Why winners keep winning: the knock-on effect of early VC success

Early venture capital success often leads to continued success. New research explores how VC firms maintain these winning streaks, and shows that to access lucrative investments, VC managers' individual skills matter less than their track record.

October 4, 2019

Backing a big winner once is many venture capitalists' dream, yet many top venture capital firms succeed again and again. Big names like Accel manage to consistently invest in successful companies, from Facebook to Spotify.

It may seem like top firms have an exceptional ability to choose — amidst the uncertainties of product, market appeal and external success factors — the startups poised for success. But in fact, says IESE's Sampsa Samila, with Ramana Nanda and Olav Sorenson, it's more a case of early success *causing* subsequent triumphs.

The authors analyzed 46,013 investments between 1961 and 2008 and found no evidence that successful VC firms have a sixth sense for sussing out promising companies, or special mentoring abilities.

Instead, they saw the knock-on effect of early success. A previous investment win opens doors, and, as a VC firm becomes more central to the investment landscape, they get preferential access to less risky deals. That is to say, winning VC firms have more opportunities to invest in promising startups in their second or third funding rounds.

To understand how success becomes a self-fulfilling prophecy, the researchers examine three of the most salient persistent success factors in detail.

1. Choosing and nurturing: VCs who repeatedly succeed are often praised as having a special skillset: an ability to distinguish good investments from bad ones, or the capacity to add significant value to their portfolio companies through their guidance. If this were the case, these VC firms or managers would not only succeed, but succeed at higher rates than other VCs who invest in similar companies. The researchers demonstrate that this is not the case, and conclude that any special aptitude for choosing and nurturing startups is not a significant factor in persistent success.

2. Selecting industry, region and timing: Even if winning VC firms show no particular ability for choosing lucrative investments at the level of individual startups, their success might be explained by their ability to choose promising industries, regions and timing. Yet the authors' analysis concludes that while many investors seem to be aware of the best segments to invest in, only some get access to the attractive deals in those segments. That is to say, the VC firms that invested in companies like Facebook weren't necessarily more prescient, they were the ones best positioned to make the deal. Furthermore, after the initial success of investing in a good sector, there's no evidence that winning VCs can choose new sectors with success.

3. Access to deal flow: The researchers found that better deal flow accounts for up to 74% of persistence in VC success rates. VC firms who experience early success change their investing behavior. Thanks to their newfound credibility, they become more central in the coinvestment network, with preferential access to the most promising startups. This power allows them to make more syndicated investments and invest in later rounds. Investing later mitigates risk, as by this stage more is known about the company's chances of success.

Even if VCs' positive track records are mostly a knock-on effect from early success, this knock-on effect produces real, persistent gains for as many as 50 subsequent investments. Understanding why the winners keep winning can help VCs to make the most of this effect and can help startups to make informed decisions about investors and their reputations.

Methodology, very briefly

The authors analyzed data on 46,013 venture capital investments made in North America between 1961 and 2008 (using the Thomson-Reuters VentureXpert database). They used linear probability models with fixed effects to test various possible reasons why early success in investment exits can predict future success controlling for characteristics of the initial investments like year, state, industry, and stage of investment.

The paper was published in the Journal of Financial Economics.

www.iese.edu/insight