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Harnessing the Crowd: The Demand-Side Dynamics of Equity Crowdfunding in Nascent Entrepreneurial Ventures

By *Ross Brown, Suzanne Mawson, Alexander Rowe and Colin Mason*

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“Harnessing the Crowd: The Demand-Side Dynamics of Equity Crowdfunding in Nascent Entrepreneurial Ventures”

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Abstract

Equity crowdfunding has rapidly established itself as an important part of the funding landscape for entrepreneurial ventures. However, little is known about the 'demand' for equity crowdfunding. This paper reports on a large-scale study of UK equity crowdfunded firms. The study found strong demand for equity crowdfunding from entrepreneurs in consumer-focused, early stage firms. Many were 'discouraged borrowers', attracted by the ability to obtain finance quickly with little diminution in their equity or autonomy. Crowdfunding also seems to confer important intangible benefits to investee companies, in terms of firm valuation and product validation. Implications for theory and future research are outlined.

Keywords: **Entrepreneurship** **Entrepreneurial Finance** **Crowdfunding** **Equity Funding** **New Ventures** **High Growth**

1. Introduction

How business start-ups are financed is a crucial issue within entrepreneurship research (Cassar, 2004; Denis, 2004). Raising finance is especially onerous for new high-tech (Colombo & Grilli, 2007) and innovative firms (Lee, Sameen & Cowling, 2014), many of whom are “high-risk, high-reward projects” (Gompers & Lerner, 2001, p. 145). These problems have undoubtedly been exacerbated by the reductions in bank lending and venture capital (VC) availability since the global financial crisis (GFC) (Cowling, Liu & Ledger, 2012). Ironically, however, during this time there has been a rapid escalation in the supply of ‘alternative’ sources of finance (Bruton et al, 2015), such as debt-based peer-to-peer lending (Duarte, Siegel & Young, 2012; Lin, Prabhala & Viswanathan, 2013), invoice trading (Beack, Collins, & Zhang, 2014), trade credit (McGuiness & Hogan, 2014) and various forms of crowdfunding (Ahlers, Cumming, Günther & Schweizer, 2015; Colombo, Franzoni, & Rossi- Lamastra, 2015; Mollick, 2014). However, to date little work has properly explored the type of ventures utilising these new sources of funding, their motivations for doing so and the perceived benefits and disadvantages. This paper aims to rectify this important gap in the literature.

Crowdfunding has emerged as a particularly prominent source of alternative finance for new ventures (Belleflamme, Lambert & Schwienbacher, 2014; Collins and Pierrakis, 2012; Schreiber & Pinelli, 2013). In essence, it comprises a large number of individuals who typically provide small amounts of finance to businesses via online platforms. There are various forms of crowdfunding: rewards-based, donation-based, lending-based and equity crowdfunding (Collins and Pierrakis, 2012; Hemer, 2011; Mollick, 2014). While originally synonymous with the US firm Kickstarter, which specializes in rewards or donation-based crowdfunding (Colombo et al., 2015; Mollick, 2014), the concept has rapidly expanded both in terms of format and geography and is now found in most parts of the world (World Bank, 2013). In recent years, it has become firmly established as a key alternative "financial instrument" for "risky and often innovative new ventures" (Moritz, Block & Lutz, 2015, p. 26), allowing entrepreneurs to harness "the 'crowd' instead of accessing specialized investors" (Belleflamme et al., 2014, p. 586). Crowdfunding now "represents a potentially disruptive change in the way that new ventures are funded" (Mollick, 2014, p. 14) with the potential to radically transform the market for entrepreneurial finance (Harrison, 2013).

The most recent form of crowdfunding to emerge is *equity crowdfunding*, which has quickly become a key part of the crowdfunding landscape (Baeck et al., 2014; Collins and Pierrakis, 2012). Indeed, some commentators suggest that it is now on the verge of becoming a "substitute seed financing source for entrepreneurial ventures" (Hemer, 2011, p. 2). Equity crowdfunding involves the owner(s) selling an equity stake in a firm in return for investment from external investors. It is growing particularly rapidly in the UK, which is the fastest growing market in Europe for this form of finance by a considerable margin (Wardrop, Zhang, Rau & Gray, 2015). The UK was one of the first countries to give regulatory approval for equity crowdfunding (Bruton, Khavul, Siegel & Wright, 2015), with the crowdfunding platform Seedrs approved by the Financial Conduct Authority in 2012. Moreover, tax incentives originally designed to foster the business angel market - the Seed Enterprise Investment Scheme (SEIS) and the Enterprise Investment Scheme (EIS) - also apply to investments made via equity crowdfunding platforms (Wiltbank, 2009; British Business Bank, 2014)[1]. In 2012, a mere £3.9m was invested through equity crowdfunding, but in 2014 this increased to £84m in 2014, a rise of 410% in only 2 years (Baeck et al., 2014). Equity crowdfunding is also quickly catching up with other forms of equity

[1] The former scheme is deliberately targeted towards seed finance for firms trading for less than two years and offers a higher rate of tax relief (50% compared to 30%).

finance in terms of the number of deals closed each year. For example, it accounted or 18.5% of all visible equity deals and 32% of all visible seed-stage deals in the first half of 2014 (British Business Bank, 2014). Indeed, since its inception in 2011, the UK's largest crowdfunding platform, Crowdcube, has alone raised over £100 million on behalf of 290 ventures.

However, there is a need to go beyond these headline figures and the associated hype to investigate how equity crowdfunding operates and, in particular, to examine the *demand side* which has been largely ignored to date. Why do firms choose to engage in equity crowdfunding? And is its emergence and growth actually a 'good thing' for small and medium-sized enterprises (SMEs)? While this issue is now being debated (Fraser, Bhaumik & Wright, 2015; Harrison, 2013), to date little research has directly addressed these questions. While a number of studies have examined the supply side of crowdfunding, such as the motivations for investing in crowdfunding campaigns (Cholakova & Clarysse, 2015; Moritz et al., 2015), little is known "about what drives entrepreneurs to use equity crowdfunding" (Ahlers et al., 2015, p. 21). Indeed, this dearth of research means that even a "basic academic knowledge of the dynamics of crowdfunding is lacking" (Mollick, 2014, p. 1).

As a contribution to closing this research gap, this paper reports findings from an interview-based study of UK equity crowdfunded ventures - to our knowledge the largest such study to date. This study examined the types of firms seeking equity crowdfunding, the rationale for seeking it, their experiences of the crowdfunding process and how the funding raised impacted their development. The overriding research question was: "*what is the nature of the demand for equity crowdfunding in the UK and what effect does this type of entrepreneurial financing have on recipient ventures and their business development*?"

