

Whitepaper

Institutional investors & crowdfunding: The right match?



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The right match?

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May 2019

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Executive Summary

Crowdfunding is a rapidly growing and maturing market, which brings with it potential for institutional investors. With the increasing focus on impact investing and contributing to the SDGs, crowdfunding can offer possibilities. That having been said, crowdfunding is not a ready-made opportunity for institutional investors. In this whitepaper we focus on the Dutch market of crowdfunding and the opportunities and challenges for institutional investors to join this party.

There is a large gap between institutional investors looking for sustainable projects to invest in, and on the other hand, small sustainable enterprises looking for investment. The reasons for this gap are clear. Such projects usually do not have the right scale and/or track record for institutional investors to be interested. But this is where crowdfunding could come in handy. When we look to our neighboring countries, we see that it is much more common for institutional investors to invest in crowdfunding platforms. Especially in the UK and Germany, institutional investors often do not invest in specific projects, but in the platform as a whole. These platforms often do offer the right conditions to be of interest for institutional investors.

There are some clear benefits in investing in crowdfunding:

- Crowdfunding platforms enable institutional investors to invest with clear **positive impact**.
- Crowdfunding **is a growing and maturing market**, offering new possibilities to institutional investors.
- Investing in crowdfunding platforms has **clear reputational advantages**, offering the right exposure to participants.

Next to the challenges of scale and track-record, in the Netherlands, this sector is not yet strongly regulated and stronger legislation would make crowdfunding platforms more attractive to institutional investors.

Next steps

In this paper, VBDO recommends several next steps including:

- **More (international) research** on the opportunities and crowdfunding platforms offer and the needs of institutional investors to eliminate the current mismatch.
- Investments in crowdfunding platforms could be **structured in more innovative ways**, e.g. combined with other seed funds.
- Institutional investors could **stimulate further (EU) regulation** for crowdfunding platforms to increase reliability of returns and higher standards of information to meet reporting requirements of institutional investors.
- **Government guarantees for (part) of the investment into crowdfunding platforms** would help decrease risks for investors. In England, for example, this practice is already more common and leads to encouraging results for investors.

Call to action

With this whitepaper VBDO intends to open a discussion about the opportunities and challenges of investing in crowdfunding platforms. Please contact us if you have questions or further information about this topic.

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Introduction

The world of investing is changing rapidly. Due to changing preferences of participants and consumers, and the growing awareness to enhance sustainable development for the next generations, institutional investors increasingly acknowledge the importance and profitability of responsible investments.

Governments and international institutions such as the United Nations and the OECD are more and more pushing for cooperation between public and private actors, in order to boost sustainable development. The UN has stressed the importance of enhancing sustainable development for future generations by developing the Sustainable Development Goals (SDGs).

But there often appears to be a missing link between sustainable projects or companies looking for investments and institutional investors looking for responsible investments. The question is whether crowdfunding platforms could play a role in filling this gap.

In this paper we discuss the market of crowdfunding, the current sustainable crowdfunding platforms and the opportunities and challenges of crowdfunding for institutional investors. This study is part of a bigger research of VBDO concerning innovative sustainable funding opportunities, to make a better match between sustainable projects and institutional investors.

With this whitepaper VBDO intends to open the discussion about the opportunities and challenges of investing in crowdfunding platforms for institutional investors. VBDO encourages experts in the field to react and shape the next steps together with us.

Please do not hesitate to contact us.

Crowdfunding: What is it?

In short, crowdfunding is a method of raising capital through the collective effort of friends, family, customers, and other investors. This approach taps into the collective efforts of a large pool of individuals—primarily online via social media and crowdfunding platforms—and leverages their networks for greater reach and exposure.¹ Crowdfunding knows a long history, but in its current form gained popularity at the turn of the last century. In the US crowdfunding was mostly used in the cultural sector and from there it has spread to other countries and different sectors.

