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An Interview with Carl Esposti, Crowdfunding Industry Research

The industry has been abuzz this week with the release of the first market research on the crowdfunding industry, the **Crowdfunding Industry Research** report from www.crowdsourcing.org, which also coincides with the launch of the Crowdfunding Professional Association (CfPA).

I wrote about the report last week in my May 10 article for *Harvard Business Review*: bit.ly/K6D4rz. I also thought it would also be interesting to pose some of the tough questions to the authors themselves. Here they are: Massolution CEO and Crowdfunding Professional Association executive committee member Carl Esposti and Sr. Analyst Gerrit Ahlers. Their first full presentation of their findings will take place in my own region, at the 2012 Crowd Funding Symposium in Salt Lake City, which I will be keynoting on May 31. Mr. Esposti will be presenting the new report as the first presentation on the second day of the event, on June 1.

Here's some of what they said in our interview this week (I'll post additional information in next week's column as well).

Alan: There's been some highly negative backlash to the concept of equity-based crowdfunding, which will become legal in the U.S. next year. What do you think?

Carl: Our best indication of how equity-based crowdfunding will work is to look at the places it already exists. We track the Australian platform ASSOB that was founded in 2005, so we have 6-7 years of data to look at. Through their platform, they've helped fund 176 companies so far. Nearly 6% have gone on to register on traditional securities exchanges and forty percent have exited through trade sales. But here is the real clincher: 86% of these companies are still in operation. Clearly, ASSOB has a long-enough history of successful funding to demonstrate that it can work.

Our research identified a total of $112.6M of equity-based crowdfunding in 2011, globally with just over half of this in Europe, most of which is in the UK and Ireland. The largest platform is SEEDUPS. Launched in February 2011 in

the UK and Ireland, SEEDUPS has attracted over 1,400 entrepreneurs and nearly 700 investors and has raised over $65m in capital funding for Tech start-ups. Other new equity-based platforms in Europe are showing early signs that they are performing well: CrowdCube, another UK equity-based platform, launched just over a year ago and has already funded 11 projects raising just under $2.5 million pounds. Symbid, the first Dutch platform, has funded 5 projects and is gaining in traction as well.

Alan: What about the assertion that equity-based crowdfunding is dangerous for investors?

Carl: For crowdfunding to establish itself as a viable and sustainable model for capital formation, the potential "dangers" for investors have to be managed, both in regards to levels of investor exposure and the potential for issuers to be fraudulent.

I think few doubt that there are limits we need to put in place both in terms of the size of the offering and individual investor exposure. From a legislative perspective, thresholds have been defined. For example, once implemented, the legislation governing US equity-based crowdfunding will allow non-accredited investors to invest the greater of $2,000 or up to 5% of annual income if they earn less than $100,000 or 10%, up to a maximum of $100,000, if their income is more than $100,000 or more.

There are also limits around how much a company can raise under the exemption being restricted to a maximum of $1m over a twelve-month period. As additional protection, if the issue is less than $100,000, the CEO of the entity must certify the accuracy of financials. Between $100,000 and $500,000, a CPA needs to review the financial results. Above $500,000, the company needs to publish audited financials.

In terms of the potential for fraud, here again, the best insight comes from looking at current models and the data we have on fraud rates from US and overseas platforms. Current data show fraud rates to be very low. The interesting thing for us is to look beyond the data to see what is keeping this number low.

People are working very hard from a platform point of view to integrate tools that provide information that investors need for their due diligence. There are also groups of industry experts forming to provide input to the SEC as they develop the rules and regulations and to guide the standards we need. The CAPS platform accreditation program [http://www.crowdsourcing.org/caps] is one of the key industry initiatives to drive standards for the operation of funding-portals that will help the industry continue to develop in a responsible manner.

Alan: What surprised you most in your research?

Carl: The total size of the market and its characteristics. It's been very interesting to aggregate this information for the first time. Everybody has been talking anecdotally about the industry or specific projects, but nobody really understood the composition of the industry, or how much money was being raised. The relationships and trust we've built over three years allowed us to gather data sets from more than 170 crowdfunding platforms. We selected 135 for our analyses that accounted for $555M of the total market. Then we gathered data that confirmed another $868M raised, and for the final 5%, we built models to estimate the total market size. This added

another $68M.

Alan: What about the difficulty of getting sufficient background on these very early stage companies to make it safe to invest?

Carl: When you're looking at a startup, you typically have very little historical financial data to review. For the issuer, the ability to provide comprehensive information in support of the offering is key. Platforms must provide tools and an environment that provides all the information the investor may need.

These tools need to force issuers to provide the information necessary to assess the business risk, or the probability of survival of these organizations. A lot of people raising money haven't raised money for previous ventures. There needs to be information to help determine whether the fundamental requirements for viability are met. Also, does the company have a plan in place for the allocation and management of the funds underpinning the integrity of the offering?

Yet it's important to remember when it comes to investing in an entrepreneur, there is no way to legislate the success of the investment and it's not the regulators job to pick the winners. Entrepreneurs will continue to fail and to succeed. This is part of the process of creating great companies and leaders. The ability of the crowd, when combined with innovative Internet based platforms that enable entrepreneurs to reach and pitch to millions of potential customers and investors, is incredibly capable of identifying and validating a good idea.

Alan: What about the valuation?

Carl: Quite frankly, at the end of the day you can get all of the other factors right and provide great clarity around the plan and the management team, and then possibly trip up around the matter of the value of the equity. We can see in established regions that market forces and the consensus of the crowd has positioned itself fairly well, determining what they decide or don't decide to fund. So it will be very interesting to see the ways in which crowdfunding, as it matures, establishes new market mechanisms for valuing companies.

Alan: What about the cost of investing? An opponent of equity based crowd funding named that aspect as his biggest complaint.

Carl: The percentages that cover the cost of investing on a platform are typically less than 10% of a project, and on rewards-based programs the cost can half that. One of the issues underpinning the viability of equity-based crowdfunding will be the function of being able to raise financing in a less frictional way, to make the process efficient and reduce the costs of raising money such as professional fees including legal and accounting costs. One thing we still don't know in the U.S. is exactly how the SEC rules will impact the cost of raising capital via crowdfunding. The actual costs have yet to be determined.

The complainant you responded to in your earlier article was talking without empirical data to back-up his statements. In comparing the costs of raising capital through traditional methods, perhaps a ten to fifteen percent cost to raise capital via crowdfunding might not be bad. As long as the issuer prepares thoroughly beforehand costs should be reduced, for example preparing a good business plan and providing good financials in order to

value the offering. As long as the regulatory framework is not over burdensome, crowdfunding as a model should eliminate many of the costs that are found in traditional methods of raising capital.

Gerrit: The crowdfunding industry is still very young. This is even truer for the equity-based crowdfunding industry. Our data shows that five platforms from four countries were responsible for 93% of the equity-based crowdfunding volume raised in 2011. As the industry matures, more platforms will be competing for aspiring entrepreneurs. This may well lead to a decrease in costs over time. More importantly, however, high costs are simply not an argument to disallow crowdfunding. Entrepreneurs will continue to have different funding alternatives, and will be able to pick the one that suits them best and investors should be allowed to decide for themselves if crowdfunding is for them.
