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COST OF CROWDFUNDING AS A SOURCE OF CAPITAL FOR THE SMALL COMPANY

Abstract:

The main object of this paper is to analyse advantages and disadvantages of capital deriving from crowdfunding compared to other sources of capital used in a company, especially in the SMEs. As the main factor used for comparison I take the cost of capital, because it is crucial in the decision process of choosing the source of financing. The explored data is mainly obtained from the Polish economy, but I use the European and World context, too. To contrast the capital from crowdfunding I have chosen debt funds (i.e. bank loans, commercial papers and leasing or hire-purchase) and equity funds (i.e. issue of shares, venture capital or private equity funds, business angels) as the more traditional sources used to finance innovative projects in the company. Although the conventional sources of capital could be cheaper or easier to raise, they have many limitation to use, especially for SMEs and earlystage enterprises. Additionally, they are not able to ensure and provide demand for the new ideas offered by firms. This fact definitely changes the cost of used capital, especially when it should finance an innovative project

Keywords:

crowdfunding, cost of capital, innovative project, SME, financial strategy

JEL Classification: G24, G30, G32

Introduction

Recent changes in technology and regulation have worked in tandem to break borders and to lower barriers to diffusion and adoption of innovations, but even the best idea might not be realized when the entrepreneurs have no funds. In many cases, especially in the early stage of company or at high uncertainty of success, the traditional financing is unreachable. Therefore, the new alternatives, such as microfinance, crowdfunding, and peer-to-peer lending, have expanded rapidly (Bruton et al., 2014). These new approaches to financing share a number of common features. Firstly, these innovations may have arisen in one part of the world, but they quickly diffused across the globe. One good example of them is microfinance. Originally, it emerged as the support for the regions suffering from poverty, but now it is used in developed economies by entrepreneurs whose loans are difficult to secure (Freedman, 2000). Secondly, new financial alternatives use an on-line platform and internet technology to aggregate many, often small, individual transactions. Thus, innovators are designing new financial instruments to provide entrepreneurs with financial services that are otherwise difficult to access (Breedon, 2012).

The alternative forms of financing economic activity are more and more popular. The growth of crowdfunding market alone is impressive. In 2012, all the funds collected by crowdfunding platforms reached the level of $2.7 billion and financed about 1.1 million campaigns (Massolution, 2013). At the end of 2014 it was over $65 billion (www.fundable.com/learn/resources/infographics/economic-value-crowdfunding) and it is forecast, that in 2020 it will be over $500 billion. this number alone could be a good motivator for further research and study. Additionally, our knowledge and understanding of the crowdfunding phenomenon remains in its infancy (Bruton, 2014; Belleflamme et al., 2014).

The objective of this article is an analysis of applying crowdfunding as a source of financing business in small and medium enterprises operating in Poland. To date, the majority of empirical studies in the domain of crowdfunding focus of identifying the project and entrepreneur characteristics associated with successfully funded projects (e.g. Mollick, 2014). I want to look on this source of capital from another point of view. Special importance will be attached to both the costs associated with using this product as well as its advantages and disadvantages relative to other, alternative solutions.

The paper is divided into three sections. The first part describes the idea of crowdfunding and analyses its main characteristics depending on the model and platform. Special attention is paid to the cost of capital. The second part presents other traditional sources of capital and it uses data from Polish economy in order to analyse the advantages and disadvantages of these instruments. In the third section I compare crowdfunding as a source of capital with other traditional sources. At the end I conclude the analysis and propose further research.

Crowdfunding – models and platforms

Financial capital is the most useful thing which made the entrepreneurial activity possible (Florin et al., 2003). To finance the ideas in the early stage, entrepreneurs usually exploit their personal savings or informal outlets, such as family members, individuals in their social network, or moneylenders (Buckley, 1997). Each of these sources is limited or implies very high interest rates (Khavul, 2010; Khavul et al., 2013). Therefore, crowdfunding appears as an alternative means to finance early stage businesses and those in expansion phases of growth (Lehner, 2013; Allison et al., 2014). It facilitates the financing process by providing an on-line platform that enables minor investors and individuals to support the initiative through investing small amounts of capital and sharing the idea with others over a fixed time period – generally a few weeks (Agrawal et al., 2013; Lambert&Scheinbacher, 2010; Meyskens&Bird, 2015; Ordanini et.al, 2011; Kuppiswamy&Bayus, 2014). Thus, crowdfunding promises to decentralize and generally transform corporate finance around the world (De Buysere et al., 2012). If entrepreneurs or SMEs have problems with accessing capital from traditional financial institutions, crowdfundig allows them to utilize their own personal networks to finance businesses or ideas. Crowdfunding as a subject for research and as a tool for financing has become very popular, especially since 2007, after the global financial crisis, when traditional financing for both cultural and commercial ventures dried up. It appears in articles and research papers published by e.g. Belleflamme et al. (2010), Mollick (2014), Moss et al. (2014). However, the knowledge about this phenomenon is still very little.

