Crowdfunding: crowding in or crowding out?

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Crowdfunding might be the solution to our funding problems, but too much could crowd out institutional investors.

Start-ups and early stage businesses have usually been the territory of the three f's: friends, family and fools. Typically, when the f's have been exhausted, the projects that survived and still show promise would turn to institutional providers – banks, debt providers and venture capitalists. However, these sources have effectively dried up over the last two to three years. At the same time, a new fourth element has emerged to add to the three f's: crowdfunding. A combination of the decline of institutional funding and the emergence of crowdfunding, has the potential to change the entire funding landscape at the early stage.

Crowdfunding is the process by which large numbers of private individual funders are connected through a web-based platform to projects and businesses that need funding, typically at a relatively early stage. Such funding covers a wide spectrum from simple donations through loans to equity investment. Crowdfunding is developing an increasingly important role in funding for smaller businesses. A recent report published by Nesta is a timely indicator of the importance of this rapidly growing phenomenon.

The action of crowds in funding has a chequered history; is it collective madness or collective wisdom? We know that crowds are perfectly capable of making dumb decisions on a truly colossal scale, such as Tuplimania and the South Sea Bubble. In that sense, are crowds any worse than the financial institutions that brought us the dot com bubble, the sub-prime crisis and many more?

The more important question is whether crowd funding could develop to the point where it progressively replaces - or, crowds out - the institutional funders. Is this good or bad? The ability of individuals using the web to invest in areas of finance from which they were previously excluded, represents a profound change in the smaller business landscape. This change will undoubtedly affect SMEs, the organisations that have been their traditional source of finance and their armies of camp followers of accountants, lawyers and corporate finance advisors.

If crowdfunding takes off in the UK, it couldn't come at a better time. Funding for SMEs is incredibly tight, but for start-up and early stage projects, is virtually non-existent.

- Banks are caught with the brutal choice of either repairing their balance sheets or providing growth. They risk money to smaller businesses, and as a taxpayer and shareholder in two of the biggest UK banks, frankly, I would prefer the former.
- Government lending and investment schemes have been woefully slow in deploying any monies (debt or equity) in the small company sector.
- Venture capitalists and VCT investors have generally moved to later stage investing.

This has effectively left just a few hardy VCs, some angels and EIS investors as the only game in town. Crowdfunding led by the likes of Kickstarter, Zopa, Funding Circle and Crowdcube, is filling up many of the gaps created as institutional providers vacate the early stage.

Crowdfunding covers a wide variety of activities from charitable giving to social projects, debt lending to individuals. From small companies through to equity investments in start-up projects, and even pre-IPO funding of substantial and fast growing companies. The common themes that characterise virtually all of these activities are:

- Investors committing small individual sums;
- More than money; projects are often of interest to investors for both financial and other reasons;
- Investments being made through a web based platform, taking responsibility for managing the fund raising and undertaking limited due diligence on behalf of investors;
- More simplified and often direct legal arrangements between investors and their targets.

So, what's driving this growth?

- Democratisation of the funding process. Ease of access through the web and utilising common social networking methods.
- Early market validation. Individuals can now decide what products and services they want to see brought to market, and participate in the development of those products.
- Lower costs for investor and the company.
- Lack of restrictive regulation. This is currently one of the true joys of the crowdfunding phenomenon. Regulation via the FSA in the UK and AIMFD in Europe is progressively throttling the early-stage funding process. Crowdfunding could return this sector to the free-wheeling, risky and highly innovative place it should be.

The whole crowdfunding process places great trust and power in the hands of the platform provider; Sponsume.co.uk, Medstartr, Rockethub. The platform provider decides who gets to invest and what projects get funded. Basic due diligence and legal structuring is provided by the platform provider. The better platforms encourage the kind of transparent debate amongst prospective investors that provide the most insightful diligence on new projects. Projects involving new ideas or products are using the fund raising process to secure valuable feedback from prospective investors. The company gets early market feedback and potentially early adopter buyers. The investors get the product they want, and early market validation. It's a win-win.

With this degree of control comes a large element of trust and responsibility on the shoulders of the platform providers. These platform providers need to appreciate that the reputational risk for the whole sector lies with them. In order to justify that trust and avoid the market being killed off by unwarranted over-regulation, the platform providers need to exercise extreme vigilance in the deals they bring forward for funding.

One of the great merits of crowdfunding is that it represents a return to a simpler and healthier relationship between funder and fundee. Early stage funding has become unnecessarily complicated with legal and regulatory structures that might suit a $100m pre-IPO funding, but make no sense in raising £50,000 or £100,000 in project finance for a medical device startup.

The development of crowdfunding will change the investment landscape from the point of view of institutions. It represents both a threat and an opportunity. Crowdfunding has the capacity to replace the role of institutions (governments, charities, investment organisations) in smaller scale activities. This could be a welcome development, allowing private individuals to experiment with projects which would, if successful, attract further funding from both crowdfunders and these institutions. In the case of financial institutions, such crowdfunding could develop to the point where they crowd out institutional investors.

We can envisage the market developing to the point where institutional funders will follow initial investments made by crowdfunders. The question will be whether crowd investors or companies will allow institutions to intrude later in the progress of young businesses. With crowdfunding expanding into just about every area from early stage through corporate bonds and IPO, we can envisage the crowd model beginning to impact the corporate finance model.

This is not all good news. There will inevitably be a crowdfunding scandal of some sort; there's a fair chance that a deal already funded will emerge as some sort of scam. Is this a reason not to proceed? No, even with the benefit of the highly regulated financial service sector, we still had a slew of scandals from rate rigging to PPI mis-selling. Could a crowd funding scandal be any worse? Probably not.

There is a trade-off here for government. Generally, crowdfunding schemes are not tax driven, and don't represent lost revenue. In addition, there is no underlying government guarantee as with bank deposits. This is very much "buyer beware" territory, but most crowd investors will understand that. Nevertheless, some form of regulation will be needed. Hopefully such regulation will reflect the underlying contract between investor and investee at the early stage, which should be an equivalent of "I will give you money and you will give me a share certificate."

Everything else should rely on proper diligence and good post investment monitoring. Every step away from this basic position will hinder rather than help both parties.

Crowdfunding as presently configured embodies this general spirit, and everybody with an interest in encouraging a vibrant early-stage sector in the UK, should welcome this crowd with open arms and open minds.

Ernie Richardson is an experienced VC fund manager who now runs his own advisory business, Eastwood Langley Ltd.