



Talking point



Economic downturn hits start-ups in multiple ways

December 5, 2008

Young and innovative companies are being hit especially hard by the current recession and financial crisis. In an economic downturn, spending is restricted to a minimum, companies avoid risky, long-term investment projects – e.g. the introduction of new technologies – and consumers are less willing to experiment with new products. This makes it increasingly difficult for start-ups to sell their new and innovative products.

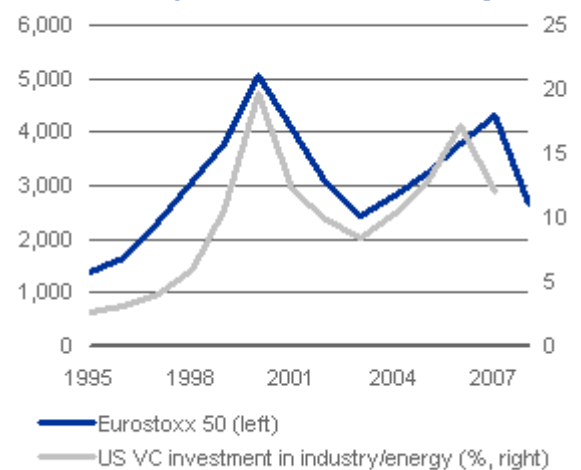
Moreover, financing terms are becoming more onerous for innovative start-ups. In Europe, in particular, venture capital investment is highly dependent on the general economic environment. In 2007, investment already fell by roughly 30% yoy.

In the US, the decline in VC investment has been less severe to date, with investment volumes in Q3 2008 only 10% below the pre-year figure. But there is a lot to suggest a turn for the worse in the near future. Short-term yields on VC funds dropped from 18% to 5% between summer 2007 and summer 2008. This is making fundraising increasingly difficult. The situation is even worse when it comes to exits. The first three quarters of 2008 saw just 6 venture-backed IPOs. By comparison, the pre-year figure was 55. Yet, stock exchange listing is considered the most lucrative exit form. Given these circumstances, some VC funds are preparing their portfolio companies for tougher times: even the most creative companies now have to exercise strict cost control, consider layoffs where necessary and strive for early commercial success.

In the New Economy bubble, young internet start-ups in Silicon Valley and their Old World offshoots were at the heart of the crisis. At present, this is not the case, as VC investment has grown modestly only in the US since the bubble burst. In Europe, VC investment had recovered more strongly – albeit at a generally lower level. Hence, the current decline is more pronounced there.

Since the turn of the millennium the focus of investment has shifted. The share of VC investment in IT, software or telecommunications has fallen considerably. In turn, a higher share of investment is going into start-ups focusing on medicine, bio-technology and most of all, energy. This shows that the founders of start-ups are responding to trends and scarcities in the real economy. Especially the debate on climate change and, above all, the soaring oil prices up until the summer of 2008 have triggered a boom in energy-related VC investment. A case in point is Tesla Motors which makes electric sports cars. Since 2003 the company has managed to collect approx. USD 150 m in venture capital. Once more, Tesla demonstrates the great economic significance of innovative start-ups. They provide important impetus for a large number of sectors, even the capital-intensive ones: Tesla's battery-powered roadsters are already out on the road – something which established carmakers have not yet achieved.

Venture Capital in the business cycle



Sources: EVCA, DB Research, 2008



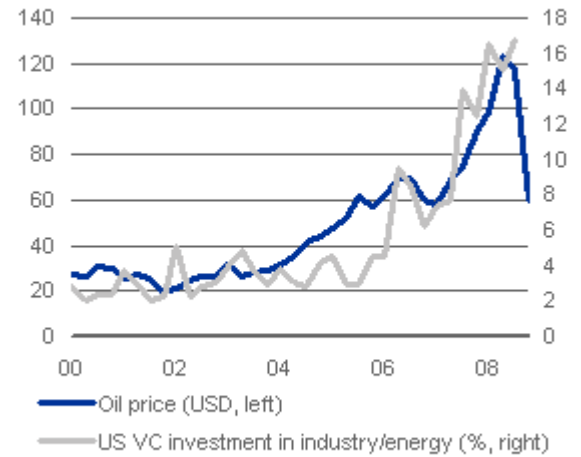
But the economic downswing has also affected commodities markets. Since the summer of 2008 the price of oil has fallen by more than 50%. This makes the search for alternative energies look less urgent at present, which will hurt those start-ups that aimed to capitalise on the situation with innovative ideas. Besides the cyclical and financial problems they will also suffer from sector-specific over-investment. Tesla, too, has meanwhile had to close down a location, lay off staff and delay the introduction of a new product variant.

It would be misguided, though, to completely dismiss the often pro-cyclical character of start-ups – regarding both the economic cycle and the topics (internet, web 2.0, energy). A strong economy often creates the necessary optimism needed by the founders of new companies. Moreover, new ideas and experiences will spread faster if numerous other firms are working on similar concepts. It is not by accident that innovative companies tend to locate in close proximity to each other, as for instance in Silicon Valley.

The macroeconomic effects of the expected weaker momentum for start-ups will first and foremost affect trend growth, and to a lesser extent the business cycle. Without innovative start-ups today, there will be a lack of new products tomorrow that are needed to ensure competitiveness and technological leadership. So over-reactions should be avoided despite the understandable impulse to shy away from all risk in an economic downswing.

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Oil is the new internet



Sources: DB Research, Global Insight, PwC MoneyTree, 2008



Thomas Meyer (+49) 69 910-46830

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