How to Invest in Startups

Does this high-risk, high-reward investment have a spot in your portfolio?

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When determining whether a startup is a solid investment, you should first consider the management's track record.

Stocks can offer high risks and rewards, but there's another way to invest your dollars if you're willing to roll the dice with companies you believe in.

Investing in startups isn't for the faint of heart. These companies haven't been proven on the public stage and can easily fail, taking your investment down with them. But, for folks who can stomach a lot of risk and uncertainty, backing a great company early in the game can reap huge rewards.

It's important to consider whether alternative investments like startups have a place in your investment portfolio. Here's what you need to know about investing in startup companies:

- What is a startup, and why should you invest in one?
- How to choose a crowdfunding platform.
- How to evaluate startups to invest in.
- The risks of investing in startups.

What Is a Startup, and Why Should You Invest in One?

A startup is a company that creates a product or service from the ground up. There are different development stages of a startup, as the company gradually grows and finds where it fits in the marketplace. Startups tend to be disruptive and innovative as they try to find solutions to an existing problem. Because of these characteristics, startups can be a strategic way to diversify your investments.

"The main benefit of investing in a startup is the opportunity to get in the ground floor of a business that, if it's successful, could provide outsized returns compared to other types of investments," says Jason Steeno, president of CoreCap Investments and CoreCap Advisors in Southfield, Michigan.

While startups can be higher-risk investments, there can be a lot more room for growth compared to publicly traded companies.

In some cases, investing in a startup is more than a portfolio diversification tool. Some decide to invest in specific startups for the satisfaction of helping someone bring to market a new product or service that uniquely meets a consumer need, Steeno says.

If you're interested in investing in startups you believe in, it's best to get in at the early stage – or what's called the seed funding stage, where money is used to get the company off the ground.

You can also get into a startup during later rounds of funding, but this could present a higher barrier of entry since a company is more developed by this stage.

How to Choose a Crowdfunding Platform

Crowdfunding platforms have simplified the process of investing in startups, but be sure to take a look at how a prospective crowdfunding platform is structured before using it.

Does the platform itself take a stake in the startups? That's an important question to ask, as well as how the crowdfunding platform screens the companies it brings to investors.

Another important factor to consider before committing your funds is the opportunity to establish a relationship with the founder, says Stash Graham, managing director of Graham Capital Wealth Management in Washington, D.C. This could give you a chance to have a greater say in the underlying operation of the business.

As the startup raises capital, the odds of building a relationship with the decision-makers shrink, Graham says.

How to Evaluate Startups to Invest In

Public companies are required to report their financials on a quarterly and annual basis. These reports allow investors to learn more about a company's growth prospects and financial position.

But startup companies are not required to provide financial reports to the public. This can make it challenging for investors to do proper due diligence. That said, there are ways to work around this challenge.

While there are countless questions you can ask to determine if a startup is worth committing your cash, it might be best to start at the source. The first thing you should consider is the management's track record, Graham says.

According to Graham, there are two questions an investor should ask themselves when considering investing in a startup: Has the founder had previous success, and have they had that success in a related industry?

"When you are investing in a company this young, you are betting on the jockey," Graham adds.

Once you have considered the company's decision-makers, it's helpful to understand what's expected of your time. Each startup differs in how involved investors are and how long your funds will be invested.

Steeno says it might be worth asking if it's a short-term investment, where you'll have your capital returned in a year, or if the intention is more long term. The stage of the startup can help determine what to expect, too.

"If you're investing in an early-stage investment, there's a high likelihood you will not be able to get any capital back out for a while," Graham says. "Even if the business is going well, they'll likely need more capital to scale up the company and don't have the excess capital to return to the early investors."

Risks of Investing in Startups

Investing in a startup is risky by nature, but it can be an especially bold move in the early stages.

"There are degrees of risk involved depending on which stage the company is in – early, mid or late stage," Steeno says. "The earlier the stage of the investment, the higher the risk, as typically the company has not yet demonstrated qualities that are indicative of a successful business."

Experts say diversification among investments is a good tool to mitigate risk in this alternative asset class, rather than being concentrated in just one or even a few companies or industries. By casting a wide net, you have a better chance of finding an investment that will succeed.

Startups as an alternative investment offer investors another way to think about their portfolio allocation strategy.

It's crucial to ask yourself how an opportunity differs from other investments in your portfolio, Steeno says. For example, if you currently hold a stake in a startup that offers a specific product or service, it may not be the best idea to back another private company in the same industry.

Startups also have liquidity risk. Your cash could be tied up for 7 to 10 years, and the money you invest may not be accessible to you for a long time. There's also a possibility of not seeing that money again.

When considering investing in a startup, experts recommend that investors have an exit strategy. Steeno says to consider if there's a plan in place to take the company public, and if the capital will be needed for the long haul.

In any scenario, there's no sure-fire way to know if a company will succeed.

Choosing to invest in a startup could result in a complete loss of an entire investment – a risk that's much greater with a private company compared to publicly traded companies, Steeno adds.

Takeaway

While startups can be a high-risk investment, investors can reap big rewards if a company finds success down the line. One of the biggest considerations you need to make is how startup investments fit into your risk tolerance and overall investment strategy.

To position yourself profitability, do your due diligence in this alternative asset class and understand all possible outcomes – both positive and negative. Even if you do your best research, you should know there is still no guarantee that a startup will be successful.