Many authors suggest (e.g. Ibrahim&Verliyantina, 2012; Bauer – Leeb&Lundqvist, 2014; Bruton et al., 2014), that crowdfunding is connecteded with crowdsourcing, which is the use of the crowd to obtain solutions, feedback, proposals and other resources (e.g. special knowledge, opinions or new contacts and networks). Thus, crowdfunding could be considered as a special kind of crowdsourcing, because its main object is to use a particular source - the capital. However, the ventures, especially social ones, utilize crowdfunding as a mechanism not only to finance their initiatives and programs, but to entice the individuals interested more in the proposed idea itself, rather than future cash flows or profits (Lehner, 2013). It is believed that it is highly probable that an investor who likes a project, also likes the product of the company and would like to be its first customer (Cholakova&Clarysse, 2014). Building the society which accepts and supports projected activities is the first step to ensure future demand for it. This is a big advantage of crowdfunding and is unique compared to other sources of capital.

In order to raise the capital, the entrepreneurial endeavors have to go through the fundraising process. First, there should be developed a campaign focused on the idea which needs to be financed. It is very important to establish, among other objectives, the financial goal of the campaign i.e., the level of the capital to be raised and the final date of campaign. Second, the initiator should choose the platform to raise these funds and establish the levels and types of rewards for funders and backers. When the campaign is launched, it needs to be widely promoted on the chosen platform, as well as in social media. It is important to encourage investors and individuals to participate in this project. If the financial goal is reached till the end of the campaign, the initiator can use the money and finalize the project. Otherwise, many platforms (e.g. Kickstarter) using the “all-or-nothing” rule return the funds to investors and backers. The initiator does not get any capital and the project probably collapses.

It is worth noting that most of crowd investors are not sophisticated and they avoid business plans, cash-flow liquidity and collateral, rational economic analysis, etc. (Bauer – Leeb&Landqvist, 2012; Ridley – Duff, 2009). However, along with the growth of popularity of crowdfunding, increases also the selectiveness of the crowd funders. It happens that venture capital funds are interested in crowdfunding platforms so as to look for good and promising ideas with great potential.

Currently, the on-line platforms offer several different models of crowdfunding which vary according to the incentives that they bid to the crowd. The literature distinguishes among donation-based, reward-based, lending-based and equity-based crowdfunding (De Buysere et al., 2012; Lambert&Scheinbacher, 2010; Cholakova&Clarysse, 2014).

Donation-based crowdfunding. It collects a specific type of backers who do not expect return or benefits of their support to the project. The model offers the donors a contract without any physical or financial rewards. It is commonly used for social campaigns whose main goals are not connected with the business itself, but with charity. Examples of platforms giving such possibility are GoFundMe or Crowdrise.com. In Poland such campaigns are very popular. One of the most effective, taking place every year, is the Great Orchestra of Christmas Charity, which in the 22 years of its work has raised over 140 million EUR (http://en.wosp.org.pl//the_grand_finale). It is not typical crowdfunding, because besides the Internet, there is still traditional fundraising in the streets. However, the majority of funds are raised through the Internet.

Reward-based crowdfunding. In this type of crowdfunding, funders are promised to obtain a non-pecuniary tangible (e.g. a product) or intangible (e.g. reputation, identity) benefit as a prize for financial participation in a project. It could be a product, which will be offered in the future after a successful end of the project: tickets, meetings gadgets like t-shirts, official thanks on website, etc. The reward may depend on the level of invested capital. The platforms which offer this type of crowdfunding include Kickstarter or Indiegogo. In Poland exist about 10 portals with reward-based crowdfunding. The most popular platforms are polakpotrafi.pl and wspieram.to. To date, these two platforms have participated in above 4000 successful projects and collected circa 17 million PLN (4,12 million EUR). The average rate of financing is 130%. The cost of capital is the sum of commission (8-9% of the raised funds total) and the administration fee (50-100PLN, i.e. 12,5-25EUR) (www.pi.gov.pl).

