Crowdfund Investing: An Exciting New Alternative for Individual Investors

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Article Highlights

- Crowdfund investing allows individual investors to participate in a venture capital market historically reserved for institutional investors and the ultra-wealthy.
- Carefully analyze a crowdfunding platform before using it, since the platform's quality will impact the quantity and quality of the investment opportunities available through it.
- Employ a sound approach to evaluate investment opportunities, including thoroughly vetting the company's idea, team and traction.

Indexing and thoughtful asset allocation are solid choices for most individual investors' core holdings. But for those seeking exceptional gains on a long-term investment horizon, alternative investments like private equity—including venture capital—can offer an uncorrelated, value-based, and often highly lucrative, complement to the otherwise staid 60% stock/40% bond investment plan.

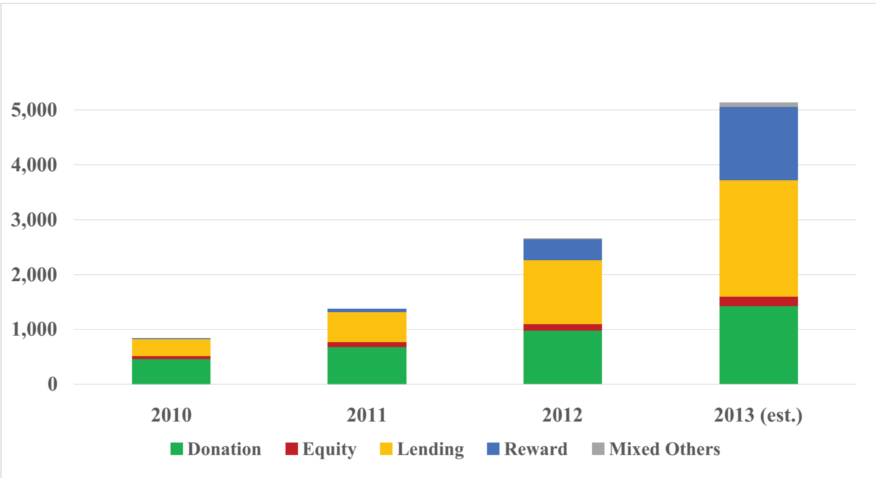
Historically, only high-net-worth individuals and institutional investors, including pension funds and university endowments, have been able to enjoy the 600+ basis points of annual incremental return that private equity and venture capital investments deliver long-term over traditional asset classes (exchanged-listed stocks and bonds). Meanwhile, an estimated $5 trillion in U.S. individual retirement and personal investing accounts has been restricted to those traditional asset classes. Now, Title III of the 2012 Jumpstart Our Business Startups (JOBS) Act is poised to change the game by allowing unaccredited investors to participate directly in equity-based crowdfund investing.

Crowdfunding, the pooling of capital from many individuals to financially back a cause, project or company, started mostly as a way for individuals to conveniently support social causes and artistic projects by donating online (commonly referred to as donation-based or reward-based crowdfunding). However, crowdfunding has evolved rapidly into what may well become a viable investment vehicle that connects investors in search of portfolio diversity and higher returns with entrepreneurs and small-to-mid-size enterprises (SMEs) in search of capital to develop their ideas and expand their businesses. Figure 1 shows the tremendous growth of crowdfunding in recent years, including the accelerating growth of crowdfunding capital raised with the hope of financial returns (commonly referred to as crowdfund investing).

Currently, accredited U.S investors (defined as individuals or couples with net worth in excess of $1 million or $300,000 in combined annual income) and unaccredited investors in most U.S. states are able to participate in lending-based crowdfund investing, in which individuals loan money to consumers and companies that are unable to secure traditional bank or institutional loans. In return, investors expect to eventually receive their principal plus interest, typically at higher interest rates than can be found in a low interest rate environment. Some of today's top contenders in the lending-based crowdfunding space are Lending Club, Prosper, Kabbage, Funding Circle, Zopa, and RateSetter. But what about equity-based crowdfund investing, which offers the potential for truly exceptional gains?

In equity-based crowdfund investing, the "crowd" of individual investors provides capital to start-ups and SMEs

Figure 1. Growth in Funding Volume by Crowdfunding Model ($ Mil)



Source: Massolution 2013 Crowdfunding Report.

in exchange for an equity stake in the companies. Equity-based crowdfund investing, essentially a more democratic version of venture capital investing, is a high-risk, high-reward activity. With prudence and luck, early-stage investors can earn tremendous returns when the companies they fund succeed. Imagine investing $10,000 as an early-stage investor in Google Inc. (GOOG) and seeing the value of your equity stake grow to $10 million in just a few years. This allure aside, equity-based crowdfunding sites have yet to deliver on a "Google" event or, for that matter, anything close.

