#284: Crowdfunding: How a radical new finance model is changing product development, research and the arts

VOICEOVER
This is Up Close, the research talk show from the University of Melbourne, Australia.

ELISABETH LOPEZ
I'm Elisabeth Lopez. Thanks for joining us. Every person with a great idea faces two fundamental hurdles in taking it to the world; money and markets. For entrepreneurs, emerging businesses and creative professionals, the Global Financial Crisis choked off traditional sources of finance. Getting past the banks and the venture capitalists was never harder. Since 2008, there's been a spectacular growth in crowdfunding where businesses, projects and products are financed by small donations or investments. Crowdfunding isn't a new idea. Since time began, businesses have got their start through family and friends financing. What is new is the power and global reach of social media to engage groups of people passionate about a cause, an art form or a niche product. By 2012, crowdfunding raised US$2.7 billion for projects and businesses globally. Many of these projects have been fun, frivolous or the stuff of dreams. But crowdfunding is now moving beyond its donation-based origins to be an important source of finance for small businesses and research institutes, for example. In the developing world, crowdfunding holds the promise of bringing small producers and marginalised groups to new markets. So how seriously should economies, large and small, view crowdfunding? In what unexpected areas are we beginning to see crowdfunding initiatives crop up? And how must crowdfunding and the laws that restrict it adapt and evolve to stay ahead of often volatile market conditions? Our guest on Up Close this episode, Dr Richard Swart, has worked with startup companies to large corporations on their digital strategies and crowd-funding initiatives. Richard heads the Crowdfunding Research Program at the University of California, Berkeley. He's the co-author of a World Bank Report called Crowdfunding's Potential for the Developing World. He's also co-author of a new UK report, The Rise of Future Finance, which is the first country-level study of an alternative finance market anywhere in the world. Richard joins us by Skype from Berkley. Richard, welcome to Up Close.
RICHARD SWART
Thank you.

ELISABETH LOPEZ
Richard, crowdfunding is often seen to be part and parcel of the United States entrepreneurial culture. And it's been said that it has the potential to create silicone valleys everywhere. Where did it actually emerge?

RICHARD SWART
Well, crowdfunded investing actually started there in Australia about 2006/2007. If you go back in history, the first crowdfunding campaign which actually existed was about 20 years ago when a group of fans crowd-funded a British rock band to come on tour. In the United States back before we even had social media sites, there was fundraising through bulletin boards in the old 1990s version of the internet. Crowdfunding for equity has been experimented with in Europe off and on for several years. But honestly the award for first equity crowd-funding market does have to be there in Australia.

ELISABETH LOPEZ
Let's take crowd donation funding, which is probably the simplest model, the one that's had the most media exposure. How does it work? And what sort of incentives are there for people to start investing?

RICHARD SWART
Well, donation crowed funding is specifically not for investing in. The most commonly known platform is Kickstarter, although there are hundreds of other platforms in the world, some very specific to one region of the world or one type of crowdfunding activity. It's essentially solicitations through websites done over social media where people are asked to contribute small amounts of money towards a project or a cause. Sometimes an entrepreneur will actually come up with a product idea and basically pre-sell their products. So please give me $50 or $100 and I will send you one of these once I manufacture it. Typically campaigns will have multiple levels of rewards. Some people call that perks-based crowdfunding, similar to a public radio station, or a public television station or a charitable foundation where they'll ask for contributions from listeners or donors. Depending on what your donation is, you may get different sorts of rewards, such as t-shirts, hats, access to events, signed autographed copies of album covers, early admission to a play. There's even crowd-funding for movies. Based on higher donations, you could fund your own cameo appearance in a movie.

ELISABETH LOPEZ
We're not talking amateurish efforts, are we? We're also talking about the kind of niche products put out by major studios but where the proposals to extend, say, a popular series have just not got past the in-house accountants.

RICHARD SWART
Yes, the most commonly used example of that is the Veronica Mars television series
that went for five years, had an extremely loyal fan base, was cancelled by the studio. And the producer went to crowdfunding sites to actually crowdfund the Veronica Mars movie, which successfully launched. I believe one of the movies that received an Oscar last year, a documentary category, had been crowd-funded. I know that two of the movies at the Sundance Film Festival which just wrapped in the United States a couple of days ago received crowdfunding backing. So crowdfunding is not just for small arts. In fact, there’s data in the United States that crowdfunding contributes more to the arts than our national endowment for the arts. That’s been true for the last two-and-a-half years. Looking at science and technology, there’s been a crowd-funded satellite. The first human-powered helicopter was crowd-funded. There’s also been crowdfunding for medical research as well as crowdfunding for medical interventions. So it’s not just a kids’ game anymore. It’s become much more of a serious tool being used by the entrepreneurs, scientists and the film producers to get backing for their projects without having to go through intermediaries.