The paper is structured as follows. First, definitional issues are discussed. The nascent literature on crowdfunding, focusing on demand side issues, is then reviewed with a number of research questions raised. The research methodology and characteristics of respondent firms are then outlined before empirical findings are presented and discussed with reference to the research questions posited. The paper ends with some conclusions and areas for further research.

2. Equity Crowdfunding: Antecedents and Definitions

First developed during the 2000s, *crowdsourcing* has become an important concept for businesses (Howe, 2006; Tapscott & Williams, 2006). Crowdsourcing is closely related to the more academic concept of ‘open innovation’ (Chesbrough, 2003), whereby firms derive sources of knowledge and resources from outside their own organisational boundaries, which is considered invaluable for resource-scarce new ventures and SMEs (Enkel, Gassmann & Chesbrough, 2009). As scholars have noted, crowdfunding is rooted in the broader concept of crowdsourcing, where the ‘crowd’ are collectively tapped to provide “ideas, feedback, and solutions to develop corporate activities” (Belleflamme et al., 2014, p. 586).

Crowdfunding itself is a multi-dimensional phenomenon. The cornerstone of the concept is the incorporation of technology, primarily the Internet, which acts as a conduit between investors (i.e. the supply side) and entrepreneurs (the demand-side). Given the multiple forms crowdfunding can take, ‘hybridisation’ can occur whereby models are combined (e.g. rewards-based and equity funding) (Cholakova & Clarysse, 2015). Thus, it is perhaps unsurprising that there is definitional variation and ambiguity in the nascent crowdfunding literature. Mollick (2014, p. 2), for example, defines crowdfunding as “the efforts by entrepreneurial individuals and groups - cultural, social, and for-profit - to fund their ventures by drawing on relatively small contributions from a relatively large number of individuals using the internet, without standard financial intermediaries". Harrison (2013, p. 286) describes crowdfunding as the "disintermediation of the finance market as funders and promoters are brought together directly." Whilst these definitions are helpful, they remain broad and do not reflect the diversity of the crowdfunding concept. There is thus a need for researchers to not only be explicit about the form of crowdfunding under investigation, but also to contribute to our understanding of these different models – and the crowdfunding phenomenon generally - through the development of more detailed and nuanced definitions.

This paper looks specifically at the equity crowdfunding model, which involves "the sale of a security" (Harrison, 2013, p. 286). It is therefore fundamentally different from other crowdfunding mechanisms in that investors become interwoven into the fabric of the firm as shareholders. Equity crowdfunding has been loosely defined as "a model in which crowdfunders receive a financial compensation" (Belleflamme et al., 2013, p. 317). Ahlers et al. (2015, p. 4) offer a more developed definition of equity crowdfunding as "a method of financing, whereby an entrepreneur sells a specified amount of equity or bond-like shares in a company to a group of (small) investors through an open call for funding on Internet-based platforms". These definitions imply that the 'crowd' are small or non-specialised investors.

This may be slightly misleading, however. Many crowdfunding investors are in fact business angels, who can hold significant influence over the decision-making within a crowdfunded firm owing to their large shareholdings (Bruton et al., 2015). Indeed, a recent study found that 45% of angels surveyed had invested through crowdfunding platforms in the UK, with younger angels more inclined to co-invest through crowdfunding platforms (Wright, Hart & Fu, 2015)[2]. Therefore, for the purposes of this paper, we define equity crowdfunding as: *investments via an internet platform undertaken by both specialist and small novice investors in return for share capital, which is issued directly to investors or held by a nominee.*

3. Literature

Entrepreneurship scholars have struggled to catch-up with the rapidly altering financial landscape confronting entrepreneurial ventures that has resulted from the rapid growth of alternative financial instruments (Bruton et al., 2015). Until recently, research on alternative sources of finance was seriously hampered by a lack of available data (Mollick, 2014). Scholars are now slowly beginning to provide evidence on the various forms of alternative finance, in particular crowdfunding, although the literature remains limited. We have therefore drawn on literature from the wider area of entrepreneurial finance to shape the research themes underpinning our study. A deliberate attempt has been made to draw upon the research gaps identified in the nascent crowdfunding literature (see, for example, Bruton et al., 2015).

A large body of literature notes the perennial problems that new and young and firms face when accessing finance. Their lack of cash flow or collateral to borrow against (Berger & Udell, 1998; Carpenter & Petersen, 2002) and absence of a credit track record (Binks & Ennew, 1996), combined with the lending technologies utilised by banks (Berger & Black, 2011), means that they are unable to access debt finance. This forces such firms to seek venture capital. However, VC funds do not make small investments given high fixed overheads and they do not invest in

[2] However, another UK study found this number to be much smaller, at around 22% (Mason and Botelho, 2014).

new and early-stage ventures, particularly those that are pre-revenue with untested technology and/or embryonic business models (Wright, Lockett, Clarysse & Binks, 2006). Business angels are inclined to invest in business propositions that are unattractive to VCs (Mason and Harrison, 1997). However, angels typically invest in just one or two percent of the opportunities that they consider (Carpentier & Suret, 2015; Riding, Dal Cin, Duxbury, Haines, & Safrata, 1993). Although the available evidence shows that levels of angel investment have been maintained since the GFC (Mason and Harrison, 2015; Wright et al., 2015), angels have placed a greater emphasis on making follow-on investments within their existing portfolios (Mason, Botelho & Harrison, 2013). This apparent 'breakage' in the funding escalator for both debt and equity funding (North, Baldock & Ullah, 2013) seems to have ignited the demand for alternative non-traditional sources of funding.

While the causal factors surrounding the emergence of crowdfunding seem fairly clear-cut, the drivers influencing entrepreneurs to utilise crowdfunding is less well understood (Ahlers et al., 2015; Frydrych, Bock, Kinder & Koeck, 2014). Some authors suggest there will be "considerable variation in the behaviour of entrepreneurs seeking different forms of this finance, and these differences warrant investigation" (Bruton et al., 2015, p. 18). The extent to which the increased demand for crowdfunding is a function of the inability to access traditional sources of funding also remains unclear. Bruton et al. (2015) hypothesise that the demand for alternative funding may hinge on certain cognitive factors that shape entrepreneurial decision-making, particularly *discouragement* (Freel, Carter, Tagg & Mason, 2012; Kon & Storey, 2003). Discouragement occurs when borrowers are deterred from apply for bank funding "because they feel they will be rejected" (Kon & Storey, 2003, p. 7). Anecdotal evidence suggests that equity crowdfunding appeals to entrepreneurs who feel unlikely to be able to access conventional forms of bank lending (Collins & Pierrakis, 2012). Indeed, bad credit scores have been found to increase the probability that ventures seek crowdfunding (Blaseg & Koetter, 2015). However, comprehensive empirical evidence on this relationship does not yet exist. Therefore, our first research question is: *are equity crowdfunded firms discouraged borrowers?*

While the rationale for seeking funding is important, so too is the preference for the type of funding chosen. Under the 'pecking order' theory of funding preferences, based on the loss of control associated with different types of finance (Myers & Majluf, 1984), firms are assumed to favour (in descending order) internal funds, bank lending and then equity sources of finance. This suggests that only after internal funds have been exhausted – the so called "3Fs" (founders, family and friends) – do firms approach external sources of funding. Their first approach will be to banks for debt funding. Only if this route is unsuccessful, will firms consider ceding equity in return for funding. A limitation of this model is that it does not distinguish between alternative types of equity finance, which becomes a critical issue when looking at equity crowdfunding.

