Risks and Rewards of Equity-Based Crowdfunding

All businesses need money, to start, to grow, and to change the world. When someone gives them the money they need, we call that "funding". When a plethora of people invest their money by funding these startups via internet platforms, this process is best-known as crowdfunding. This crowdfunding has changed conventional investment procedures, which were previously mostly an opportunity for wealthy individuals only. With the development of crowdfunding platforms however, basically, anyone can become an angel investor in projects they are interested in, while mostly only having to invest a minimum amount that is within their reach. Clearly, in a lot of situations, the investing crowd expects some kind of compensation for their investment.

Now, when a crowd investor invests in a start-up, generally a small new business venture, in exchange for shares (i.e. partial ownership in form of a predefined small percentage), this is known as **equity-based crowdfunding**, **investment crowdfunding,** or **crowd equity.**

If and when such a start-up company earns a profit, the shareholder receives a return relative to his/her/its investment. On the other side, of course, the investor can also lose the amount of investment partially or in full, depending upon the severity of the losses that the start-up would incur.

Equity-based crowdfunding in start-ups may thus be quite risky, but having said that, some of these startups can give a lucrative profit as well. Clearly, risk must be minimized by assessing and evaluating the potential of the start-up before investing.

Website: dcsx.cw Email: info@dcsx.cw

Sources of Returns

With Equity-Based Crowdfunding, the returns come from three basic sources:

1. Potential dividends
2. Share sales (or increased value) if the company becomes listed on a stock exchange
3. The sale of the entire company

The driver of each of the latter two returns is an increase in the company's value (an appreciation of the equity shares or its sale at a higher value). None of these returns is guaranteed of course. Hence, equity crowdfunding's monetary returns are uncertain. However, if the project is successful, the rewards are not just restricted to certain fixed interest payments or initial capital returns but can essentially be unlimited.

What are the Risks?

As said already, equity-based crowdfunding can be quite risky, but, could also result in a lucrative profit. So, let's look at a few very basic factors that should be considered before investing.

It can take years to see a return

Every business takes time to start giving returns. Startups are different. They are usually new entrepreneurial ideas that may not have experimented enough before, and -in any case- most do not have any track record to show. So, it is difficult to assess after how many days, months, or years the public will consider them worthy; i.e. the public will buy this new service or product. At the same time, successful startups once succeeded have returned large profits to investors too. So, at all times the time factor is a part of the risk, because it is very uncertain.

Paying dividends to investors is difficult

Earning money right from the start is basically impossible for startups. They must (almost always) undergo massive changes and iterations to come up to a maturity level of a properly running business. So, there is a high probability that in equity-based crowdfunding the investors will not receive dividends for a long period. Usually, startups -because of their fledgling status- would not be able to make profits to pay dividends in the early stages of their development. And, as the "profitability probability/index" is not sure, it is of course also difficult to sell the shares. However, if proper due diligence has been done, the investor (who can wait) might make very substantial returns.

Liquidity is impossible

In the case of equity crowdfunding, liquidity basically does not exist. Not everyone is a high net worth angel investor with a long horizon and deep pockets, therefore, before a decision is made, investors must realize that they will have to wait for the results because selling the investment through to a next investor is often not possible. Once an investment is made there is usually no way back, the fate of the startup will decide the future.

Fraudulent startup

Equity crowdfunding could be strained by fraudulent campaigns and privacy issues. Crowdfunding uses the internet, social media, and other online platforms to find potential investors. On the one hand, this makes it somewhat trace-able and quick; but on the contrary, also easily exposed to fraud. Scammers set up ventures to attract equity crowdfunding from first-time investors. Proper due diligence is the only way to identify scammers and/or mere personal information "gatherers".