ELISABETH LOPEZ
Can you tell me a little bit more about crowdfunding for medical research? I notice that there’s an interesting website that was founded by a woman who survived breast cancer. She seems to be having some success in rallying other people who were passionate about finding the next cure for whatever ailment they’re affected by.

RICHARD SWART
It’s very early still but I believe, and this is going to be my crystal ball moment of the show, that you’ll see a much larger penetration of crowdfunding for both medical cures and also funding research. One of the magic elements of crowdfunding is that you’re organising a community that shares an interest or an affiliation. That may already be communicating through Facebook groups or following certain bloggers. But if you can channel the passion of the group through the financing mechanism of crowdfunding you can sometimes raise significant amounts of money. There have also been examples of medical crowdfunding sites that highlight the medical needs of specific individuals, sometimes first world, sometimes third world. Third world example oftentimes are done sort of like a UNESCO or Save the Children model where they’ll highlight a particular cause or a particular child. And they’ll explain how, for example, this young girl doesn’t get her arm set, which will cost approximately $200, she won’t be able to use her arm, and she’ll be ostracised from society and probably not find a husband. So the long-term ramifications of lack of access to medical care in some third world countries are significant. And there are some sites that are highlighting that. There are also some sites in the United States where due to the challenge of receiving continual funding for some of the research projects, scientists and medical doctors have been attempting to use crowdfunding to get continual support for their research, with mixed results but it’s an interesting experiment. I think you’ll see more of that in the future.

ELISABETH LOPEZ
I suppose, especially as government budgets wind back for things like the arts and research?
RICHARD SWART
It's hard to say what the governments intend to do. But I believe that it's a fair assumption of the majority of governments in the world are going to start curtailing their research, especially if you're looking at what we call an orphan disease or something that doesn't have a lot of opportunity for commercialisation. It's difficult to find large organisations willing to fund some of that research. There's also a very well-known effect in a lot of science where, if you're outside of the mainstream literature, it's hard to get your work noticed. And so crowdfunding can be a mechanism to get some of that research funded and to build a community around what you're trying to create or the researcher's trying to accomplish.

ELISABETH LOPEZ
It's easy to see the benefits of rewards-based crowdfunding to a community of fans, for instance, or people who want the next cure for a particular disease. What are some of the benefits for the people who are actually producing the product or the research? What is it that they get from crowdfunding that goes beyond just money?

RICHARD SWART
That's a great question. First of all, you connect to a community of people that care about what you're trying to accomplish, whether that's a new video game, a new type of consumer electronics device, craftsmen, wood products, artisanal food. And whatever your niche industry is, you typically find that crowdfunding mobilises and energises a community around what you're trying to create. And a community will give you extensive feedback about your business idea or model. It's not a one-way communication mechanism where you're pushing out advertising. It literally starts a conversation with your intended customers about what you would like to produce or what you are producing. And we found extensive evidence where the community comes back and gives detailed feedback to that entrepreneur, sometimes several pages of very specific and accurate feedback on product features or desired features. The most famous example of which is the Pebble watch, the most successful crowdfunding campaign ever, which was a Bluetooth-enabled watch that connected to your iPhone. They launched the campaign. And very quickly the community said, this has to be waterproof. What good is this watch if it's not waterproof? So they were able to, within the time of the crowdfunding campaign, redesign the watch to make it waterproof and tell the crowd, we've listened and we now have a waterproof watch. So think about the difficulty, complexity and cost it would take for a corporation to change design features and to modify a marketing budget and to retool production. That would have been either impossible or prohibitively expensive. Given the presale model where manufacturing, in fact, had not started yet, they were able to make that change and produce something that their customers wanted before you had made your first unit.

ELISABETH LOPEZ
And large corporations and companies in heavy industry are also getting into this, aren't they? I think you've documented a carmaker that is using crowdfunding to pretty much design new cars to customer specifications. Or is that overstating it?
RICHARD SWART
That may be overstating it. Dodge had a very successful experiment using crowdfunding for their Dodge Dart, one of their less expensive cars. I think it appeals more to college students. What they did is they had a campaign where you would produce a video about why you wanted a Dodge Dart and you would share this video with your friends. And what they found, which was amazing, was that in the first quarter following their crowdfunding campaign which was done extremely inexpensively, they sold more Dodge Darts than they had in the previous year. So think about essentially quadrupling sales in a very short period of time with a very small amount of money. It's obviously successes like that have attracted the interest of major brands. Some brands have gone public, like Conde Nast, Proctor and Gamble have initiatives around crowdfunding right now. There's a few others that I'm aware of that have not yet gone public but there will be in 2014 a significant, I call them series of experiments as corporations and major brands start to figure out how they can use crowdfunding to better connect to their customers and also receive feedback from those customers.

