Impact of Crowdfunding on Venture Capital Industry in India

Purva Ranu Jain
Research Scholar
Department of EAFM, Commerce
University of Rajasthan
Jain.purvaranu1991@gmail.com

Abstract

Startup businesses and entrepreneurs are constantly looking for creative ways to raise money, meet goals, and grow their businesses. Traditionally it was difficult for startup but nowadays there are many options available. The two most effective ways startups are accomplishing this today is through crowd funding and venture capital funding methods. Crowdfunding is a rapidly diffusing practice in the realm of entrepreneurial finance. Crowdfunding allow entrepreneurs and startups with great ideas to directly connect with, attract, and tap into the support of a new or existing fan base . In India the concept of crowdfunding is catching up fast and is more publicly recognized but still is in growing stage and is allowed in a restricted manner. The present paper discusses the impact of crowdfunding on venture capital industry in India. The paper concludes that crowdfunding projects will enlarge the potential market for informal financing and complement traditional sources of startup finance.

Key Words: Crowdfunding, Venture Capital, Startup, informal financing.

I. Introduction

Crowdfunding is solicitation of funds (small amount) from multiple investors through a web-based platform or social networking site for a specific project, business venture or social cause.

- SEBI

Crowdfunding started in US and UK is a means of raising money from large number of people through an internet or social networking sites such as Face book or LinkedIn or Twitter or even some dedicated websites for a creative project or social cause or a business venture either in the form of donations (without rewards) or in ex-change for some form of reward and/or voting rights. Crowd funding links investors with startups and small projects through an online transaction portal. It is a platform that helps small businesses and startups to increase their social media presence, investment base, and funding prospects. There are three parties involved in it namely Entrepreneur, Website Plat former and crowd or investor. The process includes creating an online profile and explaining project and fund-raising goals and sharing the same with public at large, including peers, relatives, friends of friends, and so forth.

Crowdfunding is useful in getting instant validation of idea, testing market and assessing demand for project, generating awareness about project, establishing market platform and receiving instant feedback during project building testing stage. Crowdfunding suffers from administrative and accounting challenges, risk and possibility of ideas being stolen, weaker investor protection, chances of fraud and has limited capacity of raising money. Crowdfunding platforms are also not permitted to give investment advice.

Majority of Indian crowd funding platforms are in the reward and donation phase. Ketto, Wishberry, Catapooolt and Crowdera are some of the eminent crowd funding platforms in India.
II. Objectives
The objectives of the study are:
1. To study various types of crowdfunding.
2. To find out the challenges of crowdfunding in India
3. To study legal provisions of crowdfunding in India
4. To compare crowdfunding with other sources of finance for small venture projects.
5. To study the impact of crowdfunding on venture capital industry in India.

III. Review of literature
1. Hemer and Joachim (2011) in paper “A Snapshot on Crowdfunding” concluded that the crowdfunding scene is currently characterized by high dynamics. Increasing numbers of projects from various application fields are trying out the crowdfunding option; the number of crowdfunding platforms is growing rapidly, and they are experimenting with various new
business models. If crowdfunding is to be established within the spectrum of serious financing instruments and be given more momentum, policymakers will certainly have to implement some rules to protect both sides: the project initiators/ start-up founders and the supporters or investors.

2. **Ibrahim and Verliyantina (2012)** in paper “The Model of Crowdfunding to Support Small and Micro Businesses in Indonesia Through a Web-based platform” proposed a business model that can be applied in Indonesia to promote the growth of SMEs. Through this business model, many institutions and individuals can collaborate in a systematic way that allows the regularity, transparency of funds activity, use of funds and progress report. The business model will be implemented in the form of a web-based platform, which enables all institutions and individuals to interact directly without being limited by time and place.

3. **Ethan Mollick (2013)** in paper “The Dynamics Of Crowdfunding: An Exploratory Study” suggested that personal networks and underlying project quality are associated with the success of crowdfunding efforts, and that geography is related to both the type of projects proposed and successful fundraising.

4. **Manchanda and Muralidharan (2014)** in paper “Crowdfunding: A New Paradigm In Startup Financing” argued that the future growth in equity crowdfunding will not come at the cost of VC industry. While venture capitalists are known to gain access to the best deals, these internet-based financing platforms will make it easier for them to learn of any opportunities they might have missed and both the industries will go hand in hand.

5. **Agarwal, Catalini and Goldfarb (2015)** in paper “Crowdfunding: Geography, Social Networks, And the Timing of Investment Decisions” concluded that a key challenge to crowdfunding markets is the information asymmetry between funders and the recipients of the funds.

6. **Jhaveri and Choksi (2016)** in article “Crowdfunding – A Mode of Risk Financing” concluded that Crowd funding is a new method of obtaining funds has a bright future as internet penetration and e-commerce success will pave the way for crowd funding. To make this a safer platform of fund raising, regulations is required.

