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CROWDFUNDING OF SMALL ENTREPRENEURIAL VENTURES

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INTRODUCTION

An inherent problem that entrepreneurs face at the very beginning of their entrepreneurial initiative is to attract outside capital, given the lack of collateral and sufficient cash flows and the presence of significant information asymmetry with investors (Cosh et al., 2009). While different investors exist for larger amounts of capital such as VC funds and banks, entrepreneurial initiatives that require much smaller amounts to start with need to rely on friends and family or own savings. They then also make extensive use of bootstrapping techniques to mitigate their financial constraints (Bhidé, 1992; Winborg and Landstrom, 2001; Ebben and Johnson, 2006), by boosting their short-term profits.

More recently, some entrepreneurs have started to rely on the Internet to directly seek financial help from the general public (the "crowd") instead of approaching financial investors such as business angels, banks or venture capital funds (Kleemann et al., 2008; Lambert and Schwienbacher, 2010). This technique, called "crowdfunding", has made possible to seek capital for project-specific investments as well as for starting up new ventures. A prominent example is *Trampoline Systems*, a UK-based software company that intends to raise £ 1 million through crowdfunding. A first tranche was successfully raised at the end of 2009, with the remaining to be completed in 2010 through three follow-up tranches. To our knowledge this is the largest amount ever raised by a single venture through crowdfunding. It shows that crowdfunding may potentially be a mean to raise funds not only for small projects but also for high-growth startups that are typically financed by business angels and even venture capital funds. Whether it will become a meaningful alternative to angel finance and venture capital still needs to be seen. However, *Trampoline Systems* has shown that it is possible. While this is certainly an exception in terms of amounts targeted, crowdfunding has been used already by many other startup companies to raise smaller amounts of money for their initial stage.

In this chapter, we discuss crowdfunding as an alternative way of financing projects, with a focus on small, entrepreneurial ventures. The structure of the remaining chapter is as follows. The next section provides a description of crowdfunding and discusses existing research on the topic. The follow-up section puts crowdfunding into perspective of entrepreneurial finance and thereby describes factors affecting entrepreneurial preferences for crowdfunding as source of finance. Thereafter, we elaborate different business models used to raise money from the crowd, in particular with respect to the structure of the crowdfunding process. Building on this discussion, we present and discuss extensively a case study, namely *Media No Mad* (a French startup). Finally we conclude with recommendations for entrepreneurs seeking to make use of crowdfunding and with suggestions for researchers about yet unexplored avenues of research.

CROWDFUNDING: TAPPING THE CROWD FOR MONEY

In this section, we provide a theoretical discussion of the concept of crowdfunding. First, we present a definition of crowdfunding. We then describe the market. Existing literature on the topic is described in the last part of this section, and enables to present motivations of entrepreneurs to use crowdfunding as well as motivations of crowdfunders (i.e., those who provide funding) to participate in ventures as investor.

Definition of crowdfunding

In simple terms, crowdfunding is the financing of a project or a venture by a group of individuals instead of professional parties (like, for instance, banks, venture capitalists or business angels). In theory, individuals already finance investments indirectly through their savings, since banks act as intermediary between those who have and those who need money. In contrast, crowdfunding occurs without any intermediary: entrepreneurs "tap the crowd" by raising the money directly from individuals. The typical mode of communication is through the Internet.

More conceptually, Lambert and Schwienbacher (2010) extend the definition of crowdsourcing provided by Klemann et al. (2008), by describing crowdfunding as *"an open call, essentially through the Internet, for the provision of financial resources either in form of donation or in exchange for some form of reward and/or voting rights in order to support initiatives for specific purposes"*.

In the meantime, several platforms have emerged that help intermediate between crowdfunders (those who invest in projects) and individuals with a project. One which has helped in making the concept famous is *Sellaband.com*. Launched in 2006, it acts as intermediary between new music bands and their fans, who can invest in the production of a band's first CD. In exchange, investors obtain rewards, like a free copy of the CD or benefits from its sales. In roughly three years, the company raised more than US$ 3 million from individuals in order to promote new artists. In total, almost 4,000 artists received support from more than 65,000 "believers" (source: https://www.sellaband.com/, viewed on June 22, 2010).

The market of crowdfunding initiatives

To our knowledge, the only analysis to date about crowdfunding is the survey done by Lambert and Schwienbacher (2010), which focuses on entrepreneurial crowdfunding initiatives (thus excluding platforms, fundraising by individual artists and any form of peer-to-peer social lending). Other existing studies are limited to describing individual case studies, such as Cassarino and Geuna (2007) and Brabham (2008a).

The study by Lambert and Schwienbacher (2010) indicate**s** that the market is still very young, with most of them having taken place the last 3-4 years, with about 60% taking place in Anglo-Saxon countries. Before, the concept of crowdfunding was primarily applied by individual artists and movie makers. In terms of industry, their sample is widely dispersed, containing cases in industries ranging from ICT, sport, journalism and movies. While they target about € 100,000 (median, not mean), entrepreneurs raise around € 28,500 (median). While some of the fundraising initiatives are based on donations, around 80% appear to offer some form of reward to the crowd. These include the issuance of shares, direct cash payments, a free copy of the product and a simple credit on the product (that mentions the names of who provided funding).

