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Crowdfunding

SUMMARY: In the wake of the global economic crisis, crowdfunding has become an increasingly significant alternative form of financing. Of the various business models that have evolved during recent years, this study focuses on equity, credit, reward and donation-based models. The investor/supporter motivations of crowdfunders are different from the objectives of traditional financiers. Besides the benefits of crowdfunding, its risks should be also mentioned as they will shape the future development of this particular financial innovation.

KEYWORDS: crowdfunding, financial innovation, startup financing
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The 2008 global financial crisis retrenched the banking sector's willingness to lend and simultaneously, trust in banks deteriorated (Wood and Berg, 2011). The financing needs of innovative ideas, startups and already existing small and medium-sized enterprises (SMEs), as well as the development of digital technology and financial innovation brought to life an alternative form of financing, one that uses internet platforms to moderate between project ideas and crowds of backers willing to invest funds. Compared to the selection of – highly standardised – services provided by banks, crowdfunding, which can be tailored far better to individual needs, offers the SME sector a more flexible way to raise funds, where communication between funders and fundees plays a special role.

With crowdfunding, in response to an open call, members of a large audience voluntarily decide to finance some kind of a goal directly, each individual usually providing only a small sum of contribution in exchange for money, a product or a service or even when they are not promised anything in return (Belleflamme et al., 2013a). Crowdfunding platforms are websites that enable managers, entrepreneurs and the initiators of other projects to solicit funding through an open call and post details about the projects. Potential backers may browse through the projects and support the ones they find attractive by providing funds. Through the use of the current digital technology, countless users, initiators and potential donors can sign on these sites easily and inexpensively. The platform assists in the launch of campaigns and fundraising.

Crowdfunding renders project financing and financing methods more democratic. According to *Shiller* (2013), there have been three financial innovations in recent years, one of which, besides benefit corporation and the social impact bonds is crowdfunding itself. The common trait of all three innovations is a focus on society, community and the crowd.

FORMS OF CROWDFUNDING

Crowdfunding is not a homogeneous form, and has several types; we can distinguish between equity-based, credit-based, donation-based and reward-based crowdfunding. The first two types are of a business nature with

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investment in focus, while the latter two are characterised by patronage and support.

Equity-based crowdfunding involves the cheap issuance of shares through the internet, where investors can acquire stock in corporations for a small amount of money, with a claim over the company's future cash-flow. It has proved to be a viable form of corporate finance, enabling even those companies to access funding, which have failed to get funds from angel investors, government programmes, friends or family alike. *Crowdinvesting* deals with the financing of corporate growth and innovation (Bradford, 2012a; Klöhn – Hornuf, 2012).

In the case of credit-based crowdfunding – also known as peer-to-peer (P2P) lending – funds contributed by individual creditors are disbursed as personal loans to requestors through internet platforms without financial intermediation and collateral, with high risks involved. The fact that in this case diversified, small sums of contributions are made by supporters to individual loans can be considered as an attempt to minimise losses. Certain sites offer access to the funds of private backers to pre-screened enterprises *(peer-to-business lending, P2B lending)*. It has become a trend that institutional investors take recourse to P2P lending, which shifts certain platforms to an *institution-to-peer* type of lending (Moenninghoff – Wieandt, 2012).

Donation-based crowdfunding is aimed at supporting charitable, research, creative and personal projects, where contributors do not expect any financial or non-financial returns. The reward is more of an emotional nature and beneficiaries have no obligations whatsoever toward their backers.

Reward-based crowdfunding can be used also to provide funding to startups, expand existing companies or finance personal creative projects. In this case, funders receive either real products or services in exchange. The process of reward-based crowdfunding is started by the project initiators by posting all relevant information, and is continued by offering sales incentives. The precise goal of the project, the investment needs and the deadline are posted on the project website. If the project fails to receive the solicited amount, depending on the platform, supporters may be refunded. The different reward categories established by the initiators depend on the amount of support. Supporters offering more money are classified in a higher category and can expect a proportionately higher reward. Sometimes expanded objectives are set up, which can be implemented in case the project receives a significant amount of overfunding.

A new phenomenon is crowdfunding outside of platforms, where individual project initiators post their calls on their own homepage. Outside of standardised platforms, much more individualised projects can be generated, which can be better tailored to personal needs (Belleflamme et al., 2013b). In order to succeed, the owner's website must have a large number of financially fit visitors and, depending on the type of financing, this kind of funding may even be illegal, which could cause problems.

