
Equity Crowdfunding

A Model for Financing Start-Ups and Small Businesses

Canvas Impact
November 2017

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Canvas is an impact investment advisory firm focused on mobilizing capital to drive social and environmental outcomes. Our team has been part of developing the Canadian social innovation and social finance ecosystem for over a decade.

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Acknowledgements

PROJECT SUPPORTERS

We would like to thank our subject matter experts, reviewers and interviewees.

We would like to thank all those who contributed to this research by generously giving their time to be interviewed and provide input.

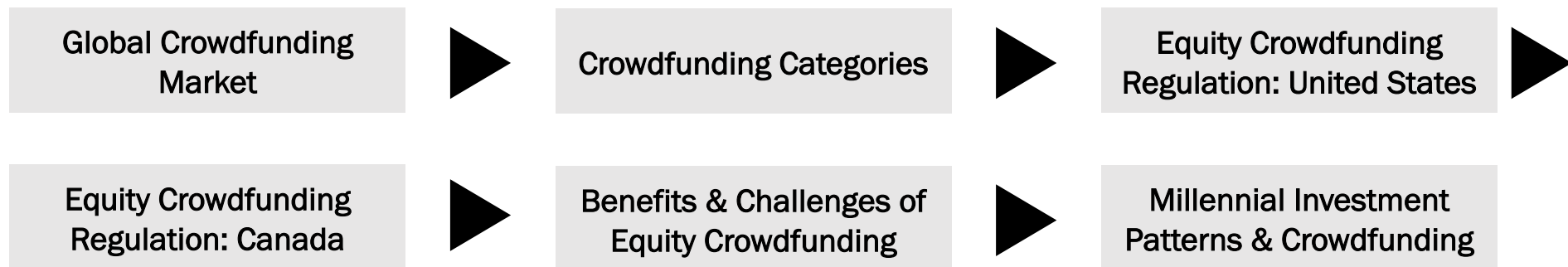
RESEARCH TEAM

We would like to thank our team of researchers: Varun Srivatsan, McKenzie Rainey, Sheen Sagalongos

Background

Outline

This Research is divided as follows:



