The Role of Crowdfunding in Entrepreneurial Finance

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Abstract

This study examines the relatively new trend of crowdfunding in entrepreneurial finance. Crowdfunding is the financing of a project or a venture by a group of individuals instead of professional parties such as, for instance, banks, venture capitalists or business angels. The study examines how crowdfunding works and compares and contrasts this concept with the related concept of crowdsourcing. The study also examines the global market for crowdfunding and the rationale of businesses to crowdfund or crowdsource their new ventures, given the challenges of capital formation for fledgling enterprises. The market for crowdfunding is examined in the context of different crowdfunding models. In this context, the study also includes illustrations of enterprises that have adopted specific models given their strategic objectives. Presently, equity crowdfunding is not legal in Canada and is sought to be legalized in the U.S. under the JOBS Act. These issues are be discussed in the study.
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An Introduction to Crowdfunding

Crowdfunding can be defined as the financing of a project or a venture by a group of individuals (“the crowd”) instead of professionals such as banks, venture capitalists, or business angels. Typically, in crowdfunding initiatives, funds are raised through relatively small contributions from a large number of people (who represent “the crowd”), mostly through the internet without a traditional intermediary such as a bank.

As many businesses have increasing difficulty in gaining access to capital, entrepreneurs are seeking alternative financing venues. This phenomenon has spurred the global growth of crowdfunding websites that provide platforms for entrepreneurs to raise funds (Griffin, 2012). As Griffin points out, crowdfunding is akin to posting a classified advertisement on a website like Craigslist.com with the difference that, through crowdfunding sites, entrepreneur can also advertises a business concepts and requests for funding from “the crowd”. Entrepreneurs provide a pitch, usually a business plan, detailing the businesses’ activities and objectives and the entrepreneurs’ plans for using the funds that are sought to be raised. The platforms also inform funders what, if anything, he or she will receive in return for the capital contribution. This is typically done through a terms sheet.

Crowdfunding vs. crowdsourcing

In this context, it would be interesting to examine a related concept, that of “crowdsourcing”. Through crowdsourcing, a firm outsources specific tasks essential for the making or sale of its
product to the general public (the crowd) with the aid of an open call over the internet. Consumers “volunteer” to contribute to production processes and create value. Indeed, in one respect, crowdfunding can be considered to be an element or sub-set of crowdsourcing as volunteers are sought to provide financial help.

**Why crowdsourced or crowdfund?**

What are some benefits of crowdsourcing? A major benefit is thought to be the voluntary task-force of consumers that often helps save costs. Also, to the extent that the crowd may provide more insights faster than a small team of employees, this can in effect reduce the length of new product development. Crowdsourcing can also be very beneficial from a marketing standpoint since involving a committed crowd is likely to result in better customer acceptance, and also more awareness of the “newness” of a product. The central idea is that “collective intelligence or wisdom” creates efficiency, more so for diverse crowds (Schweinbacher and Larraide, 2011).

However, there are differing views on the extent to which a crowd provides such collective wisdom.

A related question is how does crowdfunding work? Essentially, the process is as follows. The entrepreneur publishes a request for funding on the crowdfunding website, describes the proposed product and provides a business plan. The entrepreneur also indicates what, if anything, individuals who contribute money to finance the business will receive in return. An essential ingredient of crowdfunding is the internet and, therefore, the crowdfunding platform (website) facilitates all exchanges of funds.
Types of Crowdfunding

In this section, I examine various models of crowdfunding that have been adopted by different platforms. For an excellent detailed discussion of the different types of crowdfunding models, see Bradford (2012).

*Donation Sites:* Contributors donate funds mostly for charities and other non-profits and sometimes for-profits as well (Griffin, 2012; Bradford, 2012). These represent a small proportion of overall crowdfunding activity (about 22% in 2011). For instance, GlobalGiving.com, enables donors to directly contribute to development projects worldwide and takes a 15 percent fee. Another example is EpicStep.com which is a donation platform for financing billboards. One of EpicStep’s well known successful initiatives is the WikiLeaks billboard in Los Angeles.

*Reward and Pre-Purchase Sites* These do not offer interest or a part of the earnings of the business. However, depending on the amount of contribution, they could offer different categories of rewards. Rewards could range from notes of thank you for smaller contributions to small tokens of appreciation, such as key chains, to having the contributor’s name on the credits of movies that are sought to be financed through crowdfunding. An increasing number of movies are being financed in this manner. For instance, about 10 percent of movies at the 2011 Sundance Film Festival were financed through crowdfunding platforms.