Currently, only accredited investors (limited to 499 per company before the company must file publicly) are allowed to participate in equity-based crowdfund investing in the U.S. However, Title III of the JOBS Act, which is widely expected to take effect in this year (2014), would open the door for unaccredited investors (proposed at up to 1,999 per company) to participate as well. While the specifics have yet to be finalized, most expect Title III to limit the amount of money a company can raise in a 12-month period via equity-based crowdfunding to $1 million and cap the amount an individual can invest, per company and per year, based on criteria such as income and net worth. If the Securities and Exchange Commission (SEC) approves Title III, as it is expected to, investors will be able to participate in a venture capital market historically reserved for institutional investors and the ultra-wealthy. In addition, new ventures and SMEs will finally have access to a large pool of previously inaccessible capital that dwarfs the size of the institutional venture capital investment pool.

To help you prepare for this new investment alternative, this article covers the ins and outs of equity-based crowdfund investing, from choosing a crowdfunding platform to evaluating investment opportunities.

Allocation

First, how much of your portfolio should you allocate? Needless to say, every investor's strategy will differ based on their existing portfolio makeup, short- and long-term investment goals, family and job status, age, and a number of other factors.

As a starting point, within the context of a traditional 60% stocks/40% bonds (60/40) investment portfolio, we generally recommend a diversified target of 12% to 15% private equity and venture capital assets.

Keep in mind that equity holdings in start-ups and small businesses are not usually liquid assets (meaning they cannot be easily bought and sold), as new ventures need time to grow and prove themselves before a significant liquidity event—such as an initial public offering (IPO) or acquisition by a larger company—can take place. Therefore, investors with lower risk tolerances or short-term investment horizons may want to consider a slightly smaller allocation or target companies with the potential and focus to have a liquidity event sooner rather than later.

Conversely, those with a bigger appetite for risk or a long-term investment horizon may want to consider a larger allocation or target very early-stage companies with immense growth potential that may not become liquid assets for at least three to five years.

Deal Sourcing

Now that you've determined how much capital you're willing to put to work, where do you find investment opportunities?

Deal sourcing is a huge component of a traditional venture capital fund's skill set. Without a substantial number of investment opportunities coming through the door looking to raise capital, a venture capital fund's chances of finding quality investments are minimal. In fact, most venture capital funds meet with and vet thousands of companies each year and may only invest in three or four of them.

The beauty, and the danger, of equity-based crowdfunding is the presumption that deal sourcing is already taken care of for investors. While venture capital funds must develop extensive networks, keep their ear to the ground, and continually pound the pavement to keep deal flow strong, individual investors have easy access to thousands of investment opportunities. Just fire up your computer, launch your favorite Web browser, visit some of the many crowdfunding platforms and you'll find hundreds of equity-based crowdfund investment opportunities at any given time.

As is often the case, though, if it feels too good to be true, it probably is. Some crowdfunding platforms will allow any company to launch a capital campaign on their platform with little, if any, vetting. There are usually safeguards to ensure that the companies raising capital are, in fact, real companies. Beyond that, few crowdfunding platforms actually vet the quality of individual investment opportunities and filter out deals that are almost sure to fail.

This leaves investors to browse and screen hundreds of deals to find a few that might pique their interest from an investment standpoint. Among the few crowdfunding platforms that do vet the quality of individual investment opportunities before allowing companies to raise funds on their platform, very few have teams with a proven track record of success evaluating start-ups.

Crowdfunding Platforms

A number of crowdfunding platforms have begun jockeying for position as the go-to platform for the most promising equity-based investment opportunities. Most notably, U.S.-based AngelList and Israeli-based OurCrowd already serve accredited U.S. investors and plan to expand their offerings to unaccredited investors when Title III takes effect. Abroad, U.K.-based CrowdCube and Sweden-based FundedbyMe serve accredited and unaccredited investors from non-U.S. countries with more flexible investment regulations. Undoubtedly, other players will emerge.

In our view, the secret to becoming a leader of the pack will be the platform's ability to attract top venture capital talent to their teams or partner directly with proven venture capital funds in order to both offer and vet investment opportunities and filter out bad deals. Crowdfunding platforms will likely need to offer minimum investment thresholds well below the traditional institutional venture capital minimums to platform subscribers. Additionally, successful crowdfunding platforms may evolve their platforms to include secondary exchanges, offering investors liquidity for an otherwise illiquid asset class.

