Nesta...

CROWDING IN

HOW THE UK'S BUSINESSES, CHARITIES, GOVERNMENT, AND FINANCIAL SYSTEM CAN MAKE THE MOST OF CROWDFUNDING

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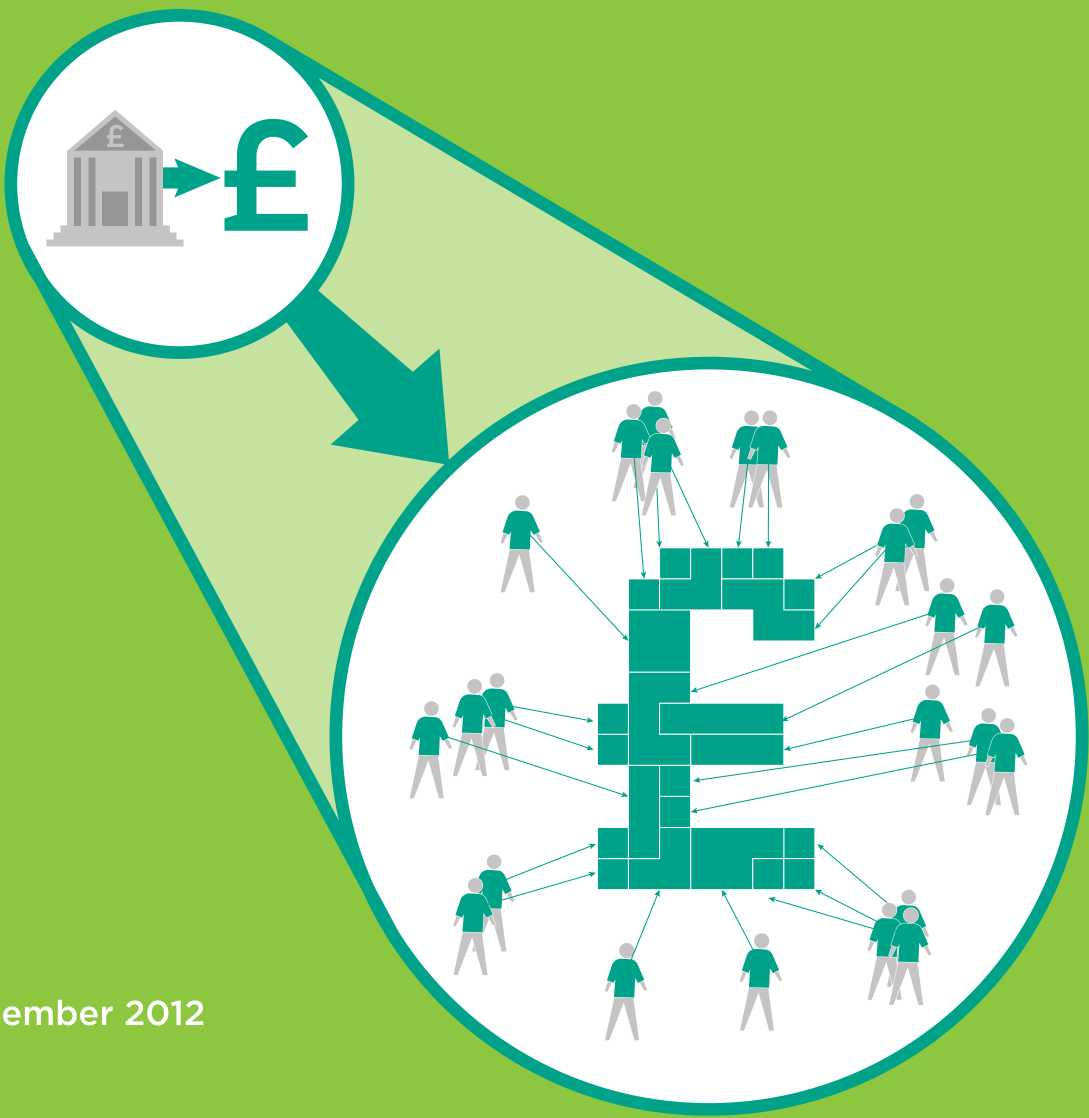

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About Nesta

Nesta is the UK's innovation foundation. We help people and organisations bring great ideas to life. We do this by providing investments and grants and mobilising research, networks and skills.

