Financial Crowdfunding

A brief discussion on the future in Belgium and abroad

Januari 2016

BoleroCrowdfunding

A brief discussion on the future of financial crowdfunding in Belgium and abroad.

Financial crowdfunding exists now for a couple of years and is – within Europe - most developed in the UK, Germany, France and the Netherlands. Although the concept is rapidly growing in Belgium, absolute numbers are still very low. Relative numbers (e.g. volume/ inhabitant) also show that Belgium is significantly lagging behind the Netherlands, Germany and the UK.

We are convinced that crowdfunding can further grow in Belgium, given the current 'startups explosion', the government's positive attitude towards the startup community and crowdfunding in particular, as well as the availability of plenty of cash. There are – as usual – a few 'buts' holding us back: (1) there is undoubtedly a Belgian attitude of being a bit more cautious, and (2) the 'right' legislation is not yet in place, particularly tax incentives (which form the driving force behind crowdfunding's success in the UK).

In the UK and the US, but also in Australia, for instance, financial crowdfunding is entering into a new, more professional phase (Crowdfunding 2.0), whereas Belgium is still in Crowdfunding Phase 1.0.

We predict that the financial crowdfunding industry in general (beyond Belgium) will undergo a number of 'experiences', and – in order to mature – will (have to) move into a more 'stock-market-like' phase in due time, provided certain important conditions are fulfilled.

In terms of '**experiences**': so far we have mainly witnessed the 'hooray' ones, which is great and stimulating. Year after year, the crowdfunding volume has been steadily increasing and financial crowdfunding, chiefly lending, is establishing itself as an alternative financing vehicle.

As such, there have been thousands of successfully funded deals, i.e.,

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projects which achieved their funding target on a crowdfunding platform (albeit in a syndicated form with 'offline' investors).

While moving forward however, the following experiences will likely occur:

1. **Fraud** will remain under control - as it has been so far

2. **(Equity) Crowdfunding** exits will increase, but will remain a fraction of the total funded deals (less than 10%, and likely less than 5% for the next five years)

3. Failures will increase in the next two to three years and becoming even more significant in the next five years

4. Crowdlending will become a much more important financial vehicle...

5. but lending will face higher delinquency rates

Is this a gloomy picture? At first sight, it appears so, but in our view it is a logical evolution "and reflects the old expression 'there is no such thing as a free lunch'. There is nothing wrong with that, but it is important that crowdfunding at large is (a) adequately 'managed' to the extent possible, (b) priced properly (risk – reward), (c) and that the stakeholders, especially retail investors, are properly educated and informed.

Exits have been few, but their number is increasing as illustrated on the next page.

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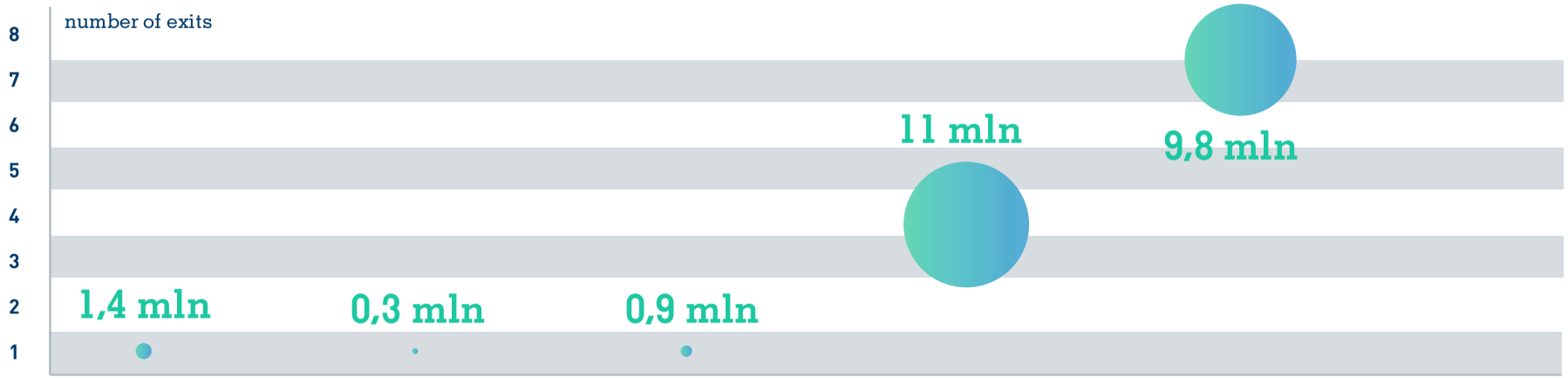
An overiew of crowdfunding-exits worldwide (EUR)



