

# Fast-Growing Crowdfunding Sites Not Likely To Replace VCs

by Renee Hopkins | STAFF WRITER | July 24, 2012

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## Takeaway

- Crowdfunding from unaccredited investors has been restricted in the U.S., but under the JOBS Act more individuals will be able to invest in startups without triggering public listing.
- Still, rewards-based sites such as Kickstarter may be more good at providing market validation than actually raising money for a startup.

In 2010, websites like Kickstarter began to gain traction with consumers, as quirky petitions for help funding CDs, events, and films began to show up routinely on Facebook and Twitter and in email inboxes. By 2012, a variety of these kinds of sites were popping up and helping to generate relatively small sums, usually in the thousands or tens of thousands. Then in May 2012, startup Pebble Technology shattered the ceiling by raising **more than \$10 million** in a Kickstarter campaign to pre-sell its “smart watch.”

That same month, new research about “crowdfunding” — this new type of crowdsourcing in which an individual, group, or company raises money from multiple sources online — was released by Massolution (the consulting arm of [crowdsourcing.org](#)).

The report, [Crowdfunding Industry Report: Market Trends, Composition, and Crowdfunding Platforms](#), which made a big splash in the startup funding world, revealed that crowdfunding has found a huge market — \$1.5 billion was raised worldwide through one million campaigns in 2011, a figure that’s projected to double in 2012, and explode in 2013.

In addition to sizing the current market and predicting future market size, the report describes four types of crowdfunding, depending on the business model:

- **Equity-based:** funders receive an interest in the form of equity in the venture they fund or, alternatively, revenue or profit-share arrangements.
- **Lending-based:** funders often receive fixed periodic income and expect repayment of the original principal investment.
- **Reward-based:** funders gain a non-financial benefit in return for financial contributions. Non-monetary rewards often take the form of a token of appreciation or the pre-purchasing of products or services.
- **Donation-based:** funders donate to causes that they want to support, with no expected compensation (i.e., philanthropic or sponsorship-based incentive).

According to the report, the main source of the growth in 2012 will be driven by reward-based crowdfunding sites such as Kickstarter. Equity-based crowdfunding is already strong in Europe, although crowdfunding from unaccredited investors has been restricted in this country.

But starting in 2013, equity-based crowdfunding is expected to increase in the U.S. due to the JOBS Act. Passed in April with bipartisan support, the JOBS Act is intended to create jobs by dramatically reshaping the financing landscape of American business.

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Under the JOBS Act, individuals will be able to invest in startups in return for shares of the company. Companies will also be able to amass a larger total number of investors before triggering public disclosure regulations that now require companies to list their shares publicly. The [SEC is still working on](#) the specific regulations that will govern crowdfunding activity under the act.

“The passing of the JOBS Act will have a profound effect on the growth of crowdfunding in the U.S. In 2013, we expect securities-based crowdfunding to bring new sources of funding to many startups and early stage businesses,” said Massolution chief executive Carl Esposti in a statement.

### Will Crowdsourcing Supplant Venture Capital?

The Massolution report contained research conducted last spring by Gerrit Ahlers and Matthias Knoche, when they were dual-degree MBA exchange students at the McCombs School of Business. Their other degree is from Wissenschaftliche Hochschule für Unternehmensführung (WHU) in Germany.

Ahlers, who came to McCombs to focus on entrepreneurship and finance, began to research crowdfunding as part of his thesis on finance and the Internet under the direction of John Doggett, senior lecturer in the Management Department. While researching, Ahlers connected with [crowdsourcing.org](#) and learned they had research underway, so they joined forces.

Though the report is largely based on Ahlers’ research, he doesn’t necessarily agree with Esposti on the conclusion that equity-based crowdfunding will take off.

“I have a finance background and got interested in crowdfunding because it is a new way of financing,” said Ahlers, who is now a consultant in A.T. Kearney’s Berlin office. “My take on crowdfunding is that it is an amazing way to finance the development of new products, foundations, etc. That said, I think that it will be difficult to make money from equity crowdfunding, and that it will take considerable time to build an online venture capital industry.”

