Will the stream of new funding platforms (such as crowd-funding) become a flood?

A PHASE IN THE CROWD

By Cynthia Harrington, CFA

In finance, cracks in what seem like solid edifices can explode into catastrophic-sized holes. Here's an analogy that hydroelectric engineers will understand. A concrete slab called a spillway is built opposite all dams for emergency runoff. Rains in early 2017 caused the spillway in Oroville, California, to be used for the first time in its 48-year history. An enormous chunk fell out of the middle of it, dropping water down into a three-story jagged hole and diverting billions of gallons of water toward unsuspecting people's homes below.

The main culprit is suspected to be cavitation—the formation of a cavity within a solid object. The process begins with water pounding over the small imperfections in the formed concrete, which creates tiny water vapor bubbles that collapse like a horde of jackhammers. We may be on the brink of a similar collapse with the changes in small- and emerging-growth company financing.

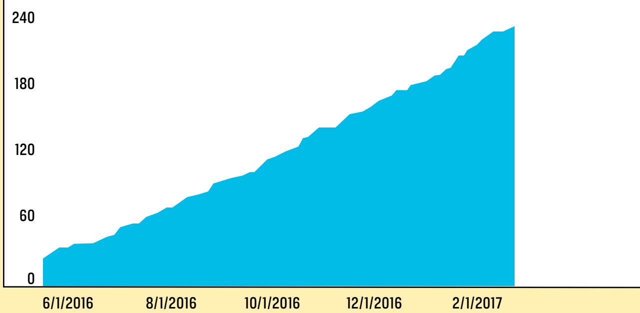
TRULY PUBLIC OFFERINGS

With the signing of the Jumpstart Our Business Start-ups (JOBS) Act five years ago, companies needing capital became able to solicit investors directly. Reportedly, almost $3 billion flowed to new companies from accredited investors in that first year. "Title II [accredited investors] came out like a rocket ship when the act was signed in 2012," says Matthew R. Nutting, who practices corporate law at Fresno, California, law firm Coleman & Horowitt and is a director of the National Crowdfunding Association. "There were few publicly traded offerings then and lots of money chasing those deals."

According to CFX Markets, a trading platform for alternative assets, there are several reasons the market will grow to an estimated $300 billion by 2025. For one, the JOBS Act makes everyone in the US a potential investor. Sixty-two percent of self-directed IRA investors report that they either plan to or already have increased their allocation of non-traded alternatives in response to market volatility. Institutional investor demand for alternatives is similarly growing. Preqin, a data and analysis firm for alternative assets, reports in its 2017 investor outlook that one-third of institutional investors have exposure to at least four alternative asset classes, up from one-quarter just a year ago.

Both the demand and the supply sides of the still-nascent crowdfunding marketplace are flowing strong. There is a generous supply of companies looking for funding, and in smaller amounts. Such technologies as cloud computing and open-source software, as well as dynamic languages like Ruby and JavaScript, make it cheap to get a company started. What used to take tens of millions of dollars can be accomplished for hundreds of thousands. Lots of new companies plus lower capital requirements

Cumulative # of Regulation Crowdfunding Offerings Filed with SEC



Source: www.crowdfundcapitaladvisors.com/cca-regulation-crowdfunding-indices equals a great opportunity for hundreds of millions of potential investors.

Despite the pent-up demand for investments and capital, Nutting adds a note of caution: "I think Title III [of the JOBS Act] is going to be a slow build." Nutting, who also co-wrote a book on this new asset class called *Equity Crowdfunding for Investors*, believes the most recent changes to the JOBS Act, which increase the potential size of deals and make crowdfunding available to as many as 240 million Americans, will take time to find their place.

Advisers to institutions and high-net-worth individuals may want to take note of these tiny bubbles. For one, the supply of available companies trading on public exchanges is half what it was two decades ago, bringing the total to just over 4,000. For another, this is where high-net-worth and institutional dollars are going. Millennials notoriously avoid public markets, and the younger among them are more likely to invest in their friends' private start-ups than in public companies. The Facebook IPO, for example, made 1,000 new millionaires. The pool of these investors is growing; if the near-10% annual rate continues, by the end of 2017, there will be more than 9.5 million high-net-worth investors in the United States, an increase of 68% from 2012, with the total wealth of this group increasing by 83% to just under $40 trillion.

While each country has its own rules, the US has lagged in facilitating crowdfunding for emerging companies, and the traditional venture-capital industry is taking note. Crowdfunded deals raised $34 billion throughout 2015; this is catching up to the annual US venture-capital activity of $69 billion.

