Crowdfunding solves market failures in new venture financing

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Entrepreneurship is essential for economic growth and employment creation. Yet despite its key role in the economy, entrepreneurs find it hard to access the financing they need to start and expand their businesses. Lack of funding is perennially identified as a major constraint on new venture growth. Moreover, traditional venture capital markets have been criticised for not being inclusive in terms of geographic reach, gender, or race.

Over the last several years, we have been researching equity crowdfunding, a financial innovation poised to change the dynamics of entrepreneurial finance. *Equity crowdfunding* uses network effects and social media to bring entrepreneurs and investors together at lower transaction costs and greater outreach to a more diverse set of investors.

The UK has been a leader in fostering this entirely novel mechanism for raising capital for entrepreneurs. Equity crowdfunding has expanded along with the rest of the alternative finance sector and now supplies to entrepreneurs over £300 million a year, up from a just a few million four years ago.

Our research has built on collaboration with Crowdcube, the largest crowdfunding platform in the UK, and has yielded some unique and timely insights. We find that equity crowdfunding does offer a viable new path to increased investor activity supporting new ventures and generates a valuable new source of funds to entrepreneurs.

How is equity crowdfunding different from all other crowdfunding?

Media and research attention has focused on gift-type crowdfunders, where artists receive money from their social network in exchange for rewards associated with the product itself, for example free tickets and meetings with the artists in return for funding albums or films via platforms like Kickstarter. Equity crowdfunding is of much greater significance for capital starved entrepreneurs. It provides founders of new ventures an on-line social media marketplace where they can access a large number of investors who, in turn, each supply funds to finance initiatives that they find attractive.

How does equity crowdfunding work?

There are multiple models of equity crowdfunding platforms, but all share some basic features. Each platform has two networks, one of investors and the other of entrepreneurs. Entrepreneurs bid for funding by making pitches to the network. Investors on the platform include professional early stage investors, sector specialists, angels and venture capitalists, as well as potential small investors. A pitch is usually live on the platform for a fixed period. During the pitch there is an exchange of information and data around the network, between investors as well as between entrepreneurs and investors. An offer to supply funds is only taken up if the pitch itself is successful. Thus, whether or not the entrepreneurial project is funded is determined through the platform mechanism but is not under the control of the individual players themselves.

Qualitative evidence suggest that admission to pitching is a fairly closely screened process; in practice (on Crowdcube) only about 10 per cent of the entrepreneurs seeking to make pitches are allowed to do so by the platform and on average 30 per cent are successful. Individual lead investments in pitches are routinely between £100,000 and £200,000 and, depending on the model that the equity crowdfunding platform follows, average investments are between £1,000 and £3,000. Even so, minimum investments of £10 remain popular.

What our research finds…

Do investors follow the herd by stampeding into popular pitches and investing irrationally in equity crowdfunding?

Analysis of the data from our unique proprietary dataset allows us to look at two aspects of investor behaviour; the supply of funds within a pitch, and whether or not a pitch is funded through the crowdfunding process.

We find that, in fact, information accumulates through the pitch process, with each incremental investment acting to provide additional information, visible to all other potential investors, about how the pitch is currently evaluated.

However the impact of other investor actions does not generate unstable or explosive investment paths. One pound invested on one day of the pitch generates an additional 51 pence in the subsequent day, and an additional 76 pence over five days. These lagged effects taper quickly, suggesting fairly rapid absorption of the incremental information driving the initial new investment and since the sum of the lagged effects is less than unity, the impact of fresh investment is not explosive for the pitch.

What determines whether the pitch is successful?

We find that easily available information in the public domain about the entrepreneur and the firm, such as the sector or location of the business or the gender of the entrepreneur, do not have a significant influence on the likelihood that a pitch is financed. On the other hand, information that the entrepreneur must reveal in order to enter the pitch process, notably the price and number of shares on offer, the company valuation, and the current size and prospective growth of the firm in the future, do have the expected impact on pitch outcomes and these effects are statistically significant. For example, as the valuation rises, the likelihood that a pitch will be funded declines.

In sum, we show that when entrepreneurs and investors exchange (positive) signals about themselves and their ventures on the platform, the effect is to increase the supply of funds and to increase the chances that their pitch will be funded. Moreover, this new virtual market acts to improve the flows of information between investors and entrepreneurs and to reduce the gender and race biases and geographic limitations of funding which are typical of traditional forms of early stage entrepreneurial finance.

Conclusions

We therefore suggest that the architecture of equity crowdfunding platforms is able to exploit the low transactions costs characteristic of its online environment and to bring increasing network effects to bear on investor decisions in early stage entrepreneurial finance. Thus, by moving from the physical to the digital space, equity crowdfunding engages larger networks of entrepreneurs and investors, creating an opportunity to solve the persistent market failures that are known to bedevil the provision of finance to entrepreneurial ventures. In the process, as equity crowdfunding offers an entry point for investors across demographies and geographies, it may also socialise entrepreneurial finance.

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Notes:

- *This post is based on the authors' article* Equity crowdfunding: a new model for financing entrepreneurship?*, published in CentrePiece, the magazine of LSE's Centre for Economic Performance.*
- *The post gives the views of its authors, not the position of LSE Business Review or the London School of Economics.*
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