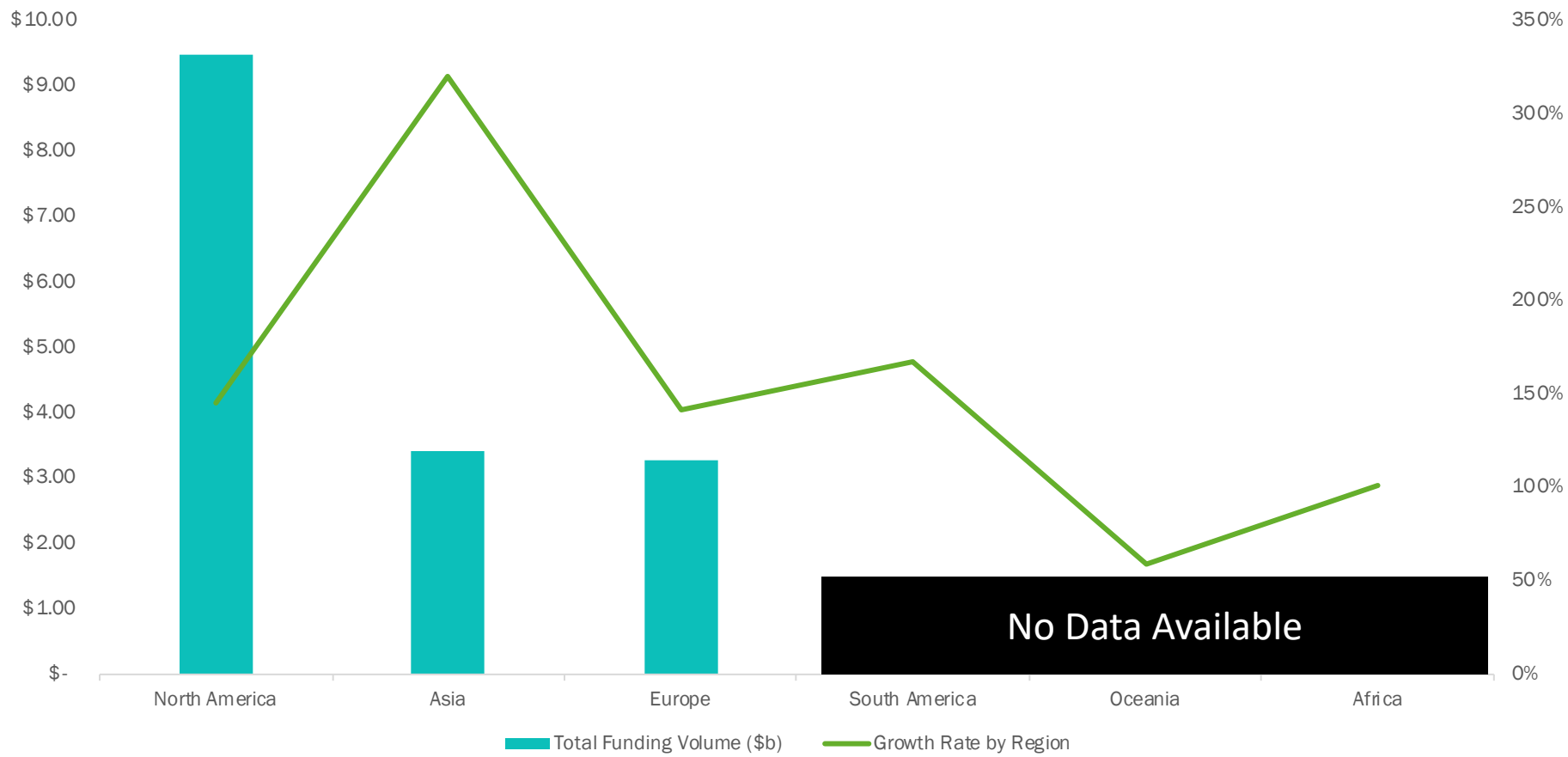
Introduction

Crowdfunding, the practice of funding a project or venture by raising small amounts of money from a large number of investors, has expanded as a potential new funding source for start-ups and small businesses. In light of legislative changes related to equity crowdfunding in both the United States (US) and Canada, this research discusses major types of crowdfunding and their growth before focusing on equity crowdfunding as a method of financing for small businesses and start-ups. It will cover the current global market and both countries' new legislation, as well the specific challenges and benefits of equity crowdfunding. Lastly, the report will also touch on what the new trends in crowdfunding could mean for impact investing with a spotlight on the millennial generation's investing patterns.

The global crowdfunding market

The *Massolution Crowdfunding Industry 2015 Report* estimated, based on 1,250 active crowdfunding platforms worldwide, that \$16.2 billion (USD) was raised in 2014; almost triple the \$1 billion from 2013. This translated to a global growth rate of 167%.

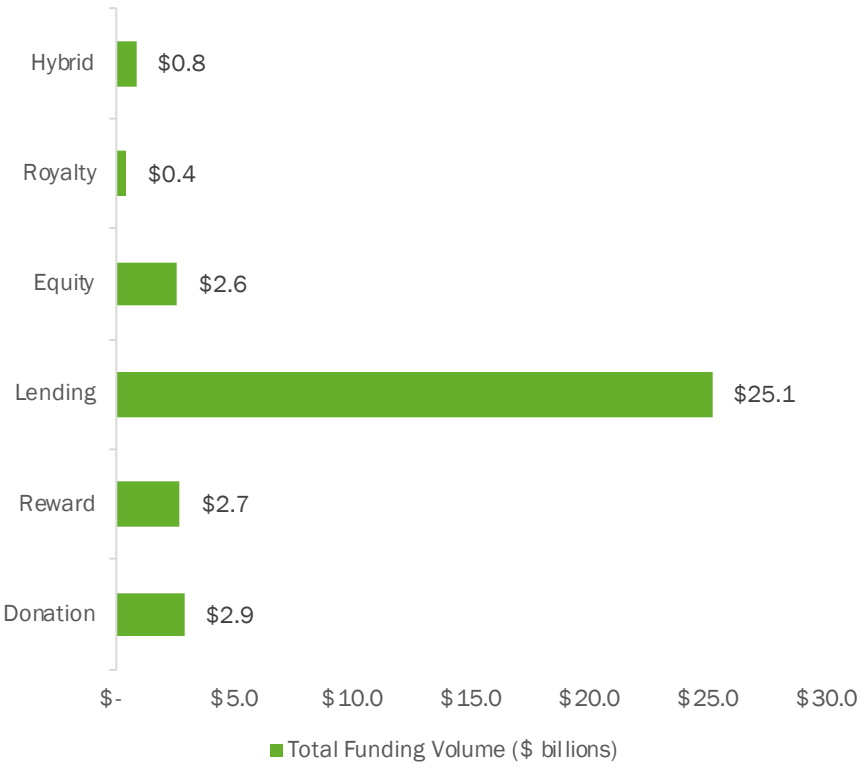
Crowdfunding Amounts & Growth Rates, By Continent (2013 - 2014)



