



## The Risks and Rewards of Debt-Based Crowdfunding

Debt-based crowdfunding, often also referred to as peer-to-peer lending or P2P, is one of the easiest ways to raise funds through crowdfunding. According to data published by [P2PMarketData](#), it is the crowdfunding model that's proven to raise the largest capital on different platforms.

So, what really is debt-based crowdfunding? And is it as rewarding as the statistics show? And if so for who? These are some of the questions we'll try to answer in this article.

In layman's language, debt-based crowdfunding is a crowdfunding model used to raise capital by taking loans from several investors (lenders) who expect to be repaid their loan with an added interest over the period that the loan was "used". The entire process takes place through a crowdfunding platform.

### How does it work?

Think of debt-based crowdfunding like taking a normal loan from the bank. But instead of the bank, in this model, you get the capital/funds from different investors through a crowdfunding platform.

So, for your business to raise funds through this model, you'll have to be registered on a crowdfunding or peer-to-peer lending platform. Next, you'll have to draft a pitch with the details "around the loan(s), i.e.:

- how much are you looking to raise?
- what kind of investors are you looking for?
- what's the minimum investment amount?

- how many investors are you looking for?
- what is your business plan and how do you think to accomplish that?
- what will the funds be used for?
- and ultimately, how do you see the repayment of the loan and interest being done.

Besides all this, an “overall” important factor is also that you and the team who will run the business have to explain who you are, what’s your experience is, and why are you “sure” that this business will be able to succeed. The platform will then conduct a background check and due diligence of your company and its principals to prove your credibility. It will also -in conjunction with you- determine your APR (Annual Percentage Rate) of the loan payment. This will depend on the nature of the business, the experience of the principals, and thus on the overall risk involved in the business being successful.

Depending on the target amount for the loan and the type of business, the platform may also suggest and/or require the company to provide some form of security, which can either be a personal guarantee or a business asset.

Once this is complete, the platform can then promote your venture to investors through its online channels. It’s now open for lending.

## What makes debt-based crowdfunding attractive?

Over the past decade, debt-based crowdfunding has increasingly gained popularity among both investors and companies. The reason for this being that it is a fast, easy, and secure way to raise capital for businesses (everything is online).

It also offers investors better return rates compared to what they’d get from banks or savings account societies; especially in the recent years’ low-interest environment. Furthermore, and on the other side, unlike equity-based crowdfunding, in this model, the owner gets to retain control over his business.

So, there is a win for each side of the structure.

## Risks of Debt-based Crowdfunding

As with all investments, debt-based crowdfunding bears its risks for both the business and the investors. Here are some of the most important risk factors for both sides that you should be aware of before seeking capital or investing some of your capital through this model.

## Loss of investments for investor

It's possible to lose all your money or investment in one bad investment – even though the business owner is obliged to repay you. Circumstances can arise like forced liquidation or bankruptcy, where the owner(s) and the business become unable to repay the debt.

If we set forth the 3 main risks by investing through this model, you can be exposed to:

1. Default risk: In this case, the borrower is not able to pay back your principal amount or the interest. So, you may lose some or all of your investment.
2. Inflation risk: For every investment you make, there's a risk that inflation will affect your purchasing power, and so, your investment may not be as valuable in the future as it is now. In other words, you have to consider this when you make the investment and feel comfortable that the interest that you will be receiving is sufficient to cover the inflation. If not, you are a “thief of your own pocket”.
3. Interest rate risks: There's also the risk of a potential short or medium-term rise in the market's interest rates, which may undervalue your investment because you miss out on higher returns than you are getting now.

## Repayment of loans

As the business owner who borrowed the loan, you'll have to repay the loan, with the agreed fixed interest within the agreed time – regardless of how the business is performing.

If the business can't repay the debts, you may be forced to liquidate all your assets and shut down. You might also be held accountable for all or some of the debts that your business has amassed if you provided a personal guarantee for the loan. Basically, this works the same as if the loan was from a bank.

## Limited access to alternative financial institutions

Your existing debt to the investors may restrict you from pursuing other financing options of course. Huge debts in terms of accrued interests also affect your credit ratings and thus may “chase away” other potential investors you may want to approach in the next step.

## Rewards of Debt-based crowdfunding

Despite its risks, many debt-based crowdfunding campaigns have proven to be very profitable for both investors and business owners. In the following paragraphs we will discuss some benefits to this model.

*For Business Owners:*

### **You retain company ownership**

Unlike other crowdfunding models, with debt financing, you don't have to share equity of your company with the investors. This means that they have less of a say really in how you run your day to day business. As long as you repay their interests on time and there is no fear that the principal of the loan runs any risk, you are good to go about your business in general.

### **Loan is short-term**

Your relationship with your lenders lasts only as long as you have their debt. Once you've repaid the loan, all future earnings remain "in" the company. You have no further obligations to the lenders. This may result in more profitability for the business in the long run.

### **Low-interest rates**

Interest rates posed on debt-based crowdfunding are usually lower than those offered by banks and other financial institutions. It's also much easier and faster to access the loan with p2p lending since you don't have to wait for (often) months for your loan approval.

### **Tax deductions for the debt**

In most cases, your debt interest paid to investors can be deducted as a business expense under your company's tax return, just as if it were paid to a bank. This -indirectly- reduces the total value of the loan to be repaid and saves you some capital.

*For investors:*

### **Minimal risks for investor**

Since the loan is shared among several investors, the amount you place at risk is lowered. Moreover, in the event that the business undergoes liquidation or bankruptcy, debt is usually among the first items to be repaid from the assets. So, you're more likely to be paid back.

### **Better cash flow for investors**

As an investor, your investment generates interest payments every month, or as per the agreed interest payment schedule in the loan agreement. This gives you better cash flow management for as long as your loan repayment lasts, which is usually three to five years.

## *Who should use Debt-based Crowdfunding?*

While debt-based crowdfunding is available for businesses of all sizes, the truth is, it may not be particularly suitable for startups. Most investors prefer investing in businesses that have been in the industry for a while. Businesses that have proven to have adequate cash flow.

However, peer-to-peer lending has also worked for a select number of startups, so go for it if you think it's the right option for your business.

## **Final Thoughts**

Debt-based crowdfunding can be one of the best ways to raise capital for businesses. It's also an excellent investment opportunity. However, before pursuing it, you need to ensure that you've met all the requirements of the crowdfunding platform you want to use.

If you are an investor, always do your due diligence, assess the risks involved, and the potential returns of the investment.

But most importantly, in the end, invest only what you can afford to lose!

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