Debt-based crowdfunding. The model offers a credit contract, in which there are no intermediaries (i.e. no banks involved). This crowdfunding tends to be used by entrepreneurs and projects, which could not be financed by traditional institutions, because of difficult access to their funds, insufficient liquidity, big financial risk, etc. The main object of this crowdfunding model is to offer an alternative financial support, not a direct way to raise funds (Allison et al., 2013; Moss, Neubaum & Meyskens, 2014).

Individuals or small investors lend their money to another person or group. In return they can receive some interest with the repayment. It is, however, dependent on the platform (Outlow, 2013). The wellknown platforms for debt crowdfunding is Puddle (www.puddle.com) and Kiva (www.kiva.org). In Poland, the oldest social lending platform is Kokos, established in 2007 (www.kokos.pl). To date, through the platform above 125 million PLN (around 30 million EUR) has been lent on average interest rate of 17,55% in 110 953 auctions. The share of outstanding loans is at the 16,92% level. The initiator is charged commission, which is no higher than 5% total amount of the loan and the one-time fee for verification, which is about 50PLN (12 EUR). The commission is dependent on the degree of credibility and the amount of financial needs.

Equity-based crowdfunding. This is the least common model of crowdfunding (Mollick, 2014), especially because of the law restrictions in many countries. However, equity-based crowdfunding is growing very fast and the governments are still working on such solutions, which make this form of support much easier and safer. The Jumpstart Our Business Startups Act (JOBS Act), established in 2012 is a good example of it. It prevents sales of equity in private companies to accredited investors (Simon, 2014) and legalizes some types of equity financing for start-ups and small businesses based on the amount of crowdfunding sought (Parrino&Romeo, 2012). In this model of crowdfunding, the individuals invest their money and instead of it, they become shareholders. Thus, they could take part in distribution of the gains, as a paid dividend or in the growth the value of shares (Futko, 2014). Examples of the platforms offering such crowdfunding include: OfferBoard, CircleUp, OurCrowd, ASSOB.com.au, Symbid, crowdfunder.com. In Poland the most popular platforms which offer equity-based crowdfunding are crowdcube.pl and crowdangels.pl. The cost of a campaign on these platforms is the sum of commission (6% from totally raised funds) and the administration fee (999PLN, e.g. 248EUR). To date, there are 2 successfully ended projects – first in the amount of 50 000PLN (12 100EUR) and second – 102500PLN (24 818EUR).

There are existing platforms which offer mixed models of crowdfunding and the projects with such offers have successfully raised funds through them (see Collins&Pierrakis, 2012).

Regardless of the model of crowdfunding, projects can come from different industries, like art, dance, theater, film, video, publishing, technology, and more. It is worth noticing that indeprndently from the industry, people are more likely to support projects that have already reached 80% of their target (Burtch, Ghose&Wattal, 2013). The research made by Mollick (2014) suggests, that the success rates of projects are affected by a few factors , e.g. margin (small margin promises higher probability of success), social network and preparedness (when the social network grows, the chance of success increases) as well as quality signals.

The traditional sources of capital

Although in literature exist many theories regarding the use of certain capital, e.g. Modigliani&Miller (1958), trade-off theory and pecking order theory (Myers, 1984), or agency cost theory (Jensen&Meckling, 1976), all these theories focus on optimal capital structure and concentrate on debt and equity capital. The financing choices could be, however, divided by source: internal and external financing. Internal funding consists of the part of equity capital which is generated by internal cash flow and that results in retained earnings. External funding consist of the capital supplied by the institutions or individuals outside of the company. The external sources include bank loans, overdrafts or credit line, issue of securities (shares or commercial papers), contributions to equity capital, leasing or hire-purchase, trade credit, factoring, franchising, venture capital funds or private equity funds and business angels. In Europe, especially in countries after transition, which joined the European Union, as a very important source of capital should be mentioned the EU funds. Each of these sources has limitations or barriers in their acquisition and is connected to another cost of use. In reference to this, I made a comparison of the main features of the above-listed sources with special respect to the SMEs and the conditions in Polish economy (see Table 1). From this analysis I excluded short-term funds, which are usually not used for investment projects. Due to the fact, that entrepreneurs prefer those sources of capital that involve giving up less control and require lower servicing costs (Cosh et al., 2009; Vanacker&Manigart, 2010), I chose the following four attributes:

- cost of capital, as the crucial determinant of financial decision [annual %];
- impact on the control [5 degree Likert scale, where 1-no impact, 5-very big impact];
- limitation of use [description];
- complexity of the acquisition process [5 degree Likert scale, where 1-no complexity, 5-very big complexity]

Descriptive assessment is under the table.

