A brief introduction to Crowdfunding

Crowdfunding refers to the collective funding that a business can accumulate for a project with assistance from the public. Crowdfunding platforms are often based on and have become possible due to fintech, which is basically the integration of finance and technology to provide services to different businesses and individual customers.

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These platforms act as an intermediary for financial transactions between basically a “capital seeker” and a “capital provider”. One of the first real crowdfunding “projects” that we know of is a rock bank in England in 1997 that managed to finance their tour through a crowdfunding activity.

Especially after the credit crisis of 2007 to 2009, more and more investors also started to pay serious attention to these platforms. This attention enticed the development of new fintech platforms related to crowdfunding activities.

When we talk about crowdfunding there are basically four known formats of platforms or ways of raising capital:

- **Equity-based crowdfunding**
- **Rewards-based crowdfunding**
- **Donation-based crowdfunding**
- **Debt-based crowdfunding**

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Equity-Based crowdfunding (or ECF for short) is the crowdfunding method in which the investor seeks a return from the project in the long-run in the form of dividend-like payment or other profit-sharing arrangements. If the "project/business" did well, the investor may thus receive a return or can sell his crowdfunding participation to someone else at a capital gain.
Rewards-based crowdfunding does not include monetary gains. Instead, the contributor (we don't really talk about investors in these cases) receives maybe a discount or early access to a to-be-launched product.
Donation-based crowdfunding does not include a formal return at all. Unlike other financing mechanisms, traditional donation-based crowdfunding is not bound by a repayment commitment.
Debt-based crowdfunding basically refers to the situation where the public/marketplace provides the capital through lending. With crowdfunding for debt instruments, the public is mostly given a choice to put their money into some sort of securitized loan/debt instrument, such as small denomination corporate bonds, for example.

Importance and benefits of crowdfunding for start-ups

There are several benefits that crowdfunding presents when startups need to raise funds for a project. Some of the areas where crowdfunding can help are the following:

- Limited Funding: It is typical for start-ups to lack the capital for expansion, and traditional financiers are often very reluctant to finance startups.
- Public listing: Usually, start-ups are unable to meet the criteria for full out public listing (an Initial Public Offering or IPO) due to their size, the fairly small size of the needed capital, and the often high costs related to such an IPO.
- Grabbing attention: Conventional investment channels such as seasoned investors often require smaller start-ups to under-go lengthy and costly processes. Additionally, many of these investors only put their focus on start-ups that offer extensive public offerings at the initial stage and do not look at the smaller ones. Hooking up to the investor base that crowdfunding platforms have can be a big advantage.

How does crowdfunding work?

In simple terms, crowdfunding is funding by and from the crowd. It is mostly used by start-ups and often goes hand in hand with the use of computer technology and its digital ways of communicating.

In a lot of instances, the start-ups are unable to organize and present a direct pitch or attend a physical meeting with the benefactors or investment firms, thus the new ways of digital communication, branding, and marketing are used.

A component that makes crowdfunding unique is that, from the perspective of an investor, and with the use on an open-source platform: anyone who meets the criteria/believes in the project as having a realistic chance to achieve what they say they want to achieve, can be a part of the funding.

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Some practical factors that differentiate crowdfunding from other sources or ways of funding are thus the following:

- It allows a company to present its ideas through a virtual exposure via the crowdfunding platforms' participants.
- It allows a company to access numerous investors at the same time via the participants of the crowdfunding platform.
- It allows a company to acquire funding in a cost-effective manner because the platform often charges far less than traditional financiers.

Additionally, it also allows investors to have access to a diverse portfolio of investments and more options to choose from. Most crowdfunding platforms enable investors to draw a comparison between different projects before they decide to invest in a one.

On the other hand, investors must always be protected as best as possible. There are times when the investment acquired is lesser than the investment required. In such cases, many platforms follow the approach of returning the investment if the target amount is not met. This allows the investors to feel safe, as there is a high probability of project failure in case of insufficient funding at the initial stage.

Difference between crowdfunding and other funding methods

Unlike other approaches to obtaining financing, crowdfunding does not require an entrepreneur to go through different complex processes. It is a cost-effective medium that allows an entrepreneur to showcase their business idea to a broader audience using a single platform.

In a typical crowdfunding setting, an entrepreneur showcases the business plan and puts forward the total capital it requires to be successful. Clearly, the business plan must contain an explanation of how the business will make sufficient revenues and profits to pay the investors in accordance with their type of investment. After launching the project on the platform, there is often an interactive and online "counter" that tally's the amount needed vs. the acquired amount to keep the investors up to date. The business plan will also have stipulations about how (often) the business must update the investors about how things are going financially wise.

Crowdfunding platforms do not have difficult or high barriers to entry and are open for anyone who wants to invest in a specific project. Some projects might outline certain minimal criteria with respect to the investors' financial situation, in which you can only invest if you do qualify to the established criteria.

Conventional funding practices often limit a business where they can only approach a few key players, (such as angel investors, banks, or capital firms) to acquire the funding for their business. In contrast, crowdfunding provides a company with vast opportunities to obtain financing and raise capital. Requesting "friends and family" members to share the business proposal and market the project from within, for instance, if a standard practice amongst entrepreneurs searching for crowdfunding, that has proven to provide fairly good results.

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Final Thoughts

Crowdfunding allows the raising of capital from a broad base of investors for a project. The ways of engaging are mostly done using digital platforms. Projects differ in nature depending on the goal of the crowdfunding activity, which indicates what type of crowdfunding is being sought: donation types, reward types, equity, or debt types. The funding can be backed by contributors from all over the world: anyone can be a part of the financing if they meet the criteria of the relevant project and/or platform.

Crowdfunding platforms have given start-ups an alternative to raise capital from a larger group of investors who have the same views and interests or values. So, often the investors themselves also become ambassadors for the business. Well organized crowdfunding platforms allow start-ups to present their ideas to numerous investors at the same time, and the investors are also able to do in-depth research about the project before committing their funding towards a specific project.

In the next publications, we will be getting into some details on the different types of existing crowdfunding platforms and projects. It is a too important development to not look at more closely.

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