Interestingly, respondents to their survey declare that other reasons than raising money are also important motivations for opting for crowdfunding. While raising money is the most important one, other important motivations stem from the public attention they may get and validation for their product before bringing it to the market. Entrepreneurs use a wide range of communication methods available on the Internet, with a pronounced use of interactive methods (e.g., specialized blogs, *Facebook* and *Twitter*); these allow communicating directly and personally with the crowd next to solely posting content on the Internet.

Existing literature

In this sub-section we discuss how crowdfunding can be embedded in broader strategies of corporate development. We further discuss characteristics of crowdfunding initiatives and why entrepreneurs may make use of crowdfunding.

From "crowdsourcing" to "crowdfunding"

In order to describe this new concept in further details, let us start with the parent notion of "crowdsourcing". Research on crowdfunding specifically is (to our knowledge) largely inexistent; however it can be seen as part of the more general concept of crowdsourcing.

The term "crowdsourcing" has been first used by Jeff Howe and Mark Robinson in the June 2006 issue of *Wired Magazine*, an American magazine for high technology. Kleemann et al. (2008) provide a good definition of it: "Crowdsourcing takes place when a profit oriented firm outsources specific tasks essential for the making or sale of its product to the general public (the crowd) in the form of an open call over the Internet, with the intention of animating individuals to make a [voluntary] contribution to the firm's production process for free or for significantly less than that contribution is worth to the firm." Put differently, for-profit companies create value by using consumers as volunteers and almost free taskforce.

This taskforce is given another name by Kleemann et al. (2008), who talk about the rise of the working consumer. This working consumer takes part in the production process and replaces a former need for employees to perform specific tasks. They have three characteristics: they take part in the production process and create value; their capacities can be considered as valuable assets; they are integrated into corporate structures and their actions can be monitored as if they were employees.

Several authors (including Brabham, 2008a, and Kleemann et al., 2008) identify the development of Web 2.0 as a prerequisite to the development of crowdsourcing. They argue that its structure was mandatory for companies to be able to reach networks of consumers that easily. Lee et al. (2008) describe Web 2.0 from several points of view. Technologically, it is based on computers being able to automatically process information, meaning that it can be spread more easily, and recombined in other formats. Sociologically, Web 2.0 is the foundation for the creation of networks of people who share common interest. On an economical point of view, the Web 2.0 is characterized by the ability for anyone to create content and upload it on the net. This generates an abundance of information and results in a scarcity of attention from consumers, since we are not mentally able to process the entire set of information available. An explanation of people's motivation to create content is future rewards, from recognition to tangible products.

Lee et al. (2008) define three main characteristics for the Web 2.0. First, collaboration permits to combine each other's knowledge and resources. Second, openness allows people to contribute freely to different projects. And third, participation is increased thanks to the ease of access and use of computers and Internet. Their research is based on these three characteristics to find that Web 2.0 especially broadens the capabilities of small firms by allowing user content to inflow and create value for the company.

TABLE 1: Different sources of crowdsourcing, as characterized by Kleemann et al. (2008)

Type of Crowdsourcing	Description
Participation of consumers in product development and configuration	Companies ask for comments and suggestions on current and future products
Product design	Companies ask to develop a whole new product from A to Z
Competitive bids on specifically defined tasks or problems	Companies ask to give a solution to unsolved problems
Permanent open calls	Companies ask for any new information or documentation
Community reporting	Same as before apart that the work is done by a known community instead
Product rating by consumers and consumer profiling	Companies ask for product reviews and opinions for other users to see
Customer-to-customer support	Companies ask customers to help other customers and use it for consumer knowledge and product design

Kleemann et al. (2008) describe different types of crowdsourcing, as presented in Table 1. Crowdfunding is not included specifically in this characterization, but may be viewed as part of consumers' support in a broader sense. Crowdfunding can be viewed as an element of crowdsourcing. In particular, it deals with consumers and other individuals providing financial help to the company.

Why do companies crowdsource/crowdfund?

According to Kleemann et al. (2008), companies make use of the crowd mainly for cost-reduction reasons. By participating in the product design and improvement, users contribute to creating value for the company. Moreover, this allows the company to reduce the length of new product development as well as its costs, have a better customer acceptance, and increase the customers' perception of product newness. Within the crowdfunding activities, consumers and/or individuals provide needed capital to the company to make its investments such as acquire new assets or pay employees.

Besides, crowds may at times be more efficient than individuals or small teams (Howe, 2008).[1] According to Brabham (2008b), the efficiency of crowds in solving problems of companies is related to its composition; the more diverse it is, the more efficient it can be. While quoting Surowiecki (2004), he explains that the 'wisdom of crowd' is due to crowd's solutions aggregating to each other, as opposed to averaging out. In other terms, members of the crowd may build up their own solution using others' suggestions and hence end up having better solutions overall. Lévy (1997) goes even further with his notion of "collective intelligence": 'no one knows everything, everyone knows something, [and] all knowledge resides in humanity'. It makes pretty clear the fact that knowledge becomes more important as communities share it.

While crowdfunding (and crowdsourcing in general) can be useful for companies seeking solutions to their problems, it can also provide valuable signals on the market potential of a product they wish to launch. As argued by Lambert and Schwienbacher (2010), at times the use of crowdfunding can be seen as an excuse to generate hype around a new product in order to create a marketing campaign in which consumers are able to participate. For the company, it can provide an indication whether there will be a demand for the product. This is best the case for instance for artists that use *Sellaband.com*, since consumers commit financially to purchase the CD if it goes into production.

