1. **HIGH DILUTION AT EARLY STAGE**

A higher-than-usual amount of dilution, especially in early funding raises, can be a cause of concern for VCs. Highly diluted startups pose several questions: 'Will your firm be able to retain the necessary power required to make operational changes at the startup?', 'Can there be operational and philosophical conflicts with other investors?', 'Would the founders be motivated to opt for a profitable exit soon?', and so on.

A highly diluted startup usually already has several investors on board, which directly translates to a loss of voting power for your firm. Not being able to make the right changes at the required time might lead to the startup progressing in a direction that isn't necessarily in line with your goals. Further, the presence of several investors also means the presence of multiple investment philosophies, which might not all coincide with each other. This can lead to major operational and philosophical conflicts in the future. Veteran accelerator firm YCombinator has laid down these general guidelines to judge equity dilution in startups:

1. Founders should only sell 10%-15% of their startups in the seed round.
2. Equity dilution can go up another 15%-25% in the series-A round.
3. Series A dilution should be limited to around 7% if an accelerator is involved.
4. The total dilution (if one big funding round is being held) should not exceed 30%-40%.

It is important to know that these are simply general guidelines and not hard-and-fast rules that VCs are expected to follow. YCombinator itself proceeds to quote instances where founders retaining 50%-60% of their equity in their series-B funding round have gone on to be very successful. The amount of dilution that should be tolerable depends on your investment philosophies, future goals, and the particular startup being assessed.

2. Poor financials

Are you thinking about seeking investment from venture capitalists or other professional investors? If so, it's important to make sure you're prepared before approaching potential investors.

One way to gauge your readiness is to examine your financials. If your financials are weak, it could signal to investors that you're not ready to raise money.

Here are some specific red flags to watch out for:

1. Your revenue is declining.

If your revenue is trending downward, it's a sign that your business is struggling. This is a major red flag for investors, who will be reluctant to invest in a company that is not growing.

2. Your costs are rising faster than your revenue.

If your costs are increasing faster than your revenue, it means that your business is becoming less efficient. This is another red flag for investors, who will be concerned about your ability to generate profits.

3. You're not generating enough cash flow.

Cash flow is the lifeblood of any business. If you're not generating enough cash flow, it means that your business is not sustainable. This is a major red flag for investors, who will be reluctant to invest in a company that is not financially healthy.

4. You're carrying too much debt.

If you're carrying a lot of debt, it means that your business is at risk of defaulting on its obligations. This is a major red flag for investors, who will be reluctant to invest in a company that is not financially stable.

5. You're losing money.

If you're losing money, it's a sign that your business is in trouble. This is a major red flag for investors, who will be reluctant to invest in a company that is not profitable.

If you're seeing any of these red flags in your financials, it's a sign that you're not ready to raise money from investors. Before approaching potential investors, make sure you address these issues so that you can demonstrate that your business is ready for growth.

3. Non-Scalability

Scalability is typically the issue that makes me pass an otherwise interesting opportunity. I need to make my returns and it means that the business needs to grow large enough and fast enough.

Especially with tech companies, the founders tend to think scalability as a technical issue, but there is more to it. Every element of the business needs to be scalable: Product, tech, sales model, distribution, HR and so on. (It does not matter how many users the system can handle at the same time if the bottleneck is in onboarding or product demonstrations.)

In these cases, the founders should note that their business might be good business as such for the founders, but due to the lack of scalability, it will not be good for the investors. The question to be answered at this point is whether the founders wish to pivot the business model on a more scalable one or continue building the business without investor funding. It should be kept in mind that both are feasible options.

4. Valuation Issues

There are three elements through which an angel investor can create good returns: Making a great exit, optimizing the holding time of the investment and getting in with a reasonable valuation. Thus, the valuation of the company by the time of the investment round is crucial for the investor.

While there is always the possibility to negotiate, the valuation of the company has to be in the ballpark for what the angel investor is prepared to pay considering the stage, traction, and quality of the startup. (Yes, the valuation of a startup is based on these factors. It is not based on the alternative cost of the hours the team has put into the startup or how big the IPO valuation of the unicorn X was.) If the valuation is through the roof, there is no point in wasting time meeting the team.

5. Legal Issues

It is only natural that a startup cuts some corners when it comes to administration and legal side of the business – after all, a company with 100% legal compliance can rarely be characterized as a startup. However, there are some legal issues that may constitute a deal breaker.

The most important legal issues are related to IPRs: If the competitive edge of the company relies on the IPRs the company should have ironclad protection over those IPRs. Options and other rights granted to the shares of the company can also raise issues: The cap table has to be clear and undisputed (pro-tip: always follow the fully diluted cap table). Disputes with previous shareholders' – even if they are no longer holding the shares – should be cleared.

Legal disputes are risky for the investor even when the startup ends up being on a winning side of the dispute: Startup has limited resources, so fighting a legal battle is a no-go – there is little difference between losing a legal battle and going bankrupt and going bankrupt before winning a legal battle.