Everything micro-SMEs need to know about crowdfunding

UKCF
UK Crowdfunding

Trillion Fund™

premierline direct
BUSINESS INSURANCE
A company of Allianz

Contents

Everything micro-SMEs need to know about crowdfunding.

Foreword

One of the vital ingredients to running a successful business is effectively managing its finances. Achieving this isn't just about cutting costs. Businesses also have to know where to spend money to function and invest it to grow. But insufficiency of funds from within small businesses, particularly those with less than 10 employees, can be restrictive.

"Looking beyond just the traditional means of funding is becoming much more popular to small business owners and crowdfunding has captured the headlines like no other type of alternative funding so far. We think that access to information that help business owners fully understand crowdfunding and decide if it's right for them before they start investing in the process is essential", comments **Ibi Moghraby**, Managing Director at Premierline, one of the UK's leading providers of small business insurance.

This Crowdfunding guide aims to help micro-SMEs make an informed decision about whether or not it's the right source of finance for them, how to maximise success and provides direction to resources to help make this work.

Everything micro-SMEs need to know about crowdfunding.

95% of UK businesses employ less than 10 people

In 2013, 95% of UK businesses employed less than 10 people[1]. That's 4.7 million micro-businesses vying for space to grow in a persistently tough economic environment.

Until the banks release the tight grip on their reserves, micro-SMEs sometimes have to seek alternative forms of funding to overdrafts and bank loans. Crowdfunding is becoming more popular for many.

Crowdfunding is a way of raising money from lots of people via a website. Businesses with a good idea pitch their project online and offer rewards or financial returns for people that pledge or invest money.

However there's a lot more to crowdfunding than just raising funds. It's a great way of building a community of followers, engaging with a target audience and establishing long term relationships with those who will support the business into its future.

Many of us have perhaps heard about crowdfunding for business. But start-ups and micro-SMEs that are considering using it to raise funds need to fully understand it before diving in. That way they are more likely to reap the rewards they're after.

[1] www.parliament.uk/briefing-papers/sn06152.pdf

Everything micro-SMEs need to know about crowdfunding.

> “Crowdfunding is a very broad term covering very different models from the lending model where you get a loan from the crowd which you have to repay with interest, to reward based models where your backers prepurchase the product you are making.”
>
> **Liam Collins**, Nesta

What is crowdfunding?

Let’s start with a crowdfunding definition.

Crowdfunding is a way for businesses or projects to raise money by inviting lots of people to pledge or invest small amounts, usually online. It’s a form of alternative finance, which means that it doesn’t involve traditional banks.

Generally businesses advertise their project on a crowdfunding website and potential investors choose whether to pledge money, how much, and the return (if any) they expect.

So when did crowdfunding begin? Modern crowdfunding started life in the UK, when rock band Marillion asked its fans to fund its US tour in 1997. From then on it gradually grew, before erupting into British lives in 2009 when it became a significant, plausible choice for people wanting to finance their ideas.

There are three types of crowdfunding:

Reward Crowdfunding -

this relies on contributions from investors for intangible or non-monetary reward

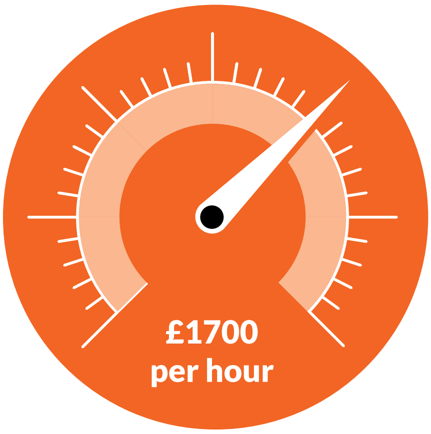
Debt Crowdfunding -

the crowd donate to your business or project in exchange for financial return and/or interest at a future date

Equity Crowdfunding -

investors receive a stake or shares in the company in return for their investment

Everything micro-SMEs need to know about crowdfunding.



The size of the crowdfunding market

Since the beginning of 2014, businesses have been raising £1,700 per hour[2] through crowdfunding, which is a form of alternative finance (because no banks are involved). The alternative finance market as a whole is growing at an astonishing rate in the UK and is predicted to be worth over £1.5bn[3].

Some businesses are basing their entire growth on crowdfunding. Global records of $40m have been raised through US crowdfunding websites like Kickstarter and Indiegogo. The craze is embedded in the UK too, with the Bristol Park and Slide and the Arran Brewery both hitting the headlines because of the support they have gathered through crowdfunding.