Sites offering the *pre-purchase* option are very common. The pre-purchase concept enables contributors to receive the product that the entrepreneur is making. For instance, if a music
album is being sought to be financed through crowdfunding, through the pre-purchase option, contributors would have the right to buy the album at a reduced price upon completion. Leading Reward and pre-purchase sites include Kickstarter and IndieGoGo.

**Transaction-Based Compensation**

Often, crowdfunding sites charge fees only if financing is successful. If fundraising is unsuccessful, entrepreneurs pay no fee. Fees can range from 4 to 9 percent. Sites that charge fees in this manner include Kickstarter and IndieGoGo (Bradford, 2012).

**Lending crowdfunding sites**

There are two categories of lending sites; those not offering interest and those that do offer interest. A prominent example of a site that does not offer interest is Kiva, which provides funds to microfinance lenders, or “field partners” worldwide. Entrepreneurs post loan-requests on the Kiva site. Lenders only receive their principal back; the field partners use any interest received to cover their operating costs. There are also a number of traditional lending crowdfunding sites that offer interest. These are known as peer-to-peer lending sites. Two U.S. based examples of such sites are Prosper and Lending Club. Lenders purchase notes issued by the sites which use those funds to lend through Paypal to borrowers.

Lenders get paid if borrowers pay back. Transaction fees and interest on loans depend on the borrowers “credit risk”. Loans that charge interest typically are viewed as ‘securities” and, therefore, for regulatory purposes fall within the domain of securities regulation. As we will be seeing in a later section, the issuance of securities by crowdfunding sites is still in the process of
being legalized in the U.S. In Canada, at present crowdfunding sites cannot legally issue securities.

**Equity crowdfunding sites:**

These exist mostly in some European countries and to some extent in Australia. Equity crowdfunding sites offer investors a share of the profits of the business they are funding rights. Depending on a country’s regulatory regime, equity crowdfunding sites can take different forms. For instance, these may or may not include voting. Such sites do not exist in Canada because of regulatory issues pertaining to the sale of securities. Indeed, at present, these sites exist mostly outside North America. A prominent German site that has been successful with the equity crowdfunding model is SellABand.com. This site raises funding through donations as well as investments in the form of debt and equity to fund independent musicians seeking to complete albums. A unique feature of the site’s business model is the option to share revenue from album sales with investors. Some pure equity sites include Crowdcube.com from UK or Buzz Entrepreneur from France.

**The state of crowdfunding globally:**

According to the website, crowdsourcing.org, as of April 2012, 452 crowdfunding platforms (or CFPs) were operating globally. In aggregate, CFP’s had raised almost $1.5 billion in funds in 2011. By and large, while the United States remains the largest market for fundraising the European market has been growing rapidly. Funds raised through crowdfunding initiatives grew at a 63% compounded annual growth rate (CAGR) over the last 3 years, primarily driven by donation and lending-based platforms. Currently, reward-based platforms are growing at the fastest rate but perhaps this is so because the growth has occurred from a smaller base.
As of 2012, most CFP’s belong to the reward-based category of CFPs, although equity-based platforms represent the fastest-growing category in terms of net year-on-year growth. At present, there are no equity-based platforms in Canada or the United States. Not surprisingly, therefore, reward-based and equity based platforms are higher in numbers in Europe than in North America.

Crowdfunding platforms have been very active and, in 2011, ran over 1 million successful campaigns. The majority of these campaigns were in the donation based category, followed by rewards-based ones but equity-based campaigns were, on average, much larger in size in terms of funds raised. Lending-based campaigns had the smallest share. For instance, on equity-based platforms, only 6% of funds raised were for projects below $10,000 of total funding. However, about 21% of funds raised were for projects of $250,000 or more in funding of which 80% exceeded $25,000.

Clearly, relatively larger sums are raised through equity-based platforms. These platforms are, therefore, viewed as a viable option for raising capital to fund small business and start-up initiatives. The campaigns in the donation and reward categories are generally smaller in size.

**Crowdfunding type and nature of projects**

Are different funding models more suitable for certain types of activities or initiatives? In general, according to crowdsourcing.org, crowdfunding enterprises that provide for financial return through equity-and lending-based platforms appear to be best suited for digital
or computer games, films, music, or literature. On the other hand, donation-and reward-based crowdfunding models appear to be best suited for cause-based campaigns that appeal to funders’ personal beliefs and passions, for instance, the environment, community or faith-based initiatives, or those pertaining to the performing arts.