The Dutch crowdfunding market

Looking at the crowdfunding market, and more specifically the crowdfunding investments made in the Netherlands over the last few years, a large increase can be seen.

In 2017, more than 5000 projects and enterprises were successfully financed using crowdfunding in the Netherlands. Enterprises collected a total of 233 million euros in 2017, with an average amount of 102.000 euros. In 2018 crowdfunding platforms in the Netherlands collected 329 million euros, an increase of 48% compared to the 2017.²

Five different crowdfunding-models can be distinguished:

- 1 **Rewards-based crowdfunding**, backers give a small amount of money in exchange for a reward (e.g. a product or service).
- 2 **Donation-based crowdfunding**, donors donate a small amount of money in exchange for gratitude and the feeling of supporting a cause they believe in.
- 3 **Equity crowdfunding**, investors invest large amounts of money in a company in exchange for a small piece of equity in the company.
- 4 **Debt crowdfunding**, lenders make a loan with the expectation to make back their principal plus interest.³
- 5 **Convertible loan crowdfunding**, an investment that is later converted into a loan or shares.

A distinction has been made in crowdfunding categories, these are:

- **consumer loans**: for example for the purchase of a car or renovation of a house (also called peer-to-peer loans);
- **enterprises**: funding for entrepreneurs (starters, growers and SMEs);
- **creative projects**: funding for creative projects, such as a film or theater performance;
- **social projects**: from funding social projects in developing countries to funding projects such as a sports clubs or neighborhood initiatives.

Growing annual investments in crowdfunding in the Netherlands

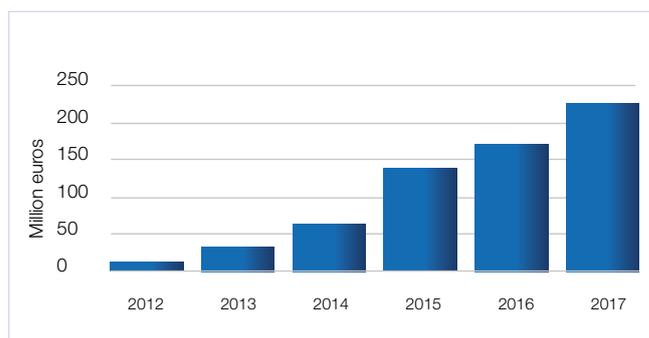


Figure 1: Annual investments in crowdfunding in the Netherlands. Source: crowdfundingcijfers.nl

76% of the Dutch crowdfunding market applied debt crowdfunding in 2017

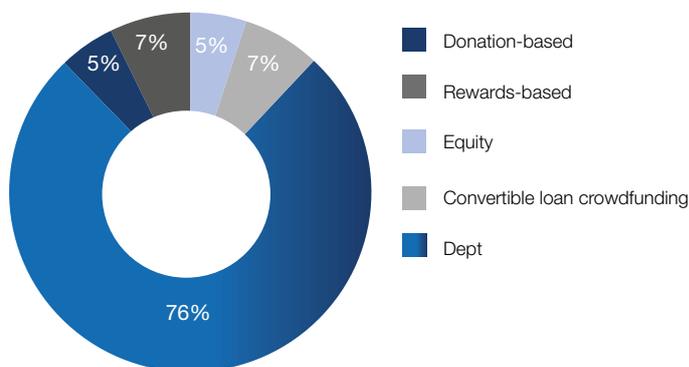


Figure 2: Amount of money funded for each of the crowdfunding-models in 2017 in the Netherlands. Source: crowdfundingcijfers.nl

