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CASE STUDY

Running ballistics on the Dragons' eight silver bullets

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Raising capital is perhaps the most dreaded and difficult task an entrepreneur can face. This is not surprising given that the lion's share of new ventures fail to attract adequate funding. After exhausting their personal resources and the goodwill of friends, family and fools, entrepreneurs must then approach outside sources to fund their ventures.

To date, angel investors are the most important source of risk capital for early-stage ventures. Because venture capitalists often prefer to invest during later stages of a new venture, angel investors are often the only outside source of capital to drive the growth and survival of young ventures. How angel investors decide which project to finance – and more importantly, which venture proposals to immediately nix – is of utmost interest for aspiring entrepreneurs.

An analysis of CBC's popular reality television show Dragons' Den reveals that angel investors use eight rules of thumb to quickly weed out what they consider flawed venture proposals. These TV angel investors teach us valuable lessons about the venture capital process in the way they deploy these so-called silver bullets.

The study: To better understand angel investors' decision-making process, we conducted an in-depth analysis of the decisions of five seasoned angel investors participating in the Canadian Dragons' Den reality TV show (similar to Shark Tank, based in the U.S.). In this hour-long weekly show, entrepreneurs pitch their business plans to Dragons (angel investors) hoping to win an investment commitment. We collected data for the study from the unedited line recordings (averaging 45 minutes or roughly eight to ten times longer than what was aired on TV) that included all interactions between each of the five Dragons with the 150 entrepreneurs who pitched their ideas over an entire season of the show. Three trained raters coded each interaction independently (based on what could result in a flawed venture proposal), and showed a very high (95 per cent) inter-rater agreement. This unique data offered a rare opportunity to understand angel investors' decision-making process in real time because, unlike the usual 'real life' pitch to an investor, the Dragons explained their decisions to invest in or reject a venture proposal. (A full description of the study was published in the Journal of Business Venturing in an article titled Business Angel Early Stage Decision Making *[http://www.cemi.com.au/node/452]*.)

The analysis uncovers intriguing findings. The Dragon angel investors used a two-stage process to make investment decisions. In the first stage they employed a decision-making heuristic, basing their decisions on an objective list of eight criteria (described below), and made quick decisions based on these criteria. If only one of the eight criteria was not met, then the venture plan would be 'killed.' Based almost solely on these eight decision criteria, the angels substantially trimmed the set of 150 hopeful entrepreneurs to 16 finalists. Interestingly, in this stage, no 'compensatory effect' was considered. That is, once they identified just one shortcoming (on one of the eight criteria), even a very high score on two or more of the other dimensions would not keep the entrepreneur in the game. We label each of these eight potential shortcomings a 'silver bullet' because it acts as a deadly instrument that is sufficient to eliminate the odds of the entrepreneur raising funds. It is worth emphasizing that the vast majority of entrepreneur hopefuls were thrown out based on this decision heuristic. After cutting down the number of potential ventures, the Dragon angels moved to a different mode of decision making. They dug deeper to learn more about the much smaller set of 16 entrepreneurs who had no 'fatal flaw.' In this second stage, the Dragon angels moved to a more subjective assessment of the investment opportunity, including an evaluation of the entrepreneur's qualifications.

The eight silver bullets: This study's findings illuminate the eight critical factors that entrepreneurs should attend to if they wish to have any chance of raising capital. The first two criteria focused on the product or service.

1. Close to market. The product had to be close to market. The Dragons rejected products that required additional research and development, that would take them along rocky paths strewn with barriers.

2. Competition. The entrepreneur needed to demonstrate that the product could be protected from potential competitors. If a product or service could be easily imitated, the odds that the entrepreneur could capture value (and investment capital) were quite slim.

3. Value to customers. Did the entrepreneur have strong evidence that customers would be likely to adopt the product or service? The entrepreneurs had to show a clear benefit from their venture's proposed product or service; without this, the venture would not fly.

4. Knowing the customers. The Dragon angels strongly preferred cases where actual customers had already purchased the product or service, or at least had expressed commitment to buy it in the future. When the venture entrepreneur could not identify its first customer, the Dragon angels marked this as a fatal flaw.

5. Marketing and distribution. Did the entrepreneur sufficiently plan how to bring the product or service to market, and map out clear distribution channels? If the answer was 'no' or 'maybe,' the Dragons nixed the proposed venture.

6. Market potential. The Dragons strongly preferred markets larger than $20-million. To satisfy this demand, the entrepreneur had to predict at least a $5-million market and back this up with figures.

7. Venture management team. The entrepreneur had to competently and confidently lead the new enterprise. Dragons looked for strong evidence that the entrepreneur or her/his management team had relevant experience leading the enterprise forward. If the entrepreneur could not demonstrate the required knowledge and experience, the Dragons dismissed that entrepreneur.

8. Sound financial plan. Here the entrepreneur needed not only to provide evidence of the proposed venture's profitability but also needed to demonstrate that the funds raised in the current round (i.e. on the game show) would be sufficient to bring the new venture to profitability and sustained growth.

What these findings suggest: A common belief among researchers and entrepreneurs is that investors use a very complex and wide ranging set of criteria to make investment decisions. This vague understanding provides little guidance to entrepreneurs seeking funding, as they do not know what venture aspects are key.

Entrepreneurs who are aware of the eight factors identified in this study can focus on all potential ‘fatal flaws’ so they are not immediately rejected when they approach angel investors for funding. For example, if entrepreneurs lack relevant experience, they can recruit an experienced individual to join their team; if they have no sales commitments yet they can focus their efforts on identifying a few customers willing to sign letters of intent to purchase their product or service. Furthermore, entrepreneurs need to ensure that they alleviate angels’ concerns on each of the eight factors by clearly communicating how they have addressed each issue. Failing to do so even on one of the factors is likely to be a ‘silver bullet’ and kill their chances of raising capital.

We are confident that the study’s findings provide quite a truthful description of the two-stage process that angels generally use when making investment decisions. However, by using this ‘fatal flaw’ process, angels can overlook many promising investment opportunities. Furthermore, by weeding them out immediately, they miss the opportunity to put their own strategic edge into action. While we agree that an enterprise lacking one of these eight criteria is less likely to prosper, we do not believe that dismissing enterprises with one of these flaws is necessarily an efficient decision-making process. This ‘all-or-none’ decision-making process makes sense only when the investor is interested in making a purely financial investment. A flaw in one of the eight dimensions may not be fatal but may be exactly where an angel investor can add value to a prospective venture. The angel can use his/her vast experience, networks, and industry knowledge to fix that flaw. For example, instead of rejecting an entrepreneur who lacks a solid distribution channel, an angel investor can remedy this shortcoming by picking up the phone and introducing the entrepreneur to potential distributors. In fact, very likely the angel will be able to get a better deal from the entrepreneur when that angel’s strengths can potentially alleviate one or more of the flaws, because the angel brings more than a purely monetary value to the deal. Under these conditions the ‘silver bullets’ could be golden opportunities.

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