As an important aside, this opportunity for unaccredited investors to invest in professionally managed venture capital funds and direct investments via crowdfunding platforms may end up being the savviest investment in the equity-based crowdfunding space because it offers instant diversity with a portfolio of companies carefully chosen by professionals. Should you choose to take advantage of this opportunity, make sure the fund manager is credible and has a proven and realized track record (meaning returns have been collected and distributed to investors) before committing your investment capital. As is the case in any industry, not all venture capital fund managers are created equal.

While the quantity and quality of investment opportunities will be driven largely by the quality of the crowdfunding platform teams and partnerships, the other primary factors to consider and investigate include:

- Are the platforms a match for your risk/reward profile?
- Are the selected platforms the right size/right fit for your desired investment allocation?
- Are the terms and conditions of investment fully transparent and economically aligned with yours?
- Does the underlying platform investment team possess the required pedigree, experience and track record, and is it correlated with the proposed strategy of the fund or investment?
- What is the fee structure of the platform? How big are the cuts taken from investors and companies, and at what point(s) in the process are they collected?
- Does the platform require a minimum annual investment commitment or a minimum amount per investment?
- Can you fund your investments with your IRA, 401(k), bank account, credit card, PayPal account or other sources you prefer?
- Is the platform reliable and easy to navigate?

Due Diligence

The easiest parts are over. You've now reached the critical step of conducting your due diligence to decide whether or not to pull the trigger and invest. Here, we turn to insights gleaned from decades of venture capital investing to develop a systematic process for evaluating equity-based crowdfund investment opportunities.

Ideally, the platform(s) you use will provide most of the information you need, or at least offer a relatively easy way to find the information. If the company under consideration doesn't provide easily accessible investor information or doesn't paint a clear picture of what they do and how they plan to use the capital raised to increase the value of their business, that may be a red flag regarding the company's leadership and long-term viability. The following is a checklist of key criteria to research and carefully consider before making an investment in a start-up or small business:

1. Idea: Every entrepreneur believes his or her idea is compelling, but in reality, very few ideas are unique. Speaking from decades of venture capital experience, what makes an idea compelling to an investor is clear depth of understanding of a big problem or opportunity and an elegant or, more often, a simple solution to solve or exploit it.

2. Team: A great idea is only as valuable as the core team can make it. The founders, in particular, must have the vision, talent and credibility to develop the idea and attract word-class talent to fill in the gaps. Serial entrepreneurs with a track record of successful exits—the company being acquired or completing an initial public offering—are particularly compelling.

3. Market Opportunity: How big are the markets that the product or solution can play in over the short term and long term? Venture capital funds are generally wary of companies focused on a product or market opportunity that is not technology-based, as those companies may be difficult to scale without large amounts of capital more commonly secured via other sources.

4. Technology: What is it about the technology that makes it so great? The best answer is that there are plenty of customers with plenty of money who desperately want or need it.

5. Competitive Advantage: Every interesting business has real competition, including direct alternatives, "good enough" solutions, and even the status quo. Does the company's plan address all these forms of competition, and can it sustain an advantage over them for several years?

6. Financial Projections: A popular adage coined by Brad Feld of The Foundry Group states, "The only thing that we know about financial predictions of start-ups is that 100% of them are wrong." While that may very well be true, financial projections are still important in terms of understanding, directionally at least, when a company expects to be profitable and how they plan to get there.

7. Validation: Does the company have customers and cash flow? Is the deal clean, or are there lawsuits waiting in the wings for the first whiff of money? The more credibility and customer traction a company has already, the better. Financial backing from reputable angel investors or venture capital funds certainly doesn't hurt, either.

Granted, some of these criteria are difficult to quantify and evaluate with any degree of certainty. There is often some measure of guesswork involved, and at times you must simply follow your gut. After all, we're talking about largely unproven ventures that may be setting out to redefine an industry, or even create an entirely new one. The very nature of that proposition lends itself to a degree of uncertainty, which is one of the main reasons venture capital is a high-risk, high-reward investment activity.

All of that considered, after doing some digging, you're convinced the company you've investigated is the next big thing, or at the very least can provide you with a solid return on investment. It's time to pull the trigger, right? Not so fast.

