



# Banking & Technology Snapshot

## Digital economy and structural change

# Crowdfunding

## An alternative source of funding with potential

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**Crowdfunding as an alternative type of funding.** Besides traditional sources of funding, such as loans, venture capital (VC) or grants, crowdfunding platforms are also increasingly offering an alternative or a complementary type of funding in smaller volumes for start-ups, freelancers and creative persons (e.g. artists, authors, musicians, journalists, designers etc.) or private borrowers.

**Investors in a crowdfunding process are not traditional investors** as they do not acquire any shares in the planned project or the business model created, but they receive alternative compensation.

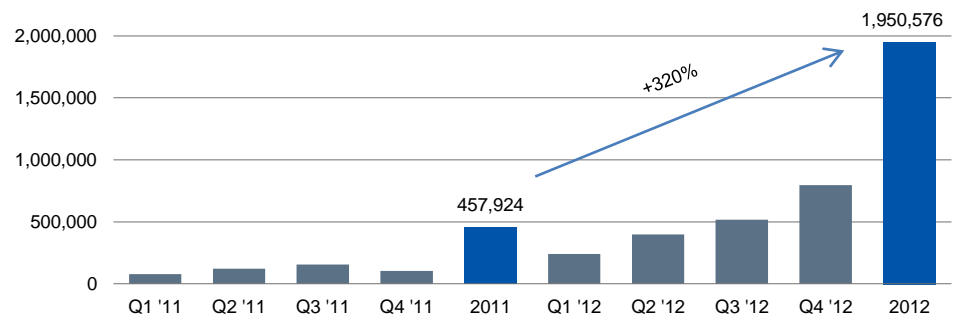
**The volume of funds raised on crowdfunding platforms in Germany is negligible** if e.g. for illustrative purposes, compared with the funding volumes made by traditional banks for e.g. companies or self-employed. Crowdfunding and traditional funding serve different purposes and follow different commercial logic, though, of course.

**Many (solo) self-employed, freelancers and creative persons have difficulties financing their projects in the early phases.** But the reluctance to provide start-ups with risk capital is not an exclusively German problem. A glance across to Germany's neighbours reveals a picture that is similarly bleak.

**From the standpoint of (potential) founders and the self-employed the inadequate supply of funding is a key (economic) problem.** So, from an economic standpoint and above all with regard to growth the efforts of the crowdfunding and crowdinvesting platforms are to be welcomed. Both funding ideas are still in their infancy, but will undoubtedly develop further over the next few years.

Crowdfunding volume in Germany rising

Funds raised, 494 successful projects, EUR



Source: Für-Gründer.de-Monitor 2012



## Crowdfunding: An alternative source of funding with potential

### Crowdfunding – An alternative source of funding



In the past decade the number of employees and the number of self-employed persons have risen sharply (Chart 1). According to a recent DIW report the positive trend in self-employment is solely due to those operating as one-person companies (solo self-employment).<sup>1</sup> Becoming one's own boss of course brings with it considerable risks.<sup>2</sup> In the early stage, above all, the self-employed require start-up capital to make investments.

Besides traditional sources of funding, such as loans, venture capital (VC) or grants, crowdfunding platforms are also increasingly offering an alternative or a complementary type of funding in smaller volumes for start-ups, freelancers and creative persons (e.g. artists, authors, musicians, journalists, designers etc.) or private borrowers. For start-ups the platforms are an ideal way, for example, to prepare for their market entry via microinvestments, enabling the young author to finance his first book and the filmmaker to complete her first film – all funded voluntarily by “the crowd”. The project categories for which monies are collected range from films, music and gaming to design, journalism and fashion right through to web-based technologies or new products for the retail sector.

Basically everyone can appeal for funding for their project using a (public) internet campaign. The start-up financing via crowdfunding is based on the principle of trust, because the financing occurs in the early phase and the actual project does not get implemented until a later stage.