Enterprises and social projects offered most on Dutch crowdfunding platforms

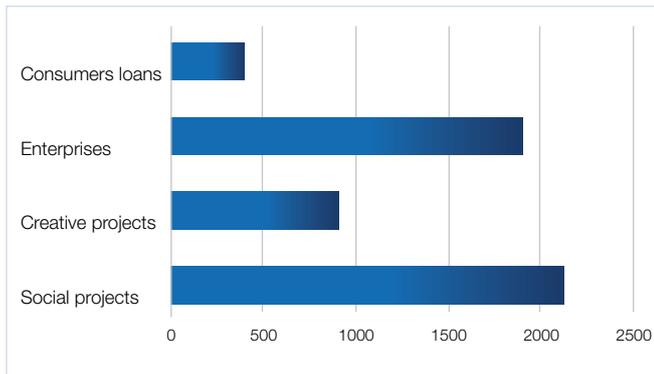


Figure 3: Number of projects/enterprises/loans per category in 2017 in the Netherlands. Source: crowdfundingcijfers.nl

Enterprises receive the highest amount of funding

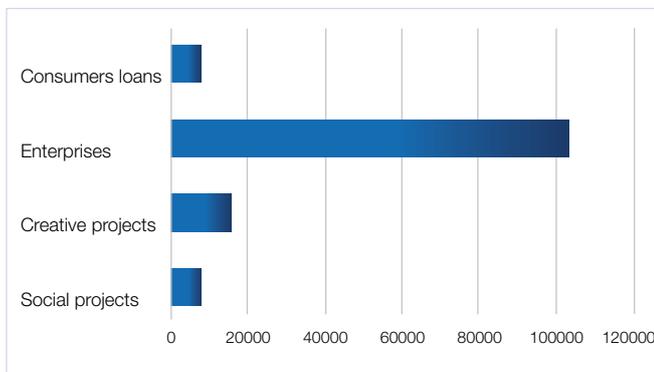


Figure 4: Average amount funded per project/enterprise/loan in euros in 2017 in the Netherlands. Source: crowdfundingcijfers.nl

Crowdfunding for sustainable development in the Netherlands

There are 50 different crowdfunding platforms active in the Netherlands. The three platforms that funded the largest amount of money are Geldvoorelkaar, Collin Crowdfund and Funding Circle. A number of crowdfunding platforms that focus on sustainable development are also present in the Netherlands. Some examples are:

- **Duurzaaminvesteren.nl** (focused on sustainable projects), funded €42.836.000 in 2018.
- **Oneplanetcrowd** (focused on sustainable enterprises), funded €11.792.917 in 2018.
- **Lendahand** (focused on entrepreneurs in developing countries), funded €13.058.050 in 2018.⁴

Added value of crowdfunding for society

One of the many perceived outcomes of crowdfunding is the democratization of capital. Individuals using crowdfunding can benefit from some advantages such as: favourable funding terms thanks to an open, market driven valuation of the projects; lower transaction costs and product, price and market validation through customer feedback and peer review systems. For private investors crowdfunding offers possibilities to have an emotional connection with the enterprise and the possibility to be an active investor by providing input at all stages of the funding process.⁵

A number of benefits of crowdfunding over traditional methods can be distinguished.

- Firstly, a **crowdfunding platform may extend the reach of possible investors**, leading to more exposure and a higher chance of finding investors. Banks or other traditional investors regularly decline projects if they do not fit in their business strategies; when

there is no clear track record; or when the risk-return balance is off.

- Secondly, **crowdfunding can be used as a marketing tool**. When using such platforms, one can test how the public responds to certain companies or projects. When investors are relatively easily found, this could imply there is quite some interest in the company/projects. Besides, investors may follow the progress and give advice or feedback.
- Thirdly, an advantage of online crowdfunding is its **ability to centralize and streamline the fundraising efforts**. By building a single, comprehensive profile to which you can funnel all your prospects and potential investors, you eliminate the need to pursue each of them individually.
- Fourth, for investors, crowdfunding can be interesting because **investors can decide for themselves in which projects they invest**. In addition, most of the paperwork has already been arranged and investors immediately get insight into (the conditions of) the project.

