

Crowdfunding In France: A New Revolution?

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ABSTRACT

In the last few years, small firms have had difficulties to finance their projects via the traditional bank system. A new type of financing has recently appeared in Europe and in particular in France: the crowdfunding. It is a method for funding a variety of new ventures, allowing individual founders of for-profit, cultural, or social projects to request funding from many individuals via Internet. Our paper contributes to the literature by introducing this financial innovation and building a theoretical framework to explain its success. We also discuss some more practical issues to enhance crowdfunding in France.

Keywords: Financial Innovation; Crowdfunding; SMEs; France

1. INTRODUCTION

Since the subprime crisis, banks have reduced the number of loans to businesses of any size. According to data from La Banque de France (Bank of France), the rate of credit to small and medium enterprises (SMEs) and micro-enterprises was stable between April and July 2013, while the rate of credit to medium-sized business and large enterprises increased by approximately 15 basis points over this period. The spread rate between loans to firms with more than 3 years and those granted to companies under 3 years decreased from 100 to 75 basis points. The credit rate of the best listed companies is significantly lower than those of poorer quotes (about 70 basis points). This strongly impacts corporate finance and reduces their development. An inherent problem that entrepreneurs face at the very beginning of their entrepreneurial initiative is to attract outside capital, given the lack of collateral and sufficient cash-flows and the presence of significant information asymmetry with investors (Cosh et al., 2009).

More recently, some entrepreneurs have started to rely on the Internet to directly seek financial help from the general public (the “crowd”) instead of approaching financial investors such as business angels, banks or venture capital funds (Kleemann et al., 2008; Lambert and Schwenbacher, 2010). This technique, called “crowdfunding”, has made possible to seek capital for project-specific investments as well as for starting up new ventures. Crowdfunding was originally used by creative actors such as artists, musicians and writers as alternative financing. Indeed, it can allow finding the necessary funds for the completion of a work retaining the full copyright. The main interest of crowdfunding is the financial aspect. However, it also creates an opportunity for communication and creates a real community. Its role is becoming increasingly important and is presented as an alternative financing system to traditional modes of financing.

A prominent example is Trampoline Systems, a UK-based software company that intends to raise £ 1 million through crowdfunding. It shows that crowdfunding may potentially be a mean to raise funds not only for small projects but also for high-growth start-ups that are typically financed by business angels and even venture capital funds. Whether it will become a meaningful alternative to angel finance and venture capital still needs to be seen. Since 2009, in France, we note that the creation of platforms has more than doubled each year to reach 22 platforms in 2012. Since its inception in 2007 in France, crowdfunding has risen over € 55 million and it was able to finance 17,000 projects. These results are all the most important, when we speak to the pioneers of this funding: the United States. Indeed, more than a billion dollars has been raised in recent years.

In view of these results, can we tell today that crowdfunding is no longer an emerging track but a viable source of funding? To answer this question, we organized the paper as follows. Section 2 introduces the principals of crowdfunding. Section 3 discusses the existing literature and shows that solid theoretical arguments may explain the observed success of crowdfunding. Section 4 studies the impact of the French legal reform on the development of crowdfunding. Section 5 concludes.

2. CONTEXT OF CROWDFUNDING

Crowdfunding is a novel method for funding a variety of new ventures, allowing individual founders of for-profit, cultural, or social projects to request funding from many individuals, often in return for future products or equity. Crowdfunding projects can range greatly in both goal and magnitude, from small artistic projects to entrepreneurs seeking hundreds or thousands of dollars in seed capital as an alternative to traditional venture capital investment (Schwienbacher and Larralde, 2010). In a few words, crowdfunding is the financing of a project or a venture by a group of individuals instead of professional parties for instance, banks, venture capitalists or business angels. Crowdfunding draws inspiration from concepts like micro-finance (Morduch, 1999) and crowdsourcing (Poetz and Schreier, 2012), but represents its own unique category of fundraising, facilitated by a growing number of internet sites devoted to the topic.

As in any emergent field, the popular and academic conceptions of crowdfunding are in a state of evolution which makes complete definitions arbitrarily limiting. In one of the few published overviews of the topic, Schwienbacher and Larralde (2010) define crowdfunding as “an open call, essentially through the Internet, for the provision of financial resources either in form of donation or in exchange for some form of reward and/or voting rights in order to support initiatives for specific purposes.” However, even this expansive definition potentially leaves out examples that scholars in various fields have labelled “crowdfunding,” including internet-based peer-to-peer lending (Lin and Viswanathan, 2013) and fundraising drives initiated by fans of a music group (Burkett, 2011).