ELISABETH LOPEZ
Do they tend to get hamstrung, these large corporations by their own inertia, the bigger the firm is, the more bureaucratised it is and the more closed to innovation it often is, they don't necessarily have the agility of an emerging firm?

RICHARD SWART
You're absolutely correct. There's two types of crowdfunding that your comment implies. The first is sort of crowdfunding innovation or crowd sourcing innovation whereby putting out product or product features in a crowdfunding campaign, the real initiative of the corporation is to get very fast and rapid feedback from either intended customers or, in some cases, even suppliers and distributors will give feedback. There's documented literature around crowd sourcing innovation and crowdfunding. crowdfunding platforms has become a much more public and fast way of doing this crowd source innovation which is sometimes is only done inside of companies. But there's also crowdfunding where you have a particular project. What you're noticing is that some of these corporations are attaching their crowdfunding campaign to a charitable cause or to highlight the passion of a particular entrepreneur. So they're not just taking well-known branded product which is already in production and saying, let's crowdfund Tide laundry detergent or something like that. They'll come up with a specific product or a new issue, if you will, a new type of tennis shoe or a branded tennis racket using sport examples. Or they might come up with a limited production run of a food item. And sometimes they'll tie the production of that item to a donation to a charitable cause. So it's a bit of a hybrid between social giving, public good and philanthropic giving of the organisations with a marketing campaign blended in.

ELISABETH LOPEZ
So, in terms of crowdfunding platforms, Kickstarter is probably the one that's best known in the world and that most of its projects are creative projects. But who are some of the major players that are emerging? What trends are you seeing in terms
of, I guess, specialisation of platforms and the differences in the openness and the accountability that they offer investors or donors?

RICHARD SWART
There are several types of platforms. The first that you're referring to are the pledger donation platforms where there's no equity. There's no debt. It's not an investment activity. It's simply a company is using those platforms to ask for small donations or presale inventory. The big three in the world are Kickstarter, Indiegogo and RocketHub. Kickstarter's very narrow in what they allow. They only allow 11 types of projects, of which two or three of them counts for the vast majority of all projects on the site. Indiegogo basically allows anything that's legal. They intentionally want crowdfunding to not be bounded. They want anyone to be able to figure out how to use crowdfunding to fuel their passion and their dreams. RocketHub is similar to Indiegogo; they're much more liberal in what they'll allow on their sites. RocketHub has also shown the most momentum in marrying their crowdfunding platform to these major brands. I think you'll start to see RocketHub quickly emerge as the dominant platform for corporations to use, as opposed to Kickstarter which is not so open to corporations. You will also see crowdfund equity sites where people are able to invest in companies using crowdfunding. The most well-known example here in the United States is one called AngelList. AngelList has started when our laws passed to allow equity crowdfunding. It's been growing relatively fast in numbers of individuals posting deals, the number of investors looking at deals. But the total volume has only been about $30 million in the last four months. So it's getting a slow start. And some of that's due to regulation.

ELISABETH LOPEZ
I'm Elisabeth Lopez. On Up Close this episode we're speaking with Dr Richard Swart from the University of California Berkeley about the extraordinary global growth of crowdfunding. Richard, it seems a paradox that crowdfunding relies so much on trust and community. Yet your research has shown that fraud, at least for now, has been minimal. Why is this?

RICHARD SWART
There are several things that we think explain it. There's no definitive research that absolutely answers that question. We started off with the most simple example of to what extent has there been any documented fraud on any of these platforms? And we're looking worldwide. There's a strong market in Europe. There's a very strong market in the United Kingdom and, of course, there in Australia. There are two or three things that we think account for it. First of all, most equity transactions, whether it's ASSOB (Australian Small Scale Offerings Board) there in Australia or the British Market, require a fairly comprehensive disclosure, background checks, identity verification before a deal can even be put up there. So if a criminal intends to defraud people, there's much more efficient, fast and less risky ways of defrauding individuals in crowdfunding. In terms of the actual Kickstarter or Indiegogo pledge and donation model, Ethan Mollick at Wharton Business School did some research. He found that less than 1/100th of one per cent of sites appear to be fraudulent. That's one of 10,000 campaigns that would be potentially fraudulent. And what we
find is it's the actual interaction of the community around the product. So you say, here's what my product is. Here's its features. Here's what it can do. You put that out there in the world and you share it through social media. You have no idea who will get that information. What we find is, interestingly, many times experts in an area will find that posting and will say that's physically impossible, that can't be done or the laws don't allow that. There's a very rapid, we find, 24 to 48 hours these projects are called out by the crowd. And so there's something wrong. We find oftentimes the company seeking funding simply drops the campaign when they're called out.

