



Henry McDougall

FAILURES IN VENTURE CAPITAL

Bachelor's Thesis

Bachelor of Science in Economics and Business Administration

May 2022

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1 INTRODUCTION

1.1 Introduction to the topic

Successful companies such as Facebook, Google, Airbnb, and PayPal all share a common feature, which is that they were all venture capital (VC) funded. Many new and innovative companies are being financed by a sector called VC. VC is a subsector of private equity focused on financing start-ups. The VC markets fill a certain void in the financing of companies. Many innovative and early-stage start-up companies might not be ideal candidates for traditional financing institutions. This is where venture capitalists come in and start financing the most prospective candidates. The reason why VC companies finance these traditionally not ideal companies is that they present an opportunity for a venture capital return that is both a higher risk and return profile associated with the asset class. The VC market is relatively small but its effects on the economy are far greater than its size. A 2015 study on the economic impact of VC shows that, VC-backed companies account for 41% of total US market capitalization, 42% of companies that went public in the US after 1978 were funded by VC, in 2020 VC-backed US public companies spent \$244 billion on research and development (R&D), up from essentially zero in the 1970s, which accounts for 62% of all R&D spending by all US public companies (Gornall & Strebulaev, 2015).

The VC markets and the amount of money invested have been growing at a very rapid pace over the last five years. As an asset class VC is also performing quite well. The growth and returns of VC will be covered in more detail in the second chapter of this research. Still a lot of capital in the view of investors is being used inefficiently since on average most venture capital investments will not return any profits nor the original invested capital to the investors. Finding out why investment failure is so high in VC could prove beneficial in trying get a better return rate for investments and thus making VC funds more profitable and thus more competitive individually and as an asset class.

1.2 Research problem and objective

It is general knowledge of investors that high returns are accompanied with high risk. As mentioned, VC is known for success stories such as Facebook, Google, Airbnb,

and PayPal. These companies have achieved extraordinary results and completely reshaped or created new industries and all of them have been funded with VC. Unicorns (which refer to start-ups that reach a valuation of 1 billion USD) and other success stories of the start-up and VC world often manage to get lots of publicity from the media. What is not so commonly known about is the massive number of failures in VC. Most start-up companies are failures, which somewhat explains why most VC investments fail. The goal of this research is to find out why experienced investors invest more often into companies that do not return any profits nor the original invested capital, than companies that do.

The main research problem to be answered by this study is:

Why do venture capital investments fail so often?

This study will also have a focus on start-ups and start-up failure since they play a crucial role in understanding why investments fail so often. When the start-ups fail the investments will also most likely fail. Since VC is not that well known as a sector this study will start with explaining VC and its goals, methods, and trends. If this study provides critical insights into failed investments, investors could use this study to gain new insights into their investing and due diligence processes to avoid certain losers or to acknowledge better the characteristics of poor prospective investment opportunities.

1.3 Research methodology

The research methodology for this study is literature research. The research was done by searching for relevant literature, statistics, articles, books, and reports from databases such as EBSCO, and Google Scholar, also many independent companies, and organizations were good sources of information. Keywords such as “venture capital”, “return”, “performance”, “failure rate”, and “start-up” were used while searching for information.

1.4 Structure of the paper

The structure of this document is divided into four chapters. The first chapter is an introduction to the research paper. This chapter involves an introduction into the topic of the research paper.

In the second chapter the main terms and concepts are defined such as venture capital, venture capital investing, venture capital market trends, and failed investments. The second chapter also explains how the data and statistics vary depending on the VC fund.

The third chapter will cover what are the most common reasons that cause investments to fail. This chapter will also have a focus on the three most common early-stage and late-stage failure patterns of start-up companies.

The fourth chapter will collect and summarize the research from the third chapter and try explaining the reasons for the failure rates of investments in VC.

2 VENTURE CAPITAL

This chapter will familiarize the reader with the main terms, trends, stakeholders, definitions, and concepts of venture capital.

