

THURSDAY 16.08.07

# REPORT ON BUSINESS

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| <b>S&amp;P/TSX</b><br>11,826.44<br>-39.32<br>Energy stocks lead first decline in four sessions | <b>DJ Ind.</b><br>11,069.06<br>-46.26<br>Interest rate worries undermine blue chips | <b>Nasdaq</b><br>2,262.96<br>-19.40<br>Chip stocks drop as Citigroup cuts recommendation | <b>Dollar</b><br>87.18c (U.S.)<br>Unchanged<br>Rate concerns in U.S. and Canada squeeze loonie |
|  |   |  | <b>Gold</b><br>\$556.60 (U.S.)<br>+2.00<br>Renewed inflation concern underpins bullion gain    |


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## VENTURE CAPITAL

### Turning Silver into Gold: How Do You Know if Your Idea Sucks?



**SEAN WISE**  
WISE WORDS

In the ten years I've been involved in the venture capital industry, I've been blessed to meet thousands of entrepreneurs, each believing they had the "next great thing". In fact, I can safely say that in the hundreds of funding pitches I've heard, no founder has ever said "ehhh, it is just an okay idea". It simply doesn't happen. Entrepreneurs, by necessity, have to embrace their venture wholeheartedly, sometimes believing in it blindly. Investors, on the other hand, need to apply a more objective methodology in evaluating the opportunities before them. Pre-2000, proof of concept meant "I turn on the light switch, and the light goes on", i.e. technical feasibility was often sufficient to confirm an opportunity's viability. In the modern day however, proof of concept has become "I turn the light switch on, the light goes on, and customers are paying me to read under it". Customer validation has become the precursor to investment. But what

if you aren't ready for customers yet? How can you objectively review your opportunity to gauge its true potential? For that, I recommend following **Silver's First Law of Entrepreneurship**.

#### Silver's Law

David Silver is the founder of the Santa Fe Capital Group, an angel capital firm based in New Mexico. He is also the author of thirty books on entrepreneurship and finance. The latest "Smart Start-ups: How Entrepreneurs and Corporations Can Profit by Starting Online Communities" provides, amongst other valuable insights, a formula for evaluating a venture's potential. It is dubbed, Silver's First Law of Entrepreneurship.

"I invented these rules for assessing the quality of business models, and they have served me well over time in my angel investments", Silver says. I asked him to elaborate, and he said, "Well, Sean, let's put it this way: I have had to kiss fewer frogs to get to the princess."

#### The Formula

Silver's First Law of Entrepreneurship  
 $V = (P \times S \times E) + DEJ + (FMS)$

Where:

V = the value of your venture, from 1-45

P = the size of the problem, out of 3

S = elegance of the solution, out of 3

E = experience of the founders, out of 3

DEJ = Demonstrable Economic Justification, scored from 1-8

FMS = Forward looking, Multiple Revenue Sstreams, scored from 1-10

**The Size of the Problem**, which is scored out of 3, relates to the size of the market, the size of the problem being addressed and the size of the opportunity. As discussed in

earlier columns, this is really the # of people affected by the problem multiplied by the cost of the solution. A large result, 1 billion dollars or more, would receive a P factor of 3. A niche market, worth \$250M or less would receive a P factor of 1.

**The Elegance of the Solution** factor addresses barriers to entry, how duplicable your solution is and your time to market. A first to market technology that is proprietary and difficult to replicate would receive a 3 for S.

**The Experience of the Founders**, as also discussed in earlier columns, founders with experience running a startup, taking a product to market and/or domain knowledge in the industry being approached are all desirable. One point is given for each when tabulating E.

Once you have evaluated the three key factors (P, S, E) you next turn your mind to reviewing 8 possible indicia of **Demonstrable Economic Justification**. Assign one point for each of the following statements that are true:

- Existence of a Large Number of Receivers.** Are there many potential consumers of your solution, and are they aware of the problem that your solution addresses?
- Homogeneity of Receivers.** Will the consumers of your solution accept a standard product or service, or will you have to customize it? This speaks to the *scalability* of the venture.
- Existence of Qualified Receivers.** Are future customers aware they have an issue? Do they want a solution, or are

they happy with the status quo?