According to information released by the Massolution company[1] (2013), based on data gathered from 308 platforms, USD 2.7 billion was raised through crowdfunding in 2012 worldwide, and the industry insider forecasts an increase in the market to USD 5.1 billion in 2013. Based on their survey, reward-based crowdfunding had the largest share in 2011 worldwide, followed by the donation, lending and equity-based models. According to *Collins et al.* (2013), the alternative finance market grew by 91 per cent from GBP 492 million in 2012 to GBP 939 million in 2013, of which donation–based crowdfunding represented the largest segment with GBP 310 million in 2013, which is followed by P2P lending (GBP 287 million) and P2B lending (GBP 193 million).

The prevalence of crowdfunding and the internal market proportions of the respective business models may demonstrate significant geographical and cultural differences. In recent years, Hungarian crowdfunding initiatives (Indulj.be, CreativeSelector, Kezdheted.hu) have been facing the challenges presented by the groundbreaking phase.

ADVANTAGES AND DISADVANTAGES OF CROWDFUNDING

In a comprehensive research, *Agrawal et al.* (2013a) summed up the incentives and deterrents of crowdfunding from the perspective of creators, funders and platforms *(see Table 1)*.

Accordingly, apart from obtaining capital, when choosing crowdfunding, initiators may also have some other considerations. They can form connections with users and supporters and receive encouragement and feedback from them, and monitoring the progress of other projects through the social media allows their work to become more conscious; moreover, they get inspiration from the success of others (Gerber et al., 2011). Research shows that one of the greatest advantages of crowdfunding is the fact that its functioning is similar to that of social media, enabling initiators to make personal contacts and communicate with a large number of visitors who are interested in the future of their projects and are emotionally attached to them as well. This is certainly not true for bank loans, venture capital or stock exchanges.

Crowdfunding, therefore, has implications that go beyond the financial and legal spheres and involves different other motivations, including getting attention (reduced marketing costs); access to feedback (market testing, market validation); crowdfunding can be used as a promotion device, as a means to support mass customisation or user-based innovation, or as a way to gain better knowledge of consumer preferences (Belleflamme – Lambert, 2014). There is a wide range of motivating factors behind investors' decisions; ;indeed, the perceived economic value of the project goal, the investor's personal financial gain, the possibility of self expression, perceived community involvement, and the enjoyment of supporting a crowdfunding project all have a positive effect on a consumer's intention to invest (Harms, 2007).

There is a significant difference between crowdfunding platforms and other forms of financing; the former has three specificities that may not be found together anywhere else (Giudici et al., 2012):

- the presence of an enabling organisation with which those seeking capital (initiators) and those in possession of capital (supporters) are affiliated;
- direct interaction between entrepreneurs and investors;
- emergence of social groups among investors and entrepreneurs.

Crowdfunding overcomes the distance-related economic frictions usually associated with the financing of early-stage projects (Agrawal et al., 2011). In examining geographic drivers, *Schwartz* (2013) found that start-ups in rural America lag behind their urban peers because, due to the high risk associated with them, there is a persistent lack of banks loans for rural entrepreneurs, and venture capital tends to focus on metropolitan areas along the coasts. According to the author's argument, rural entrepreneurs use crowdfunding to raise attention and get in contact with supporters and business angels from across the country. The quality of some projects posted on crowdfunding sites is not good enough to

Table 1

DRIVERS AND DETERRENTS OF CROWDFUNDING

For whom	Incentives	Disincentives
Creators	Reasons for lower cost of capital • Better matches between projects and supporters, access to global funders; • Bundling: bundling the sale of equity with early access to products, limited-edition products and name recognition; • Provide information about the projects; • Crowdfunding increases supply in the area of early-stage capital. Background of more information: • Early access to products; • Early market research, which reduces the variance of post-launch demand; • Facilitate the early development of an ecosystem around the product; • Engage potential users in the ideation and design of a product.	• Disclosure risk: disclosing information may have negative repercussions on patentability and on bargaining with potential suppliers. Another potential disadvantage is the fact that, besides the product or the service, strategy, key employees, customers and costs must also be disclosed. • Unlike with business angels and venture capitalists, there is no industry knowledge, relationship and status. • Due to the large number of investors, investor management may be more costly (comments, attention, interaction); in addition, creators must deal with differing visions and strong personalities. • It is difficult to raise follow-up financing
Funders	• Access to investment opportunities; • Early access to new products; • Community participation: social activity, consumption value, recognition from the creator; • Support for a product, service, or idea; • Formalisation of contracts: crowdfunding formalises what would otherwise be informal finance..	• Creator incompetence. • Fraud: the lack of repeated financing interaction increases the potential for fraud. They may become a target for professional criminals. • Project risk, information asymmetry
Platforms	• Revenue model: the transaction fee for successful projects is 4–5 per cent of the total funding amount; • Objective: to maximise the number and size of successful projects; • Requirements: to attract a large community of funders and creators and to develop a market design to attract high-quality projects, reduce fraud and facilitate efficient matching between ideas and capital.	• Reputation risk

Source: Own editing based on Agrawal et al. 2013a.

succeed in finding capital resources on a local basis (Giudici et al., 2013). It is important to note that companies succeeding in obtaining crowdfunding can achieve the same quality as those backed by business angels; however, funders are less subject to geographic or gender biases (Mollick, 2013a).