BEER, ICE CREAM, AND ROBOT ARMS

Emerging growth companies (EGCs) are drawn to the new funding streams for many reasons. Top on the list is the lower cost. An IPO's start-up costs are in the millions; a JOBS Act business can get off the ground with investments in the hundreds of thousands. Fewer filing and reporting requirements save time and money. According to the SEC, the JOBS Act provides "scaled disclosure provisions for emerging growth companies, including, among other things, two years of audited financial statements in the Securities Act registration statement for an initial public offering of common equity securities, the smaller reporting company version of Item 402 of Regulation S-K, and no requirement for Sarbanes–Oxley Act Section 404(b) auditor attestations of internal control over financial reporting." Firms can avoid the costly requirements associated with traditional IPOs, such as disclosures of compensation for executives and board members, regular filings of Forms 10 and 8, stockholder meetings, expensive directors' insurance, and pressures to favor short-term results over long-term strategy.

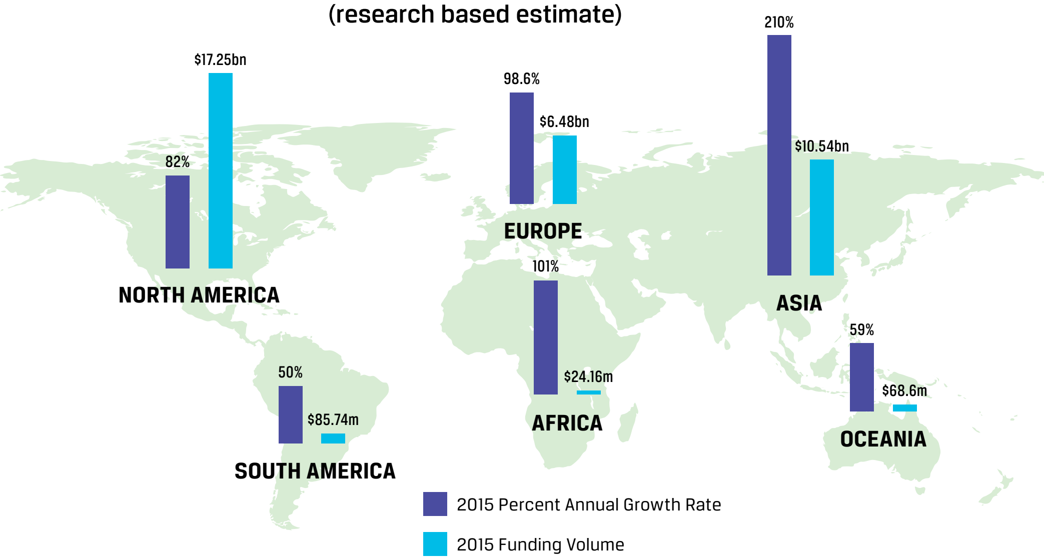
Benefits are given in equal measure as requirements are diminished. Companies can communicate with qualified institutional buyers or institutions of all accredited investors through the "test the waters" provision prior to pricing to determine demand for the company's securities. Research reports on EGCs follow more liberal rules under the new laws than those that govern traditional IPOs.

The companies likely to be successful at marketing to the general public still follow a certain pattern. "Most companies are not marketing to the wealth manager or institutional investor yet," says Mark Elenowitz, founder and CEO of TriPoint Global Equities in New York City. "Companies are presenting to an investor [who is] doing their own due diligence, and these investors have to understand what the company does in the first 30 seconds."

Elenowitz points to two such companies that have raised funds through his company's crowdfunding platform, called BANQ®. The first is Yuengling, one of the oldest breweries in the US, which has huge brand awareness. When it launched a new product line of ice cream in 2014, its customer base of 225,000 people (as well as its huge social media audience) created demand for its shares through familiarity with and passion for the products. A second company with appeal to the public is Myomo. Its exoskeleton robotic arm, built for people who have paralysis or MS that restricts arm mobility, is highly visual. "Investors look on the site and see this device move a previously immobile arm, and they get it immediately," he explains.

For crowdfunding industry veterans, the process of connecting companies with the public for money started before the JOBS Act. An industry report published by crowdsourcing.org polled 135 crowdfunding platforms (CFPs) that were already actively fundraising in 2010, before the JOBS Act

Growth of crowdfunding region prediction for 2015 in millions of USD (research based estimate)



Source: Massolution 2015CF Crowdfunding Industry Report was passed. These platforms created and tested the technology for processing transactions and the methods to attract individual funders. Darren Marble, CEO of CrowdfundX in Los Angeles, has led the marketing for more than 100 crowdfunding campaigns over the last seven years.