Table 1. The basic characteristics of traditional source of capital

Source	Limitation of use	Cost of use	Complexity of the acquisition process	Impact on the control
Retained earnings	Existing companies with positive financial results	1,5% plus company's risk	1	1
Bank loans	Banks prefer the bigger companies with at least 2 years history	20-25% minus tax savings **real (average): 18,2%**	3	2
Issue of shares	Only for joint-stock companies	5-7% total amount of issue + every year – administration cost (max. 26000EUR – about 0,05%) and cost of dividend (average 4,23%) **real (average): 1year – 10,7% next years– ca.4,3%**	5	2

Issue of commercial papers	Big or medium companies	Preparation cost – as in the issue of shares Then, interest (average 12%) + administration cost if the offer was public (ca.0,007%) **real (average): 1year – 18,5% next years– ca.12%**	5	1
Leasing or hire-purchase	Existing companies with minimum 6 months history	4-10% + additional fee (5-10%) – tax savings **real (average): 11,75%**	2	1
Venture capital/Private Equity funds/Business Angels	Existing companies with good idea for business and high potential	Cost of participation in profits **real (average): 25%**	3	5
EU funds	Start-ups or existing companies	Cost of preparing the proposal	5	3

Source: Own adjustment

Retained earnings. This is the most commonly used source of capital in existing companies in Poland, especially in SMEs. Its share in all capital is about 60% (PARP, 2012), but it is considered a relevant source only for 25% of them (Doove et al., 2014).

This source of capital can be used only by the existing companies which achieve positive financial results and the owners agree to reinvest them.

The cost of use of the retained earnings is usually considered as a cost of foregone benefits and commonly estimated by the Capital Assets Price Model (CAPM) (Bruner, 1998). Thus, this cost is much higher than the cost of external capital. Besides, the cost of retained earnings cannot be deducted from profits and do not offer savings in tax. On the other hand, using this source of capital does not raise the financial risk.

Bank loans. This is the most common debt capital in Polish companies, but there are many limitations in accessing it. Banks prefer bigger companies (more than 9 employees) with at least 2 years history (PARP, 2012). These basic requirements and complexity of the acquisition process are the crucial factors in motivation to applying. Most entrepreneurs regard this source of capital as unattainable. In fact, one third of all applications are rejected (PARP, 2012) and about 40% of them are not argued.

The cost of using the bank loans varies depending on the type of credit and the bank. The interest rate is calculated as a sum of the reference rate and margin, which can range from 2 to 5% (annual). Besides, the company is charged the one-time commission (0-5% of the amount of the loan) and other payments, e.g. insurance or administration fee. Thus, the real interest rate is much higher and can reach 20-25%

(www.comperia.pl). Every commission and interest can be later deducted as a financial cost and thus decrease the profit and tax.

The acquisition process begins with fulfilling an application form and collecting the documents, where one of the most complicated ones is business plan with its special structure performed by the bank. It takes about 3 to 14 days to receive the decision.

The raised funds should be spent only on the previously declared aim.

Issue of shares. This is the kind of source of capital, which is possible to use only for joint-stock companies and capital companies in general. Thus, it is not dedicated to small and medium enterprises. There are many law restrictions, especially when the offer is public. Therefore, the acquisition process is very complex.

The cost of using the capital from a share offer is divided into two parts: first - appropriate for preparing the offer, and second - appropriate for managing and quotation of the shares. The first part consists of cost of auditor (20%), prospectus (30%), promotion (15%), underwriter (15%) and other administrative costs (20%). All these costs summarize to 5-7% of the desired amount of funds (Raport *Kapitał z giełdy*). Additionally, the company is charged by the administration costs (e.g. managing and quotation of the shares), which cannot exceed 106 500PLN (about 26000EUR). The shareholders can, additionally, decide to pay a dividend. The average rate of dividend paying in 2014 was 4,23% (Mackiewicz, 2014)

Issue of commercial papers. Similarly, as in the case of issue of shares, this is a source of capital which could be used only by the big or medium companies with a good history and relations with business environment.

