The risks of following the crowd – The London Economic

By David Willbe, Director in the Technology team at law firm DWF Equity crowdfunding is experiencing a boom in publicity and popularity, but investors and startups alike must be aware of the risks when equity is involved.

Prominent advertising by the likes of CrowdCube in recent months is a clear sign that crowdfunding has moved beyond being an advance payment for consumer products and become a mainstream investment model. But for all the hype, crowdfunding is not new. As long ago as 1997, an internet campaign raised $60,000 to fund British rock band Marillion's US tour – and in 2001 the band pre-empted the Kickstarter/Indiegogo model by asking fans to pay in advance for an album so that they could afford to record it.

The simple concept of paying in advance for goods has now morphed into platforms marketing equity (and debt) finance opportunities, enabling the general public to take a position on a company's longer-term prospects. Some argue that this has created a means for businesses to be financed in economic times when more traditional routes to funding have largely been blocked. Others counter that businesses that could not attract institutional investment have been pushed into the retail market – meaning that the riskiest investments are now being financed by those least able to afford the risk. Whatever positions are adopted in this debate, there are some cautionary notes to bear in mind, two of which we can see already from the crowdfunding of products.

First – the market is fickle. The Coolest Cooler, which shattered Kickstarter records in raising $13.2 million, had failed in a previous campaign to make its target of $150,000. The "trending" effect is key in equity crowdfunding: companies that appear to have momentum (on the site or in the news) attract more investment within the prescribed timeframe. So a company looking to crowd fund its equity should be prepared to do what it can to promote its campaign and, if possible, to source some capital in advance that can be invested through the platform to get the ball rolling. Moreover, with equity – as opposed to product – crowdfunding, not attracting the target investment is a very public failure and may harm a subsequent campaign or any remaining chances of securing professional investment privately.

Second – the public does not invest rationally or dispassionately, preferring projects that appeal to personal interests. This distorts valuations, making crowdfunding investment an unreliable indicator of long-term success. Marillion crowdfunded multiple albums with relative ease, drawing on their dedicated fan base, and the success rate of Kickstarter projects including zombies, ninjas, pirates, or video games in any combination remains reliably high – but these do not have any particular correlation with how a product will sell to the wider market. In the same vein, raising funds on crowdfunding platforms may not be a good indicator of which companies will subsequently achieve real traction in the market or attract later stage (professional) investment.

Beyond the lessons that can be learned from the product market, there are a couple of points unique to equity crowdfunding that companies considering this route should also factor in to their thinking.

The main question at this point is how well this asset class is understood by the people investing in it. The hope is that public investors are clear that there is no guarantee of a return, and that among people who do this for a living there is an expectation that a good proportion of the companies in which they invest will not

deliver a return on the investment at all. If we start to see high-profile failures of crowdfunded companies investor sentiment may begin to turn – particularly in terms of appetite for future investment.

The other main consideration is that something akin to a “format war” has emerged in equity crowdfunding, with platforms falling broadly into two distinct categories. The first category contains platforms that allow investors to hold their stake as an individual; platforms in the second category group investors within a nominee vehicle that represents the group. At this stage it remains unclear which version will get to critical mass – and for companies that take equity crowdfunding, taking it from the right model may prove important in the future.

The outcome is tied in to how the market will evolve. One next logical step for equity crowdfunding would be the creation of a platform that enables investors to sell their crowdfunded investments from different platforms peer-to-peer, effectively creating a secondary market. This would enable people to cash out in a way that they can’t at the moment, removing one significant issue with the asset class as it stands. If such a platform were to become popular, that could be a major shot in the “format war” for whichever structure worked with the platform.

As the market matures, this may also lead to other companies becoming comfortable with using a crowdfunding model as a source of investment. For example, businesses heavily dependent on IP do not tend currently to crowdfund, owing to the risk of disclosing unregistered IP into the market. If a platform emerges that enables this to be done securely, the pool of potential candidates for crowdfunding may expand.

Perhaps the biggest test is how later-stage investors, and ultimately the public markets, will react to these companies as they grow. Historically, later-stage investors have been wary of investing in startups with long shareholder registers. Major corporate transactions, including the all-important exit process, can become more complicated if, for example, a disgruntled ex-employee who retains a stake is uncooperative, or if a shareholder simply becomes uncontactable. Equity crowdfunded startups are now coming through in numbers, and we are starting to see success stories of professional investors coming in either alongside or after a crowdfunding round, but as yet the sample size is too small to draw any definitive conclusions as to whether either of the two structures will pose a significant problem for future financings.

For now, at least, equity crowdfunding is a viable option for companies that are mindful of its unique concerns. As the processes and platforms evolve and mature, the longer-term trends will be interesting to watch.

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