Role of Crowdfunding in Financing Start-Ups and SME in India

CA Mohit Bahal
Research Scholar
Department of Commerce and Business Administration,
University of Allahabad,
Allahabad, Uttar Pradesh, India

Abstract

One of the most important factors of production is the capital. Capital may be in the form of funds invested by the owner or funds borrowed from any institution or public. Such borrowings may not be so easy to obtain, especially for small businesses and Start-ups.
Crowdfunding has emerged as an alternative source of finance in recent years and it appears that it has great future prospects. Crowdfunding, as the name suggests, is funding from the crowd or public. Crowdfunding can act as a catalyst in the case of Start-ups and new businesses.
The objective of this study is to evaluate the concept of Crowdfunding, risks and benefits related to it and its role in financing Start-ups and SME in India. The study is descriptive in nature and the data has been collected from various websites, blogs, books, concept papers, newspapers, research journals etc.
The first online Crowdfuding project was launched in 1997 and since then it has gained popularity day-by-day. In 2013, there were more than 500 Crowdfunding platforms online, raising over $5.1 billion worldwide. This amount grew to around $34 billion in year 2015.
In India also Crowdfunding is gaining popularity and many platforms have been launched in the recent years. SEBI has issued a concept paper on Crowdfunding in which it has proposed measures to use Crowdfunding as an alternate source of finance for startups and SME and to balance the same with protection of interest of investors.

Keywords

Crowdfunding, Funding, Platform, Start-up, SME

Introduction

Crowdfunding is a new method of raising capital through the combined efforts of family members, friends, customers, individual investors and public at large. This approach utilises the collective efforts of a large number of individuals, mainly through online Crowdfunding platforms.

Crowdfunding is essentially the opposite of the traditional approach to business finance. Traditionally, if anyone wants to raise capital to start a business or introduce a new product, he is required to approach some wealthy individuals or institutions. These sources include banks, financial institutions, venture capital firms, angel investors, stock markets etc. However, in Crowdfunding, the seeker of funds has to just highlight his project details mostly on an online platform and the investors can discover him and make the contributions.

Types of Crowdfunding

There are a variety of Crowdfunding methods. Which Crowdfunding method is selected by entrepreneur depends on the type of product or service he offers and his goals for growth.

1. **Donation-Based Crowdfunding**
   A Crowdfunding campaign in which there is no financial return to the investors or contributors is known as donation-based Crowdfunding. Common donation-based Crowdfunding objectives include fundraising for disaster relief, charities, non-profit organisations etc. Examples of donation-based Crowdfunding include Kickstarter, Indiegogo etc.
2. **Rewards-Based Crowdfunding**
   Rewards-based Crowdfunding campaign involves people contributing to a project in exchange for a "reward," which is typically in the form of a product or service offered by the company. Although this method offers investors a reward, still it is generally considered a subset of donation-based Crowdfunding because there is no financial or equity return involved in this method. This is the reason why most of the websites which support donation-based Crowdfunding also provide rewards, like Kickstarter, Indiegogo, Rockethub etc. Business-owners can provide some incentives to their investors without incurring too much expenses or providing ownership stake.
3. **Equity-Based Crowdfunding**
   Equity-based Crowdfunding offers contributors equity stake in the business in return for the funds invested by them. As equity owners,

contributors receive a financial return on their investment and ultimately receive a share of the profits in the form of a dividend. Some examples of equity-based Crowdfunding platforms are Crowdcube, Seedrs and Syndicate Room etc.

4. **Peer-to-Peer lending**

   Under Peer-to-Peer lending, an online platform is used to match lenders with borrowers, so that investors can provide unsecured loans to the borrowers and the interest rate on such loan is fixed by the platform. Some Peer-to-Peer lending platforms arrange loans between individuals, while some other platforms collect funds which are then provided as loans to small and medium-sized businesses. Some examples of peer-to-peer lending platforms are Lending Club, Prosper, Zopa and Funding Circle etc.

