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Equity-Based Crowdfunding Vs. Debt-Based Crowdfunding: Who Wins?

The struggle to access funds is one nearly all small businesses go through. Most banks remain, shall we say, “extremely careful” when it comes to offering loans to Small and Medium-Sized Enterprises (SME’s) and Startup businesses, even when some of these are already making profits. The issue is -often- not having sufficient collateral backing. So, what can these SME’s and Startups do? They can, and more and more do, actually is turning to crowdfunding.

Crowdfunding has rapidly become a go-to strategy for a lot of SME’s s and Startups. These businesses all have different maturity stages and thus different needs to access funds for their operations and/or expansion plans. Equity-based crowdfunding and debt-based crowdfunding, in particular, have been the most popular methods used to raise funds.

However, a lot of business owners, and even various media houses, tend to confuse these two crowdfunding methods, and this can be a serious problem for basically any business.

Despite their similarities, the model you choose to use can and mostly will have a long-term impact on your business’ cash flow and profitability.

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Understanding Equity-based Crowdfunding

Of all types of crowdfunding available, this is the most popular and also best-regulated crowdfunding model.

In this model, a business in need of capital raises capital from a “pool” of investors through a crowdfunding platform in exchange for partial ownership by those investors (equity) in their company. The actual process is often very similar to the traditional rewards-based crowdfunding, but instead of rewards, the business gives up a percentage of its ownership.

Through a regulated crowdfunding platform, the entire process takes place online and connects the business to the investors. The business owner registers the business on the crowdfunding platform and provides the details of the business campaign, explaining the need and use of funds and the expected profit results. Once the platform completes its due diligence on the business and its management, the campaign is made public for potential investors.

In most cases, there are some restrictions in place on several platforms to protect the investors and ensure that only legitimate campaigns are advertised. This is part of the due diligence process. As the business owner, it is also crucial that you go through your platform's regulations to ensure that the business campaign isn't rejected unexpectedly on the basis of some issue that you could have known.

The crowdfunding platforms will also charge the business owner a subscription fee monthly or cut a commission fee depending on the amount raised. The percentage varies between platforms.

What makes this model appealing is that the business owner has a lot of control over the terms. The business owner decides how much to raise, how much equity to give up, and the minimum investment amount for each investor. The more detailed and concise the business terms, the more likely your campaign will succeed.

Furthermore, since the investors own part of the business, should it go sideways, the business owner, -legally and technically- does not owe them anything. The investor risks his own money by investing in the business. The business owner should, therefore, be prepared to submit regular reports to investors on the progress of the business. They must be informed on how much money is spent, and in general, how the business is going. Are goals being reached? And if not, why not yet?

Recent developments in the crowdfunding industry now allow more and more people, not just accredited investors, to crowdfund invest into businesses. This means that this crowdfunding method has the potential to raise constantly higher lumps of money quickly. The only thing that hampers further growth is the illiquidity because of the lack of a regulated secondary market. So, if an investor wants to get rid of their shares in your business after a while, they should be able to sell it on a public marketplace or exchange.

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Equity-based crowdfunding is quite popular in the real estate world. Many developers and landlords use it to raise money from many investors instead of just one. It's a fast, time-saving, and convenient way to raise capital for startup businesses.

Benefits of using Equity-based Crowdfunding to Raise Capital

- Debt-free fund-raising model

With equity-based crowdfunding, you don't owe any of your investors a dime in case the venture doesn't work out. The investors bear all the risk.

- New opportunities for your business

With the right investors, your business can be connected to other potential brands, which can be crucial to expanding your business growth. Well-connected investors can also offer free marketing, brand recognition, and improve your business' visibility in the market.

- Fast and easy access to capital

Crowdfunding platforms give your business access to a large pool of investors, both accredited and non-accredited, which increases the odds of hitting your target amount. The process also takes a much shorter time compared to the conventional banking process.

Challenges of using Equity-based Crowdfunding to Raise Capital

- You give up a part of your ownership

Even though this model can make it easier to raise cash, you give up a percentage of the business ownership to your investors. This means that you're obliged to share your profits with all your investors.