Finally, Franke and Klausberger (2008) notice that the phenomenon of crowdsourcing (and thus also crowdfunding) is currently a working concept, because it is not broadly used. If more and more companies start using it, the resource 'crowd' will become scarce.

Characteristics of crowdfunders

Communities can at times be more intelligent than individuals, but is this the reason why people form groups? An ongoing study by Lambert and Schwienbacher (2010) indicate that many projects financed by crowdfunding do not offer any reward to their investors, but rather live from donations. Other considerations than financial ones often seem to be of importance for crowdfunders.

Kozinets et al. (2008) define different kinds of groups and discuss the concept of Online Creative Consumer Communities (OCCC). The term 'consumer' relates to people with values and cultures linked to industrial-commercial society. 'Online consumer' is then meant to distinguish from face-to-face communities and other non consumer web communities. These communities are those which participate in crowdsourcing projects.

According to Kleemann et al. (2008), participants in crowdsourcing projects have either intrinsic or extrinsic motivations. Intrinsic motivation relates to the pleasure or fun of doing the particular task, whereas an extrinsic motivation calls for an external reward, as money and goods, career benefits, learning, recognition or even dissatisfaction with current products.

[1] Relatedly, one can also speak of "madness of crowds" at times, when an uncoordinated crowd leads to sub-optimal outcomes. The current financial crisis could be included in this.

Further explanations to why people participate in these projects are given by Brabham (2008b), who examines who and why people participate in *iStockphoto*, a website where users can upload their photos and be paid for their use. He finds that the average user is a so-called 'elite web user', that is to say middle-to-upper class, highly educated, married, middle-aged, white man with high speed Internet connection. As first motivation, he finds money followed by a willingness to improve one's skills and have fun. According to the same study, networking and peer recognition did not seem to be very important factors.

Franke and Klausberger (2008) focus on the effect of perceived fairness of crowdsourcing projects for participant consumers. They find that consumers are more likely to accept to participate when they perceive the project as being fair for them, and that it is linked to the business model of the company. It is important whether the participant obtain rewards (tangible or not), have their say in making the related decisions, and have intellectual rights over the ideas they submitted.

CROWDFUNDING DECISIONS IN THE CONTEXT OF ENTREPRENEURIAL PROJECTS

In this section of the chapter, we link crowdsourcing to crowdfunding. But first, we briefly describe the part of the current research on entrepreneurial finance that is of interest to us.

Existing sources of finance

Sources of financing can broadly be divided into two main categories: equity and debt. When money is invested against equity, it goes directly into the capital of the company for which investors receive shares. As a consequence, they obtain some control over the company, while at the same time bearing risk. On the other hand, those who give finance for debt (mainly bank loans) remain external parties, linked to the company by a detailed contractual agreement. They bear lower risk thanks to collateral and seniority of their claims over equity. Many startup companies however cannot access debt finance, since they do not have the needed collateral nor stable cash flows to ensure regular interest payments (Berger and Udell, 1998).

Different sources of financing exist among each category. They are described in Table 2. Some of these types of financing can be used together with crowdfunding. This is notably the case of bootstrapping techniques (Bhidé, 1992; Winborg and Landstrom, 2001; Ebben and Johnson, 2006). In addition, crowdfunding actually looks pretty similar to bootstrapping in certain matters. In particular, bootstrappers try to use as many alternative resources as possible, and that is what entrepreneurs do when they exploit capabilities of crowdfunders. In both cases, founders use creative ways to finance their investments, while avoiding traditional investors. At the same time, crowdfunding differs from bootstrapping in many ways; most importantly, founders relying on crowdfunding do seek to attract external investors, unlike bootstrappers who primarily rely on internal resources and active cash management techniques.

TABLE 2: Different types of entrepreneurial finance investors, grouped by debt and equity claims

	Investor	Description
Equity	*Entrepreneur and team members*	The entrepreneur invests his own money in the company, or money he obtained through a personal loan
	Friends and family	The entrepreneurs' friends and family
	Business angels	Wealthy individuals willing to invest in small projects
	Venture capitalists	Specialized investors gathering money from non specialists and placing it into bigger projects for a period of 5-7 years
	Other companies/ strategic investors	Other companies can decide to invest in projects they believe have strategic importance to them
	Stock markets	Members of the public invest in the company through a public offering
Debt	*Banks*	Loans
	Leasing companies	Provide equipments and office space to entrepreneurs against lease payments
	Government agencies	Subsidy for particular projects
	Customers/ suppliers	e.g., trade credit
	Bootstrapping	Use of trade credit, credit card and other methods, including working capital management

Factors influencing the use of crowdfunding

When choosing how to finance his company, an entrepreneur needs to take into account several factors. We discuss below factors likely to be important for the use of crowdfunding.

Lack of pre-existing resources

The first important question is about the entrepreneur's pre-resources: what does he possess to secure the investment on fund providers? Does he have the required skills to run the project and make it successful? At times, this may be the case; in other times not.