- Difficulty to sell.** Can anyone sell your solution? Is it easy to understand, or will sales cycles be long?
- Absence of Institutional Barriers to Entry.** Once you build your product, is it free from regulatory requirements, or do you need an agency (ex. the FDA) to approve it prior to sale?
- Viral Marketing Potential.** Will the solution be so revolutionary that each user will tell 2 or more people to try it?
- Invisibility.** Are you able to build in "stealth mode" i.e. by slowly sneaking up on current incumbents?
- Optimum Price-Cost Factor** Are the margins above 80%?

Next up, founders need to examine the FMS, which Silver defines as "Float Many Clubs", but which really represents: the ability to be prepaid (i.e. through subscription revenue); the number of potential revenue channels your venture has and the ability to involve the customers in loyalty programs (i.e. subscribing to newsletters). A business which requires an annual prepaid subscription has lots of opportunity for monetizing the customer base, and multiple points of contact would score a 10. For example, a company that registers domain names would have a 9 or 10 for FMS, since domains are paid for in advance (often for 2 or more years). Once you sell a domain, selling a website or email hosting is a natural value add. Then you have the customer's contact information and can involve them in marketing services.

The optimum result for Silver's Law is 45. A 45, according to the author, indicates a possible billion dollar opportunity. Anything less than a 35 on the Silver Scale, should be expanded, reconsidered or leveraged more fully before proceeding. "It seems to me", says Silver, "Those entrepreneurs who are creating business models for online communities and mobile social networks are doing a better job of it than in any other period of intense new business formation activity that I can recall." I ask him to give me some examples, and Silver answers, "Women entrepreneurs, in particular, are building online business models that in many respects emulate the successful offline business models of the 1960s such as Weight Watchers International, Mary Kay Cosmetics and the Billy Graham Crusade, for communities dedicated to weight loss, feeling prettier and spiritualism".

#### Silver's Law in Action

Intrigued, I tracked down the CEO of Forgefinder Inc., Kyle Gillman. Forgefinder operates an online reverse auction engine that enables buyers of components from multiple vendors to drive down raw material prices through a controlled bidding process. Forgefinder was selected for funding by Santa Fe Capital Group's angels after it scored 40 on Silver's test a few years ago.

"To be honest, at first I thought David's scoring systems was frivolous", says Kyle Gillman, Forgefinder's founder and CEO, who earned a law degree at the University of Pittsburgh prior to conceiving of a community of buyers and sellers in a range of industries from forgings to cancer drugs. "But once I began scoring the various parts of Forgefinder's business model, I discovered that it

was a valuable intellectual process", Gillman adds. It appears that Forgefinder deserved its high ranking on the Silver Scale. Today, Forgefinder has established itself as the leading online auction company having won business from the likes of: Ford, MG Rover, Bosch, Massey-Ferguson and New Holland Case among many others in capital equipment, such as One Oncology in cancer drugs and McVities, Crawfords and Swainson's in food.

#### The Bottom Line

As my mother said, "Founding a venture and being an entrepreneur is the third hardest thing a person can do" (for numbers one and two see my earlier article on Marriage and Startups). So, the last thing you want to do is found a venture doomed to mediocrity from the start. Before investing time, energy and heartache into launching a new venture, ensure that you aren't the only one "drinking the Kool-Aid™" by applying Silver's Law. You can do so online at: <http://www.smartstartups.com/scoring.html> or by giving Silver's follow-up text, Smart Start-ups a read (it's worth it).

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Sean speaks at more than 20 Entrepreneurial Boot-camps and events across North America annually. Sean is the online host and industry advisor for CBC's hit business reality show [www.INSIDetheDRAGONSden.com](http://www.INSIDetheDRAGONSden.com)

His monthly column on [www.theglobeandmail.com/smallbusiness](http://www.theglobeandmail.com/smallbusiness) covers a wide range of topics on entrepreneurship and venture capital as does his blog found at [www.SeanWise.com](http://www.SeanWise.com). Sean's new book on Entrepreneurship & Venture Capital is currently available at [www.AMAZON.com](http://www.AMAZON.com)