CHAPTER 1

Deciphering Crowdfunding

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Abstract Crowdfunding is one of the funding sources that entrepreneurs are increasingly being exposed to above and beyond venture capital and angel funding. After introducing the most popular crowdfunding types, this chapter proceeds to present and compare the evolution of the phenomenon across three macro regions: Europe, USA, and Asia-Pacific. Furthermore, the chapter offers an overview of the state-of-the-art of the crowdfunding literature, highlighting creators' and funders' incentives and disincentives for starting or engaging in crowdfunding projects, the characteristics of a successful campaign, and the contextual factors that explain the evolution of the phenomenon across countries. The chapter closes providing suggestions for future work in this area.

Keywords Crowdfunding · Geographic markets · Crowdfunding platforms · Successful crowdfunding campaign characteristics

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1.1 The Crowdfunding Phenomenon: An Overview

Crowdfunding can be defined as "an open call, essentially through the Internet, for the provision of financial resources in order to support initiatives for specific purposes" (Belleflamme et al. 2014, p. 588). Mollick (2014), narrowing the definition in an entrepreneurial context, defines crowdfunding as the efforts by entrepreneurial individuals and groups–cultural, social, and for-profit–to fund their ventures by drawing on small contributions from a relatively large number of individuals using the Internet. Crowdfunding draws inspiration from the concept of microfinance (Morduch 1999) and crowdsourcing. It represents a unique form of fundraising where capital seekers (project proponents) are linked with capital givers (investors) through a crowdfunding intermediary (platform) (Haas et al. 2014).

During the past five years different forms of crowdfunding have emerged. Based on the risk of funding for investors, we can distinguish between investment and non-investment crowdfunding models. Within these two groups, according to the right of crowdfunders in the projects' outcome, crowdfunding platforms can further be categorised as follows:

Investment models:

- Lending-based crowdfunding: funds are paid back and funders have the right to receive a contractually agreed interest payment. This model is further categorised into two major submodels–(1) peer-to-peer lending (P2P) which is characterised by direct interaction between the two parties (see Chapter 2), and (2) social lending, usually used for entrepreneurial projects at local level.
- Equity-based crowdfunding: funds are provided in exchange for company's shares. Investors have the right to receive returns on investments if the company performs well.

Non-investment models:

- Reward-based crowdfunding: funds are provided in exchange for non-monetary benefits. Common benefits include a small gift (reward) or a reservation for a product which is still under production (pre-order).
- Donation-based crowdfunding: funds are provided for philanthropic or sponsorship reasons with no expectation of remuneration.

Crowdfunding platforms can also be categorised at a macro level. Generalist platforms enable crowdfunding for any area of interest while vertical (or thematic) platforms focus on crowdfunding for projects within a specific field or sector.

Lastly, crowdfunding platforms can be distinguished based on the different funding mechanisms adopted. Platforms can regulate the pledge levels, the minimum investment amounts, and decide whether to adopt an "all or nothing" or "keep it all" funding principle (Gerber et al. 2012; Mollick 2014; Cumming et al. 2015). The "all or nothing" funding approach allows project proponents to receive funding only if the campaign achieves 100% of the target (Belleflamme et al. 2010; Cumming et al. 2015; Haas et al. 2014). If the target amount is not met, investors receive their money back. On the other hand, the "keep it all" funding approach allows project proponents to receive any collected amount (Gerber et al. 2012).

1.1.1 The European Market

Since its inception, the crowdfunding market in Europe has experienced exponential regional and country level growth (Cambridge Centre for Alternative Finance 2018). Overall the market volume increased by 41% annually, from €5.431 billion in 2015 to €7.671 billion in 2016. This growth was driven by dramatic growth in the UK market (accounting for 73% of the entire European market alone), and the fast expansion of alternative finance markets in smaller European countries like the Nordics, the Iberian Peninsula, and the Baltics. The second largest European market is France, accounting for 22% of the European crowdfunding market in 2016, followed by the German market (15.6%).

