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Equity Crowdfunding Market

The market for equity-based crowdfunding has recently emerged allowing entrepreneurs to allocate funds by drawing on small financial contributions from a distributed audience of investors in exchange of equity or equity-like shares of the business (Ahlers et al. 2015; Gerber et al. 2013). The crowdfunding movement might be a paradigm shift in allocating financial resources (Bellaflamme et al. 2012; Burtch et al. 2012) as it allows entrepreneurs to spread their ideas, plans and visions to millions of potential investors all around the globe in a quick and efficient way that is mainly boosted by the expansion of Web 2.0. and its inherent social networking capabilities (Lehner 2013; Kopetzky et al. 2013; Ernst et al. 2016; Vismara 2016; Ernst et al. 2017). Ever since the first crowdfunding platform ArtistShare was launched in 2003 by Biran Camelio in order to find a new way that enables musicians to collect donations for their new album recordings, different forms of crowdfunding models have emerged and projects of nearly any conceivable kind have been realized by drawing on small financial contributions from a large group of people. This paper focusses on equity-based service models as they are a frequently used and maybe the most promising type of crowdfunding for the financing of startup businesses. The crucial ingredient in crowdfunding is its internet-based approach that allows entrepreneurs to reach out to a substantially larger audience of potential investors (Ordanni et al. 2011; Griffin 2012).

So far, several types of crowdfunding service models have emerged which are usually classified among four different categories (donation based, reward-based, lending-based, equity-based). Equity-based crowdfunding is the most recent service model and subject to various regulations. In this type of crowdfunding investors receive the opportunity to financially support a startup in exchange of equity or equity-like shares of the business. Equity crowdfunding models are typically arranged as silent partnerships, debt participation rights and subordinate profit-participating loans, although all dominant equity platforms in Austria and Germany make use of subordinate profit-participating loans as their underlying form of participation. In subordinate profit-participating loans investors can yield a monetary return in three ways.

Firstly, they can receive an annual interest in profits in return for their investment. This profit-sharing scheme enables investors to yield an annual financial compensation according to the periodical gains of the business. Secondly, investors have the chance to financially profit from exit proceeds in case the enterprise experienced an appreciation in value during the loan period. If a third large investor buys the majority of the startups shares during this loan period, investors from the crowd are bought out and receive a compensation according to their initially acquired stake. If the business is not sold, an investor has to pass the entire length of partnership in order to sell his shares which are typically reevaluated on the basis of industry multiples. The loan period for equity crowdfunding investments is contractually fixed to a minimum period of time, usually 5 years and more. As startups usually do not yield large profits in their initial phases, exit proceeds are likely to be of higher importance to investors than the periodical profit-sharing schemes. A last reward component that may yield a monetary return in equity crowdfunding initiatives that are arranged as subordinate profit-participating loans are fixed interest rates in the contractual item. These are typically low, ranging between 1 and 2 percent per year and have to be regarded as a form of debt. This makes many equity-based crowdfunding campaigns a form of mezzanine financing that are characteristic of something in between debt and equity (Vismara 2016). In the case of insolvency, an investors claims are not honored until the claims of all other creditors are satisfied and they are further incapable to directly influence the startups business operations, as the commonly granted voting rights of shareholders are not associated with subordinate profit-participating loans. If an initiative is able to successfully collect the aspired funds, crowdfunding platforms for equity charge a transaction fee that typically amounts for 5 to 10% of the total financing volume.

Assets

The main advantage of crowdfunding is given by the opportunity to allocate funds by drawing on small financial contributions from a large group of people. Because of its internet-based approach and the accordingly low search costs, the matching of entrepreneurs with investors became more effective and efficient in crowdfunding (Agrawal et al. 2014). This might bring people together to whom it would not have been possible to connect without this medium, but apart from that the speed of funding is intensified as well. Apart from the WEB 2.0 characteristics that make the matching more efficient and effective, the usually small participations might accelerate the funding ***speed*** as well. One might argue that a small investor from the crowd does perform less risk evaluations and due diligence as each minute spent on analysis for a small investment becomes relatively more expansive compared to time spend on analysis for larger sums provided by for example business angles and venture capitalists. So equity crowdfunding provides startup businesses the opportunity to allocate large sums fast and efficiently, but the phenomenon does incorporate more benefits than a pure allocation of funds.