2.1 Definition of Venture Capital

Venture capital at its core is a segment of private equity. VC is quite a broad topic, and it can be defined in multiple ways. VC typically involves multiple stakeholders, so the definition varies from whose perspective you are defining it from. To better understand the dynamics and nature of venture capital it is essential to introduce the common stakeholders in VC.

2.1.1 Stakeholders

There are two very important stakeholders in VC, general partners (GP) and limited partners (LP). GP are the venture capitalist who manage the fund or funds and make the investments into companies. A VC fund is a sum of money investors commit for investment in early-stage companies (Business Development Bank of Canada, n.d.). So where do the GP acquire the funds to invest into these companies? Well, the answer is quite simple, some GP invest a portion of their own money into their fund, and the rest of the capital is acquired from the LP. As the name describes LP are limited partners; they invest their money into the funds for the GP to invest. A LP can be for example university endowments, foundations, corporate and state pension funds, or family offices. VC is from the view of LP an asset class, since they are investing their capital into a fund, which hopefully will return a good profit.

2.1.2 Start-ups

Most commonly VC is thought of as financing for companies, especially start-up companies “it [VC] is a source of funding for companies ... that are not otherwise good candidates to get funding from other, more traditional financial institutions” (Kupor, 2019, p. 26). The way VC financing differs from a business loan is that the venture capitalists will invest capital into a company in exchange for equity. Venture

capitalists also tend to focus on financing companies that have high long term growth potential. An early VC investment into a successful company can be very lucrative for the investors.

2.1.3 Funds

VC funds are also in itself quite a wide topic. Most funds tend to focus on certain stage of funding e.g., seed-stage fund compared to late-stage fund. The main stages of funding in VC are the following: Seed- & Angel-Stage, Early-Stage VC, and Late-Stage VC.

The first stage, which contains seed and angel investments are a very early stage of funding to help the entrepreneurs develop their product. Ben Fowler From Silicon Valley Bank describes the use of seed-stage capital as “Most of the modest sums you raise in the seed stage are for specific activities like market research, business plan development, setting up a management team and product development” (Fowler, 2021).

The next investment stage is called early-stage VC. The main difference between seed and early-stage is that in an early-stage company the product exists and is ready and is also possibly generating revenue. The main use of early-stage capital is the following: “This [early-stage capital] will allow them [early-stage companies] to invest in customer acquisition and further business development” (Peak Capital).

The last stage of investing is called late-stage VC. Late-stage VC focuses on scaling the actual business. Late-stage VC is often described as: “This stage of venture capital supports actual product manufacturing, marketing, and sales operations. To expand, you’ll likely need a much larger capital investment than earlier ones” (Fowler, 2021). The other difference between early and late-stage VC is that: “Whereas Series A [early-stage] investors will measure your potential, for Series B [late-stage] they want to see actual performance and evidence of a commercially viable product or service to support future fundraising” (Fowler, 2021).

There are certain things that are important to understand from these stages. There can be multiple rounds of funding in one stage. The investment sizes usually grow with the stage of the company, also the expected returns decrease with the stage of the companies. A Blog post by Ulu ventures explains this well: “Given that most venture money is going into late-stage investments, you would think it best to bet on later stage companies. But early-stage venture has much higher average returns, 22% when compared with later stage returns of 12%” (Riviera, 2020). The number of companies that manage to get the next stage of funding decreases notably every round. A study from CB Insights proves this phenomenon:

Less than half, or 48%, managed to raise a second round of funding. Every round sees fewer companies advance toward new infusions of capital and (hopefully) larger outcomes. Only 15% of our companies went on to raise a fourth round of funding, which typically corresponds to a Series C round (CB Insights, 2018).

Before diving into the dynamics of VC investing it can also be good to understand to current state of the VC market.

