

The Financial Power of the Crowd Part I



The Democratization and Socialization of Raising Capital

Raising capital has never been an easy task for entrepreneurs, and for most entrepreneurs launching a business raising capital can be the “straw” that often breaks the camel’s back; the challenge most likely to derail their business vision. Until recently, raising equity for a business venture, be it start-up capital or growth capital, was comparable to a soldier navigating a minefield without a mine detector.

At the height of the recession a confluence of variables (i.e., stricter lending practices by banks, movement of venture capital away from start-ups, private equity firms retrenching and refocusing on proven business models, shifts in consumer purchasing behavior, shrinking personal savings accounts, impact of the cloud and social media and a new generation of young entrepreneurs) came to bear what would forever change the landscape for how entrepreneurs sought capital to bring their business vision to reality. This innovative new world of financing called **crowdfunding** has opened doors for entrepreneurs who only a decade ago would have had no chance of raising the capital needed to start or grow their business.

Crowdfunding is rooted in the convergence of social connectivity, investing democratization (i.e. anyone can invest), cloud-based technology and government regulation. In 2012 the passage of the JOBS Act (Jumpstart Our Business Start-Ups) added an exponentially more powerful environment for the introduction of additional



approaches for crowdfunding, opening the doors for both accredited and non-accredited investors to invest in the dreams and business solutions of entrepreneurs. Clifford Holekap, Senior Lecturer of Entrepreneurship at Washington University offers a very succinct description of the appeal and popularity of crowdfunding in today’s new economy. He said, “The real reward of crowdfunding investors is not financial – it’s the opportunity to participate. Helping an

entrepreneur achieve their dreams and being part of a company that changes its industry and even the world – is exciting and personally rewarding. Everyone should have the freedom to make a difference with their dollars.”

According to recent statistics, \$16.2 billion was raised in 2014 using crowdfunding platforms. In 2015 experts estimate crowdfunding platforms will generate over \$34 billion in capital. According to a recent article that appeared in Entrepreneur online, approximately 41% of all funds raised through crowdfunding platforms are used to launch a small business.

Crowdfunding today is not unlike the “wild west” of the past. Today, entrepreneurs can attract capital through five different crowdfunding approaches, each uniquely different, and in most cases not nearly as well regulated as more traditional means of raising capital. The five crowdfunding approaches are donation-based crowdfunding, reward-based crowdfunding, debt-based crowdfunding, equity-based crowdfunding and royalty-based crowdfunding.

In part one of this two-part series on crowdfunding we will explore the most tenured approaches to raising capital in the world of crowdfunding; donation-based and reward-based crowd funding. Part two of this series, which will arrive next month will look at the newer forms of crowdfunding that leverage the financial upside of supporting an entrepreneur's dream; debt-based crowdfunding, also known as peer-to-peer lending, equity-based crowd funding and royalty-based crowd funding.

Donation-based Crowd Funding; Empowered by the Passion of Fans

Donation-based crowdfunding, and its sibling, reward-based crowdfunding, first arose in 2003 with the introduction of ArtistShare, a donation-based funding platform designed to help raise funds for musicians seeking to digitally publish their recordings. Donation-based platforms focus on helping individuals, as well as small business raise capital by appealing to a common and compelling sense of purpose and passion, in many instances an altruistic one. Some have even referred to donation-based crowdfunding as charity crowdfunding. Individuals who donate to a campaign or project on a donation-based crowd funding platform do not receive a tangible benefit for their contribution, rather they receive a very intangible, yet potent benefit; knowing they are making a difference by helping someone achieve their vision. Today, the largest crowdfunding platform in the world is donation-based site GoFundMe, which in 2014 raised approximately 470 million dollars from its 6 million plus donors. According to a variety of published articles, donation-based crowdfunding and its sibling sites offering rewards-based crowd funding are successful in raising the entrepreneur's targeted funds 54% of the time.

Rewards-based Crowd Funding; Empowered by Passion and Reward

Reward-based funding platforms, which evolved from donation-based platforms, are presently the most popular globally, including leading sites such as KickStarter that launched in 2008, as well as Indiegogo and RocketHub. Rewards-based funding platforms operate similarly to donation-based sites, extending fans, friends and followers the opportunity to contribute to a project that inspires them, leveraging the intangible benefits that accompany having contributed to the achievement of an entrepreneur's dreams and passions. Rewards-based sites one-up the donation-based sites by offering tangible benefits to sweeten the pot and generate additional buzz and participation. The top four crowdfunding sites (donation and reward-based) based on contributor traffic are GoFundMe, Kickstarter, Indiegogo and teespring. One example of the fund raising power exhibited by these crowdfunding sites is illustrated by the \$440 million that KickStarter was able to raise for entrepreneurs in 2014 from its base of over 3 million contributors.

Things to Know about Donation and Rewards-based Crowdfunding

- Not every funding campaign succeeds. Industry statistics indicate that approximately half of all reward-based and donation-based crowdfunding campaigns achieve their goal. An entrepreneur's success rate is dependent upon multiple factors, but one thing the statistics show is that the larger the financial target the lower the success rate. According to a recent article appearing on VisionLaunch, 43.8% of campaigns

launched the past year on Kickstarter where successful, while approximately 10% of those launched on Indiegogo were successful. Campaigns seeking to generate between \$100,000 and \$1 million (likely target for a start-up fitness business) were successful approximately 12% of the time on Kickstarter and 1% of the time on Indiegogo. For campaigns seeking \$20,000 to \$99,999 the success rates were 25% and 3% respectfully. According to the same article, small business ventures have the lowest success rate at approximately 3%.