However, there are also some disadvantages to crowdfunding. Just like any other form of investing, there are risks that come with crowdfunding. Crowdfunding platforms can decline a project from their website, and the predetermined target of the amount of investments needed for the project may not be achieved. Platforms also differ in the services they provide, some only provide the investment opportunity and others also track and manage the invest during its duration. In the Netherlands the real return is often lower than the promised returns. Dutch regulators could look at Belgium, France and especially the UK, where crowdfunding is regulated more strongly. In the UK every provider has to demonstrate to its users that the predicted returns are realistic.⁶

Regulation

The crowdfunding market in the EU is underdeveloped compared to other major world economies. The biggest challenge is a lack of common rules across the EU. In March 2018, the European Commission presented a pro-

posal for a regulation on crowdfunding service providers. When it will be adopted at EU level, this new regulation will create a single set of rules, which will make it easier for platforms to offer their services across the EU. Investors on crowdfunding platforms will benefit from a better protection regime and a higher level of guarantees, based on:

- clear rules on information disclosures for project owners and crowdfunding platforms;
- rules on governance and risk management;
- a coherent approach to supervision.

The proposal only applies to those crowdfunding services entailing a financial return for investors, such as investment and lending based crowdfunding.

For now, crowdfunding is not yet strongly regulated in the Netherlands. One may consider it positive that crowdfunding has arisen without being confronted with strict regulations in an early stage, as it may impede innovation. This has led, among other things, to a large number of crowdfunding platforms that have been able to develop their services in a divergent manner. However, it also means that quality assurance of services and consumer protection are difficult to standardize and professionalize.

Crowdfunding models of loan and equity-based crowdfunding do need an exemption or permit requirement from AFM (Autoriteit Financiële Markten). If a crowdfunding platform is only active in the field of donating, sponsoring and/or reward-based crowdfunding, it is not mandatory for them to have a permit or exemption from the AFM for carrying out crowdfunding activities.⁹

Crowdfunding and Institutional Investors

As more and more institutional investors are searching for the right projects for impact investing, crowdfunding can offer opportunities, but these are not ready made opportunities. The projects are often too small and the risk-return rate might be unclear and uncertain.

Opportunities for institutional investors

In the previous chapter, some general pros were already briefly touched upon. In this section, we will focus more specifically on the benefits for institutional investors.

Impact investing & measurement opportunities

Institutional investors can make a direct positive impact by investing in one of the abovementioned sustainable crowdfunding platforms. Sustainable crowdfunding platforms present a clear overview of projects to create direct impact that contributes to sustainable development. Crowdfunding platforms commonly report on the progress of their projects. For sustainable enterprises or projects this may imply that the initiator also reports on the positive and negative impact made on the environment. Crowdfunding platforms can prove to be beneficial for the direct impact made by investors and the impact measurement and reporting thereof. Crowdfunding in itself can be seen as a form of impact investing, since it supports those projects and companies that are not found to be eligible for a traditional loan.¹⁰

Reputational benefits

Next to opportunities for impact investing, the exposure from investing in sustainable projects using crowdfunding is another benefit for institutional investors. Crowdfunding offers marketing benefits: one of the key advantages of online crowdfunding campaigns is the exposure it creates for the enterprise or project to the general public. For institutional investors, funding such initiatives can create a positive image towards their participants.

A growing and maturing market

In general, the crowdfunding market is relatively upcoming, and needs to reach a more mature state before institutional investors will invest. For example, many crowdfunding platforms do not have the previously mentioned AFM permit. They would need to professionalize in order to meet the more stringent (reporting) requirements of institutional investors, related to risk and return. Other challenges could arise regarding the investments of crowdfunding platforms, since these are often companies in the smallest “seed” stage which are more risky. However, in 2017, according to the data set of Beauhurst (a searchable database of the UK’s top startups and scaleups), a shift is ongoing with more companies registering on crowdfunding platforms in the so-called “growth stage” instead of smaller “seed stage”. It is recognized that growth stage companies are preferred by institutional investors, and therefore it is no surprise that institutional investors are keener for a piece of action in the world of crowdfunding.¹¹ Motivations to further diversify the portfolio by investing in crowdfunding could also be valid in this case.