Marble, in typical start-up lingo, describes the genesis of his current company as having "failed into the business" after two previous attempts, including a film-financing effort. CrowdfundX, whose lead investor is Steven Johnson, former chief investment officer of Apple, has at least one claim to fame in the crowdfunding world. The company designed, produced, and marketed the Regulation-A+ equity-crowdfunding campaign for the first crowdfunded IPO in the US—Elio Motors, which raised $17 million from more than 6,500 investors before listing on the OTCQX under the symbol "ELIO." Marble is also behind the Crowd Invest Summit, which hosted 1,400 attendees at its inaugural two-day event in December 2016. "Over the last seven years, different pieces of the JOBS Act have gone live at different points," says Marble, who is currently managing 15 Reg-A campaigns. "This last piece takes [away] a big deterrence for people investing in deals in that it doesn't make accredited investors jump through hoops to prove they're accredited."

Skeptics seem quick to dismiss the market due to the slow ramp up since Reg A+ opened the doors to all. Marble disagrees with that assessment, calling Reg A+ an entirely transformational piece of legislation, as the first substantial change to securities laws in 80 years. The internet took years to build its base before it exploded. "After the first couple of successful deals, you're going to see the floodgates open, especially with Reg A+," Marble goes on to say. "In fact, I predict that after a few companies hit the $50 million max, we'll see the SEC and Congress comfortable with raising that bar."

PLATFORMS

These new rules necessitate new methods for investors and companies to find each other. For each type of crowdfunding, specialist platforms exist. As opposed to the early CFPs that described products but gave little information about the company offering the goods, the new CFPs deliver detailed financials, as well as data on the crowdfunding itself. "The platforms are tinkering and trying to find their role in this new space," says Nutting. "The number one issue, as I see it, is that too many early stage companies are filing Form 1-A way too early. Before Reg A+, companies need operating history and customers, not pre-product or pre-revenue."

Wefunder, located in Boston, is an example of a platform that has tinkered with its model. One of the first crowdfunding platforms in 2012, it now does only regulation crowdfunding. That being said, it also no longer solicits individual investors directly; companies bring their own lists of potential funders, and the site's base audience already numbers over 90,000. "I opened my firm immediately after 2012 [when the JOBS Act began], driven by a passion to democratize markets," says Mike Norman, co-founder and president of Wefunder. "Now, with Reg A+, we do only regulation crowdfunding."

Wefunder lists success stories for 153 companies raising $34.5 million through Reg-D offerings. The deals are often done out of a personal passion or familiarity. An investor who lives in New York and likes beer could invest in a microbrewery in Alabama or a brew-your-own bar in Boston. Another investor whose life has been touched by diabetes could find a company making a bionic pancreas that auto-monitors blood sugar levels to guide the release of insulin. The craft brewery investor, doing due diligence, can see that a particular beer maker has big-name customers and good sales and enjoys first-mover advantage. Our diabetic investor might note that the bionic device was developed by a medical researcher for his son and that Eli Lilly has made a $5 million investment ahead of the Reg-D offering.

"Under the new rules, investors get far more data, with financial statements, risk disclosures, and an analysis of the debt structure," says Norman. "This is in addition to the data points on the site, like the consumer product company is getting their customers to invest in."

The business models at other platforms are approaching the gatekeepers of past traditions. Ryan Feit and James Han launched SeedInvest in 2012 out of frustration that their Wharton classmates with great ideas weren't getting funded. Based on their experiences in careers at Wellspring Capital, Francisco Partners, Lehman Brothers, and Morgan Stanley, they steered SeedInvest toward traditional review of potential companies. Professional investors vet all applicants to this platform in house. The additional scrutiny comes from self-interest as well; SeedInvest puts an extra $200,000 into each company that meets its crowdfunding goal. "Of the 400–500 applicants each month, about 1% get through internal due diligence," says Feit. "Then we outsource the legal and confirmatory work."

One hundred twenty companies have raised an average of $500,000, and 150,000 investors are currently registered on the SeedInvest platform. Several people on the vetting team, all of whom have MBAs and extensive financial experience, are partway through the CFA Program. Of the registered investors, a fair amount are registered investment advisers and family offices. "Advisers looking for an uncorrelated, high-potential return are talking with us," says Feit. "In this environment, it's critical for advisers to offer an alternative to clients to differentiate a firm."

"If you're already on our platform, it's likely a client asked you to look into it," he adds.

At BANQ, a new offering from a traditional investment bank serving the small- to mid-cap market, they take the scrutiny a step further. They see Form 1-A as simply a replacement for Form S-1. "We see this regulation bringing back the small-cap IPO, filling the void in the sub-$500 million funding space," says Elenowitz.

The companies coming in under the new regulation enjoy all the services of TriPoint as an investment bank. Companies go through standard due diligence, valuation analysis, fundamental analysis, and the industry peer comparison. "The issues are priced based on a defensible position," explains Elenowitz.

