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Agenda

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Joining the crowd? Crowdfunding from an investor perspective

Technological developments have encouraged the growth of many forms of 'disintermediation', whereby intermediaries that bring together consumers with producers are replaced by Internet-based marketplaces or platforms. Crowdfunding, which connects investors and fundraisers, is a rapidly growing example of this. So far, discussion has focused on the implications of crowdfunding for companies raising finance, but as crowdfunding investment reaches the mass market, there is a need to understand the phenomenon from the investor's perspective as well

Crowdfunding is a form of financial disintermediation that channels funds from lenders to borrowers (known as peer-to-peer, or P2P, lending),[1] or from investors to users of equity capital (known as equity crowdfunding), without involving traditional financial organisations such as banks. Crowdfunding typically involves raising finance from a large number of individual investors ('the crowd'), each of whom makes a relatively small contribution. However, it is also increasingly attracting institutional and professional investors.

The rapid rise of crowdfunding has generated lively discussion, which has predominantly centred on the fundraiser—for example, by asking whether crowdfunding is 'filling a gap' resulting from banks' cautious attitudes to lending following the global financial crisis.[2]

But how does crowdfunding work from an investor's perspective? Who are crowdfunding investors, and what marketplace do they use? How are potential risks understood, and how do platforms facilitate risk assessment? This article, based on a recently published study by Oxera for the European Commission,[3] looks at these questions in the context of crowdfunding activities that generate financial returns, rather than donation- or reward-based crowdfunding (which have also seen substantial growth, but are not used as a vehicle for financial investment). The article considers crowdfunding from the perspective of an individual investor rather than an institutional investor.

How has crowdfunding investment evolved in Europe?

Crowdfunding has emerged in Europe as a new form of finance, and the amounts invested have evolved in three main ways.

- First, the level of crowdfunding is increasing at a remarkable pace. Between 2013 and 2014, for example, across all forms of equity crowdfunding and P2P lending, the volumes invested grew on average by 146%.[4]
- Second, the rate of growth in crowdfunding has varied across Europe, with a much quicker expansion in the UK than in the rest of Europe. For P2P business lending, where the difference is most pronounced, €998m was invested in the UK in 2014, compared with €93m in the rest of Europe put together. Crowdfunding is thus at different stages of development across Europe.
- Finally, the level of activity also varies by the type of crowdfunding, and investing in debt is generally more widespread than investing in equity. P2P lending to businesses has been particularly successful in the UK, while the UK's lead in lending to consumers and equity crowdfunding is less pronounced. While in the UK there is evidence that the volumes lent to businesses will soon overtake those lent to consumers, in France P2P consumer lending remains significantly more popular than P2P business lending.[5]

While the level of crowdfunded investment has grown rapidly in Europe, it still accounts for only a small proportion of total investment. In the UK, for example, it has been estimated that P2P business lending accounted for 12% of total lending to small businesses in 2015, and represented a much smaller proportion of lending to medium and larger-sized companies.[6] This is shown in Figure 1.

The crowd and its marketplace: investors and platforms

What are the characteristics of people who are aware of crowdfunding with financial returns? Oxera commissioned telephone and online surveys to understand the awareness of crowdfunding with financial returns and investment patterns in Germany, Poland and Spain. The findings highlight that men, younger people, people with a high education level, and wealthier individuals are likely to have a higher awareness of crowdfunding (see Table 1).

Why are investors joining the crowd?