**Challenges of capital formation**

Can crowdfunding play an useful role given the well-known challenges associated with capital formation for small and fledgling enterprises? Broadly, the challenges are as follows:

(a). Small businesses face a capital funding gap. Traditional sources of small business funding such as bank loans, venture capital or angel funds, are generally not available to most start-ups and other very small businesses. Often, entrepreneurs have no choice but to use personal funds, credit card debt, second mortgages, funds from friends and family members or other means that are commonly referred to as “bootstrapping”.

(b). From a societal perspective, a funding gap could result in promising projects going unfunded costing an economy jobs and loss of potential innovations.

(c). A related problem is that of informational inefficiency resulting in the failure to match sources of capital with opportunities. The creation of geographical clusters can often help mitigate this challenge. Crowdfunding platforms, by enabling virtual clusters on the internet, can potentially provide powerful benefits in this regard.
Benefits and Costs of the crowdfunding exemption

An often cited benefit of crowdfunding enterprises is that these facilitate capital formation, especially for very small startups that would otherwise not have access to fund-raising opportunities. Crowdfunding enables small investors to fund smaller business opportunities that venture capitalists and angel investors would otherwise not touch.

Another cited benefit of crowdfunding is that it also allows poorer entrepreneurs, who may not have access to personal funds or wealthy friends and family-members, somewhere else to turn. A limitation of the crowdfunding model relative to venture capital or angel funding is that the latter also, often, provide valuable mentorship to investee enterprises (Burtsch et.al 2012).

Since a fundamental tenet of the crowdfunding model is to seek funding from the public, if such funding is sought through the issuance of securities, then registering such securities through the provincial securities commissions in Canada or the Securities and Exchange Commission becomes a requirement. However, proponents of crowdfunding exemption feel that this is not a viable option because the securities registration process can be prohibitively expensive. One way of being exempt is to offer securities as “private placements” to accredited investors. However, the nature of crowdfunding prevents security issues to be classified as “private placements’ to accredited investors. The central debate, therefore, is whether the potential benefits of crowdfunding in terms of facilitating capital formation outweigh the costs that pertain largely to investor risks associated with business failure or fraud. A counter-
argument, however, is that a securities exemption would not open investors to new risks because they are already contributing through “non-securities” crowdfunding. Under this perspective, issuing securities could offer higher returns to offset those risks.

The JOBS Act (2012) in the United States

Following an intense lobbying effort by different interest groups, the Jump-start our Business Startups (or JOBS) Act was passed in the United States in 2012. The enactment, in effect, legalizes, under Title III, debt and equity-based crowdfunding. Until the passage of this Act, investors could not publicly solicit funds from unaccredited investors. The legislation is still in its formative stages and the Securities and Exchange Commission in the United States is in the process of designing many of the rules.

Some salient aspects of this Act are provided below:

(i). Companies can raise upto $1 million from investors and upto $2 million if they provide audited financial statements

(ii). Financial statements disclosure is not needed for enterprises in which the number of shareholders is below 1000.

(iii). Investors with annual income of less than $100,000 may invest upto the greater of $2,000 or 5% of their annual income in such enterprises. For income above $100,000 per year investment
permitted up to 10% of total salary but should not exceed $100,000.

The JOBS Act is not expected to be fully effective until 2013.

**What about Canada?**

Securities-based crowdfunding is illegal in Canada but donation-based platforms exist. An example is FundWeaver that is aimed at funding Native Canadian ventures and projects. Another example is Podium Ventures that uses social networks to connect new high-tech ventures with accredited investors. Some other crowdfunding platforms based in Canada include Sokap and IdeaVibes.

**Conclusions:**

This study examines the relatively new trend of crowdfunding in entrepreneurial finance. The study examines how crowdfunding works and compares and contrasts this concept with the related concept of crowdsourcing. The study also examines the global market for crowdfunding and the rationale of businesses to crowdfunding or crowdsource their new ventures, given the challenges of capital formation for fledgling enterprises. The market for crowdfunding is examined in the context of different crowdfunding models. In this context, the study also includes illustrations of enterprises that have adopted specific models given their strategic objectives. The legal environment for equity crowdfunding in North America, including the recent passage of the JOBS Act in the U.S, is also discussed.
Bibliography:


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