In 2016, P2P lending was the most popular crowdfunding investment model in Europe. P2P consumer and business lending accounted for 33.8% (€696.81 million) and 17% (€349.96 million), respectively of the total crowdfunding market. In contrast, equity-based and reward-based crowdfunding experienced a decline in 2016, each accounting for approximately 10% of the market. Donation-based platforms grew modestly in 2016 however only represent 1.6% of the market share.

The further development of the crowdfunding market is challenged by risk factors perceived by prospective investors. In the investment models and reward-based model, for instance, two main risks highlighted by potential investors are (1) the risk of fraud, e.g. the possibility that the product or project announced during the campaign may be false or non-existent and thus the fundraiser could attempt to use the funds collected from the backers for other (personal) purposes; and (2) the risk of platform collapse due to malpractice by fundraisers (Cambridge Centre for Alternative Finance 2018). Other risks, such as the loan default or late repayments to investors, in the case of lending-based crowdfunding, as well as changes in local and/or EU regulation were perceived as less critical for investors (Cambridge Centre for Alternative Finance 2018). It is noteworthy that in the UK, unlike the general EU outlook, cybersecurity was viewed as a major risk factor and the impact of Brexit was not a major concern (Cambridge Centre for Alternative Finance 2017c).

1.1.2 The US Market

In the United States, one of the world's largest and most innovative countries for alternative finance, the total volume raised via crowdfunding in 2016 was US$34.5 billion. Regulatory interventions, such as the signing of JOBS ACT, in April 2012, have significantly contributed to the development of the crowdfunding market. Specifically, the Tittle III of the JOBS ACT brought big changes within the entrepreneurial finance landscape, alleviating the burden of entrepreneurs' in raising finance, allowing fundraising from large number of investors through approved intermediary portals.

Like in the European market, P2P lending is the dominant crowdfunding model in the United States, accounting for 61% of the market in 2016, followed by the equity-based model which delivered US$549 million to approximately 637 businesses and reward-based crowdfunding (US$551 million) (Cambridge Centre for Alternative Finance 2017b). Data also reveals a slight drop in equity-based crowdfunding compared to 2015, which seems to be related to regulatory ambiguity, also a feature of the EU market. Among the non-investment models, donation-based crowdfunding expanded a great deal in 2016 with US$224 million raised, while reward-based crowdfunding suffered a decline from 2015 to 2016, but still continues to attract significant funds from crowds (Cambridge Centre for Alternative Finance 2017b).

According to investors' risk perceptions, in the United States the risk of fraud involving high-profile campaigns and business failure rate were viewed as the greatest risks to the crowdfunding industry (Cambridge Centre for Alternative Finance 2017b).

1.1.3 The Asia-Pacific Market

Another area of interest for the development of the crowdfunding market is the Asia-Pacific region with the key regional markets being China, Oceania, and South Asia. China is the market leader accounting for 99.2% of the total Asia Pacific crowdfunding market. In 2016, the total volume of transactions in China was US$245.38 billion, an annual growth of 136% compared to 2015. Like the EU and the US, P2P lending represents the main segment of interest with 56% of the total market in China (Cambridge Centre for Alternative Finance 2017a).

Outside of mainland China, Australia has shown high growth rates, reaching US$609 million in total volume in 2016, followed by Japan (US$400 million), and South Korea (US$376 million). P2P lending in the Australian market accounts for about 60% of the total market (Cambridge Centre for Alternative Finance 2017a). In South Asia, the prominent country active in the alternative finance industry is India, with a total of $124 million collected in 2016. From 2013 to 2016 Indian activity was mainly concentrated in P2P lending, accounting for about 60% of the market. Equity-based and donation-based crowdfunding each accounted for around 15% of the total crowdfunding market volume, representing US$32.3 million of funds raised (Cambridge Centre for Alternative Finance 2017a). A distinctive aspect of the Indian economy is the lack of access to bank credit for the majority of the population. In fact, only 10% of the 1 billion inhabitants have access to it. The growth of crowdfunding, allowing people to connect via the Internet and access financial services that are not available elsewhere, could benefit a huge portion of the population.

