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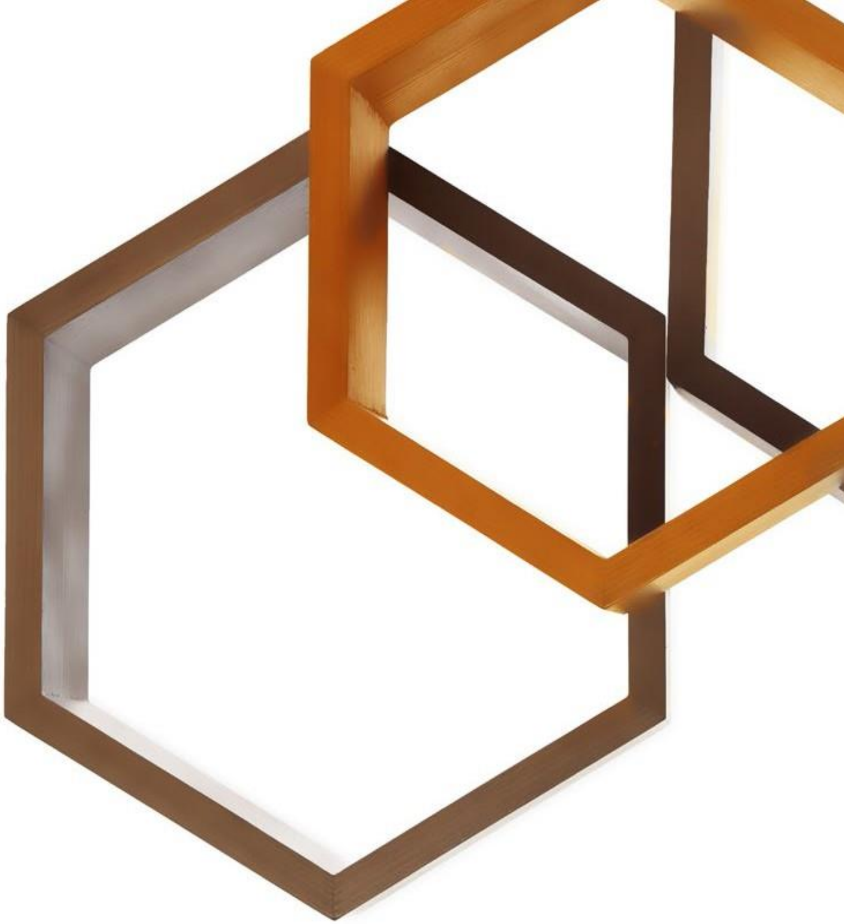
FINANCIAL ALTERNATIVE FOR INVESTORS AND ENTREPRENEURS

CROWD FUNDING



FINTECH SERIE BY innovation edge

01

The eight keys to the boom in crowdfunding

We're not revealing anything new if we say that crowdfunding has become the new financial option whereby investors with funds and entrepreneurs or startups in search of funds reach an agreement that serves the interests of both parties. This is the application of the collaborative model in the financial sphere. Here are the eight keys to its rise.

1

Funding needs

Digital In the current crisis scenario, there is an ever more pressing need for funding, which has driven the search for alternative models for raising funds, particularly in the initial phases of a project when the risk is greatest.

2

Technological developments

Digital innovations are making it possible to link up investors' and entrepreneurs' knowledge in a faster and more reliable way. Improvements in infrastructure –and particularly in the speed of data processing– mean more efficient calculations of the scoring of this type of operation.

3

Search for greater profitability

Investors have also begun to look for greater profitability in these alternative financial markets, in response to the drop in interest rates. This is the case of microinvestors, who make small financial contributions of up to 6000 euros.

4

Lower transaction costs

Transaction costs are considerably reduced as there is less friction in the relationship between funding supply and demand. The peer-to-peer relationship is the main difference compared to the relationship between the person and the traditional bank.

5

The value of the community

Although most of the investments are P2P, we are also seeing a “community” arising around the project in the investment. This interest in the evolution and development of the project can also be channeled into a way of testing the product/service in this small community of “partners”. These small investors become ambassadors for the project, and also have an stake in raising its profile, guaranteeing that the social community around the project will gradually grow.

6 Increased revenues

According to a study published by Forbes in 2014, projects *by crowdfunding* ( ) increased their sales by 341% after completing the investment round. These figures endorse this new funding channel, particularly in the case of startups.

