10 Red Flags that Scare Away Investors

A "red flag" is an aspect of you or your business that will stop an investor from listening to you. This booklet outlines most of the major not-so-obvious "red flags" that we know of. We developed this list by interviewing several dozen angel and professional venture capital investors over the past five years. We asked them to give us the top three reasons they would stop reading or listening to a presentation without giving you the chance to complete your presentation. Below are the most common answers investors give.

The conclusion you can draw is this: One red flag may not be a show-stopper, but if you were to show up with multiple red flags, although you may still have a great opportunity for investment, investors won't be listening after the first few minutes. So even if you don't believe that these are problems for you, we encourage you to review these potential issues and address them in some way.

1. There's no co-founder(s), just one founder

Increasingly, smart investors look for founding teams consisting of at least two experienced co-founders, each with an ownership position and with skin in the game. Ideally, co-founders should be similar in their values and different in their leadership styles and skillsets. An example would be the key developer, operations executive or marketing executive you're going to need to launch or grow.

If your company is at an early stage and only has one founder, and you don't have the money to hire a key executive, we strongly advise that you look around your industry for possible partners and identify them. These can be contingent relationships that you intend to make real upon initial funding. Ideally, co-founders should not have 50-50 ownership and they should not be a married couple nor in a romantic relationship, and especially not both.

2. No one on the founding team has ever started a new business

It's not uncommon that the visionary founder has never started a new business, or never started one of your intended size or larger. This is a red-flag UNLESS there is also a co-founder who has the needed experience in the same field of business. In that case, you may have a very powerful founding team.

3. Business plan sounds like wishful thinking (or there's no business plan at all)

Obviously, it's impossible to know that your own business plan sounds like wishful thinking or is confusing or unfocussed from an investor's point of view. The only way to know is to make sure that several experienced individuals read and review the plan and you accept their coaching.

4. Founders (and their friends and family) have not put money into the company

Investors are naturally scared off when they find that the founders have not put any of their own money into the company. This is called "not having skin in the game." On the other hand, many founders don't have money to put into their business. In that case, investors are scared off if the founders have not enrolled their friends and families into helping them. This could either be because the founders don't have any friends or family; or the founders are afraid to ask. Either reason is a red flag.

5. Invested funds will be used mainly for founders' salaries or to pay off debt

This is the other side of the coin, where friends and family DID loan you a great deal of money to get started. Now you have to pay them back and are hoping new investors will do that. This is a huge red flag. Investors want to know that most or all of their funds are going to new use, such as marketing, further product development or erecting barriers to competition (like applying for patents.)

6. Future growth of company is not large enough to pay back investors

You would be surprised how often founders will ask for an investment of $500,000 dollars when the total projected revenue for the business over the next five years is perhaps a million dollars. It doesn't have to be this obvious to be a red flag. In general, there has to be some believable way to pay back investors. One way to pay back investors is to accumulate a large number of users or clients and then sell the company user-base. Since this is rare, the two most common ways are 1) to sell the company to a larger firm who wants the strategic value of your product and clients, or 2) to pay your investors back with a percentage of revenues or profits. We'll discuss the idea of repaying as a percentage of revenue below. In any case, there has to be a realistic way to do this.

7. The overall market is small

This is a red flag because it throws doubt on your growth projections. Investors will not consider your projections believable if you have to dominate your market for the next 10 years. To be honest, this is a difficult red flag to understand, because it may be difficult to determine exactly how big the market is. One strong indication that a market is too small is if it is regional in nature, such as just Southern California. If it turns out that Southern California does not accept the idea, there's nowhere else to go.

8. Product is a "me-too" product (not the first to market)

Investors don't get excited about a product that is similar to existing products, with the main difference being improved branding, packaging, selling or a lower price. This kind of difference is easy for the incumbents to counter and they are likely to try. Investors generally want to get involved if you have a "*sustainable* competitive advantage." Important: Being less expensive is

not sustainable. Providing better service or better sales strategy is also not sustainable because the competition can easily replicate what you do. A sustainable advantage could be 1) product features that are substantially different and will take years to copy, if ever, or 2) solving a problem that has never been addressed before, such as a machine that diagnoses a disease condition before the disease becomes noticeable.

9. False or misleading statements

It goes without saying that deliberately misleading statements will be discovered and will limit whatever chance you have of obtaining capital. It may not be obvious when writing your business plan and pitch deck that some statements are exaggerations or misleading. We strongly suggest that you ask an advisor or coach or knowledgeable friend to read all of your materials and listen to your pitch and tell you where you don't sound completely credible.

10. Founders are not coachable

You may have noticed that we suggest in several places that you get the advice and coaching of trusted advisors. In general, investors also want to be able to advise you and coach you. In fact, this is one of the great joys in assisting an innovative visionary, beyond just making money. Most investors want to know they are important and valued as insightful guides. If you really do believe you don't need any coaching and just need people's money, this will be a drag on your ability to enroll investors in your vision.

Even More Red Flags

The above red flags apply to just about any kind of project at the early stages. To assist you further, here are four more red flags. These apply specifically to selling privately held equity (stock), which is the most common form of investment today. This would include a "convertible note" since it is converted at a later date to privately held stock. Here they are:

11. Valuation of company is too high and not negotiable

This is the same as saying that you only want to sell a small piece of your company (less than 20%). In other words, if you're looking for $1 million for 10% of the company, you are essentially saying the company is worth $10 million after you've received the investment. The problem comes when you send the signal during initial presentations that you are not negotiable. We suggest that you send the signal that you are negotiable when it comes to valuation.

12. You have a lifestyle business

If they're buying equity (stock), investors can only get paid back when you sell the company. What if you don't really want to sell it? Investors understand that it is often not in founders' interest to sell their company. After all, your company represents your livelihood, your lifestyle and a great deal of status in the community. So, if you send the signal that you don't really want

to sell your business within the next seven years, this would be a significant red flag – but only if you're selling stock or a convertible note. On the other hand, if you're offering Revenue Royalties (also known as Revenue Participation or Revenue Sharing), then this is not a problem and may be an advantage.

13. There's no exit plan or the exit plan is unrealistic

The same points presented in the previous red flag apply here. Even if you do want to sell your company within seven years, there may be no realistic way to do it. Yours may just be the kind of business, such as most service businesses, that can't be sold at a price high enough to pay both the founders and the investors, including the return on investment they expect. There has to be an upside to interest investors. This problem disappears with Revenue Royalties. With Revenue Royalties, the traditional exit options become a non-issue as your investor(s) earn their returns from your revenue stream and you don't have to sell the business.

14. There's no "barriers to entry" to stop competition

This is a red flag particularly when you are offering equity (stock) or a convertible note. Barriers include intellectual property such as essential patents or trade secrets, or key business relationships that give you an unfair advantage. Think stamps.com and its alliance with the U.S. Postal Service. This may be essential in order to last long enough to sell the company, say in seven to ten years. Though still important, an impenetrable barrier to entry is not critical if you are considering Revenue Royalties, since the investors will probably receive their expected return before competition can hurt your company, in about five years.

Since the above four red flags do not apply if you are asking for Revenue Royalties, you can see why it is easier to attract investors by asking for Revenue Royalties instead of selling equity. Please contact Intelliversity for more information on Revenue Royalties.

Reminder: For updates and more information, you're immediately invited to our weekly Wednesday webinar at 11 a.m. Pacific time (every Wednesday) on the subject of faster access to capital. Click here now to register: A Faster Way to Fund your Business