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I. M.

Crowdfunding. Overview of the industry, regulation and role of crowdfunding in the venture startup

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Structured Abstract

(Purpose) This thesis aims to take stock and systemize existing knowledge on crowdfunding while providing overview of the industry, its regulatory environment and advancing the insight into the role of crowdfunding in the startup lifecycle.

(Design/metodology/approach) It is adopting an exploratory and phenomenon-based approach which is deemed appropriate when investigating rather new phenomena. Furthermore, the work combines survey and interview methodologies to assess the opinion and real-world behavior of different stakeholders in crowdfunding marketplace and identify gaps requiring further academic consideration.

(Theoretical Perspective) Grounded in limited theories surrounding crowdfunding as well as adjacent fields such as early stage, informal and angel investment.

(Metodology) Empirical data was gathered using multiple interactive web-based questionnaires distributed to different stakeholders and "informed general public" mainly through the social networks (Linkedin, Facebook and Twitter) and di rect solicitation of entrepreneurial associations, networks and online communities. The study relies on bot h qualitative and qu antitative analysis in attempt to find data patterns useful in future research and establish some managerial and pol icymaker recommendations based on limited evidence collected.

(Originality and practical implications) The work adds value to this field through a 3-fold contribution: Taking a look at crowdfunding through the prism of SWOT analysis of the practice itself and Porter's 5 forces analysis of crowdfunding platforms industry. Providing evidence in favor of implementing various degrees of regulation based on different crowdfunding categories, using the Italian case of equity-based crowdfunding regulation as a model. Finally, it yields some interesting findings on relevance of crowdfunding in the venture startup while pointing out key motivators which make entrepreneurs consider this fundraising option. In addition, related policymaker/managerial implications are exposed and academic literature updated with reference to contemporary developments in this dynamic field.

Keywords: crowdfunding, industry overview, regulation, role, dynamics

Paper type: MSc thesis

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Introduction

The last few decades have been filled with technological advances and persistent innovation. Advent of new communications channels, such as Internet, has revolutionized the way how people interact and conduct business. Naturally, some sectors of the economy have seen more change than others. Private equity and business lending institutions remained mostly unchanged during this period, resisting any significant adjustments in their business models. However, their role might soon be complemented, if not even challenged, by potentially disruptive advancements in the Web space populated by globalized collaborative communities.

Web 2.0 made it possible for internet users to be more than just passive recipients of the content; it enabled active participation and interaction, thus laying foundation for the emergence of many recent phenomena, such as social media, crowdsourcing and crowdfunding. The role of Web 2.0 as a marketing, communicational and educational tool has been analyzed and extensively explained (Jones and Iredale, 2009), however little less is known about how Web 2.0 facilitates formation of new ventures by assisting in pooling ideas and overcoming difficulties in acquiring sufficient funding. In this work we will focus on the role of crowdfunding in a venture startup, always having in mind that Web 2.0 is a critical ingredient which actually facilitates the access to the “crowd” (Belleflamme et al., 2010).

Through crowdfunding an entrepreneur rises external financing by leveraging a large group of people (hereafter referred to as simply the “crowd”), where each individual provides a relatively small amount of money (Belleflamme et al., 2013). This is done as an alternative to soliciting one or more sophisticated investors and the internet is almost exclusively being used as a channel of communication instead of face-to-face presentations or “pitches”. Crowdfunding derives from a broader concept of crowdsourcing, which is simply pooling ideas or solutions from the crowd in order to meet some private or corporate need (Belleflamme et al., 2013).

After the financial crises of 2007-08, acquiring traditional funding, such as startup loans, angel or venture capital (VC) became increasingly harder for young firms. Crowdfunding emerged, roughly at that time, as an answer to difficulties faced by early stage entrepreneurs. In the last 6 years this new form of capital origination gained traction in most developed economies (Netherlands, UK, USA, Italy and Australia among others). Shiller (2008) views crowdfunding as an important financial innovation which essentially democratizes finance and brings in light the “knowledge dispersed over millions of people”. So crowdfunding can be viewed as more than just a form of financing; it is an important point of reference when estimating the market for future products or services, a source of collective wisdom and feedback during venture development and a foundation for future community of lead users. The phenomenon is increasingly attracting attention in developing economies as well, where according to The World Bank (2013) it should play a major role in support of innovation, jobs and growth in the future.

