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Lending, Crowdfunding, and Modern Investing

Introduction to Crowdfunding

David Musto, Ronald O. Perelman Professor in Finance, Department Chair

Focus of These Lectures

- The promise and the conceptual challenges
- Very possible to lose money investing this way and that the average investor will have a negative experience
- A framework for thinking about these challenges and how to overcome them

Topics Covered

- Review of how companies have traditionally connected with retail investors
- The JOBS Act of 2012, that gave several new ways to finance innovation, including crowdfunding
- Costs of funding and investing through crowdfunding
- Banking on the wisdom of crowds
- Non-financial motives for crowdfunding



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Raising Capital

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Raising Capital From Retail Investors

- GK Chesterton
 - Before you tear down a fence, learn why it was put there in the first place
- Crowdfunding tears the fences down around raising money from the general public

Offering

1. Engage an underwriter
 - Might hold a bake-off
2. Submit a draft registration statement to the Securities and Exchange Commission (SEC)
 - They send comments back
 - Can go back and forth multiple times
3. Submit finished registration statement, called your S1
 - Choose price range and number of shares

Offering

4. Go on the road show to pitch institutional investors
 - Book building – building a book of investors as they express interest in buying a number of shares at a given price
5. Set the price and place the shares

Retail Access to IPO Shares

- On average, the IPO goes up 18% from the offer price to where it trades the next day
 - If the IPO is priced down from its initial range, that's not a bargain
 - The IPOs that price up, tend to do well

Number of IPOs is Way Down

- In the mid nineties, there were over seven thousand public companies trading on the U.S. exchanges
- The population has indeed kept growing, but the number of public companies in fact turned and started heading down, and now it's half of what it was, around 3,600

Why Has it Gone Down?

- Easier to just stay private
 - Uber has stayed private
 - The goal may be to sell out to a larger company like Facebook, Google, Apple, etc.

To Summarize

- Companies tapping the retail public for capital
 - Tightly regulated process, offering through established intermediaries who set the price
 - Not a lot of IPOs, very little retail access to IPOs at the offer price



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Looking Back at the JOBS Act

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JOB Act

- JOB (Jumpstart Our Business Startups) Act developed in 2011 and was signed into law by President Obama in April 2012
- This was a bipartisan effort, with Democrats and Republicans cooperating all the way through, in an election year

Trying to Get the Economy Going

- Slow recovery from the Great Recession
- Ben Bernanke's phrase: looking for “green shoots”
- The JOBS Act
 - Four titles
 - When we talk about crowdfunding, we're talking about Title III
 - Focuses on different points in the startup growth curve

The Jobs Act – Title I

- “Emerging Growth Companies”,
 - Companies who want to go public but something is holding them back
 - Identify those obstacles and relax disclosure rules
 - Companies with revenues under a billion dollars
 - Can “test the waters” when going public

Confidential Review

- Traditionally, a company going public submits a draft registration statement, and then goes through several rounds with the SEC
- Under the JOBS Act, you can do all of this confidentially
 - The public sees none of this
 - Until you submit a public registration statement
- This was limited to just emerging growth companies but the Trump administration has extended this to all companies

Fail Privately

- Several other enticements to go public in Title I
 - Need only two years of audited financials, not three
 - Don't have to disclose as much about compensation
 - Exempt from Say on Pay
 - Don't need an auditor to attest to internal controls over financial reporting
 - Would be very expensive and often cited as a deterrent to small firms going public

The Jobs Act – Title II

- Allows companies to stay private
- Regulation D – allows private companies to raise money without going public
 - Can take investment from friends, and friends of friends, and people they've been introduced to
 - Can't bring in money by advertising (general solicitation)
- Title II allows business to bring in money through advertising

General Solicitation

- The catch
 - Investors all have to be what the SEC calls “accredited investors”
 - Net worth of at least \$1 million (excluding primary residence) OR
 - Have income at least \$200,000 each year for the last two years

Title II Portals

- Some of the crowdfunding portals are dedicated to Title II
 - Verifies wealth or income of potential investors so the entrepreneur doesn't have to worry about it
- Title II is crowdfunding but it's just for the rich

The Jobs Act – Title III

- Title III is crowdfunding for anybody
 - People of any means can invest
 - Limits how much someone can invest
 - Limits how much a company can raise

