6 Tips to Invest Like a Venture Capitalist

Having a deep industry knowledge and expertise can help when investing in startups.

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For nearly two decades, John Dougery, managing director of Inventus Capital Partners, has been investing in the startup community in Silicon Valley and India.

"Last year I reviewed 2,200 business plans," he says. "And I invested in six of them." That was after Dougery says he personally met with representatives of more than 600 startups.

The venture capital firm based in San Mateo, California, focuses on technology-based startups and has invested nearly $160 million in companies that work on Cloud and mobile computing and software services.

"It's not that mysterious," Dougery says. "But you do have to have insights that the next VC doesn't have that helps you identify a market opportunity."

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As capital has grown scarce, more venture firms are being pragmatic and judicious, cognizant of the fact that many unicorns – billion dollar startups – might be overvalued.

Still, many ventures say there are opportunities for the savvy investor. Here's a few tips to consider.

Look for markets that are transitioning. With India's GDP growth rate of 7.3 percent – the same rate as China in 2014, according to the World Bank Group, and more than triple the U.S. – Dougery says venture investing in developing economies is a smart bet for someone who knows and understands the market.

"It's a little known fact that one-third of Silicon Valley startups have a partner in India," says Dougery, who has half of his six-person team in the U.S. and the other half in the high-tech hub of Bangalore, India.

Many analysts are seeing a rise in consumer consumption with the growth of the middle class as countries like India develop. Consumers with more disposable income are looking for services that help with comforts and efficiencies in their lives, now that their basic food, shelter and clothing needs have been met.

As India's economy modernizes over the next decade, Dougery says startups, which typically take six to 10 years to mature, will be poised to have an impact.

Understand fundamental parts of the business. The investor needs to understand how and why a business operates. Look at the market and a startup team's potential for success. "That's the hardest, because it's the most subjective, but it's the most important," Dougery says.

Many investors follow what Patrick McGinnis, a venture capitalist and managing partner of New York City-based Dirigo Advisors, calls the "wildebeest" mentality where they blindly follow others without enough vetting.

"The sexier the world thinks the market is, the less successful you'll likely be as an investor," says Zach Ware, the managing partner of VTF Capital in Las Vegas. "The global big load freight market is more than 10 times the size of the taxi market. No one talks about freight."

Meanwhile, find people, including former co-workers and colleagues, who know about anyone involved in a startup you are considering investing in, McGinnis says. Then make sure you can add value to the company.

"You want to be involved," McGinnis says. "Because if you don't know the business well enough to add value to the company, you don't know the business at all."

No matter the venture, McGinnis, author of "The 10% Entrepreneur," says investors should focus on three main topics: the business, your partners and your role.

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"If you invest in companies solely because you think it's cool to be an investor, you're doomed to failure," Ware says. "Good early stage investors work hard with their companies. It's a marathon and it's bloody. Most of the upside is in areas most people can't see. You have to trust your gut."

Invest in companies focusing on a single solution. The simpler, the better. "If (a startup) is trying to do more, there's too many opportunities to fail," say Dmitry Grishin, CEO and founder of Moscow-based Grishin Robotics, a $100 million VC fund that focuses on hardware, robotics and the Internet of Things.

To find startups that have staying power, focus on companies trying to make something "truly useful" rather than gadgets and toys. "Pay attention to entrepreneurs looking to fix or improve an existing category, not to establish an entirely new category," Grishin says.

Review profit margins and spending habits. Experts say it's important to find startups run by entrepreneurs who show restraint when it comes to spending.

If a company's margins are below 50 percent, it requires venture capital to operate, as opposed to focusing on growth. "That's a huge red flag to an investor," Ware says.

McGinnis says he values entrepreneurs where every dollar goes into the growth of the business. "People are building these ridiculous headquarters instead of focusing on building great businesses," he says.

Some companies will subsidize their initial customers below cost to capture a large amount of the market quickly, then see if they can raise their rates once they have gathered interest. "We haven't invested in those types of businesses because it takes a lot of capital and they are riskier," Dougery says.

It's also important to see if an early stage company can capture a repeat market and turn first-time buyers into return customers. "Venture capital gives companies a safety net, which allows for mistakes and bad business decisions, so look for bootstrapped companies that weren't allotted that luxury early on," Ware says.

Then think long-term. Many venture deals take at least seven years before the investor can exit. Experts says it's best to invest in 10 to 12 companies at a time. Typically, if you invest in 10 companies, two will be successful, three will "do OK" and five will fail, McGinnis says.

"Don't invest in a company where everyone is putting $10 bucks in like they are playing the lottery," Dougery says. Instead, look for companies where there's a lead investor who shows "conviction and leadership" by taking a 20, 30 or 40 percent financial ownership and will watch their significant amount of capital.

Prepare to frequently fail. It may seem counterintuitive, but the better investors have a higher failure rate. That's because good investors bet on companies, like Facebook, that look absolutely insane when they start out.

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"Most of them are wild crazy ideas," Dougery says. "And there's a really high failure rate. But the ones that succeed make it all worthwhile. That's venture investing."