The cost of using funds from commercial papers is divided into preparing cost and costs incurred after the issue (e.g. interest rate and administration cost, when the offer is public). The first part of cost is similar to that in the share issue. The only difference is that the offer price is established by the company (not market) as well as the expiration date. The second part of costs, however, differs in many features. First of all, the funds are available for the company till the expiration date, but in the meantime the company should regularly pay the interest. The interest rates in commercial papers in Poland are highly diversified (4-20%) and dependent on many factors, e.g. the rate could be fixed or variable related to WIBOR, LIBOR etc. The level of interest rate is connected with liquidity risk of the issuer, the term of expiration as well as the warranty. Both the cost of preparing the issue and due interest decrease the profits, and thus the tax, too.

Leasing or hire-purchase. Next to loans, leasing is a very popular source of investment financing, especially in SMEs. The particular limitation to use it is the company history. It need not be so long as in the case of bank loans, but still it is expected. Thereby, the early stage enterprises cannot easily apply.

The cost of leasing is dependent on two factors: level of entry fee and leasing period. The higher the level of entry fee and longer period, the lower the leasing installment and vice versa. The average cost of leasing in Poland is 4-10% (www.comperia.pl), but the company is charged with additional costs, e.g. insurance, guarantee, etc. All the other costs are summarized to further 5-10%. The big advantage of the leasing is the fact that most of the cost can be deducted from profits and reduce tax.

Venture capital/Private Equity/Business Angels. The three sources of capital are very similar. The difference concerns the level of support, i.e. the amount of money. Private equity funds are interested in projects involving millions euro. Venture capital – hundreds of thousands euro. And the Business Angels, as individuals (not institutions) – thousands euro. Private equity and venture capitals usually look for established companies with good ideas for business and wide perspectives. Business angels usually support start-ups and early stage enterprises (www.psik.org.pl).

The cost of use of these funds is sharing the control and decision-making in company with the supporting institution or individuals. Thus, this cost is immeasurable. It is completely different when an investor wants to participate in profits. It is worth noticing that only a few percent of all projects flowing into Venture/Private equity funds or Business angels are supported by them. The procedure of acquisition is very long-lasting and in Poland the process of making a decision takes about 6-12 months. Although it is very difficult to calculate the cost of using such sources, the approximate estimation for Polish market is about 20-30% (www.ipo.pl).

EU funds. This source of capital is specific, because many programs provide support to companies by means of donations. Certain special activities are addressed to start-ups and early stage enterprises and other – to established companies. The biggest support is dedicated to SMEs, innovative activity and increase in efficiency.

The main costs of using these funds are expenses incurred to prepare a proposal and own contribution, which is not the cost in the literal meaning, but it creates additional expenses many times.

The acquisition procedure is dependent on the type of program, but usually is very complicated and long-lasting.

Crowdfunding versus other sources of capital

I compare this all selected above sources of capital with crowdfunding in Figure 1. On the horizontal axis is postponed the impact of control. On the vertical axis – cost of capital