#### *Storytelling paves the way to success*

The rules of crowdfunding are relatively simple and thus satisfy exactly the currently very widespread desire for “convenience” among the tech savvy. First of all, initiators present their project or ideas, for example in the form of a video, supplemented with written comments. The project needs to inspire as broad a group of people as possible by triggering collective “fundraising” via network effects. Then there is the definition of the fundraising target, i.e. how much money is meant to be raised for the project. In addition, there is the setting of a cut-off date, i.e. the date by when the fundraising should have been completed. Linking with social networks, online forums, blogs and bulletin boards enables the viral – and above all inexpensive – marketing of the project. If the fundraising target is not met within the allotted time, it is usually the

### Legal basis 2

According to Section 2(3) of the Capital Investment Act (Vermögensanlagegesetz – VermAnlG), offers worth up to certain de minimis limits are exempt from the requirement to issue a prospectus. The law assumes that the investor does not require special protection if the issuance volume does not exceed EUR 100,000 in twelve months. With financing via crowdfunding platforms the volume limit of EUR 100,000 is usually not exceeded, i.e. a sales prospectus does not have to be produced. This provision is also to be found in the Securities Prospectus Act (WpPG) in keeping with the EU Prospectus Directive.<sup>3</sup>

Other exemptions in accordance with the VermAnlG, such as the limitation to a maximum of 20 shares or a minimum price of EUR 200,000 per share, do not apply to crowdfunding either, because the crowd consists of numerous investors whose stakes tend to be quite small amounts.

The requirement to issue a prospectus does apply, however, to the still relatively unknown type of funding called **crowdinvesting**. The funding volumes in crowdinvesting are mostly above the de minimis limit of EUR 100,000. This means that the prospectus requirement applies to the initiator (not to the platform, because these are legally separate persons). In addition, the prospectus has to be approved by the Federal Financial Supervisory Authority (BaFin). In contrast to crowdfunding the money invested in crowdinvesting projects is meant to also provide the investor with a monetary share of potential profits made. The investors receive for their capital for example shares in the company or a silent partnership without voting rights. Crowdinvesting thus entails far more risks for investors than crowdfunding, because they can also lose the capital they have invested.

<sup>1</sup> Brenke, K. (2013). Allein tätige Selbständige: starkes Beschäftigungswachstum, oft nur geringe Einkommen. DIW Wochenbericht 7/2013. Berlin.

<sup>2</sup> Besides the necessary income that has to be earned to meet the everyday costs of living, financial provision also has to be made for retirement.

<sup>3</sup> Begner, J. (2012). Crowdfunding im Licht des Aufsichtsrechts. Mitteilungen der Bundesanstalt für Finanzdienstleistungsaufsicht. BaFinJournal 09/12. Bonn.



## Crowdfunding: An alternative source of funding with potential

case that all those involved withdraw their financial support (all-or-nothing principle).

### *There are a myriad of incentives for “getting involved”*

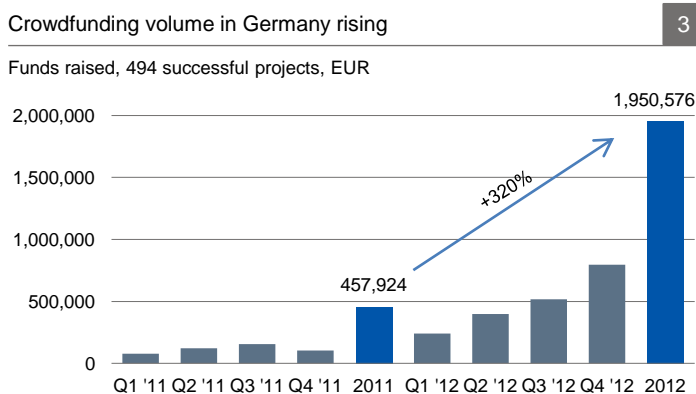
Investors in a crowdfunding process are not traditional investors as they do not acquire any shares in the planned project or the business model created, but they receive alternative compensation. What they receive in return is often intangible or provided in kind (books, music CDs, tickets for the cinema, a mention in the closing credits of a film, a role in a video, private concerts etc.), with the value geared towards the size of the investment.