Even though crowdfunding gets comparably high volumes of media coverage, alternative finance is still a relatively small market compared to traditional bank lending (which totalled some £7bn[4] for SMEs in Q3 2013 alone). In fact, only 5,000 UK SMEs raised funding through the alternative finance market between 2011 and 2013[5]. Nevertheless it's growing at an astonishing rate, with the UK market growing at 350% in February and March 2014[6].

Crowdfunding is taking off in the UK for a variety of reasons, the most popular being lack of available funding from banks. So with the rise of social media it makes sense that businesses are turning to their networks to raise money instead[7].

2 http://www.businesszone.co.uk/topic/finances/entrepreneurs-raise-1700-hour-through-crowdfunding/55927

3 http://www.nesta.org.uk/media_colorbox/2279/media_original/en

4 http://british-business-bank.co.uk/

5 http://www.nesta.org.uk/publications/rise-future-finance

6 http://thecrowdfundingcentre.com/?page=datacenter

7 http://www.theguardian.com/business/2014/jan/21/small-business-funding-bank-of-england
http://www.biz-works.net/index.php5?SID&fl=y&pgid=bp&art=474&st=banks-turn-away-over-half-of-smes

"Banks will continue to be a vital source of finance but it's not a one-size-fits-all solution, and we're encouraging growing firms to open their eyes to the broad range of funding options on the market."

CBI

"Beware that responding to requests and comments from the hundreds (and in some cases 1,000+) [of] backers of your campaign is very different from managing one or two traditional funders and will require quite a lot of time and effort."

Peter Baeck, Nesta

Everything micro-SMEs need to know about crowdfunding.

How is crowdfunding different to other ways of accessing funds?

Traditionally if a small business wanted money its only option was to report to its bank manager with a business plan and request the funds. Thankfully times have changed and there are now several ways to access capital, of which crowdfunding is one.

Other than bank loans, overdrafts and credit cards, the main sources of finance for smaller businesses in the UK[8] are:

- **Trade credit:** suppliers allowing their customers to buy now and pay later
- **Asset backed finance:** lending that is secured by an asset, which is taken if the loan is not repaid
- **Invoice discounting:** a third party buys sales invoices for a fee
- **Angel investment:** affluent individuals or groups provide capital in return for debt interest or equity shares
- **Venture capital:** funds, guidance and reputation are given to rapid-growth businesses in return for ownership positions or high interest rates (or both)

The major difference between these forms of finance and crowdfunding is the number of individuals or institutions involved. All of the above depend on one or just a few contributors, where as crowdfunding relies on many small investments from lots of people. This can result in significant amounts of time and effort being spent engaging with investors.

Deciding which type of finance is right for a business is, therefore, far from simple. However, 57% of small and medium-sized firms spend less than an hour researching according to the CBI[9] finance providers. The CBI has therefore launched FindmyFinance, an online tool that helps businesses identify the types of alternative funding that are suitable for their needs.

[8] http://british-business-bank.co.uk/performance/facts-and-figures/

[9] http://www.cbi.org.uk/media-centre/press-releases/2014/02/we-need-to-shatter-the-equity-finance-glass-ceiling/

"Irrespective of the type of crowdfunding model, it is key to provide a compelling proposition in order to be relevant in the current market."

Julia Groves,
Trillion Fund

"Businesses often choose debt crowdfunding because it's fast and you don't always need a track record, as is the case with equity crowdfunding. Reward crowdfunding can be appealing because rewards rather than money are given back to the crowd."

Anne Strachan,
Crowdfund UK

Everything micro-SMEs need to know about crowdfunding.

Types of crowdfunding

Crowdfunding has three hats depending on the needs of the business or project and the motivations and expectations of the potential investors.

Reward crowdfunding (sometimes called donation crowdfunding) relies on people's contributions to projects or causes for often intangible or no return. Depending on the situation, investors might get an acknowledgement in a book or free entry to an event, but their real motivations are usually to support a good cause or to feel bought in to something in their community.

Debt crowdfunding (also known as crowdlending and peer to peer (P2P) lending) is the most akin to getting finance for a business or project through traditional means. Investors generally expect a financial return for contributing money (although in the case of microfinance, where money is lent to the very poor, no interest is paid).

Equity crowdfunding (also known as crowdinvesting) means that people get shares or a stake in the business or project in return for their monetary investment. As with any equity investment, when things go well the value of their investment goes up but it can drop too. Investors are usually experienced funders and expect their returns at the end of the project.

Case study: Dreamgenii®

Pregnant with her first child, Vanessa Blake found herself struggling to sleep at night. After exhausting the range of specific pregnancy pillows available on the market Vanessa designed her own. It quickly became apparent that they had a popular product and Dreamgenii® needed access to finance in order to expand the business.