Besides the chance to receive valuable feedback on how to improve the business, equity crowdfunding might also ***reduce the risks*** for entrepreneurs. As the allocated capital is usually just payed off to the entrepreneur after a predefined threshold in funds is reached, or exceeded and as the already invested funds are returned to the investors in case it is not, negative feedback and an unfavorable group assessment from the crowd can allow entrepreneurs to stop the funding in time without being forced to undergo any financial obligations.

Unlike equity participations from venture capitalists or business angles that come along with a deep involvement in the business and a partial loss of ***control***, the rather equity-like arrangements in crowdfunding do enable entrepreneurs to keep more control of their business as they do not comprise any active voting rights for investors. In contrast to traditional equity investments, founders in equity crowdfunding can therefore remain the sole decision maker of the enterprise.

Furthermore, the equity market for startup businesses is highly ***geographical*** concentrated and startups can remain unfunded due to these geographic frictions. Equity crowdfunding has the potential to bridge these geographic burdens because the Web 2.0. capabilities allow for it and also Agrawal et al. (2014) have empirically shown that the average distance between artist-entrepreneurs and investor is about 5.000 km in equity crowdfunding, indicating that the geographical barriers which are typically associated with the financing of entrepreneurial ventures can be lowered through this from of funding.

Equity crowdfunding can be regarded as a more ***democratic*** way of allocating financial resources. In crowdfunding, it is the platform that acts as an intermediate to pool other people's money just like banks, venture capitalists and other financial institutions do. The fact that each small investor out of millions worldwide individually decides on which initiative to support makes crowdfunding a more democratic means for allocating funds, in contrast to the financial decisions made by a single or only view traditional sources of capital. Considering all these benefits, equity crowdfunding cannot solely be regarded as a new way of raising funds, which most definitions imply. The phenomenon should also be considered as a new and more democratic means that enables entrepreneurs to perform a pre-market product validation, to increase the public attention, to attract further resources for the business development, to reduce their risk and to stay the sole decision maker of the business.

Hence, an entrepreneur's motivation to use equity crowdfunding might be driven by the opportunity to perform a ***pre-market test***. In crowdfunding, low communication costs can ease the gathering and monitoring of information for distant investors, but they do likewise enable the crowd to participate in the development of the business itself (Agrawal et al. 2014). Apart from the fact that investors do obtain no active voting rights with their participation, many platforms for equity crowdfunding have closed investor-relations-areas that allow entrepreneurs and investors, but also investors among each other, to share critical thoughts and to provide feedback. It still has to be questioned how valuable the feedback from these small and unsophisticated investors in crowdfunding really is. One advantage may come from the reward-based elements that are frequently included in equity crowdfunding campaigns as they might make the project highly attractive for product enthusiast. If investors in are from the startups core market at the same time, they are likely to be endowed with relevant information about the needs and requirements of the targeted consumer group. The reward-based elements do further allow entrepreneurs to better asses their consumers' willingness to pay as they enable them to perform an initial form of price discrimination. Price discrimination takes place, when: "...the same commodity is sold at different prices to different consumers (Phlips 1983). In equity crowdfunding, the pre-ordering elements can allow entrepreneurs to yield larger profits as they might price discriminate between the consumer groups of supporters that pre-order the product through crowdfunding and those future consumers who wait until the product is launched on the market (Belleflamme et al. 2014). By prescribing varying prices to these groups, entrepreneurs might on the one hand charge higher prices to those eager customers who do not want to wait until the actual product is available on the market, but it also allows them to derive first conclusions about their future consumers' willingness to pay and to get a better understanding on which prices to be set later on the market.

Drawbacks

Next to multifaceted advantages that equity crowdfunding can provide, there are also problems associated with the phenomenon for both, investors and fund-seekers.

As the potential of equity crowdfunding is not limited to the attraction of financial resources, the risks associated with the phenomenon are likewise not restricted to ***unsuccessful funding*** attempts. At the very beginning of a crowdfunding attempt, entrepreneurs might face the situation of not being accepted to post their project on a crowdfunding platform. Compared to other service models in which basically everybody can post his project, platforms for equity crowdfunding do by contrast perform sophisticated due diligence of the business plan and idea with a special focus on the financial figures before accepting an initiative. The number of rejected attempts is hard to determine as some platforms are also blamed to lack in transparency. A further hurdle for entrepreneurs, in the case of being accepted by an equity crowdfunding platform, is that many projects fail to raise the required capital and do not reach their targeted financing threshold. This situation is solely caused by insufficient support from the crowd.