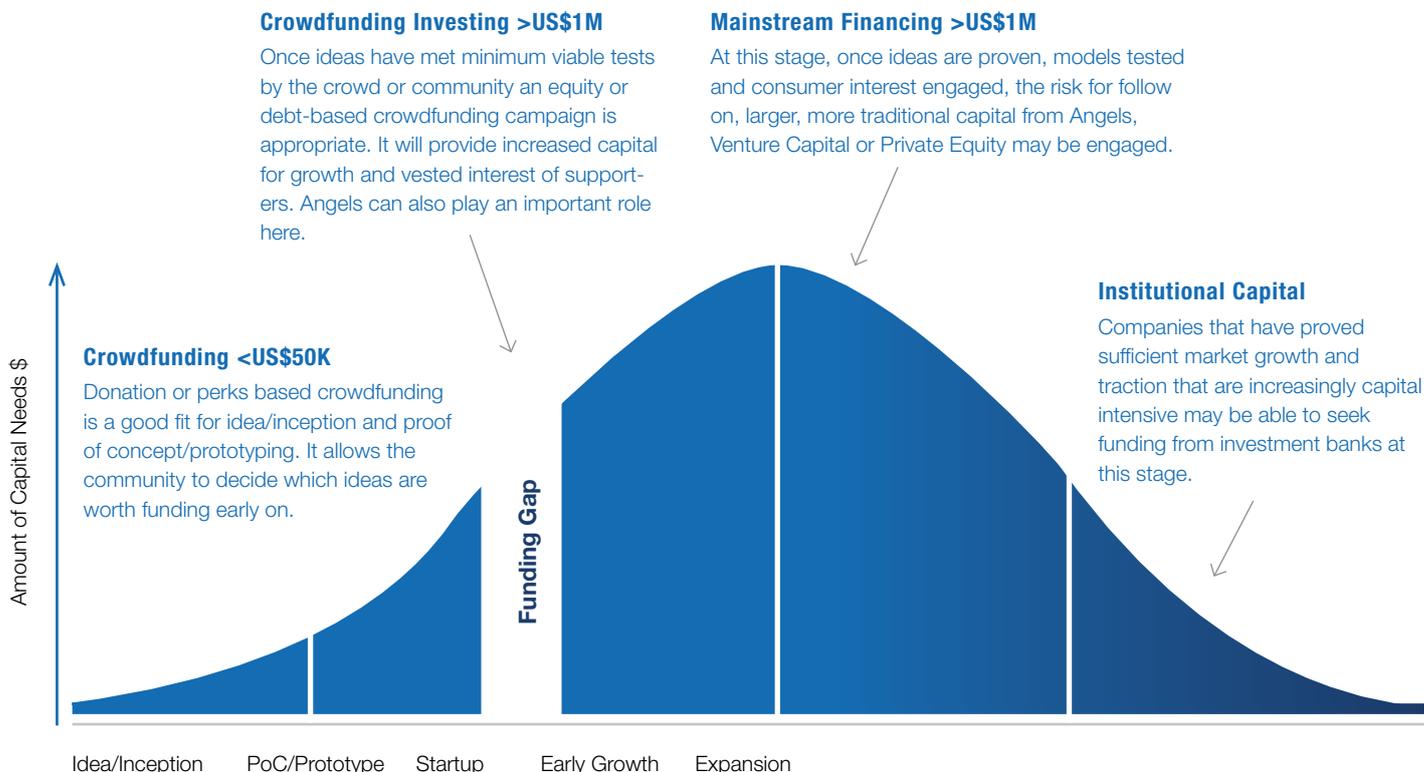


Figure 5: Crowdfunding and Funding Gap Sources, Worldbank (2013)