Glen Iron
1,4 mln
ASSOB
IPO

Antabio
0,3 mln
Wi Seed
Buy out by business angel at 44% ROI

Republic Project
0,9 mln
MicroVentures
Acquisition

TalentBin
2 mln
Fundersclub
Acquisition

Mill Residential REIT
3 mln
Syndicate Room
IPO

Chapel Down
3 mln
Seedrs
Stock listed when CF-campaign launched

ReWalk
3 mln
OurCrowd
IPO X 5.5

5 CUPS and Some Sugar
300.000
Companisto
buy-back at 45% ROI

Lottohelden
459.000
Seedmatch
Details unknown

Big Blue Parrot
2.3 mln
iAngels
Acquisition

Flayvr (MyRoll)
1.8 mln
iAngels
Acquisition

Mena
128.193
Eureeca
Buy-back at 150%

E-Car Club
135.085
Crowdcube
Acquisition with multiple return

Chapel Down
1 mln
Seedrs
Stock listed when CF-campaign launched

Camden Town Brewery
3.71 mln
Crowdcube
Acquisition by AB Inbev

deal
crowdfunding dealsize
crowdfunding platform
exit type

Sources: Crowdsourcing, What Investment, Seedmatch, Crowdcube

In order for financial crowdfunding to further mature and become a viable alternative financing vehicle, we believe that it needs to evolve into a 'stock-market-type' ecosystem. A few phases can be distinguished and are illustrated in the stylized graph below.

Source: Bolero Crowdfunding

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The potential end game could look as follows – and some elements are already falling into place in bits and pieces in some countries

1. Harmonized EU crowdfunding-specific legislation – *comprehensive but not 'choking'*
2. EU and country level professional crowdfunding industry organizations
3. Accredited, professional crowdfunding platforms – *fewer than today*
4. Smart funding setups – allowing easier exits and next rounds
5. Smart syndication – inspiring trust and creating win-wins for both professional and non-professional investors
6. Accredited and non-accredited investors
7. Other limits for maximum amounts to be invested/non-accredited investor and amounts which can be raised (online) per deal – higher than today in some countries and lower than today in other countries
8. The right set of incentives – *in particular tax-related*
9. Specific rating agencies for crowdfunding – *new and/or embedded in existing ones*
10. Specific crowdfunding news agencies – *new and/or embedded in existing ones*
11. Educational, academic and informational ecosystems – a matter of responsibility
12. Liquid secondary market(s) – potentially using block chain technology

Keep it 'light'... seeking a balance between 'investor protection' and 'limiting the bureaucratic burden and costs for startups'

The above items seem to be 'a lot' and possibly come across as 'heavy'. They are, however, logical elements of any well-functioning finance system.

Few people need convincing that a **specific legislation** for crowdfunding makes sense in order to allow for e.g. tax incentives, accreditation mechanisms, the need for a low cost administrative system given the 'smallness' of startups, etc. In a next step, EU harmonization would be nice. But ... keep it light. Let's avoid what happened with, for instance, the reality of the IPO prospectus: a very thick book, that obscures the real risk and costs a lot
of money.