Having discussed the advantages of crowdfunding, disadvantages and risks should be also mentioned. The limitations of regionality are demonstrated by the fact that utilising the benefits provided by crowdfunding is often impaired by cultural and linguistic differences. Lending-based crowdfunding platforms tend to indicate “home bias”, ;a tendency that investors prefer to invest in companies and stock located in the same geographical area, often forgoing better alternatives with lower risk and higher return if they are located in geographically more distant areas (Lin − Viswanathan, 2014). On the other hand, lenders prefer borrowers and entrepreneurs of the developing world who stand out from the crowd and are socially proximate to them, i.e. their social distance from the investor is smaller (Galak et al., 2011).

Borrowing follows existing agglomerations. Despite the decoupling of funding and location, funds from crowdfunding disproportionately flow to the same regions as traditional sources of finance (Agrawal et al., 2013b), perhaps due to the location of human capital, complementary assets, and access to capital for follow-on financing.

Since crowdfunding “fills a void left between microfinance and professional/institutional investors” (World Bank, 2013, p. 22), it is not always the best choice of borrowing, given that it is aimed at the financing of start-ups or individual projects. Subsequent crowdfunding borrowing is negatively related to initial crowdfunding support (Kuppuswamy − Bayus, 2013). Equity-based crowdfunding may generate a capital structure unattractive to angel investors and venture capitalists. There is a risk that crowdfunding leads to myopia, which might subsequently scare away potential future funders due to the dispersion of the masses constituting the ownership structure and the logistical difficulties of voting and approval processes.

Crowdfunding investments have numerous risks, including securities market scandals, business failure, the threat of money laundering, excessive capital allocation to sectors preferred by crowdfunding, subsequent funding failure, investors’ lack of liquidity due to the lack of a secondary market, lack of issuer experience, regulatory and compliance risk, potential market rejection (World Bank, 2013).

It gives rise to horizontal risks that small investors obtaining a stake through crowdfunding have little information about the control rights and covenants they need in order to keep their stake in proportion; in addition, their position is not strong enough to safeguard against a potential dilution of investors’ interests (Bradford, 2012). The small amount invested by a crowd of investors and the remote, impersonal nature of the business relationship preclude any meaningful negotiations between the partners; the protection of smaller crowdfunders, for instance, creates agency conflicts vis-à-vis larger investors with more capital. Crowdfunders have limited exit options; however, sometimes angel investors or venture capitalists allow crowds of investors to exit by providing follow-on financing to the company.

The information asymmetry between heterogeneous supporter/funder crowds gives rise to client/agent problems. In the case of equity-based crowdfunding disclosure and reporting regulation is often challenging, given that it applies to a hard-to-define, unstructured future and existing crowd of investors, who are difficult to classify according to geographical or financial status, social standing, financial awareness or any other criteria; in addition, this crowd is driven and supported by the internet, where members of affinity groups are connected through “social technologies”. Equity-based crowdfunders do not have either a single, focused investment goal or a group of such goals (Mollick, 2013b).

Crowdfunding gives rise to – and is unable to manage – the double trust dilemma, which means that the owners of groundbreaking ideas do not necessarily turn to funders who can use the information without compensation to the innovator (Cooter – Edlin, 2013).

The rule system of platforms represents a risk factor as well. In the United States, the Jumpstart Our Business Startups (JOBS-) Act encourages equity-based crowdfunding. The Act prohibits financial organisations, such as mutual fund managers from participating in equity-based crowdfunding. With this, due to the lack of time and expertise, the target group – middle-income investors – may have difficulties with diversification; indeed, they have an option to invest in high-risk and high-return companies; however, they cannot take advantage of it because the Act does not facilitate the mitigation of risk (Williamson, 2013).