Many 'crowdinvestors' are not professional investors and as such "they tend to require less information upfront and spend less time (if any at all) negotiating detailed contracts" (Macht & Weatherston, 2014, p. 9). Individual shareholders also do not have a big enough shareholding to exert power over the management team and they may be offered B-class shares that have no voting rights attached. All of this is in sharp contrast to the usual process of venture capital angel investment. VCs and angels require much more information when considering whether or not to invest and negotiate on the valuation of the business (Alexy, Block, Sandner & Ter Wal, 2012; Mason and Harrison, 1996). Recent research has also found that the amount of equity given during the crowdfunding process is significantly lower than that given to angel investors (Financial Times, 2015). Just as "investor heterogeneity matters" between VCs and angels

(Collewaert and Manigart, 2015), firms obtaining crowdfunding may be able to relinquish less equity compared with these traditional sources of entrepreneurial finance. This leads to our second research question: *do firms specifically pursue crowdfunding rather than other entrepreneurial finance to minimise their equity dilution and to retain maximum autonomy?*

A further promising theme emerging from the nascent crowdfunding literature concerns the determinants of success of crowdfunding campaigns. In equity crowdfunding, entrepreneurs with higher levels of human capital, such as MBAs, were found to have more success in raising funding (Ahlers et al., 2015). The success of campaigns is also thought to rest heavily on the levels of social capital that a firm can develop during the early stages of the fundraising process, ascribing a close association between campaign success and the "interplay of observational learning, constructive feedback, and word-of-mouth" (Colombo et al., 2015, p. 96). This echoes other work which emphasises how networking and relational factors are crucial for early stage ventures more generally (Sullivan & Ford, 2014; Witt, 2004) – the so-called "network success hypothesis" (Brüderl & Preisendörfer, 1998). It would seem likely that relational compatibility and goal congruence between investors and firms seeking investment would enhance the chance of successful crowdfunding campaigns. However not all the empirical evidence corroborates the importance of social capital (Ahlers et al., 2015). From this line of reasoning we derive the following supplementary question: *are personal networks important for firms to successfully undertake crowdfunding?*

Finally, whereas there exists a sizeable literature surrounding the value added contributions that VCs and business angels make to their investee companies (Hellmann & Puri, 2002; Politis, 2008), there is little evidence whether value-added benefits also accrue from equity crowdfunding (Macht & Weatherston, 2014). Some early observers felt that crowdfunding could provide the “wisdom of the crowds” (Surowiecki, 2004) whereby “individuals from diverse backgrounds, with expertise in different fields, bring various pools of local knowledge together” (Collins & Pierrakis, 2012, p. 25). Indeed, a number of studies have identified various benefits that can arise from crowdfunding (Belleflamme et al., 2014; Lehner et al., 2015), including public exposure and validation from customers. In this sense, “crowdfunding can be used as a promotion device, as a means to support mass customization or user-based innovation” (Belleflamme et al., 2014, p. 602). However, other scholars note that as “crowds are frequently stupid” (Isenberg, 2012, p 4) their benefit to a firm outwith initial financial investment might be limited. Therefore, the final research question is: *do firms obtain tangible and non-tangible benefits from crowdfunding?*

4. Method, Data Analysis and Sample Characteristics

As with many areas of entrepreneurship research (Suddaby, Bruton & Si, 2015), most crowdfunding research has been quantitative (e.g. Belleflamme et al., 2014; Cholakova & Clarysse, 2015; Colombo et al., 2015; Mollick, 2014), with very few studies adopting a qualitative approach (e.g. Lehner et al., 2015; Schweinbacher & Larralde, 2012). The consequence is that many aspects of crowdfunding remain poorly understood, including the nature of entrepreneurs who opt for this mode of funding, the motivational drivers for undertaking crowdfunding, the process of raising finance through crowdfunding, and the impact of the finance raised through crowdfunding on business development. As other scholars have noted, "it is [therefore] important to move crowdfunding research into more qualitative research methods to provide deeper understanding of specific entrepreneurial activities and processes"

(Frydrych, Kinder & Koch, 2014, p. 15). This study draws on in-depth qualitative interviews with 42 UK-based entrepreneurs who have successfully obtained equity crowdfunding to explore how and why entrepreneurs engage in crowdfunding. In the UK, 228 equity crowdfunding deals[3] have been documented between 2011 and the first half of 2014 (British Business Bank, 2014). Our sample therefore represents 18% of all equity crowdfunded deals completed in the UK during this time period.

Data collection and analysis

Interviews with entrepreneurs were undertaken between March and June 2015. The interviews were semi-structured and were conducted either by telephone or Skype, and were on average 50 minutes in length. They were then recorded and transcribed. Respondents were identified purposively via the three main equity crowdfunding platforms in the UK - Crowdcube, Seedrs and SyndicateRoom[4]. To be eligible for inclusion in the study, they were required to have completed the funding process by February 2015. Through a process of snowballing, a small number of other firms (n=4) were identified and interviewed who had raised crowdfunding through other UK-based equity platforms (ShareIn and Crowdbank). Entrepreneurial founders/owners were targeted, as they were deemed to be the most appropriate respondents (Seidler, 1974) for this research. Of the 160 entrepreneurs contacted, 42 agreed to participate, giving a response rate of 26%. Although it varies from platform-to-platform, it is important to note that the success rate for raising equity finance on crowdfunding platforms is relatively low, with only around 40% of firms successfully completing the funding process (Financial Times,

[3] This figure includes equity deals completed via crowdfunding platforms as well equity deals completed by individual companies independent of a third party crowdfunding platform.
[4] Company information is available via Crowdcube, Seedrs and Syndicate Room for the majority of firms that have successfully raised crowdfunding. 156 firms were identified across the three platforms for this study.

2015). Thus the entrepreneurs interviewed should be considered atypical rather than representative of all those who start the crowdfunding process.