2.2 Venture Capital Market Trends

The number of deals and overall value of VC investments have been increasing at a rapid rate over the last five years. In Europe the value of VC investments in 2020 was 46.8 billion Euros compared to 18.8 billion Euros in 2015. A preliminary valuation of 2021 VC investments in Europe totals 102.9 billion euros (PitchBook, 2022). In the USA the respective investment amounts are 166.6 billion dollars in 2020 and 85.8 billion dollars in 2015. A preliminary valuation of 2021 VC investments in the US totals 329.6 billion dollars (NVCA, PitchBook, 2022).

The value and number of investments made by nontraditional investors in VC has also significantly increased in the US and Europe. In Europe the 2016 deal count was 2,041, and total value was 12.3 billion Euros, and the 2021 respective values were 3,601 and 78.4 billion Euros. While in the US the 2016 deal count was 2,857, and the value was 58.2 billion USD, and the 2021 respective values were 6,483 and 253.5 billion USD.

This can be seen as nontraditional investors embracing VC. Nontraditional investors refer to:

Nontraditional investors: Corporate Venture Capital (CVC) includes rounds executed by established CVC arms as well as direct equity investments by corporations into VC-backed companies. Private equity (PE) includes VC deals by investors whose primary classification is PE/buyout, growth, mezzanine, or other private equity. Crossover investors are a subset of nontraditional investors—specifically asset managers, hedge funds, mutual funds, and sovereign wealth funds—that have been active in VC investment across any stage. They are referred to as crossover as these investors are likely to be participating at the late stages directly prior to an exit (NVCA, PitchBook, 2022).

The current trends in VC are very positive, the amount and value of investments are growing at a positive rate. Nontraditional investors are entering the market and embracing VC as an asset class to invest into. These market trends will most likely help VC become more accessible and common for start-up companies.

2.3 Venture Capital Investing

The beginning of a traditional VC firm will start with the GPs fundraising capital for a fund. As mentioned earlier the LPs are the stakeholders that invest into the fund. Usually a Limited Partnership Agreement (LPA) will be done between the LP and GP. An LPA will cover important aspects of the fund. For example, the management fee and carried interest is usually determined in the LPA. Considering that the LP invest large sums of money into these funds, but really don't have any control over the actual investments they might wish to have certain rules for the fund. A common one is the investment domain, this refers to which sector the GP are allowed to invest into, what stage companies, there might also be geographical restrictions. An example of the life cycle of a VC fund after fundraising is the following:

VC funds are structured under the assumption that fund managers will invest in new companies over a period of 2-3 years, deploy all the capital

in a fund within 5 years, and return all capital to investors within 10 years (FundersClub, 2022).

The venture capitalist will start investing into companies. The actual investing is done often with a debt instrument called a convertible note.

A convertible note is a form of short-term debt that converts into equity, typically in conjunction with a future financing round; in effect, the investor would be loaning money to a startup and instead of a return in the form of principal plus interest, the investor would receive equity in the company (Kellner, 2017).

Venture capitalists might also use other debt instruments and methods as well “While VCs use convertible securities most frequently, they also implement a similar allocation of rights using combinations of multiple classes of common stock and straight preferred stock.” (Kaplan & Strömberg, 2003, p. 24)

2.4 Definition of Failed Investments

Since this study is focusing on why VC investments fail so often, it is crucial to define a failed VC investment. From a VC fund level, it is crucial for the GPs to outperform stock indexes. Otherwise, it would make no sense for investors (limited partners) to invest their money into an illiquid asset if it is being outperformed by common stock indexes. Repetitive poor fund level performances can also mean the end for a VC company since fundraising for another fund can be challenging with poor previous fund performance.

In VC the number of investments that return profits to the investors is about 4 out of 10. Over half of the investments (64.8%) return 0-1X. About a fourth (25.3%) of the investments return 1-5x the capital invested. The rest of the investments, which account for about a tenth of all investments (9.9%), return high multiples e.g., 5-50X+ (Correlation Ventures, 2014). Since there are so many failed investments the lower returns can be absorbed by the losses. Low returns are also bad since the returns are from a long period of time. For example, a total return of 1.5X money back on

investment from a five-year period is quite poor. Only the investments with very high returns are the ones that typically make the fund profitable. As we see from the return statistics over a half (64.8%) of all VC investments are failures, since they are at best only returning the invested capital, these investments we can consider to be failures.