Besides, the manager's competencies might also influence his need for additional managerial support in sales, marketing, accounting, distribution or any other field. This can be provided mainly by equity investors (e.g., VC funds, business angels and strategic investors) who already have experience in running a company as well as previous knowledge about the industry. Other sources such as debt are said to provide 'stupid money', since they do not come with any support. Keuschnigg (2004) and Botazzi and Da Rin (2001) show that innovative companies which benefit from external support from VC funds perform better than the average and have higher growth rates. Also, collateral is often required for obtaining debt finance. As a consequence, Ueda (2004) shows that entrepreneurs with little collateral would be more likely to obtain financing from VC funds than from banks.

Risk, moral hazard and information asymmetry

How much risk the entrepreneur is willing to bear is also a condition when choosing financing. Indeed, managers take risks, but shareholders are those who actually carry it (Short, 1994). As a result, equity finance is a way to spread risk over different people. In contrast, debt finance makes the entrepreneur (provided he is the only shareholder) bear the risk alone. Therefore, the financial structure of a company is influenced by the original riskiness of the project along with the risk-taking personality of the entrepreneur.

Next to risk, a major issue is moral hazard that can come in various forms. A prominent way how equity investors deal with it is by staging their investments in several rounds. This enables investors to make decisions based on the achievement of milestones and the arrival of new information about the technological and market risk of the project (Bergemann and Hege, 1998).

Finally, information asymmetry is another issue in financing entrepreneurial initiatives. This is the common issue of information asymmetry, whereby different parties engaged in a deal do not have access to the same level of information (Myers and Majluf, 1984 ; Narayanan, 1998). In the case of crowdfunding, this issue may be even more pronounced. Indeed, investors are not specialists and thus have access to less information about the industry, past performance of the entrepreneur and many other pieces of value-relevant information. Moreover, the entrepreneur might be even more reluctant to disclose information to this type of investors, due to their number and lack of professionalism. Idea stealing may further be particularly strong here, since the entrepreneur needs to disclose sensible information to a wider audience than under traditional forms of fundraising.

However, not all investors require the same level of information disclosure from borrowers. Most of the time, investors acquiring equity ask for more information than debt financers since they bear more risk. Related to this point, Ueda (2004) finds that entrepreneurs who go to VCs are more likely to have secured their ideas via intellectual property rights, which also implies that the entrepreneur's legal environment has a direct influence on his choice.

Organizational form

A main finding in Lambert and Schwienbacher (2010) is that not-for-profit organizations tend to be more successful in achieving their fundraising targets as compared to for-profit organizations and project-based initiatives. This suggests that the organizational form may be an important driver of the success of crowdfunding initiatives. Lambert and Schwienbacher (2010) suggest that a possible explanation for this result stems from the fact that not-for-profit organizations may be more prone to commit to high quality products or services if quality comes at the expense of quantity. In contrast, for-profit organizations will set their quantity-quality mix that only maximizes corporate profits. Since not-for-profit organizations put less emphasis on profit making, they may therefore focus more on quality, which may be an important requirement for attracting donations (Glaeser and Shleifer, 2001).

Control preferences

An extensive part of literature exists on possible conflicts of interest between owners and managers. Short (1994) find that performance is affected by the ownership structure since it has consequences on the strategy. Particularly, in line with the general consensus (Thomsen and Pedersen, 2000), they show that owners want to focus on profit maximization in order to maximize dividends, while managers might have more value creation/prestige-related goals like being innovative (Czarnitzki and Kraft, 2002).

Following the incomplete contracting literature, Hart and Moore (1998) show that control needs to be clearly held by one of the parties (owners or managers) but not both, so that conflicts of interest cannot appear in decision-making. This can be the case for instance for ethical companies that do not want to have shareholders focused more on profits rather than on accomplishing the ethical mission of the firm. However, owner-manager firms may also become less efficient than when the functions are separated subsequent to a lack of managerial monitoring and oversight functions by external shareholders. This can partially be explained by the interest of owner-managers to be their own boss, and focus less on growth (Berger and Udell, 1998). Venture capital funds structure their contracts in such a way that ownership and control becomes largely separate (Hellmann, 1998). Cash flow and control rights may further shift hands over time, depending on pre-specified contingencies. Berglöf (1994) show how this can be implemented with convertible preferred shares, as done by venture capitalists. However, this requires sophisticated contracting that is unsuitable for the crowd.

One question is whether crowdfunders should be able to have their say on the management of the company. This issue deals with the legitimacy of such investors to control a company. Indeed, they might be quite numerous and each has brought only a small amount of money into the firm. How much power would they get then? And how could they exercise it? The Web 2.0 could at times be an alternative to high coordination cost where the number of investors is particularly large; in this case, voting power can be given to crowdfunders for very specific decisions about the product design or other corporate strategies. However it is unlikely to be manageable for any kind of managerial decision, such as voting right given the common shareholders in true equity issuance.

Amounts required by entrepreneurs

How much money is needed is another discriminating factor. Indeed, financiers all have different pre-defined amounts they are willing to invest (Bhidé, 1992). For IPOs, for instance, there is a legal minimal threshold to be placed on the stock market; this prevents small companies to use it (Botazzi and Da Rin, 2001). In addition, its implementation cost is very high and imposes companies to have reached a certain scale and have reduced the risk factor (Berger and Udell, 1998). Similarly, VCs usually have high minimum investments that reveal to be unsuited to the needs of small ventures (Bhidé, 1992). Schwienbacher (2007) shows that this may lead to a crucial trade-off as to when to start entrepreneurial activities, since smaller amounts need to be financed by other investor types like business angels.