Interviews were also conducted with a number of business angels who had co-invested through crowdfunding platforms (n=2), equity crowdfunding platforms themselves (n=3), intermediaries (lawyers, accountants) (n=2) and a specialist crowdfunding consultant (n=1) to triangulate emerging themes (Patton, 2002) and develop a more holistic understanding of the entire crowdfunding process and the wider crowdfunding ecosystem.

The data was analysed using a coding framework based on *a priori* codes derived from the literature, as well from themes that emerged during the interviews (Graebner, 2009). To ensure analytical rigour and "authenticity" of constructs and classifications (Guba & Lincoln, 1994), coding was undertaken by each of the researchers independently before coming together to discuss the findings. Key direct quotations have been used in order to ensure transparency of collected data (Healy & Perry, 2000).

Profile of Interviewee Businesses

The vast majority (90%) of entrepreneurs who that raised finance were male (n=38), predominantly in the 25-45 age range, many of whom had significant previous entrepreneurial experience. All of the entrepreneurs exhibited the classic attitudes and behaviours of growth oriented entrepreneurs, noting an appreciation of risk, high levels of entrepreneurial ambition, and the desire to grow their business (in both turnover and profitability). The firms had innovative make-ups in the widest sense – many had cutting edge patentable IP (e.g. graphene-based materials), many were proposing new technological propositions or product/service offerings within traditional sectors while others were adopting innovative business models

(Teece, 2010). The vast majority of entrepreneurs were looking for start-up and growth capital to develop their businesses.

The majority of businesses were early stage (often pre-revenue) aged between 1-3 years (see Figure 1). This suggests that it is primarily new start-ups who succeed in raising this form of finance. However, due to the presence of some more established firms, the average firm age in our sample was 4 years.

Insert Figure 1 here

The firms were operating in a wide range of industrial sectors (see Figure 2), the most common being Food and Drink (n=11), Digital Media (n=7) Clean Tech (n=5) and Transport (n=4).

Insert Figure 2 here

Very few of the companies in the sample (n=4) exemplified the traditional 'high tech' venture with high levels of Research and Development (R&D) activity. Most were operating in the B2C markets focusing on consumer products and services, although B2B firms were also well represented.

The firms had a distinctive geography (see Figure 3), with half of the sample located in London (n=21), with other small pockets in Bristol (n=3), Edinburgh (n=2) and Oxford (n=2). The remaining 14 firms were scattered around the country, including in the South West, the Midlands, the North of England and the central belt of Scotland.

Insert Figure 3 here

This spatial concentration in London and the south east of England corresponds with other research on equity crowdfunding in the UK (Baeck et al., 2014; British Business Bank, 2014).

This suggests that access to – and engagement with – crowdfunding is subject to the same north-south geographical bias exhibited by venture capital investments (Martin, Berndt, Klagge & Sunley, 2005; Mason & Pierrakis, 2013)

Approximately half of the firms (n=20) raised between £100k and £199k (see Figure 4). The average amount raised by firms in our sample was £408,484, while the median value was £150,785. The average amount raised was double that identified by Nesta (£199k) for the 2012-2014 period (Baeck et al., 2014), suggesting that deal size is increasing. Five companies raised over £1million. Excluding these firms from the analysis, the average amount raised drops to £237,339, still above the Nesta figure.

Insert Figure 4 here

To raise this investment, firms issued between 5.81% and 32.17% equity (on average 18.95%) to between 3 and 966 individual investors (on average 165). These figures exclude firms which raised finance using the Seedrs platform (n=13) which has a nominee structure where all investments are managed by a single nominee. While it was not always possible to know the exact composition of investors within the crowdfunded rounds, interestingly, business angels were active in roughly two-thirds of the cases examined (n=28).

5. Findings

The following discussion is structured around five key themes: the preparatory work required before engaging in crowdfunding; the rationale underpinning the demand for crowdfunding; the benefits (and drawbacks) of this form of entrepreneurial finance; and the impact of finance raised on the entrepreneur and their business, including its effect on demand for further rounds of crowdfunding.

Preparatory Undertakings

The first issue explored was how entrepreneurs became aware of the specific crowdfunding platform that they utilised. For approximately half of the entrepreneurs (n=20), engaging with a crowdfunding platform was an *ad hoc* rather than planned 'event', often influenced by peer-to-peer interactions and word of mouth. For the large minority (n=18) of entrepreneurs, it was a planned process, whereby financing options (and their pros and cons) had been critically appraised, with crowdfunding deemed to be the most appropriate funding mechanism. In a minority of cases (n=4), crowdfunding was a 'last resort' for firms that needed funding as soon as possible and had no alternative avenues to pursue.

Regardless of whether the approach was planned or ad hoc, the entrepreneurs interviewed were all well-informed individuals, with the majority (n=35) actively tracking and reading up on crowdfunding in advance of exploring this funding mechanism for their own ventures. They could be considered 'early adopters' of both the crowdfunding concept and of its use as a source of alternative entrepreneurial finance. However, despite their knowledge, not all entrepreneurs were successful with their initial approaches to crowdfunding platforms. Two entrepreneurs in our sample were rejected on their first approach to a platform because of a perceived lack of fit with the platform's investor profile, disagreements over the company valuation and doubts about the firm's potential to meet the fundraising target[5]. This required these entrepreneurs to investigate and make further approaches to other platforms, which vary widely in terms of the nature of their 'crowd', how they take equity, company valuation and account management.

[5] Respondents from Crowdcube and Seedrs noted that only 1 in 5 applications to their platforms are accepted.

A number of entrepreneurs (n=11) explicitly noted the significant pressure that platforms placed on them to quickly line up funds and investors in advance of launching their crowdfunding campaign, in order to build early momentum. Others observed that they had anticipated this requirement (given their background research on crowdfunding) and were prepared for this eventuality. Hence many firms had to undertake a *pre-seeding* round of funding in order to influence 'herding' behaviour by the crowd. If a firm had already raised - or had commitments for - 30% or more of their funding target, investors appeared to be more ready and willing to invest.[6] Business angels were often used in this pre-seeding function to give the campaign early momentum, highlighting the emerging complementarity between angels and the crowd.

> "*The big angel investors we brought in to seed the crowdfunding round- they came independently of Seedrs so we have 3 additional shareholders on the register in addition to the Seedrs nominee*"

In other instances pre-seeding was facilitated through family, friends and other business relationships, emphasising the importance of social capital and personal networks.

