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Due Diligence: Red Flags On Investment Schemes

By L Burke Files, CDDP, President, Financial Examinations & Evaluations, Inc (01/07/2014)

Everyone has their own biases when investing and I am certainly not immune. One bias that has nothing to do with any factual support is anyone wearing Qiana shirts. This was a big thing back when I was an investment banker in the late 70's and anyone wearing a Qiana shirt was shown the door – quickly.

Red Flag 1 – Too many moving parts
Any project that has more moving parts than a Swiss watch, thank you but no thank you. Possessing many moving parts maybe attractive for Swiss watches or models parading down a runway in Milan, but not in an investment. Many moving parts at best add distraction to the objective of the company. Time and money will be wasted tending to these moving parts and thus, will necessarily be taken away from the objectives of the company. At best this increases risk of failure through wasteful dissipation of assets and time. At worst these moving parts are a smoke screen for a fraud. So I say "Go way Rube Goldberg investment schemes."

Red Flag 2 – Glossy Brochure
I know it costs money to raise money. I know it takes time and effort to explain an investment scheme. That is why I prefer the entrepreneurs take that time and effort to explain the investment and not spend the money and time on glossy brochures. Those glossy brochures are especially worrisome during the initial stage investment, this is a big turn off for me. Why have they spent the money on flashy brochures instead of the project? This is a question that has to be asked and answered.

These coloured brochures remind me a bit of what it is like walking down the midway at a carnival with all of the rigged games, each displaying their increasing outrageous collections of multicolored blinky lights and smiling carnies trying to lure you to their game. I also have a big bias against glossy brochures as almost all of the frauds I have chased from Irvine, California or Boca Raton, Florida – had truly beautiful coloured brochures to mask the callow attempts of the sales men and entrepreneurs to lure victims to the investments. So I say "No thanks to blinky lights carnal midways and colour brochures."

Red Flag 3 – Who?
Ok, I am a due diligence weenie, I get it. Yet, look at some of the offering documents even for NYSE listed companies. Who are their officers and directors and what are their backgrounds? So many offering documents are so sparse on management bios you think they are worried about the cost of additional ink. I have seen these disclosure documents contain barley a name and two or three sentences on their background! I found better formatted backgrounds on LinkedIn than one often finds in many of these offering circulars and disclosure documents. I want to read more than "Thurston Ez Garunak attended an ivy league school and has worked in senior management positions for the last 21 years." A company is led and managed by management. These truncated bios are utterly insufficient for any choice making whatsoever. So I say "No bios – no bucks."

Red Flag 4 – What?
"...Our product possess ethically derived technology that is appropriate for integration in resource poor areas and will remain culturally sensitive while also being sufficiently

scalable as to allow the company to leverage its position with the initial placements of the technological devices, in LDCs and TPLACs, to less margin sensitive areas and mobile applications without harming the integrity of the intellectual property protections afforded to all new devices until plural party patent treaty recognition frameworks as adopted by the UN, EU and the Federation for such devices."

Huh? The Jingoistic jumbles of buzz words leave ones cerebral cortex is such a state of flux and overt synaptic discharge fatigue that one might be wary of the collective of the entrepreneurial enterprisal body's ability to covey to the anxious but yet less learned rabble of the street the nexus of the opportunity afforded to them. Ok so that was fun, in short if they cannot explain to Ma and Pa Kettle what it is they are doing – they cannot explain it to themselves, the investor, or the ultimate consumers. So I say "Kiss off to those what can't understand K.I.S.S."

Red Flag 5 – Who is your customer?
Businesses are established to create and deliver services and products to customers for money. Wow there's a concept. But, so often when I ask an entrepreneur these questions: Who is your customer? Where are your customers? How do you know your customers will buy your service/product? – I get a blank stare. A good idea is just a good idea without understanding the market, really understanding the market.

To understand your market you need to assemble lists of customers or types of customers and begin to actually talk to them. As an investor in, and coach of, development stage companies this is one of the most overlooked areas I come across. No matter how honest, sincere, and diligent a team of entrepreneurs may be, if they do not have detailed knowledge of their customers – they are not ready for money. Money applied to additional research and development is mostly likely to be wasted as one does not know the nature of the end product that will be most commercially desirable and at what price points. So I say "If you don't know you customer you will not know my cash."

Red Flag 6 – Too many suits.
It has been my experience that development stage companies staffed with senior managers of big corporations, lawyers and accountants are a bad choice. I am sure that they are very talented and skilled professionals. I am sure that they have a lot to offer, but not in an entrepreneurial environment. To make an analogy – these professionals are used to driving modern luxury cars that are insured, cleaned, and serviced by others. That is fine, that is their world but to continue the analogy, entrepreneurial organisations are more akin to driving a Deux Chevaux and enjoying all the F^3 (fiddle fart factor) of owning and operating those lovely crusty beasts. These people just do not get down and sweep the floor or fix programming failures – they look for others to do it. So I say "Too many suits – not many shillings."

Red Flag 7 – Flash without cash.
I am reminded of a company back in the 1980s, one of my first due diligence reports. I visited the company that had no products and was only raising money to defend their patents. In the President's marked and shaded parking spot was a Ferrari. Some people just cannot be allowed to touch other people's money. Instead of investing the money in what could be considered productive deployment – it consumed on leased Cadillacs, leased expensive furniture, office space at expensive addresses and event tickets or expensive golf outings. Flashy consumption is not how investor money is to be used. Investor funds are to be used in a Spartan fashion, aggressively deployed to get a service or product to market. No, I say "If you like flash, I'll keep my cash.

All of these are my, "back of the envelope" assessments. Quick assessments used to ferret out guaranteed losers.

Do share with me and the IFC any of your "back of the envelope" assessments that you like to use.