A broad definition of crowdfunding is therefore elusive, especially as crowdfunding covers so many current (and likely future) uses across many disciplines. Instead, we would argue that, for academics examining new ventures and entrepreneurial finance where crowdfunding is particularly salient, a narrower definition of the term is preferable. In an entrepreneurial context, the following definition provides specificity. Crowdfunding refers to the efforts by entrepreneurial individuals and groups – cultural, social, and for-profit – to fund their ventures by drawing on relatively small contributions from a relatively large number of individuals using the internet, without standard financial intermediaries.

In the meantime, several platforms have emerged that help intermediate between crowdfunders (those who invest in projects) and individuals with a project. There are a lot of platforms in crowdfunding but we can mention some: babyloan.org is the first European website of crowdfunding created in 2008 in France. This platform wants to expand into other European countries such as Germany, Italy, and Spain. Team Babyloan gathered 2.75 million Euros solidarity loans enjoyed by 8 000 micro-entrepreneurs in 12 different countries (including France). KissKissBankBank.com is another platform created in France in 2010 and it is now an international platform.

Crowdfunding is a mechanism to collect funds for realization of projects that come from companies or individuals. All funds are collected from Internet users through Internet platforms that provide visibility to different projects. Some figures help to understand the popularity of this new funding. According to the Association Funding Participatory France, crowdfunding helped raise 40 million Euros invested in 60,000 projects between 2007 and 2012 in France, including 25 million Euros for the single year of 2012. It represented \$ 2.7 billion in 2012 worldwide, spread over 308 platforms for more than a million successful fundraising; this represents an 81% increase in one year. The U.S. Massolution firm provides \$ 5 billion in 2013 and the firm Xerfi provides \$ 80 million for France. Forbes makes forecasts on the potential funding crowdfunding to 1000 billion in 2020. According to Deloitte, \$ 6 billion will be collected throughout the world via the crowdfunding in 2013.

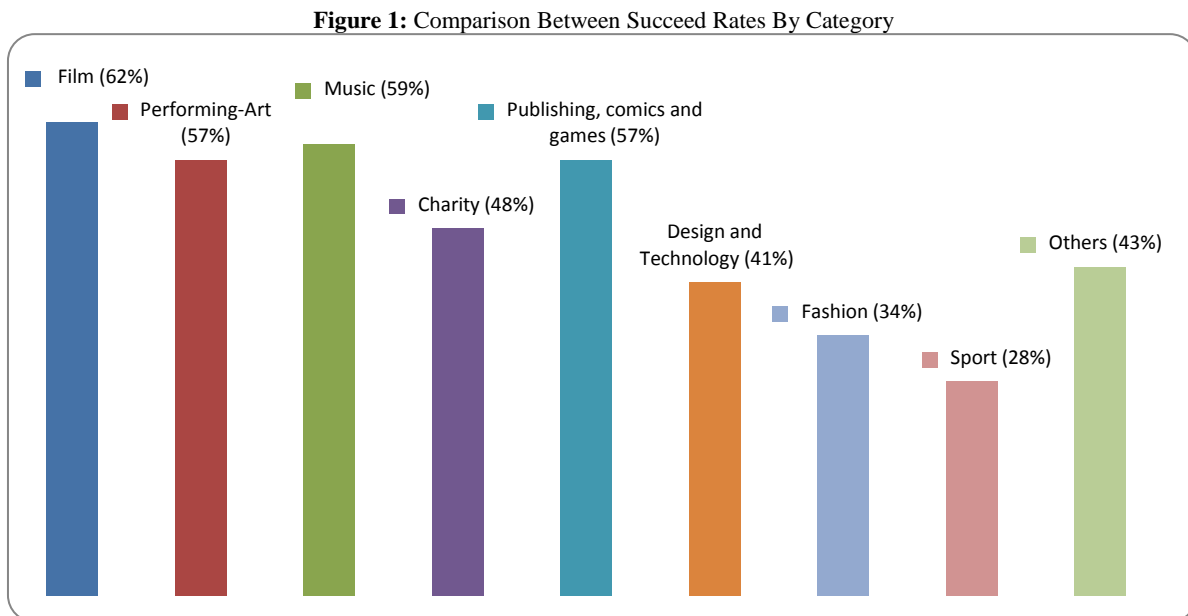
To understand this method of financing, it is first necessary to study the principals of this financing mode.