Nature of the Demand for Equity Crowdfunding

The entrepreneurs articulated a number of factors that had influenced their interest in, and ultimately use of, equity crowdfunding as a source of entrepreneurial finance. An important consideration for the majority (n=29) was the perceived lack of other financing alternatives available. As the majority of these firms were early stage ventures, they often lacked collateral and assets, as well as a proven financial track record. These 'liabilities of newness' (Stinchcombe, 1965) resulted in entrepreneurs thinking that they were unlikely to be able to

[6] Indeed, interviews with the platforms suggest that they actively encourage firms to pre-seed around a third of the target value.

obtain debt funding from traditional bank lending (n=26) or equity funding from venture capital (n=17) and business angels (n=19). As one entrepreneur explained:

> *"Banks are just too expensive and VCs want too high an amount of money. Also, they require you to have revenue, so when you don't have revenue it's a pretty hard thing to crack. And it's not like Silicon Valley where people will invest in pre-revenue companies based on valuations of individuals like engineers or MBA candidates."*

The entrepreneurs interviewed were therefore *discouraged* (Kon & Storey, 2003) rather than *declined borrowers*[7]. Very few (n=11) had directly considered approaching their bank or other financial institutions, let alone had made an approach (n=9). No one had been turned down by a financial institution.

> *"We didn't even look in to [a bank loan]. We felt banks would not fund us for the amount we needed and the limited experience we had under our belts."*

The general feeling amongst respondents was that it is currently easier to get money "*from the crowd than from the bank*", particularly if firms are selling a product or service that resonate with the general public. Again, the common view appeared to be that individuals tend to buy into concepts and thus growth potential, whereas financial institutions tend to be more interested in a financial track record to mitigate lending risks.

Although the firms included in our sample had all pursued equity crowdfunding, it was clear that these entrepreneurs were very conscious of the equity-finance trade-off (as well as other financing options available to them). Most of the entrepreneurs explained that crowdfunding

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[7] While the term 'discouraged borrowers' (Kon & Storey, 2003) is normally associated with bank debt finance, we extend it here to other forms of funding such as VC and business angels etc.

offered the most attractive mechanism to retain maximum equity and autonomy, whilst still raising much needed capital. Many (n=11) noted that Crowdfunding offered relatively favourable valuations of their companies, in contrast to business angels, who tend to be "*tougher on price*". The entrepreneurs also indicated that, due to difficulties obtaining business angels given a lack of contacts, they were "*happy to experiment*" with crowdfunding as an alternative source of equity financing. In summary, the focus of the nearly all the firms interviewed was to raise 'growth capital' through equity crowdfunding, which they felt they could do without losing either significant equity to investors or entering into a long repayment process with the banks.

> "*It filled a gap – good way of getting angels together as well as friends and family. Great advantage over control, you name the price yourself – it's not a negotiation.*"

However, although interviewees considered crowdfunding to be a critical mechanism for raising early-stage growth capital, they all regarded it as only one part of a wider funding strategy. These entrepreneurs were therefore not looking to replace other sources of financing with crowdfunding. Rather they sought to augment other debt and equity instruments as "*part of [their] wider funding strategy*" to best serve the needs and interests of their companies.

The majority of respondents (n=29) noted that, whilst crowdfunding is particularly relevant to them at this point in time, they will certainly look to other sources of finance in the future and will adjust their funding strategies as appropriate.

Benefits of Equity Crowdfunding

Respondents articulated a number of benefits with regard to equity crowdfunding. A critical issue for most respondents was 'speed'. Unquestionably, the biggest single advantage associated with crowdfunding cited by 19 entrepreneurs was the speed at which a round of crowdfunding can be completed, in comparison with other sources of financing.

> *"Crowdfunding is probably quicker than VCs or angel investors."*
>
> *"[Angels and VCs] are slow, they drag their feet"*

The average length of time taken by the entrepreneurs in our sample to raise financing via crowdfunding varied from nine days to over four months, with many entrepreneurs noting their surprise at how quickly the process was completed.[8] The speed of raising funding meant that "*distractions were minimised*", thus allowing firms to "*get back into action*" quickly. Indeed, the majority of entrepreneurs were quick to identify the importance of speed when raising finance for early stage businesses, as drawn-out discussions with potential investors can hinder day-to-day operations and put at risk the sustainability and growth of a new venture.

Respondents also noted that crowdfunding offered non-financial benefits in terms of concept validation and company valuation. Given the early-stage nature of the majority of companies in the sample, achieving proof-of-concept and product/service validation were of particular concern. A significant number (n=21) emphasised that they hoped obtaining funding from the crowd would validate and endorse their core offering and their business model generally. They also hoped that they would build a pipeline of potential customers in the process. Additionally, around half of the firms in our sample - particularly those that had very recently started trading and those that had grown rapidly - sought to use the crowdfunding process to put a value on the company as the entrepreneurs were unsure of the business' market value.

[8] Note that many entrepreneurs did not include the amount of time spent on preparatory work (e.g. developing a business plan; obtaining initial investment from the angel community) in their conception of the length of the crowdfunding process. In reality, the process was often more lengthy than respondents acknowledged.

> *"Crowdfunding had a useful purpose in pinning down the value of the business and that's what it did – it pinned down the value of the company at a level that we worked with."*

> *"It was Crowdcube who valued the company at a certain value which was great for me and people were willing to offer investments for essentially something that didn't really exist yet. So, in a way, it was sort of 'free money.'"*

A number of entrepreneurs reported that the crowdfunding process gave them a more favourable valuation than they would have had from VCs or business angels.

> "*We did do a little more angel hunting before deciding to crowdfund, but tended to find that in general both angels and venture capital firms were asking for larger equity stakes than we were prepared to give.*"

Finally, respondents were keen to stress the importance of having external investors. The majority (n=24) specifically emphasised the benefit of being held accountable to those with a stake in the business, noting that this provided a set of checks and balances to ensure that the performance of the business was kept on track. This perceived accountability to investors was consistent regardless of the type of investor (professional or 'one of the crowd') and the amount invested. As one entrepreneur commented:

> *"We feel that equity makes you more accountable, it makes you more responsible, it makes you work harder."*

In summary, the entrepreneurs in the sample were genuinely appreciative of having a "*critical mass*" of supporters, offering not just financial support but also potentially other forms of assistance as required.

"The fact that someone has put their faith in me is a real thing for me but it's also quite worrying and daunting."

"You have an audience who are willing you on – they want to see you succeed and they have a vested interest in you being a success."

Disadvantages of Equity Crowdfunding

Respondents noted that crowdfunding also has some disadvantages. A significant minority of entrepreneurs (n=18) reported that it entailed a significant administrative burden, including liaising with the crowdfunding platform, meeting the requirements for EIS/SEIS, responding to requests for business plans and other company information from potential investors and, upon receipt of funding, responding to queries from a multitude of investors.

"[Your investors] have all put in a chunk of equity. If you're spending half your time keeping them happy then that's a problem, not a benefit."

