ALTERNATIVE FINANCE AND CROWDFUNDING

Introduction

Alternative Finance and Crowdfunding is increasingly popular and growing at an exponential rate in the UK. It has certainly enabled smaller investors to access investments previously available only to venture capitalists, angel investors and private equity. This article discusses the major players, the opportunities and risks for investors, lenders, entrepreneurs and businesses.

With the disruptive nature of the sector and the increasing use of "Fintech", we will also consider the wider implications for traditional lenders such as high street banks and NBFIs (non-bank financial institutions).

Apple Pay, PayPal Pass and Google Wallet have entered the retail payments market. Will platforms such as Crowdcube and Kickstarter do the same for commercial banking or will they sit alongside banks offering a slightly differentiated product?

We must also consider what part the regulatory regime plays. While banks continue to be squeezed by an increased compliance burden, the regulatory authorities also provide a significant barrier to entry. Too much regulation may burden the nascent sector, but too little may see the advent of less scrupulous practices.

At present sophisticated investors (primarily for regulatory reasons) dominate the sector and there remains limited awareness by the wider public however, given its disruptive nature, awareness will certainly increase. The dotcom bubble of 2001 foretold the omnipresence of the online possibilities, albeit 6-7 years too early; so will history repeat itself?

Industry overview

In recent years there has been a growing awareness and acceptance of Alternative Finance. In February 2015 a University of Cambridge and Ernst and Young study found that funds raised by the European alternative finance sector grew by 144% in 2014, representing EUR 2.96bn[1]. The UK, having first introduced the concept in 2005, was by far the region's largest, representing EUR 2.3bn and growing at 159%[2] per annum.

Exeter-based Crowdcube has become one of the nation's largest, raising £85m for 140 businesses in 2015[3]. With 250,000 registered investors, 100,000 of who registered in the past 12 months, they are likely to continue to lead the market. Notably, of the 300 businesses that have secured finance, only 6% have gone into administration, which compares favourably to an industry average of ca. 20% for equity crowdfunding[4].

Other well known UK platforms include: Seedrs, SyndicateRoom, Zopa, Funding Circle and Venture Founders. Market leaders in the US are Kickstarter, Gofundme and Indiegogo.

When comparing start-ups who have accessed alternative funding and those businesses who have not, crowd funded business appear more likely to succeed. Approximately 50% of start-ups (on a national basis) fail within 5 years.

[1] Moving Mainstream - The European Alternative Finance Benchmarking Report, February 2015
[2] Ibid.
[3] Why angel investors shouldn't be lone wolves - the Telegraph, Rebecca Burn-Callander, 15 February 2016
[4] Where are they now (2011-13) - AltFi Data and Nabarro, November 2015

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We should however note that the industry remains in its early stages and failure rates may increase. We must also recognise a distinction between investments and the platforms which have facilitated it.

Alternative finance should be considered to be a broad category that covers a range of mechanisms, which differ by type of investor and nature of and motive for investment:

P2P Business Lending allows debt-based transactions between individuals and existing SMEs to obtain growth and working capital directly from a pool of online investors (both individual and institutional), bypassing the often prolonged and uncertain traditional lending processes.

P2P Consumer Lending involves individual borrowers accessing primarily unsecured personal loans from a number of other individual lenders (often lending small amounts each) through an online 'marketplace'. This is the largest segment in mainland Europe (excluding UK).

Equity-based Crowdfunding facilitates the sale of a stake in a business to a number of investors in return for investment. Although this segment remains small, in comparison with the total European early stage investment market, it has achieved the highest level of growth over the past 3 years. It enables European entrepreneurs and start-ups to raise early-stage capital in a transparent and perhaps more 'empowering' online marketplace, directly from individual investors, angel groups and VC firms.

Invoice Trading (£270m, 174%, £56k) - allows firms to sell their invoices at a discount to a pool of individual or institutional investors in order to receive funds immediately rather than waiting for invoices to be paid.

FY 2014 Sector financials[5]

	Total amount (GBP m)	2012-14 CAGR[6]	Average amount (GBP k)
P2P Business Lending	749.0	250.0	73.2
P2P Consumer Lending	547.0	108.0	5.5
Equity-based Crowdfunding	84.0	410.0	199.1
Invoice Trading	270.0	174.0	56.1

While invoice trading represents the 3rd largest sector of the Alternative Finance, universe it is more reflective of asset-based finance and therefore does not rely heavily on the creditworthiness of the counterparty or the enterprise value of the investment.