7 Gaps in the regulation

At the moment there are gray areas in the regulations governing transactions on crowdfunding platforms, which was what originally led to the development of these operations. The varying regulations in the different countries may somewhat temper the boom in this financial trend, as it depends largely on the global nature of the collaborative culture ( ).

8 Access to others investments

The crowdfunding platform and the initial funding initiatives allow the new projects to become known ( ) and bring access to professional and institutional investors who study these platforms as to test the market and the viability of the project. According to this study by Forbes, 43% of the entrepreneurs that make it through the first round of financing end up making contact with professional investors.

02 Crowdfunding and traditional banking

Collaborative models in the social and economic realms are coming of age through the Internet and the use of new technologies. In the financial market, crowdfunding platforms are at the forefront of this trend in collaboration.

"We have seen an explosion of interest in crowdfunding among political figures, academics, governments, and *think tanks* all over the world". This is how Richard Swart, director of Research on Crowdfinance at the University of California, Berkeley, opened a symposium on crowdfunding in late 2014. It is neither a tendency nor a new fashion in the funding sector, it is a very significant new funding system. "It is transforming entrepreneurship, innovation, and venture capital first rounds." This spirit of transformation is linking crowdfunding and the traditional financial system, converting them in two complementary, rather than mutually exclusive, models. In recent years the economic turmoil has severely impacted markets, leading to a surge of collaborative alternatives that also reached the finance world through crowdfunding. We therefore analyze herein those aspects in which, more than mere differences between both systems, one can find formulas where the two can complement each other in their mutual growth:

Securing deposits

Probably one of the main differences between the two models is that the crowdfunding platforms are not an authorized bank operating under the protection of the corresponding deposit guarantee funds, or licensed as a credit entity. In fact, these platforms do not receive deposits, so that the financial liability investors acquire is not a deposit. For this reason, the two systems might become complementary.

Innovation

From the point of view of the investor, the traditional system offers greater experience: it possesses more information on the projects of its customers and it is governed by a market regulation that in the case of crowdfunding is still developing. However, in light of this experience value, crowdfunding is placing new ideas on the table that are spurring innovation in the financial sector. The development of online banking, mobile banking, and customer experience strategies is taking place while new models are increasingly being used–such as crowdfunding–whose foundations lie in new technologies and innovation.

Scoring

It is therefore important to note that, along with the rise of crowdfunding a number of new scoring tools are being used that go beyond traditional methods based on the customer's credit performance history.

For instance, some platforms extract additional information from the entrepreneur or startup seeking funding to complete the standard credit profile, in particular with respect to his or her reputation online.

This type of information may be obtained using data analysis, specifically with semantics analysis based on responses to particular questions, the way one interacts with the platform, response times, etc. The objective is to gain knowledge of the customer from his or her behaviour on the platform, just like information is gleaned from the interviews in person that are conducted in the branch offices of credit entities.
The tools to get to know the customer/user are also being implemented in traditional banking to improve the customer experience. To increase the knowledge of one's customer is one of the challenges of the new banking era.

New products

In fact, with the rise of crowdfunding new products are being generated for the retail investor that the P2P platforms are trying to recruit. These are financial instruments of a similar nature to fixed or variable return instruments already on the market but for much smaller investments in projects that are closer to the investor. Nowadays, through its digital channels, traditional banking is offering these products.

The customer

One of the advantages of the crowdfunding platforms are their flexibility in offering a service to the customer. This is, in part, thanks to new technologies. In fact, the transformation of traditional banking toward a more digital banking system is following the same path: approaching potential customers through online and mobile banking.

A posible collaboration between banks and crowdfunding platforms

Collaboration does not have to be a far-fetched idea. Banks can send to the P2P platforms those customers whose risk profile is not within their limits, while the platforms can promote other banking services that don't compete with its service (an account or treasury services, for instance).

Other collaboration opportunities could exist in the area of sharing risks between the bank and the platform, with the first covering a portion of the funding through collective investments, for instance for projects in corporate social responsibility, or of a marked social nature.

In sum, crowdfunding investment is boosting innovation in the sector, as well as the creation of new tools that are more digital, more flexible, and always focused on the customer.

INFOGRAPHIC

03

Crowdfunding platforms

A number of investors invest or make monetary contributions to a Project through a technological platform that brings them together. This model of collaborative funding is gaining more followers every day.