Professional industry bodies for crowdfunding can act like similar industry bodies and have such responsibilities as representing the industry vis-à-vis local and EU authorities, centralizing knowledge, organizing events, nurturing networking, etc.

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The phrase 'cowboy platforms' has been dropped left and right to describe financial crowdfunding. Financial crowdfunding is a horse of a different color compared to selling online shares or even non-financial crowdfunding. Therefore, a reasonable set of standards related to risk management, transparency, reporting, privacy management, etc., should be established and crowdfunding platforms should qualify to meet those standards, in order to ensure that the risks investors incur are 'pure' investment risks. Only **accredited platforms** should be allowed to operate financial crowdfunding so that the rules are the same for all players (which is currently not the case as platforms operated by financial institutions face tougher legislations).

Some commentators argue that one of the disadvantages of crowdfunding is that – because of the many different investors – second round financing and exits may become troublesome. This is true. But there are clever ways **to set up up the crowdfunding 'investment'** in such a way that they (= the 'Crowd') are all grouped into one legal unit, so that the startup faces only 'one investor', Mister Crowd, as it were and not hundreds. At Bolero Crowdfunding, we have used this approach and most Belgian PE firms and VCs seem to approve, and find our approach 'very workable'. There are likely other structures available. For instance, another strategy could be to focus only on crowdfunding investors, eventually resulting in an exit via a corporate takeover or IPO with no other investors involved.

Along the same lines, we believe that a **'smart syndication'** is a win-win for most stakeholders. Syndication in this context implies that both professional investors (VCs, PE firms, professional investors, government bodies) invest alongside 'normal' retail investors. Large and small, working together, albeit under the same or different conditions. The advantage for retail investors would be a feeling of reassurance that professionals (who typically have done extensive due diligence) also invest. The other way around also applies: professional investors might not only value the opportunity to close a potential gap in the funding, but they might also value the implicit 'wisdom of the crowds', as well as the 'marketing value' a crowdfunding campaign can bring. Bolero Crowdfunding in Belgium, iAngels in Israel and the Syndicate Room in the UK are examples of platforms pursuing this route.

Every country has different investment regulations for crowdfunding. As a result, investors face different crowdfunding investment regulations, in particular, varying minimum and maximum amounts which can be invested 'per deal'. Our opinion is that there should be a fixed maximum – to avoid that too much risk taken by a retail investor (perhaps hoping for and chasing the 'next' Google or Facebook – but that maximum should be 'adequate'. Our advice to establish/determine this 'adequate' maximum for non-accredited investors would be to compare typical amounts invested by retail investors (not by private banking or wealth clients) via online brokers, which is an amount of between 5,000 EUR and 6,000 EUR. We therefore propose an initial limit of 5k, which will eventually reach, but not exceed, 10k. An alternative approach could be to limit the amount per deal (and the overall amount invested in

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high-risk crowdfunding deals) to maximum X% of investable assets, e.g. 5%. In order to allow for wealthier investors to invest amounts that 'make sense to them', a system of accredited investors could be introduced, modelled on the US system. In that case, investment tickets could be much higher or even unlimited and left to the **accredited investor's** discretion. In addition to having this condition related to the investor's assets, further requirements could be certain professional qualifications, a certain level of stock market experience (based on years spent investing), etc. But... keep it light. Let's keep the US system in mind where finally non-accredited investors are allowed to invest in crowdfunding, but only upon meeting severe requirements. If the maximum amount which can be invested is kept under control, conditions should be few, transparent, and... light.

