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The Venture Capital Secret: 3 Out of 4 Start-Ups Fail

By DEBORAH GAGE

It looks so easy from the outside. An entrepreneur with a hot technology and venture-capital funding becomes a billionaire in his 20s.

But now there is evidence that venture-backed start-ups fail at far higher numbers than the rate the industry usually cites.

About three-quarters of venture-backed firms in the U.S. don't return investors' capital, according to recent research by Shikhar Ghosh, a senior lecturer at Harvard Business School.

Compare that with the figures that venture capitalists toss around. The common rule of thumb is that of 10 start-ups, only three or four fail completely. Another three or four return the original investment, and one or two produce substantial returns. The National Venture Capital Association estimates that 25% to 30% of venture-backed businesses fail.

Mr. Ghosh chalks up the discrepancy in part to a dearth of in-depth research into failures. "We're just getting more light on the entrepreneurial process," he says.

His findings are based on data from more than 2,000 companies that received venture funding, generally at least $1 million, from 2004 through 2010. He also combed the portfolios of VC firms and talked to people at start-ups, he says. The results were similar when he examined data for companies funded from 2000 to 2010, he says.

Venture capitalists "bury their dead very quietly," Mr. Ghosh says. "They emphasize the successes but they don't talk about the failures at all."

There are also different definitions of failure. If failure means liquidating all assets, with investors losing all their money, an estimated 30% to 40% of high potential U.S. start-ups fail, he says. If failure is defined as failing to see the projected return on investment—say, a specific revenue growth rate or date to break even on cash flow—then more than 95% of start-ups fail, based on Mr. Ghosh's research.

Failure often is harder on entrepreneurs who lose money that they've borrowed on credit cards or from friends and relatives than it is on those who raised venture capital.

"When you've bootstrapped a business where you're not drawing a salary and depleting whatever savings you have, that's one of the very difficult things to do," says Toby Stuart, a professor at the Haas School of Business at the University of California, Berkeley.

Venture capitalists make high-risk investments and expect some of them to fail, and entrepreneurs who raise venture capital often draw salaries, he says.

Consider Daniel Dreymann, a founder of Goodmail Systems Inc., a service for minimizing spam. Mr. Dreymann moved his family from Israel in 2004 after co-founding Goodmail in Mountain View, Calif., the previous year. The company raised $45 million in venture capital from firms including DCM, Emergence Capital Partners and Bessemer Venture Partners, and built partnerships with AOL Inc., AOL -0.44% Comcast Corp., CMCSA +1.50% and Verizon Communications Inc. VZ +0.79% At its peak, in 2010, Goodmail had roughly 40 employees.

But the company began to struggle after its relationship with Yahoo Inc. YHOO -0.60% fell apart early that year, Mr. Dreymann says. A Yahoo spokeswoman declined to comment.

In early 2011 an acquisition by a Fortune 500 company fell apart. Soon after, Mr. Dreymann turned over his Goodmail keys to a corporate liquidator.

All Goodmail investors incurred "substantial losses," Mr. Dreymann says. He helped the liquidator return whatever he could to Goodmail's investors, he says. "Those people believed in me and supported me."

How well a failed entrepreneur has managed his company, and how well he worked with his previous investors, makes a difference in his ability to persuade U.S. venture capitalists to back his future start-ups, says Charles Holloway, director of Stanford University's Center for Entrepreneurial Studies.

David Cowan of Bessemer Venture Partners has stuck with Mr. Dreymann. The 20-year venture capitalist is an "angel" investor in Mr. Dreymann's new start-up, Mowingo Inc., which makes a mobile app that rewards shoppers for creating a personal shopping mall and following their favorite stores.

"People are embarrassed to talk about their failures, but the truth is that if you don't have a lot of failures, then you're just not doing it right, because that means that you're not investing in risky ventures," Mr. Cowan says. "I believe failure is an option for entrepreneurs and if you don't believe that, then you can bang your head against the wall trying to make it work."

Overall, nonventure-backed companies fail more often than venture-backed companies in the first four years of existence, typically because they don't have the capital to keep going if the business model doesn't work, Harvard's Mr. Ghosh says. Venture-backed companies tend to fail following their fourth years—after investors stop injecting more capital, he says.

Of all companies, about 60% of start-ups survive to age three and roughly 35% survive to age 10, according to separate studies by the U.S. Bureau of Labor Statistics and the Ewing Marion Kauffman Foundation, a nonprofit that promotes U.S. entrepreneurship. Both studies counted only incorporated companies with employees. And companies that didn't survive might have closed their doors for reasons other than failure, for example, getting acquired or the founders moving on to new projects. Languishing businesses were counted as survivors.

Of the 6,613 U.S.-based companies initially funded by venture capital between 2006 and 2011, 84% now are closely held and operating independently, 11% were acquired or made initial public offerings of stock and 4% went out of business, according to Dow Jones VentureSource. Less than 1% are currently in IPO registration.

—Vanessa O'Connell contributed to this article.

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