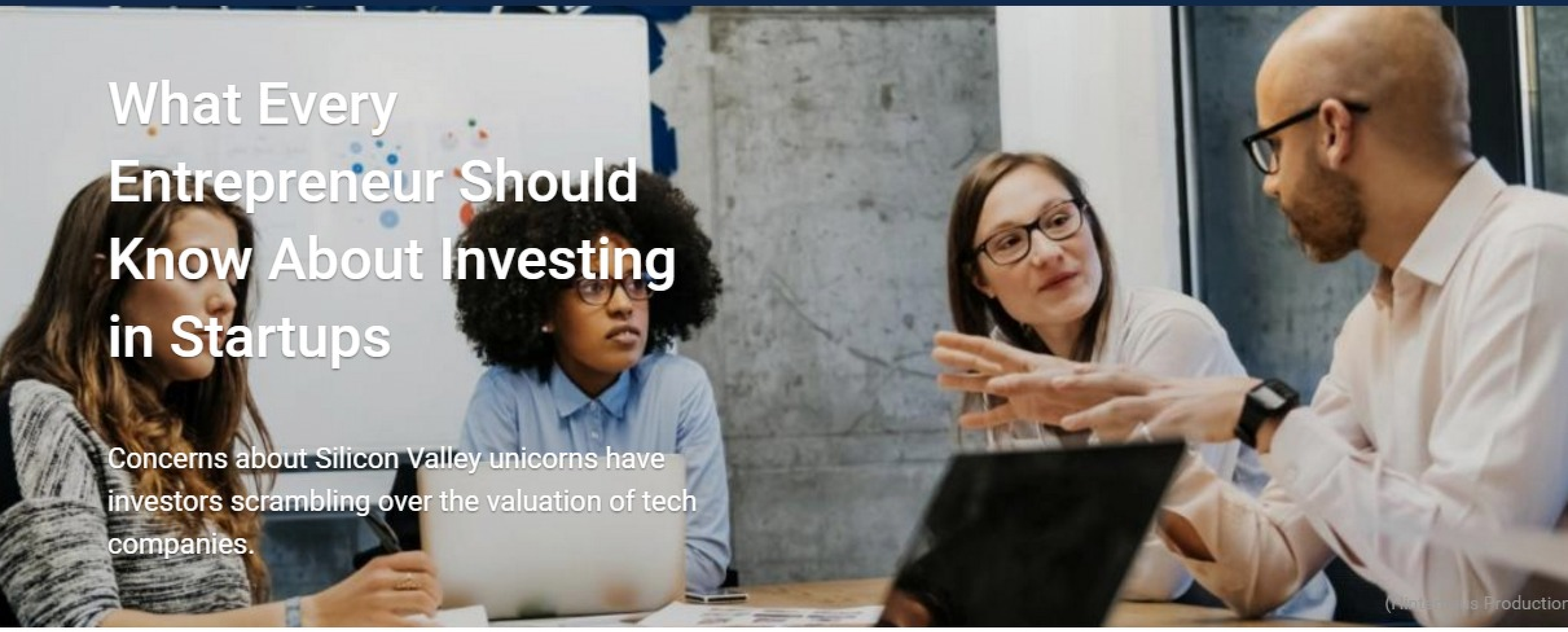

What Every Entrepreneur Should Know About Investing in Startups

Concerns about Silicon Valley unicorns have investors scrambling over the valuation of tech companies.

By Dawn Reiss | Contributor

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When Bill Gurley, a partner at California-based venture capital firm Benchmark, wrote an epic thesis akin to "The Odyssey" last week, its dissection of Silicon Valley unicorn startups and their vitality – or their lack of it – ricocheted throughout the tech industry.

He told late-stage and venture investors who are now being approached that the situation is comparable to the being in the "14th inning in a five-hour baseball game," as they were being viewed as lenders of last resort.

As Gurley and many other industry experts are sounding the alarm that the mid- to late-stage funding bubble is about to burst – thanks to investors buying higher than they should which is leading to overvaluation – many are left wondering about next steps when it comes investing in the tech startup arena.

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"We are in the middle of a massive funding bubble," says Matt Maloney, co-founder and CEO of GrubHub (ticker: GRUB) in Chicago. "Bill [Gurley] is trying to deflate that as fast as possible because the bigger it gets the harder everyone falls … It really depends on if everything blows up or if this lets the air out."

As investors, founders, employees and plenty of other interested parties continue to pivot, here's a few things to consider.

Buyer beware of potential overvalued startups. "There are many investors who knowingly paid an irrational aggressive price or value for a company," Maloney says.

Why? Because they wanted to get in on a deal.

"It was worth more to them to get in on the deal then the expected ROI was in business," Maloney says.

Top Movers DAILY CHANGE %

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▴19.7%	MGT Capital Investments Inc MGT
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▾5.4%	Valeant Pharmaceuticals International Inc VRX
▾5.0%	Freeport-McMoRan Inc FCX

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There's also plenty of startups that are terrified of having a down round of funding – where investors purchase stock from a company at a lower valuation – and are willing to go to the "sharks" aka opportunistic investors, who Gurley points out have "dirty term sheets" if a founder agrees.