Review of Literature

- As per Keith Roberts (2011), the full sweep of business history actually begins, with the initial cities of Mesopotamia. Roberts has depicted the society of ancient traders and consumers, tracing the roots of modern business and underlining the relationship between early and modern business practice.
- Roberts's writing starts before business, which he defines as selling to voluntary buyers at a profit. He has emphasised that before business, the material conditions and concepts for earning the profits did not exist, although trade and manufacturing took place. The earliest business, arose with the long distance trade of early Mesopotamia, and expanded into retail, manufacturing and finance in these economies, flourishing in the Middle Eastern empires.
- However, it was the largely independent rise of business, money, and markets in classical Greece that produced business much as we know it now. Alexander the Great's conquests and the societies that his successors created in their kingdoms brought a version of this system to the old Middle Eastern empires, and beyond. At Rome this entrepreneurial market system gained distinct and important new features, which included business corporations, public contracting, and even shopping malls.
- As per Joachim Hemer (2011), Crowdfunding applications in the area of social projects were more visible such as health care, aid to developing countries, alleviation of poverty, diffusion of new technologies, support

of democratic movements etc. In these fields, the major characteristic is the provision of funds through small donations or sponsoring by individuals from various Internet communities or from organisations which identify themselves with the specific project seeking funding.

- As per Paul Belleflamme, Thomas Lambert and Armin Schwienbacher (2013), Crowdfunding initiatives that are structured as nonprofit organizations tend to be significantly more successful than other organizational forms in achieving their fundraising targets, even after controlling for various project characteristics.
- As per R M Koning and J Model (2014), the rise of Crowdfunding marketplaces, online platforms that enable fundraisers to easily aggregate even small contributions to reach a publicly announced fundraising goal, have begun to change the way fundraisers raise capital. These open fundraising marketplaces stand in stark contrast to traditional fundraising markets that restrict participation to investors with large amounts of monetary and social capital.
- As per Miguel Carvajal, Jose A. Garcia-Aviles & Jose L. Gonzalez (2012), for these new models, profit margins and income are unwelcome. Despite the fact that they could be regarded as non-business models, they are actually changing the paradigm of public interest journalism while providing fresh ideas for traditional media. Transparency, user involvement and control over where their money goes tend to be the success factors of these initiatives.
- As per www.ukcfa.org.uk Crowdfunding is a way of raising finance by asking a large number of people each for a small amount of money.
- As per www.fundable.com despite becoming a popular funding method relatively recently, the underlying principles of Crowdfunding have a long and rich history, dating back centuries. It’s the technology and social sharing mindset driving it that make it feel like something new and novel, and that have shaped it into what we think of today as modern Crowdfunding.
- The principles of microlending reach as far back to early-1700s Ireland, where Jonathan Swift, dubbed “the father of microcredit,” founded the Irish Loan Fund. The fund provided small loans to low-income, rural families with no collateral or credit history. By the 1800s, more than 300 programs across Ireland were participants, lending small sums to individuals for short periods of time.

Through the mid-90s and early-00s, people were starting to become more connected online with the emergence of popular messaging tools and social sharing platforms, which gave rise to some early examples of cause-based or charity-based Crowdfunding.

In 1997, British rock group Marillion raised $60,000 to fund their U.S. reunion tour through online donations from fans. Following the example of Marillion and a number of other Crowdfunded bands, ArtistShare sprang onto the scene in 2000 to become the first ever dedicated fan-funding platform for artists.

Into the mid-00s, the cause-based Crowdfunding of the late-90s and early-00s gave way to a surge of what came to be known as microlending, microfinance, or peer-to-peer (P2P) lending. Platforms that allowed individuals to lend money outside the bounds of a traditional bank began to emerge—one of the most successful of which was Kiva. Launched in 2005, Kiva gave lenders the opportunity to provide small loans to underprivileged individuals in developing countries with the goal of combating poverty. Since 2005, Kiva has raised an impressive $425 Million in crowdfunded loans with a 99% repayment rate.

In the years after, more microlending platforms with similar models emerged—platforms like Prosper and Lending Club—that capitalized on some of the same altruistic and cause-based drivers of early Crowdfunding, but gained additional staying power from an increasingly social web. Becoming more and more common were social features like pictures, videos, stories, and progress updates—all of which helped give backers a better and better sense of the impact of their contribution. In 2006, in-step with this growing social momentum, Michael Sullivan coined the term "Crowdfunding."

Objectives of study

- To identify the benefits of Crowdfunding.
- To identify the risks involved in Crowdfunding.
- To study the need of Crowdfunding in India.
- To review the scope of Crowdfunding for Start-ups and SMEs in India.

Research Methodology

The study is descriptive in nature. The secondary data has been collected from various websites, books, journals etc.

Benefits of Crowdfunding

From tapping into a wider investor pool to enjoying more flexible fundraising options, there are a number of benefits to Crowdfunding over traditional methods.