The global crowdfunding market

Within the crowdfunding industry, lending-based or debt-based crowdfunding is the most popular mode—raising \$11.08 billion in 2014. Royalty-based and hybrid-based crowdfunding have less volume but are growing the fastest. Equity-based and debt-based crowdfunding models are slowly gaining traction amongst other models.

Total Funding Volume by Crowdfunding Model (2015)

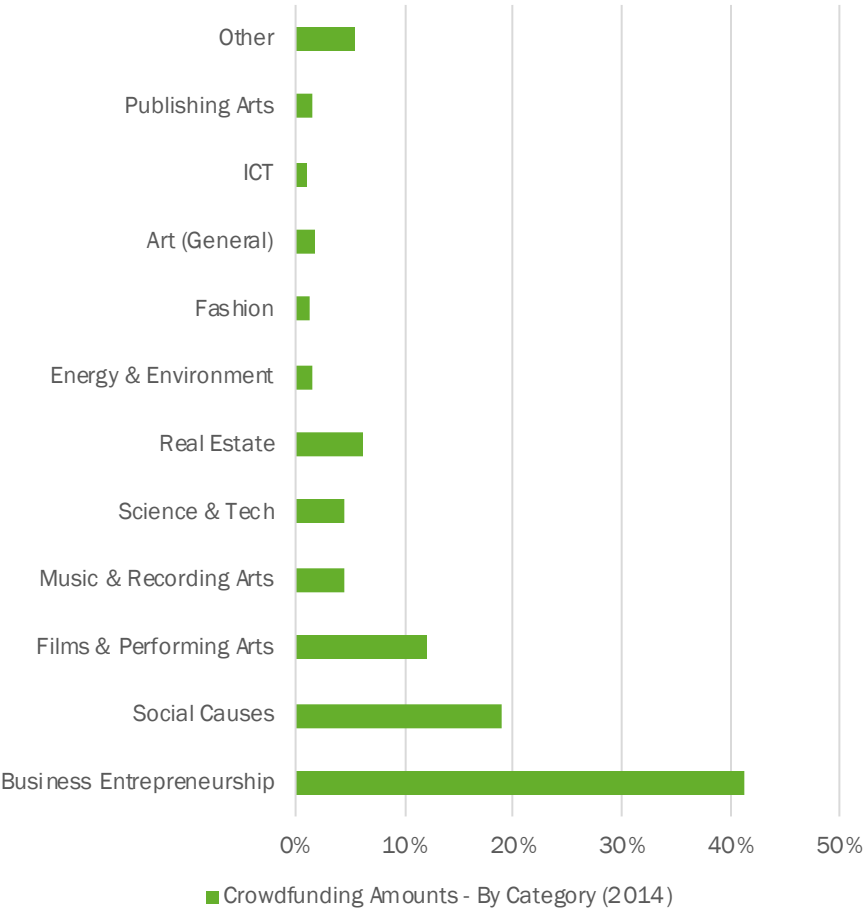


Crowdfunding Amounts & Growth Rates, by Crowdfunding Model (2013-2014)