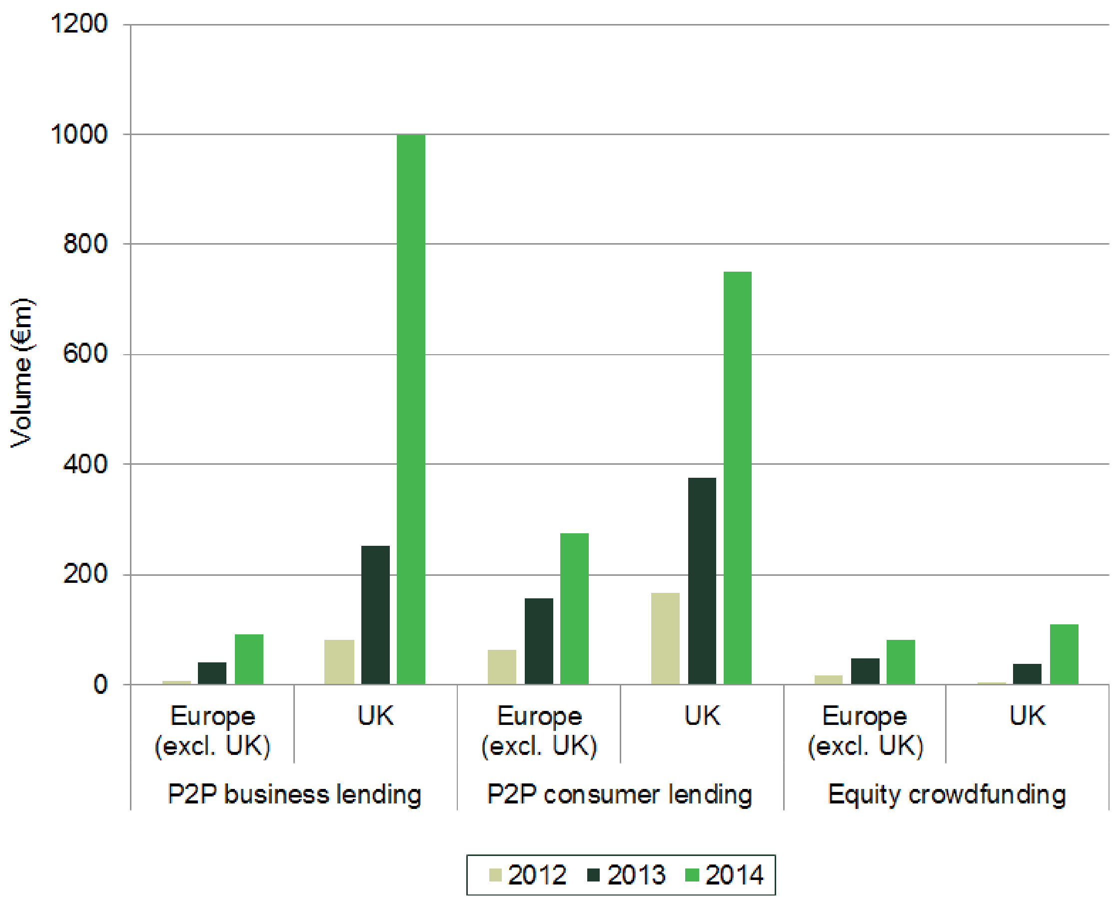
The literature on crowdfunding highlights a number of reasons why it may be attractive to investors.

Table 1 Respondent characteristics generally associated with high awareness levels

	General tendency
Gender	Awareness greater among males
Age	Awareness greater among young people: • age 18–24 in Spain • age 25–34 in Germany • age 35–44 in Poland (weaker relationship)
Education	Awareness greater among respondents with high education level
Income (or social class for Spain)	Awareness greater among wealthier individuals

Source: Oxera, based on the results of a telephone market study carried out by Millward Brown.

Figure 1 Volumes invested in equity crowdfunding and P2P lending, 2012–14



Source: Wardrop, R., Zhang, B., Rau, R. and Gray, M. (2015), 'Moving Mainstream: The European Alternative Finance Benchmarking Report', February, http://ec.europa.eu/finance/general-policy/docs/crowdfunding/150304-presentations-ecsf_en.pdf.

- Crowdfunding is seen to offer potentially higher returns than traditional finance.
- It may open up new options for spreading risk (especially for small investors with small portfolios).
- Crowdfunding provides easier access to investment opportunities.
- By 'cutting out the middleman', crowdfunding may lower administrative costs.[7]
- Aside from purely financial motivations, investors are often driven to contribute by a certain interest in, and excitement about, a particular project.
- The 'crowd' element may also be attractive. Crowdfunding enables information and experience to be pooled across a wide range of investors, and (for example) early investments may serve as quality signals to later investors. Investors may also contribute their own ideas, and be able to influence business decisions to an extent that may not be possible with traditional finance.[8]