2.1 Funding Models

There are four types of platforms, each corresponding to a distinct form of transaction:

- ⇒ Platforms donations: the user provides financial support to the project without receiving anything in return. The project owner retains all its intellectual property.
- ⇒ Non-monetary reward crowdfunding: the user provides financial support to the project and receives and non-monetary return such as a DVD for supporting a film production. Platforms loans: it is a loan with or without interest, which is granted by a user to an individual or organization without going through a financial institution.
- ⇒ Platforms financing with equity or co-production of the qualified investor user acquires an interest in the project and became co-producer and the right in exchange for financial compensation in the event of commercial success of the project. The project manager may have to sell part of its intellectual property, unlike the other three platforms.

Figure 1 shows the success of crowdfunding depending on the industry.



Source: europecrowdfunding.org

2.2 Operating Model

To set the operating model of crowdfunding, we must take into account two aspects: on the one hand, the investor who wants to invest some money in a project that interests and secondly, the holder of a project for the creation of a company that does not have the funds needed to start his business and does not wish to appeal to bank credit. And crowdfunding may have a primary function of funding but also investment. These two dimensions are found on the internet via a platform. The projects are presented by their holders and investors. This operation is easy to use and has the advantage of being transparent for the user knows what it funds, according to the fact that a choice has made itself and according to its own values.

3. LITERATURE REVIEW

3.1 Literature Review: A Synthesis

According to Kleemann et al. (2008), companies make use of the crowd mainly for cost- reduction reasons. By participating in the product design and improvement, users contribute to creating value for the company. Moreover, this allows the company to reduce the length of new product development as well as its costs, to have a better customer acceptance, and to increase the customers' perception of product newness. Within the crowdfunding activities, consumers and/or individuals provide needed capital to the company to finance its investments such as acquire new assets or pay employees. Besides, crowds may at times be more efficient than individuals or small teams (Howe, 2008). According to Brabham (2008b), the efficiency of crowds in solving problems of companies is related to its composition; the more diverse it is, the more efficient it can be. Surowiecki (2004) explains that the 'wisdom of crowd' is due to crowd's solutions aggregating to each other. In other terms, members of the crowd may build up their own solution using others' suggestions and hence end up having better solutions overall. Lévy (1997) goes even further with his notion of "collective intelligence": 'no one knows everything, everyone knows something, and all knowledge resides in humanity'. It makes pretty clear the fact that knowledge becomes more important as communities share it.

While crowdfunding (and crowdsourcing in general) can be useful for companies seeking solutions to their problems, it can also provide valuable signals on the market potential of a product they wish to launch. As argued by Lambert and Schwenbacher (2010), at times the use of crowdfunding can be seen as an excuse to generate hype around a new product in order to create a marketing campaign in which consumers are able to participate. For the company, it can provide an indication on whether there will be a demand for the product. This is best in the case for instance for artists that use Sellaband.com to purchase the CD.

Finally, Franke and Klausberger (2008) notice that the phenomenon of crowdsourcing (and thus also crowdfunding) is currently a working concept, because it is not broadly used. If more and more companies start using it, the resource 'crowd' will become scarce.

Different sources of financing exist among each category. Some of these types of financing can be used together with crowdfunding. This is notably the case of bootstrapping techniques¹ (Bhidé, 1992; Winborg and Landstrom, 2001; Ebben and Johnson, 2006). In addition, crowdfunding actually looks pretty similar to bootstrapping in certain matters. In particular, bootstrappers try to use as many alternative resources as possible, and that is what entrepreneurs do when they exploit capabilities of crowdfunders. In both cases, founders use creative ways to finance their investments, while avoiding traditional investors. At the same time, crowdfunding differs from bootstrapping in many ways; most importantly, founders relying on crowdfunding do seek to attract external investors, unlike bootstrappers who primarily rely on internal resources and active cash management techniques.

