Equity-based Crowdfunding: Is FinTech Competition a Threat to Traditional Banks?

Bachelorarbeit

zur Erlangung des akademischen Grades „Bachelor of Science (B. Sc.)“ im Studiengang Wirtschaftswissenschaft der Wirtschaftswissenschaftlichen Fakultät der Leibniz Universität Hannover

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1. Introduction

“Crowdfunding has the potential to revolutionise the financing of small business, transforming millions of users of social media such as Facebook into overnight venture capitalists, and giving life to valuable business ideas that might otherwise go unfunded.”

- Zachary J. Gubler (The Wall Street Journal, 2013)

1.1 Motivation and Relevance

The term *FinTech* gained an increasing attention within the financial sector during the past decade. Established financial institutes have to acknowledge the emerging market participants which are young, innovative firms that combine financial services with technology as the name FinTech indicates. On the one hand, FinTechs offer niche products that the established banks do not provide. On the other hand, the young firms are additionally able to take over standardised banking services in a more efficient way than competitors. As a result, market participants question banks´ market positions and expect shifts of the market shares.

One of FinTechs´ niche products is presented by equity-based crowdfunding that is an innovative financing instrument for startup, real estate, SME and energy projects. As Gubler´s quote indicates, this new type of financing revolutionises the funding of small businesses with social network presence. It enables startups to close the early-stage finance gap since bank loans are usually not granted to risky and unprofitable firms (Klöhn, and Hornuf, 2012, p. 238). The German crowdinvesting business started in 2011 with the launch of the CI platform Seedmatch and developed rapidly with an increasing trend (crowdfunding.de, 2017g). Therefore, the rise of FinTechs and the equity crowdfunding business shows the topicality of the emerging market participants in the financial industry.

Since equity crowdfunding is a young business, the related literature is not extensive. Most literature in the crowdfunding context considers crowdfunding, but does not focus on equity-based crowdfunding.

1.2 Research Objective and Structure

The objective of this bachelor thesis is to evaluate how FinTechs´ new way of financing small businesses competes with traditional financing instruments from an investor´s perspective. Furthermore, the competitive advantages compared to banks present investigation goals which leads to the following three research questions of the thesis.

1) What is the competitive advantage of equity-based crowdfunding over traditional financing instruments?

2) How can information technology in conjunction with business processes bring a competitive advantage to equity-based crowdfunding platforms?

3) What are the deciding factors for investors to choose between traditional and crowdinvesting products and how can investors manage the risk?

In order to examine the research questions, the paper is structured as depicted in Figure 1.