We would however note that the average deal size is substantial and that a third of businesses felt that they would not have received finance from a traditional invoice trading provider. Of those who were successful 75% have said they would use invoice trading in the future, even if banks were to offer similar terms.[7]

Other - other avenues of alternative financing include the Business Growth Fund, Enterprise Finance Guarantee, Business Accelerators, business angel networks and government initiatives.

Opportunities

Going forward growth is likely to continue, as more than half of P2P business lenders plan to lend again and 86% of borrowers said they would be 'likely' or 'very likely' to approach alternative finance platforms first in the future, even if a bank were to offer funding on similar terms[8].

While a diverse range of sectors have used alternative financing, there appears to be a growing divergence between those who are likely to seek debt or equity investment.

[5] Understanding Alternative Finance - The UK Alternative Finance Industry Report 2014, Baeck, Collins and Zhang, November 2014
[6] Compound Annual Growth Rate
[7] Moving Mainstream - The European Alternative Finance Benchmarking Report, February 2015
[8] Understanding Alternative Finance - The UK Alternative Finance Industry Report 2014, Baeck, Collins and Zhang, November 2014

Manufacturers, professional businesses, construction and retailers are more likely to raise debt, and not unsurprisingly, the technology and consumer-facing sectors were more likely to seek an equity investment. This may be attributable to the fact that borrowers will need to be more established in order to service the debt payments.

Notably, for an online sector, the **physical location** of crowdfunding platforms materially impacts the regional spread of deals with a disproportionate share of transactions in the South East and London (majority of platforms) and the South West (Crowdcube).

Both corporate borrowers and entrepreneurs (who are more likely to raise equity) differentiate between funding platforms on the basis of the speed and ease with which they are able to raise funding

Consequently there is ultimately a fine line alternative platforms will have walk. The required compliance checks which traditional lenders must carry out may seem burdensome and overly complicated but they also protect the industry's reputation.

<u>Risks</u>

Any industry experiencing such rapid growth faces challenges and risk, particularly an IT-based one. In our opinion the sector's primary risks are both reputational.

As knowledge of alternative finance grows beyond the finance sector to the broader public, there is a risk that the success of an online platform will become intertwined with that of its investments. A perception may then develop that because **an investment is associated with a particular platform** it carries an implied endorsement. This is something online retailers such as Amazon and ebay have had to address. This may consequently result in platforms having to carry out a level of due diligence. While legally, platforms may simply be facilitating a transaction, the court of public opinion may see it differently.

The second risk we have identified is essentially the "**one bad apple scenario**". While UK platforms are regulated by the FCA (albeit not included in the FCSC scheme) platforms emanating from lightly regulated countries may not hold the same standards. The collapse of such a platform, or a platform endorsing highly speculative investments, may seriously damage a young industry. Such platforms may also provide limited or misleading information on investments or promise exaggerated returns. If it looks too good to be true, it usually is!

Credit risk - while Alternative Finance is no doubt helping support business growth, it may also be doing so by providing funding to riskier ventures. While a clear majority of those that have received funding have gone on to launch a new product or service and have seen turnover and profit grow, a number of these businesses may have been unlikely to receive funding elsewhere.

This we believe is a reflection of two factors: (1) the business model may not be consistent with banking's more conservative risk appetite and (2) the industry remains in its early stages and a fuller picture may yet develop when a substantial number of investments reach a traditional exit phase at 5-7 years.

<u>Innovation and different structures</u>

Platforms will generally use a **direct ownership structure**, where individual investors are independently responsible for their shares or a **nominee structure** where the platform will act as nominee for all the small investors and deal with all the legal paperwork involved, providing an investee with a single point of contact.

For example, **Crowdcube** has set up a venture fund, managed by Braveheart Investment Group, in which the 'crowd' can invest as a Limited Partner, a structure more reflective of a PE fund. They also provide unsecured mini-bonds.

Seedrs also offers the option of investing in a fund or an incubator programme; both are ways of spreading the risk across a group of companies that are chosen by more experienced investors. They also offer convertible loans.