Ellen Chisa: Crowdfunding and the Internet, An Overview of Crowdfunding Platforms, Creating a Sustainable Crowdfunding Platform

Wednesday, February 3, 2016 – blog post / forum thread

Good morning,

As I announced last week, I am on vacation for this week. In place of the usual Daily Updates providing analysis of the news of the day, this week will feature guest writers focusing on their particular area of expertise that I believe is also pertinent to Stratechery subscribers.

Today's guest writer is Ellen Chisa. Ellen is the VP of Product at Lola, a travel-focused startup founded by former Kayak executives that is currently in a closed beta, and a former product manager at Kickstarter. Ellen is one of my favorite writers, and not only because we share an MBA and Microsoft background; she has a very distinct and approachable style that gives credence to her background as a product management teacher.

Today Ellen is writing about crowdfunding, which, surprisingly, I haven't covered at all on Stratechery. It really is an oversight, particularly given the fact that crowdfunding is something uniquely enabled by the Internet: it's a great solution for serving niches that are too large for one person but too small for venture capital.

On to the update. Do note that this is Ellen's work, and does not necessarily reflect the opinion of Stratechery (this is boilerplate! I again think it's pretty good):

I'm excited to be filling in for Ben today for the Daily Update. I wanted to explore a popular topic that's Stratechery hasn't not yet touched: crowdfunding.

I spent a couple years at Kickstarter as a Product Manager for the Backer Experience. I also participated in the Awesome Foundation, charitable giving akin to crowdfunding. Though I've since left both organizations, crowdfunding still stands out: I love this unique funding model because it's weird and unexpected.

Zack Brown was just raising $10 from his friends to make potato salad as a joke. The internet got the joke too: people got together and provided $55,000, that Brown then used for Potato Stock, a giant potato salad party, in Columbus. He got so much traction that Hellman's ended up sponsoring. People were upset that more "worthy" projects didn't get funding, but for me there's just the joyful feeling of "Who could have guessed THAT would happen?!"

So, it's weird. It's also deeply practical for many projects. Now that the platforms are successful, I field the same question every time I talk to a VC. "Would you have invested in Kickstarter? Could you have seen that coming?" Probably not. But now that it's here I can tell that it is interesting. Here's a bit about why crowdfunding happened now, an overview of the different types of crowdfunding, and what goes into building a viable crowdfunding company.

Crowdfunding and the Internet

The concept of crowdfunding itself is not new; it started from the patronage system of funding (Kickstarter covered the history of crowdfunding in this blog post). Historically, the only crowd-funded projects were those with widespread popular support. It makes sense the Statue of Liberty could raise enough public appeal. It's less obvious that a niche artist could.

This was exactly why Perry Chen decided to start Kickstarter. As Perry recounted on his blog, he didn't have the ability to raise the funds to pay for a concert he wanted to host, because it was too difficult to accumulate $20,000 in $20 and $50 chunks, presuming you could even find all of the interested people in the first place.

What makes crowdfunding possible now is the emergence of new communication platforms. The Internet allows us to surface niche communities that weren't so obvious beforehand. People create deep communities, and then these communities blur over into the "real" world. For example, my friend Ann met her roommate from a subreddit dedicated to a subsegment of women's fashion: try explaining that to someone from thirty years ago!

The ability to build new communities has simultaneously been supplemented by new payments technology. Payments technology used to mirror real world transactions. Paypal started with merchants on eBay. They were selling items to consumers and needed to collect payment (but did not have credit card processing abilities).

However, these tools were not as effective in crowdfunding situations. Having people commit to pay, and then pay later often doesn't work. In the first month of FundClub (an initiative of AlterConf and Model View Culture), for example, only half of promised donations were collected because the payment was separated from the commitment.

Crowdfunding addresses this mismatch, and makes sense for projects that rely on communities for funding. It's basically a technological platform that helps with things that were happening naturally.

It's also really interesting for people who are working in technology. There's still a big gap between bootstrapping and being ready for significant venture funding. Just look around at the emergence of accelerators, incubators, and seed-dedicated funds. Yet, these smaller funds do tend to funnel towards venture backing. After all, the original financiers need to get paid back somehow.

