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FACULTY OF BUSINESS ECONOMICS
Master of Management: Management Information Systems

Masterproef

Crowdfunding as an alternative to traditional funding: An exploratory analysis

Promotor :
Prof. dr. Benoit DEPAIRE

Andreea Zala
Master Thesis nominated to obtain the degree of Master of Management , specialization Management Information Systems

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This master thesis is the final assignment at Hasselt University, Master of Management MIS. It symbolizes the end of my time as a student. The time spent in Belgium and at UHasselt has been a wonderful experience.

When I started this project, I barely knew what crowdfunding is. This project has given me the opportunity to discover and study this interesting topic, which I believe has had and still has a great impact in the entire world.

Although this project has been mostly an individual assignment, the completion of this project would not have been possible without the help of several people. Here, I would like to take the opportunity to thank all of them for their effort and support.

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Thank you!

Preface

Entrepreneurs are facing a big problem when trying to find the funds necessary to launch and eventually grow their businesses.

A large amount from the start-up capital for the small businesses is provided by family and friends or business owners themselves. Entrepreneurs can try to find more funding, bigger amounts, for the new business from banks, venture capitalists, angel investors, corporate investors, grants. But they face difficulties in finding finances in the early stage of development from the traditional means of funding because of the large amount of money needed or unsuccessful attempts to find and convince investors or lack of trust and credibility.

In the past years, this new way of funding emerged – crowdfunding – which is gathering money from the crowd, a large audience, instead of specialized investors. This process of gathering money from the crowd takes place on specialised crowdfunding platforms. The platforms play the role of intermediary between the entrepreneurs and the crowd, the bakers. For this money gathering, the “price” paid to the crowdfunders is a compensation, acknowledgement or a reward.

The existence of these multiple sources of financing raises questions like “what is the best source of funding?” or “what is the option that fits best the new project or start-up company?”

The goal of this thesis is to study the phenomenon of crowdfunding and to compare it to traditional ways of funding projects or businesses.

Summary

The subject of this thesis is crowdfunding in comparison with the traditional ways of funding. It is divided in 5 chapters in which different aspects of the topic are investigated. This summary provides an overview of the content of the thesis.

The main research question of the thesis, as shown in chapter 1, is the following*: Is crowdfunding an alternative to the traditional funding?*

Chapter 1 is an Introduction to this study, where the main terms are explained, how did I came up with the main research question and the sub questions, and the research methodology.

Chapter 2 represents a short presentation of the crowdsourcing definitions, taking into consideration that different authors argue that crowdfunding finds its roots in the concept of crowdsourcing, followed by an explanation why crowdfunding can be seen as one specific form of crowdsourcing.

Chapter 3 dives into the crowdfunding phenomenon. Definitions, actors, rewards will be presented in the first part of the chapter, followed by an analysis of the crowdfunding platforms and some legal issues in the second part. This chapter represents the first main step in answering the main question of this thesis.

Chapter 4 is a presentation of the traditional ways of funding, followed by an analysis of these different types of funding. This represents the second main step in answering the main research question.

Chapter 5 contains an analysis, a comparison between crowdfunding and the traditional ways of funding presented in chapters 3 and 4. It represents the answer to the main research question and the conclusion of this thesis.

TABLE OF CONTENTS

CHAPTER 1 INTRODUCTION 11

- Research objective 11
- General research question 13
- Specific research questions 13
- Research Methodology 15

CHAPTER 2 CROWDSOURCING 17

- Introduction 17
- Crowdsourcing and the Internet 18
- Conclusion 22

CHAPTER 3 CROWDFUNDING 23

- Introduction 23
- Crowdfunding process 24
- Rewards and motivation 26
  - Crowd donations 26
  - Crowd sponsoring 26
  - Crowd pre-selling 26
  - Crowd lending 27
  - Crowd equity 27
- Crowdfunding Platforms 28
  - A typology by form of investment 28
  - A typology by form of rewards 29
- Crowdfunding and the JOBS Act 32
- Conclusion 35