It is also important to understand that the numbers mentioned above are averages. The actual returns of investments will vary depending on the VC company's nature e.g., late-stage VC compared to early-stage VC. Early-stage funds typically have higher average returns, but also the average failure rates are higher in early-stage funds.

3 WHY DO VENTURE CAPITAL INVESTMENTS FAIL SO OFTEN?

This chapter will investigate why investments fail so often. This will be done by researching investment methods, and start-up failure reasons.

3.1 Reasons for Venture Capital Investment Failures

As mentioned earlier, failed investments are quite a common sight in VC. A venture capitalist might wonder to himself or herself if these poor investments could be avoided. The point of this study is to find out why certain investments perform so poorly. Through the research we can try to deduce if the poor investments could be avoided. It is very important to keep in mind that failure rates for VC funds and single investments can vary a lot. Different VC firms have different return expectations and different investment strategies. Since this research paper is now focusing on failed investments it will focus on the two main stakeholders in the investment. These stakeholders are the ones who have the most impact on the performance of the investment. The investments involve two main stakeholders, the target company, and the VC company.

The venture capitalist's role in the investment is essentially picking out the company to invest into. This role will have a large effect on the failure rates of single investments. The amount of effect varies slightly depending on the nature of the venture capitalists. If they are actively working with the management of the start-ups, they will have more control over the performance of investments. Whereas venture capitalists that tend to be less active have of course less effect.

There is a very basic investing doctrine, that would explain why some VC funds have higher rates of failure in investments. As noted before the average returns of VC investments aren't that good, and fund level performance is often dependent on highly performing investments. These highly performing investments are very rare, so it is obvious that if a venture capitalist invests into more companies, he or she will have a higher chance of making a high returning investment. This method is quite simple and a recognized method in VC. A quote from Dave McClures blog post explains this method well.

Most VC funds are far too concentrated in a small number (<20–40) of companies. The industry would be better served by doubling or tripling the average # of investments in a portfolio, particularly for early-stage investors where startup attrition is even greater. If unicorns happen only 1–2% of the time, it logically follows that portfolio size should include a minimum of 50–100+ companies in order to have a reasonable shot at capturing these elusive and mythical creatures. (McClure, 2016)

The second common investing doctrine in VC is, cultivating the investments. This refers to a fund investing into fewer companies with relatively larger tickets. Then the venture capitalist will tend to be more hands on with managing their portfolio companies and doing their best to help them succeed and thus returning better results for the fund.

The reason why the first method of investing will have higher rates of failure is closely related to the previously mentioned investment method. Effectively the funds that invest into more companies will have their return rates on single investment level roughly follow the market averages. Roughly 65 companies out of 100 will fail to return the initially invested capital. On the other hand, the funds investing into less companies, which they will then actively manage will invest to for example 15 companies. But since these companies are being closely helped and steered by the investors the failure rates will decrease under the market averages. Interestingly statistically funds with the best positive returns have higher failure rates. “But the best-performing funds [funds with 5X+ returns] actually had more <1x deals ... you take more risks to get the best returns. A fund gets better returns by having more really big hits, not by having fewer failures” (Evands, 2016). Effectively this phenomenon backs up the notion that *when venture capitalists invest, they don't focus on avoiding failures they focus on getting the winners.*

It is obvious that venture capitalists are only interested in the high performing investments since VC investing has such high failure rates. If venture capitalists invest into companies hoping for very high returns for every investment opportunity, it begs to ask the question: Why do they still lose money in most of their investments? Not

that this is an issue at the fund level performance if the VC company has a high performing investment in their fund.