The remuneration for the crowd (the consumers) in the form of tangible goods also provides the opportunity to integrate creative sponsors interactively in the value creation processes. Idea competitions can be offered using additional feedback or voting tools. The crowd can support the projects with ideas for design, blueprints or branding. Crowdfunding thereby acquires a type of open innovation/ crowdsourcing component.<sup>4</sup>

Moreover, besides the purely economic criteria that decide whether a project is implemented or not crowdfunding projects provide a grass-root funding structure. Some projects can be implemented despite being rejected by traditional financial institutions, because the crowd considers the project to be worth supporting and provides funding. Crowdfunding can thus be used as a community funding instrument to promote regional projects that would fail due to lack of support from traditional funding sources.<sup>5</sup>

### *Crowdfunding in practice*

The funding volumes raised via crowdfunding are at the lower end of the scale compared with traditional sources of funding. For instance in Germany last year five platforms raised nearly EUR 2 million via the crowd. The funding volume quadrupled compared with 2011 (Chart 3).<sup>6</sup> The average funding volume per completed project came to EUR 3,950 last year. In 2011 the average volume per project came to EUR 2,700. Projects were supported by an average of 59 investors in 2012. In all last year more than 40% of the total 1,150 projects were successfully financed via the individual platforms.<sup>7</sup>



<sup>4</sup> Dapp, T. (2011). The digital society. New ways to more transparency, participation and innovation. Current Issues. Aug 1, 2011. Deutsche Bank Research. Frankfurt am Main.

<sup>5</sup> Theil, A. (2012). Cofunding zwischen privater und öffentlicher Förderung. In: Das Co:funding Handbuch. 2nd edition, May 2012. Published by tyclipso.me in association with Startnext.de.

<sup>6</sup> Für-Gründer.de-Monitor (2012). Crowd funding und Crowd investing in Deutschland. As of December 31, 2012. <http://www.fuer-gruender.de>.

<sup>7</sup> Für-Gründer.de-Monitor (2012).



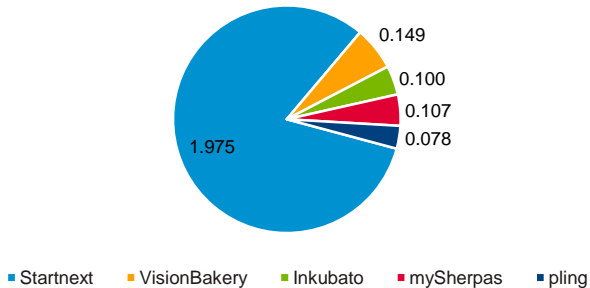
## Crowdfunding: An alternative source of funding with potential

### A few platforms advertise in a (still) young market

Funds raised since 2011

4

By platform, EUR m



Source: Für-Gründer.de-Monitor 2012

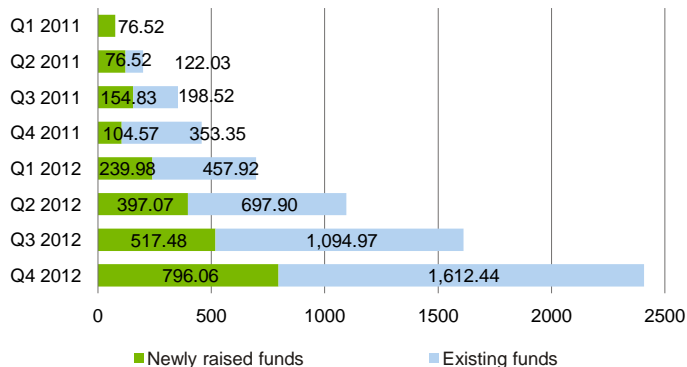
Among the crowdfunding platforms active in Germany, one single platform has gained predominance in raising capital. The Startnext platform generated around 82% of all capital raised. Last year the funds raised came to EUR 1.975 m, which represents an increase of 712% compared with 2011. The second biggest platform is VisionBakery with a funding volume of only EUR 149,109 in 2012 (Chart 4). In addition, there are several small crowdfunding platforms that attract little attention because of their minimal funding volumes.

The German crowdfunding market is gradually becoming established, but experts assume that consolidation will set in for two reasons: First, the platforms are competing in a relatively modest national market, so the commission fees are under threat of shrinking further, whereas, second, at the same time US-competitors (Kickstarter) are benefiting from an active and expanding global community.