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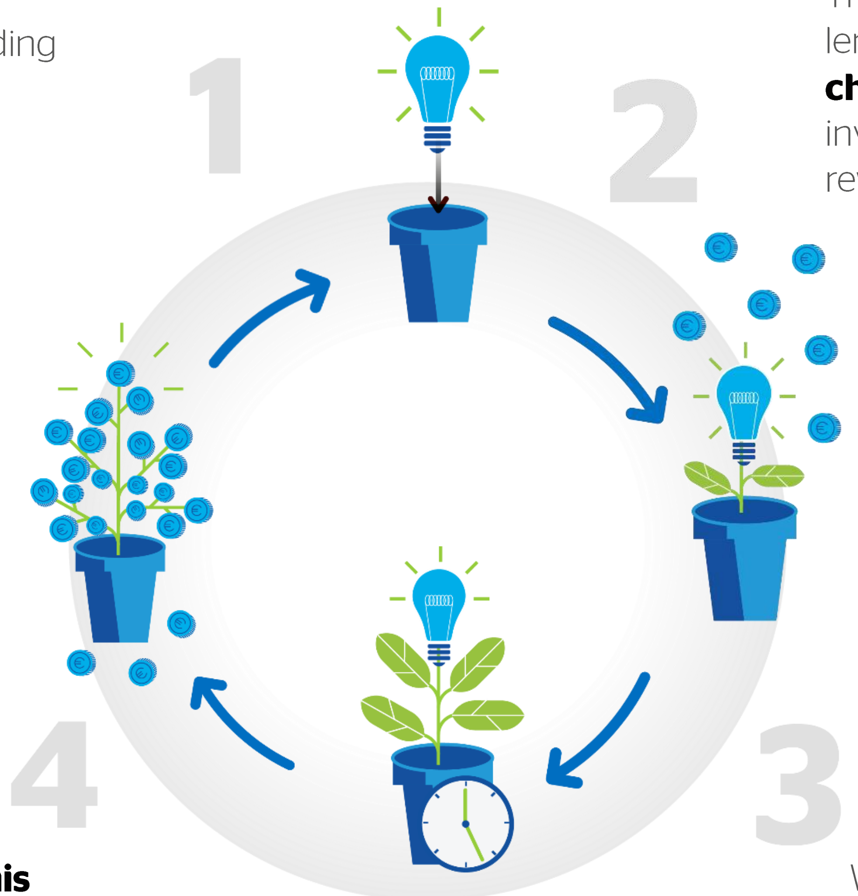
The **crowdfunding** process

The entrepreneur **adds the idea** in a crowdfunding platform and sets a fundraising target.