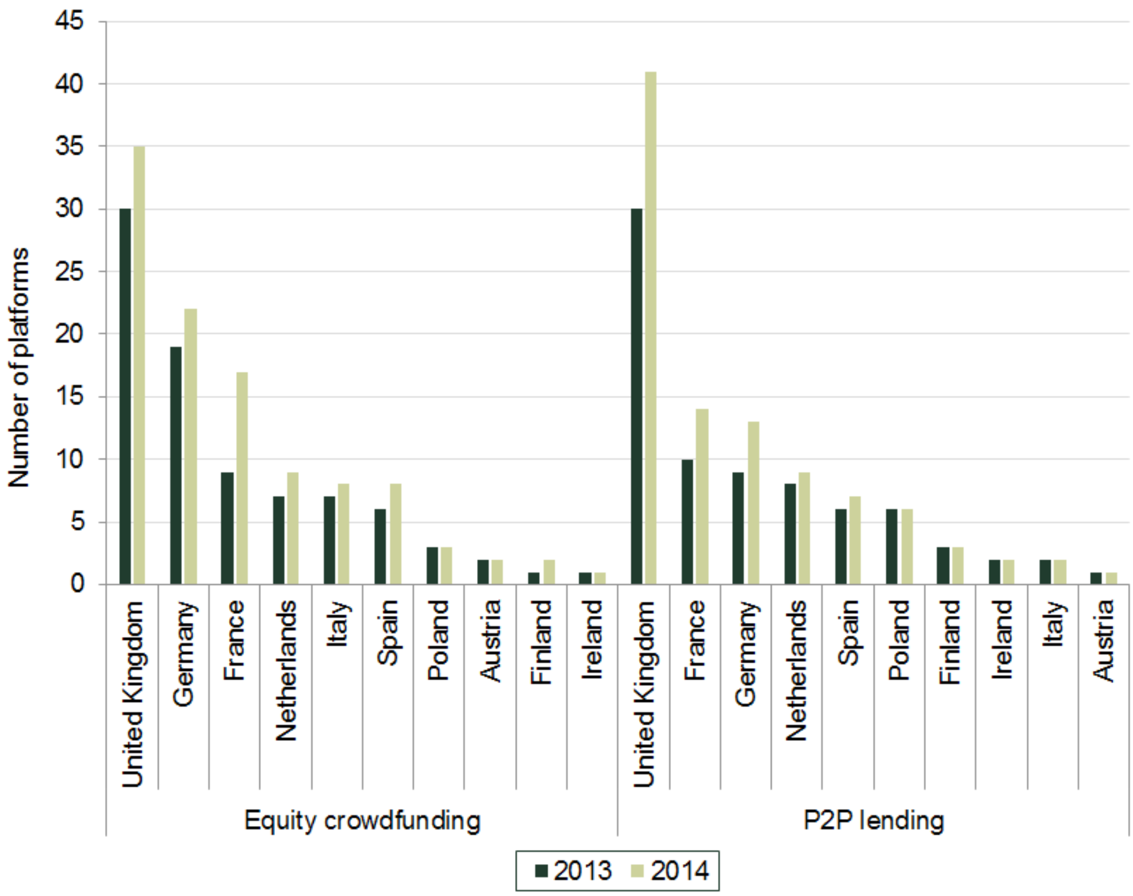
How to invest, how to lend?

Crowdfunding investments are generally made via dedicated online platforms. The number of platforms per country is one indication of the different stages of crowdfunding's development in Europe—for example, the UK has a higher number of platforms than other European countries—and evidence suggests that the pool of platforms has been increasing in most European countries (see Figure 2).

Oxera interviewed ten platforms across Germany, Poland, Spain and the UK to better understand their recent growth and their investor characteristics, as well as the risk perception and risk assessment mechanisms that they have in place.

The research found that P2P lenders tend to invest more money and in a larger number of projects than equity crowdfunding investors, albeit over a shorter investment timeframe. The length of a P2P loan was found to vary from a few months to several years, while an investment in equity crowdfunding was more likely to last several years.

Figure 2 Number of crowdfunding platforms in a sample of European countries in 2013 and 2014



Source: European Commission (2015), 'Crowdfunding: Mapping EU markets and events study', 30 September.

Given the short history of this form of finance, most equity crowdfunding projects are still at an early stage of development. In the UK, for example, the majority of equity crowdfunding projects are currently at the 'seed' stage, corresponding to the pre-revenue phase of initial R&D, product development and marketing (see Figure 3).[9] The first successful 'exit' for an equity project on Crowdcube, one of the UK's largest crowdfunding platforms, occurred in July 2015 with the acquisition of E-Car by Europcar.

