5
Dealflow quality	+22.9	+6.0	+29.2	-22.6
Taxation framework	+17.3	+4.2	+35.8	-27.7
Write-downs	-22.5	-25.8	+28.3	-50.0
Interest rates	-92.6	-47.9	+36.6	-92.6

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. The indicators of exits, taxes and valuation pressure cannot be compared to the previous quarter’s publication due to corrections.

Source: KfW Research, BVK and DBVN.

For fund investors, rising interest rates make the VC asset class less attractive than safer investments. With the large interest rate hike, the fundraising climate among VC funds has therefore also continued its decline. We have seen the second-highest fall to date in fundraising sentiment since the coronavirus shock. The decline in early 2020 was triggered by uncertainty about the further progression of the pandemic. This uncertainty subsided quickly, and a year later fundraising sentiment was already back to the old record-high level. Such a V-shaped recovery, however, currently appears unlikely in view of the changed macroeconomic fundamentals.

Uncertainty weighs on investment appetite

The noticeable cooling of the fundraising climate is evidently affecting the willingness of VC investors to make new investments. Despite the more favourable entry opportunities, the corresponding indicator has suffered a setback, with the expectations component most affected. Given the foreseeable difficulties in attracting new funds, investors may be attempting to stretch their available funds across a longer period or to use them to stabilise their existing portfolio. It may also be a response to the announcement of further interest rate increases should inflation rates remain high. If their market expectations are not fulfilled, further losses in prices and thus valuations must be expected. Some investors are evidently reluctant to invest further in this phase of uncertainty. Anecdotal reports of market stakeholders refer to investors' 'extended summer holidays'. It has therefore become more likely that the less favourable market sentiment will translate into a more significant weakening of investment activity in the third quarter.

Neither the indicator of investment appetite nor the realised deals reveal any major restraint thus far. Deal volume in the first half of this year clearly remained below the two previous half-years, but 2021 was also an unexpected exceptional year. Deal volume tripled on the previous year 2020, driven by US investors. Starting from this high level and given the changed market conditions, a sharper decline than the observed -25% drop from the first half of 2021 was now feared for the first half of 2022. Thus, the first six months of 2022 were actually the third best half-year ever for investment activity in the German VC market. For now, the outlook for investment activity has now dimmed for the short term but remains good for the medium term. Many new funds have been launched in the past years because of the very good fundraising conditions. Even this year saw a number of closings. That means a lot of 'dry powder' still remains in the market that must be invested within the investment phases of the respective funds. These young funds in particular, which can still draw on the greatest portion of their capital from the fund investors, will likely benefit from the more favourable entry opportunities. When their portfolios enter their divestment phases the exit opportunities may already have improved for them again.

Dismal mood for exits

The exit environment is currently being regarded as very poor. The only time it was worse was after the coronavirus shock and during the global financial crisis. What is new is how fast the exit environment has worsened. The corresponding indicator lost more than 50 points over two consecutive quarters. The IPO environment in particular has deteriorated. Never before has the IPO window closed as fast as it did in the first half of 2022. After 2021 proved to be the best IPO year in the long time, the first half of this year saw the lowest number of IPOs of VC-funded companies in the US and Europe since the first half of 2009. While sentiment for IPOs is aligned with market observations, the situation is different for trade sales. The mood is on a similarly low level here as for IPOs, but this was the third strongest half-year ever for the number of registered acquisitions of VC-funded companies from Germany. The discrepancy between sentiment and observed exits might have to do with the fallen valuations. Not only are these reflected in new deals and the portfolio, of course; they also weigh on possible sales proceeds. Even if the number of trade sales was high, investors may not have generated the exit proceeds they had hoped for.

Deal flow – separating the wheat from the chaff

Current developments in VC markets have also left an imprint in the deal flow of VC investors. The indicator for the level of deal flow has fallen significantly from the record level achieved in the first quarter. There may be different reasons for this. Dismissals and downrounds in start-ups and recommendations from investors to their portfolio companies to save costs characterised media reports in the last quarter. The negative headlines may have discouraged potential start-up entrepreneurs from founding a business. That would have reduced deal flow in the (pre-)seed segment. Moreover, the shift in the strategic focus of many investors' investment decisions – away from fast growth towards positive cash flow – may also have had an impact. It may have prompted start-ups with a heavily growth-oriented business model to exercise restraint with funding requests. In general, in the current market environment it is rather more likely for those start-ups that need new funds to acquire capital because they are unable to stretch their remaining capital any further. Financing rounds for expanding the existing liquidity buffer, on the other hand, are likely to have become rare. What deserves to be highlighted, however, is that the quality of remaining deal flow still appears to be high. The quality indicator has risen further and remains on a high level.

Comments on the current trend

Dr Fritzi Köhler-Geib, Chief Economist of KfW

‘VC business sentiment continued to cool in the second quarter of 2022. The markets showed surprise at the resoluteness and strength with which the Fed went ahead with the interest rate reversal’, said Dr Fritzi Köhler-Geib, Chief Economist at KfW. ‘This has put pressure on fundraising and valuations in the VC market. So long as rates of inflation remain high, it is always possible that the central banks’ interest rate moves deviate from expectations and lead to market swings. Uncertainty in the VC market will therefore remain high in the short term. And even if it abates, deal volume is likely to fall short of the exceptional year 2021. However, based on the information currently available, a sharp drop appears unlikely. Basically, we are in a transition phase from a hot to a cooler market.’

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