The first Reg-A+ offering to list on the OTCQX was Elio Motors, which makes a car priced under $10,000 with an

NO ONE IS CLAIMING THESE ARE NOT VERY HIGH-RISK PROSPECTS. WITH 90% OF START-UPS FAILING AND ONLY 30% GAINING FINANCING BEYOND THE SEED STAGE, THERE WILL BE MORE FAILURES TO DISCUSS THAN WINNERS.

84-miles-per-tank range. Elio raised $17 million with the StartEngine platform in early 2016. BANQ has three companies listed on the "upcoming offerings" section of its site; a furniture company, an ice cream company, and a company that recovers treasures from the ocean floor are testing the waters with real investors to determine interest in a potential deal. With that information in hand, Elenowitz works with entrepreneurs to craft a potential offering. "Every entrepreneur thinks they're going to be the next Twitter," he says. "My job is to marry reality with vision to know where the street is going to price the deal."

BANQ offerings will be immediately listed on an exchange. "Our issuances look, act, and feel like standard IPOs," Elenowitz says. "It took a long time to convince the exchanges, but these offerings are no different than sales of a regular IPO."

A key part of the start-up ecosystem is having an exit strategy planned at the time of investment. Companies not planning to list on an exchange must keep in mind which big company might buy them as their replacement R&D strategy. Another factor in start-up investing is to plan for future funding rounds. The average hold for a private company is seven years; fast growers will need additional capital. Some platforms promote their follow-on investing experience. "Part of the value we offer companies is to finance them from a $500,000 or $1 million seed all the way up to the larger $5 million to $20 million rounds," says Feit about SeedInvest.

He gives two examples. The first is Virtuix, a leader in virtual reality for gamers. Virtuix created a piece of hardware that's a circular treadmill. Wearing the oculus headgear, the player moving on the treadmill is what controls the game action. Virtuix raised a $1.5 million seed round through SeedInvest two years ago. The company is enjoying success, particularly in China, where it is retrofitting internet cafes to be virtual reality cafes. It returned to raise another $7.5 million last year for further expansion. Similarly, Knightscope, which makes a five-foot, 300-pound robotic security guard used on the campuses at Uber and Microsoft, raised early through SeedInvest and returned for the next round at 20 times the valuation of the first.

INEFFICIENT FRONTIER

One way to see any opportunity in the crowdfunding sector is to consider that what was old is new again. After decades of computers taking over public market investing, here's an inefficient asset class demanding fundamental investment analysis skills—an asset class that performs the function stock exchanges were created for, which is to bring capital to young companies so they can grow and create innovative products and jobs. Inefficiencies mean returns are uncorrelated and likely to continue at the current pace of twice the S&P 500 for a while.

Some advisers may already be in the game, and others may be considering developing an expertise in the new funding platforms and regulations. To those who are considering, Feit suggests three points. First, the crowdfunded companies are a unique investment opportunity in which their clients are investing alongside venture funds in the same deals. Second, there aren't many advisers in the game as of yet. And third, getting clients into deals with cocktail-party appeal will lead to a high degree of client referrals. "The 5%–10% of companies in their portfolio that they're excited about are what they talk about 90% of the time," says Feit.

No one is claiming these are not very high-risk prospects. With 90% of start-ups failing and only 30% gaining financing beyond the seed stage, there will be more failures to discuss than winners. That has always been the situation for high-growth companies, even with traditional IPOs. When Apple's IPO happened in 1980, it was the largest offering since Ford Motor Company in 1956. The general public showed up in droves for a few of the shares, many of whom were passionate Apple users. Underwriters Hambrecht & Quist participated in the deal; this firm enjoyed almost celebrity status at the time for picking winning companies to represent. The stock was priced at $14, opened at $22, and closed that day at $29. No investor in Massachusetts got even a single share, because the state securities regulators would not allow sale there. It was considered too high risk.

As fintech takes away, it also gives. The new vehicles and regulations open up new opportunities for financial experts. Information about technologies potentially disrupting all industries is now easily accessible through online platforms. The new industry needs a host of ancillary services—specialist attorneys, broker/dealers, and marketing companies—to do due diligence. There has to be a market growing for an index and pooled investment structures. "Don't want to offer clients crowdfunded investments?" asks Nutting. "How about setting up a mini-rating agency, offer services to write summary sheets, or maybe devise an insurance product against fraud and bankruptcy around the new methods of issuance."

These conversations with clients about their passions stand to change investment culture. "What are clients going to want to talk about in the quarterly portfolio review meetings?" Norman posits. "It can get to be a lot more compelling to talk about how much craft beer their favorite company has shipped or how many new people have relief from diabetic shock than the performance of an asset class of securities against their benchmark."

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