Crowdfunding, a fresh source of financing for SMEs

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Abstract:
Crowdfunding provides an amazing opportunity for both businesses and entrepreneurs. Following fast expansion in English-speaking countries, it spread to mainland Europe. It gained a reputation for donations but gradually evolved to cover equity financing and loans.
The most thriving segment of this new form of financing is crowdlending. The latter emerged in 2005 and was initially uncontrolled and unstructured. After a certain amount of teething trouble, it is now in a position to provide a credible supplement to traditional bank financing. Thanks to current technology and regulations that are clear, strict yet benevolent, many lending platforms have emerged in France, Germany, Spain and the Netherlands. Today, these stakeholders hold a number of trump cards to achieve substantial financing volumes. It is down to them to control their growth and to handle their main mandate of converting entrepreneurs and savers.

Crowdfunding, P2P lending, Kickstarter, AngelList, LendingClub… These expressions and names have been flying around on social media in recent years but even clued-up readers are starting to get nonplussed.

Although it would have been unthinkable several years ago, crowdfunding is in the process of upending incumbent financial models. Whilst making donations or investing in startups' equity – two of the main crowdfunding categories – are established concepts, direct loans from individuals represent a real shake-up. For centuries, savers were strictly prevented from lending money.

In late 2014, French lawmakers, having taken stock of the huge changes underway in the United States and the United Kingdom, introduced a clear and forward-looking set of regulations for all online platforms looking to match savers up with SMEs seeking funding. This represented an unprecedented chance for very small companies and SMEs which, unlike major groups, had previously had no alternative to bank financing. In France alone, the market is estimated at between €80 and €100 billion per year.

English version: Translation Centre of the French economy and finance ministries

Crowdlending, which emerged in the wake of this legislation, pledges to offer broader financing to very small companies and SMEs, which all observers agree are valuable to the domestic economy. They also drive competition and foster private investment. However, for this pledge to equate with success, the new stakeholders need to be scrupulously serious so as not to let private investors down and to encourage institutional investors to show interest in this new category of asset. The expected returns with acceptable risk offered by lending platforms, compared to the current yields of no-risk investments, should spur on all investor profiles and allow for better financing of the economy.

The origins of crowdfunding

Crowdfunding is a means of gathering the funds required to carry out a project by calling on a vast number of people.

The first platforms were set up in the United Kingdom and the United States in 2005 and focused on micro-lending and donations. Since then, the number of platforms has been constantly increasing worldwide, and the market is expanding rapidly, in step with countries' adaptation of their regulatory frameworks.

There are three main types of platform:

- Donation or reward crowdfunding which has more to do with sponsoring or pre-sales. Depending on the project, the donor may receive a gift from the project leader or the pre-ordered product at a preferential price.
- Equity crowdfunding allows investors to take a stake in unlisted companies which are most often startups.
- Peer-to-Peer lending enables individual investors to lend money directly to other individuals or to businesses.

These three types of crowdfunding all exist on a market that is hard to assess as a whole due to their different business models. So, for a better understanding of crowdfunding, the three methods, which only have as common ground the broad base of subscribers that they marshal, need to be analysed separately.

Donation crowdfunding

Donations allow donors to support projects that interest them, whether these are entrepreneurial, artistic or charity-based. Depending on the project, donations may be made for consideration such as a concert ticket for a music group or a product offered for pre-sale by a company.

Donation websites collect subscribers' donations and then pay the funds over to the project leaders when the amount is reached or exceeded.

Many platforms operate in this sector. The leading one, Kickstarter, is American. At the time of writing, it had funded over 155,000 projects for an amount of $4,053,320,122. Kickstarter has become a global benchmark in this field. Many venture capitalists have even taken to monitoring the website for pointers to tomorrow's success stories, as Kickstarter is ultimately the best source of market research in the B2C sector!

In France, the market is shared by two websites: Ulule, which was set up in 2011, and Kisskissbankbank, which was launched in 2010 and is now owned by Banque Postale.

Equity crowdfunding

Equity crowdfunding allows investors to fund SMEs by taking stakes in their capital. Startups and SMEs are selected by the platforms before being presented to investors who can contribute to the project of their choice. In return, the investors become company shareholders and are therefore provided with all relevant information concerning the business activity.

In practice, this type of funding is essentially centred on seed capital and property. It was banned in the United States until the Jobs Act was adopted in April 2012. This legislation provided a regulatory framework for these platforms but this means that the American market is still in its infancy. In France, Wiseed and Anaxago are this segment's market leaders.

P2P lending

Crowdlending enables investors to lend directly to companies. As with all loans, borrowers repay them to the lenders on the basis of an instalment schedule and a fixed interest rate. Through the platforms, individuals become "bankers" for the companies they fund. Investors expect the platforms to provide an upstream analysis of projects that shows the level of risks for each of them. In addition, the platforms are also tasked with managing loans and ensuring repayments are made throughout the loan term.

There are two main categories of crowdlending: loans to individuals for which the main players are Lending Club in the United States and Younited Credit in France, and loans to companies, for which the market leaders are Funding Circle (UK), OnDeck (US) and the French platform October (formerly Lendix). The US market is very highly specialised with stakeholders offering student loans, mortgage loans and even loans in the medical sector.