Doggett shares Ahlers’ view. “Crowdfunding is a phenomenon that is taking off, so I am very comfortable with the projections [in the report]. I expect that crowdfunding will become a significant additional source of funding for startups, but I don’t expect it to supplant any existing sources,” he said.

He continued, “Traditional investors would be concerned that crowdfunding would create a large number of individual ‘investors’ who would have to agree to any additional funding. That concern can be addressed by giving one ‘mutual fund-like’ investment manager the power to make decisions that commit all crowdfunding ‘investors’.

“If this approach to investment management is included in the initial offering statement, the problem goes away. Given the growth of crowdfunding in the U.S., the ability to raise money this way will give a project even more credibility.”

### Crowdfunding Gains Momentum: See Rally.org

Another crowdfunding coup came in June when Rally.org, a startup designed to facilitate crowdfunding, raised \$8 million in series A funding. That’s right, Rally, the brainchild of Tom Serres, itself provides a platform for individuals and groups to raise funds for causes through donation-based crowdfunding.

This space is not new to Serres, who founded Piryx.com as an undergraduate at McCombs in 2008. The first use of Piryx was by politicians to solicit donations online, a form of political fundraising that came into its own during the last presidential election. For Rally, Serres raised most of the funds from [AngelList](#), an online platform that connects seed investors and entrepreneurs, making it the largest series A round ever raised online. Some in Silicon Valley saw the deal as a [confirmation](#) that crowdfunding is here to stay, though [others still voiced concerns](#) similar to those of Doggett and Ahlers’.

Serres believes that those who are patterning equity-based crowdfunding after reward-based platforms such as Kickstarter are missing the point about fundraising for startups. For him, fundraising is more of a process than a rewards-based event — more storytelling and relationship-building — with solicitation a complementary process that’s no less important.

“Four years ago crowdfunding was nonexistent, but in one sense you were always funding from a crowd,” he said. “Communicating ideas to people who might be interested in helping to make them a reality has



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been going on for centuries, but now it's on a new medium that's breaking down barriers to that communication."

### Crowdfunding's Real Value for Startups

Serres agrees with Doggett and Ahlers that it's unlikely crowdfunding would replace venture capital for startups. "From the venture equity point of view, crowdfunding isn't optimal, because it's better to raise money from investors who know you," he says, rather than expecting investors to commit on the basis of an online presentation.

"The problem from a crowdfunding perspective is that [rewards-based sites such as] Kickstarter are simply a way to pre-sell a product or a project. You need a stronger reason to seek VC funding — you still have to build the business environment around it."

To Serres, the value provided by Kickstarter and many other crowdfunding sites is more market validation than access to capital. "It's a good way to raise money in small amounts, usually less than \$1 million." But more importantly, Serres believes that where crowdfunding adds value is in bringing customers.

"Crowdfunding brings the product and the market together for investors to see.

"The issue is more about giving innovators a better mechanism to share their ideas," he said. "The \$7.9 million I received from Angellist now provides me a mechanism to get the Rally story out" to potential customers and to more investors.

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### COMMENTS

#### #1 Hi, French investors have

Submitted by nedmic (not verified) on September 20, 2012.

Hi, French investors have appealed to their government in a manifesto for crowdfunding. We all need your help in order to make the european regulation going on. To sign the petition :

<http://finpart.p2pventure.org/petition/>

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#### #2 I've started to see a

Submitted by Kristen Maxwell (not verified) on August 2, 2012.

I've started to see a building backlash against Kickstarter and micro-finance in the media. I wonder if the effectiveness of these platforms will diminish as interest wanes or potential donors become more skittish.



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### #3 I truly hope that

Submitted by David Lowe (not verified) on July 25, 2012.

I truly hope that crowdfunding stays hot and replaces VCs. Kind hearted individuals who back startups and new ideas versus angry people in suits trying to tell you why they "should part with his children's inheritance!" I have just launched my first Kickstarter (Uberpong - combining ping pong and art <http://kck.st/O1TLG3>) and have been impressed at the reach of the site. I have had backers as far away as Australia and can really see crowdfunding sites going from strength to strength. Nice article Renee.

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