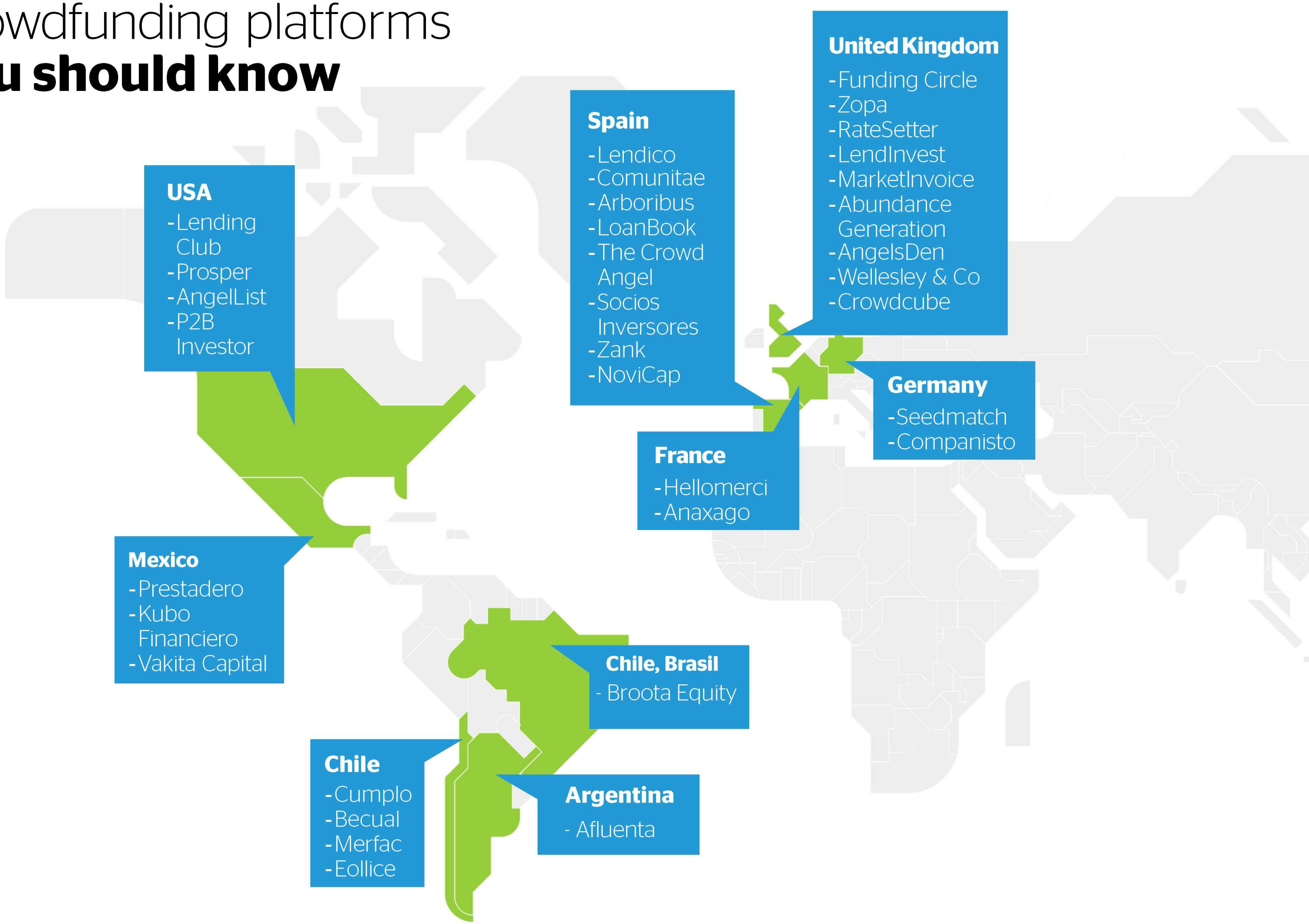
The investor registers as a lender on a platform and **chooses the project** to invest in exchange for a reward.



The investor **receives his compensation,** which he can invest again (or not) in other ideas.

When the entrepreneur gets all the expected funds, the project **goes ahead**.

Crowdfunding platforms **you should know**



A snapshot on crowdfunding

Showcase

The entrepreneur describes his Project to attract investors, who will invest money to achieve profitability.

Intermediation

From managing contracts to payments and collections, platforms charge small fees to both investors and entrepreneurs.

Efficiency

Transaction costs are reduced, allowing a quick match between the need of capital and funding capacity.

Classification

Projects are catalogued according to their risk, assessing the creditworthiness of the entrepreneur or the viability of the initiative.

Risk manager

The risk of default is borne by the investors, in order to diversify financial risks.

Limited liability

Solvency and liquidity risks are covered by the entrepreneur or investor.

Tradicional models

Tradicional financing, with a single investment entity, within a framework with many investors: loans, shares, investors.

04 CASE STUDY

Hemav, the crowdfunding success of drones

This drones startup has managed to raise €450,000 in just six days during the first investment round with the Crowdcube, crowdfunding platform. Under this funding, the founders of this small company have given 20% of it to their 73 new investors.

Drones are in fashion. They are one of the leading new technologies that everyone wants to get behind. And this is what is happening with Hemav, a startup dedicated to offering solutions using unmanned aerial vehicles (drones), which was looking for a formula to allow friends and acquaintances to take part in its project financially. That is how the company got involved in crowdfunding, through a platform that is well established in the UK but that has only recently been set up in Spain: Crowdcube. This platform offers them a professional solution to taking up this funding option which the company believed would help it keep growing. The first step was to get through the strict Crowdcube filter: only 30% of projects received by the platform are published and enter the investment round. They must have a structure project, with a business plan and a financing plan, and must present their return on investment proposal.

Once they had made it past this filter, they had to prepare in Hemav, with advice from experts in the platform, a professional presentation for their product, and improve their business plan and their financial plan for the next three years. With the security of its investors in mind, Crowdcube verifies that every item of financial data published is correct and true. And after this step, the moment comes to get ready to convince the investor.

A good video, a good claim. Everything is keyed to drawing the attention of small and big investors.

