

5 Reasons Why Equity Crowdfunding's Time Has Come!

By Stewart V. Nelson, April 4, 2018



Early-stage deals crater!

No one needs to remind entrepreneurs that finding Pre-seed and Seed funding is time consuming and painfully hard to accomplish and seemingly becoming even more difficult. What individual founders have anecdotally experienced is now verified by the data. According to TechCrunch, the number of pre-seed and seed-stage deals completed nationally has drastically declined from over 13,000 in 2014 to less than 6,000 in 2017! Ironically, the amount of venture money available has been climbing steadily, but the lion's share of that money has found its way into later-stage deals, especially startups with multiple billion dollar valuations instead of nurturing early stage startups. More on that later....

Equity crowdfunding to the rescue!

Thankfully, just as early stage financing from traditional sources reached its peak and started to decline, equity crowdfunding has emerged as a viable alternative source of funding for startups. Title III, Reg. CF. of the 2012 JOB's Act (Jump Start Our Business Startups) signed into law on May 16, 2016, allows businesses to raise \$1M from registered online equity crowdfunding platforms as often as once every 12 months. The purpose of the law is to open the potential pool of investors and capital by easing SEC restrictions on investor accreditation requirements. Two years later, as new equity crowdfunding platforms come online, we are starting to see the beneficial effects of less restrictive access to capital.

Undoubtedly, there will be some shakeout in the numbers of successful equity crowdfunding platforms, but the "genie is out of the bottle," and there will be no holding back the stimulative effect on our startup communities and the U.S. economy.

Consequently, what once was the sole domain of wealthy investors and venture capitalists, private placement investing, is now available to average individuals through online portals that allow them to participate in the potential economic rewards from investing in startups.

All that said, raising money is just plain hard! I don't want to imply in any way that crowdfunding will be any easier than traditional methods of raising money. If you don't have a great product, service, and a well-conceived fundraising plan or strategy, using any funding approach will **not** succeed. Crowdfunding's main benefit is that it exposes founders to more potential sources of capital to grow their businesses.

Top 5 reasons why equity crowdfunding is rapidly becoming more important for early-stage startups

- 1. Better valuations and economic terms**
- 2. Less stringent control provisions**
- 3. Saves scarce time for busy startup management teams**
- 4. Conserves precious cash flow**
- 5. Improves chances of successful funding**

Better valuations and economic terms

Investing in startups is inherently risky with a historical average of less than 2 out of 10 investments returning the investor's money. As a consequence, angel and other early-stage investors are cutting down on the number of early-stage deals — putting more money into later-stage investments in order to mitigate risk. With fewer deals, investors have been able to drop deal valuations (at least here in Michigan) and impose draconian valuation caps with the questionable motivation that these terms will boost their returns.

In addition, they are imposing other economic terms on startups that were previously reserved for more mature companies, such as demanding first dibs on investment returns with 2-3x liquidity preferences. If you are not familiar with liquidity preferences, it simply means that investors get up to 2-3 times their investment back before management and employees have their payday.

Other economic terms like mandatory increases in option pools and anti-dilution provisions are also finding their way into early stage term sheets to the detriment of founders, negatively affecting all stakeholders by potentially prohibiting actions that may be in the best interest of the long-term health of the startup.

By expanding founders' access to significantly greater numbers of investors and capital, equity crowdfunding is helping founders simplify the process of fundraising, obtain better terms, raise average deal sizes, and minimize dilution. All this can be accomplished while still adequately protecting investors.

Less stringent control provisions

One common control provision, typically only requested in later-stage deals, is the request for board seats, even on pre-seed investments. As most founders do not understand the proper protocols for managing a board of directors, this activity can become a huge time-sink for time-strapped CEO's. If

the investor board member(s) is an experienced board member that knows how to mentor green CEO's, this may work out well; but it also has the potential to become a nightmare for management and the undoing of the company. Rather than a formal board seat, experienced early investors should serve on Advisory Boards in lieu of joining a formal board. Because Reg. CF crowdfunding investor term sheets typically do not have additional protective rights (and, in some cases voting rights), the company and management team can become more seasoned in their roles before having to deal with outside board members. This factor alone makes crowdfunding significantly more attractive than traditional early sources of capital.

Saves time for time-starved founders and their teams

Anyone who has raised money knows how time consuming fundraising and investor communication can be for founders. In fact, as a rule, when founders start fundraising, they should plan on spending 75% of their time finding suitable investors and working with attorneys. Even after the money is in the bank, founders need to communicate regularly with their investors, communicating progress as well as chasing paperwork and signatures. Equity crowdfunding sites can substantially cut down on these activities by acting as a communications link between the company and investors to facilitate obtaining needed signatures, answer inevitable questions, and provide accurate record-keeping for the company and investors.

Saves precious cash the life-blood of the business

Having a supply of ready-made subscription agreements, filing forms, and other handy templates, equity crowdfunding sites can become a one-stop shop for all paperwork required to put a deal together. Many crowdfunding sites will put the entire deal together for a small percentage of the deal (saving cash), collecting only when the startup is successful.

Improves success rate of fundings

Some crowdfunding sites are claiming that 30% of their offerings are getting funded. Whether this trend will continue or not is uncertain. However, when you consider that only 1 in 250 companies received funding prior to the proliferation of equity crowdfunding sites, this is a quantum jump in the number of startups that will potentially receive funding.

Conclusion

Because equity crowdfunding has the potential to become the dominant equity fundraising mechanism for startups, founders and managers must familiarize themselves with how equity crowdfunding works and plan how to best avail themselves of this source of capital.