1. **Reach –** By using a Crowdfunding platform, Start-ups, SME and other entrepreneurs have access to millions of accredited investors who can see, interact with, and share his fundraising campaign.
2. **Presentation –** By creating a Crowdfunding campaign, entrepreneur has to go through an important process of looking at his business from the top level—its history, traction, offerings, addressable market, value proposition, and bringing it down into a polished, simplified and acceptable package.
3. **Public Relations & Marketing –** The entrepreneur can share and promote his campaign through social media, email, newsletters, and other online marketing tactics regularly from the beginning to the end of the project. This is not only a cheap option but also gives the project a wide coverage easily.
4. **Validation of Concept –** When the entrepreneur presents his project to the public, he has an excellent opportunity to validate and refine his offering. As potential investors and lenders begin to express interest and ask queries, he can quickly see and analyse the shortcomings and missing components of the project if any and persuade the investors to make the investment.
5. **Efficiency –** One of the greatest benefits of online Crowdfunding is its ability to centralize and streamline fundraising efforts of entrepreneur. By building a single, comprehensive profile in which he can incorporate all the prospects and invite all potential investors, he eliminates the need to pursue each of them individually. Therefore, instead of duplicating efforts by printing documents, making reports, and manually updating each investor when there is an update in the project, he can present everything online in a much more accessible format and manner, leaving him with much more time to concentrate on his business instead of fundraising.
6. **Cost effectiveness –** Start-ups, SMEs and others are able to raise funds at lower cost of capital without undergoing rigorous procedures for borrowing of funds as in other modes.

7. **Investment opportunity–** Crowdfunding provides new investment opportunity and a new product for portfolio diversification of investors.

Risks of Crowdfunding

1. **Risk of default –** There is no proper risk coverage to the investor in case of default by the borrower. The borrower does not directly borrows the funds from the lender. He does so through the platform. The platform may or may not have conducted the due diligence of the borrower, which may result in non-repayment of the borrowed amount. If the platform or the project is closed, no relief is available to the investors.
2. **Risk of Fraud** – There is a risk of commitment of fraud through misuse of websites. The fraud may be committed by the borrowers or the platform. The funds or information related to debit and/or credit cards can be misutilised.
3. **Information risks –** There is a risk that different information may be available to different investors. There is also a possibility that false information is provided to the investors so as to misguide them regarding the project. The expected returns from the project may be inflated so as to attract the investors.
4. **Systematic risk –** Due to peculiar nature of Crowdfunding, the investors may not properly diversify their portfolio, resulting in systematic risk.
5. **Liquidity risk –** There is no secondary market available in Crowdfunding which can result in locking up of funds of investors in a particular project.
6. **Substitution of Institutional Risk by Retail Risk –** At present, the risk in financing Start-ups and SMEs is borne by the Venture Capital Funds (VCF) and Private Equity (PE) Investors. In case of Crowdfunding, investments are made in smaller sums by large number of investors. Therefore, risk taking by VCF/PE is substituted with retail investors. The risk tolerance level of retail investors is generally very low. Retail investors may not be able to understand the risk in these type of investments and hence may be unable to bear the loss from investments. This situation becomes more dangerous, due to the fact that investments in SMEs and Start-up may involve high risk and low liquidity and are generally considered as aggressive and long term investments.

Need of Crowdfunding in India

In India, during the last few years, the IPO market has been quite inactive. Although, SEBI, has taken many steps for facilitating fund raising by SMEs, still there is need to encourage innovative way of fund raising so as to provide a boost to genuine SMEs/Start-ups and to explore other models of fund raising with appropriate framework alongwith retail investor protection. Crowdfunding is gaining popularity very quickly, and therefore it cannot be ignored. India being a very large country it is not easy to provide financial services to each and every person and to every project by the banking and financial institutions. Moreover, many projects are not able to fulfill the minimum requirments for listing so that they can raise funds from the stock market. Hence, new avenues of finance like Crowdfunding must be explored. It is very important to note that while it is necessary to ensure that Start-ups/SMEs can raise funds easily, it is equally important to ensure that no systemic risks are created within the system due to Crowdfunding. Hence, it is necessary to strike a proper balance between investor protection and financing needs.

Scope of Crowdfunding for Start-ups and SMEs in India

The provisions in the existing legal framework for raising funds by companies are regulated under Companies' Act 2013 and Securities Act i.e. SEBI Act, 1992, Securities Contracts (Regulation) Act, 1956, Depositories Act, 1996. Raising of pooled managed investment funds by various entities such as Alternative Investment Fund (AIF), Mutual Fund (MF) etc. is regulated under Securities Laws.

