

FINANCE

Crowdfunding: A Grassroots Revolution in Startup Investment

by Adelia Gregory



Today, small-time entrepreneurs with big-time ideas can leverage the geographic and social reach of the internet to raise money for their businesses from people around the world.

✓ **INSIGHT** | NOTE 11 Mar 2016

Background

In 2009, crowdfunding – a type of financing that aggregates small amounts of capital from a large number of individuals – was still mostly part of startup folklore, representing only \$530 million in global market value. Just five years later, crowdfunding has become a viable alternative to venture capital, as a \$16.2 billion industry. Crowdfunding is truly a

grassroots-level revolution in the finance/investment world: small-time entrepreneurs with big-time ideas can use their social media accounts and similar venues to reach friends, family, college classmates and others to “test the waters” for their product. If people respond by investing in the entrepreneur’s concept, it shows that there’s not only a market for the idea, but that people are willing to spend their money on its potential success. Obviously, crowdfunding is the antithesis of venture capital (VC): no longer do people with great ideas need to inflate the valuation of their company to convince investors before there’s even a penny of revenue. Now, regular people can take a Bernie Sanders-style campaign approach, and seize on a democratic revolution in investment strategy.

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But why would an entrepreneur decide to crowdfund instead of seeking traditional VC? Aside from the level of autonomy that crowdfunding affords, it comes down to the fact that “over 95% of business plans received by accredited investors and VCs [are] rejected”. It’s evident that VCs are pickier than ever after the 2008 financial crash, which has been prompting innovative entrepreneurs—mostly those outside of San Francisco, Boston, and New York City—to seek investors through sites like Kickstarter and AngelList. One common form of investment is equity-based crowdfunding—used for startups—which offers investors shares/stakes in the business in exchange for their cash investment to accelerate the company’s growth. Another form is peer-to-peer lending, a type of debt-based crowdfunding that allows money to be loaned and borrowed with the lender holding an IOU with interest rates can be as high as 7%. Since the days of the pre-2008 easy investments from banks and VCs are over, let’s assess some of the associated risks with democratically raising capital.

Risk and Return

1. **The culture of startups embraces ambivalence and risk** — sometimes this means regulated risk and sometimes not. It’s important to understand that even if a new company is regulated, there’s not always a guarantee that you will get your money

back if the company fails.

2. **There are no standard, universalized rules** about the information crowdfunding platforms have to provide on the startups they feature—remember that these platforms exist for their own profit, and promoting particular companies is part of their marketing strategy. Research is absolutely paramount to startup investment success; never trust a company's claims without assessing of the company's history, the potentiality of its market(s), and what returns for shareholders will realistically look like.

So you too can invest in a startup, right? Not so fast, budding investors! The U.S. Securities and Exchange Commission—the regulatory agency in charge of preventing the Myspaces of the world from masquerading as Facebook —has approved certain rules to protect consumer investors.

1. People with an annual income or net worth below \$100,000 can invest no more than \$2,000, or up to 5% of their annual income or net worth (whichever is lesser). For those who make at least \$100,000, the SEC has stipulated that they can invest no more than 10% of either their annual income or net worth (whichever amount is smaller).
2. For startups, the new rules allow them to raise up to \$1 million per year through crowdfunding. Realize that while the SEC is requiring them to disclose basic financial details, it's vital to stay proactive and not count on the company you're investing in to provide you with regular reports of performance or profitability metrics. With democratic investing, expect to keep the budding firm accountable—the burden of proof is not on the company.
3. In the age of startups—where some become “Unicorns,” startups valued at over \$1 billion—be prepared to take it slow. Richard Swart, a former crowdfunding and alternative finance researcher at the University of California, Berkeley, advises that, “Even if you're truly invested in investing in a startup, the odds are against you.” Swart says, “It's the law of startups—mathematically the most likely exit for a startup is failure”. Venture capital works by investing in hundreds of companies, accepting

that most will undoubtedly fail within a year or two. VCs get their return on investment (ROI) by using their industry expertise, experience, research, and copious funds to invest in the next Uber. Without those aspects, crowdfunding will more than likely prove a risky investment for an inexperienced investor.

Once you understand the risks, you can make educated choices about upcoming startups, “Unicorn” companies, and the ambivalent uncertainty associated with any kind of investment. The right VC or crowdfunding investment is like hitting the lottery: the key is to never get comfortable.



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