We are an independent charity and our work is enabled by an endowment from the National Lottery.

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INTRODUCTION

Crowdfunding is hot news right now. Platforms like Kickstarter, Peoplefund.it, Buzzbnk, Zopa, Funding Circle and Crowdcube are allowing thousands of individuals to directly fund projects, businesses and causes.

In 2011, crowdfunders raised $1.5 billion, mostly in the US, to finance over a million projects, ranging from start–ups to community projects, and from new video games to scientific research. The UK crowdfunding market is small, but growing fast. We expect that over the course of 2012 UK crowdfunders will deploy double the £120 million they invested in 2011.

But the real growth lies ahead. It is possible that within three years, crowdfunding could provide around £15 billion of finance per year in the UK. With the right frameworks and standards, this could grow even further, and a day could come where crowdfunding replaces a large proportion of the £115 billion financial services industry.

Crowdfunding is a way of financing projects, businesses and loans through small contributions from a large number of sources, rather than large amounts from a few. The contributions are made directly or through a light–touch platform rather than through banks, charities or stock exchanges. In its modern incarnation, it usually takes advantage of online platforms, such as Kickstarter or Zopa, that allow people to scrutinise projects directly. People often talk of 'peer–to–peer' finance, using the analogy of peer–to–peer computing networks.[1]

Crowdfunding is a very old idea. Public subscriptions were used to fund the base of the Statue of Liberty, mosques on the Indian subcontinent and countless patriotic statues in cities around the world.

What has brought crowdfunding back into the limelight is a combination of modern technology and the financial crisis. The Internet makes it radically easier to connect potential funders with people looking for funding. And it makes it possible to find funders with a special interest in backing even the most esoteric project. People looking to raise funds are no longer limited to appealing to widely held motivations, like the first crowdfunders who drew on people's religious devotion or nationalism. Using the Web, it's possible to identify 10,000 people willing to commemorate Nikola Tesla or mobilise a group of local people to raise £7,793 for a pirate–themed learning centre in London.

1. Sometimes a distinction is made between crowdfunding and peer-to-peer finance. For the purposes of this report, we are treating both as forms of crowdfunding.

A number of models operating in a variety of sectors

The sudden rise of crowdfunding has seen the emergence of several different varieties. They differ primarily in what they offer to funders and what they expect from projects. Some are close to charitable giving – funders expect to receive a warm glow rather than hard cash from their investment. Others offer funders a solid commercial return, in some cases better than the return available from mainstream financial institutions. And in between the two, there are many arrangements that offer funders a mixture of the two types of benefits. For the sake of simplicity, they can be thought of in four categories:

	Form of contribution	Form of return	Motivation of funder
Donation Crowdfunding	Donation	Intangible benefits.	Intrinsic and social motivation.
Reward Crowdfunding	Donation/ Pre-purchase	Rewards but also intangible benefits.	Combination of intrinsic and social motivation and desire for reward.
Crowdfunded Lending	Loan	Repayment of loan with interest. Some socially motivated lending is interest free.	Combination of intrinsic, social and financial motivation.
Equity Crowdfunding	Investment	Return on investment in time if the business does well. Rewards also offered sometimes. Intangible benefits another factor for many investors.	Combination of intrinsic, social and financial motivation.

Within these categories, there is much variation in how crowdfunding takes place.

At the heart of most crowdfunding is the idea of a 'platform': a mechanism, usually a website, that allows would-be investees to make offers to funders, and helps the two parties interact. Kickstarter, Zopa, Peoplefund.it, Buzzbnk, Crowdcude, Seedrs and Funding Circle are all examples of platforms.