"If you get funding right now, the deals you do see are basically debt," Maloney says. "It's a lie to call it traditional venture investing because of the extremes on the deals make sure the new investors make at least their money back if not some guaranteed percentage of interest."

Think of it as going to a loan shark. In exchange for paying the overinflated evaluation of the company, an investor will likely demand a founder of a startup to repay the entire investment, plus interest and if the founder isn't able to make those terms, the investor may have veto rights to all company compensation and essentially have full control of the company.

"So they are asking for outlandish control of the company," Maloney says. "Things that should rightfully be the responsibility of the board."

There are still plenty of great startups that need funding. Maloney is quick to point that there hasn't been an increase or decrease of excellent business ideas. Much of the heat is pointed toward late-stage funding, not initial startups who are trying to secure their seed or first-round (Series A) funding.

"There are still good companies that need investments to take their company to the next level," Maloney says. "Even if the ideas have been significantly overvalued, many of them were good. They are still great companies that should be nurtured and grown."

Before investing, do your homework. Start by asking the founder, "Who are your customers? What do you do for them and why do they care?" Maloney says. "The real point is understanding why people are paying this company. You have to make sure the value the company is producing is worthwhile. That it's not smoke and mirrors."

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Assuming that the customers understand the value of the product or service, potential investors should then ask startups: How are you different, unique or special? Why are you the only ones who are doing this? What is different about the way you are doing it from anyone who has ever done this before?

Know your own risk tolerance. No matter the stage, investing is always risky. "People underestimate how risky it is," says Brad Flora, an angel investor in San Francisco who sold his social media advertising startup, Perfect Audience, to Marin Software (MRIN) for $22.8 million in 2012. "You have to understand there is a very good chance your money is going to be gone forever."

That's why he says the first question any entrepreneur should ask themselves: How much risk are you really willing to take?

"If you're not willing to lose your entire investment, then it's probably not the right space for you," says Bill Pescatello, a partner at Lightbank, a technology-based venture capital firm in Chicago. "You've got to be comfortable your return is going to be absolutely zero. If a third of your portfolio are zeros or a quarter of your portfolio are zeros, that's pretty typical."

At the same time, every investor is going to try and find the outlier startup, a home run that might offer a significant return.

That's why it's important to consider the power law. There's a reason big risks can equal big rewards. Even if other investments fail, one large success may equal the rest of the returns (or lack of return) on investments, fondly called the power law.

"Typically they say, if you write 10 checks, one of them might be a success, but that one might pay for the other nine," says Flora, who estimates he's invested in 15 to 20 startups.

That's why Flora says he prefers to angel invest at small amounts of $50,000 or less. He couples his monetary investment with his business expertise that may also include introductions to other potential investors, as well as introductions to serial entrepreneurs who can also administer advice and support.

Don't be afraid to ask questions. Many startups will try to elevate their knowledge of the space and throw out acronyms and other industry monikers to potential investors.

"People are scared of asking dumb questions," Pescatello says. "If someone is throwing terms out that you're not aware of, don't pretend you know what they're talking about. Some of the smartest people I know are absolutely fearless when it comes to asking questions."

Instead be transparent with a startup's founder about what you do and don't know, Pescatello says. "People really respect the honesty they have with founders and companies," he says. "The biggest mistake people can make is not asking the questions they have because they aren't comfortable or want to pretend they have more expertise than they really do."

If you're looking at investing in first-time entrepreneurs, Pescatello says look at their other accomplishments, track record and history of success in whatever they've done before starting this company.

And if a deal looks too good to be true, it probably is.

"I've had deals where founders have offered to bring us in at a previous discount to other investors," he says. "If someone is willing to give you a discount a beyond a certain point, it's a question mark. Do they truly believe in what they are doing? Should I be concerned they are desperate for help?"

If a founder is willing to give up too much, it's clear there is some doubt so be careful, Pescatello says. The founder may be seeing something that they investor needs to examine more thoroughly.

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Sometimes your initial reaction isn't always right. Even if an initial reaction is "that's a terrible idea," Flora cautions against not considering the product or service a second time. "That doesn't mean you shouldn't invest. Often the best ideas are the ones that seem terrible at first," Flora says, citing Airbnb.

When the company first began, did anyone think they would put their home up on the Internet and invite strangers in their home? "No," Flora says. "But everyone does it now. When you think about it that way, it's pretty crazy."

Still, any investor must reconcile with their inner compass to make sure it's truly a good idea and they can get over the initial objections they felt to be an active investor.

Be willing to walk away. Be wary of founders that put pressure on you. "People get so scared of missing that one magical deal," Pescatello says. "But in reality, there's an infinite amount of companies being started. There's always a chance you're going to miss the next Facebook, but if they're pressuring you, don't feel bad about walking away. Ninety-nine percent of the time you'll be fine."

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