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Disruptive start-ups: do they attract more funding?

By Timo van Balen, Murat Tarakci and Ashish Sood

Getting a first round of financing is arguably the most difficult stage of financing for any new venture. Entrepreneurs running start-ups must convince investors. This is not a revolutionary observation. But often investors will have little in the way of concrete information available beyond what the potential investee chooses to say, and may therefore be reluctant to provide financial capital.

Typically, the cry is: ‘Entrepreneurs should write a detailed business plan, which should inform investors, right?!’ This may come as a shock, but one of the core academic observations is that investors don’t look at elaborate business plans in their initial investment decision. They know that there is much unknowable uncertainty, and so intuitively they rely on their perception of the entrepreneur and the message that is conveyed for the start-up.

For example, research finds that entrepreneurs who (through their communication) raise positive perceptions (for example, feelings of warmth, trust and preparedness), who use figurative language, hand gestures to ‘illustrate’ their presentation, and who demonstrate a record of achievement, are more likely to convince investors to provide financial capital.

Additionally, what we observe is that the most successful start-ups (in terms of obtaining financing) are the ones that also communicate a vision: images of the future of the start-up’s ecosystem, extending beyond the immediate business in hand, telling us what the venture will achieve in the greater scheme of things.

This informs investors of the substantive value of the venture as an investment opportunity. It makes explicit what the entrepreneur and the venture stand for. Think of Elon Musk’s SpaceX, on a daily basis pursuing the implementation of self-landing rockets, so they can be re-used and are more cost-efficient than current offerings.

Musk communicates, inter alia, the eye-catching, even jaw-dropping vision of a future where humankind colonises Mars and explores space. He has proven his ability to raise considerable investments through this ultimate aim, though it has to be acknowledged that more recent eccentric behaviour has shifted attention away from his early success.

However, such outlandish images are not an uncommon conveyance in the entrepreneurial scene. Readers will be familiar with the term disruption. The world’s media often celebrate successful disruptors; businesses appoint “Chief Disruption Officers”, and arguably the most renowned entrepreneur trade show is called TechCrunch Disrupt.

Perhaps the term disruptor has been popularised to such an extent that it might have lost some of its power.

Attracting funding

A study we conducted is the first to show that specific thematic contents of entrepreneurial visions might damage an entrepreneur’s ability to attract large investments. Equally important, we offer practical advice for entrepreneurial
framing of disruptive visions and highlight the consequences of following it.

We found in our study of 918 Israeli start-ups and a subsequent online experiment with would-be investors that early stage investors perceive start-ups that communicate a disruptive vision as an option for extraordinary returns. More detailed accounts of our findings can be found in articles published in the September 2018 edition of Harvard Business Review and in the Journal of Management Studies. The findings are ultimately based on data supplied by Startup Nation Central, which is a private non-profit organisation that tracks the Israeli start-up ecosystem and offers an exhaustive platform for investors to scout for promising start-ups.

With a disruptive vision, the entrepreneurs raise the idea that their venture can be the next big money-spinning opportunity. A fear of missing out on a potentially significant investment opportunity can drive investors to invest.

Nonetheless, while investors are about 22 per cent more likely to invest in a start-up that is communicating disruptively, the amount of funding they provide is about 24 per cent less than they would provide to a start-up that communicates without a disruptive vision. For a typical Israeli venture that meant getting US$87,000 less in the Seed round, and US$361,000 less in the series A round.

That raised an interesting question: why would investors be more willing to invest and less generous at the same time? To answer this question, we recruited 203 participants with previous investment experiences for our follow-up online experiment.

We randomly split them into two experimental conditions in which we presented them with an investment opportunity into a venture. As the venture was taken from our Israeli sample it was identical in both experimental conditions. The only difference was that we manipulated the venture’s description to present the venture as a disruptor or not. We then asked participants to assess the upside potential of the venture, and to decide whether and how much they'd invest in the venture.

Next big thing
What the experiment revealed was that investors treated disruptive ventures like options. They wanted the chance to be part of “the next big thing”: a venture that has the potential for extraordinary returns. But they didn’t want too many eggs in any one basket at once. This is the real options logic we described earlier.

The potential for disruption raises both the appeal and the perception of risk by investors, and so they do invest – but only a lower amount. Initial investment thus becomes an option on future investment once a company’s initial promise has been confirmed. This can be neatly described as real options logic. If a company does not succeed after first round financing, investors will not invest in the next round. We believe that our paper is the first in its field to quantify the power of such dramatic communication.

Start-ups, as already noted, need financing for development and growth, but being too brash will reduce the amount they can raise from investors.
This holds true across many sectors, geographies and age groups. To paraphrase an old proverb: softly, softly catches investors.

Prior research on disruption and impression management has argued that entrepreneurs’ impression management efforts are key in the disruption process. Impression management activities have also included communications about venture activities, innovations, capabilities, achievements, and affiliations that help regulators, competitors, suppliers, and investors to embrace the venture. These communications attempt to establish identities that distinguish the venture from other market constituents in the eyes of investors.

Such well-established identities define who the entrepreneurs are and what the ventures do. These presentations aim to showcase the venture as ‘desirable, proper, or appropriate within some socially constructed system of norms, beliefs, and definitions.’

Our own research raises a number of other tangential but related issues. When should we stop referring to a start-up, even the most disruptive of the breed, as a start-up? Put differently, when does a start-up become part of the establishment that it intended to disrupt? And how will today’s disruptors face up to the next wave of start-ups determined to disrupt them?

But all this is literally another story, or two, or three. In the meantime, we will conclude with an ironic, counterintuitive thought. To disrupt, an entrepreneur needs money. To attract money, the entrepreneur needs to stand out from other ventures looking for investors. However, while doing so they need to avoid becoming too different from what investors understand in the context of early stage entrepreneurship. In order to disrupt, even the most potentially disruptive disruptor must also conform...

This article draws its inspiration from the paper *Do Disruptive Visions Pay Off? The Impact of Disruptive Entrepreneurial Visions on Venture Funding*, written by Timo van Balen, Murat Tarakci and Ashish Sood, and published in the *Journal of Management Studies*, 2018;00:1–40. DOI: https://doi.org/10.1111/joms.12390

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