“There are two kinds of people in the world: those who believe in the future and those who create it: Hemav”. With this motto and with the help of the following video, they prepared an event at which they convinced a large part of the investors.

The attractiveness of the company's technology (design and development of drones for civil applications) is added to by its experience in the sector (it is the first company to install itself in the incubator of the European Space Agency in Spain), plus, at the core of the startup, its multi-disciplinary teams.

But the biggest attraction for investors were the conditions of the return on investment: its financial plan proposes distributing 5% of after-tax profits in the form of dividends in 2016 and 15% in the following years. In addition, it proposed a minimum return of 30%, making it much more attractive. And still to be added to all this are the tax deductions on the investment, which are 20% on the state portion and up to an additional 30% on the regional portion, depending on the regional government concerned.

With these financial incentives (f) and the good marketing job done by Hemav and Crowdcube, this young company had set itself a target of between €150,000 and €200,000 in this investment round, but, given the success they had in the first few days, they decided to extend the round to €450,000, assigning up to 20% of the company.

A process that usually takes 40 to 60 days, to reach the funding target, was completed in just six days after extending the goal to €450,000. 73 people invested, all of them small investors with an average of €6,000, except for one major investor with €112,500, which became the company's mentor on obtaining financial and policy rights in the company.

In Crowdcube, investors are divided in two groups: small investors, who acquire financial rights in the company that they fund; and major investors, who, in addition to financial rights, acquire policy rights.

That is to say, the mentors or advisers, who often need startups to keep developing their business, become what is known as "intelligent money", explained the platform's CEO, Pepe Borrell.

With 73 new participants entering the company, its legal structure was changed considerably. The crowdfunding platform once again fulfilled advisory and management roles here, in the steps.

involving a public notary and the commercial register, where all certifications of new holdings in a company must be issued.

Once everything is completed and the legal documentation has been sent to the new investors, who have 14 days to review it and to raise any issues, transfer orders are issued for the investments, which are transferred directly to the startup, without passing, at any time, through the technology platform that has acted as broker.

05

The six financial risks of crowdfunding

The investments in P2P platforms include certain risks linked to liquidity, credit, the market itself... As an additional risk ( ) , "intermediary" platforms may not always correctly assist.

In fact, the less stringent regulation of this alternative market and the degree of informality with which many of the platforms operate increase the liquidity and solvency risks faced by the investors. "The best defense against the latter risks is to ensure that the platform on which we invest provides sufficient transparency in the selection of projects or loansas well as commissions, risk management, etc." , says Pablo Díaz, Business Development Supervisor at the Zencap platform. In finance, risk is associated to uncertainty. In other words when one speaks of risk he or she is speaking of the possibility that something will happen that will result in losses for participants in the financial operation, including investors. And these probabilities of uncertainty also occur in P2P financial operations.

“The best defense against the latter risks is to ensure that the platform on which we invest provides sufficient transparency in the selection of projects or loans as well as commissions, risk management...”

Liquidity risk

That one party in the financial operation might not obtain the necessary liquidity to assume its obligations is one of the main financial risks [in traditional operations as well as in P2P](#). in

Market risk

The risk that exists because the fair value or future cash flows of a financial instrument may fluctuate as a result of price variations in the market.

Lack of coordination in regulation

Although new rules are beginning to be created to regulate P2P financial operations, a degree of uncertainty persists with respect to the application of certain local rules in the global context in which crowdfunding takes place, given that access to relevant Internet operations is international. This poor coordination between the regulators in different countries may cause a fragmented market that doesn't help in the rise of crowdfunding.

Specific regulations are beginning to emerge in the countries where P2P funding operations are most common, that regulate these operations in pursuit of two objectives: on one hand, to protect unqualified investors and, on the other, to make it easier to access funding for startups or small businesses, which are the ones that find it difficult to fund themselves in the conventional financial market.

Credit risk

Although this may be linked to the liquidity risk, this type of risk is based on the possibility that one of the parties in the financial operation may fail to assume all of the obligations agreed between the entrepreneur and the investor and, therefore, that a financial loss may be incurred for the other party of the agreement.

Solvency risk

In P2P operations this type of risk can be increased due to greater asymmetry of information between entrepreneurs and investors, given that there is no regulation specifying what information is to be shared between them.

Operational risk

This refers to the possibility of experiencing losses resulting from failures in processes, information, and internal systems of the platform as well as losses resulting from human error or the consequences of events external to the operation that affect its process, such as reputation risks for instance.

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