Good practice: Aegon

For examples of institutional investors investing in crowdfunding we can best look at the United Kingdom and Germany. The UK is a world leader when it comes to crowdfunding platforms. Aegon has made 175 million euro available to help Funding Circle provide loans for Small and Medium Sized Enterprises (SME's) in the UK. Funding Circle is a UK listed company that uses crowdfunding to help businesses get a loan, including in their starting phase, when regular banks are not able to finance them yet. With this investment Aegon is contributing to supporting about 6400 new businesses and up to 2600 new jobs in the United Kingdom. Aegon has also agreed to make 1,5 billion

available to a crowdfunding platform in Germany called Auxmoney.¹² Auxmoney is an online peer-to-peer (P2P) marketplace that connects credit-worthy borrowers and investors so that both can benefit financially. The company assesses applicants' ability to repay personal loans and lets investors lend directly to individuals or create their own portfolios by spreading their money across a number of loans. Auxmoney eliminates the high cost and complexity of traditional bank lending by offering a transparent marketplace where its users can directly invest in and borrow from each other. One of the motivations for Aegon to invest in Auxmoney is diversification of the investment portfolio.

Conclusions

The million-dollar question of course is: how to bring institutional investors and crowdfunding platforms closer together?

Crowdfunding is not a ready made opportunity for institutional investors, but it could be an important opportunity nonetheless. Especially given the increasing motivation to invest with positive impact, it makes sense for the financial sector to look into crowdfunding platforms. This also offers the possibility to close the gap between small sustainable projects looking for investors and institutional investors looking for sustainable projects to invest in. Although lack of scale and a lack of trackrecords are holding investors back, there are several advantages to investing in crowdfunding as the market is maturing.

- Crowdfunding platforms enable institutional investors to invest with clear impact. Institutional investors can make a direct positive impact by investing in sustainable crowdfunding platforms and can specifically contribute to one or more of the SDGs.
- Crowdfunding platforms are a growing market that is maturing, offering interesting possibilities to institutional investors.
- Investing in crowdfunding platforms offers institutional investors exposure to the general public. For institutional investors, funding such initiatives can create a positive image towards their participants.

Next steps

With the crowdfunding market growing rapidly and the push for SDG investing, there seem to arise several opportunities to match crowdfunding platforms and institutional investors. From our initial desk research and several interviews with the crowdfunding sector and institutional investors, we have identified at least the following next steps to bring both worlds closer together:

- 1 To start with, a broader (international) research towards the possibilities of crowdfunding platforms and the needs and requirements of investors needs to be conducted. This could possibly identify other possibilities to eliminate the current mismatch.
- 2 Government guarantees for (part of) the investment into crowdfunding platforms would help decrease risks for investors. For example in England, this is practice is already more common and leads to encouraging results for investors. Possibly, development banks could also take up this role.
- 3 Investments in crowdfunding platforms could be structured in more innovative ways. For example, institutional investors could also combine investments in crowdfunding with investments in other venture capital funds under management of the funding platform. In this way, the fund is more diversified and crowdfunding could be used as an “add-on” option.
- 4 Stimulating (EU) regulation for crowdfunding platforms would make the market more accessible for institutional investors. This could increase reliability of returns and higher standards of information to meet reporting requirements.
- 5 Selecting the right platforms for investment is key, e.g. there are several crowdfunding platforms that work with government agencies. These agencies already require high quality standards, including clear reporting requirements. Investors could benefit from these requirements.
- 6 Crowdfunding platforms should increase the scale of companies they invest in. Eventually, this could lead to an initial public offering, making the platform available to a wide range of investors.

Call to action

With this whitepaper VBDO is intending to open the discussion about the opportunities and challenges of investing in crowdfunding platforms for institutional investors. VBDO encourages experts in the field to react and shape the next steps together with us.

Sources

We have spoken with several crowdfunding platforms and institutional investors on the basis of anonymity to create more insight in the opportunities and challenges for institutional investors to invest in crowdfunding platforms.

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