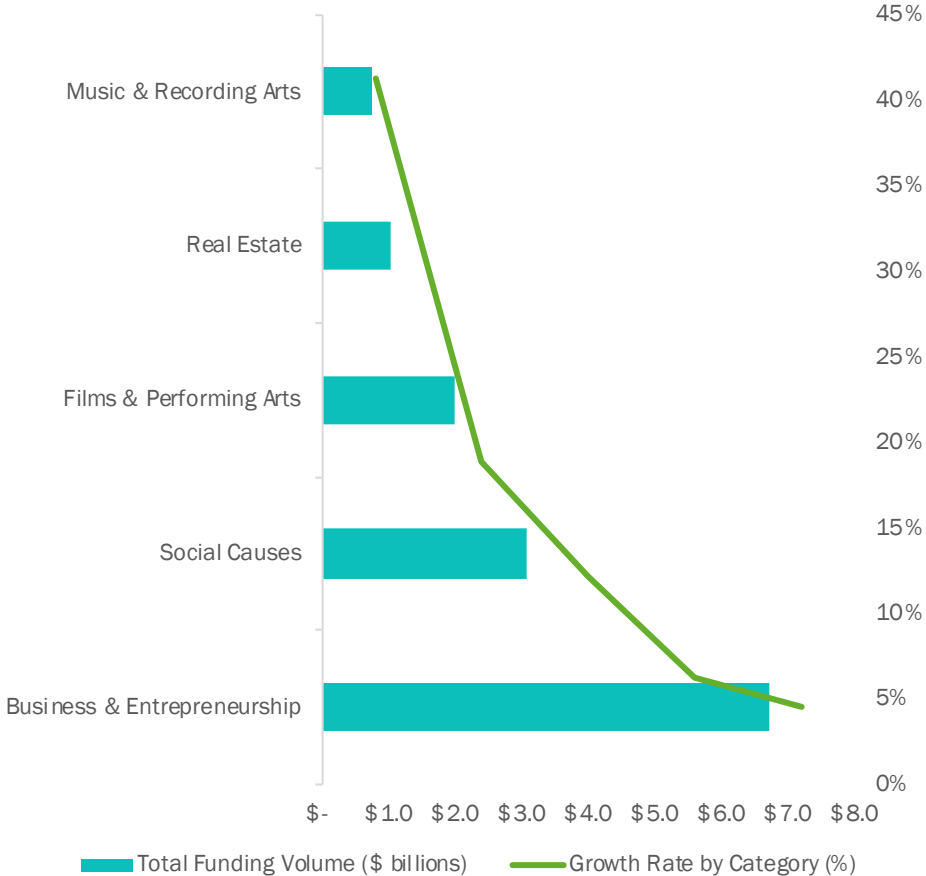


The global crowdfunding market

Crowdfunding Amounts - By Category (2014)



Crowdfunding Amounts & Growth Rates, By Sector/ Category (2013-2014)

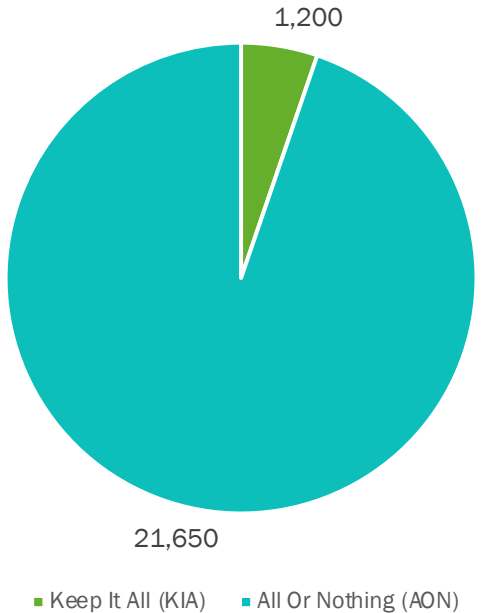


Business & Entrepreneurship-related crowdfunding projects are the most popular initiatives and the fastest growing category; followed by social causes.