Crowdfunding provides another option. It fits in a few different ways:

- It can precede venture funding, particularly if venture isn't confident in the market. An iconic case is Oculus Rift, which raised its initial $2 million on Kickstarter. After a few rounds of venture funding, Facebook acquired the company. In that way, it plays a similar role to a seed funder, but without an equity compromise. Similarly, Pebble (the makers of the Pebble smartwatch) struggled to raise VC money originally, but was a massive success in crowdfunding. After the crowdfunding it was able to raise venture (and more crowdfunding), and play a role in the future of wearables.

- Crowdfunding can also replace the entire venture process if it gets a company to a place where it can grow profitably. Studio Neat, for instance, which builds niche products like smartphone tripods and Apple TV remote stands, has financed a wide array of products using crowdfunding instead of venture (both hardware to software). Makey Makey created a hardware kit that allows you to use bananas (or other fruit) as a piano without venture funding. Jewelbots is creating programmable friendship bracelets for girls, and while the company started at the TechStars' accelerator, it hasn't raised a formal round.

- Money isn't the only reason certain products turn to crowdfunding. Misfit used a campaign on IndieGoGo to generate early customers for the Shine. This campaign happened even though they'd already raised substantially more money from venture firms. The crowdfunding helped generate press and interest (and created time pressure for sales!)

To be sure, crowdfunding has had prominent failures as well, like the PID-controlled espresso machine. Stories abound with people who didn't get their wallet, light bulb, or smart watch. This has become a popular debate, to the piont that Ethan Mollock at the University of Pennsylvania ran a large scale study on Kickstarter projects, generating a fulfillment report. It's not as bad as many think: his takeaway was that 9% of projects fail to deliver rewards, but this isn't always viewed as a "failure" by backers. Oftentimes the projects that fail are smaller (raising less than $1,000), but we tend to hear more about the high profile failures so they seem prominent.

An Overview of CrowdFunding Platforms

Crowdfunding platforms vary widely; the largest point of distinction between platforms is the goal of the funder. Is it to support a cause, get a reward, or gain equity?

- Cause crowdfunding is about coming together to help someone. These are akin to the type of fundraiser we're accustomed to. "I'm running a marathon, could you donate to X charity?" Or the birthday party fundraising for charity. Rather than being tied to a specific positive event (marathon, birthday) they're tied to a crisis or need. You'll often see these fundraisers on GoFundMe, StartSomeGood, or Generosity (part of IndieGoGo). Some common uses are for medical bills, tuition, and other life concerns during an employment gap or crisis.

- Reward crowdfunding includes most of the projects mentioned in the first section. This is about participating in funding in order to "get" something, and is similar to a pre-order. If you support a band, for instance, you'll get a copy of the latest album. If you back the potato salad, you get to attend Potato Stock, etc. This is the type of crowdfunding that is often confused with "shopping" even when that is not the intent.

- Equity crowdfunding is the newest area, as a result of the JOBS act of 2012. The JOBS act reduced security regulation for funding small businesses. This allows average people to invest a small amount in exchange for equity. (Up to $5,000 for people making up to $100,000 and $10,000 for those making more).

Even when a platform provides services for multiple types of funding, there tends to be a clear distinction in brand and experience. For instance, IndieGoGo provides service in two areas: the company runs a reward based platform at IndieGoGo.com, and it also runs a cause platform at Generosity.com. The company has expressed an interest into expanding to equity crowdfunding as well. If they were to reach equity crowdfunding, they would start it under a new domain or find a way to separate it within the core site.

I will note, this view of the three types of funding is US-centric. These spaces also vary internationally. In Japan, one platform, readyfor.jp focuses on community-oriented projects. This is due to the reputation risk associated with trying to fund a personal project. And, in countries with strong government arts funding, there may be less need for a reward-based platform for artists.

Within each of the three categories, there is further differentiation. One example of this is the implication of meeting or not meeting a fundraising goal. On Kickstarter, a funder is protected by "all or nothing" fundraising. On other platforms creators can collect even if they don't reach their goal.