Restrictions on Entrepreneurs

- Limited to \$1 million in a 12 month period
- Financial and other disclosures
 - <\$100K, Company officer has to sign off on the disclosure
 - \$100-\$500K, Reviewed by a public accountant
 - \$500-\$1M, Reviewed if it's your first time, but audit if it's the second or later

Restrictions on Investors

- Depends on your income
 - < \$100K, greater of \$2K/year or 5% of your income
 - > \$100K, 10% of your income, up to \$100K
- This is the total investment from all crowdfunding put together in a given 12-month period
- Have to wait at least a year before selling

The Jobs Act – Title IV

- Referred to as Regulation “A+”
 - Mini IPO
 - Done on a best efforts basis
 - Sell directly to the retail investor
 - Less expensive



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Cost of Crowdfunding

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Cost to Raise Money This Way

- Professional time (lawyers, accountants, etc.)
 - Around 100 hours
 - \$500/hour = \$50K
- \$50k is 5% of \$1 million (Max amount allowed to raise)

Intermediary Fee

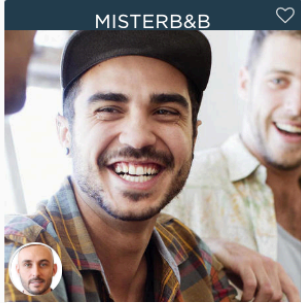
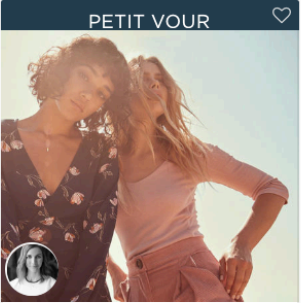
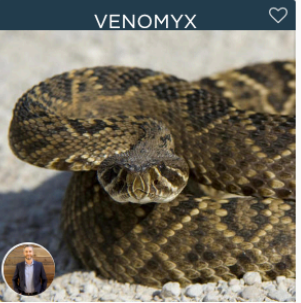

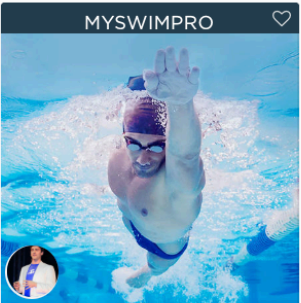

- On top of professional fees, you also pay a fraction of the proceeds to the internet portal used
- SEC study of Title III crowdfunding offerings in 2016
 - Median fee of 5%
 - Wefunder, charges up to seven percent
- 5% in professional costs + 5% in portal fees = 10% in minimum costs to raise money
 - Does not include the cost of the campaign itself such as videos, advertising material, and your own time

Cost to the Investors

- Suppose you make \$100,000/year, so you're allowed to invest 10%, or \$10,000, over the year
- You decide to spread your \$10,000 limit across five offerings, so you're investing \$2,000 each time

Sample Offerings From Wefunder

- MisterB&B: Largest Gay Travel Community in the World
- Liquidpiston: First Wholly New Combustion Engine/Cycle in 85 yrs
- Medford Brewing Company: Profitable MA beermaker opening own brewery
- MySwimPro: Swim coach app on your Apple watch

 <p>MISTERB&B</p> <p>Largest gay travel community in the world</p> <ul style="list-style-type: none">• Alumni of 500 Startups.• 220,000+ hosts over <p>CONVERTIBLE NOTE @ \$40M VALUATION CAP</p>	 <p>PETIT VOUR</p> <p>Award-Winning Cruelty-Free & Vegan Subscription + Retailer</p> <ul style="list-style-type: none">• PROVEN SALES: \$8M+ <p>FUTURE EQUITY @ \$6M VALUATION CAP</p>	 <p>VENOMYX</p> <p>EpiPen for snakebites: the antivenom of tomorrow!</p> <ul style="list-style-type: none">• 10x more effective than conventional <p>FUTURE EQUITY @ \$5M VALUATION CAP</p>
 <p>CHATTANOOGA</p> <p>For the first time in America, a soccer club offers fans true ownership.</p> <p>STOCK @ \$2.948M PREMONEY VALUATION</p>	 <p>MYSWIMPRO</p> <p>Personal Swim Coaching Program — named best Apple Watch app of the year</p> <p>FUTURE EQUITY @ \$10M VALUATION CAP</p>	 <p>WINSANTOR</p> <p>CLOSING IN 2 DAYS</p> <p>Ensuring no one suffers from Peripheral Neuropathy</p> <ul style="list-style-type: none">• CEO's prior two <p>FUTURE EQUITY @ \$70M VALUATION CAP</p>

Investors Opportunity Costs

- If you earn \$100K/year, you're making about \$50/hour
- Presumably you picked something you already have some comfort with
 - Takes one work day, eight hours in research
 - Eight hours at \$50/hour = \$400
 - \$400 in opportunity costs

Expected Return for Investor

- If you spend \$400 in opportunity costs to check out an investment of \$2,000 with a 50% chance of actually making the investment,
 - then the expected return would have to be at least \$800

Sound Plausible?