Besides, small business finance is highly and disproportionally affected by macroeconomic conditions (Berger and Udell, 1998). Indeed, market forecasts, stock market health, overall economy health, and monetary policy all have effects on small business finance. For example, the US credit crunch of 1990 caused the small firm lending to fall by 38% from $144bn to $88bn. VC financing is also affected by market conditions, since their entry is conditioned by their exit strategy based on the stock market health (Black and Gilson, 1998).

Legal issues regarding equity issuance and multiple investors

Regulation on equity issuance for private companies may limit the extent to which crowdfunding can be a viable source of financing and the capacity of firms to seek funding from the crowd, as it may be perceived as being a general solicitation of public saving. Moreover, in some countries there is a limit on the number of shareholders that some forms of business organizations are allowed have.

The case of *Trampoline Systems* clearly shows the legal concerns that companies may face. National regulations typically limit the extent to which companies can advertise security offerings to the public, limiting it often to qualified investors and people with whom the entrepreneur already has clear links.[2] Regulators further limit the number of shareholders a private company can have. Solving these issues has cost to *Trampoline Systems* significant time and legal costs in order to have its crowdfunding process in line with UK regulation for issuing equity privately. Among other things, it implied that the crowdfunding process had to be restricted to qualified investors, and the general public could not participate.

Therefore, the crowdfunding participation is often structured in the form of making the participating crowd a member instead of a shareholder, such as *BeerBankroll* and *MyFootballClub* (that now owns the club *Ebbsfleet United*). Others offer investors part of the revenues without issuing shares however. An interesting example is *Sandawe* that allows investors to finance comic books and earn a slice of the revenues generated by subsequent sales of the albums selected by investors. There, the crowdfunding initiative combines profit sharing and voting on which albums to sponsor with the money provided.

The "wisdom of the crowd" argument

Entrepreneurs may require external support on how to run their company or to assess the economic potential of their product. Unlike business angels or venture capital funds, crowdfunders might not have any special knowledge about the industry. However, the "wisdom of the crowd" argument states that a crowd can at times be more efficient than individuals or teams in solving corporate problems. Hence, crowdfunders as a crowd would be more efficient than a few equity investors alone.

From another point of view, the risk taken by crowdfunders might be smaller, and not only because of the small amounts that they provide individually. The crowd may further become consumers once the product has been brought to the market and have an incentive to disseminate the information about the product it if they participate in the profits of the venture. In contrast, similar information dissemination would require significant advertisement campaign if the venture were financed by a few, larger investors.

[2] A discussion of legal issues for crowdfunding initiatives done in the US is provided by Kappel (2009).

BUSINESS MODELS OF CROWDFUNDED VENTURES AND CROWDFUNDING PLATFORMS

Different business models can be observed based on the type of rewards that is offered to the participating crowd. In the section, we present several of them, which we complement with the discussion of specific, real-world examples. In grouping the types of remuneration schemes, we follow the structure of Lambert and Schwienbacher (2010). This study distinguishes between donations, passive investments and active investments by the crowd.

Donations

Interestingly, several crowdfunding initiatives seek to attract donations rather than offer financial rewards or any other form of recognition to investors.[3] Following arguments of Glaeser and Shleifer (2001), it may facilitate fundraising in contexts where companies are structured as a not-for-profit organization. This is due to the fact that such organizations are more inclined to produce high quality products than for-profit organizations, since profit maximization objectives are at times better achieved with standardized, lower quality products that can be more widely distributed. This may however go against the objectives of donors. This intuition is consistent with empirical findings presented by Lambert and Schwienbacher (2010), who finds that 22% of their sample of crowdfunding initiatives relies on donations.

Passive investments by the crowd

Most initiatives indentified by Lambert and Schwienbacher (2010) offer some form of rewards to their investors; these rewards can take various forms, as discussed above. Most of them however do not offer any possibility to investors to become actively involved in the initiative, such as voting for selected characteristics of the final product or provide working time to the company. Entrepreneurs seeking passive investments by the crowd therefore are solely interested in raising money but not using the crowd as active consumers or giving up some control.

Active investments by the crowd

Other entrepreneurs offer investors to become active in the initiative, next to offering rewards to them. This may provide valuable feedback to the entrepreneur on potential market demand and product characteristics that the market may prefer most. Also, the active involvement may be structured in forms discussed above under the concept of crowdsourcing.

Each remuneration scheme may generate different forms of information and may vary in terms of degree of credibility of the signal. For instance, while pre-ordering at discount may be a credible signal for a pre-specified product (here, investors are automatically consumers), letting investors participate in the profit sharing and the voting process regarding certain product characteristics may at times yield to the entrepreneur feedback not about whether investors like to product per se but rather their market sentiment in general. Indeed, in the latter case, investors do not need to be consumers. In this latter case however, making investors become active by giving

[3] Wojciechowski (2009) discusses different models of charity in connection with crowdfunding.

them voting rights may provide the entrepreneur with valuable information for designing his product and selecting the optimal consumer targets.

A CASE STUDY: Media No Mad (http://medianomad.com/)

The previous sections gave insights into different issues that arise in the structuring of a crowdfunding process. In this section, we present a real-world case study that provides additional insights into the fundraising process. We further raise a number of questions that can be used for teaching purposes in any entrepreneurial finance course.

We study a company that successfully raised money using crowdfunding techniques. Qualitative and quantitative data were analyzed. The major part of the data comes from an interview given with the main founder of the company. Complementary information was found on blogs linked to the event.