CHAPTER 4 TRADITIONAL FUNDING 37

- Introduction 37
- Sources of funding 39
  - Family and Friends 39
  - Bank loans 39
  - Angel investors 40
  - Venture capital 41

Corporations 42
Public or private grants 43
Analysis of the traditional ways of funding 44
Conclusion 50
CHAPTER 5 CROWDFUNDING VS TRADITIONAL FUNDING 51
Analysis/Comparison.. 51
CONCLUSION 54
REFERENCES 57

LIST OF FIGURES AND TABLES

FIGURE 3.1: BASIC ACTORS IN THE CROWDFUNDING PROCESS 24
FIGURE 3.2: THE MAJOR FORMS OF CAPITAL PROVISION RANKED BY PROCESS COMPLEXITY 24
FIGURE 3.3: THE CROWDFUNDING PROCESS INVOLVING INTERMEDIARIES 25

TABLE 4.1 CHARACTERISTICS OF THE DIFFERENT PROVIDERS OF VENTURE CAPITAL 46
TABLE 4.2: GLOBAL ANNUAL VC INVESTMENT, 2005-2011 47
TABLE 4.3: CORPORATE PARTICIPATION IN FINANCING ROUNDS, 2003-2011 (NUMBER OF ROUNDS AND PERCENTAGE OF ALL VC ROUNDS) 48
TABLE 4.4: CORPORATE VENTURE CAPITAL INVESTMENT AMOUNT BY STAGE OF COMPANY DEVELOPMENT (AS PERCENT OF TOTAL INVESTMENT), BY REGION, 2006-2011 49

CHAPTER 1 INTRODUCTION

Research objective

One of the biggest challenges for entrepreneurs is finding the funds necessary to launch and eventually grow their businesses. Indeed, there are several ways of financing a new business or project, but the existence of multiple sources of financing raises the question of whether the source of funding matters for the entrepreneurial firm. It does, if we take into consideration the time spent, the related costs and the end result.

First, the entrepreneurs try to launch their business with their own funds. When these are done, or don't exist at all, they go for funding at friends and family. A large amount from the start-up capital for the small businesses is provided by family and friends or business owners themselves. Entrepreneurs can try to find more funding, bigger amounts, for the new business from banks, venture capitalists, angel investors, corporate investors, grants. But they face difficulties in finding finances in the early stage of development from the traditional means of funding because of the large amount of money needed or unsuccessful attempts to find and convince investors or lack of trust and credibility.

The banks face difficulties when deciding to approve or not a loan for a new business or project. When applying for a business loan in general, the banks ask for the track record, the financial records, but in case of a new business there is none. In this case, a good business plan could help the entrepreneurs receive a bank loan, but this is not for sure also. Two considerations are key ones in evaluating a firm's riskiness: the company's ability to generate sufficient cash flow to service the bank loan and the presence of collateral security to ensure that the bank can recover its funds from the liquidation of the business and/or personal assets if the business fails (Mason and stark, 2004). But these two are often lacking or are difficult to prove by the start-ups.

The venture capitalists' and the angel investors' reasons to invest in a new business or project are for gaining money and sharing success. But in case of failure, they share it too.

The angel investors usually search to invest in a domain that they have knowledge of or they used to work in. They are also interested to take part in the process, to bring some

contribution to the business. On the other side, the venture capitalists are more interested on the market situation and characteristics, and on the management capabilities.