3.2 Factors Influencing The Use Of Crowdfunding

When you choose how to finance his company, an entrepreneur needs to take into account several factors. We discuss below factors likely to be important for the use of crowdfunding.

3.2.1 Lack Of Pre-Existing Resources

The first important question is about the entrepreneur's pre-resources: what does he possess to secure the investment on fund providers? Does he have the required skills to run the project and make it successful? At times, this may be the case; in other times not.

¹ It is a situation in which an entrepreneur starts a company with little capital. An individual is said to be bootstrapping when he or she attempts to found and build a company from personal finances or from the operating revenues of the new company. Compared to using venture capital, bootstrapping can be beneficial because the entrepreneur is able to maintain control over all decisions. On the downside, however, this form of financing may place unnecessary financial risk on the entrepreneur. Furthermore, bootstrapping may not provide enough investment for the company to become successful at a reasonable rate.

Besides, the manager's competencies might also influence his need for additional managerial support in sales, marketing, accounting, distribution or any other field. This can be provided mainly by equity investors (e.g., VC funds, business angels and strategic investors) who already have experience in running a company as well as previous knowledge about the industry. Other sources such as debt are said to provide 'stupid money', since they do not come with any support. Keuschnigg (2004) and Botazzi and Da Rin (2001) show that innovative companies which benefit from external support from VC funds perform better than the average and have higher growth rates. Also, collateral is often required for obtaining debt finance. As a consequence, Ueda (2004) shows that entrepreneurs with little collateral would be more likely to obtain financing from VC funds than from banks.

3.2.2 Risk Moral Hazard And Information Asymmetry

What risk an entrepreneur can support is a condition to choose a funding. Indeed, managers take risks, but shareholders are those who actually carry it (Short, 1994). As a result, equity finance is a way to spread risk over different people. In contrast, debt finance makes the entrepreneur (provided he is the only shareholder) to bear the risk alone. Therefore, the financial structure of a company is influenced by the original riskiness of the project along with the risk-taking personality of the entrepreneur.

Finally, information asymmetry is another issue in financing entrepreneurial initiatives. This is the common issue of information asymmetry, whereby different parties engaged in a deal do not have access to the same level of information (Myers and Majluf, 1984; Narayanan, 1998). In the case of crowdfunding, this issue may be even more pronounced. Indeed, investors are not specialists and thus have access to less information about the industry, past performance of the entrepreneur and many other pieces of value-relevant information. Moreover, the entrepreneur might be even more reluctant to disclose information to this type of investors, due to their number and lack of professionalism.

However, not all investors require the same level of information disclosure from borrowers. Most of the time, investors acquiring equity ask for more information than debt financiers since they bear more risk. Related to this point, Ueda (2004) finds that entrepreneurs who go to VCs are more likely to have secured their ideas via intellectual property rights, which also implies that the entrepreneur's legal environment has a direct influence on his choice.

3.2.3 Organizational Form

A main finding in Lambert and Schwienbacher (2010) is that not-for-profit organizations tend to be more successful in achieving their fundraising targets as compared to for-profit organizations. This suggests that the organizational form may be an important driver of the success of crowdfunding initiatives. Lambert and Schwienbacher (2010) suggest that a possible explanation for this result stems from the fact that not-for-profit organizations may be more prone to commit to high quality products or services. In contrast, for-profit organizations will set their quantity-quality mix that only maximizes corporate profits. Since not-for-profit organizations put less emphasis on profit making, they may therefore focus more on quality, which may be an important requirement for attracting donations (Glaeser and Shleifer, 2001).

3.2.4 Control Preferences

An extensive part of literature exists on possible conflicts of interest between owners and managers. Short (1994) find that performance is affected by the ownership structure since it has consequences on the strategy. Particularly, in line with the general consensus (Thomsen and Pedersen, 2000), they show that owners want to focus on profit maximization in order to maximize dividends, while managers might have more value creation/prestige-related goals like being innovative (Czarnitzki and Kraft, 2002).