7. **Chen , Gal - Or and Roma (2017)** in paper “Reward-Based Crowdfunding Campaigns: Informational Value And Access To Venture Capital” concluded that Running a reward-based crowdfunding campaign may be extremely valuable, especially for projects that aim at developing new technology-based consumer products, which typically face high market uncertainty and require supplemental capital from professional investors.

IV. Research Methodology

The study is descriptive in nature and based on secondary data collected from articles of research journals, books, prominent sites and report sets relevant to Crowdfunding. The paper focuses on finding out the impact of crowdfunding on venture capital industry in India.

V. Types of crowd funding

Crowdfunding investment platforms currently include four different business models. These include; investment-based; lending-based; donation; and reward-based platforms.

**Donation crowd-funding**: It is a way of fundraising for charitable cause. There is no financial return to investor or contributor.

**Reward crowd-funding**: investors receive some existing or future tangible reward or service (such as an existing or future consumer product or a membership) as consideration in return for their funds.

**Peer-to-Peer lending**: an online platform used to fund unsecured loans which are to be paid back with interest. It is a platform which matches lenders with borrowers. Borrowers pay origination fee and lenders pay administration fee to the platform. P2P lending falls under the domain of bank.
Equity Based Crowd-funding: In this mode of crowdfunding, investors take a share of equity in a project or startup. Businesses seeking to raise capital through this mode give online advertisement through a crowd-funding platform website, which serves as an intermediary between investors and the start-up companies. This is not legal in India.

VI. CHALLENGES OF CROWD FUNDING IN INDIA

The idea of crowd funding is not new in India. It has always been a part of India’s rich heritage. Most of the temples built in India have been financed through money contributed by thousands of devotees. Local people such as businessmen, shopkeepers, housewives, factory workers etc provide financial support for every mass based, popular festival or event in India. However, the concept of online crowd funding is new to the country.

The challenges of crowd funding are as follows:

1. The industry is also not very investor-friendly. People are still not ready for this concept.
2. Internet literacy is not widespread in India. Internet usage penetration is 34.8% in 2016 in India. Most of the people do not have access to internet facility.
3. A low trust level of doing the things online is also a challenge. India’s ecommerce is not fully matured to contribute towards success of crowdfunding platforms.
4. Crowd funding is not completely legal in India, with India’s most important financial regulatory body, SEBI, not yet allowing equity-based online Crowd funding, where donors have a right to equity in the Crowd funding project. Crowd funding projects in India are Donation / Reward based (where reward include being credited in a movie, having creative input into a product under development, or being given an opportunity to meet the creators of a project, allowing access to the products produced by funded projects at an earlier date, better price, or with some other special benefit) or Lending based (where financing of projects is done in form of very small or micro loans).
5. Online Crowd funding in India is still not being used by tech start-ups as a source of financial support. The most important reason for this could be that India is not an entrepreneur-driven country, so there is a shortage of tech start-ups in India. Most of the projects relate to films, cultural events and other forms of entertainment.
6. Crowd funding platforms are only theoretically safe to operate in India but practically unsafe to operate due to lack of regulations. Therefore to build credibility and transparency these platforms should approach the regulators and work with them to help the industry to grow in India.
7. Crowd funded projects statistics shows that most of the crowd funded projects failed by large margins. Successes rate is very less.

VII. NORMS FOR CROWDFUNDING IN INDIA

Crowdfunding has become a global phenomenon. In India the concept is gaining popularity and is in growing stage with no legal or regulatory framework. Recently SEBI has released a consultation paper proposing legal, structural and regulatory framework about crowdfunding in India. Highlights of the paper are as follows:

1. Only Accredited investors can invest money in crowdfunding projects. Accredited investors include (a) Qualified Institutional Buyers as defined in SEBI regulations 2009 (b) Companies incorporated under the companies act with minimum net worth of Rs 20 crore. (c)High net worth individuals with a minimum net worth of Rs 2 crore excluding primary residence and loan secured on such property. (d) Retail investors who receive investment advice, avail services of portfolio manager, have passed an Appropriateness test, have minimum annual gross income of 10 lacs, have filed income tax return for last three financial years, will invest less than equal to 60,000 in an issue through crowdfunding platform and who certify that they will not invest more than 10% of their net worth through crowdfunding platform.
2. An early stage startup or SME which is an unlisted public company incorporated in India are eligible to raise crowdfunding if they meet following criteria.
The company intending to raise capital not exceeding Rs. 10 Crore in a period of 12 months

- A company having turnover of more than equal to 25 crore and is not promoted sponsored or related to an industrial group.
- A company which is not listed on any exchange
- A company which is not more than 4 years old
- A company engaged in real estate or performing activities not permitted under industrial policy of government of India is not eligible to raise money.
- The companies should not have directors, promoters or associates mentioned as a ‘defaulter’ or a ‘willful defaulter’ by RBI or CIBIL.

3. Recognized stock exchanges with nationwide terminal presence, SEBI registered depositories, Technology business incubators and entities with relevant knowledge and domain experience are allowed to launch crowdfunding platforms.