No free lunch? The risks associated with investing in crowdfunding

How do potential and actual investors understand risks?

Crowdfunding often deals with early-stage projects, which are subject to high levels of uncertainty about future performance. The term 'project risk' captures risks of a different nature, such as the risk of a project being low-quality, fraudulent or delayed, and, in the worst case, that it will fail. Consistent with traditional finance theory, which views equity as being generally of higher risk than debt, equity crowdfunding is associated with higher risk levels than P2P lending.

Oxera's survey indicated that there is some awareness of the risks that crowdfunding involves. We asked respondents who were aware of this form of finance but had never used it to rank five potential reasons why they had not done so. The results highlight that concerns regarding the potential lack of reliability and regulation of crowdfunding were considered to be a greater barrier to investing than having an insufficient understanding of crowdfunding, or concerns that returns might be too low. This shows some degree of risk-awareness from potential (rather than current) investors.

The top five potential reasons for not investing in crowdfunding were as follows.

1. 'I am concerned about the reliability of investing in crowdfunding'

2. 'I am concerned about the lack of regulation of crowdfunding platforms'

3. 'I do not have enough understanding about crowdfunding'

4. 'I have not had the opportunity to invest in crowdfunding (e.g. lack of funds or lack of time)'

5. 'I am concerned about poor financial returns'

Regulators have also acknowledged concerns about risk. The UK's Financial Conduct Authority (FCA) has published advice for potential investors on the risks associated with crowdfunding, with an emphasis on equity crowdfunding:[10]

> We regard investment-based crowdfunding in particular to be a high-risk investment activity…It is very likely that you will lose all your money. Most investments are in shares or debt securities in start-up companies and will result in a 100% loss of capital as most start-up businesses fail.

Investor inexperience is a particular concern.[11] While early investments may serve as quality signals, they may also lead to cases of quick funding where inexperienced investors 'herd' and follow a popular trend without conducting appropriate due diligence.

The FCA also considers that '[p]rofessional investors may know more about investment in some enterprises and be better able to select the best investments, leaving options with higher risk or poor value to retail investors.'[12] This could give rise to a concern about professional investors 'crowding out the crowd', although there is no firm evidence to show that this has occurred.[13]

However, even a professional investor's understanding of the risks associated with crowdfunding may be limited, given the immaturity of this form of finance, and the fact that it has yet to be subjected to a full economic cycle. Further investor education on risks would be beneficial if crowdfunding begins to develop into a mass market.

How do platforms facilitate risk assessment?

Measuring the risks associated with alternative finance to an appropriate level of precision is not straightforward. Data from crowdfunding platforms can offer some insights into these risks, and project risk can thus be proxied by the observed default rates. As would be expected, equity crowdfunding is generally associated with higher default rates than P2P lending. However, as noted above, given

Figure 3 The three stages of an equity project

Source: Department for Business, Innovation & Skills (2014), 'Equity Crowdfunding in the UK: Evidence from the Equity Tracker', Research Report.

the short history of this form of finance, there is limited data available on default rates.

The risk-assessment process generally starts with an initial screening undertaken by the crowdfunding platform prior to the project being allowed to call for funding. All platforms included in the Oxera study carry out project screening and project/loan assessments and/or risk analysis. For these platforms, the vast majority (70–99%[14]) of applications are reported to be rejected as part of the initial screening. Potential investors may also conduct their own due diligence before lending or investing.

Platforms may also advise their members to mitigate risks in various ways, such as by facilitating risk-spreading through automated portfolio tools. This is particularly the case for P2P lending, where large numbers of projects are active at once, even on small platforms. Platforms may also have a secondary market in place through which investors can exit their investment.

Certain crowdfunding platforms have therefore developed risk-assessment mechanisms that help investors to spread risks, choose their risk level and gain access to a secondary market. As platforms develop, the Oxera report found that they tend to offer investors more mechanisms to help mitigate project risk. Risks can be spread more easily, and more sophisticated initial screening may be conducted.

As crowdfunding matures, where next?