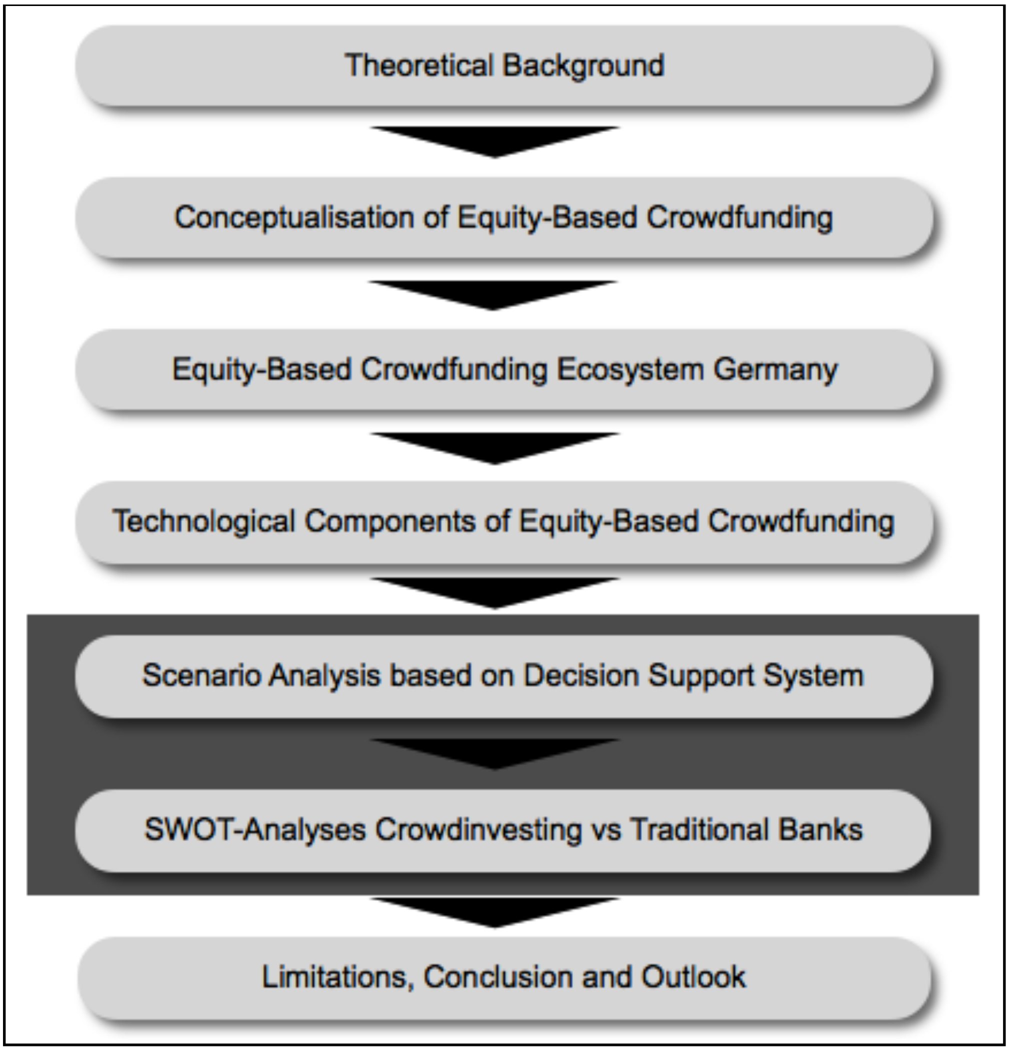

Figure 1: Structure of Thesis
(source: own representation)

After the introduction in section 1, the theoretical background outlines in section 2 all technical terms concerning FinTechs, equity crowdfunding, traditional financing instruments and business models. This is necessary in order to perform a systematic literature review on crowdfunding business models. Section 3 presents the conceptualisation of equity-based crowdfunding which provides an essential understanding about the involved stakeholders, the business model process, investors´ motivation for participation, requirements for platform providers and the related asymmetric information problems. Thereafter, the development of equity crowdfunding, the main crowdinvesting platforms by market capitalisation as well as the regulatory framework in section 4 illustrate insights in the German crowdinvesting ecosystem to clarify the practical scope in Germany. In section 5 follows an analysis of the technological components used by equity crowdfunding platforms with the help of a literature review to investigate how FinTechs gain competitive advantages with technology. Section 6 aims to provide a performance measurement of equity crowdfunding in Germany to evaluate the profitability of the financing instrument. Thereafter, a scenario analysis based on a decision support system in section 7 aims to examine how investors create investment portfolios and how they diverse the risk related to equity crowdfunding. Furthermore, two data sets of completed CI projects are investigated concerning factors that affect investment decisions. The section is completed by a correlation analysis with the objective to identify characteristics of successfully funded projects. The main part of this paper ends in section 8 with SWOT-analyses regarding equity crowdfunding and traditional banks in order to build a basis for a critical discussion with a comparison. This is essential for the evaluation of the competitive advantages and investment decisions.
Finally, limitations in section 9 and the conclusion with a proposal of areas for further research in section 10 complete this thesis.

2. Theoretical Background

This section aims to provide explanations about all technical terms in order to build a theoretical basis for this paper. The definitions refer to FinTechs, their business models and traditional financing instruments in banks which are necessary to compare FinTechs with traditional banks. Furthermore, the terminology of crowdsourcing and crowdfunding complete the theoretical framework.

2.1 The Concept of FinTechs

The enormous growth of technology combined with the digitisation trend allows companies to optimise their business or even create new business models such as Fin-

The other critique on website traffic measurements is the comparison between the website usage of banks and CI platforms. The initial purpose of website traffic analyses is to identify the information procurement of investors concerning equity CF and banking products. Nevertheless, the values between CI platforms and banks are not comparable since banking websites are additionally used for online banking and brokerage which distort the values for the initial purpose.

In addition, the German crowdinvesting business developed rapidly and is still young and emerging. The observation period of six years is hardly comparable to traditional banking products since banks have been existing in Germany for approx. 150 years. It serves rather as an initial tendency than as a credible final evaluation of both businesses. FinTechs need more time for development in order to gain more acceptance in the financial sector.