Crowdfunding overall

5

By newly raised and existing funds, EUR '000



Source: Für-Gründer.de-Monitor 2012

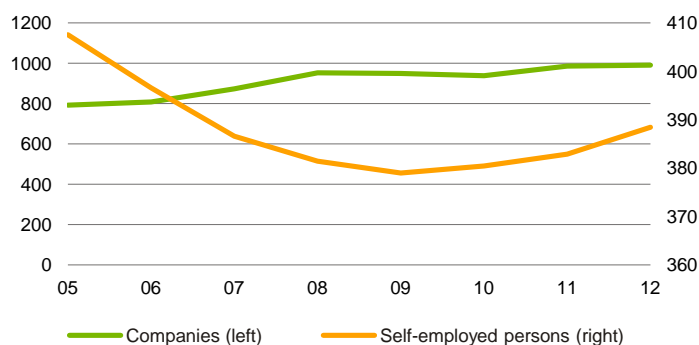
### Crowdfunding demand on the rise

In 2011 and 2012 the funds raised on crowdfunding platforms increased from EUR 76,515 at the outset to more than EUR 2.4 m. In Q1 2011 there were just 23 newly financed projects, whereas in Q4 2012 the number of projects had already risen to 664. Some 528 of these projects were already funded and 136 projects were new additions (Chart 5). Evidently the supply of alternative sources of funding for smaller funding volumes is being met by rising demand. Especially for the early phases (start-up phase) of financing projects and ideas crowdfunding platforms provide an ideal point of contact for the self-employed, freelancers and creative persons.

Lending volumes in Germany

6

EUR bn



Source: Deutsche Bundesbank

### Traditional sources of financing

The volume of funds raised on crowdfunding platforms in Germany is negligible compared with the loan volumes provided by traditional banks. According to Bundesbank statistics loans outstanding to German corporates and self-employed amounted to nearly EUR 1.4 tr. The total loan volume has risen by more than 10% since 2005.

### Crowdfunding has niche potential

However, the statistics also show that the loan volumes especially for the self-employed between 2005 and now has fallen by nearly 5%. By contrast, the loans for corporates rose by around 25% during the same period (Chart 6).

Many (solo) self-employed, freelancers and creative persons have difficulties financing their projects. Future monetary inflows – and thus the basis for credit repayments – are often difficult to gauge. In addition, many of the



## Crowdfunding: An alternative source of funding with potential

self-employed usually do not have (sufficient) collateral or regular income streams.

This makes it a challenge to obtain financing from traditional financial institutions. A second problem for the self-employed and micro-firms is small credit volumes: often they require amounts of less than EUR 30,000. Lending volumes of this size are often not attractive to commercial banks, for example, owing to the administrative costs required.<sup>8</sup> Financing therefore remains difficult for large numbers of the (solo) self-employed.

### Venture capital

Besides conventional bank loans there is also the option of equity financing via venture capital (VC) funds. However, the activities of such funds especially in the important early financing phases of projects and ideas in Germany are (also) quite modest and have declined steadily since 2008.

The euro crisis has weighed heavily on German equity capital<sup>9</sup> in recent years. Venture capital investments in 2011 had contracted by 38% compared with 2008 to nearly EUR 687 m (Chart 7). The sharp contraction in the German equity financing market reflected the intensifying recession at the periphery of the eurozone, the tangible economic slowdown in Germany and the stock market development which was disappointing for many investors.

### Only selected sectors receive funding

A large proportion of equity investments flowed into information and telecommunications technology projects and into the life-sciences sector. Start-ups with projects from the transport and financial services sectors had relatively little prospect of obtaining venture capital/start capital (Chart 8).

### Start-up financing still difficult to obtain outside Germany, too

The reluctance to provide start-ups with venture capital is not an exclusively German problem. A glance across to Germany's neighbours reveals a picture that is similarly bleak. Although Sweden topped the rankings in Europe in 2010 it only invested 0.07% of GDP in the ideas and projects of start-ups, followed by Norway and Finland, each with 0.06% of GDP. Germany has a midtable ranking of 0.03% of GDP, on a par with the EU average (Chart 9). On a European country comparison it was also only young entrepreneurs in certain sectors who had improved access