Maximum amounts... we alluded to this point previously. There is very little upward potential in absolute terms if – like in Belgium – the maximum amount which can be invested in one deal is too low. Even if, in relative terms, a potential exit generated high returns, the absolute return on an investment of 1,000 EUR, for instance, will most often be modest. In addition, in order to gather the required funds online, it is of course much easier if this goal can be reached with fewer people. This logic needs no explanation. The same applies to the maximum amount which ...can be crowdfunded, without a prospectus.. In Belgium this is set at 300k EUR. There are few to no occasions where this maximum has been realized solely by online financial crowdfunding (also because of the limit of 1000 EUR per investor), yet, in practice, many startups require between 500k and 2 million EUR... Let's follow the example of one of the highest crowdfunding rounds to date, as reported by startups.co.uk: "Making the shift from traditional funding options to crowdfunding, in March of this year parking app JustPark raised £3.7m – the UK's largest tech start-up equity crowdfunding round to date – having previously raised investment from venture capital firms. The deal, the highest amount ever invested through crowdfunding platform Crowdcube, was secured in just 34 days of the pitch going live with backing from over 2,900 'armchair' investors. Smashing the company's original £1m target, the campaign saw investments of as little as £10 up to £500,000."

Nothing (or almost nothing) works better than a... **tax incentive**... in which case backers are allowed to use their financial crowdfunding contributions to qualify for tax deductions.

We believe that these tax incentives are not only needed to motivate investors, but also to compensate for the low returns. According to the EVCA statistics, which measure the performance of European VC and PE funds, it is very clear that early stage investing does not pay off. Average returns are near zero. This also implies that higher risks taken in early stage investing are not compensated by better returns. Investing in later stage companies thus makes more sense. And this is where the tax incentive kicks in. If your investment is tax deductible, you have at least a better starting position, and a higher likelihood of positive returns. In this case, the government also benefits: the money flowing into these start-ups doesn't go to other investors, but to the real economy. This

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generates employment, VAT income, and tax income.

The more objective the information, the better. External rating agencies (if they perform well... remember what happened with Enron) and news agencies can play an important role. Dealindex in the UK for instance has been set up with precisely this goal in mind. More transparency is certainly welcome. For example, equity exits are currently not particularly well documented (we have made an attempt here below), and potential returns associated with such exits are hard to figure out.

Our own research has revealed – at least in Belgium – that crowdfunding is still quite unknown, and that financial crowdfunding in particular could benefit from a wider understanding of how it works, its risks, its benefits, etc. In theory, early stage deals could be a valid part of a diversified portfolio, but the (much) higher inherent risk needs to be properly understood. Various stakeholders such as universities, business schools, government bodies and, of course, the crowdfunding platforms themselves should and are all playing key roles in getting the word out through various channels, e.g. papers, info sessions, conferences, webinars, demo sessions, etc. People don't tend to speculate via crowdfunding. Research shows that backers strongly value an 'emotional connection [to] and interest' in the project they are investing. "It is more than the financial play".

Despite the previous statement, one of the main reasons backers engage in financial crowdfunding is the potential financial upside. In cases with a tax incentive, the mere act of investing already provides a financial gain. Apart from the motivational aspect of 'contributing to the economy by supporting a project/company I believe in', the promise of a favorable exit is of course another reason to invest. Exits can occur via the startup being taken over or by an IPO, or by repayments of the principal and interest in the case of crowdlending. However, backers may – just like normal stock market investors – wish to 'back out' and sell (or buy) shares. This is one of the single most important questions our retail stock market investors ask themselves. In due time, a well-functioning **secondary market** will be crucial to maintain a successful financial crowdfunding industry. But... keep it light. If for instance reporting requirements would be the same for this secondary market as those for their big brothers in the 'normal stock market', these startups would likely be crushed by the administrative and reporting burden. There are already such secondary markets active in Australia and New Zeeland (Syndex, set up mid 2015), the US (CircleUp set up mid 2015; CFX owned by PeerRealty set up in April 2015), Finland (Invesdor and Privanet), and the UK (Crowd2Fund which was just set up at the end of 2015). However, these secondary markets are still at a very early stage. Circle Up, for example, only allows investors to sell their shares twice per year. So there will be (a need for) others, there will be consolidation and, in due time, there will (ideally) be transparent, liquid secondary markets for crowdfunding deals.

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