4. Company interested to raise crowdfunding should not list on multiple crowdfunding platforms.

5. The companies should compulsorily route all crowdfunding issues through a SEBI recognized Crowdfunding Platform.

6. The company interested in crowdfunding should also provide provisions for oversubscription.

7. Issuer can raise only up to 10 crore by issuing equity shares. No single investor shall hold more than 25% stake in the company and the promoter(s) shall be required to maintain a minimum of 5% equity stake in the company for at least 3 years.

8. Disclosure requirements includes anticipated business plan, usage of funds, audited financial statements management details.

9. Equity crowdfunding, specifically digital equity crowdfunding platforms is illegal in India.

VIII. COMPARISON BETWEEN CROWDFUNDING AND OTHER SOURCES OF FINANCE FOR SMALL VENTURE PROJECTS

<table>
<thead>
<tr>
<th></th>
<th>Crowdfunding</th>
<th>Venture capital and private equity funds</th>
<th>Business angels</th>
<th>Stock exchanges and trading platforms</th>
<th>Bank loans</th>
<th>Leasing finance / trade credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enabler organization</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Yes (with exceptions)</td>
</tr>
<tr>
<td>Direct interaction</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Yes (with exceptions)</td>
<td>No (with exceptions)</td>
</tr>
<tr>
<td>Affiliation of investor / investee</td>
<td>Yes</td>
<td>No</td>
<td>No (with exceptions)</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Mentoring and assistance</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

IX. IMPACT OF CROWDFUNDING ON VENTURE CAPITAL INDUSTRY IN INDIA
Crowdfunding raises small amounts from a large number of investors instead of a large amount from a few investors. Crowdfunding can help entrepreneurs fund one product or a whole company. Crowdfunding is uniquely positioned to assist two groups of people in securing funding: (1) entrepreneurs trying to convert their ideas into viable businesses, and (2) small business owners trying to keep their businesses afloat or get them to grow. The traditional sources of finance such as issuing shares to the public in the primary markets, private placements (to institutional and venture capital investors) and debt finance, banks, and retained earnings are not easily approachable for these groups.
The eligibility criteria for raising finance through usual sources is complex containing mainly formalities and most start-ups may not be in a position to meet those requirements in the early years of their operations.

Venture capitalists focus on larger start-ups in specific sectors of the economy and have extensive due diligence requirements. They invest in slightly less risky companies that have proven track records and which can also provide clearer exit opportunities. They often require high returns for the high risk of investing in private equity companies therefore Venture capital firms are usually not an option for start-ups as well, as VCs are known to turn down most of their applicants as they are usually very selective and not approachable for many small businesses and entrepreneurs.

Crowdfunding is not a direct competitor of Venture capital industry. Venture capitalists can benefit through crowdfunding as it can help identify promising startups much easily and simultaneously gather public reviews giving a long-term picture of any business future. VC firms are not merely a financing option but also equip the start-up companies with an industry expertise, help make introductions to key industry players and assist in overall company’s management. Crowdfunding will be beneficial to venture capitalists by maintaining a suitable control process over the valuation of the companies held by venture capitalists. Crowdfunding can strategize the IPO process in an efficient manner backed by the support of general public, thus maximizing the returns on investment. These internet-based financing platforms will make it easier for Venture capitalists to gain access to opportunities they might have missed and both the industries will go hand in hand.

X. CONCLUSION

The advent of advanced technologies along with new age algorithms and digital platforms has given entrepreneurs massive scope to start a company and the means to get it funded. Crowdfunding is one of such means and represents a potentially disruptive change in the way that new ventures are funded. According to Global crowdfunding market 2016-2020 report, crowdfunding market is expected to grow at CAGR (Compound Annual Growth Rate) of 26.87% during the period of 2016-2020. By the end of 2020 crowdfunding industry is expected to surpass venture capital.

India is now the world’s second largest internet market with more than 342 million mobile users. Due to this reason Crowdfunding in India is looked upon as a key factor in raising funds for startups and new ventures. Crowdfunding have the potential to help catalyze existing efforts to create entrepreneurial cultures and ecosystems in developing nations like India. It can prove effective to get through the first trial of a business product but it is not a viable long-term option for funding and it does not work for complex businesses or startups with large capital requirements.

Crowdfunding transactions are susceptible to frauds and regulatory arbitrage. Issuance of securities through crowdfunding may be introduced in a phased manner to gauge its suitability for the Indian markets. Companies in sectors with dynamic entrepreneurial activity could be allowed to raise money through crowdfunding on a pilot basis (for instance, in the technology sector), before introducing this on a wider scale. Crowdfunding if introduced properly can act as a complement to traditional sources of finance which are available to startups.

XI. References:


10. Anand Mahajan (2016), Understanding the key factors of Indian crowdfunding scenario and how they are beneficial for startups, https://inc42.com/resources/indian-crowdfunding-scenario-beneficial-startups/