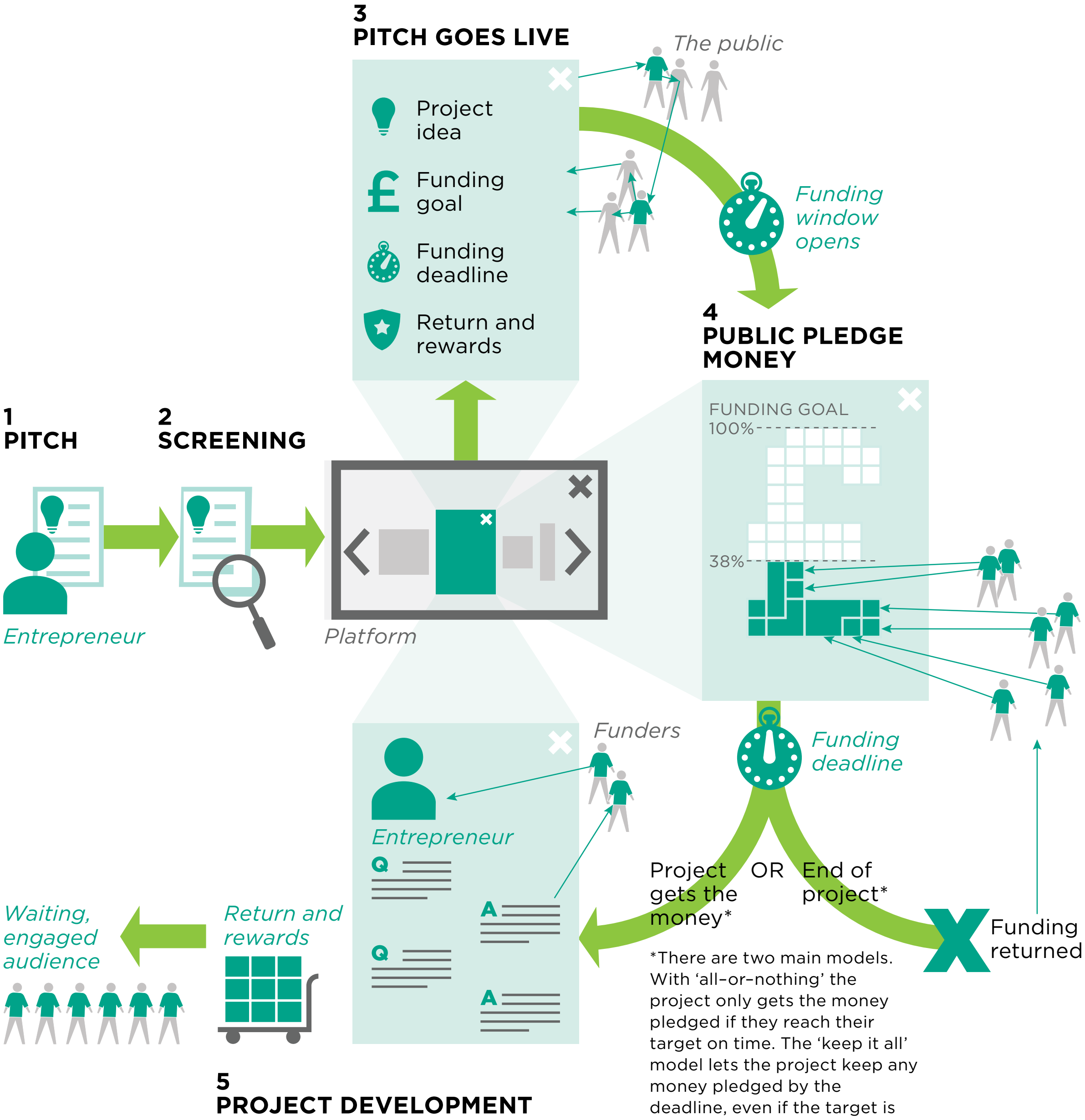
Some are generalists, while others specialise. The dominant players in the market so far have had a general focus on creative projects but we have seen others with a specific focus on games, books, research and public spaces.

But it's not easy

Crowdfunding presents an attractive proposition to those seeking finance in a time where many traditional providers are either less able or less willing to provide finance. It is, however, important to note that it is not easy money. The 'all-or-nothing' operated by most platforms allows individuals to receive the money they raise only if they have met a predetermined target. This means that failure is possible and on many platforms failure rates are large.

In the reward model in particular, platforms have shown that the majority of contributions will be driven there from off-site by the promoting work of the person running the campaign. Although it can be a valuable source of finance it can be a grueling process and those aiming to raise crowdfunds need to work hard and be strategic in their approach if they are to succeed.

THE CROWDFUNDING PROCESS



*There are two main models. With 'all-or-nothing' the project only gets the money pledged if they reach their target on time. The 'keep it all' model lets the project keep any money pledged by the deadline, even if the target is not reached.