Crowdfunding has expanded rapidly over the last few years to become an attractive alternative way for many investors to engage in financial markets. In this sense, it might be seen as increasingly reaching the mass market.[15] Potential investors may visit a crowdfunding platform because they are seeking better returns than those offered in traditional finance; because they are looking for a form of direct investing with limited intermediaries; or because they have a passion for a particular entrepreneurial initiative. In this sense, crowdfunding has proven to be both a substitute and a complement to traditional finance.

Nevertheless, alternative finance involves risks that may not yet be well understood by potential and actual investors. Regulation thus has an important role to play in enhancing risk awareness, as well as risk-assessment and management mechanisms. The question about greater harmonisation of rules across Europe is also important. Any regulatory measures should seek to strike a delicate balance between consumer protection and low regulatory costs, to avoid taking attractive financial opportunities away from investors, and denying new businesses and households a necessary source of funding.

This article is based on Oxera (2015), 'Crowdfunding from an investor perspective', final report, prepared for the European Commission Financial Services User Group, 17 July, http://www.oxera.com/Latest-Thinking/Publications/Reports/2016/Crowdfunding-from-an-investor-perspective.aspx, and recently published by the Commission.

[1] P2P lending is then segmented into P2P consumer lending and P2P business lending.

[2] For example, see Deutsche Bank Research (2014), 'Fintech – The digital (r)evolution in the financial sector: Algorithm-based banking with the human touch', *Current Issues. Digital economy and structural change.*

[3] Oxera (2015), 'Crowdfunding from an investor perspective', final report, prepared for the European Commission Financial Services User Group, 17 July, http://www.oxera.com/Latest-Thinking/Publications/Reports/2016/Crowdfunding-from-an-investor-perspective.aspx.

[4] Wardrop, R., Zhang, B., Rau, R. and Gray, M. (2015), 'Moving Mainstream: The European Alternative Finance Benchmarking Report', February, http://ec.europa.eu/finance/general-policy/docs/crowdfunding/150304-presentations-ecsf_en.pdf.

[5] Evans, J. (2015), 'P2P business lending to eclipse consumer sector', *Financial Times*, 19 June.

[6] Zhang, B., Baeck, P., Ziegler, T., Bone, J. and Garvey, K. (2016), 'Pushing boundaries: the 2015 UK alternative finance industry report', 17 February, http://www.nesta.org.uk/sites/default/files/pushing_boundaries_0.pdf.

[7] Belleflamme, P. and Lambert, T. (2014), 'Crowdfunding: Some Empirical Findings and Microeconomic Underpinnings', SSRN 2437786.

[8] For example, see Agrawal, A.K., Catalini, C. and Goldfarb, A. (2013), 'Some simple economics of crowdfunding (No. w19133)', National Bureau of Economic Research; Belleflamme, P. and Lambert, T. (2014), 'Crowdfunding: Some Empirical Findings and Microeconomic Underpinnings', SSRN 2437786; and Hagedorn, A. and Pinkwart, A. (2013), 'Crowdinvesting as a Financing Instrument for Startups in Germany', HHL Working Paper No. 120.

[9] Department for Business, Innovation & Skills (2014), 'Equity Crowdfunding in the UK: Evidence from the Equity Tracker', Research Report.

[10] Financial Conduct Authority (2016), 'Crowdfunding', 19 January, http://www.fca.org.uk/consumers/financial-services-products/investments/types-of-investment/crowdfunding.

[11] For example, see IOSCO (2014), 'Crowdfunding: An Infant Industry Growing Fast', staff working paper, http://www.iosco.org/research/pdf/swp/Crowd-funding-An-Infant-Industry-Growing-Fast.pdf.

[12] Financial Conduct Authority (2013), 'The FCA's regulatory approach to crowdfunding (and similar activities)', FCA Consultation Paper CP13/13.

[13] For example, see Wardrop, R., Zhang, B., Rau, R. and Gray, M. (2015), 'Moving Mainstream: The European Alternative Finance Benchmarking Report', February, http://ec.europa.eu/finance/general-policy/docs/crowdfunding/150304-presentations-ecsf_en.pdf.

[14] This range indicates the lowest and highest rejection rates cited by the platforms.

[15] For example, in the UK P2P lending can now be included in a tax-free Individual Savings Account (ISA) wrapper.