Ready to explore alternative finance, Dreamgenii® approached the peer-to-peer business lender Funding Circle.

The company's loan of £75,000 was accepted and fully funded within two weeks with almost 1,400 people from across the country lending from as little as £20. The company has gone on to develop a wide range of products which are now sold in major British nursery retailers.

[8] http://british-business-bank.co.uk/performance/facts-and-figures/

[9] http://www.cbi.org.uk/media-centre/press-releases/2014/02/we-need-to-shatter-the-equity-finance-glass-ceiling/

"The decision on which type of crowdfunding route to go down depends on the type of business and what the funds will be used for. For instance in order to raise debt funding a company will need to provide evidence that they will be able to service the debt (ie they are profitable and can pay the interest). This route isn't appropriate for a start-up looking to grow their business and that is not yet profitable.

Reward based crowdfunding is excellent for businesses who are focused on consumer products at around the £100 or less mark. It's a fantastic way to test the market for your product and effectively pre-sell some goods. You'll get lots of really valuable feedback and it will test whether there is a market for your product.

Equity based crowdfunding is the best route for businesses that can scale and are looking for funds to grow their businesses and provide a return for shareholders. "

Jude Cook, ShareIn

"Feedback from the crowd, such as comments on the characters in the videogame you are developing or changes to the colour options for the watch you want to design can help you refine and develop your product to be even more successful as you are running your campaign."

Liam Collins, Nesta

Everything micro-SMEs need to know about crowdfunding.

Advantages and disadvantages of crowdfunding

Crowdfunding isn't for everyone. Before a business dives into the exciting but time consuming world of profiling their project, securing supporters and then implementing their idea, taking time to understand the advantages and disadvantages of crowdfunding up front could save a lot of time and energy down the line.

Advantages of crowdfunding	Disadvantages of crowdfunding
Businesses set a target amount that they want to raise for their project. If this is hit they get every penny.	"Crowdfundable projects are visible, finite and understandable. If your project isn't all three, it's unlikely to succeed." **Anne Strachan**, Crowdfund UK
Successfully crowdfunded projects can get huge amounts of attention, on social media and elsewhere, which can help them grow beyond what the money raised alone could have done.	If the target amount isn't reached, potential investors get their money back and the business goes away empty handed
Pitching a project or business through crowdfunding can be a valuable form of marketing	Failed projects risk damage to the reputation of the business and people who have pledged money to them
Some businesses raise £100,000s in just a few days, giving them almost instant access to funds	Such a public display of an idea risks others copying it
As part of the crowdfunding process the business can get feedback about their idea and how to improve it	Businesses need the time and money to gear up the community, publish their project and bring in investors before any money is raised
Crowdfunding is great for niche ideas that wouldn't otherwise have access to a receptive audience or funds	A strong, established existing network is vital to the success of a project. Without it, even the best ideas don't get backing
As a result of the crowdfunding process, a business's audience becomes its most loyal customers	Getting the rewards or returns wrong can mean giving away too much of the business to investors
"A successful crowdfunding campaign can serve as a positive signal for other funders and can help you attract more funding or funding at better terms." **Liam Collins**, Nesta	"A company that has a limited network, no digital or social media presence, or a very complicated product will find it harder to crowdfund." **Jude Cook**, ShareIn

"It is important for SMEs to find the model that suits them best to improve the likelihood of them securing the funds they need as well as getting funding on the right terms."

Liam Collins, Nesta

Everything micro-SMEs need to know about crowdfunding.

What are crowdfunding platforms?

In order to raise funds through crowdfunding, a business must first find the crowdfunding website (or platform) on which they want to pitch their project.

With so many platforms to choose from, this is no easy task. Several websites and publications have summarised the UK's best crowdfunding sites (such as the Telegraph[10]) but Nesta also has a useful directory crowdingin.com which features a comprehensive, searchable list of crowdfunding platforms available in the UK and is a great place to look for the service that could deliver the best results for your business.