SOME EXAMPLES OF UK PLATFORMS EXPLORING CROWDFUNDING POTENTIAL

Peoplefund.it: Is a UK-based platform that helps launch ideas with a social focus. Peoplefund.it builds on the momentum and interest in grass roots campaigning and unlike many other platforms, it lets users donate skills and time as well as money. It is run by the team behind River Cottage and supported by TV food campaigner Hugh Fearnley-Whittingstall, which has enabled the platform to engage a large audience of people interested in projects with a social and sustainable focus. The platform also integrates the book publishing specialist Unbound and arts specialist WeDidThis.

Buzzbnk: Specialises in crowdfunding for social ventures. They do this by creating a community of people who think differently about their philanthropic capital, and encourage them to move from giving reactively to proactively supporting specific projects with a social focus. Buzzbnk has developed a range of flexible financial tools for ventures seeking funds including lending as well as donation and revenue participation.

Solar Schools: Is a very niche platform that helps schools crowdfund solar panels. It does this through combining targeted issue-based campaigning with practical action to cut carbon emissions. Schools apply to be part of the programme and then are supported to crowdfund the cost of installing their own solar roof. The project piloted the idea in 2011 and is currently rolling out and expanding its network further into communities across the UK.

Seedrs: Is a UK-based equity crowdfunding platform that seeks to lower the barrier to entry to investing in start-ups. They do this by making it possible for people to invest as little as £10 in start-ups (traditional angel investing tends to require at least £10,000 per investment).

FundingCircle: Is a peer-to-peer lending platform which cuts out the bank as the middleman and allows people to lend money directly to small businesses that are seeking a loan. Since its launch in 2010, £61 million has been lent to businesses via funding circle.

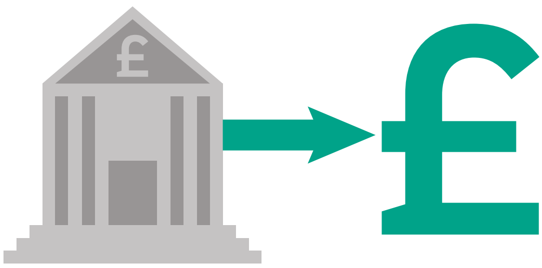
Crowdcube: Is a UK-based equity crowdfunding platform that enable investors to buy up small stakes in start-ups, and for as little as £10 get full dividend rights and a share in the future of the business.

WHAT DOES CROWDFUNDING OFFER?

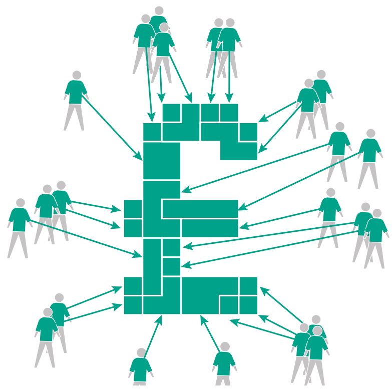
The great promise of crowdfunding is that it offers some advantages that other forms of financing do not. This means that more worthwhile projects and businesses get funded than would otherwise do, and people looking to invest or donate their money have more choices about how to do it. In a world in which financial innovation has come to be associated with greed and skulduggery, it's a welcome change.

In particular, crowdfunding offers four benefits. It is a way to harness people's goodwill towards particular worthwhile or interesting ventures to help them secure funding. It offers lower transaction costs than many established financial channels. By allowing potential customers to be funders, it helps link the supply of finance to demand for a product. And it offers a way to get niche products off the ground. Let's consider each advantage in turn.

TRADITIONAL FUNDING
Large amounts from one, or a few, sources



CROWDFUNDING
Many small sums from a large group of individuals



HARNESSING PEOPLE'S MOTIVATIONS TO GET WORTHWHILE PROJECTS FUNDED

The direct connection between entrepreneur and the crowd gives people the chance to fund a more personalised product, and the entrepreneurs the chance to appeal to investors' motivations and interests as well as their wallets.

"Everyone should be able to buy food that's good for you and that is not detrimental to the environment either." This was the aim of five Edinburgh friends when they started to set up The New Leaf Co-op in Edinburgh in early 2012. To address the need for start-up costs they turned to crowdfunding platform Buzzbnk hoping to tap into what they believed was a significant community that shared the same aim. The founders borrowed £3,340 from the community giving benefits such as discounts and vouchers for the shop instead of an interest rate.