Finally, a last form of data gathering was used, i.e. a survey. This was intended to collect more precise information directly from the investors. It was communicated to respondents through the company shareholder platform. For that reason, the sample might not be entirely representative: first, only investors accessing this platform and paying attention to its content can be made aware of it. Second, these people are not forced to fill in the questionnaire, which causes the sample to be self-selected. Nevertheless, the answers are still valuable because they allow to profile participating users, or in other words those who bring value to the firm.

Description of the company and the crowdfunding round

Media No Mad is a French startup founded in October 2007 by Benoît Laurent and his wife Emilie Agniel. This company's unique activity is the development of a website called *benoot.com*. The principle of this website is to create a community of travelers that would share their photos, videos, sounds and comments about places they have visited while traveling around the world. It is based on a few items: the possibility for members to create their own travel diaries accessible to all, an application displaying pictures and videos in a fancy way, and a *Google* Map pointing where these pictures have been taken, hence enabling both to find pictures taken in a particular place and know where in the world a particular sight can be found.

Finally, as most Internet-based businesses, this firm expects advertising to be their main (if not unique) source of income. Digital advertisement works in two ways: for most small websites, media agencies (like *Google*'s) provide pay-per-click ads. But on bigger websites with more traffic, space can also be bought like for regular ad boards. Consequently, the success of the business, or in other words the revenues of *Media No Mad*, is strongly correlated with the number of single-users visiting the website.

Out of necessity?

In order to launch the second version (V2) of the website, *Media No Mad* needed more money. This V2 was vital to the firm in the sense that the current version (V1) was considered as a beta version only (test product). Therefore, if they wanted to increase their community, they would need to offer more functionalities and a better navigation experience.

Originally, they collected funds from local partners, such as banks and local incubators, but mostly they had to invest their own savings. After failing to raise a second round of money from regular sources like business angels and other private individuals, they decided to use their networking skills to find investors from the web.

Communicate to everybody but just select a few

First of all, they needed to communicate their offer to their close network. To that extent, they created a separate operation called *BuzzMoney* and a separate website where they described their approach and were welcoming candidates. As they were already very involved in networking and blogging, they knew other Internet users with very powerful networking skills. These people were very enthusiastic about the project and had strong faith in it. As a result, the communication around the project grew exponentially and attracted more and more people. It first started from blog posts, but then went to other network sites like *Facebook* and *Twitter*. At some point, it also reached regular media on the Internet and even on television and paper. However, at the moment it did reach regular media, investors had already been found and hence this communication was only useful to promote the company by itself, not the funding round anymore.

Eventually, the conducted survey shows that 70% of the current investors had read articles on blogs, 20% heard of it from word of mouth, and only 10% knew the website beforehand! This clearly shows how efficient and broad the communication has been.

In a need for privacy, confidential information such as their business plan and shareholder contracts were not publicly disclosed on the website and required a private login. This login was given to those who asked for it and seemed to be serious enough about the bid. For instance, they would avoid giving it to potential competitors or kids. The main part of the selection process was rather natural. Indeed, first it was needed to provide private information, which filtered some users. Later, if the candidacy was accepted, the potential shareholder was required to sign a non-disclosure and non-competition agreement, which contributed to the rest of the filtering. In general, those who were not really motivated in that deal or that had reasons not to sign the agreement (for instance, a competitor would make his job illegal if he did sign the paper) quickly abandoned the project.

Investing more than money

Their original plan was to raise €90,000 in order to pay for a developer's salary, communicate and optimize search engines requests (so-called SEO techniques). Obviously, the developer would be in charge of adding functionalities to the current website, and the rest of the money was meant to increase traffic and recruit new users.

The €90,000 were cut into 300 shares of €300 each and were designed to accommodate 80 investors. That would amount to 23% of the overall capital, the two founders possessing 500 shares each, which represents €300,000 in total. Eventually, after a month of fundraising, they obtained promises for €55,800. In numbers, that adds up to 186 shares from 81 investors, and 15% of the capital. From the performed survey, we found that most investors bought only one share (55%), one third bought two shares and the highest number of shares being five (11% of the cases). On average, 1.7 shares were sold per investor.

Once they reached €55,800, they decided it was enough and stopped raising further funds. Why so? Because their investors would not only provide them with money, but will also build on their skills to develop, communicate and reference the website, all of this at no cost for the company! Indeed, the selected investors were web experts, marketing experts, professional search engines optimizers, or at least have experience as being customers. From the survey, we found that crowdfunders were relatively young: between 18 and 36 years old, with a median and average of respectively 25 and 26.2. 40% were still students and the rest had jobs related to IT. The founder also added that many entrepreneurs had joined the crowd.

For most of them, the concept of investing in a company in order to make a later profit by reselling the shares was not the most important reason for investing. Indeed, when asked if they were expecting to make high profits from the deal, 78% answer that they are not planning to earn from it neither do they want to make a loss. However, what they seek is mostly to participate in the exciting adventure of building a startup, since 100% partly or fully agree to the statement that they want to be part of an entrepreneurial project. They are therefore appealed by the challenge and the experience they can derive. But the investors also have faith in the product and the managerial team, as respectively 89% and 89% partly or fully agree that the product has potential and the team is competent in what it does. Finally, a few members also added another motivation in the open comments: since it involves more than 80 investors, they also thought it would be a good way for them to extend their network. Indeed, since all are gathered around the same project (an entrepreneurial/innovative website), it is very likely that they will build strong relationships. Eventually, each member will have access to the competences that belong to this network.