Risk of percentage share dilution

As the ultimate capital needed to run the startup is never exactly known, to raise more of it, the company may issue more shares to new investors. By doing this, the existing shareholder's percentage investment shrinks up or gets diluted. With the issuance of these new shares, businesses may come up with a substantial number of new investors which can significantly decrease the pre-existing investors' rights. Before an equity investment takes place, one should pay attention to the businesses' investor's protection policy: the new investment methodology and need has to be clearly mentioned and explained, including the exact level of dilution this will bring to the original investors.

What are the Rewards?

If the startup that has been funded through equity crowdfunding gets successful, there are many rewards that may cover-up all anxieties and insecurities of the crowd. Cleary this is always in hindsight.

Potential Returns can be high beyond expectations

High risks may produce higher profits. The interesting thing about startups is that they are often unique; they may not have competitors; they are usually a better solution to one or more conventional methods; and are mostly integrated with technology. A startup like Oculus Rift for instance (just to pick one well-known example) is a great example of a very successful equity-based crowdfunding project. According to Chance Barnett, CEO of Crowd funder, when Oculus Rift was sold to Facebook, every individual investor gained a profit of around 145 to 200 times their initial investment.

Invest like high Net-Worth Investors

Previously, only investment banks and accredited high net-worth investors could invest like Angel Investors in the startups. And then, even only if they felt and could substantiate that the investment would probably be lucrative. In most cases, they would also include many liabilities, guarantees, and reservations on the startup entrepreneurs themselves. But, after the concept of equity crowdfunding, now, an average investor can also be an equity partner, albeit very small, in a promising start-up venture. Equity-based crowdfunding has created a greater level playing field between the accredited and non-accredited angel investors.

Higher Level of Satisfaction

Equity-based crowdfunding has paved a new way of investment for the masses, especially for an average level investor who could previously basically only invest in listed stocks. Startups can be quite transparent and open compared to other larger (and sometimes even blue-chip) companies. Though it is often very much a matter of “patience” for the equity crowdfunding investor, in the end, the profit expectation is high and can be enticing. Moreover, equity-based crowdfunding has been an attractive equity investment type for the environmentalists, because a lot of these startups are from the get-go environmentally friendly structured these days. So, investors have a higher level of satisfaction while funding these kinds of businesses.

Final Thoughts

In conclusion, it should be well understood that equity-based crowdfunding of course has many risks. But with high risks, higher profits may come too. Investors in equity crowdfunding should be concerned with and focus on the quality of the available investments and make use of professional analysts when making decisions to invest. Entrepreneurs that are in search of equity crowdfunding, need to keep in mind that companies that are tapping the crowd without evident signals of quality are -more and more- less likely to be successful than those who do. Equity crowdfunding investors have matured, and entrepreneurs must live up to that development.

In the next publication, we will look into equity-based crowdfunding regulations.

Sources:

Anderson. G, May 24, 2012. Invesdor Launches Equity-Crowdfunding Platform That Skips The Paperwork https://web.archive.org/web/20141205053629/http://www.arcticstartup.com/2012/05/24/invesdor-launch

Douglas, D. and Overly, S. 2020. As regulators set rules for equity-based crowdfunding, investors prepare for its impact. May 20, 2012. https://www.washingtonpost.com/as-regulators-set-rules-for-equity-based-crowdfunding-investors-prepare-for-its-impact/2012/05/18/gIQAFwmVdU_story.html

IOSCO. 2017. IOSCO research report on financial technologies (Fintech). IOSCO. Last accessed https://www.iosco.org/library/pubdocs/pdf/IOSCOPD554.pdf

Hofmann, C., 2018. An Easy Start for Start-ups: Crowdfunding Regulation in Singapore. Berkeley Bus. Law Journal, 15, p.219.

Schroter, W. 2014. "Crowdfunding around the World." Retrieved July 2019 https://www.forbes.com/sites/wilschroter/2014/07/09/crowdfunding-around-the-world/#6e2938672448

This publication is presented to you by the Dutch Caribbean Securities Exchange

Website: dcsx.cw Email: info@dcsx.cw