Given that the majority of lenders were motivated to participate by their hope that the shop would become a reality, the founders were also able to source assistance as well as funds from the crowd. Backers helped in numerous ways from the fitting of the shop to providing recipe ideas for soups. In return they were empowered to make a shop they would like to use a reality.

The current state of play

In many cases there is a disconnect that exists between the funders of goods and services and their consumers or end-users.

- Consumers are rarely given the option to directly influence what goods get produced and what services get delivered.
- Entrepreneurs have few options to leverage the intrinsic or social motivations of those who want to see their ideas a reality to get financing on more favourable terms.
- The amount of non-financial support that can be sourced from some traditional funders can be limited.

How crowdfunding can add value

- **Money on more favourable terms:** Crowdfunding allows you the opportunity to access funding from investors who have an inherent interest in making your project or business a success. These funders will often be willing to provide finance on more favourable terms – in the case of some crowdfunding platforms even for free or in return for a token of recognition. In some ways, this is the same phenomenon at work in some of centuries-old 'crowdfunding' projects like subscriptions to build civic statues or places of worship. What has changed is whereas once this benefit was only available to projects that drew on very widely held motivations (such as religious devotion or nationalism), the wide reach of the Web makes it possible to target very narrow communities to fund projects of intrinsic interest.
- **Getting a better product by engaging with the entrepreneur:** Crowdfunding engages consumers in shaping and influencing what they want produced. Early engagement also supports a feeling of added ownership where backers in partnership with the entrepreneur have a stake in trying to make the campaign successful.
- **Getting more than money:** While the crowd can be an excellent source of funds, in many cases their commitment or interest in what you are doing will motivate them to give you other forms of assistance also. This can be in the form of mentoring or feedback, marketing the project to others or assisting with specific tasks.

LOWER TRANSACTION COSTS

By giving investors more of a role in carrying out due diligence, and automating more of of the funding process, crowdfunding can reduce the transaction costs of getting capital to entrepreneurs, making financing cheaper.

Environmental consultancy Sustainable Direction was the first business to seek a crowdfunded loan from platform Funding Circle, who aim to give businesses and savers better deals by reducing the cost and effort of getting money from one to the other. Sustainable Direction received a three-year loan for £12,000 from 53 individual lenders at a rate of 8.4 per cent. The Gloustershire business had sought finance from banks but interest rates of over 12 per cent were requested for the equivalent finance he received via Funding Circle.

The current state of play

Financing businesses and projects through intermediaries involves a number of costs:

- Staff costs required to approve loans, undertake due diligence, and process payments.
- Bricks-and-mortar offices run by the intermediaries.
- The effort expended by entrepreneurs in applying for and receiving funding.

How crowdfunding can add value

Crowdfunding of course involves costs too. But by getting funders involved in the due diligence process and acting as a platform, not as a principal, these costs can be lower than those of traditional finance providers or grant-givers.

- Crowdfunding platforms themselves tend to charge a flat commission of around 5 per cent on the money raised if successful.
- Social media makes it cheaper to reach and engage with geographically dispersed backers.

DEMOCRATISING FUNDING

Crowdfunding is a powerful way of identifying what people want to consume, and what projects they want to see go ahead.

This applies both to for-profit crowdfunding and to charitable crowdfunding. When funding entrepreneurs, a successful crowdfunding round offers validation that there will be a market for a product. When it comes to charitable crowdfunding, the involvement of the crowd can direct funding to popular causes that might be neglected by large institutional funders.

The Albatros is a bookmark with a difference. Unlike traditional models it remains attached to the book and automatically follows you as you read. While perhaps not the most impactful innovation it was something that potentially held significant value for many avid readers. In early 2012 London-based entrepreneur Oscar Lhermitte had finalised on the design but was lacking in capital to put it into production.

Turning to the crowd, he sought to raise $3,000 on crowdfunding site Indiegogo. A clear indication of the potential for the product was revealed as almost 2,000 backers came forward to pre-order the bookmarks contributing a combined amount of $44,596.