Overall, the latest statistics suggest that over the course of the past three years in the three main macro-regions, Europe, USA, and Asia-Pacific, the alternative finance market doubled its volumes and is continuing to growth impressively. P2P crowdfunding and reward-based crowdfunding are consistently the most popular models in all markets.

1.2 Crowdfunding State-of-the-Art

Although crowdfunding is a relatively new method of funding for start-ups and small ventures, it has become an increasingly relevant means of alternative financing. Researchers and scholars have started to investigate this phenomenon in the attempt to construct a theoretical model that could fully explain the dynamics behind crowdfunding, focusing on two main aspects: (1) the incentives and disincentives for starting or taking part in crowdfunding projects (see, e.g., Gerber et al. 2012; Agrawal et al. 2014; Allison et al. 2015) and (2) factors associated with successful campaigns (see, e.g., Agrawal et al. 2011; Mollick 2014; Colombo et al. 2015; Giudici et al. 2018).

Investigating initiators' incentives for starting a crowdfunding project, research shows that fundraisers consider crowdfunding as an opportunity (1) to finance their company at a lower cost of capital; (2) to receive public attention; and (3) obtain feedback on the product or service offered (Gerber et al. 2012; Agarwal et al. 2014; Belleflamme et al. 2014). Crowdfunding platforms are easily accessible and thereby represent an opportunity for entrepreneurs to test the marketability of the project and receive suggestions. Nevertheless, embracing crowdfunding entails a great deal of public exposure and information disclosure (Agarwal et al. 2014). If creators are unable to collect the necessary funds from the crowd they will face the threat of not only reducing their chances of receiving future investments but also that others may steal their ideas.

Funders, on the other hand, finance crowdfunding campaigns to support an innovative idea, to help others to realise their dreams, to gain early access to new products, and to be part of a community (Zhang 2012; Agarwal et al. 2014). The exchange of resources, followed by continuous interactions among members (both supporters and creators) of these platforms, generates a sense of belonging to a community where individuals share similar views and beliefs. Nonetheless, funders face some disincentives in engaging in crowdfunding projects. Early-stage companies that generally approach crowdfunding are inherently risky and often funders and creators are overoptimistic about projects outcomes (Mollick 2014). Moreover, crowdfunding is a fertile ground for fraudulent behaviours. Creators could provide false information to promote their company and information asymmetries are very high (Agarwal et al. 2014). Lastly, in crowdfunding, virtual meetings replace real-life encounters, making it more challenging for the crowd to understand what businesses and what intermediary can be trusted (Schwienbacher and Larralde 2010).

1.2.1 Investment Models

Although it represents the greatest share of the crowdfunding market, there is a relatively small literature on lending crowdfunding. Lending crowdfunding is best suited for ventures that have built a viable product and generates some initial revenue, demonstrating early traction (Paschen 2017). Scholars have analysed the role of networks within peer-to-peer lending crowds and their effect on crowdfunding campaigns' performance. Network relations provide larger proportions of loans, lending four times more than strangers. Investors with preexisting network ties also respond to loan requests on average 59.5% sooner than strangers (Horvát et al. 2015). These results are in line with extant research on other crowdfunding models highlighting the importance of relations and network in online fundraising success (Agrawal et al. 2011; Mollick 2014; Colombo et al. 2015; Butticè et al. 2017).

Scholars have further investigated the lending behaviour in P2P crowdfunding platforms. Cummins et al. (2018), comparing lending practices of non-banking institutional investors and retail investors, found that institutional investors generally outperform retail investors, achieving higher returns upon repayments and having a lower likelihood of loan default than retail investors. Along the same lines, Kgoroeadira et al. (2018), investigated whether P2P small business lending has different characteristics than traditional small business lending. Unlike traditional lenders, P2P online lenders, in deciding whether or not to lend money to businesses, focus more on entrepreneurs' personal characteristics—e.g. person's credit score, employment, picture, etc.—than business characteristics. This suggests that entrepreneurs should approach online markets, tailoring their pitch as personal rather than focusing on firm characteristics, since the latter are the main determinants of securing funding.