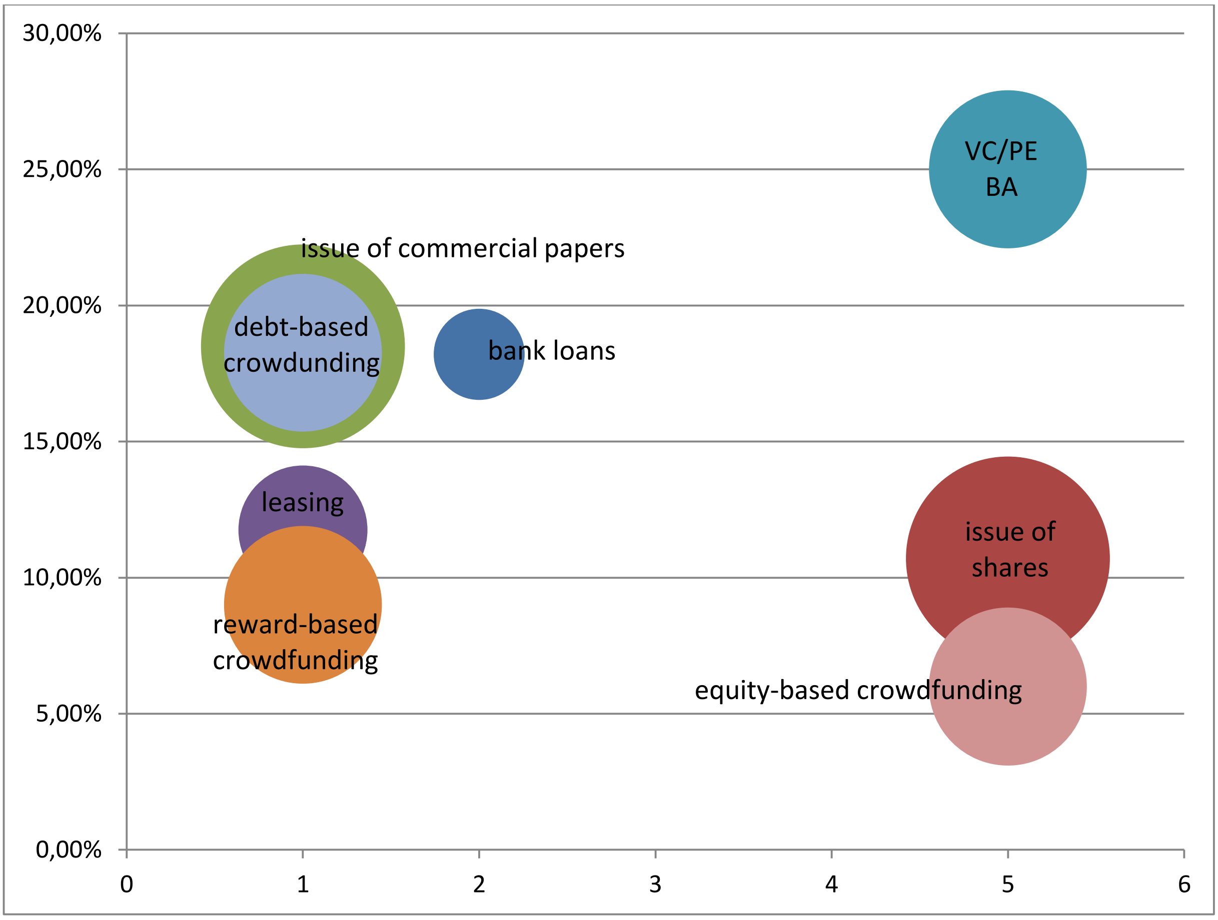
As we can see from Figure 1, concerning the impact of control, all the sources can be divided on three groups. The first group covers debt and reward-based crowdfunding, issue of commercial papers and leasing or hire-purchase. Those sources have the least impact of control. The entrepreneurs raise the funds and can freely dispose of them. The second group is subject to bigger impact. The raised funds are controlled by the institution and can be spent on unplanned expenses. This group includes bank loans.

The last group consists of venture capital/private equity funds or business angels, equity-based crowdfunding and issue of shares. All these sources have a very big impact of control because of accession of new shareholders who have potential right to take part in the decision process.

The most expensive capital comes from venture capital/private equity funds and business angels. The cheaper one is equity-based crowdfunding, but the short term of existence of this source of capital could give confusing information, especially because we have data only from two successful projects.

We can see that debt-based crowdfunding is very similar to issue of commercial papers, but the acquisition procedure is much more complicated for the latter one. Also, the reward-based crowdfunding could be a substitute to leasing. Although, it requires more effort, the price is slightly smaller. Likewise, the equity-based crowdfunding has its equivalent. This is the issue of shares.

Figure 1. The analysis of source of capital



Source: Own adjustment

Conclusion

The effectiveness and innovations have stimulated the development of new financial alternatives (Financial Conduct Authority, 2014). In the time of widespread use of social media and growing importance of corporate social responsibility, crowdfunding appears as a suitable novel way to raise capital for a wide variety of projects. Given its rapid rise, the causes of this dynamics of crowdfunding and the consequences of using it have been largely unstudied. This paper offers some exploratory insights into what is the cost of crowdfunding and what are the advantages and disadvantages when compared to other sources of capital.

The SMEs and early-stage entrepreneurs look for secure long-term financing and sources of capital outside banking (De Buysere et al., 2012). The above analysis shows that crowdfunding, regardless of the type, is a good alternative to traditional sources of capital and in many cases is much cheaper and easier to achieve. I do not know whether these findings are relevant also for other countries. It should be investigated. Further research could be concentrated on in-depth analysis of these similar sources or try to use other measures.

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