- You lose your decision-making power

Giving up equity of your business means that your investors have a “part” say in the decisions you make for the business. And in some cases, some investors are not necessarily good business leaders, and so, giving them decision-making powers can make things difficult.

- Failed campaigns are public

Once you attempt to raise capital and fail to reach your target, these results remain public. This can have a negative impact on other potential investors who may have liked your idea. Furthermore, as a rule in crowdfunding, you'll be sharing a lot of the details and plans for your business with the public.

Understanding Debt-based Crowdfunding

With debt-based crowdfunding, most of the processes involved are similar to equity-based crowdfunding.

In this model though, a business takes a loan from many different investors through a crowdfunding platform, in exchange for interest and payback of the loan(s) after an agreed period of time. It is much like taking a loan from the bank and repaying it later with interest.

Like equity crowdfunding, this process also takes place online through a crowdfunding platform that regulates the process. As a business looking to raise funds, the business owner has to register the business on a crowdfunding platform, then put down the details for the business campaign for investors to be able to consider their participation. The platform then conducts the necessary due diligence, including credit checks and then publishes the campaign to the availability of the investors. The investors can now place their bids. Sometimes the interest rate is set upfront, but sometimes there is the possibility for investors to sort of "bid" on several interest options.

Just like a bank, the business owner may be required to provide some sort of security based on the amount he/she intends to raise through this model. This can be a business asset or a personal guarantee. The larger the loan target for the business, the more qualifications the business owner will be required to meet.

Once you, as a business owner, have enough investors ready to loan you their money, the crowdfunding platform then irons out the details of the loan and interest payments. This model of raising money is very attractive for small businesses that have been in the industry for a while and already have a defined plan. Yet, there are also some Startups that have been successfully raising funds using this model too. However, most investors tend to shun startups for this model as they bear more risks.

Benefits of using Debt-based Crowdfunding to Raise Capital

- You retain ownership

Unlike in equity-based crowdfunding, in crowdlending, you retain 100% of business ownership. Your only obligation to the investors is paying them their interest and finally repaying the principal amount once it matures.

- Low-interest rates

Since the whole lending process takes place over the internet, the administrative costs are significantly slashed. This means that the interest rates can be lower.

- No profit-sharing

Once your business has completed the repayment of the loans and interest, your relationship with investors is cut off. Therefore, all the profits that the business gains henceforth belong solely to your business. You have no further commitments to the investors.

- Faster loan approval

With debt-based crowdfunding platforms, loan application and approval take a much shorter time compared to the banking system.

Challenges of using Debt-based Crowdfunding to Raise Capital

- Loans have to be paid

Once you have received the loans, your investors expect you to pay back their loan and interest per your agreement, regardless of how good or bad, the business performs in the market. This is an enormous burden for startups. If you cannot repay your loans, you may be forced to liquidate your assets or shut down the business.

- You might be responsible

With debt crowdfunding, you, the business owner may be held responsible for the debt, in the event that your business can't repay the loan and for instance if you issued a personal guarantee for repayment of a part or even the entire loan. Reputation is on the line

The decision to "publicly" seek a loan for your business may send the wrong message to your customers and potential other business relations other "indirect" investors. Furthermore, if you are unable to repay your loan, no potential future investor will want to work with you, and other businesses may not want to partner with your brand either. Running a failed campaign, on the other hand, may also damage your reputation in the market.

- 'Too much' transparency

By running your fundraising campaign on a crowdfunding platform, you reveal your business structure, plans, goals, and other vital information, which can be copied by other businesses. It' i a risk you have to consider.

Final Thoughts

Both the equity-based crowdfunding model and the debt-based crowdfunding model are great ways to raise capital for your business. However, your decision solely depends on the nature of your business, its time in operation, and the thereto related funding needs. It is therefore important for you as a business owner to know at what stage of business maturity your startup of SME is at, to choose the most appropriate funding method to help your business grow.

Based on past investor trends, if you are looking to raise your business from the ground up as a startup, equity-based crowdfunding is probably the better of the two, because people know what they are getting into. However, if you have been in operation for a while but simply need capital to expand or grow your business, then debt-based crowdfunding is an option to consider.

So, after careful consideration, chose your preferred model of raising capital; make sure you have assessed the risks and are comfortable with your chosen crowdfunding model's pros and cons.

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