INVESTOR OR SUPPORTER ATTITUDE OF CROWDFUNDERS

The motivation of crowdfunders largely depends on the type of crowdfunding and the goal of the specific project. Accordingly, in contrast with the main motivation of equity-based crowdfunding – financial gain –, the greatest incentive in reward-based crowdfunding is the fact that the supporter can assume the role of a patron supporting the creator or the inventor as opposed to participate as an ordinary customer. As regards donation-based crowdfunding, the strongest factor is participation in a community or social cause (Ordanini et al., 2011). Crowdfunders, who are neither creditors, nor consumers, are not merely motivated by financial gain; they also seek social activity-related "community benefits", which could be consumer experience in the case of reward-based crowdfunding, or investor experience in the case of the equity-based model (Belleflamme et al., 2013a). In case of equity-based and lending-based crowdfunding, the contributor must decide on an investment, while in the case of reward-based crowdfunding, the pre-orderer of the reward also assumes the role of a consumer and the contributors in the donation-based model are simply donors.

We should also take a look at the differences between crowdfunders and other formal or informal capital providers. In addition to crowdfunding, innovative start-up projects may also receive funding from friends and family, banks, tenders, angel investors and venture capitalists. Each alternative has different features in terms of available financing volume, conditions, maturity, costs incurred by the entrepreneur and the contribution provided by the funder during the relationship. In contrast with business angels and venture capitalists, the "crowd" does not expect to have an active role in supporting and controlling the enterprise. Friends and family play a key role as an important source of capital for early-stage ventures, when cumulative investment serves as a signal for future investments (Agrawal et al., 2011). On the other hand, crowdfunding may also serve as an undesired negative signal, indicating that the project that seeks financing is so high-risk that it was unable to raise funds from the environment of the founders, their friends and families.

The question as to whether crowdinvesting will complement or substitute angel finance cannot be answered unambiguously: crowdfunders may at times co-invest with professional investors; in other cases, they may compete with business angels for the same investments (Hornuf – Schwienbacher, 2014). During the course of equity-based crowdfunding, neither the individual investors of the crowd, nor the small security-issuers generating the projects have the expertise on the evaluation methods used for pricing; therefore, in order to be successful on both sides, crowdfunding structures must include a price analysis, disclosure and protection (Palmiter, 2012).

There is an asymmetry between active hot hands investors and crowdfunders on the investment horizon (Andrieu – Groh, 2013). The authors found that active investors were better informed but had a shorter investment horizon than the crowd;: at the perceived optimal time they collect their profits or cut their losses and discontinue their positions, looking for another investment, while crowdfunders are usually more interested in the long-term success of a start-up venture and adjust their time horizons accordingly.

Lay crowds are more prone to trust the initiator of a project than professional investors as, in some cases, they decide on an impulsive basis as opposed to the rational judgements financial investors tend to make (Vass, 2013). As regards the upside potential, crowdfunders may benefit from the "wisdom of crowds" (Surowiecki, 2005), while, on the downside, they are exposed to groupthink (Janis, 1972) and herd behaviour (Scharfstein – Stein, 1990).

In respect of the time dispersion of contributions made by reward-based crowdfunders, three distinct phases may be identified (Ordanini et al., 2011). According to the authors, owing to the significant, fast influx of capital, investments in the first phase reach approximately half of the project's target capital. The large initial momentum can be primarily attributed to the support of friends, acquaintances and the social network, and to the initial enthusiasm over the new idea. The second stage usually slows down or stagnates in investment growth. This is the most critical phase of the project that demands the highest responsibility of the project owners; their marketing and PR activity will ultimately determine the success or failure of the project, i.e. whether it proceeds to the third phase: an accelerated growth toward the target amount.

Based on a research on financing dynamics, if the influx of funds is fast and high volume in the early phase, it may crowd out or substitute the subsequent, slower and longer capital influx cycle, thereby increasing, in general, the likelihood of achieving the funding target and the accumulation of sufficient capital and, by boosting attention, it establishes the conditions of a successful start-up or the launch of a venture (Burtch et al., 2013). The trend of financing is also influenced by the fact that experts and experienced investors have a significant influence on the online crowdfunding community in the context of "rational herding" (Kim – Viswanathan, 2013). The willingness to lend grows in line with the accumulated capital, and confidence in others' judgement about the quality of the project may lead to irrational herding, which is particularly accelerated toward the end of the fundraising campaign (Zhang – Liu, 2012). Successful projects, however may see a pronounced lull in project activity during the middle period of the funding cycle due to a the bystander effect, when new backers' willingness to contribute declines as they perceive that the funding goal has been achieved (Kuppuswamy – Bayus, 2013).