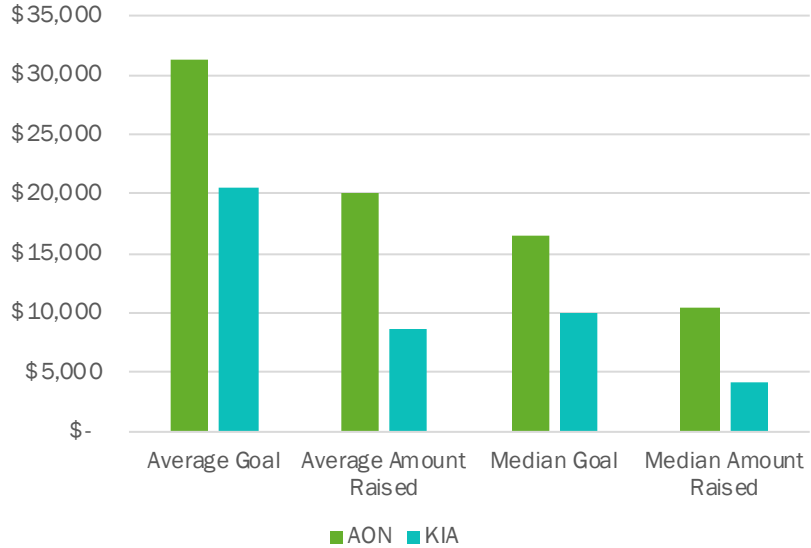
Categories of crowdfunding

Rewards-based crowdfunding is the most popular type of crowdfunding, when measuring the number of campaigns popularized by sites like Indiegogo and Kickstarter (2008 & 2009, respectively). It offers individuals a chance to contribute to a project or product in which they are interested, in exchange for current or future goods or services; often referred to as ‘perks’.

Number of Campaigns, by Model



Fundraising Goals & Amount Raised, by Model (KIA vs. AON)



Rewards-based crowdfunding raised approximately \$2.68 billion (USD) in 2015, between ‘all-or-nothing’ (AON) and ‘keep-it-all’ (KIA) contracts. In the former, the entrepreneur or company keeps all of the funding that they raise on the platform; in the latter, they set a goal amount and only collect funds if the target is met. Small, scalable projects use KIA often, large, non- scalable projects with high fixed-costs frequently use AON.

Categories of crowdfunding

Charity or 'Pure' Donation Crowdfunding

Charity-based crowdfunding (also referred to as 'donation' crowdfunding) takes place when an individual, company or organization accepts charitable donations. The total value of all *GoFundMe* campaigns surpassed \$1 billion in 2015.

Debt Crowdfunding

Debt-based crowdfunding, also known as lending-based crowdfunding or peer-to-peer (P2P) lending, is a vehicle for borrowers to obtain a loan at a lower interest rate than through traditional avenues (i.e., banks) and allows lenders to potentially receive a higher rate of return than through traditional investments (i.e. savings or government bonds). It continues to have the largest funding by volume compared to other models of crowdfunding and is growing rapidly.

Equity Crowdfunding

Equity-based crowdfunding involves investors contributing money in exchange for a tangible interest in the venture they are funding, most often stock. In comparison to venture capital funding, which accounted for \$47 billion in investment in the US in 2014, the global equity-based crowdfunding market was only around \$400 million in 2013, \$1.1 billion in 2014, \$2.1 billion in 2015, and an estimated growth to \$3.5 billion in 2016

Equity crowdfunding regulation: United States

Supporting Small Business & Start-Ups

Small businesses and start-ups reportedly generated approximately 65% of the net new jobs in the US from 1993 to 2009 and generated approximately 77% of new private jobs in Canada. However, many of these enterprises struggle to raise the seed funding needed to be operational. In response, governments in both the US and Canada have amended legislation in the past to allow new ways for equity crowdfunding to play a part in small business and start-up financing.

The *Jumpstart Our Business Start-ups (JOBS) Act*

Virtually anyone can take part in crowdfunding investments; they are only limited by total investment in a given 12-month period. The conditions are as follows:

- For an annual income or net worth <\$100,000, you can invest up to the greater of \$2,000 or 5% of the lesser of your annual income or net worth in the 12-month period.
- If both your annual income and net worth are >=\$100,000, you can invest up to 10% of the lesser of your annual income or net worth in the 12-month period, for a maximum of \$100,000.