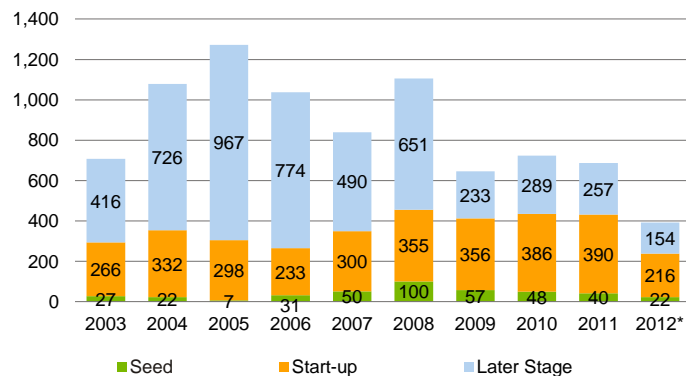
<sup>8</sup> Dapp, T. and Ehmer, P. (2011). Cultural and creative industries. Deutsche Bank Research. Frankfurt am Main.

<sup>9</sup> As providers of equity financing a distinction can be made between venture capital and private equity funds, private investors (e.g. business angels), development institutions and other providers of equity, such as other companies.

Venture capital in Germany

7

Seed, Start-up and Later Stage VC, EUR m



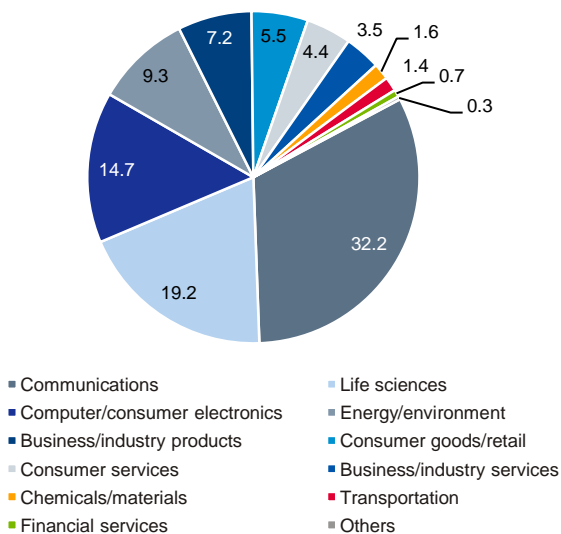
Source: BVK

\* Jan - Sep

Venture capital in Germany

8

By sector, Seed, Start up and Later Stage VC, Jan - Sep 2012, %



Source: BVK

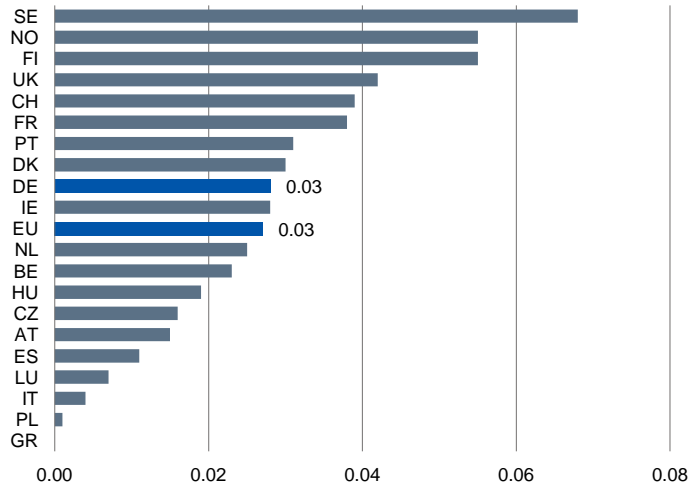


## Crowdfunding: An alternative source of funding with potential

### Venture Capital in Europe

9

% of GDP, 2010



Source: BVK

to equity and venture capital. The main recipients of funding were projects and ideas from the life-sciences, computer and consumer electronics sectors.