Term Sheets, Investment Stages and Probability of Success

Before you put your capital to work, make sure that the deal terms are fair and align with your investment objectives by carefully reviewing the term sheet. This document should include the percentage of the company being sold, the valuation of the company, the type of security investors will receive, how the company plans to use the investment capital, what rights investors will have, and how the company will keep investors informed. Sure, the company might look promising, but if a venture still in its infancy is trying to raise $1 million in exchange for only 1% ownership stake, is that a prudent investment? In order for the answer to be yes, the company would have to be worth $100 million already and have the potential to be worth much more a few years down the road. As a reference point, Table 1 provides an overview of the typical stages of venture capital financing, including the typical investment ranges and the approximate risk of loss of capital.

As Table 1 clearly illustrates, the earlier the stage, the riskier the investment is. In fact, a recent study conducted by Harvard Business School Senior Lecturer Shikhar Ghosh suggests that approximately 75% of venture capital–backed companies fail to have a successful exit.

Because equity-based crowdfund investing is still in its infancy, accurate and representative data regarding crowd-backed companies is not yet available. However, it's a safe bet that their failure rate will be even higher than the 75% failure rate of companies identified by professional venture capital funds as worthwhile investments. No sugar-coating here: This is a risky and often unpredictable asset class with many moving parts. That said, huge returns are possible, and risk can be minimized by diversifying your portfolio of companies. Note that due to the fundraising limitations likely to be included in Title III, equity-based crowdfund opportunities are more than likely going to present in the early seed and start-up stages.

Tracking and Monetization

You're confident you've unearthed a gem, you feel the term sheet is fair and you've put your money where your mouth is. Now it's time to carefully track the progress of your investment and be ready to move if need be. Follow company news, read the quarterly investor reports and any other materials provided by the company, and reach out via the proper investor relations channels if questions arise.

Should the company decline or fail to prosper, a number of outcomes are possible. The worst case, of course, would be for the company to go belly up, in which case investors stand to lose most or all of their investment. A more common outcome is for a company to stall, grinding away tirelessly without gaining additional traction, or

Table 1. Stages of Venture Capital Funding

Investment Stage	Typical Investment Range	Risk of Loss of Capital	Likely Crowdfunding Stage?
Seed stage	< $500,000	66.2%	√
Start-up stage	< $2 million	53.0%	√
Expansion/2nd stage	~$10 million	33.7%	
Expansion/3rd stage	~$10 million	20.1%	
Bridge/pre-public stage	Up to $100 million	20.9%	

perhaps even losing some. Depending upon your rights as an investor, at this point you may be able to affect change in the company through a board or C-level executive shake-up. You may also be able to exercise warrants that allow you to either recoup some of your original capital or increase your stake in the company through a discount of the original valuation. More likely courses of action include selling your stake on the secondary market (likely for less than you bought it), sticking it out in hopes that the company is able to start moving in a positive direction, recapitalizing by selling your shares back to the company, or the company winding down and selling off all assets in order to pay investors back. All of these options may or may not be available to you, depending upon the term sheet agreement and your ability to galvanize the "crowd" of investors into unified action. A venture capital fund generally doesn't have to contend with the latter concern, as it has more consolidated power and a more unified voice with which to affect change in a portfolio company.

Another common scenario is for a company to initiate another round of funding, hopefully at a higher valuation than when you invested. In some instances, a new round of financing could mean a dilution of your ownership stake. In other instances, part of the new round of funding could be used to buy out previous investors' shares. Sometimes, the investor or company has a choice in how existing shares are handled during a new round of financing. Because there are many ways a new funding round can be handled, it's critical that you understand the term sheet before committing your capital.

Ideally, though, the company will grow quickly and have a successful exit in the form of an initial public offering or acquisition by another company. In the rare case of an IPO, you will likely be the proud owner of liquid, publicly tradable shares of a company that is almost certainly exponentially more valuable than when you invested in it. In the more common case of an acquisition (according to a 2011 Ernst & Young report, 80% to 90% of all venture capital–backed exits are acquisitions), your shares will be paid out as set forth in the term sheet. In either case, you've likely made a great investment and will be rewarded accordingly. At the end of the day, these are the two outcomes most venture capital funds are aiming for.

Should you join the ranks of successful investors in early-stage companies, enjoy your substantial gains and reinvest wisely, taking care to stick to your overall investment strategy and asset class allocations, including additional venture capital or equity-based crowdfund investments.

Conclusion

We hope this article has provided you with a fundamental understanding of what crowdfund investing is, how Title III of the American JOBS Act is poised to impact individual investors, and how to participate in equity-based crowdfund investing once Title III takes effect.

Armed with the knowledge necessary to select the best crowdfunding platforms and employ a sound approach to evaluate investment opportunities, and with a little luck, you can diversify your personal investment portfolio and take advantage of the exceptional gains that savvy equity-based crowdfund investing can offer. ➤

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