SEBI has taken various steps in the recent past to enable Start-ups and SME to raise funds through various routes such as SME Segment of Exchanges, Institutional Trading Platform (ITP), Category I- SME Fund under AIF Regulations.

SEBI has specified framework for a SME segment (platform) on Recognized Stock Exchanges, where Small and Medium Enterprises (SME) can list their securities. A company which has its post-issue face value capital not exceeding ten crore rupees shall list only in SME platform. A company, which has its post issue face value capital more than ten crore rupees and upto twenty five crore rupees, has an option to list in SME platform. In case the post-issue face value capital exceeds Rupees twenty five crore rupees, the issuer should compulsorily list only on main board of the Stock Exchanges. Various relaxations have been provided to SMEs listing on SME segment under SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009. SME Segments were launched on BSE and NSE on December 14, 2012 and September 18, 2012 respectively.

SEBI has provided various frameworks for raising of funds by startups, SMEs etc. In addition to the available frameworks, SEBI seeks to provide fresh avenues for startups and SMEs set up by young entrepreneurs and technology professionals to raise early stage funding through internet based platforms, potentially more efficiently and cost effectively than through public issue or private placement offering.

Crowdfunding is an innovative way to provide modest amount of funding to entrepreneurs and technology professionals needing early stage capital for startup businesses which may subsequently boost the growth rate of real economy.

A company which seeks to raise funds through online Crowdfunding platforms or websites offers equity or debt interests in its business to investors/contributors who make small contributions, through Crowdfunding platform or social media in the business of the fund-seeker. In most of the cases funds are collected through online platform on the basis of future projections of the business rather than a proper business model, which in turn increases the risk of failure and ultimate loss to the investors.

In case costs related to investor protection are high, Crowdfunding may not become a viable capital raising method. On the other hand, investors would be concerned about the risks involved in Crowdfunding and may not invest if there is absence of adequate safeguards in place. Therefore there is a need to strike a balance between retail investor protection and costs associated with Crowdfunding by providing adequate investor safeguard without creating too many entry barriers or heavy regulatory burdens on the issuers.

Pure Donation Based Crowdfunding, Reward Based Crowdfunding and Peer-to-Peer lending do not fall within the regulatory purview of SEBI, as they do not generally involve issuance of securities for financial return, and may require authorization from other regulators. For example, Peer-to-Peer lending may fall under the purview of RBI.

Some Success Stories of Start-ups and SMEs in India through Crowdfunding

1. Biosense Technologies – Bionsense, a Mumbai-based medical technology company, disproved the theory that only film makers succeed in Crowdfunding. By March 2013, the company founded by

a team of doctors, engineers, and product designers managed to raise $500,000 for its urine analysis application called uChek on Indiegogo.

2. Lucia – It only took Pawan Kumar, the director of Lucia, to write a blog post called "Making Enemies" to generate interest in it. Ten days post the write-up, several strangers came together to donate whatever little they could to make his dream come true. Eighteen months after the campaign on Catapooolt, Lucia was released in the theatres.
3. Mean Metal Motors – Sarthak Paul raised INR 4,05,793 for his business through Catapooolt.
4. Manjunath – Sandeep Varma raised INR 15,61,845 for his film Manjunath through Catapooolt.
5. Mr. Srinivasan Mohan raised a loan of INR 1,25,000 at Interest Rate of 18.00% p.a. for a duration of 18 months through Faircent.
6. Rang De has helped Ushamani Barik, a betel farmer from Orissa, to raise a loan of INR 18,000 in May 2016 at interest rate of 10% p.a.

Conclusion

Crowdfunding is rapidly being looked upon as an effective way of raising funds for Start-ups, SME and new businesses. An efficient Crowdfunding system can really play the role of catalyst in bringing the start-up ideas into reality. However, Crowdfunding involves risk and there are some important factors, which make it necessary to bring this method under the purview of law. USA and European countries have started making and implementing laws for Crowdfunding. India may soon bring in the requisite laws to support this in a big way. The Securities and Exchange Board of India (SEBI) is taking a fresh look at setting up a regulatory framework for Crowdfunding.

If Crowdfunding can be utilised systematically, honestly and efficiently, it will be a great boon for the businesses, especially, Start-ups and SME and can change the funding industry forever.

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