Besides, the default rates of capital seekers imply that investors lose their entire investments. This paper assumes that this is the only financial risk investors have to face for equity-based crowdfunding. However, there is also the risk of receiving only parts of the investments when capital seekers are insolvent. The insolvency process in Germany clarifies that debt holders have a primary position of receiving their debt claims and equity holders have a lower priority.

Finally, the performance measurement of crowdinvesting is based on a study of *crowdfunding.de* that determined average returns p.a. and default rates by customer segment. This study seems to distort the default rates in a positive way for equity crowdfunding platforms due to the fact that most of the projects are still in progress and may default in their later stage. The default rate of 0% for film, energy and real estate projects is not credible in practice since crowdinvesting is not known as a risk-free business. The film project default rates are mainly explainable by the low number of four observed projects. Also the returns on investment are not verifiable by investors due to the lack of published realised returns on most CI websites. Therefore, this study has to be seen in a critical way.

10. Conclusion and Outlook

The objective of this paper was to evaluate equity-based crowdfunding as an innovative way of financing by FinTechs from an investor´s perspective.

Regarding the research questions of this paper, it can be concluded that equity crowdfunding platforms gain technological competitive advantages over traditional banks with social networks and further enablers such as mobility-orientation and intuitive user interfaces. Blockchain technology and big data analytics can develop to potential significant crowdinvesting technologies in the future, but are not competitive

advantages for current crowdinvesting platforms.
Furthermore, the performance indicators in section 6 illustrate that the innovative financing measure provides its highest expected returns as well as default rates for startup projects and the lowest in real estate as well as energy segments. The high overall default risks with high expected returns compared to alternative financing instruments are in line with Markowitz´ portfolio selection theory. Investors need to invest regarding their family situation, risk appetite and available capital. Also the investor´s age and available time are influencing factors for the investment decision.
On top of that, investors manage the high risk related to equity crowdfunding with diversification. This includes investing in a large number of assets and having uncorrelated securities with different expected returns and risks in the portfolio to minimise the unsystematic risk. However, the invested amounts of micro investors are relatively low compared to traditional investment possibilities. More often than not, they do not depend on the expected returns of CI projects which does not necessarily require all investors to hedge the high risk related to the low amounts of investments.
Furthermore, investors need to generate information related to equity crowdfunding in order to manage the risk. In the majority of cases, CI platforms publish their completed projects, but not always the realised returns on investment. As a result, platforms do not provide sufficient information for investors to create diversified portfolios. Also network traffic analytic tools enable investors to measure the attractiveness of capital seekers´ websites, but at the end of the day, investors mostly rely on the information provided by platforms and on their investor sentiment. Therefore, investors need to choose the CI platform wisely since they depend on platforms´ reviews and due diligences.
The correlation analysis performed on 46 projects published by Companisto indicates that the funding success is affected by the number of investors. This illustrates the herding behaviour which states that investors often support projects which seem to be attractive to other investors.
Finally, the SWOT-analyses for crowdinvesting and traditional banking investment products clarify that there are significant differences due to the complementary characteristics. In contrast to traditional banking products, equity crowdfunding mainly addresses small businesses as capital seekers and involves relatively low minimum capital requirements for investors. This creates opportunities for cooperations between FinTechs and traditional financial institutes to gain competitive advantages.
As a concluding remark, crowdinvesting is not acknowledged by investors only because of financial reasons, but also due to emotional motives. They either identify with the entrepreneur or convince themselves about the innovative product. Never-

theless, crowdinvesting is a relatively unknown and unpopular financing instrument for rational profit-oriented investors.

Areas for further research concerning equity-based crowdfunding present practical investigations about the deciding factors for investors to participate in crowdinvesting as a verification for this thesis. This may be conducted with surveys in order to identify the potential of equity crowdfunding as a future and long-term financing measure for small, medium-sized or even large businesses. The development of crowdinvesting needs to be observed continuously to determine, if the young, emerging business is solely a hype or has the potential to gain more market shares of banks. Furthermore, the cooperation opportunities between FinTechs and traditional financial institutes present further research areas regarding the implementation, the competitive advantages and success factors of cooperations. Also alternative cooperation opportunities in the financial sector are research gaps such as cooperations with consulting firms. Finally, the changing economic as well as technological frameworks such as interest rates and digital innovations require further research concerning equity crowdfunding as an attractive investment possibility of small businesses.