- \$800 profit on \$2,000 is 40%, over and above whatever else you could have done with the money
- Does that sound realistic?
 - That the expected profit on a startup that passes your screen is as high as that?
- If the probability of passing your screen is less than half, the expected profit would have to be even higher than 40%
 - Reaches the point where it just makes no sense to do the homework

Due Diligence

- Alternative is not to perform due diligence
 - Rely with what you know

Is That Enough?

- Will the expected return be positive using your own experience?
 - Not like investing in the public markets
 - The price you pay is where the world's supply and demand meet
 - The price you pay for Tesla shares is the price where the world's demand to buy Tesla equals the world's demand to sell it
 - But the price you would pay to invest in on a crowdfunding site is simply the price the company chose
 - No way for negative demand to have an impact

Already Picked Over

- Is crowdfunding a last resort for raising funds?
 - Family and friends
 - Venture capitals

So What Does Make Sense?

- When crowdfunding is not a last resort
 - Proof of concept
 - To attract shareholders who will then likely be customers
 - Crowdfunding success can lead to VC funding

To Summarize

- Hard to justify making a time-consuming effort to check out a crowdfunding investment
- It's possibly that crowdfunding is not a last resort



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Learning From the Crowd

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Learning From the Crowd

- Opportunities to learn from the crowd
 - The value of an investment based on the demand
 - Having a set minimum raise
 - If the minimum is not met, investors get their money back
 - Your investment goes through only if enough other people also choose the same company to invest in

Wisdom of the Crowd

- Each person in a crowd has some knowledge
 - The aggregate of that information can be performative

Long Tradition: Criminal Juries

- If all 12 vote guilty, then a decision has been made
- You've got more than a reasonable doubt about the defendant's guilt, so that would mean voting not guilty
 - Your reasoning might also go something like this:
 - If I vote guilty, that vote of mine only convicts the defendant if all 11 other people also vote guilty
 - If all eleven other people think the defendant is guilty beyond a reasonable doubt, then I guess I think that, too
 - Despite my doubts, maybe I should vote guilty

Free Riding

- If you're free riding on other investor's information, then how do you know they're not doing the same thing?
- The wisdom of crowds makes the most sense when people have different information



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Impact Investing

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Not Just About Profit

- The most realistic view of crowdfunding investments is that they are not just about profit
- People enjoy making a profit, but they also:
 - Like to give entrepreneurs a chance
 - Like the positive impact a company can do on a society

Impact Investing

- Investing with both financial returns and social impact in mind
- Publicly listed companies, where impact investors either screen out companies they don't like, or buy the shares in order to use their votes and their voice to influence management

Impact Venture Capital

- Fostering startups with social missions
 - The goal is for the startup to become financially self-sustaining and successful while carrying out its mission

“ Our opinion is that investing should not be solely about earning a return. To invest in something as risky as a startup, you should feel something extra, beyond just the business model. For us, that “something extra” is the personal fulfillment we get from helping a founder take “their shot” at making our world a slightly better place. We also think it’s pretty cool to learn about different industries when we get updates from the founder.”

— WEFUNDER WEBSITE

B Corps

- Is the company a B Corp?
 - A corporation whose practices have been vetted and approved by a private outfit called B Lab
 - Vet the company's practices along many of the dimensions you might care about
 - If the company scores high enough, it will be designated a B Corp

Benefit Corporation

- Benefit Corporation
 - A company that has incorporated under state law as a Benefit Corporation
 - Commit to a specific social impact purpose or goal
 - Map out how the goal will be measured
 - Designate a corporate director to be in charge of seeing to it that you pursue that purpose
- A strong legal commitment to a social benefit purpose

To Summarize

- Crowdfunding starts to make more sense from a financial perspective if investors are looking for more than just financial returns



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