Signals and social effects have an influence on backer behaviour. Participation in reward-based crowdfunding is motivated by four factors: altruism, social benefits, rewards and reputation (Lin et al., 2014). The authors identified four archetypes of crowdfunders on Kickstarter:

- Active Backers tend to back a large number of projects and are more likely to create projects themselves; they post more comments and have a broader range of interests, i.e. they are motivated by social benefits and reputation;
- Trend Followers tend to be more risk adverse, backing more popular projects that have a smaller average goal size;

- The Altruistic are less risk adverse, with an emphasis on backing projects that do not provide rewards; and
- The Crowd (comprising 54 per cent of the sample) tends to be focused on rewards; this group is relatively risk adverse, backing a smaller number of projects in fewer categories and with smaller goals. Participants do not create projects and are less likely to leave comments.

In case of donation-based crowdfunding, at a psychological level two processes play a role in donors' decisions. One of them is sympathy: donors are more prone to support those that they can sympathise with, or those they perceive closer to themselves, a close friend or a relative, facing the same kinds of misfortune that they or someone close to them have faced before. The second such psychological effect is rational deliberation, i.e. the donors simply tend to support project initiators who, in their own assessment, are most in need of support and who would be helped the most by the donation (Loewenstein – Small, 2007). This psychological effect is manifested both in lending-based and donation-based crowdfunding; beyond the motivation of own reward, similarities between the initiator and the investor and the initiator's level of need play an important role in every case; the more the initiator stands out from the crowd, the more likely they are to receive funding.

SUCCESS FACTORS OF CROWDFUNDING

The success of all crowdfunding projects depends on whether they succeed in raising sufficient funds during the time available. The volume of funds, in turn, directly depends on two factors: the number of funders supporting the project and the sums provided by them on average. Presumably, the goal of project initiators is to maximise both factors. With that in mind, they need to know how to reach the highest number of potential supporters, and offer such rewards in exchange for their contributions for which they are willing to support the project with the largest possible sum of money. In a wider sense, additional methods may also be available to motivate crowdfunders' decisions to invest or donate, and the crowdfunding process itself may have long-term results which could also contribute to the successes of the product or the initiators behind it.

Besides providing the funds, crowdfunders can also facilitate the success of the project by advertising it. At this time, there is no platform to monitor or reward the advertising efforts of supporters; however, the advertising of a project ("shares" by supporters via social networks, project updates by creators, featuring the project on the platform's front page) has a positive effect on its success (Qiu, 2013).

The positive effect of advertising and the attention generated remain intact even after the end of the campaign. According to the research of *Mollick* and *Kuppuswamy* (2014), a very high percentage (over 90 per cent) of successful Kickstarter projects remained ongoing ventures years after the campaign, and nearly one third of them reported annual revenues of around USD 100,000. The authors found that, apart from fundraising, the role of marketing is just as important; ;during the campaign creators had an opportunity to connect with consumers, establish their own community of supporters, gain information about the market and receive high publicity.

Those project creators who have backed many projects are more likely to create successfully funded projects, showing that through the process they learn about evaluation and monitoring of the projects (Zvilichovsky et al., 2013). The authors pointed out that project owners who back the projects of others form sub-communities, which increases their network visibility and credibility and hence, lead to higher funding rates for projects initiated by such owners. The social capital of entrepreneurs improves the success rate of crowdfunding projects (Giudici et al., 2013).

Project quality is an important factor. On Kickstarter, for instance, quality signals – such as level of completion – are positively related to willingness to support (Mollick, 2013b). Crowdfunding is most successful when entrepreneurs are able to reduce uncertainty for potential investors by sending quality signals (Belleflamme − Lambert, 2014). Signals, such as a detailed report on risk factors (e.g. for financial forecasts) and internal governance (e.g. a board of educated directors, adequate management structure) had a positive impact on fundraising success (Ahlers et al., 2012). In respect of project quality, it is an interesting proposition that a higher proportion of bad projects in the pool can paradoxically increase the number of good projects that end up funded;, while having more good projects in the pool may prompt investors to spread resources so thinly that diminishes the returns on any platform efforts designed to improve the quality of participating projects and investors. (Parker, 2014). Future research is needed to estimate the optimal balance between good and bad projects.

CONCLUSIONS

Innovation, enterprises' needs for growth, technological development and the increasingly more democratic capital market role of the masses enabled the emergence of a new breed of financing forms, where funders – supporters or investors – strive to gain, among other things, social benefits through the allocation of funds via internet platforms. In recent years, crowdfunding has become a dynamically increasing financing method worldwide. Research on this untraditional financing logic has brought numerous instructive results and pointed out the importance of quality signals and social effects in the shaping of crowdfunder behaviour.

Note

[1] Source: http://www.crowdsourcing.org/editorial/2013cf-crowdfunding-outlook-report/26448

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