Crowdfunding takes many forms (Hemer, 2011) which will be discussed in more depth in subsequent chapters and caters to many different projects, especially those in creative industries, charity and entrepreneurial startups. This work will focus mostly on startups and the role of crowdfunding in promoting, nurturing and sustaining entrepreneurial activities as an engine of economic growth. The research conducted here is mostly of exploratory and descriptive nature, seeking to help understand better this new phenomenon and fill some of the gaps in a rather scarce academic knowledge on this topic. Additionally, it should contribute to the debate on whether crowdfunding is suitable as an addition to or as substitution of more traditional funding channels, such as business angels or VCs. Analysis of recent policy actions by governments and further recommendations provided in this work shall also have significant managerial implications, guiding entrepreneurs about how to set up and manage their crowdfunding campaigns.

This manuscript is organized in a following way: In the first part I offer a more extensive definition of crowdfunding, its place in equity "food" chain and an overview of the key elements of the crowdfunding ecosystem. Various models of crowdfunding are presented in detail together with a comprehensive literature review on existing academic work in this field. Intermediaries such as crowdfunding portals are briefly analyzed together with preliminary observations on biases, conflicts of interest and liability issues. Furthermore, I provide some recent data on the size of crowdfunding market and its major players accompanied by a SWOT and Porter analysis of the industry. Second part discusses the risks of crowdfunding and current regulatory framework in major economies, such as USA, EEA and Italy. The aim is to critically analyze current legislation and come up with conclusions which will serve as a foundation for policymaker recommendations presented in Part III. The third part opens with some general observations about the VC industry and traditional sources of funding while putting crowdfunding in this perspective and arguing how and why crowdfunding can be either complementary or substitute for more traditional investors. Main research question, whether crowdfunding can serve as a pillar in venture startup, is introduced together with the description and reasoning behind the methodologies used. Case studies are presented together with the results of a custom-made survey and expert interviews. Results are then discussed together with policymaker suggestions and managerial implications which emerged during the research. The manuscript concludes with some ideas for further work and a list of appendices and resources discussed in the text.

Part I

What is crowdfunding?

Crowdfunding (also known as crowdfinance) is a term used to describe a form of fundraising, usually conducted over the internet, in which a large number of people pool relatively small individual contributions in order to support a specific goal (Ahlers et al., 2012). Review of a rather modest literature on the topic uncovers a number of nuances in how crowdfunding is defined; confirming that substantial academic knowledge in this field is yet to be developed in order for consensus to emerge. Definition by Schwienbacher and Larralde (2010) explicitly states that crowdfunding is financing of a project or a venture by a group of individuals instead of professional investors such as business angels, VCs or banks. This definition stresses the point that there is no intermediary, since entrepreneurs raise money directly from individuals. In theory, majority of individuals already invest albeit indirectly through their savings which are being managed by intermediary institutions such as banks or mutual funds, so crowdfunding implies some sort of more direct interaction between funders and entrepreneurs. Definition by Rubinton (2011) acknowledges “parties” exchanging contributions in exchange for a form of value, without specifying who or what a “party” might be.

Belleflamme et al. (2013) extended upon the definition of a more general concept of crowdsourcing provided by Kleemann et al. (2008) in order to define crowdfunding as *“an open call, essentially through the Internet, for the provision of financial resources either in form of donation or in exchange for a form of reward and/or voting rights in order to support initiatives for specific purposes”.* Mollick (2014) and Bradford (2012) acknowledge that crowdfunding essentially draws inspiration from concepts like microfinance and crowdsourcing, but still represents a unique category of fundraising enabled by the proliferation of internet sites dedicated to the concept. The former also acknowledges a state of “evolutionary flux” in this domain, pointing out that even an expansive definition such as that of Belleflamme et al. (2013) leaves out examples such as peer-to-peer lending and fundraising initiatives by music or movie fans, among others. However, one might argue that crowdfunding is still fundamentally different from microfinance or social lending given that both funding objectives and targets are different, so it would be justifiable to treat it as a separate class in contemporary private capital markets.

Some authors labeled it as “community funding” (Kleverlaan, 2013), stressing out the potential of crowdfunding “community” to fill smaller investment gaps (< € 1 million) routinely faced by SMEs (small and medium enterprises) in their earliest stages. Since in this work the focus is on the role of crowdfunding in a venture startup, the most appropriate working definition seems that of Mollick (2013):

“Crowdfunding refers to a variety of different efforts by entrepreneurs – cultural, social and for profit to fund their efforts by drawing on relatively small contributions