Similarly, while equity crowdfunding has reached significant investment volumes, the number of research studies on the area is relatively small. One of the first studies tackling the equity crowdfunding phenomenon was conducted by Ahlers et al. (2015) examining the impact of project quality (human capital, social capital, and intellectual capital) and perceived level of uncertainty on the success of a campaign. The authors found that while entrepreneur's human capital was relevant in attracting a higher number of investors and capital, social, and intellectual capital did not appear to be key success factors. They also highlighted the importance of providing detailed information about the company—e.g. financial roadmaps, risk factors, etc.—to prospective backers to reduce information asymmetry. Nevin et al. (2017), focusing on the role of social media activities in equity-crowdfunding campaign success, show that being active on social media, engaging with the crowd, and understanding social media selectivity—using different social media according to the target audience—positively impact the outcome of a crowdfunding campaign. Lynn et al. (2017) provide insights on the crowdfunding network on Twitter—comprising multiple subcommunities, hubs, and influencers–illustrating the geographical concentration of crowdfunding in specific areas or communities and highlighting the importance of the social media use during crowdfunding campaigns.

Looking at the post-equity funding performance of crowd-backed start-ups in the UK, Signori and Vismara (2018) found that 18% of them were not active anymore, whereas 35% raised further funding from either traditional investors (9%) or follow-on crowdfunding offering (25%). Lastly, taking a qualitative perspective, the study by Di Pietro et al. (2018c) illustrates how entrepreneurs leveraging investor networks generated in the course of equity-based crowdfunding campaigns, contributes to the success of start-up firms. Crowd investors can provide firm founders with knowledge related to the product, strategy, and market as well as network ties with industry players and other stakeholders.

1.2.2 Non-investment Models

Agrawal et al. (2011) conducted one of the first studies investigating how online reward-based crowdfunding platforms reduce investors' costs related to early-stage financing (e.g. collecting initial information, monitoring, providing inputs, etc.) and eliminate most of the distance-related economic frictions. Their study shows that Family and Friends (F&F) investors are mostly local and invest in the project in the early phases of the funding process, whereas non-F&F investors are more geographically disperse and willing to fund as the capital raised increases. Mollick (2014), taking a broader perspective, focused on the role of the founders themselves in determining the success (or failure) of their online reward-based campaigns. The perceived quality of the underlying project, which can be signalled, for example, by including videos, providing frequent updates, and avoiding spelling errors, together with the founders' social network size, increase the chances of success of a crowdfunding campaign. The effects of geography on the success of the project were also considered, in terms of proximity to funders, supporting Agrawal et al. (2011) findings.

Colombo et al. (2015), investigating reward-based crowdfunding from a social capital perspective, show that during the first stages of the campaign, when the level of uncertainty concerning the proposed projects is high, the founders' relationships within the crowdfunding community are necessary to spread information and attract early backers. The relationships and social contacts developed among founders and backers within the same online platform—*internal social capital*—appears to be crucial in attracting both early-capital and early-backers, which are strong predictors of a campaign's success. Internal social capital, reducing the information asymmetry between founders and backers, triggers imitating behaviours of other investors that feel more confident in endorsing the proposed project. Along this line, Butticè et al. (2017) showed that serial projects' proponents in reward-based crowdfunding platforms were able to build internal social capital by launching several successful campaigns, increasing their chances of succeeding also in their subsequent campaigns. By supporting the same project throughout its whole creative process, backers become part of a virtual community sharing common views and goals and this creates an emotional connection with other members of the group and with the entrepreneur as well.