Creating a Sustainable Crowdfunding Platform

To return to the VC question I opened with, is it possible to build a business around a crowd-funding platform? How do you build a moat? Let's look at the functions a crowd-funding platform provides:

Payments — As noted above, the initial benefit of crowdfunding was being able to collect payments. Lots of the early innovation in crowdfunding happened here. The Self-starter repository created by Lockitron allows independent payments processing. Patreon, which just raised a $30M series B, shifted towards ongoing funding per piece of work, or per time period, rather than per project.

However, while this was the original benefit of the category, at this point, it's a stretch to call the ability to collect payments a "benefit." Appropriate payments processing has become a commodity, and many of the innovations in payment attributes are replicable. For example, after Kickstarter introduced "All or Nothing" other platforms quickly built similar things. The necessary payments technology just becomes more available. As that happens, the barriers to entry in payment processing continue to drop. Ultimately, while innovations in the funding space continue to happen, they are unlikely to be defensible in the long term.

Social Acceptability & Network Effects — The second piece is the legitimacy platforms provide to campaigns. The platform sets up some set of expectations for what the creator has to achieve before launching. Most of the time, the creator needs to create some sort of video, imagery, and a written narrative. This helps legitimize projects, which on its own is a benefit. Of course, if a platform becomes known for having a high percentage of projects that fail, this effect may be diminished.

The more common discussed benefit is the network effects from being on the platform. Of course, crowdfunding isn't free money. Nearly a quarter (22.8%) of projects that fail on Kickstarter never got a single pledge. That said, once a project has some traction it's more likely to find an additional audience. Each platform has users who regularly are looking for new projects to support. Those influencers might notify others by sharing projects in other places, like the communities discussed earlier. A platform can create their own internal community, or work with one hosted elsewhere.

While social acceptance of crowdfunding is not defendable by one platform, the network effect can be. That said, this isn't a place that's easy to start from. If you're building a platform from scratch, the space is already crowded and you need another differentiator.

Additional Resources and True Differentiation

The greatest place a platform can generate unique value is in specializing and creating unique resources. The highest level of this is the type of funding, as described above. But new platforms are expanding beyond the "funding" moment to the "planning" or "executing" moments.

Two examples of this are Fig and Dragon Innovation.

- Fig is a platform for crowdfunding video games. Fig helps with licensing terms, campaign, strategy, marketing, PR, game launch, and distribution support. Video game makers are more likely to seek out Fig not simply because of its payment mechanism or community, but because they help take care of the business side.
- Dragon Innovation is a platform specifically for projects with manufacturing needs. They started as a crowdfunding platform with additional manufacturing advice, and have moved into being a platform that "certifies" projects as manufacturable (They also still help previously crowdfunded projects work with manufacturers). They've moved entirely away from funding and payment processing and focused on one of the key failure points for many crowd-funded projects.

This differentiation by type also plays back into the network effect. A platform solely for video games, or for cool new tech products, allows people to find things targeted to their interests. While this may be bad from a filter bubble / serendipity experiment, it's positive for finding a community, which is ultimately where crowdfunding shines.

The incumbent platforms have also seen this advantage and pushed further into this area. Kickstarter has turned the community team into a true community team. Specialists are hired for each project category - be it food, technology, or journalism. The office building has space to allow artists to do gallery shows, and filmmakers to show films.

Differentiation by needed service for particular types of projects is the place we will most likely see innovation going forwards in the crowdfunding space. This is how platforms will retain value.

To close where we started, I don't think I'd have funded Perry if he'd pitched Kickstarter to me in 2009. I wouldn't have been able to see the unique benefits of the platform, or understood how large the space was.

In retrospect, there were a few key differentiators that led to success. The first was the choice to focus on reward-based funding. The second was specifically differentiating with a focus on creative projects. Finally, a unique payments processing philosophy ("all or nothing") that reflected the chosen space. Perry, Yancey, and Charles managed to make a platform slid right into a funding gap.

Going forward, there will be a variety of crowdfunding platforms. The ones that succeed will be able to differentiate themselves in terms of what services they offer. Crowdfunding is no longer just a new payments model: it's collecting the payments, finding the community, and building onto the funding moment.

My thanks to Ellen Chisa for writing today's Daily Update!

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