The current state of play

When delivering new or improved products or services to the public the most important piece of information is whether there is demand for what is being delivered. However, the accurate measurement of demand is difficult, due to:

- Few large funders faced with the task of assessing the preferences of many potential customers.
- Difficult to distinguish between indicative and real demand in advance of committing capital.

How crowdfunding can add value

Crowdfunding can help better meet demand and reduce wasteful investment by:

- Measuring demand in advance of capital being committed. The all-or-nothing model adopted by the majority of platforms ensures that only those projects that have sufficient support get funded.
- Transparent indication of poor demand from a failed campaign can convince the entrepreneur against committing more effort and capital to the project.
- The model allows flexibility around what is being offered to match the levels of demand that exist. This is generally achieved through stretch limits where you can add extra scale or features to what you are raising money for, if the crowd is willing to fund its development.

FROM MASS PRODUCTION TO PERSONAL PRODUCTION

Crowdfunding helps businesses serve a more diverse and personalised market, by backing what otherwise would fail to get funded.

Manchester-based business niftydrives crowdfunded $384,000 from a crowd of almost 10,000 Kickstarter funders to make the 'Nifty MiniDrive', a memory card designed for Apple's Macbook laptop computer. The entrepreneur's found that the only way to increase the memory on a MacBook was to either physical open it up to increase the built-in memory (voiding your warranty in the process) or using standard memory cards which protrude from the side of the MacBook. Identifying the un-served market of consumers seeking additional memory that did not adversely affect the aesthetic of the Mac, they came up with the Nifty MiniDrive which is shallower than the standard card allowing it to fit flush with the side of the Mac. Offering backers the option to pre-purchase the drives in a variety of colours, they raised significantly more than their $11,000 goal in less than a month.

The current state of play

Entrepreneurs often struggle with accessing funding from both public and private funders, as these tend to operate with criteria of what they fund based on:

- Having upper or lower limits on the amounts they are willing to fund.
- Limiting the scope of what they fund to a particular service or sector.
- Meeting the majority of demand through hit-driven approaches.

How crowdfunding can add value

There are three ways crowdfunding can be seen as addressing these challenges.

- **Spans across traditional sector and funder boundaries.** Many crowdfunding platforms are agnostic with regard to sector and willing to accept projects that span across traditional sector boundaries. The crowd is left to decide what the remit for what can be funded is.
- **Go big or go small – your choice.** Crowdfunding platforms impose few or no limits on how little or how much money can be raised through the platform.
- **Only needs enough demand, not lots of demand.** Can serve smaller markets as potential to scale massively and serve large markets not a condition of receiving funding.

NEW FRONTIERS FOR CROWDFUNDING

These four advantages open a range of new possibilities for crowdfunding. At the moment, it's a niche way of funding small or new businesses, cool projects or charitable undertakings. But it could be much more.

- There's scope for crowdfunding to be a much larger part of the market for business finance. Models like Funding Circle, Market Invoice and Crowdcube are all highly scalable, especially at a time when the main providers of business finance – banks – are trying to deleverage and reduce their exposure.

- Forward-thinking foundations and charitable funders are considering using crowdfunding as a way to disburse philanthropic funds – for example by using some of their money to match crowdfunding commitments, or by using crowdfunding platforms to democratise their own funding process.

- This approach is also being mooted by parts of the public sector. There are many aspects of public spending where government is keen to give a greater role to democracy on how money is spent, from science funding to community development budgets. Crowdfunding platforms offer a way to do this. Could a proportion of the Government's scientific research budget be allocated not by committees and councils but by a democratic process, run through a crowdfunding platform, perhaps with people offering to match funding? What about community development budgets or National Lottery awards?

- Crowdfunding also offers new ways for savers to deploy their funds. Peer-to-peer platforms like Zopa, Funding Circle and Market Invoice already offer better rates for savers than mainstream banks.

- Finally, crowdfunding offers a source of risk capital for businesses too small or too slow growing to be of interest to venture capitalists, who can only afford to look at a tiny minority of companies. If, as some technologists predict, we are entering an age of mass customisation and personal manufacturing, crowdfunding may be an effective way of financing the kind of micro-businesses and small entrepreneurs that will create this new economy.

WHAT NEEDS TO HAPPEN FOR CROWDFUNDING TO THRIVE?

