The Bond Market vs. Debt-based Crowdfunding: Who Wins?

The financial markets have drastically changed over the past decade. Traditionally, business owners would simply run to the banks with business ideas and hope to come out with the capital they needed. Today, things have changed; the 2008 /09 crisis has created a situation where banks have become extremely careful one could say. On the bright side, this has led to the growth of several alternative financial and financing sources that make it easier to obtain funds. Among them is debt-based crowdfunding and a Small and Medium Enterprises bond market.

While both these financial models can help a business raise capital, they each bear their respective ”issues” and risks for both: the business as well as for the investors. Furthermore, the model you opt for can play a crucial role in the financial future of the company.

Basics of the Bond market

As you know, when you buy a bond, you are essentially issuing a loan to the bond issuer. There are three major types of bonds: Government bonds, municipal bonds, and corporate bonds.

Government bonds are a government’s way of raising money. It’s their way of taking loans from the public and other governments. So, when you invest in a government bond, you’re lending the government some money. Usually, these bonds bear the least risks, but also the least interest.

The same applies to municipal bonds/loans. As the name suggests: these are loans to smaller types of Governments like Sates, Cities, Counties, etc.

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

Corporate bonds are loans to/for companies and businesses. It is the more riskier type of bond since for the investor inflation can decrease your yield (actual return) and the probability of returns is based 100% on a company's creditworthiness. Here is how this works in short:

When a business needs to raise a certain amount of money, say $1 million, they can decide to sell bonds to investors, with the promise of paying it back after a fixed amount of time, with interest. Assuming each bond is worth $1000, then the company will have to sell 1000 bonds to investors.

The company, now the bond issuer, agrees on a coupon and a fixed time after which they will repay the loan. To put this into perspective, if the business sells a 10-year bond at a 10% coupon, the bond issuer will have to pay the bondholders $100 in interest each year until the bond matures, and further repay the $1000 (face value) once the bond matures.

Ideally, the longer the bond takes to mature, the higher the interest rates the bond issuer must pay the bondholders. This is because, more time means more exposure to the investor's investments, which increases the risks.

Benefits of the Bond Market for SMEs

➢ You retain ownership

Selling bonds is an effective way to raise cash without putting your ownership at risk or diluting it. As long as you continue paying back the investors' interest, you continue to own and run 100% of the business. Your present shareholders are also not affected by the deal.

➢ No profit stakes

Even though you (i.e the company) have used the investor's money to expand your business, you're not obligated to share any of your profits with them. All you need to pay is the agreed-upon interest and the face value if the bond matures. So, you can reap good profits after paying your debt.

➢ Investor interest is tax-deductible

Some governments recognize the interest rates you have to pay your investors as a business expense. This means that it can be deducted from the company's tax, ensuring that there are more funds left for the business. This can have particular conditions depending on the jurisdiction.

➢ Control of your debt

With bonds, you can often get faster access to funds from investors at lower interest rates compared to banks. You're also more directly involved in setting/negotiating the interest rates and the maturity periods for the bond. This enables you to more accurately predict your business' financial obligations at any time.

Challenges of the Bond Market for SMEs

➢ Operations limitation

Even though your investors don't have a say in your decision making, to protect their bonds, they usually will require or set some limitations on how the money can be used. Therefore, money raised from selling a bond can -normally- only be utilized for a specific purpose. For instance, if you sell bonds to construct a new headquarters, that money can only be used for this purpose, even if a better proposal comes along and you would like to for instance quickly go accept that offer.

➢ Interest repayment can be a burden

You are responsible for the payment of the investor interests monthly or annually, (depending on your agreement), regardless of how your business performs in the market. You also must pay the principal amount once the bond matures. So, if even if your business is only "temporarily" failing, you may have to borrow more money to settle the debt, or risk the failure of your business. A very stringent cash flow management needs to be in place.

➢ Public perception

Selling bonds can also send a mixed message to potential existing or future equity investors/buyers and even your customers. Investors sometimes prefer companies that have adequate capital as proof that they're profitable. Even if you have enough money, but need more for a project, acquiring debt may cause people to shun your company's stock. That is why the decision to attract capital through either a bond issue or by issuing additional equity is sometimes a difficult one.

Basics of Debt-based crowdfunding

In this model, businesses use a so-called "crowdfunding platform" to attract investors who are willing to lend them money, with the promise of payback with interest.

Here, a business registers itself on a Peer 2 Peer lending platform, fills in the required details about their business, and the platform then conducts due diligence on the business to “investigate and / or confirm” their credibility, and determines the risks of the business. It also determines the annual percentage rates (APR) of the debt as well, or in any case, advises the borrower how to enter the market.

Once the business is approved by the platform for offering to the investors’ pool, it can now have access to the investors that are registered on the crowdfunding platform based on the assigned credit rating and thereto related interest rates. The business owner can then assess the offer, and if accepted, the subscription period can start for the investors.

After that, the business owner is expected to pay the (annual or otherwise agreed) interest to the investors and the principal amount once the loan matures.