Venture capitalists acknowledge that they are investing into a high-risk industry. There is an important phase of VC investing that this study research hasn't covered yet. This phase is called due diligence (DD). A blog post by PitchBook Data (a data company for VC, PE, and M&A) explains due diligence as follows:

At its simplest, due diligence is an investigation to collect critical financial information—and it's one of the most important workflows for any investment professional. The due diligence process will explore and confirm details of a company in an effort to uncover and mitigate potential risks in an investment decision. Not only will the due diligence process lead an investor or buyer to pursue or drop a deal, it will lay the foundation for structuring the deal if you decide to move forward. (PitchBook, 2021)

The fact that venture capitalists conduct DD before investments proves the assumption that venture capitalists are aware of the risks they face. Even though DD is being conducted the failure rates of single investments are still quite high. To some extent the failure rates can be justified by the lack of data. Especially in seed-stage and early-stage investing venture capitalists are investing into ideas and beliefs that a company will do well.

3.2 Reasons for Start-Up Failures

To better understand why investments fail it is quite essential to have a look at start-up companies. Start-ups are the focus of VC and start-ups have notoriously high failure rates “Like they have in the past, startup failure rates continue to hover around 90%” (Camberato, 2020). “About three-quarters of venture-backed firms in the U.S. don't return investors' capital” (Ghosh, 2012). “Most start-ups don't succeed: More than two-thirds of them never deliver a positive return to investors” (Eisenmann, 2021). These high failure rates already help to explain the reason why over half of VC investments fail. If you invest into start-ups and most start-ups fail, most of your

investments will also fail. Managing to get VC funding does help start-ups to succeed. Even with VC funding the prospective outlooks of the start-ups and of course the investments aren't that good.

Tom Eisenmann's book on start-up failures explains that there are six main patterns that explain a large portion of start-up failures. Three of which focus on early-stage failure and three that focus on late-stage failure.

3.2.1 Reasons for Early-Stage failure

The first one of the three early-stage failure patterns is called "Good Idea, Bad Bedfellows". There is a certain notion in VC investing that is important to know to better understand this pattern. While conducting due diligence many venture capitalists investigate two main characteristics of the company: the team and the opportunity. Most venture capitalist consider these two factors to be the most important characteristics especially in early-stage investing. Eisenmann explains this phenomenon quite well in his book: "Many venture capitalists think that a talented jockey [founder] is more important than a fast horse [good opportunity]. So, VCs look for founders with the right stuff: grit, vision, an industry insider's acumen, and experience leading startup teams" (Eisenmann, 2021, p. 10). Eisenmann then goes on to explain how solely focusing on the founders can blindside investors: "But focusing solely on founders neglects the other parties whose contributions are crucial to a new venture. ... In studying early-stage startup failures, I saw this pattern of dysfunctional relationships with key resource providers repeated regularly" (Eisenmann, 2021, p. 10). Essentially this pattern refers to when a start-up has a good idea, but the early execution goes poorly. Quincy which is the example company of this pattern in Eisenmann's book had many dysfunctional relationships. The most important thing to note regarding this study is the bad match between the investors and the company. The VC company that invested into Quincy was a technology VC company, while Quincy was an apparel manufacturer. This relationship between Quincy and the VC company was more harmful than it was beneficial. "The founders had assumed that their lead VCs would have relevant expertise because they'd previously invested in other direct-to-consumer fashion tech startups ... But Quincy's VCs hadn't been as directly involved in those ventures as the founders had surmised" (Eisenmann, 2021, p. 70). The

founders also noted that “Instead of raising funds from VC firms, Quincy could have sought financial backing from a clothing factory”. (Eisenmann, 2021, p. 72) The downfall of this company wasn’t caused by the venture capitalists, but a better and more related VC company could’ve helped the company substantially.

The second pattern is called False Starts. False starts are explained by Eisenmann as:

They [the start-up companies] launched minimum viable products (MVPs)—the simplest possible offering that would yield reliable customer feedback—and iterated on them in response. By putting their MVP out there and testing how customers responded, these founders should have been able to avoid squandering too much time and money building and marketing a product that no one wanted. Yet by neglecting to research customer needs before commencing their engineering efforts, they ended up wasting valuable time and capital on an MVP that was likely to miss its mark. These were False Starts. (Eisenmann, 2021, p. 11)

Essentially what this failure pattern refers to is founders being too hurried in making a product and ignoring what the market wants or needs. Especially skipping the Lean Startup precept: complete customer discovery. Which refers to conducting thorough interviews with prospective customers.