Crowdfunding has the power to change funding in a whole range of fields, from business finance to charitable giving. But we shouldn't naively assume it will transform the world overnight. Indeed, if crowdfunding is to achieve its potential, there are a few key challenges to consider.

Ensuring equality

When it comes to extending crowdfunding to public funds, in fields from community development to scientific research, there's an important trade–off to be managed. On the one hand, crowdfunding can harness the energies and investment of interested citizens – a big plus. On the other hand, not everyone has the same capability and time to get engaged. There is always a risk that those with more time, money, education or agency will get a bigger slice of the pie if crowdfunding is used to portion it up.

The way to deal with this is to be careful in the use of crowdfunding in the allocation of public money: take advantage of its ability to involve motivated people, but don't make the mistake of using it to apportion whole budgets or funds that are intended to go to those unlikely to make use of the underlying technologies. And where possible, build people's awareness of how to use these kinds of platforms to help improve their own communities,

Where will the crowdfunding platforms be based?

If crowdfunding grows significantly, the platforms themselves will become important economic actors. An important question for UK policymakers, then, is where will these platforms be located? There are a number of existing industries where the UK has suffered economically because it has failed to develop a strategic platform: plenty of video games and films are made in the UK, for example, but distributed and financed by foreign firms, which as a result capture a disproportionate amount of value. If crowdfunding takes off but UK platforms don't thrive, we may see a similar loss of value to the UK economy. One important thing the UK Government can do to tackle this is to create the right conditions for UK platforms to grow now: the right regulation, and a willingness to see crowdfunding as a legitimate form of financing.

Risk and regulation

As crowdfunding grows in both the scale and scope, it makes the requirement for some form of oversight more important. This is particularly true of equity crowdfunding where unsophisticated investors will be backing risky ventures in many cases driven primarily by the expectation of making a financial return. But at the same time, the Government should not overreact and introduce the kind of heavy–handed regulation likely to stifle small new platforms. On the whole, the crowdfunding industry is in favour of some kind of proportionate regulation to ensure the sector maintains a good reputation and protects investors' interests. In December, Nesta is hosting a conference of crowdfunders and regulators to discuss exactly what this might consist of and how best to achieve it.

Managing communities

The Internet holds great promise for connecting would-be investors with investees. But the experience of most crowdfunding platforms that Nesta has worked with and interviewed is that developing and 'curating' a community of funders requires real effort. Those who can do it effectively, and who can keep their communities happy and engaged are likely to have a major advantage in the emerging sector.

Standards and data

As well as putting in place the regulations that are prudent but not excessive, there is another role government can play: helping to set the industry and make available the data that can help crowdfunding flourish.

There are two interesting ideas at stake here. Andy Haldane, a senior Bank of England executive, recently suggested that the right standards for financial products could help make peer-to-peer finance easier and less risky. Just as Universal Product Codes (barcodes) on supermarket goods allowed supermarkets to revolutionise their inventories, Haldane argues that the right standards for financial products would allow people to lend money to one another with much less need for banks and other organisations that pool risk.

The second idea relates to business crowdfunding. Many peer-to-peer platforms use some sort of credit scoring to help investors decide where to put their money. Data analytics are getting better by the month, and are increasingly able to provide individual investors with useful guidance on which risks are more or less likely to pay off: businesses such as Duedil are specialising in sophisticated analytics based on public business data. The Government can play a role here by ensuring that businesses continue to produce timely accounts – crowdfunding if anything increases the benefits of regular disclosure.

THE SIZE OF THE CROWDFUNDING OPPORTUNITY

If the crowdfunding industry in the UK and the Government can effectively address these challenges, it's well positioned for rapid growth.

Although it is currently small, providing less than £100 million in finance per year in the UK, it has the potential to expand in a number of large areas. We've considered its potential for expansion in the next three years in a number of sectors below. Together, these add up to a very significant £14.5 billion.

	£ billions, per year		
	Size of segment	**Addressable by crowdfunding**	**Value**
Arts funding and revenue	3.0	20%	0.6
Science funding	4.6	10%	0.5
Other public spending*	5.0	20%	1.0
Business lending	74.9	10%	7.5
Risk capital for businesses	2.1	10%	0.2
Charitable donations	9.3	50%	4.7
Total			**14.5**

*Includes spending by Lottery Funds, DCLG and other Government departments with programmes amenable to crowdfunding.

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