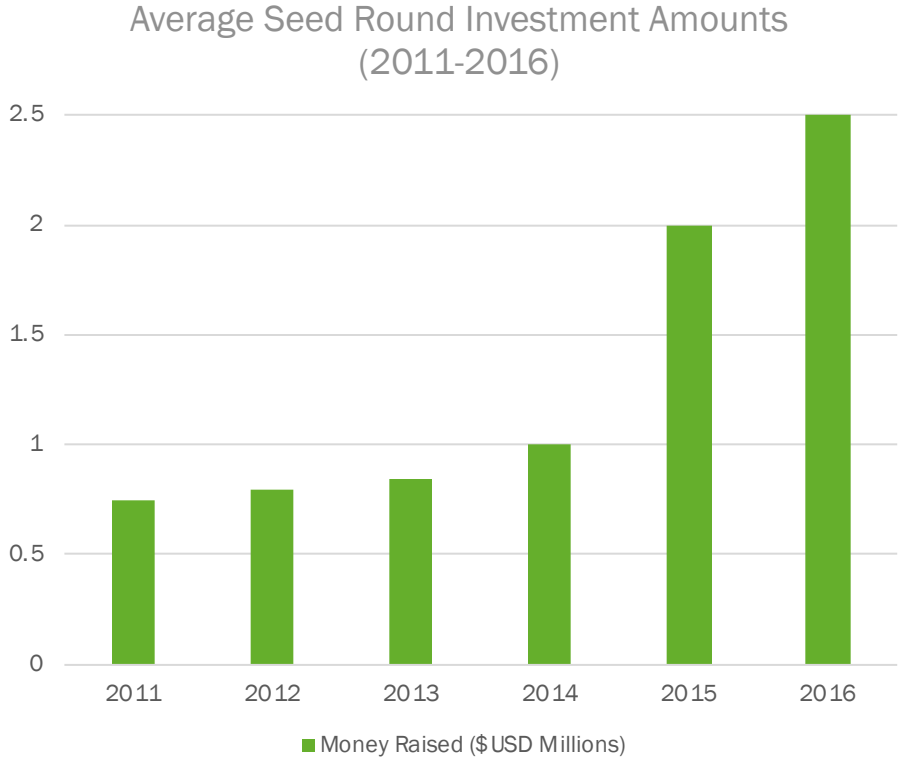
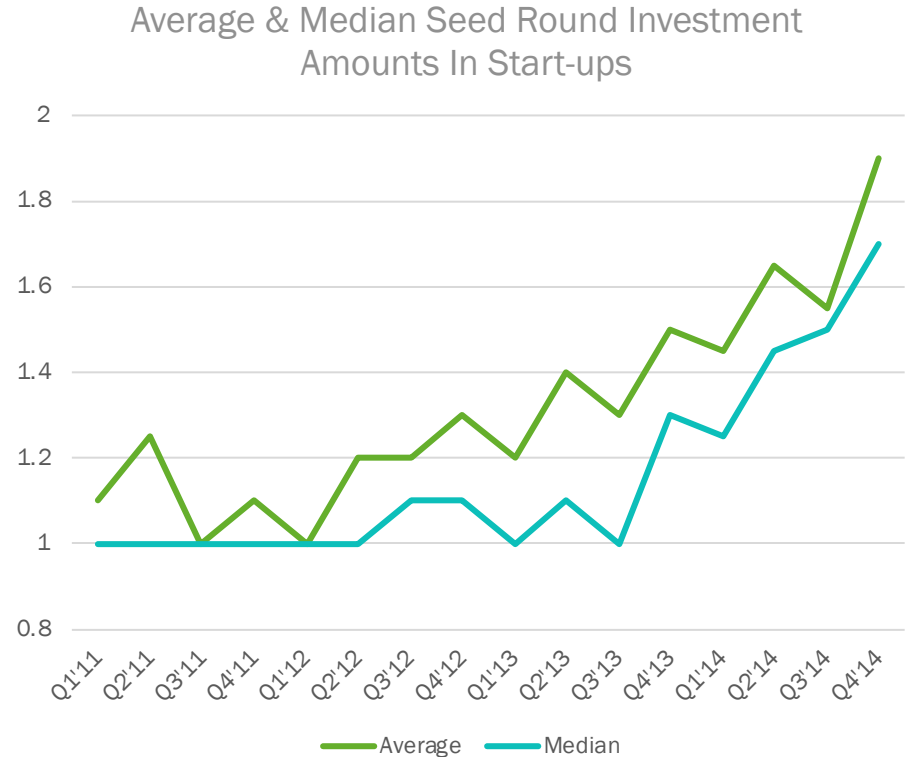
For issuers, the 12-month period fundraising limit is \$1 million. Financial disclosure is also required for compliance:

- For <=\$100,000– financial statements must be certified by the principal executive officer of the company
- Between \$100,000 & \$500,000 – financial statements must be reviewed by an independent public accountant.
- Between \$500,000 and up to \$1,000,000 – financial statements audited by an independent public accountant and the accountant’s audit report.