Many entrepreneurs noted that queries from investors had taken up significantly more time than they had anticipated. In some cases, particularly in more technical B2B concepts, this was due to the fact that investors had a limited understanding of the nature of the business and its produce/service offering and required significant "*education*" about the business. In other cases it was simply a challenge to manage a multitude of small investors, all of whom had different interests, queries, motivations and investment knowledge. This was particularly the case in firms that added over 100 new investors (n=15). As one of these entrepreneurs explained:

"Dealing with 120+ investors individually can be a nightmare! The structure with, say, 120 individual investors can also put off future investors such as VCs just due to the admin involved."

Although largely considered a benefit, valuation was, for a minority of businesses, considered to be a potential drawback of crowdfunding. A number of entrepreneurs noted that they struggled to come to a fair valuation of their business with the crowdfunding platform, only to have to subsequently revise this valuation in order to generate interest from the crowd.

> *"We hit a wall about 5/6 weeks in when investment dried up. So we made the decision to reduce the valuation of the company. In came some heavy hitters and the whole thing was over in a week."*

This raises an important question about firm valuation, specifically is a 'fair valuation' for a business by experts a valuation that the wider 'crowd' will ultimately accept? Or are businesses at the mercy of uninformed 'amateurs'?

A further potential disadvantage of crowdfunding is the reputational risk (and potentially longer-term viability) to the business should it be unable to raise its minimum target funding. A number of entrepreneurs (n=8) commented that they were under significant pressure to meet their fund-raising threshold, because failure to do so would have a negative impact on public perception of the business and influence the possibility of raising future finance through follow-on rounds of crowdfunding or other entrepreneurial finance. Although crowdfunding was recognised to offer enhanced visibility compared with raising investment from business angels and VCs, this visibility could also have a downside.

A final disadvantage identified by entrepreneurs was the issue of access to further rounds of finance. The vast majority of respondents (n=37) noted that crowdfunding provided short term limited finance and that, over time, this mechanism would become simply one part of their overarching financing strategy.

"We would consider using it again, but we'd think carefully if it was the right approach. Many investors are lacking business experience and this could be difficult for us – we're not only looking for the money."

A number of entrepreneurs expressed concern over how easy it would be to undertake repeat rounds of crowdfunding, particularly once the business has scaled, noting that at that point it might be less efficient and straightforward compared with taking out a bank loan or standing line of credit. Very few entrepreneurs (n=4) were expecting to undertake further rounds of crowdfunding, with the majority expressing hesitation about its appropriateness as their companies expanded.

"*We won't be using [crowdfunding] again. We'll be looking to raise a lot more next time around and I don't think that the crowd will be the best source."*

Longer-Term Impact of Equity Crowdfunding

Reflections by the entrepreneurs on the impact of the crowdfunding process, while varied, highlighted a number of key benefits. First, respondents noted that engaging in crowdfunding resulted in "*more than money*". Nearly all respondents acknowledged that various intangible benefits arose from the crowdfunding process, specifically in terms of accessing new customers, gaining media and press attention to supplement their other marketing activities, validation of their product/service offering and development of their business model. These benefits, while not themselves financial, have the potential to financially benefit firms as they develop and grow and are linked to the 'affinity' created between investors and firms.

“We found it extremely useful just from the amount of people who want to support us and the amount of opportunities it has opened up just off the back of getting mass marketing exposure.”

“The feedback from the advertising and the publicity of it were all beneficial to the company as a whole, not just the finance.”

Secondly, by raising capital, firms were able to take on new employees. A number of entrepreneurs (n=7) stressed just how important job creation was in order to adequately scale up their businesses, with significant proportions of the funding they raised earmarked specifically for salary costs. Not all firms could articulate the precise number of new jobs they intended to create, but many anticipated growing from around 5-10 to around 20-30 employees in the next six months. However, respondents did note that these new jobs would not be sustained through the money raised via crowdfunding, and that other sources of income would be needed to maintain employment and create new jobs in the future. According to one firm, who planned to double their employees from 20 to 40, the funding only bought them “*around 6 months*”, after which time other further sources of funding would be needed to sustain their growth. Another entrepreneur noted:

“We already burned [through the money] very quickly. We need more because we didn’t raise enough money to hire sales people.”

The final theme identified concerned access to follow-on funding. The majority of the entrepreneurs’ felt that having had a successful crowdfunding campaign enabled them to attract the attention and interest of business angels and VCs and also “*opened doors*” to other forms of future equity financing.

> *"We're on the radar of the [VC] community now, so I think we have more options than we did in terms of next-stage funding."*

Indeed, a considerable number of entrepreneurs noted that the experience would be "*useful in future funding rounds*". They also observed that successful fundraising might have beneficial implications for accessing other sources of finance in the future such as private equity and in some cases grant funding, whereby a track record of obtaining other forms of finance can be seen as beneficial.

6. Discussion

This rich empirical data presented enables us to draw some important conclusions regarding the nature of entrepreneurial firms utilising equity crowdfunding, thereby providing evidence in relation to the research questions posed. A number of common features seem germane across the firms examined.

First, in line with other research on equity crowdfunding (Ahlers et al., 2015), high levels of human capital and entrepreneurial experience were strong features of the interviewees. In addition to human capital, many of the entrepreneurs had previous experience of either establishing or working in new start-ups. A key feature of these entrepreneurs appears to be their willingness to experiment[9]. These skilled entrepreneurs seemed very proficient at 'bundling' financial resources from a variety of different sources – friends, family, business angels and 'the crowd' – to help alleviate and overcome their internal resource constraints. This 'bricolage' approach to assembling financial resources requires a considerable and well-honed

[9] Indeed, one entrepreneur used rewards-based crowdfunding to test the market for his product and generate demand. This 'order book' was then used to secure further equity crowdfunding.

entrepreneurial skill-set, as displayed by the entrepreneurs in this study. They showed a strong desire to use crowdfunding as one part of their overall funding strategy, rather than as a purely distinctive alternative to other existing sources. In this respect, equity crowdfunding can be viewed as a compliment to - rather than a direct replacement for - other existing sources of start-up funding. Indeed, the strong prevalence of business angels within the majority of the crowdfunding campaigns in this study indicates that crowdfunding might be easily linked in with other sources of entrepreneurial finance. Our findings also contradict others who suggest that the 'crowd' is a distinctive cohort excluding specialist investors (Belleflamme et al., 2014). Further work is needed to tease out the ways in which equity crowdfunding is changing the nature of business angel investing.