ELISABETH LOPEZ
What influence does a crowding platform's policies on all or nothing funding, for instance, have on the potential for fraudsters to get involved in crowdfundng?

RICHARD SWART
I believe it actually is a bit of a protective mechanism in that you have to believe you have the ability to go out there, reach a crowd of people and solicit donations. Typically, if you're going to commit financial fraud, given the outsized risk you're taking, you're going to want to raise a substantial amount of money. So I think requiring people to raise all the money that you ask for and then there's no benefit to you unless you raise that amount, which is the Kickstarter model, the all or nothing model, it does have something of a preventative effect. We also know that the platforms themselves do an extensive amount of work trying to weed out the fraud. They all have artificial intelligence, natural language processing and other software technologies running in the background looking at the nature of the offerings and the nature of the individuals. And the platforms, unbeknownst to most individuals, actually do weed out a lot of potentially questionable offerings or campaigns.

ELISABETH LOPEZ
Yes, and as we're seeing venture capital firms get into this space, I suppose they're starting to vet projects before they even see the light of day online.

RICHARD SWART
Almost without exception, all crowndfunding platforms do some sort of screening or vetting, which it's for legal compliance or identity verification. Those platforms that are dealing with cross board or money flows also have a fairly extensive compliance burden in that they're not doing equity. Think about a situation where you're collecting money from individuals in dozens of countries, there's a lot of law and regulation about tracking where that money comes from and how it's being used. These sites have a burden on them to do a lot of accounting and a lot of compliance work on the back. They're doing a good job of that. The interest of venture capitalists really hasn't affected the dynamics of how the sites are posting deals. What it has done is sort of give credibility to the industry. We know that Google Ventures back on the large peer-to-peer lending platforms. We know of private equity firms and hedge funds that are pushing money through peer-to-peer lending platforms. It seems like Wall Street and major financial institutions around the world are starting to pay attention to crowdfundng. They're going to start deploying capital through
their mechanisms. I think because of that, the leading sites are recognising that there's an investment opportunity there and there's a chance to partner with these larger firms. They are, if you will, becoming even more professional at what they're doing in order to attract more interest from these venture capital firms.

ELISABETH LOPEZ
So if Wall Street and private equity in the hedge funds are getting involved, it sounds like the original reasons why crowdfundng really took off a few years, because the banks were starving lending to households and businesses, it does sound that once banks get to normal, crowdfundung is not going to go and die a quiet death?

RICHARD SWART
No, crowdfundung will always be here. In fact, I fully expect it to continue to grow exponentially for a number of years, even with the entrance of the major players. The major players don't want to move small amounts of money. They want to deploy tens or hundreds of millions of dollars through platforms. So their interest is on two sides of the market. On the peer-to-peer lending space or the peer-to-business lending space such as they have in the United Kingdom, they want to deploy 50/hundred/200 dollar million loan portfolios because they can generate very good returns for these loan products that they cannot get through money market accounts or banking. So there are hedge funds that are using peer-to-peer lending platforms and with leverage are getting 12 to 18 per cent returns, which is a pretty healthy return. It's actually a good thing because it means there’s money available to lend to entrepreneurs and people with dreams. And these hedge funds are basically using crowdfundung platforms as a way of deploying that lending capital. Small banks are so constrained around the world in their credit-worthiness requirements and their collateral requirements that in many times crowdfunded companies are companies that have approached banks and have been told, no, you don't have enough revenue. You don't have enough time in business. You don't have enough collateral. We can't lend to you. They then approach crowdfundung as an alternative to that. In fact, there's data suggesting that crowdfundung is now the first choice of lending companies, not bank lending. They raise money through crowdfundung. And then our research shows that fairly quickly they then approach institutional investors or bankers. And their success in crowdfundung oftentimes makes it much easier for them to subsequently acquire a loan or an investor.