### Business angels

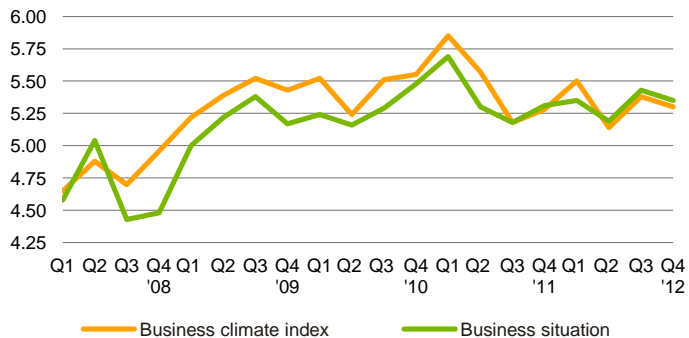
Venture capital firms have considerably reduced their involvement in early-stage financing and have trained their focus more heavily on equity stakes at companies undergoing growth phases.<sup>10</sup> By contrast, private investors, especially business angels, are far more involved in the early stages of a company's development. The main criteria for business angel funding are that one private individual deploys own funds to acquire an equity stake in a company and that furthermore strategic support is provided to the company concerned in the form of networks and mentoring programmes.

However, the number of business angels in Germany also shows that there is (still) considerable growth potential. According to the Business Angels Netzwerk Deutschland (BAND) there are an estimated 5,000 or so active business angels in Germany, who invest a total of between EUR 200 m and EUR 300 m each year.<sup>11</sup> Despite their currently modest stakes in start-ups business angels in Germany described their business situation as relatively good at the end of 2012 (Chart 10).<sup>12</sup>

### Business Angel Climate Index in Germany

10

Index [7=very good; 1=very bad]



Source: Business Angels Panel

Against this background there certainly are opportunities for crowdfunding platforms to become more appealing especially for freelancers and creative persons searching for relatively small loans. Start-up or combination financing raised via crowdfunding could thus become more firmly established as a niche offering in future and assume a greater size if the legal provisions, such as the requirement for the initiator to issue a prospectus for volumes only above the de minimis limit of EUR 100,000, continue to apply (Box 11). Crowdfunding also has growth potential. However, the legal requirements for the initiators and the risks for investors are much greater; also the expectation of a return on investment is a key factor.

<sup>10</sup> Engeln, J. et al. (2012). Wachstumsbedingungen bzw. Wachstums-hemmnisse für junge Unternehmen. Studie zum deutschen Innovations-system Nr. 14-2012. Zentrum für europäische Wirtschaftsforschung (ZEW), KfW Bankengruppe.

<sup>11</sup> In the US, according to domestic research findings, around USD 25 bn is invested by 200,000 business angels each year.

<sup>12</sup> www.ba-panel.de.



## Crowdfunding: An alternative source of funding with potential

Signal from the US to boost employment: Crowdfunding Act **11**

Last year in the US the “Crowdfunding Act” (Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act) was passed as part of the “Job Act” and put into force by the US Senate in March. The main objective is to create new jobs. The law is designed to encourage more investments by households and make it easier for start-ups and fledgling firms to gain access to start-up financing via crowdfunding platforms. Deregulatory measures were taken for this and clear guidelines defined by companies via the crowd.

Crowdfunding platforms that are not solely concerned with funding the self-employed and private individuals, but also with companies have to register in advance with the [US Securities and Exchange Commission](#), (SEC). Companies must not generate more than USD 1 m via the platform. The investment amount for private investors with an annual income of up to USD 40,000 is 2% of annual income and rises to a maximum of 10% for incomes from USD 100,000. The maximum number of private shareholders in a company was raised from 500 to 2,000 investors.

Legal text: <http://www.govtrack.us/congress/bills/112/s2190/text>

At the European level representatives and supporters of the crowdfunding movement submitted a paper to the EU in which they called for, among other things, appropriate framework conditions, research efforts in this still youthful area as well as deregulatory measures.

Info: <http://www.crowdfundingframework.eu>

## Conclusion

From the standpoint of (potential) founders and the self-employed the inadequate supply of funding is a key (economic) problem and can particularly for entrepreneurs with limited financial resources lead to projects being cancelled at an early stage. Also, the lack of expansion and growth financing leads under certain circumstances to the termination of existing projects and companies.

From an economic standpoint and above all with regard to growth the efforts of the crowdfunding and crowdinvesting platforms are to be welcomed. Both funding ideas are, however, still in their infancy, but will undoubtedly develop further over the next few years.

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