

## Cherub Ventures

### (an attempt to make investment an adaptive, experimental process)

When considering whether or not to invest in a new, IP-based business idea, the default approach is to undertake an extensive due diligence process. This makes sense for some combination of the following reasons:

- The investment required is large
- Only investments generating a very high rate of return are considered
- The team may be unproven
- The product or service is new
- The market is not yet certain

It does, however, rule out many (>95%) early-stage ideas, including those offering slow growth initially or requiring only a small initial injection. Exclusion of a proposal from the established commercial assessment process often causes entrepreneurs to believe that the risk/reward ratio is universally unattractive or that their idea lacks any potential.

I sense that this is a serious oversight by those of us with interests in growing an innovation-based economy. The talents of large numbers of creative, would-be entrepreneurs are being deflected from their potential for wealth generation.

(The history of, for example, Silicon Valley is that, after sustained government investment in research programmes within large corporations, a diverse raft of small, agile start-ups emerged to exploit the results. It is now seen as riskier for graduates to join the big corporations than start-ups because, although start-ups frequently fail, the raft recycles the accumulated expertise and stays stubbornly afloat).

With the advent of desktop and overseas manufacturing, online marketing and the increasing emphasis on software-centred products, many new, IP-based business ideas no longer need an instant, massive cash injection. To help support opportunities of this sort, I developed a workshop entitled 'Bootstrap Bootcamp' which has been used by organisations such as i10, Connect Estonia, St Andrews University and Glasgow University. This has been subsumed into a new business: ScotSkills ([www.scotskills.com](http://www.scotskills.com)) which has recently undertaken a 60-participant entrepreneurship workshop for the Scottish research pools (SUPA, SICSA and SINAPSE).

Due diligence is costly and slow, often foreign to innovators and by no means infallible. The dot-com debacle illustrates the danger of attempting to rely on market research to 'cherry pick' future winners. The size of the investments required to achieve the necessary competitive rate of growth and return (~50%) puts too much emphasis on filtering out weaknesses in the team, the plan or the idea. There is too little scope for reshaping, redirecting or upgrading projects. It's essentially **all or nothing**.

Here, I propose an alternative approach, inspired partly by the activities of the microfinance movement, which is applicable to the earliest stages of many new, technology-based business ideas.

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## Mechanism

Each fledgling business would submit a one-page description of its proposed objectives and immediate activities. These applications could be quickly assessed with only the credible ones progressing to the next stage. Each of these would then be given the opportunity to trade a (small) % of their equity in return for a small amount of cash ('roundlet') to invest in the business. They would be encouraged to return every 8 weeks -at which point they would illustrate the new results of their work, in another one-side document and demo. They would receive advice, a further small tranche in return for an increased stake or a polite termination -with feedback.

The onus would be on entrepreneurs to show something interesting, useful and increasingly valuable, at frequent intervals...so that genuine research projects (necessarily long-term, curiosity-driven and unpredictable), would exclude themselves and a sense of urgency would be maintained. Thus, investment in early stage businesses could be managed, without a high nuisance factor for investors.

This high-frequency cycle of cash and advice injections would repeat until either larger-scale funding was required, the business was entirely self-supporting or a better idea refocused the resources elsewhere. At each stage, funders would have the option to decide whether to continue investing and negotiate the level of extra equity that would be required.

Normally, a high-risk investment is characterised as having a sizeable probability of losing a significant amount and is only entered into because of the modest probability of a huge return. Since almost every new technology opportunity is, by definition, untried, none of these probabilities is known, which can lead to indecision, brinkmanship and loss of momentum.

In the scheme proposed here, there would, at each stage, generally be a **decreasing** probability of losing the amount then invested, which would have grown approximately linearly with time.

This has the following additional merits:

- Less emphasis on estimates; more on **experimentation and real data**
- It's a new approach, and will therefore attract hitherto unserved proposals
- Active investors can impart their experience, monitor their exposure to risk more directly and spot opportunities for co-operation and resource sharing between start-ups
- Investors start with a portfolio or 'pool', rather than having all eggs in one basket
- Many more attempts to create proto-businesses will be seriously undertaken, so risk is diversified and experience is gained by more people at an early stage in their career
- A more clearly defined, evidence-based picture of what works and why can be obtained
- Fast feedback allows flexibility to divert to a better idea before resources are wasted
- Those people who are temperamentally unsuited to business can identify themselves early
- The process can insist on early customer feedback and that this is acted upon
- The frequent (but straightforward) scrutiny of activity by funded groups, would largely rule out the possibility of misappropriation
- An increase in the numbers of failures-to-progress (for good reasons) would lessen the associated societal stigma and encourage entrepreneurship

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There will be some businesses that fail to become viable within the scheme, but most of these will be controlled failures, brought about by conscious decisions and with understanding on all sides.

Investment in early stage operations can thus become more of a genuinely **experimental** process (in the sense of testing and revising understanding). This is familiar territory to many tech start-up founders and would allow them to be less daunted by suddenly assuming full corporate responsibilities.

Lowering the risk associated with any given roundlet enables cooler, more prudent decision making and more effective feedback as to rationale.

This process can, I believe, act as a cost-effective pre-qualifier for entry to the established business angel funding process, if appropriate. It also offers investors an opportunity to obtain first sight of a large number of ideas that would otherwise stay dormant and to negotiate deals on favourable terms.

My aim is to put together a fund capable of investing the first £50k in each of 100 projects i.e. **£5M in total** (although in practice there should probably be >>100 1<sup>st</sup> roundlets of £1k each).

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