ELISABETH LOPEZ
Can you tell us what's been happening in the UK with small to medium enterprises? Lending there to businesses has tanked and it's not recovered to pre-GFC levels. To what extent is crowdfundung filling that void? Who are the players in this new, I guess, ecosystem that's starting up?

RICHARD SWART
You know, the UK is a very interesting case study. The banking regulations are very different there. And there's only actually five major banks in all the United Kingdom. It's very different than here in the United States where we've thousands and thousands of banks. It's a very tightly-controlled, essentially monopolised banking
model with very tight central regulation. And because of multiple economic and political factors, the banks really are constrained in their lending. That does not appear to be getting better any time soon. So the peer-to-peer lending and peer-to-business lending space has exploded in the United Kingdom, growing well over 100 per cent a year for the past three or four years and continues to grow in velocity. Major venture capital firms are now backing those platforms and investing money through those platforms. It's been seen as a very disruptive influence. That being said, the total volume of alternative finance in the United Kingdom was roughly £1 billion last year which, in terms of a major financial market, is still a very small amount. The bad news is that, despite significant growth and well over 100 per cent increase in loan volume and over a 600 per cent increase in crowdfund equity activity in the United Kingdom, that entire pool of activity is still very small and not able to fill the gap yet.

ELISABETH LOPEZ
How important is the role of government in developed economy? What's its main value?

RICHARD SWART
On two things, and I don't want to come across as an anti-government radical. But the research clearly shows that limited regulation is better for crowdfundng, both empirical research and also we built in a econometric model study in the emergence of crowdfunding around the world. We found that the countries where crowdfunding seems to be doing best are those that have what we call light-touch or limited regulation. If governments see crowdfunding as an equivalent or alternative to a full security offering and layer on extensive costs, financial auditing, paperwork and difficulty, they sort of miss the fact that this is not a large institution with lawyers, accountants and security brokers that they're already working with that can produce those sorts of documents. Those compliance costs and documentation preparation costs can be a prohibitive barrier for these small companies. We did a study, for example, of the average company utilising crowdfunding in the last year. Again, this is a self-reported study so there's some variation in the actual outcome here. Approximately two to three employee companies are those going out there using crowdfunding. The interesting thing is, after they have success, these companies very quickly hire about two more employees. The average number was 2.2. So if governments intend to utilise some sort of financial market intervention to create jobs, I don't know of any data which suggests a more effective and fast way of doing so than putting through crowdfunding.

ELISABETH LOPEZ
Which brings us to the legislative responses to crowdfunding. The US and the UK have both passed laws to enable it. In the US we saw the JOBS Act passed last year, legalising equity crowdfunding. What sort of opportunities has this opened up? Are the regulations up to speed yet? Can they follow such a fast-moving phenomenon adequately?

RICHARD SWART
They're not following adequately. And I feel sorry for the SEC, the Securities and Exchange Commission. They're basically being exposed to a new world and a new set of conditions that they're not comfortable with or familiar with. Now, security regulations are based on basically phone calls, boilers rooms and paper transactions. That model has been around for dozens of years. They're being sort of forced to deal with a new paradigm. There's no regulatory guidance for them. In enacting the provisions of the JOBS Act here in the United States, there's essentially two pieces that matter. And I won't bore your audience with a lot of technical detail. Basically there's crowdfundinng for the wealthy, so crowdfundinng for what we call an accredited investor, someone who makes over $200,000 a year or has $1 million of net worth, not including their house. And that's what's legal today in the United States. And there's AngelList, CrowdFunder, WeFunder and a few other sites out there that have got the what we call Title II crowdfundinng operating. It's going fairly slowly. One of the things that happened was our securities commission said in the past you had to know the people you were soliciting to. Now you're able to do what's called general solicitation, utilise social media marketing, Twitter, any sort of messaging that you want. So the burden has now shifted to the platforms or the issuer of the security instrument to verify that the potential investor's actually qualified and can legally make that investment here in the United States. The laws are a little bit unclear as to exactly how that verification should be done. Until the SEC comes out with very specific guidance in the minds of their intended customers makes that clear you're not going to see a lot of growth. Now, Title III is what you think of as crowdfundinng, what the average citizen can buy part of a company, the mum and pop who wants to invest in a local business or who wants to utilise crowdfundinng. Those laws will not go into effect for several months. We don't know exactly when. So we're probably still four to six months away in the United States, from seeing equity crowdfundinng emerge. A structure of the rules unfortunately imposes a fairly high degree of cost on the companies. It's going to be one of the more expensive ways for a company to raise funds which sort of goes counter to the intent of the legislation.

