Venture capitalists' reputations take a hit when publicly listed companies they once endorsed fail, study says

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An initial public offering (IPO) is usually seen as the start of a company's independence from its venture capitalist (VC) backers. But new research published in the *Academy of Management Journal* suggests that even after companies have been listed on the stock exchange, their failures can still negatively impact the reputations of VCs that once endorsed them.

When businesses decide whether to invest in or partner with a new company, they treat its affiliations with prominent third parties—such as endorsements from VCs—as valuable signals of the quality of the company. However, it is unclear whether VCs' reputations are really at risk should their endorsements turn out to be unreliable signals, and the company they vouch for fails to live up to expectations.

Titled "Crossed Wires: Endorsement Signals and the Effects of IPO Firm Delistings on Venture Capitalists' Reputations," the present study examines the impact on VCs' reputations when newly public companies they once endorsed are delisted from the stock exchange. The research was carried out by an international team of scholars from Singapore Management University (SMU), Singapore; the Gwangju Institute of Science and Technology, Korea; and Arizona State University and the University of Tennessee-Knoxville in the U.S.

The researchers considered the following indicators to measure VC reputation: the amount and number of funds managed by the VC, the number of companies the VC invests in and the amount invested, and the number of companies the VC took public. They found that endorsing VCs indeed suffered reputational damage when their portfolio companies failed to meet expectations, even after such companies have gone public.

"We show that a firm's reputation is precarious and can be damaged even by an event that is not within the full control of the affected firm. Specifically, firm reputation can be vulnerable to negative events occurring in different industries or by past relationships that a firm no longer has," says study first author Assistant Professor David Gomulya of the SMU Lee Kong Chian School of Business. The results imply that

VCs create high expectations of companies they endorse, which when violated, can have long-lasting consequences for the VCs' own reputations, say the authors. VCs concerned with protecting their reputations should therefore temper the expectations they create, and try to ensure that near-term performance expectations are met, says Professor Gomulya.

"VCs must remain vigilant about their reputation. If they want to bring startups public, they should ideally do so after the startups are strong enough to perform in the public arena. They should not rush this process prematurely," he explains. "Otherwise, any delisting the startups suffer within five years after the IPO can go back and hurt the VC's reputation even after it has 'handed over' the startups to the public domain."

More information: David Gomulya et al. Crossed Wires: Endorsement Signals and the Effects of IPO Firm Delistings on Venture Capitalists' Reputations, *Academy of Management Journal* (2018). DOI: 10.5465/amj.2016.0796

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