5 Red Flags Tech Investors Look for Before Buying Stake in a Startup

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This spring was disheartening for tech investors. The five biggest technology stocks — Google, Amazon, Meta, Apple and Microsoft — shed over $2.5 trillion off their valuations between January and the end of May, with similarly large drops seen among tech startups across the board.

The media is full of references to the bursting of the dot-com bubble, which is not helping assuage fears about the stability of the tech sector. When companies receive extremely high valuations — as has become commonplace for tech in recent decades — there is an increased risk of large fluctuations.

Experts agree that the current downswing is a market correction of overvaluations that occurred during the pandemic and not the harbinger of a full-blown crash. General demand within the tech sector was stimulated by the unprecedented "lockdown" policies and subsequent surge in tech adoption, leading to unsustainable growth projections that could not outlive the end of the pandemic.

However, the falling stock prices have put technology investors on edge, inclining them to be more diligent than ever when assessing whether to invest in a tech startup. If you are a startup seeking funding right now, here are five red flags investors will be looking out for as well as advice on how to preempt any concerns.

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1. Inability to move beyond negative unit economics

The definition of what constitutes a “solid” business plan for a tech startup has fundamentally changed. Previously, it was considered acceptable, even normal, for tech startups to fuel aggressive growth strategies through negative unit economics — regularly spending more on acquiring new customers than they made from them.

However, the collapse of high-profile startups like Casper Sleep has increased sensitivity to business models that appear overly dependent on negative unit economics to grow their customer base. Market uncertainty has also led to higher expectations, with many investors demanding that companies show signs of generating a profit before they are willing to commit any capital.

To navigate this issue, startups should avoid overly ambitious growth plans and construct their business model around financial stability and long-term profits.

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2. Conflating alternative metrics, such as active users, with financial performance

The days of securing funding based on monthly active users are over. Twitter‘s struggles to turn a profit have demonstrated that the number of app downloads or platform users a company has is not directly correlated with long-term profitability.

When it comes to startups, revenue goes hand in hand with business scalability. Several thousand downloads of a free app mean nothing if it does not contribute to the bottom line. The focus should be on showcasing a viable business plan with scope for multiple revenue streams – the key word here being "revenue" – backed up by financial data. Skipping on the financials and trying to use social media engagement to bump up a valuation is a sure way to put off potential investors.

3. Lack of business planning and unclear KPIs

Going hand in hand with the demand for financial data is a desire to see concrete KPIs rather than vague business projections. Investors want to know how a startup's current capital will be spent and what that spending is meant to achieve – such as reaching a certain number of customers or developing a new revenue stream – and this key information is not found in aspirational PowerPoint slides.

Startup leaders need to formulate clear, time-bound business plans and KPIs that they are willing to be held accountable to, guaranteeing investors greater oversight of business progress. This increased accountability is beneficial for both startups and investors alike, helping to manage burn rate so that initial capital can be stretched farther, as well as preventing some of the problems associated with premature startup growth like over-engineered product releases.

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4. Lack of market landscape

analysis

Is this technology already available in the market? How long would it take for competitors to replicate similar technology? Do you have a strategy to distinguish your startup from potential competitors, such as IP protections, licenses and distribution relationships?

Investors will ask these obvious questions about any tech startup, so there is no excuse for not preparing detailed answers. Startups should complete a thorough market landscape analysis and use the findings to draft a solid business plan before approaching an investor. Without this key information to hand, attempts to engage potential backers will quickly end in disappointment.

5. Depending on high valuations to secure funding

As demonstrated by the WeWork debacle, unexpected devaluations have the potential to throw everything off the rails, especially if a company is being poorly managed.

If your startup has a high valuation, congratulations! However, be wary of assuming this valuation grants you a spending buffer, falling into the trap of believing that additional spending can be offset by securing an increased amount of funding. Investment rounds should not be used as the means to address existing debts and over expenditures.

Experienced investors know better than anyone that public market valuations are liable to change, so startups should be wary of valuations based on external metrics. Instead, demonstrate the value of your business through a well-thought-out business plan and stick to it, resisting the urge to secure a short-term valuation increase without considering the consequences down the line.

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