Equity crowdfunding regulation: United States

The Jumpstart Our Business Start-ups (JOBS) Act: Complications

The limit facing issuers of raising a maximum of \$1 million within a 12-month period has become a barrier over time. Since the JOBS Act was signed, the average seed funding amount invested has grown: with an average seed round of over \$2 million in 2016, equity crowdfunding specifically under Title III is unable to meet 100% of seed funding needs.



Equity crowdfunding regulation: United States

State Legislation

The delay in the US federal government's official and final rules of the JOBS Act led to individual states passing their own equity crowdfunding laws and rules. As of June 2016, the North American Securities Administrators Association (NASAA) compiled a summary of 45 different states in the US that have, or will have, state laws regarding equity crowdfunding. Many states provide more favorable terms to both the investors and the issuers than the federal *JOBS Act*. Although they vary, state laws often have higher caps that range from \$2 million to \$5 million, and the amount that accredited and non-accredited investors are allowed to invest is higher than the federal law allows for.

Ultimately, it seems as though equity crowdfunding portals themselves have the power to choose which law, state or federal, it (and its users—investors and issuers) would like to follow.

Equity crowdfunding regulation: Canada

The Canadian Market

As of June 20th 2016, there were 15 equity-specific crowdfunding portals operating in Canada. While there is some overlap between Canadian and American campaigns in terms of investors due to the nature of the industry, the National Crowdfunding Association of Canada maintains a directory of active (or beta) Canadian crowdfunding platforms, alternative finance funding portals, and service providers.

Equity crowdfunding regulation: Canada

Multilateral CSA Notice 45-316: The Start-Up Crowdfunding Exemptions

The Start-Up Crowdfunding Exemptions (also known as the Start-Up Regime) refers to simultaneous regulatory amendments in British Columbia, Saskatchewan, Manitoba, Quebec, Nova Scotia and New Brunswick (the ‘participating jurisdictions’) in May of 2015 by way of local blanket orders. It limits an individual’s investment to no more than \$1,500 per distribution; it caps a distribution at \$250,000 per individual offering (with no more than two offerings a year, i.e., a \$500,000 aggregate cap every 12-month period).

Multilateral Instrument 45-108: The Integrated Crowdfunding Exemption

MI 45-108 was introduced to allow businesses to benefit from greater access to capital from a larger number of investors online, through a funding portal operated by a registered dealer. MI 45-108 facilitates equity crowdfunding by offering a structure to raise both offering and investor limits on securities. This includes:

- A \$1.5 million limit on proceeds raised in a 12-month period.
- Non-accredited investors may invest no more than \$2,500 per distribution and accredited investors no more than \$25,000.
- In Ontario, non-accredited investors are subject to a \$10,000 annual limit, and accredited investors to a \$50,000 annual limit. Ontario exempts investors from the distribution and annual limits if they qualify as “permitted clients” by having net “financial assets” of greater than \$5 million.

Equity crowdfunding regulation: Canada

\$70M

Value of the Canadian equity crowdfunding market (2015)

15

Equity-specific crowdfunding portals operating in Canada (June 2016)

27

Companies listed on the platform of exempt market dealer *FrontFundr* (July 2016)

Spotlight: Mining Equity Crowdfunding and *Red Cloud* (Prev. *KlondikeStrike*)

Red Cloud, the world's first equity crowdfunding platform for mining companies, was launched in 2016. Investors use the Canadian platform to buy securities in new mining companies and mining companies gain access to new forms of capital. Thanks to the use of the offering memorandum exception, unaccredited investors are able to make (capped) investments. The market structure of the mining industry may help shape the success of *Red Cloud*. Small companies have the potential for scalable growth, often very quickly.

Potential benefits of equity crowdfunding

Encouraging innovation & job growth by decreasing barriers

The ability to raise funds online from the public through a single funding portal potentially lowers transaction costs and increases the development of new ventures. SMEs account for about 77% of all private jobs created in Canada and 65% of net new jobs in the US.