Eisenmann offers three reasons why false starts tend to happen often in the start-up community. The first one coming down to human error and enthusiasm in entrepreneurs. “Bias for action is typical of entrepreneurs, who often are champing at the bit to get started. And engineers love to build. So, when you have entrepreneurs who are also engineers, their impulse is often to build and launch their product as fast as they can” (Eisenmann, 2021, p. 90).

The second reason stems from the fact that some start-ups might have a lack of funding and the negative cash flow from salaries and other expenses pressures founders to make a product quickly. “However, an engineer’s hefty compensation means that the cash flow meter is running faster, so the pressure is on to build and launch a product

ASAP. As a result, the engineers often start building before the team has a good understanding of the problem or solution” (Eisenmann, 2021, p. 90).

The third reason is similar to the first one. Coming down to human error again and the lack of weight and appreciation given to feedback.

At the risk of stereotyping, another reason that some technical founders avoid interviewing prospective customers is that many engineers are simply too introverted to push themselves to query strangers. When they do get out and conduct interviews, both engineers and nontechnical founders often botch them by posing leading questions (“Do you like our idea?”) and then hearing what they want to hear. The worst offenders are so arrogant about the solution they’ve come up with—perhaps due to prior industry experience—that they don’t see any value at all in customer input. (Eisenmann, 2021, p. 90)

The third pattern is called False Positives. False positives are explained by Eisenmann as:

False Positives occur when entrepreneurs, beguiled by the enthusiasm of a few early adopters, incorrectly extrapolate strong demand to the mainstream market and step on the gas. When the next wave of marketing gets a tepid response, the team may be able to course-correct and pivot to an offering that appeals to mainstream customers. But pivots can be costly. The firm must reengineer its product and reeducate the market. Prospective buyers may be confused by the changes and skeptical of an unproven new product. Early adopters may be alienated by the changes and abandon the product. (Eisenmann, 2021, p. 11)

Eisenmann reports a certain characteristic that can possibly expose start-ups to False Starts. “The founder/CEOs of startups that are struggling or have shut down reported larger differences between the needs of their early adopters and mainstream customers. The greater the discrepancy, the greater the exposure to the False Positive failure pattern” (Eisenmann, 2021, p. 113).

Avoiding False Positives can be done by conducting more reliable market feedback and research. Essentially coming down to very similar reasons as the False Starts. “Conduct early customer research that exposes any differences between likely early adopters and mainstream customers” (Eisenmann, 2021, p. 113). Another common theme throughout VC comes once again apparent in this failure pattern. Many of the mistakes that are being done are because of a lack of reliable data and decision being made on assumptions that are being derived from insufficient data. “When entrepreneurs are pleasantly surprised by the positive responses from early adopters after the venture has launched, they should consider the possibility that the broader market may not respond in the same way” (Eisenmann, 2021, p. 113).

From the early-stage failures it can be noticed how important customer feedback, market research, and relationships between stakeholders are for start-up success. Also, the importance of not making too vast assumptions based on low levels of data.

3.2.2 Reasons for Late-Stage failure

After launching the company successfully, the companies will eventually reach the late-stage phase of their business lifecycle. When start-up companies survive from the early-stage phase to the late-stage phase the failure reasons tend to change. “Early-stage startups falter when their founders cannot identify a good opportunity or fail to mobilize the right resources—or both. Late-stage missteps also revolve around opportunity and resources, but in distinctly different ways” (Eisenmann, 2021, p. 119). Many aspects of a start-ups business change during the shift. The main target of late-stage start-up companies is to scale their business.

The first pattern of the three late-stage failure patterns is called the Speed Trap.