Factors to consider when you are choosing a platform to help ensure your crowdfunding success are:

- **Type of crowdfunding** – not all platforms offer all three types of crowdfunding. For example, Crowdcube only offers equity crowdfunding and Funding Circle focuses on debt crowdfunding.
- **Fees** – different platforms have chosen different structures to price their services. These might include arrangement fees, administration fees, legal fees, success fees, transaction fees, commission fees... the list is pretty long so it's worth costing up a few options.
- **Type of investors** – individual, business and institutional investors can all pledge money to a project, but some platforms stick to just one particular type of investor. Registering with an equity crowdfunding platform, for example, enables a business to read the questions posed by existing investors and the answers they have given, providing useful insight into what sorts of projects work on that platform and why.
- **Type of platform** – some platforms are purely a landing page that brings businesses and investors together. Others have a more active role.
- **Platform usability** – each website offers its own model, layout and pledge process, which attracts certain types of investors. Knowing what's important to potential investors and which platforms they like will help determine which is most likely to lead to the funding target being reached.
- **Security** – will investors feel secure giving money to the website? If friends and family are not comfortable, it's unlikely the crowd will either.
- **UK v foreign platform** – British businesses must use debt and equity crowdfunding platforms that are based in the UK. For reward crowdfunding, any platform worldwide can be invested in by people based in the UK, but really only Indiegogo and Kickstarter are set up for the British market.

[10] http://www.telegraph.co.uk/finance/personalfinance/investing/10435276/Which-are-the-best-crowdfunding-websites.html

What are crowdfunding platforms? (Continued).

- **General v niche site** – different platforms focus on different types of project. Indiegogo is a generalist platform, whereas Kickstarter concentrates on creative projects. There are even platforms specifically for mumpreneurs, authors and cancer research projects.

- Or some businesses do crowdfunding without using a platform, such as Brewdog. They have raised £7m[11] through three rounds of crowdfunding buying shares in their Aberdeenshire-based brewery.

"If you're raising funds through reward crowdfunding, choose a platform you and your friends like. You're then more likely to secure the first 30% of your funding target, significantly increasing your chances of success."

Anne Strachan, Crowdfund UK

Case study: The Bicycle Academy

In 2010 Andrew Denham came up with the idea of a bicycle frame-building school and open workshop. A year later he ran a crowdfunding campaign. His project was the first ever successfully funded project on peoplefund.it (now part of Crowdfunder) and raised £40,000 in just 6 days.

Pledges of between £20 and £1,000 were made by 180 people in return for various goodies including T-shirts and the very first places on the academy's frame building courses.

The Bicycle Academy now offers a range of bicycle frame building courses and skills masterclasses, including their Classic Framebuilding Course from which every student's first bike is given to someone in Africa who really needs it.

[11] http://www.bbc.co.uk/news/uk-scotland-scotland-business-25499012

> "Be aware of the time and resources required to raise crowdfunding. This differs depending on the type of crowdfunding you choose but in rewards crowdfunding for example you need to start building your campaign far in advance of launching it on a platform and make sure you are effectively tapping into your online and offline networks to help your fundraising."
>
> **Peter Baeck**, Nesta

> "The jury is still out as to whether or not businesses that secured their first round of funding through crowdfunding will find it more difficult to get their second round of funding from venture capitalists or business angels."
>
> **Anne Strachan**, Crowdfund UK

What are the risks of crowdfunding for businesses?

Crowdfunding, just like business, isn't for the faint hearted. There are risks that need to be managed throughout the process.

Investment

Significant investment is required long before a project is launched on a crowdfunding platform. This equates to time and money taken away from other things when there is no guarantee of success. So before committing to using crowdfunding to raise funds, it's important to understand whether the business can afford it by setting realistic budgets and timelines up front.

Intellectual Property

Unlike traditional methods of raising finance, where there are a few potential investors to whom a business presents its ideas, crowdfunding involves a lot of people knowing a lot about the business and its idea. It has an unwelcome side effect in that it gives other businesses the opportunity to copy ideas before they're real inventors have seen it through to fruition.

It is therefore imperative that businesses get the right intellectual property (IP) protection for their ideas before posting their campaign online. This may take the form of trademarks, patents or copyrights. Businesses with good ideas should read the legal disclosure on their chosen crowdfunding platform and get good legal advice before making their invention public. Start Up Donut offers a useful checklist on how to protect IP.

Ownership

Businesses that choose to raise funds through crowdequity sell a share of their company to investors. As part of this ownership, some investors expect to have a say in how the business is run. This can be of value to teams looking for expert guidance and advice, however it can be shackling if it holds up progress or takes the business in a different direction to that sought by the original owners.

Fraud

Unfortunately crowdfunding is not immune to fraud. Fake sites are springing up across the internet, with projects, particularly in the charitable sector, being copied and funds diverted to fraudsters. So it is important that businesses (and investors) check the credibility of the crowdfunding platform they are hoping to use before committing.