Benefits of Debt-based crowdfunding for SMEs

➢ You retain control of the business

Mostly, P2P lenders do not have any control with how you run your business. They also don’t have a say in how you use the money, because there is not an entity that is involved -on a frequent basis- in getting report on what you are doing. With bonds you often have a Bond Agent involved that performs these type of tasks.

➢ Low-interest rates

Debt-based crowdfunding platforms (mostly) set rather low-interest rates for the loans compared to banks and other financial institutions. They are focused on SME’s that need financial support, but cannot carry the burden of high interest rates payable. This allows the company to acquire the funds it needs somewhat more easily and at a more affordable rate.

➢ Tax deductions

You can “rub off” your interest rates paid and sometimes even the principal amount for the debt from your income tax as business expenses. The latter is only the case if the relevant tax code in a country allows this. This is sometimes done to stimulate certain SME areas to grow. This may significantly reduce the amount of tax you pay of course and creates more money to fuel business growth.

➢ Cash predictability

Since you've already defined the interest rates and principal amount, it becomes easy for the business to factor that into their financial goals. This is crucial when setting up future plans and operational costs. As already mentioned above, in the case of bonds, the same of course applies as for when companies have issued bonds.

Challenges of Debt-based crowdfunding for SMEs

➢ Loan repayment

Just because you got the money does not mean the business will perform well. And regardless of the business's performance, you'll have to pay back your loan to the investors. Careful reservation of yearly amounts for repayment of the principal is important. In this respect the same applies as we have seen for direct bonds.

➢ Limitations to future financing

Once your business accumulates a large debt, it may become more difficult for other investors to want to invest in your business. So, getting debt may mean you won't get more help until you clear that debt. That is why , as said before: a careful balance between debt and equity (own capital) remains important also for crowdfunding finance. Furthermore, debt affects your credit rating, which again may have an influence on your business' future risk to invest in.

➢ Collateral risk

Depending on the amount you want to raise, most lenders and crowdfunding platforms may demand some collateral. In most cases it's usually a business asset, but a personal guarantee (in case of smaller amounts borrowed) works too! This means by agreeing to take the debt; you're putting both your business and personal assets at risk!

The Bond Market and Debt-based crowdfunding Joining Forces: Does it Make sense?

One of the biggest differences between P2P lending and the bond market is "regulation". The bond market has a more developed regulatory framework -in most countries- that governs the market, while the debt crowdfunding regulation is still in development.

However, this does not mean that a business must choose either of these models. There is always the option of joining forces and we see a convergence in this area already going on.

For one, and as we saw already, selling bonds directly to investors, because of regulations in place may limit how you can use the raised money in your business. So, in the case that another financial emergency occurs, P2P lending can swoop in “help” quickly and cover some funds needed. Again, the best thing about such a combined approach is probably that you don’t have to put your ownership at risk. Combining both financial models can also be a good way to improve your business’s visibility in the market. Don’t forget that bonds will normally be sold through a broker or capital raising firm, while the crowdfunding platforms often have their own (somewhat) different basis of investors pool. If you have good creditworthiness and credit rating, then investors using both financial models will show interest in your business.

Your products will also be more visible to the market as a result.

At the same time, making use of both options may put undue pressure on your business with regard to repayment of the interest and principal amount.

Final Thoughts

In conclusion, it is difficult to decide who wins when it comes to deciding between these two financial models: Debt-Based crowdfunding and the Bond Market. Both offer benefits and equally, some risks as well. Joining forces to raise capital from both methods can be a viable option, but it can only work for really well-structured businesses.

The winner will be the platform that is best suitable to the needs of the issuer. In other words, the decision lies on the business owner. They should choose the model that not only suits their financial goals but the one that bears a risk that they can afford. It may be one of the above mentioned, neither one of them, or both. Exploration of other financial methods remains an option for businesses, especially SMEs and startups.

Sources

Black, M. July 3, 2020. Investopedia. Best Peer to Peer Lending.
https://www.investopedia.com/articles/investing/092315/7-best-peertopeer-lending-websites.asp

Chen, J. March 31, 2020. Investopedia. Bond Market.
https://www.investopedia.com/terms/b/bondmarket.asp

Faulkner, N. April 23, 2020. 4thWay. Peer-to-Peer Lending vs Bonds
https://www.4thway.co.uk/candid-opinion/peer-to-peer-lending-vs-bonds/

Milaap. Understanding The Background Of Debt-based Crowdfunding
https://milaap.org/stories/debt-based-crowdfunding

Pfau, W. December 24, 2019. Forbes. Understanding How Bonds Work
https://www.forbes.com/sites/wadepfau/2019/12/24/understanding-how-bonds-work/

The Motley Fool. January 10, 2016. Nasdaq. Advantages and Disadvantages to Issuing Bonds in Order to Raise Capital. https://www.nasdaq.com/articles/advantages-and-disadvantages-issuing-bonds-order-raise-capital-2016-01-10https://www.thebalance.com/what-are-bonds-and-how-do-they-work-3306235

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

Dutch Caribbean
Securities Exchange

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