ELISABETH LOPEZ
And I guess counter to the whole spirit in which crowdfundinng has evolved?

RICHARD SWART
Oh, absolutely. I think it's overregulated based on what was frankly a political compromise to push the bill through Congress very fast in our last election cycle. There is a strong voice in the United States from consumer product lobbies and some other organisations that are afraid of rampant fraud. And they make these arguments very loudly and successful despite the lack of empirical evidence to justify them. And those arguments in many ways have carried the day and our laws have been structured in a way to protect the investor from the perceived outsized risk of fraud. Whereas in reality the empirical evidence shows it's going to be one of the safest markets that an early stage investor could get into. That being said, it is going to be a higher risk. Any time you're going to invest in an early stage company, there is a lot of risk there. But the risk of fraud is relatively miniscule.
ELISABETH LOPEZ
This is Up Close. We're joined this episode by crowdfunding expert Dr Richard Swart. I'm Elisabeth Lopez. Richard, what are the hallmarks of a successful crowdfunding campaign?

RICHARD SWART
Several things. The first hallmark is that the campaign effectively highlights the reason why the founder or the entrepreneur wants to produce the product or produce the campaign. It's all about the idea and the passion of the individual. And a lot of the psychological motivations for donation are very similar to charitable giving. Many entrepreneurs especially suffer from what I call shiny ball syndrome, where they fall in love with their technology or what they've invented. All they do is talk about the what and not the why. The why is what motivates people to back your project.

Secondly, there's the fallacy that all crowdfunding requires is launching a video, putting it up there and money will magically pour in. A successful crowdfunding campaign starts about three or four months after the entrepreneur has started thinking about crowdfunding. They prepare a content library. And they prepare and engage their social media communities. And they build up followings. They build up Twitter followings. They engage relationships with bloggers and thought-leaders in their space. It's essentially a product launch. So you have to prepare for that and think about how you're going to have your message amplified through other channels and influential people that already have followers. You can't simultaneously build a following and do a crowdfunding campaign. Then they also do high-quality videos and audio quality, which is interesting that most people are so focused on the visual aspects of video that they forget about the audio. The audio oftentimes is so poor that it kills the crowdfunding campaign. Successful campaigns have good audio.

ELISABETH LOPEZ
All this communication sounds incredibly labour-intensive. Are a lot of start-ups or people coming into this space really aware of how much time it takes to have that very authentic relationship with donors or investors?

RICHARD SWART
I don't believe the vast majority of people who start a crowdfunding campaign know what they're getting into. My research shows that the average crowdfunding campaign which successfully raised $100,000 requires 136 hours of work once you start the campaign, that's on the average, some well over 200, 300 hours. That's done over a typically 45 day period. If you're investing 150 to 200 hours over four to six weeks, that's a part-time job. It's a significant component of your work day. It has to be on a daily basis and actually throughout the day because you have to engage with people through social media. This is essentially a social media phenomenon. So the entrepreneur or the founder has to be ready, willing and able to commit a good chunk of energy and time to that crowdfunding company once they start. It's not a set it and forget it model which unfortunately many entrepreneurs think that it is.
ELISABETH LOPEZ
You’ve pointed out that one of the big risks in crowdfunding is fulfilment risk where the enterprise just has a lot of demand for what it’s offering but it just can’t quite get there. It’s not anticipated the demand correctly or it just doesn’t have the nous or the wherewithal to get it all happening in time.

RICHARD SWART
It’s sort of ironic. There’s a direct linear relationship between the amount of money raised, the length of delays and getting a product out the door. So it shows that people that are more successful than they expected to be, oftentimes are not prepared for that success. As you pointed out, it’s typically a logistical challenge or a production challenge. Many of those companies have spent so much time focused on the product, they forgot about things like tax registration and issues about international taxation, international shipping and accounting systems and all the complexities of running a business many times they’re not prepared for. It does not mean they’ve fraudulent intent. It just means they didn’t get their act together. Now, what we found is that if these companies communicate those challenges back to their community, they provide frequent updates and they show good faith in fulfilling it, the crowd’s pretty forgiving. They understand they’re backing an early stage person with a dream. I don’t know if that will be true with major corporations. I suspect it will not be true of the bigger companies as they experiment with crowdfunding. But there’s very little evidence to show that people crowdfund without any intention of fulfilling the project. The vast majority of the time they do eventually fulfil their obligations.

ELISABETH LOPEZ
Richard, you’ve observed that there’s a perception that companies who resort to crowdfunding just can’t get funding from any other source. What’s your response to that?