Ventures that fall victim to a Speed Trap have identified an attractive opportunity. Early adopters embrace the product and spread the word about it. This attracts more customers without any investment in marketing. The rapid early growth also lures enthusiastic investors. To justify the high price they paid for equity, investors push for aggressive expansion. After marketing intensively, the startup eventually saturates

its original target market, meaning that further growth requires broadening the customer base to encompass new segments. (Eisenmann, 2021, p. 12)

Speed traps effectively refer to start-up companies trying to expand and scale too quickly. This unsustainable expansion can be driven by pressure by investors to expand aggressively. As explained by Eisenmann a very successful early-stage start-up company will attract a lot of capital from investors who usually will pay high prices for equity. They will then push towards very rapid scaling and expansion. If the company's management or investors fail to notice that the company has nearly or has already saturated the market, this can lead to very expensive and unnecessary expansion.

The second pattern of late-stage failure is called Help Wanted. Help Wanted is a failure pattern where start-ups face resource downfalls of two different types either financing or senior management. Eisenmann explains the first resource downfall, which is the lack of financing as follows:

Sometimes an entire industry sector suddenly falls out of favor with venture capital firms ... In the extreme, even healthy startups caught in a downdraft cannot attract new funds ... Funding droughts take investors and entrepreneurs by surprise and can last for months or even years. If one of these dry spells commences just as a fast-growing startup is trying to raise a new funding round, and if that startup cannot rapidly reduce its spending, the venture may not survive. (Eisenmann, 2021, p. 13)

Unfortunately, the lack of capital is a common downfall of start-up companies. A study on the most common reasons start-ups fail by CB insights ranks the lack of capital as the most common reason (CB Insights, 2021). Why financing risk can be devastating for late-stage start-ups is that they need much more capital than early-stage start-ups. Eisenmann explains the challenge that late-stage start-ups will face as:

By contrast, even after they trim their sails, late-stage ventures usually require far more capital. While existing investors might have \$10 million

on hand to fund a bridge loan, given the magnitude of this investment, they will nevertheless pause and ask whether they might be “throwing good money after bad.” ... if existing investors are wary, it’s harder to attract new ones (Eisenmann, 2021, p. 180).

The second resource downfall of the Help Wanted failure pattern, which is the lack of senior management is explained by Eisenmann as follows:

Scaling startups typically need senior executives with deep functional expertise who can manage rapidly expanding pools of employees in engineering, marketing, finance, and operations. Delaying the hiring of these executives or recruiting the wrong individuals can lead to strategic drift, spiraling costs, and a dysfunctional culture. (Eisenmann, 2021, p. 13)

Hiring the right people and having a good team is very important for start-ups in general. A study by CB Insights on the top reasons why start-ups fail lists not having the right team as a prominent failure reason accounting for 14% of failures (CB Insights, 2021). Sometimes start-ups need specialist for certain roles to help them scale properly. Hiring these specialists can sometimes be challenging and when done poorly can hurt the company. Eisenmann provides a solution to make it easier for start-ups to hire the right people:

The CEO of a scaling startup should seek lots of guidance when making these crucial hiring decisions. Board members should source candidates and also interview them. VCs have helped many other portfolio companies fill their executive ranks, so they may have valuable insights about requirements for a position—especially when a CEO lacks experience with the function. (Eisenmann, 2021, p. 185)

The third pattern of late-stage failure is called Cascading Miracles.

Some late-stage startups never achieved much traction, despite having raised hundreds of millions of dollars from VCs and having hired

hundreds of employees. Each pursued an incredibly ambitious vision, and in doing so faced multiple challenges. ... Each challenge represented a “do or die” proposition: Missing the mark on any of them would doom the venture. To win such a gamble, these entrepreneurs were betting on Cascading Miracles. With the benefit of hindsight, it’s possible to see why startups that relied on Cascading Miracles failed. But in the moment, it can be difficult to determine whether a founder’s “change-the-world” vision is delusional. There is no foolproof method for avoiding the Cascading Miracles failure pattern. (Eisenmann, 2021, p. 14)