Second, the firms interviewed were young, with an average age of four years, suggesting that equity crowd funding appeals to early stage ventures in consumer-oriented sectors. Indeed, the validation that is derived from equity crowdfunding may mitigate some of the problems associated with the 'liability of newness'. There was a large degree of sectoral heterogeneity within the cohort of firms using this source of funding, although the majority were consumer-focused (e.g. food and drink, digital media) with many service-oriented (e.g. professional services). Overall, there were few explicitly high-tech firms undertaking much in the way of intramural R&D. Indeed, one entrepreneur said he did not think "*crowdfunding is right for B2B propositions*", particularly where very technical products/services are on offer. This corresponds with the views of the entrepreneurs themselves, who often stated that crowdfunding is suitable for firms that are "*easy to get*" (i.e. understand) and those that investors have a strong affinity with. This may be exacerbated by the fact that communication between firms and their investors occur via "pseudo-personal communication tools" like videos and social media (Moritz et al., 2015), which may prohibit complex technologies or propositions from being successfully conveyed to the 'crowd'.

We now return to the research questions posited earlier. First, the study found that perceived lack of alternatives was the key rationale for seeking equity crowdfunding. Given the downturn in debt funding, coupled with the nascent nature of these innovative firms, it is perhaps unsurprising that the majority could be classified as 'discouraged borrowers' (Kon & Storey, 2003). Indeed, this work seems to strongly corroborate what others have speculated: "discouraged borrowers may turn to newer forms of alternative as the only option left available to them" (Bruton et al., 2015, p. 18). While this is a fairly unambiguous finding, preferences for explicitly seeking crowdfunding rather than other sources of equity funding or other forms of alternative finance (e.g. trade credit, peer-to-peer lending) were more difficult to discern. Our findings suggest that although the demand is influenced by several factors, speed is critical, with many firms attracted by the rapidity of the process. The relational aspect of equity crowdfunding, notably the validation and customer recognition it confers on entrepreneurial firms, suggests that equity crowdfunding is a qualitatively distinctive form of entrepreneurial finance and one perhaps best suited to certain 'types' of consumer-oriented ventures. Whereas VC and business angel investment is commonly associated with high-tech start-ups (Amit, Brander & Zott, 1998), to date equity crowdfunding platforms seem to have a predilection for funding consumer-driven ventures (e.g. food and drink).

Our second research question concerned the issue of autonomy. In accordance with the pecking order thesis (Myers & Majluf, 1984), the majority of the interviewees pursued crowdfunding to minimise the dilution of their equity stakes and to retain maximum levels of autonomy. Importantly, however, the preference for equity crowdfunding over other forms of equity funding such as business angel investment suggests that the pecking order thesis needs to be modified to include a fuller range of different types of equity finance. Crowdfunding therefore seems to be creating a 'hybrid' form of equity funding, albeit one with less prohibitive limitations to entrepreneurial autonomy than other forms of equity funding. Indeed, a large majority of the firms in this study highlighted the benefits this form of funding had in terms of retaining their operational autonomy.

However, while some entrepreneurs appreciated the lack of interference from investors, an equally large number of the study firms actively welcomed the greater level of scrutiny that outside investors would bring them and sought to develop such relationships via crowdfunding. In line with resource dependency theory, firms seek this kind of relationship so that they will be more accountable to their new shareholders. The benefits of this kind of 'control mechanism' (Street & Cameron, 2007) have been noted by others examining other forms of equity finance such as VC (Hillman & Dalziel, 2003; Wijbenga, Postma & Stratling, 2007). The organisational legitimacy crowdfunding confers on firms also seems important (Frydrych et al., 2014), particularly in the context of early stage ventures as per the firms in this study.

In line with the third research question, the findings suggest that the role of networks and other forms of social capital are also a key determinant of the success of crowdfunding (Colombo et al., 2015). In particular, the early adopters examined during this study seemed to draw upon an embryonic "crowdfunding ecosystem", comprising accelerators, incubators, crowdfunding platforms, crowdfunding consultants, business angel investors and specialist media outlets (such as Angel News in the UK)[10]. Drawing on these network actors enabled the nascent firms to

[10] Interestingly, a number of the firms had obtained initial seed funding via accelerators and incubators prior to undertaking crowdfunding.

augment their own internal resource endowments (Sullivan & Ford, 2014), which seems especially relevant given the newness of this cohort. Arguably, poorly connected new firms may not have sufficient networks or social capital to undertake crowdfunding effectively. This may explain the geographical concentration of these firms in the entrepreneurial 'hot spots' of the south east of England. However, more research is needed on this issue.

Our final research question explored the benefits equity crowdfunding confers on its recipients. In line with a range of other authors, the data reveals considerable tangible and non-tangible benefits from interacting with crowd investors (Belleflamme et al., 2014; Lehner et al., 2015). Factors such as media exposure, interaction with new shareholders, access into overseas markets, end-user engagement and feedback were all important intangible benefits that firms received from this type of funding. Indeed, one respondent noted that they engaged in crowdfunding primarily to obtain these benefits and "*didn't really need the money*". This reinforces that, by harnessing the crowd, important entrepreneurial learning can occur (Belleflamme et al., 2014; Gerber & Hui, 2013; Ordanini et al., 2011). Not only that, but similar to VC-backed firms, successfully raising crowdfunding could act as a 'signal' of quality of this cohort of firms to uniformed third parties which in turn could further facilitate future investment (Hsu, 2004). Further research is needed to explore these intangible benefits of equity crowdfunding.

7. Conclusions and Suggestions for Further Research

Given the sample size of the reported study, we can say with some certainty that equity crowdfunding appears to be a distinctive and highly relational form of entrepreneurial finance. In a short space of time, it has become firmly established as a key part of the funding ecosystem for entrepreneurs, especially in liberalized regimes like the UK. Our study found a strong demand for equity crowdfunding from innovative young firms led by growth-oriented entrepreneurs who were highly skilled entrepreneurial ‘early adopters’. Given the adverse consequences of failing to raise capital, this form of financing may be much less appealing to risk-averse entrepreneurs.

From a theoretical perspective, there is a need to better understand the rationale for and role of equity crowdfunding within the entrepreneurial finance literature. To date, the vast majority of crowdfunding research has avoided much in the way of theorisation, however as this research field matures it would benefit from further conceptual development. The risk-orientation, outward focus and desire to maintain autonomy exhibited by the entrepreneurs in this study all chime with the concept of Entrepreneurial Orientation (EO) (Lumpkin & Dess, 1996; Lumpkin, Cogliser, & Schneider, 2009). These characteristics are often found within disruptive entrepreneurial firms (Eisenhardt & Martin, 2000) and are strongly associated with the concept of dynamic capabilities (Teece, Pisano & Shuen, 1997). Therefore, concepts such as EO and dynamic capabilities may offer a suitable lens for further theoretical development of the crowdfunding phenomenon.