RICHARD SWART
The data shows that that’s pretty much not the case. We did a major study and we, in this case, is crowdfund Capital Advisors, one of the consulting groups that I work with, looking on follow-on activity after crowdfunding. And what we found was that in six months 28 per cent of firms had already close a deal with an investor. And 43 per cent of firms were still in talks with a potential investor. Oftentimes there’s a several month process to arrive at terms. We’ve also been tracing activity of several angel networks around the world. I’ve personally been contacted by more than one venture firm and have been asked to consult with them on strategy but how to best utilise crowdfunding. And it seems that’s what’s happening is these Angel Networks are waking up to the fact that there’s a pretty strong correlation between crowdfunding success, the interest in the community and buying a product. So they’re now, what we call, sourcing deals through crowdfunding. There’s investor networks that are now explicitly requiring companies they intend to invest in to go demonstrate their ability to crowdfund. Go show us people want your product. Go crowdfund $100,000 and then we’ll match that investment with $200,000 of our own. There are crowdfunding platforms emerging in Asia which are literally hybrids
of Angel Networks. All the investors are in Angel Network and they're just using a crowdfundng platform to make it easier to select deals. There are also platforms here in the United States that will allow a company to list an equity transaction but they won't due a full due diligence and all the background checks, which is really expensive, until it looks like there's crowd momentum behind that company. Then once they reach a certain threshold they then sort of tip over into a full documentation, full background check, full due diligence process. So they're basically allowing the crowd to let them know when it's worth their time and money to actually go through the process of screening these companies using crowdfunding.

ELISABETH LOPEZ
The process of gaining angel investment or venture capital investment seems to be quite labour-intensive, involving lots of meetings and to'ing and fro'ing. I suppose crowdfundng potentially eliminates a lot of that?

RICHARD SWART
Yes, I mean, the odds of receiving investment from a venture capitalist are lower than the odds of a child being accepted to Harvard University, extremely rare, in other words. The amount of time necessary to pitch to a group of investors for the average company is dozens or sometimes hundreds of pitches with require manpower, travel, time away from your office. Think about the man costs and the labour costs of that. It's extremely expensive. It's very time-consuming. crowdfundng is not always successful. I mean, only a small percentage of firms are going to raise the amounts of money they want. It's statistically much more successful than going out on a venture pitch or an Angel round pitch. Having had success in crowdfundng changes the nature of the conversation. Many firms that have been turned down or not even allowed to present to the Angel Networks go out and crowdfund and then they get a call from the very same Angel Network saying, please come in next month, we want to talk to you. It's a great way of gaining attention from them quickly and accelerating that process of getting funding.

ELISABETH LOPEZ
Richard, the World Bank believes that the developing world could leapfrog developed countries in crowdfundng. What sort of conditions are necessary for crowdfundng to take off, especially where internet access might be precarious and there are cultural attitudes that discourage entrepreneurship?

RICHARD SWART
There are several factors that come into play. You asked about leapfrogging. That's a fascinating concept and we're already seeing some evidence of that emerging. For example, we know that, while ICT penetration, meaning hardwire computer cables Cat5, fibre optic, things like that, are relatively rare in developing countries, there are still extensive networks of cellular technology, so SMS messaging, cell phones, smart phones. And even though some of the phones in the developing world might not be equivalent to a smart phone you'd buy there in Australia, they still have extensive functionality. So we're finding very innovative entrepreneurs that are utilising different models of crowdfundng. There's one that utilises basically cell
phone to cell phone with no website. It's essentially an app. We're seeing other
crowdfunding emerge that targets what I'd sort of call the next generation of
microenterprise lending where people are talking about very specific need in a village
for an entrepreneur to raise a relatively small amount of money but maybe larger
than they could get through a microenterprise loan. So we're going to see the
emergence of some very interesting hybridised combined loan and donation models
in the third-world countries that are going to facilitate these entrepreneurs from
accessing capital because in most of the developing world you either go and get a
microenterprise loan or you have to have several million dollars in revenue and then
you can access institutional capital. So what we call a valley of death in finance is so
wide in the developing world, you literally have a gap of sometimes $1000 to several
million dollars whereas in most of the first world, there's different stages of financial
investing from seed, to angel, to early stage venture capital to private equity. That
system simply does not exist in the rest of the world. So crowdfunding is going to
start filling that gap, especially the earlier parts of that spectrum.