“[Crowdlending] came under the FCA for the first time in April this year - overall that is seen as a good thing, as the regulations are proportionate to the risk profile but lenders have the benefit of a third party keeping an eye on the platforms that handle their money”

Julia Groves,
UK Crowdfunding Association

“FCA authorised platforms will ensure that all promotions are fair, clear and not misleading, that there is a balanced view on risks and returns, and that any claims made can be substantiated.”

Julia Groves,
UK Crowdfunding Association

Is crowdfunding regulated in the UK?

Since 1 April 2014, the Financial Conduct Authority (FCA) has regulated debt crowdfunding and equity crowdfunding platforms in the UK.

To find out if a firm is regulated, visit the Financial Services Register of firms.

The UK Crowdfunding Association was set up in 2012 and aims to “promote crowdfunding as a valuable and viable way for UK businesses, projects or ventures to raise funds”. It has published a code of practice which some UK crowdfunding businesses have chosen to adopt – they display the association’s logo on their website and material if they have.

The purpose of both the code of practice and FCA regulations are to ensure that investors’ money ends up where they expect, and that they have the right information on which to make decisions. There are also some good principles like cooling off periods, handling of complaints and back up processes should the platforms cease to operate.

"People's opinion of any project will be based at least in part by how well it's been received by others, so if a lot of time has gone by with little or no money raised, then it will be seen as a vote of no confidence. I can't emphasise enough how important it is to do a lot of legwork beforehand, so you have a base of people ready and willing to back your project as soon as you launch."

Andrew Denham, The Bicycle Academy

Everything micro-SMEs need to know about crowdfunding.

How to make crowdfunding work for your business

There are many resources available online that provide guidance and advice for launching a successful crowdfunding project that achieves its funding goal with the right investors. Listed below are some top crowdfunding tips and links to more information online.

Understand what crowdfunding is	What is crowdfunding from **TrillionFund**
Know the process	Working The Crowd from **Nesta**
Produce a specific and accurate business plan and marketing plan	Why business plans are invaluable to crowdfunding campaigns from **Crowdclan**
Pick the right investors and give them reasons to invest	Inspiring investment from **Crowdcube**
Tell a good story well	7 Strategies for launching a successful crowdfunding campaign from **Fundable**
Produce a compelling pitch	Creating a successful pitch from **Crowdcube**
Create a powerful video	Five steps to a great equity crowdfunding video from **Seedrs**
Secure the first 30% of your funding target	The 30% magic rule from **CrowdfundUK**
Offer the right rewards	Creating rewards from **Kickstarter**
Get some supporters to pledge their money as soon as your campaign goes live to validate it	Seven steps to crowdfunding success from **Crowdfunder**
Communicate with investors before, during and after the campaign	After your campaign from **Indiegogo**

If you're thinking about investing

As well as getting involved in crowdfunding to help a business grow, individuals may want to think about investing via crowdfunding too.

There are various reasons why it might be considered:

- to seek better or non-financial returns compared to other investments
- to do social good
- to contribute to the community
- to get involved in something that is liked or a hobby.

Investing in businesses, projects or ventures through crowdfunding requires research and a clear head. As with any investment, there are risks associated with it and there is no guarantee of return.

Investments can start at as little as £10 and can be made in to a person, business, project or idea.

However, there are some tax implications which make it an attractive alternative for some people. For example, the Seed Enterprise Investment Scheme (SEIS) and the Enterprise Investment Scheme (EIS) are both tax relief schemes that entitle some investors to tax relief on certain projects.

If you want to know more

If you want to know more about crowdfunding for your business, use any of the links in our guide.

Also, here are some Twitter handles you may like to follow:

@UKCrowdfunding

@CrowdfundCentre

@CrowdFundBeatUK

@CrowdFundingBB

@Nesta_UK

@crowdfunderuk

Thank you to all our contributors:

We would like to thank all of our contributors for providing us with their comments:

Julia Groves is Chair of the UK Crowdfunding Association, which was formed in 2012 by fourteen crowdfunding businesses to promote crowdfunding, be the voice of crowdfunding businesses in the UK and publish its code of conduct. Julia is also Managing Director of Trillion Fund.

Peter Baeck is Principal Researcher and **Liam Collins** is Policy Advisor at Nesta, an independent charity that produces information about crowdfunding, including the Crowding In directory and Venture Crowd.

Jude Cook is the Co-Founder and Managing Director of ShareIn, the UK's first tech and health focused equity crowdfunding website.

CrowdfundUK is **Anne Strachan** MinstF who runs innovative training and support for the third sector, creative and startup business on crowdfunding.

Andrew Denham is the founder of The Bicycle Academy, which offers bike building courses in Somerset.

The CBI is a business lobbying organisation, providing a voice for employers at a national and international level.