From an empirical perspective, the crowdfunding research agenda looks equally diverse and promising. Researchers could usefully explore the demand-side determinants of equity crowdfunding in other spatial and regulatory contexts. The lack of female entrepreneurs detected this study is also interesting and worthy of inspection, particularly since females have been observed to have higher success rates in obtaining crowdfunding (Frydrych et al., 2014). Further work also needs to examine crowdfunding’s long-term impact on recipient firms, perhaps looking at differences between successful firms and those who do not succeed in raising their threshold funding. Similarly, comparing the performance of crowdfunded firms relative to VC or angel-backed firms is another interesting issue meriting examination. Clearly new ventures need to be able to absorb the funding they receive and manage these new (and in some cases sizeable) external stakeholders, so another important areas for future work is to examine what it means to be ‘investment-ready’ in the context of crowdfunding (Mason & Harrison, 2001)

Methodologically, there is a need for greater pluralism in future crowdfunding studies. While the majority of entrepreneurship research has traditionally relied on quantitative methods grounded in positivist epistemology, this work demonstrates that valuable insights can be produced by inductive qualitative analysis. Future research would make an important contribution by exploring crowdfunding using a wide array of research techniques and epistemological paradigms. While the qualitative method adopted in this paper enabled valuable insights into the dynamics of equity crowdfunding, further quantitative work is also needed to explore the generalisability of these issues over a larger population of firms and to determine why start-ups harness the crowd and what impact this has on the longer-term development of these ventures.

Finally, while equity crowdfunding clearly bestows considerable benefits to entrepreneurial firms, the benefits to investors seem less certain (Wilson & Testoni, 2014; Shane 2015). We hope that our study will stimulate others to further our understanding of this and the other important issues outlined above.

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Figures

Figure 1. Age of sample firms

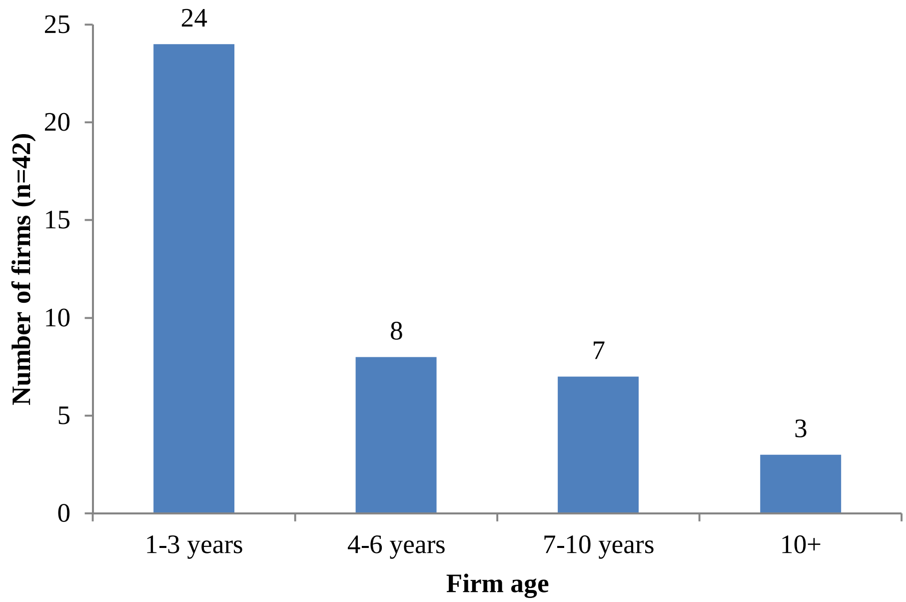
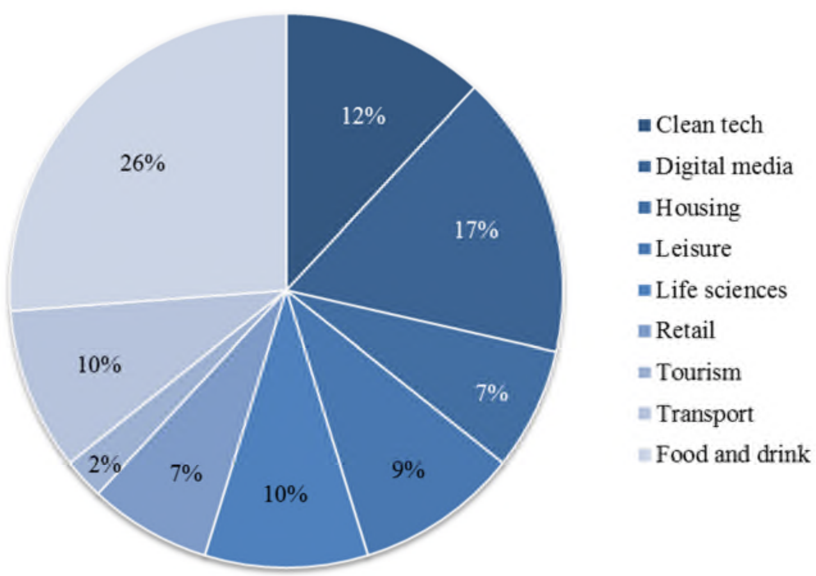


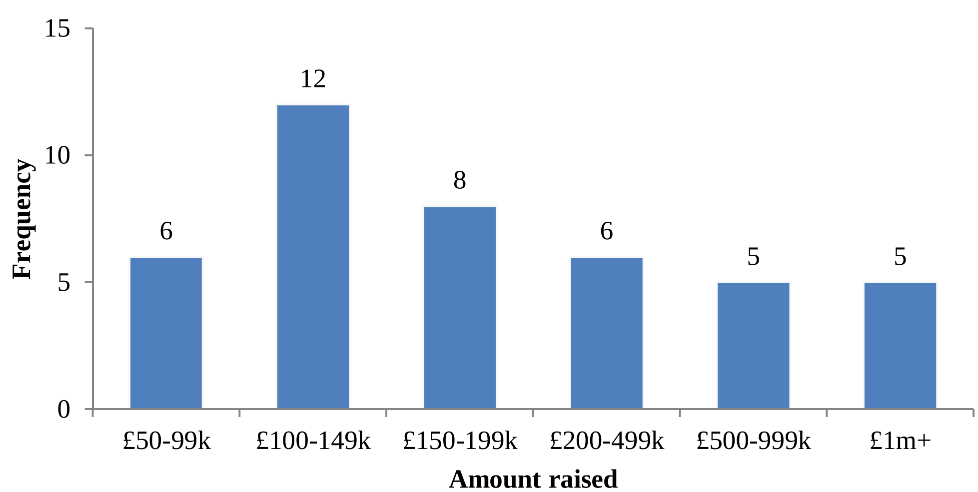
Figure 2. Sectoral breakdown of sample firms



n=42

Figure 3: Geographical distribution of sample firms

Figure 4. Financing raised



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