

Investing In a Startup – 8 Red Flags to Consider

New to the angel or seed investing world? If the answer is yes, then looking at potential investment opportunities can be a daunting task – especially if you are in a market like Boston, Silicon Valley, or New York City, where there are large, well developed startup ecosystems and lots of investment opportunities.

PS&H Partner, Dave Wittmann, often gets asked questions like – “Is this a good company to invest in?” – or – “What should I be looking for in an investment opportunity?”. As a lawyer who has worked with lots of startups over the course of his career, he has found that failed startups often share a number of common threads, or ‘red flags’. Below are 8 red flags Dave Wittmann wants you to look out for when evaluating a potential startup investment.

1. No plan for the money. If you are talking to a startup, they should present you with a well thought-out, professional ‘deck’ (something akin to a power point presentation that discusses what they do, why they are needed, and why you should invest). Of critical importance in the deck is an explanation of how the investment proceeds will be used. It should be fairly concise. If they have not thought carefully about how they are going to use your money, I would not trust them to use it. Deploy it somewhere else.

2. Lots of small rounds and no institutional money. If the startup has raised small amounts of capital on multiple occasions, and has not raised any institutional money (i.e., a VC or angel fund), it’s a great indicator that ‘sophisticated’ investors are passing. If that is the case, there is usually a good reason for it and you should probably continue your search .

3. Slow to provide diligence or answer questions. If a startup is raising capital, it should be ready, willing, and able to provide requested due diligence materials and answer questions. If due diligence materials are sloppy and the startup is slow to respond, it’s usually a pretty good indicator of the general operations and culture of the company, and likely systemic. If they can’t provide the diligence, you should not provide the money.

4. No legal counsel. If you are talking to a startup and you say – “*let’s connect our lawyers so we can get moving on things*” – and the founder says – “*ummm, I don’t have one*” – it’s a pretty good indicator that things are going to be sloppy or simply wrong. It’s also a signal of poor judgement. Even at a very early stage, a company that is interested in raising capital should have its team of basic advisers established (lawyer, CPA, etc.). In this case, I would ask them to follow up when they are a bit further along.

5. Odd investment terms. If a startup presents you a term sheet that does not look market, it could mean one of two things — neither of which are good. First, it could mean the founder thinks you are uninformed or inexperienced and is trying to take advantage. In my opinion, not a good way to start. Second, it could mean the founder doesn’t know any better. Also not a great option. There are enough deals happening that it’s easy to pick out the market and non-market deals. If you are presented with something non-market, I’d strongly consider finding a different deal.

6. Founder is a bad communicator. Successful founders are generally good sales people. After all, they need to pitch their idea (i.e., sell) to investors to raise capital. To be a good seller, you need to be able to concisely communicate, in a compelling fashion, the need for the widget you are selling. If you receive a pitch, and you’re not clear on what the startup actually does or the problem it solves, others will think the same thing. You don’t want to be the only investor – the money will run out and they will ask for more. Try to avoid this by finding a founder that is a great communicator.

7. Bad Reputation. I love Google. You can find out so much, so fast. Spend some time internet stalking, I mean, researching, the startup’s founders. If something comes up as suspect, at the very least, you should ask about it. While everyone knows 99.99% of material on the internet is true [yes, sarcasm], you should at least

give the founder a chance to explain what was found. If the explanations don't give you the level of comfort you need, I'd suggest taking a pass. If they've wronged someone in the past, they will likely do it again.

8. Spread too thin. Ask the founder if he or she is involved in other projects. If the founder is involved in other projects, there is a pretty high degree of likelihood that he or she is not 100% committed. Don't invest in a part time founder. Find someone that will be 100% dedicated to running the company you are investing in.

Does this list above contain all red flags? No. If a red flag exists, does it mean the company is destined to fail? Of course not. Investing in a startup is not like buying a toaster – there is no guarantee. It's a high risk, high reward game. We hope the red flags above will give you a few more things to consider the next time you're evaluating an investment in a startup. Best of luck!

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