Idea theft might be a major risk for entrepreneurs in crowdfunding as the disclosure of crucial information is outreaching to a much broader audience in contrast to funding attempts where traditional sources of external capital are addressed. At the same time, the disclosure of some strategically relevant information might be an unavoidable measure (Engelhart-Nowitzki et al. 2011) in order to convince investors of the startup's competitiveness and to attract their financial support. Idea theft is in particular threatening startups whose products or services can be easily imitated and as the funding process itself does take some time, there might be enough time for established competitors to copy the product, the business model or any other crucial component of the business that comprises some competitive advantage (Brasseur et al. 2017; Becker et al. 2012). Due to the large number of potential backers, non-disclosure agreements between entrepreneurs and investors appear to be no viable option as it would be either impossible or legally too difficult to arrange these on such a large scale. Attempts to reduce the circle of insiders are closed investors groups, in which elements like a detailed business plans can solely be accessed by registered users. Due to the anonymity in the internet, this measure will most likely not prevent competitors to conceal their real identity and gaining access to the desired information.

Next to the risk of revealing strategically important information online, the ***investor management*** in crowdfunding might be disadvantageous as well. In contrast to traditional financing via business angles, venture capitalists and also banks, crowdfunding involves hundreds or even thousands on small investors.

Communicating with such large groups is likely to be more costly and time consuming compared to the communication with only view financiers.

Furthermore, business angles and venture capitalists usually provide valuable product and market knowledge, business networks and founding experiences along with their financial participation. Under the assumption of small and unsophisticated investors it is less likely that these advantages can be provided by the crowd. Even under the conjecture that single investors in crowdfunding do have equivalent ***expertise*** or networking capabilities, their usually small stake in the startup is likely to prevent them to share their assets as traditional investors do with their large participations.

Apart from the entrepreneurs, equity crowdfunding might also be disadvantageous for investors. The internet and fraudulence do often co-occur and equity crowdfunding can expand the place for criminals to defraud innocent people. In a reward-based crowdfunding setting, Mollick (2014) has empirically shown that entrepreneurs appear to make attempts to deliver the promised product and that fraudulent intentions are rare. But in his study, Mollick just considers "take the money and go" situations and disregards false promises, misleading information or incorrect use of funds by crowdfunding initiator. Despite the presumable thread of ***fraud*** there are also favorable arguments against this risk which Griffin (2012) constitutes as followed. First, the social benefits that equity crowdfunding can induce will exceed the damages of fraud for the overall society. Secondly, he argues, that the online community will detect criminals and reveal their practices online. Furthermore, investment caps that limit the investable amount by each individual do serve as an appropriate investor protection and lastly the author states that also crowdfunding platforms do have an incentive to kick out fraudulent actors in order to retain a good reputation for a save investment environment.

Even if an initiative is accepted by a crowdfunding platform, has reached its desired funding goal and if there are further no fraudulent intentions of entrepreneurs, there is no assurance for investors that the project delivers in time, ***deliver*** what was promised or even delivers anything at all. Based on data from a reward-based crowdfunding provider, Mollick (2014) has empirically shown that not even one-fourth of the campaigns delivered their product in time and among those with delay, the mean was about 2.4 months. The smartwatch "Kreyos Meteor" was in contrast to the success story of the "Pepple Watch", a great story of failure. While the entrepreneurs raised 1.500% of the initially targeted $100.000, the product was delivered late and had only view common characteristics with the initial promise. Unlike claimed, the watch was not waterproof, the gesture control was entirely missing and the overall watch appeared to be of only little practical use. In equity crowdfunding, the combination of delivering the product and also equity value by establishing a company might become in particular challenging (Agrawal et al. 2014).

Conclusion

Equity crowdfunding describes a recently emerged phenomenon that allows entrepreneurs to allocate funds by drawing on small financial contributions from a distributed audience of investors in exchange of equity or equity-like shares of the business. This alternative strategy has enabled a new type of business model. This paper elaborates on assets and drawbacks of equity crowdfunding.

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