The importance of social capital in reward-based crowdfunding and, in general, the characteristics of the geographic area where project's proponent reside were also examined by Giudici et al. (2018). Their study demonstrates that *local altruism*—the level of altruism shared by people living in the founder's city—represents a key success factor for crowdfunding projects and this effect is strengthened by the entrepreneur's personal social networks, supporting the findings of Mollick (2014), and *local relations* among residents. More recently, Di Pietro et al. (2018a), looking at the characteristics of the geographic area where investors reside, suggest that *local religiosity* can play a significant role in enhancing the fundraising of cross-regional crowdfunding projects.

On the topic of donation-based crowdfunding, scholars have focused their attention mainly on the determinants of funding behaviours (Gleasure and Feller 2016), considering the benefits that donors achieve through donations. In some cases, financial benefits are gained in the form of tax deductibility as suggested by Meer (2014), but more frequently social benefits represent the main reward for donors. From this perspective, the way in which projects are described and the anonymity of users influence the propensity and the amount of donations

(Smith et al. 2013; Burtch et al. 2015). Di Pietro et al. (2018b), analysing crowdfunding donations collected in Italy by Mary's Meals Charity over a 15-month period, illustrate that (lower) *digital divide*, i.e. access to infrastructure such as broadband connection, and user's *digital literacy*, i.e. habitual use of Internet, enhance funder's propensity to use a crowdfunding platform for donation purposes. The findings also support the hypothesis that the use of social media, in particular Facebook sharing, positively influences donations.

Overall, research in both investment and non-investment crowdfunding models illustrate that (1) funding is not geographically constrained although geographical proximity matters since most of the capital flows to the same regions (e.g. Agrawal et al. 2011; Lynn et al. 2017; Cambridge Centre for Alternative Finance 2018); (2) funding propensity grows with collected capital, highlighting the importance of friends and family as well as entrepreneurs' internal social capital as they invest early in the funding cycle (e.g. Agrawal et al. 2011; Mollick 2014; Colombo et al. 2015; Butticè et al. 2017); and that (3) funding is influenced by the characteristics of the local area in which entrepreneurs and investors live (e.g. Di Pietro et al. 2018a; Giudici et al. 2018).

1.3 New Research Trends: The Language of Crowdfunding

Recent studies are exploring the relevance of linguistic style in entrepreneurial finance, a relatively nascent research area. It is widely accepted that the way entrepreneurs articulate their business is vital for fundraising and legitimacy purposes. Prior research highlights storytelling as a means for entrepreneurs to establish venture legitimacy and gain stakeholder support. Specifically, Gorbatai and Nelson (2015) focus on the linguistic features of crowdfunding platforms to test the effect of language on the outcome of alternative financing campaigns and the relationship between linguistic content and gender. The authors suggest that the three types of language most likely to be successful in crowdfunding campaigns are positive, vivid, and inclusive, while business language would be less rewarding for the outcome of a campaign. Davis et al. (2017) support the idea that product originality and passion displayed by entrepreneurs in their pitches strengthen entrepreneurs' ability to collect funding. Similarly, Parhankangas and Renko (2017) compare the linguistic style of commercial and social entrepreneurs' pitches, finding that whereas language style is of little importance to commercial entrepreneurs, social entrepreneurs need to pay more attention to *how* they deliver their pitches: the use of concrete language, precise terminology, and an interactive style, are fundamental for the success of a social crowdfunding campaign. The perception that an entrepreneur conveys to potential investors is of fundamental importance since the financing pitch is often made before or during the development stage, that is, before the audience can actually see the finished product. Future research can build on these very preliminary findings and explore the role of communication and storytelling in crowdfunding in much greater depth.

Another important question to address in future research is related to factors that help us understand cross-country and cross-regional differences in the development of crowdfunding. In fact, despite a significant variation in entrepreneurial financing activity across countries (Reynolds 2011; Cambridge Centre for Alternative Finance 2018), the theoretical explanations of the antecedents and processes are limited (Baker et al. 2005). Drawing from cognitive psychology theories, recently Di Pietro et al. (2018d) show that linguistic structures may help in explaining differences in entrepreneurial finance market dynamics across nations and cultures. More interdisciplinary research is needed to discover underlying mechanisms that will help us to understand international differences of the crowdfunding phenomenon.

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