So as to provide incentives for investors to participate, the owners built a community platform on *Hellotipi*, which is originally a website meant for families to share content. That way, they can ask shareholders for their opinion or make polls (this is where our survey was made available). Not very surprisingly, 100% of the sample visits the platform. Moreover, 11% only reads its content and does not participate (everyone else participates actively). Regarding frequentation, 56% visits the platform a few times a week, and the rest (44%) about once a week, so all come at least once a week. In conclusion, the sample was very participating as expected, and this cannot be taken as significant.

In the end, the founders have no legal obligation to take into account the investors' comments on the community platform since they still possess 85% of the shares, but are likely to do it because they need their participation and would also suffer from negative opinions. Undeniably, the web was a wonderful means to spread the awareness about their project, but likewise it would be very efficient in spreading unhappy investors' critics.

On legal matters

The French legal form of *Media No Mad* is a SARL, which corresponds to a limited company, whereby associates are only responsible for the amount of capital they brought to the company. As a result, they cannot have more than 100 shareholders, as limited by French law. This is the reason why they had to create such big shares (€300), because they needed to limit the number of investors. Furthermore, the French law forbids private companies to submit an offer to buy shares to more than 100 qualified participants (i.e. moral persons legally able to be a shareholder). The publicity about the overall crowdfunding round was public, but the final shareholder contract can only be given to sign to 100 people, even if some of them eventually decide not to invest. As a result, if they had needed more money or more shares and were still targeting small shareholders, they would have had to go to the public market, i.e. the stock market.

In order to receive the money and signatures, they finally had to go from virtual to physical and organized some kind of funding tour around France, so they could meet all investors for diners in different cities. Shareholders, as any other ones, signed a contract preventing them from collaborating with competitors as long as they possess shares. This way, they reduce competition but above all make sure that strategic information does not leave the company.

Finally, it is important to mention that the founding team did not launch that operation alone out of the blue. They asked for advice from *Add Equatio*, a company specialized in financial and legal advice for entrepreneurs seeking to raise funds.

Some lessons from *Media No Mad*

Overall, the aim of this investment was to raise money, obviously. But they ended up raising something more valuable and sustainable than money, namely skills. So it looks like angel or venture capital funding, with the difference that this time 81 people put their skills and abilities together in order to provide optimal thinking and services. As mentioned earlier in the chapter, the crowd can be more intelligent than individuals because everyone can build on each other's skills. In the case, investors had very diverse skills, all more or less related to the project. Therefore, letting investors have their say has to be considered as an asset rather than a liability.

Next, while they targeted people from their network, those were so enthusiastic about the idea that they created a huge buzz about it and it soon became famous. Here can therefore be seen the importance of (1) networking and (2) efficient communication. In order to eventually reach motivated skilled investors, it is crucial to reach as many people as possible in the first place. To achieve this, using Web 2.0 tools such as social networks or even non-Internet media is crucial. Moreover, intelligent filtering also needs to be done. In this case, the selection was rather natural given the legal and privacy constraints potential investors were facing. This was a rather time and money-effective process.

Another observation is that investors do not have financial motivations. What they want is to participate into innovative projects, be able to say "I did it", obtain recognition and personal satisfaction. These are intrinsic motivations. To allow these motivations to be satisfied, it was necessary to take more advantage of Web 2.0 and build a participative platform so that shareholders can become knowledge-sharers. In addition, the investors were interested by the project by itself, i.e. the product and the team, which is quite rational since otherwise it would mean that they would be only investing because they have nothing better to do. In that matter, it is hard to say whether help from VCs/business angels is better or not. Indeed, those are professional investors and wish to earn money from the deal. Consequently, they will have strong incentive to make the business profitable, which does not seem to be the case for crowdfunders. In fact, crowdfunders have very little to lose if the company goes bankrupt. By creating debt, it is likely that people would be expecting returns at a fixed term, therefore feeling less comfortable in the case of a bankruptcy. Nevertheless, equity holders might have more incentives to make the company grow.

Next, another point that was mentioned was very interesting: the willingness of investors to expand networks. It has long been a fact that good networks are a huge advantage in the business world, and even more in entrepreneurship, as many authors have recently discussed. Networking has also evolved with Web 2.0 and the development of professional network websites like *Viadeo* or *LinkedIn*. With crowdfunding, investors benefit from the creation of a network that can be stronger than traditional ones. Indeed, these people are not here because they have to, they are here because they want to. They all share more or less the same passions and interests and do this for fun. Therefore, the relationships they build are not quite alike professional ones but rather like personal ones. Later, they will benefit from these when it comes to business opportunities or issues.

About information asymmetry, it can be said that it was rather low. Indeed, once potential investors were (self) selected, they obtained access to business plans and other information as any VC or angel would have. What is more, since most of them do have a foot in the industry, they already know the potential outcome of the project and need not be convinced by the entrepreneur. About the entrepreneur's own potential, since he had already proven relatively successful on the web (all the information can be found freely on the Internet) and reached his own network, that by definition knew him, it was not an issue whether shareholders would have faith in him or not. Clearly, that could not have happened with bankers for these might not be that much aware of the web industry and would not rely on informal sources of information such as those on blogs or *Facebook*. This is what makes the strength of crowdfunding: potential investors are not professional financers and have therefore fewer requirements in terms of the source or quality of the information. What eventually counts is that they can trust the person they have in front of them. There is a more human contact than with other means of finance; entrepreneurs and investors are peers.