ELISABETH LOPEZ
Well, one of the really interesting crowdfunding platforms in Africa is Homestrings
funded by Guinea National who was born in New York, a guy called Eric Guichard.
Can you tell me a bit about how Homestrings has been working?

RICHARD SWART
I don't have the numbers off the top of my head but I know it's extremely successful
and growing very rapidly. It allows essentially diaspora, people that have cultural ties
that have left Africa to invest back in Africa. They can select their country or they
select the type of project they want to back. I know that in the African American
community in the United States and in several other parts of the world, it's gaining a
lot of attention and traction as a beautiful example of what community organising
around itself and trying to funnel capital back to Africa. The World Bank would call
that north-south capital flows. We're also seeing a different example of that where
there's a site called OurCrowd, which is a US-based company which primarily solicits
for investments and is really technology startup companies. And they are soliciting
essentially from Jewish diaspora around the world. They are actually the number
two equity crowdfunding site in America right now and growing rapidly. They may
emerge as the most successful equity crowdfunding site in America based on the
volume of transactions that they're pulling off. So when you can touch an emotional
connection or a cultural affinity to a country and crowdfunding becomes the
mechanism providing investment money or stabilisation money to that country, you're
going to see crowdfunding emerge very rapidly.

ELISABETH LOPEZ
And the World Bank is really moving into this space with climate innovation centres
which focus on encouraging clean technology projects. Can you tell us a bit about
those?

RICHARD SWART
Yes, they had their first centre operating in Kenya. I believe they're going to open
five or six more in the next couple of years. It's basically local entrepreneurs embedded in an area, can identity and innovate around climate technologies and energy technologies. Some of them are very simple. They don't necessarily have to be solar technology. Sometimes they can be a stove. They can be a water project. But the World Bank has recognised that oftentimes you have to provide training to people that understand all those nuances of a local community and enable them to succeed. These climate innovation centres have an accelerator co-working space. Many of them are going to have fabrication facilities or prototyping facilities where people can actually build prototype some products. They typically have ties to universities where they can get expert consulting, engineering and the science behind their ideas. Many times they have ties to venture capital or institutional investors to help them, if not [unnecessarily fund them but help them get ready for future funding. It's a great idea if executed well. And I believe the team at the World Bank is very much on top of crowdfunding and wants to utilise crowdfunding because they see that it will be a way for the World Bank to leverage their money in that country and then allow them to, if you will, follow the British model. So the World Bank will either co-invest with the community or will put some seed money in and then ready them for crowdfunding.

ELISABETH LOPEZ
China, on paper at least, is potentially the biggest market in the world for crowdfunding but it also has incredibly strict controls on social media. What's the future looking like there?

RICHARD SWART
Anyone's guess. Looking at the economic variables, China should comprise about half of the world's crowdfunding market within 10 years. There's no reason that, given the amount of capital, the growth in the middle class, the technology penetration, that China can't become the World's dominant player in all forms of crowdfunding. I fully expect there's entrepreneurs in China that have that explicit goal. But our research showed that the number one most predictive factor in crowdfunding success is Facebook utilisation. Facebook is the most common social media platform in all but five countries of the world, China being one of them. You have to have free transmission of information for crowdfunding to succeed. So if there's heavily censored social media use or people are afraid to basically exchange information openly and transparently, it's going to be very difficult for crowdfunding to emerge as it exists now. Now, peer-to-peer lending platforms where there's certain companies looking for a loan, they'll give you a certain percentage rate and individuals can loan $500 to that company. That's a lower risk involved and it's probably going to attract less creative or innovative ideas just by the nature of the requirements for a consistent revenue stream to pay back those loans. So we already are seeing some growth in the peer-to-business lending space in China but crowdfunding as we see it in the western world is far less likely to succeed unless there's a major cultural shift and a government shift that allows transparent and open communication.

ELISABETH LOPEZ
Richard, thanks very much for joining us on Up Close.

RICHARD SWART
It's been my pleasure. Thank you for having me.

ELISABETH LOPEZ
That was Dr Richard Swart, director of research on the Program for Innovation in Entrepreneurial and Social Finance at the University of California, Berkeley. Richard Swart consults to leading US financial services companies. He’s an active advisor or board member to several start-ups. You can find relevant links and a full transcript of this episode on our website. Up Close is a production of the University of Melbourne, Australia. This episode was recorded on 28 January 2014 and produced by Kelvin Param and Eric van Bemmel, audio engineering by Gavin Nebauer. Up Close is created by Eric van Bemmel and Kelvin Param. I’m Elisabeth Lopez. Thanks for joining us. Until next time, goodbye.

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