Following the incomplete contracting literature, Hart and Moore (1998) show that control needs to be clearly held by one of the parties (owners or managers) but not both, so that conflicts of interest cannot appear in decision-making. This can be the case for instance for ethical companies that do not want to have shareholders focused more on profits rather than on accomplishing the ethical mission of the firm. However, owner-manager

firms may also become less efficient than when the functions are separated subsequent to a lack of managerial monitoring and oversight functions by external shareholders. This can partially be explained by the interest of owner-managers to be their own boss, and focus less on growth (Berger and Udell, 1998). Venture capital funds structure their contracts in such a way that ownership and control becomes largely separate (Hellmann, 1998). Cash flow and control rights may further shift hands over time, depending on pre-specified contingencies. Berglöf (1994) shows how this can be implemented with convertible preferred shares, as done by venture capitalists. However, this requires sophisticated contracting that is unsuitable for the crowd.

One question is whether crowdfunders should be able to have their say on the management of the company. This issue deals with the legitimacy of such investors to control a company. Indeed, they might be quite numerous and each has brought only a small amount of money into the firm. How much power would they get then? And how could they exercise it? The Web 2.0 could at times be an alternative to high coordination cost where the number of investors is particularly large; in this case, voting power can be given to crowdfunders for very specific decisions about the product design or other corporate strategies. However it is unlikely to be manageable for any kind of managerial decision, such as voting right given the common shareholders in true equity issuance.

3.2.5 Amounts Required By Entrepreneurs

How much money is needed in another discriminating factor? Indeed, financials have all different pre-defined amounts they are willing to invest (Bhidé, 1992). For instance, there is a legal minimal threshold to be placed on the stock market; it prevents small companies to use it (Botazzi and Da Rin, 2001). In addition, its implementation cost is very high and imposes companies to have reached a certain scale and have reduced the risk factor (Berger and Udell, 1998). Similarly, VCs usually have high minimum investments that reveal to be unsuited to the needs of small ventures (Bhidé, 1992). Schwienbacher (2007) shows that this may lead to a crucial trade-off as to when to start entrepreneurial activities, since smaller amounts need to be financed by other investor types like business angels.

Besides, small business finance is highly and disproportionately affected by macroeconomic conditions (Berger and Udell, 1998). Indeed, market forecasts, stock market health, overall economy health, and monetary policy all have effects on small business finance. For example, the US credit crunch of 1990 caused the small firm lending to fall by 38% from \$144bn to \$88bn. VC financing is also affected by market conditions, since their entry is conditioned by their exit strategy based on the stock market health (Black and Gilson, 1998).

3.2.6 Legal Issues Regarding Equity Issuance And Multiple Investors

Regulation on equity issuance for private companies may limit the extent to which crowdfunding can be a viable source of financing and the capacity of firms to seek funding from the crowd, as it may be perceived as being a general solicitation of public saving. Moreover, in some countries there is a limit on the number of shareholders that some forms of business organizations are allowed to have.

The case of Trampoline Systems clearly shows the legal concerns that companies may face. National regulations typically limit the extent to which companies can advertise security offerings to the public, limiting it often to qualified investors and people with whom the entrepreneur already has clear links. Regulators may limit the number of shareholders of a private company. Solving these issues has cost to Trampoline Systems significant time and legal costs in order to have its crowdfunding process in line with UK regulation for issuing equity privately. Among other things, it implied that the crowdfunding process had to be restricted to qualified investors, and the general public could not participate.

Therefore, the crowdfunding participation is often structured in the form of making the participating crowd a member instead of a shareholder, such as BeerBankroll and MyFootballClub (that now owns the club Ebbsfleet United). Others offer investors part of the revenues without issuing shares however. An interesting example is Sandawe that allows investors to finance comic books and earn a slice of the revenues generated by subsequent sales of the albums selected by investors. There, the crowdfunding initiative combines profit sharing and voting on which albums to sponsor with the money provided.

3.2.7 Efficiency And A Decreased Risk Arguments

Entrepreneurs may require external support on how to run their company or to assess the economic potential of their product. Unlike business angels or venture capital funds, crowdfunders might not have any special knowledge about the industry. This implies that a crowd can at times be more efficient than individuals or teams in solving corporate problems. Hence, crowdfunders as a crowd would be more efficient than a few equity investors alone.

From another point of view, the risk taken by crowdfunders might be smaller, and not only because of the small amounts that they provide individually. The crowd may further become consumers once the product has been brought to the market and have an incentive to disseminate the information about the product if they participate in the profits of the venture.