The market has expanded very rapidly in the United States where the volume lent on these platforms was around $50 billion in 2017, according to Statista, and in the United Kingdom where the figure was approximately $6 billion, according to the same company. In France, this market's growth was reined in by the banking monopoly until the government broke it up with Order no. 2014-559 of 30 May 2014.

Funding very small companies and SMEs: the cornerstone for rebooting growth

A market that is highly dependent on bank loans

Taking the figures for all businesses, the credit scenario in France and Europe is fairly healthy. Nevertheless, more in-depth studies flag up wide disparities between large and small companies. Whilst major groups and mid-tier companies, which are able to diversify their sources of financing, have broad access to the debt market at unprecedentedly low rates, very small companies and SMEs looking for funding of less than €3 to €5 million often only have the banks to turn to.

For several years now, large companies (major groups and mid-tier companies) have had numerous options due to the development of private debt funds, *fonds de prêt à l'économie* (SME and mid-tier company loan funds), investment funds (Novo, Novi), rated bonds or mezzanine debt. Access to these instruments is far from easy, even for mature and structured businesses, and they are quite simply out of reach for smaller companies.

In light of the foregoing, the pledge made by peer-to-peer lending to grant loans of up to €1 million obviously represents a real breath of fresh air for very small companies and SMEs in a segment which is currently fully controlled by the banks. This goal is combined with the aim of providing a different customer experience: loans granted more rapidly (often in less than 48 hours), without a personal guarantee, to cater for requirements that fail to match, or badly match, banks' funding matrices (for instance, financing intangibles).

Changing funding offerings for very small companies and SMEs is essential

Paris Europlace's FINECO working group report highlighted the problems affecting the incumbent model for financing the French economy. The liquidity crisis between 2007 and 2009, combined with the sovereign debt crisis in Europe, deeply affected both European banks and bond markets, and emphasised the shortcomings of the funding model for SMEs and mid-tier companies which was over-reliant on banks. It took joint action by the Paris financial centre and the public authorities to guarantee the financing of SMEs by French banks.

Against this backdrop, the main priority for SMEs is to diversify their sources of financing. They are also looking for solutions that are better tailored to their requirements as regards the conditions for obtaining this funding.

For their part, banks need to reduce their outstanding loans which weighs on their equity capital to comply with Basel III ratios. According to Paris Europlace's report on debt financing for SMEs and mid-tier companies, the fast progress of French banks towards compliance with equity capital ratios has led to deleveraging (or less growth) of their balance sheets. In the future, rolling out these liquidity ratios should have the following effects, in particular for very small companies and SMEs for which the capital requirements are higher than for mid-tier companies:

- A reduction in loan maturities
- Greater selectivity for loans and a better standard of guarantees
- An increase in the cost of intermediation and of financing

In these circumstances, it is clear that SMEs' requirements, which are not currently fully met by the banks, will be even less so under an economic upswing scenario. As a result, crowdlending probably offers an appropriate solution to ensure the economic recovery of our SMEs.

Market size

The Banque de France's "Stat Info" data estimates that the SME market accounts for over €350 billion in outstanding bank loans, of which almost €55 billion is at less than a year. Between loan repayments and the growth in outstandings, which we are currently witnessing, almost €100 billion will be required annually to cover the financing requirements of very small companies and SMEs in France.

Furthermore, compared with mid-tier companies, SMEs make far fewer loan applications. Whilst almost half of mid-tier companies have applied for a credit line in the last twelve months, the figure is only one third for SMEs. The FINECO report also reveals that over a quarter of SMEs have worrying, or even critical, cashflow issues. The new SME-targeted loan options being offered by lending platforms should help meet a demand which is not currently catered for. This demand is hard to assess but should represent several dozen billion euros per year.

As stated above, banks will not be able to meet this rising demand alone. Due to the ratios they have to introduce to comply with new regulations, they will be unable to lend SMEs the funds required to finance their growth. Directly earmarking individuals' savings to finance our very small companies and SMEs is therefore essential to ensure future growth.

From peer-to-peer (P2P) to crowdlending

The face of the P2P industry has changed substantially over the last decade and, more importantly, it has learned a lot from its mistakes!

The trailblazers had a very simple approach by acting as mere intermediaries matching up supply (lenders) with demand (borrowers). Basically, lenders were alone in confronting a wealth of possibilities and varied, or even mediocre, standards. They had to form their own opinion on the quality of the projects, assess the borrowers' sincerity and put a price (i.e. an interest rate) on their returns. Reverse Dutch auctions were commonplace.

What was bound to happen did indeed happen fairly rapidly: the number of defaults exceeded the worst nightmares of the initial lenders. For instance, the Prosper lending platform had a class action instituted against it by disgruntled savers. This platform, and others, quickly realised (in 2009) that it had to offer more than a standard contact service.

As a result, there was a transition from a "quasi anti-globalisation" and "anti-banking" approach to a much more professional strategy with fixed rates (offered by the platform) and a service with value added (checking and rating borrowers, debt collection, reporting, etc.). A number of platforms, like October, even brought their interests into line with those of the lenders by automatically and systematically lending to each online project. Lastly, regulators bolstered, clarified and more actively verified platforms, and this is crucial for an industry that cannot survive without confidence in the system.

At the end of the day FinTech is not only a matter of technology and certain basic tenets of finance or regulations cannot – and must not – be compromised. These are even the fundamental requirements for sustainable development.