This pattern in its most simple form is a company that is very innovative and has multiple challenges that it must achieve for the venture to be successful. Since there are many challenges that are all vital to the ventures success none of them can fail and a cascade of miracles is needed for success. Therefore, Eisenmann calls this pattern Cascading Miracles. The challenges that these companies must achieve include persuading a critical mass of customers to change their behavior, mastering new technologies, partnering with powerful corporations, securing regulatory relief or other government support, and raising vast amounts of capital. (Eisenmann, 2021, p. 13)

4 DISCUSSION AND CONCLUSIONS

4.1 Discussion and answer to the research question

The research question for this research paper was the following. *Why do venture capital investments fail so often?* The results to this research question were figured out by studying the VC market, investment failure rates, fund returns, start-up failure patterns, and investment doctrines.

Originally this research was supposed to focus on the abilities of venture capitalists to invest into the most prospective companies and manage them to the best of their ability. It quickly became apparent that this topic was not a viable option for a literature review. To research the topic more deeply, a series of interviews and empirical analysis of results with venture capitalists regarding failed investments should be conducted. Therefore, this research paper remained focused more on a secondary survey of explained high investment failure rates. Throughout this study we can conclude that high failure rates stem from three main reasons.

The first one is closely related to the investment targets. Start-up failure rates are notoriously high. This in turn makes VC investing very risky. High risks have high returns, but also high failure rates. Start-up companies have many hurdles they must overcome to be successful. It can be concluded that the relationship between the venture capitalists and start-ups can have a positive or negative effect depending on the match and level of involvement. Some companies will need more support and guidance to prosper or to just avoid common failure patterns.

The second reason is the nature of VC investment, which stems from the high risk. The best performing funds are the ones that get most of the best investments. Lower failure rates do not equal the best fund level returns. We can conclude that purposefully avoiding failures is not necessarily the best course of action in VC investing. This notion in turn can explain why venture capitalists aren't that risk averse. Which in turn explains why failures are common, but of course not done on purpose. In a sense failed investments are a systemic byproduct of venture capital investing.

The third reason is closely related to the fact that many investments are done with relatively little available information. Especially in seed-stage and early-stage VC, investment decisions are done based on assumptions that a company can generate high returns. Since many of these companies are still in such an early phase, they do not have concrete data to convince investors. Investors then must invest in companies that have the potential to do well. Predicting if a company has a reasonable chance of achieving these goals is a different problem. Therefore, venture capitalists tend to value highly good leaders and teams. The absence of information and data is a major factor in explaining failure rates. The difference in failure rates of early-stage investments and late-stage investments backs up this conclusion. The divergence [22% average return with median returns of 5.6%] is the very real implication of seed returns having a power law rather than a normal distribution. By comparison, later stage venture fund returns generate closely correlated median and mean returns (Riviera, 2020).

The results of this research paper are closely aligned with the industry's current views. In venture capital risk and failure is not something that should be feared but should be embraced. The best funds are the ones that are taking more risk and fail more often than average funds. Through out this study it becomes very apparent that a venture capitalist must be optimistic about investments, but they also cannot be too optimistic, or they will be chasing cascading miracles as Eisenmann calls them.

4.2 Implications for practice

The implications for practice for this research paper are quite low since it does not cover any ways of effectively choosing the better investment opportunities. This research paper only focuses on explaining why the failure rates in VC are high. Essentially this research paper tells the most crucial factors to consider if a venture capitalist would want to avoid risk and failure in VC investing.

4.3 Limitations

Fully answering the research question was very challenging due to the lack of publicly available data. Especially since in the beginning of this study the goals were to figure

out why investors make failing investments so often. To properly answer this question interviews with venture capitalists should be conducted.

4.4 Suggestion for future research

For future research it would be very interesting to study and conduct interviews with venture capitalists to find out why their investments fail from their point of view. Especially because most venture capitalist expect 10X returns, but they will still end up losing money on most investments.

Another interesting topic to study would be the due diligence process and its weaknesses and strengths. Are there certain characteristics that venture capitalist overvalue or undervalue while investing into companies?

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