- Rewards are Important. Successful campaigns offer relevant and compelling rewards. They also offer a tiered incentive structure that provides increasingly valuable incentives based on the level of donation made by the contributor. Incentives vary depending on the project. Examples of the types of rewards offered by entrepreneurs seeking donations include: free tickets for an event; a thank you phone call from the



entrepreneur; physical copy of the product; exclusive access to a function; private parties; having the chance to contribute to the final product (some video game developers allow contributors at certain levels to create a character for the game) and being named in the credits (e.g., video games and movies).

- It's either all-or none sometimes. Some reward-based sites use an all-or-none approach to funding (e.g., Kickstarter) which means that entrepreneurs don't receive their funds unless they achieve their target, and likewise the contribution of the "investor" is not accounted for unless the target is achieved. Other reward-based sites (e.g., Indiegogo and RocketHub) allow the entrepreneur to retain whatever they raise rather than require them to achieve the stated target.
- Generating capital comes with a cost. Rewards-based sites, along with donation-based sites typically charge a fee for their services. These fees include the base fee, which typically runs around 4% and a processing fee (collecting funds via credit card or Paypal) of 3% to 5%. Furthermore, those sites that allow entrepreneurs to keep the funds they raise if their targets are not achieved, typically charge a base fee of 8% to 9%. For example the base-fee for Kickstarter is 5%, Rockethub is 4% and Indiegogo is 4%. Indiegogo and RocketHub charge a base fee of 9% and 8% respectfully if the entrepreneur chooses to keep donations in the absence of achieving their target. In the end, an entrepreneur should incorporate into their budget a cost of 8% to 10% for fees and processing.
- The IRS may want a take. There are federal tax implications related to the income you raise. If you are providing tangible rewards (e.g., merchandise or tickets to events) in return for donations, the IRS may classify the capital you raise as income and therefore any profit (capital raised minus expenses associated with the raise) may be subject to taxation. As a result, entrepreneurs need to consult with an accountant to better understand the potential tax implications of their capital raised.

- Niches can be leveraged. While the mass market crowdfunding sites dominate, niche-driven crowdfunding sites have emerged over the last several years. These niche-driven sites, such as teespring for entrepreneurs creating t-shirts, are platforms that provide forums for generating capital from targeted audiences. In the health and fitness segment, two promising donation/reward-based crowd funding platforms have appeared. First is MedStartr which targets entrepreneurs seeking to raise capital for health-related start-up ventures. Second is FitKicker, which according to its website seeks to be a crowd funding catalyst for fitness entrepreneurs.

Tips for Success in the Donation and Rewards-based Crowdfunding Space

As highlighted in the previous section, just because you have a dynamic and compelling business opportunity, it does not mean your crowdfunding campaign will be successful. To increase your likelihood of being successful, we offer the following tips:



- Have a well thought out business plan. Ideas don't fly, ventures with a well-thought out business plan and strategy do. If you were going to approach Angel investors you would have a business plan, so think of the crowd as a group of Angels. Being professional is critical.
- Establish a realistic target for your capital raise. Remember that the larger the capital raise the less likely it is to succeed. Consequently, you want to identify a target that will realistically allow you to achieve your business goal. Asking for more than you really need may result in your campaign not reaching its funding target. Asking for too little may result in your business being unable to achieve its goals, which will end up hurting your credibility. In the end you need to identify a number that will build trust with contributors and likewise allow you to realize your dream.
- Create a dynamic pitch. The crowd wants to be romanced and treated with respect. You need to create a pitch that appeals to both the rational and emotional brains of the crowd. A great pitch speaks to the problem your venture solves, how your venture is unique, and how your venture is relevant to the investor (what do they get out of this).
- Do your homework before selecting a crowdfunding platform. Don't select a site because it's trendy. Understand all aspects of posting your campaign on the site. Know if the site has an audience that aligns with your campaign, know what its success rates are and know what costs are involved.
- Build buzz before your campaign. Successful campaigns start well before they are launched. Entrepreneurs need to reach out to their circle of friends via their social media outlets and pitch their campaign. You want your "friends" to be the first to pledge as this will foster momentum. Furthermore, if you know individuals

who are respected in the realm of your business venture reach out to them for support. If you can get respected authorities or celebrities in your field to be on the crowdfunding site at the onset it will be an added boost to your campaign.

- Keep the campaign fresh and compelling. You don't want your campaign to be a snore. Once your crowdfunding pitch is posted you want to make it highly compelling using videos, images, testimonies, etc. You also want to keep it fresh, meaning posting regularly about your business, about the progress of the campaign, sharing interesting comments and insights, etc. Contributors want to be romanced, but they also want to be kept in the loop.
- Keep your promises. Whatever you promise to deliver in return for the crowd's support, make it happen. . Keeping your promise means being transparent, holding yourself accountable to your plan and executing on the plan. If you promise to open the doors of your business, make it happen. If you promise to deliver a portion of your business, do it. If you promise rewards in return for their support, then when you achieve your funding goal, deliver the goods.
- Always say thank you. When you reach your campaign goal, make sure you show your appreciation. Even if you don't achieve your goal, you need to thank those who supported you. Appreciation is powerful whether your goal is achieved or not. You never know when you may have to reach out again.

Concluding Thoughts

Crowdfunding has become one of the leading approaches into today's economic environment for entrepreneurs to raise capital to launch their business venture. The power of the crowd continues to grow, and over the next decade, the capital raised through these various types of crowdfunding platforms is likely to become the primary source of capital for small business entrepreneurs. In part one, we introduced the field of crowdfunding and focused on donation and reward-based crowdfunding, which to date have been the most popular approaches to crowd sourcing capital. In part two which will be published next month we will discuss debt-based and equity-based crowdfunding, which if predictions hold true will be the leading crowdfunding platforms of the future for generating start-up and growth capital.



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