Facilitating market competition

Lowering restrictions to businesses obtaining funding for innovation has the potential to increase competition for investment markets, reducing barriers to raise capital for SMEs, while making cost of capital cheaper (while reducing the fees to be paid to intermediaries).

Filling a financial gap through democratization of capital

Crowdfunding democratizes by offering virtually anyone of legal age access to the investor pool. Successful crowdfunding ventures reflect full market demand for products that may be ignored through the traditional vetting process for raising equity (VC/PE).

Adapting financing patterns to changing demographics

Small investments may be attractive for younger generations, especially Millennials (discussed below), tapping into the sharing economy and pooling resources.

Determine market interest

Crowdfunding platforms function as communication tools to potential investors. They provide business owners a relatively low-cost and low-risk method of testing potential investor interest. Interest in investing in a product may exist outside the small group of angel or accredited investors.

Potential challenges of equity crowdfunding

Risk to retail investors

The crowdfunding equity model contains an obvious and significant risk of loss of the entire amount contributed—including from fraud and abuse. Furthermore, retail investors have a lower level of understanding of valuation methods than sophisticated investors.

Heightened information asymmetry

Allowing individuals with little or no experience to invest in high-risk ventures that do not have to present a full prospectus or audited financial statements presents a limited view of the financial position of the venture to the public and potentially increases the risk of losing the investment.

Long-term uptake

Regulations designed to limit this risk also limit the potential benefit to companies. It is unlikely that equity crowdfunding will become a significant portion of an SME's contributed capital when the \$1.5 million cap in Canada and \$1 million cap under in the US are accounted for.

Uncertain Multiplier Effect

The impact that a new injection of spending will have on the economy is particularly high for the high-tech industry, which makes up a large percentage of start-ups. The catch, however, is the multiplier effect's longevity. There is uncertainty surrounding the extent to which start-ups generate multiple rounds of spending.

Capital Management Challenges

While raising small investments to gain traction in the market may be a viable funding strategy, the administrative costs of managing large capitalization tables with many shareholders may be too high for small start-ups. This may also impact future funding offerings.

Millennial investment patterns & crowdfunding

200%

Millennials are 200% more likely to donate to a crowdfunding campaign than Baby Boomers

100%

Millennials are 100% more likely than Baby Boomers to be interested in investments dedicated to solving social or environmental problems

65%

Millennials are 65% more likely than Baby Boomers to consider ESG factors before investing

67%

Millennials are 67% more likely than Baby Boomers to achieve a balance between financial return and positive societal impact

69%

69% of Millennials considered investments a way to express their social, political, and environmental values

Millennials Are Investing With a Conscience

The integration of personal values and investing has driven the rapid growth of crowdfunding. Millennials increasingly want the ability to invest in projects and ventures they believe in. Crowdfunding fulfils the demand for relatively transparent (depending on legislation and jurisdiction), interactive, peer-to-peer action when ESG implications of choices are considered to be an integrated part of decision-making.

Conclusion

Equity crowdfunding has both laudable benefits and significant challenges. Some of the most pressing issues are:

- Legislation amendments may not sufficiently overcome uncertainty to attract new users;
- There are inherent risks to inexperienced and non-accredited investors; and
- Equity crowdfunding may be unlikely to make up a significant portion of new enterprises' capital raised due to the inherent administrative costs.

Prospects for equity crowdfunding will remain limited while the majority of firms fail to create a return for investors. A major issue revealed in a study of equity crowdfunding demonstrated that 80% of the firms who initially crowdfunded were still in business, while 70 of the firms (approximately one in five) were no longer trading or were experiencing 'difficulties'. Only one firm had realized a return for investors at the time of publication of the report, although 58 firms had gone on to raise funds at higher valuations.

Despite these challenges, the Millennial generation shows promise in using crowdfunding for impact investing. As crowdfunding can tap into their desire for direct connections with the ventures they support, it facilitates direct access between impact ventures and individual investors, accredited or otherwise, interested in seeing the direct impact of their funds. If the issues (particularly the risks) are properly managed, crowdfunding may eventually become an established method to raise capital.