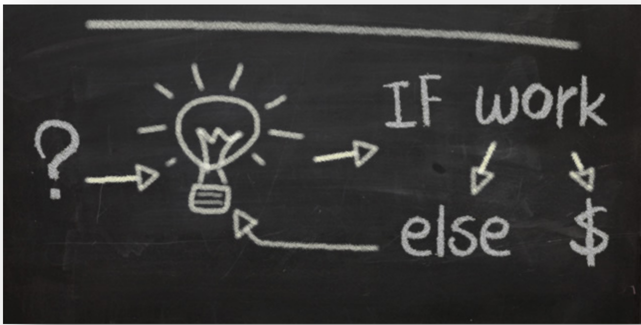
An Introduction to Crowdfunding

Crowdfunding is not a new idea but the passing of the JOBS act in the US (Jumpstart Our Business Startups), a series of 6 bills designed to make it easier for startups to gain access to capital, has been the catalyst for excitement and speculation among entrepreneurs trying to fund their next big ideas. Before the passing of the act, money raised through crowdfunding was strictly limited to donations or interest free loans because the Securities Commission did not allow companies to offer a return on people's investments. The JOBS act has now changed this, allowing startups to offer a return to their crowdfunding investors. With many traditional VC firms being understandably more cautious in recent years and favouring to invest in later-stage companies, the potential for crowdfund investing to make a major impact on the number of early-stage startups being able to finance their ideas is massive.

What is Crowdfunding?

Well, we've probably all received an email from one of our friends doing something for charity. They're planning on doing something amazing and asking us to give them money if they complete it. It's easy for us to do it; we just go online sign up on their section of a trusted website and donate some money. At their core, crowdfunding investments are pretty much the same thing – an entrepreneur tells you they're going to achieve something amazing then asks us and a bunch of other people to give them money to help them complete it. If you like the idea, you can 'donate' some money. The difference, of course, to the charity analogy is that if they do achieve it, you could walk away with a lot more than a sense of well being.



How much Investment is Available through Crowdfunding?

To get an idea we just need to look at some of the existing, non-ROI platforms have already gained traction in the U.S. Kiva is a microfinance platform which asks for a minimum of $25 from users and uses the money to fund projects all across the world, often in very poor countries where people have little access to traditional financing. Since 2005, Kiva has had more than 750,000 investors giving more than $300 million in loans. Another example is Kickstarter, which allows people to donate to fund creative projects. Since 2009, they have funded more than 20,000 projects with more than $200 million. These numbers are pretty impressive and even more so when you remember that there is no return for the investors; imagine how much those numbers could be inflated with the promise of a decent return!

What makes it Interesting?

Crowdfund investing will surely produce some incredible successes and give budding entrepreneurs access to capital they might not otherwise have. It also gives people a more accessible and simpler way to invest in companies, sometimes local, friends or family companies, that otherwise may have only had their bank to turn to for money. But let's keep things in perspective. Crowdfunding may be innovative and cool, but it's not necessarily the answer to every startup's dream.

Some of the Bad Bits?

Firstly, collaborating with many small investors is a pretty inefficient way to fund a company and could be an administrative nightmare to qualify all those 'normal folk'. But perhaps more importantly, crowdfund investing will not increase the number of great ideas, or great entrepreneurs. Many VC firms and investors have long argued that the market's worst problem right now is not too little cash but too much cash chasing too few good ideas. Adding more money to the market won't fix that but may result in a number of well-intentioned people losing a lot of money to some less well-intentioned folk.

For investors, making crowdfunding investments can help to mitigate their risk if done properly. However, having more money available doesn't make startups any less risky. Investors really need to research and investigate the company, founders and all other factors with the same diligence that they would approach any other traditional investment. And one would have to question, why should they invest if all the experts have already turned down the idea? If enough small crowdfunders have a bad experience, it won't be good for anyone, especially entrepreneurs.

In Summary

Whilst is has the potential to make a massive difference to the creation and development of startups, there are a number of pros and cons for both investors and entrepreneurs. It will be really interesting to see how this market evolves and which sites become the de-facto for crowdfund investments and could it even pose a threat to traditional VC firms getting their hands on the best, most promising companies?

Appendix (Info correct at 2012):

- Some Example Crowdfunding sites
  - Plan To Start website's top ten crowdfunding platforms: http://plantostart.com/10-crowdfunding-websites-entrepreneurs/
  - And a UK based site: https://www.fundingcircle.com/
- What does the JOBS act actually do for entrepreneurs? Basically, it will make it a lot easier for startups to raise money and will lower the cost of going public. Some specifics include:
  - It allows a startup to advertise for investors on a crowdfunding site, something that can't be done now without breaching securities laws.
  - Allows the raising of up to $1 million this way from investors putting in no more than $10,000 each, or no more than 10% of their income, whichever is less.
  - Allows up to $2 million if audited financial statements are supplied to the "crowd" investor.
  - Company financial statements need not be disclosed until there are more than 1,000 shareholders. Currently, SEC disclosure rules kick in once there are 500 shareholders.
  - Allows up to $50 million in an IPO without having to comply with the SEC's full regulatory structure and related fees.