Later, on legal issues, only the number of shareholders was caped. They could only have raised more money by increasing the mean amount invested, hardly the number of investors. However, it is highly possible that people willing to invest more money would not have such intrinsic motivations and would rather seek financial rewards. This actually proves true, because the business angels and bankers that were first asked to fully finance the second round of funding refused. An IPO would accommodate virtually unlimited shareholders, but would they be skilled? Assuming that this is not an issue, what to think about managing them? Although Web 2.0 makes it easier to keep in contact with investors, it is likely that too many of them would decrease their ability of being heard. In fact, the time the entrepreneur devotes to relations with investors is limited and will not increase if the number of investors does. If there are a lot of shareholders, the time devoted per investor will be pretty small. Consequently, investors might actually not feel valued in their help and lose all motivation to invest.

Finally, a note on debt versus equity: in this case, equity was used. They eventually gave away 15% of their capital, which kept them in control of the company. Yet, this is not the only scenario; two alternative scenarios could have happen. The first is this one, whereby the crowdfunders obtain less than 50% of the shares. In this case, the entrepreneurs retain total control over the firm. On the other hand, if they were to give more than 50%, it would be likely that they would still be main shareholders (possessing the biggest share of capital) because crowdfunders are very fractioned. Nevertheless, in any decision that requires say half or even two thirds of the capital to agree, the fragmentation might prove harmful since shareholders have different interests.

Based on the study and analysis, it would seem fairly relevant to give these few pieces of advice to potential crowdfunders:

- Know how to efficiently communicate with Web 2.0, or at least know people that do: the more communication around the project you get, the better;
- Use your network as extensively as possible: communication from people that have faith in your project is way more effective than formal communication;
- Use information asymmetry at your advantage: make the project look fancy but have barriers make it look ugly to non-serious investors;
- Know what skills your company could benefit from, and look for these skills in your potential investors;
- Motivate your shareholders to be active participants in your company, by creating the adequate platform and showing them how valuable their help is;
- Know the laws you are working under. Make sure using crowdfunding will not make you an outlaw.

CONCLUSIONS

In this article, we discussed when it makes sense for small entrepreneurial ventures to use crowdfunding rather than another source of finance. Some main characteristics of ventures emerged:

- They need to **raise a reasonably low amount of capital** that would accommodate a relatively small number of investors. First because some legal forms have limitations in respect to that, and second because managing too big groups can prove to be difficult, even with new technologies. There are however a few cases that have shown how to circumvent many of these problems.
- They **have an interesting project** to offer to prospects, in particular something innovative. Indeed, since crowdfunders are not only rent-seekers, they also need to be interested in the project, often ready to become an active investor in decision making.
- They need to **be willing to extend their skill set**, or at least welcome other people’s opinions. The reason for this is that, once again, crowdfunders seek projects where they can participate and be useful. This could be an advantage to anybody.

- They need to **know how to work the controls of Web 2.0**, because the whole process goes through the interactive Internet, from communicating the project to managing shareholders. All of this could be done without the web, but at a considerably higher cost in time, money and efficiency.

Consequently, and mainly because of the first characteristic, crowdfunding is just adapted to small ventures. Bigger ones would be hindered with the cap in associates. Some companies have however circumvented this problem, like *Trampoline Systems*. Others adopt different organizational structures such as cooperatives or are based on membership. Moreover, not all small ventures can access it, only innovative ones that plan to grow big. Finally, big ventures might not be able to satisfy shareholders in their need for participation, so that excludes them too.

This paper has studied the emergence of a new kind of business funding, the crowdfunding. It has been argued that funding was particularly difficult to obtain for small businesses in respect of their size and lack of available historical data creating information asymmetry for potential investors. Hence, traditional financing methods like bank loans, business angels or VCs are out of reach for these small companies. Moreover, bootstrapping does not allow businesses to grow fast due to its focus on cash generation, often at the expense of maximizing value creation. As a result, crowdfunding can become a viable fundraising method obtainable for small entrepreneurial companies or project-based initiatives.

Our analysis of crowdfunding practices provides avenues for future research. One urgent question is the relation with intellectual property rights. Entrepreneurs making use of crowdfunding will need to disclose some of their ideas to the crowd well in advance, creating risks of idea stealing due to the fact that potentially valuable information is put into the public domain. Does this deter financially constrained entrepreneurs from tapping the crowd?

Another interesting question concerns the informational content for entrepreneurs for obtaining the crowd committing capital. To which extent does this affect the precision about potential demand that the entrepreneurs may receive for his product? Moreover, which remuneration scheme for the crowd generates the most information about potential demand? As pointed in above, each remuneration scheme may generate different forms of information and may vary in terms of degree of credibility of the signal. While investors signal interest in the product if the investor is promised a free copy of the product only, letting investors participate the voting process of certain product characteristics may yield feedback on the market sentiment in general. Indeed, in the latter case, investors do not need to be consumers. This raises questions about the optimal remuneration and participation scheme to offer to the crowd to optimize informational content of the crowdfunding process.

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