4. IMPACT OF THE FRENCH LEGAL REFORM ON THE DEVELOPMENT OF CROWD-FUNDING

4.1 Situation Of Crowdfunding In France Before The Reform In September 2013

Before the bill (4 September 2013) to simplify and secure the lives of companies, the crowdfunding had no own legislative framework, we must refer to the applicable rules of monetary exchanges and commitments. Each internet crowdfunding platform has its own modes. There is no uniformity. We need to identify for each legal consequences in order to understand them. Crowdfunding can be represented by different forms (gift, counterpart funding, lending and acquisition of securities). Each of these forms of practices is regulated by specific laws. However, these regulations are inadequate to websites. Indeed, the purpose of these sites is to finance projects with a multitude of small amounts made by individuals.

France has only two official documents dedicated to crowdfunding published by the ACP² for the general public and to the AMF³ for platforms and project leaders. Therefore, official texts show that positive law is a real obstacle to the development of these sites. The main consequence is a leak in financing entrepreneurs in the United States where the legislation has become more interesting since the law Jobs April 2012.

In the end only one provision of the Lagarde's law in July 2010 concerns the crowdfunding. This provision has been created, following a lobbying from certain platforms like babyloan.org.

4.2 Impact Of Legal Reform On The Development Of Crowdfunding

In the entrepreneurship's Audience (April 29, 2013), the President of the Republic announced the establishment of a secure environment for the development of crowdfunding legal framework. Indeed, these models are experiencing a rapid development in all countries. For example, Google has invested \$ 125 million in the first platform of credit between individuals in the United States. This is the reason why the French government wants to render the crowdfunding as an activity managed and regulated.

September 30, 2013, is an important date for the development of the legal framework crowdfunding. The main measures that have been used are as follows:

- A user cannot individually provide more than 250 euros even that each project should not exceed a fundraiser for € 300,000 only in respect of loans.
- Under the bill on simplification of corporate life, government will in the first trimester in 2014 an ordinance creating the status of equity investment advisor. This status, which will pretend crowdfunding platforms require to have a level lower than that required for conventional financial institutions equity.

² Autorité de Contrôle Prudentiel

³ Autorité des Marchés Financiers

- The regulation of banking monopolies will also change because it will allow loans between individuals with a limited amount to 250 euros for the lender and € 300,000 in total for the borrower.
- The government has made a distinction between donations and investments. The first permits to participate in the financing of a project without becoming an investor, are not affected by the law. By cons, online loans will now be supervised.

These first steps of regulation show that France will be the only country with a status to fix crowdfunding. This is a real breakthrough.

Moreover, the fixed thresholds at 250 euros and 300 000 euros are some still too limited. However, the limit of € 300 000 per project is partially offset by the fact that all French can invest where, across the Atlantic, only qualified investors (with more than a million dollars in assets) can. Therefore, the range of investors is more important in France. It is possible to lift advantage of funds in the United States, but with fewer people. In addition, as outlined by the ministry, raise the threshold for example 300 000 to 1 million could prevent individuals from taking too many risks and that poor risk management is a platform to be bankrupt for mismanagement.

Other advances are also being studied. Indeed, it is interesting that the state supports the development of crowdfunding platforms by placing a portion of its cash as an investor - lender on crowdfunding platforms. For example in the UK, the government has recently decided to put 100 million pounds available to players' crowdfunding in this form of "direct investment". As part of this program «Business Partnership», initiated by the Ministry "Business, Innovation and Skills», 7 platforms have already been selected: 4 for December 2012 for a total investment of 55 million pounds, 3 for March 2013 to an investment of 32 million pounds.

5. CONCLUSION

A new source of funding is becoming more and more important in the financial sphere for SMEs. Since the subprime crisis, SMEs suffer for a lack of loans and stricter rules for credit conditions. This new source allows SMEs to finance new projects. Crowdfunding platforms used are specialized in the financing of households, and also for SMEs. Different platforms of crowdfunding are created and they are raised several million euro. Recent works help to build a theoretical framework to understand the success of this new financing source, Franke and Klausberger (2008), and Lambert and Schwienbacher (2010). However, the lack of regulation is a barrier to commercial development. Crowdfunding is expected to replace significant parts of the banking system. It responds to main concerns of borrowers, transparency savings and utilization in the service of the real economy, for individuals or professionals projects, simple credit products and lower rates than those by banks. With an appropriate regulation, crowdfunding growth is expected to be even faster.

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