Andrew J. Birol, President of Birol Growth Consulting and author of "Focus. Accomplish. Grow", said: “For many up and coming business moguls, angels have effectively served as their ‘Daddy Warbucks’[1]. But sometimes I wonder if angels are being exploited less for the right reasons and more for the wrong reasons. The right reasons are clear: startups have little collateral, marginal credit histories and often bring bigger ambition than track records to the bargaining table. Banks and venture capitalists are in no position to entertain these individuals and, if they do, create conditions far too onerous for most to bear. So it is the angel who steps in with vital seed capital, the lifeblood of a scrappy start up. The wrong reasons angels are in demand are more disturbing. Maybe the latest business plans are not passing muster in the established investment community and angels are more susceptible to marginal ideas.”[2]

Grants are a great solution to consider because the entrepreneurs don’t have to pay them back, don’t have to pay interest, nor share the business; but they are difficult to find, there are restrictions to take into consideration, and the application process takes long.

In the past years, a new way of funding emerged – crowdfunding – which is gathering money from the crowd, a large audience, instead of specialized investors. The concept of crowdfunding finds its root in the concept of crowdsourcing, which uses the “crowd” to obtain ideas, feedback and solutions in order to develop corporate activities. In the case of crowdfunding, the objective is to collect money for investment. This process of gathering money from the crowd takes place on specialised crowdfunding platforms. The platforms play the role of intermediary between the entrepreneurs and the crowd, the bakers. For this money gathering, the “price” paid to the crowdfunders is a compensation, acknowledgement or a reward.

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[1] http://ro.urbandictionary.com/: Someone who is rich enough to pay for someone else's expenses, either in a large lump sum or over a long time. Can either be permanent (e.g. a rich relative) or temporary (someone spotting a friend)
[2] http://entrepreneurs.about.com/cs/financing/a/angelsnotneeded.htm

General research question

Taking into consideration all mentioned above, the main research question came up:

Is crowdfunding an alternative to traditional funding?

The goal of this thesis is to study the phenomenon of crowdfunding and to compare it to traditional ways of funding projects or businesses. Further, will be discussed and analysed the crowdfunding phenomenon and the traditional ways of funding, forms, actors, advantages and disadvantages. Also an analysis of the crowdfunding platforms will be made in order to explain their role, the benefits and limitations when using one, advantages and disadvantages.

In order to answer the general research question and outline the structure of the whole thesis, some sub questions will be formulated and comments on them will be given as well as some main definitions that will be necessary as preliminaries of the whole subject.

Specific research questions

What is crowdfunding?

As said above, crowdfunding represents a process of gathering money for investment from people via the Internet. The concept of crowdfunding finds its root in the concept of crowdsourcing (Lambert and Schwienbacher (2010), Hemer (2011)).

In order to understand what crowdfunding really is, we have to know where it comes from, meaning that we have to know what crowdsourcing is. This is the next sub questions and the first chapter of the thesis.

What is crowdsourcing?

Howe (2006) defines it as "...the act of taking a job traditionally performed by a designated agent (usually an employee) and outsourcing it to an undefined, generally large group of people in the form of an open call."

After explaining what crowdsourcing is, we return to crowdfunding, in the third chapter of the thesis. In this chapter we explain the crowdfunding process, the actors involved, and the result of the process.

Further, a description of the crowdfunding platforms will be made, which will be the answer for next sub question:

What are the crowdfunding platforms and how do they work?

Crowdfunding platforms are the intermediaries that act as facilitators for crowdfunding. In order to see how they work, a study of the platforms categories was made.

The next chapter, chapter 4, will provide the answer for the following sub questions.

What are the sources of traditional funding?

What are the advantages and disadvantages of the traditional ways of funding?

It starts with a short explanation of the traditional ways of funding: angel investors, venture capital, corporation investors, banks, friends and family, grants.

Angel investors are individuals that invest their capital in small start-ups, entrepreneurial companies, looking for a higher rate of return than would receive from traditional investments.

Venture capital represents financial capital invested in starting up a new business having in return equity in the company invested in.

Corporations, in general, invest on behalf of their shareholders, for financial and/or strategic reasons.

Public or private grants represent a sum of money given by a government or other organization for a particular purpose.

The second part of the chapter represents an analysis of the traditional ways of funding mentioned above and an answer to the sub question "*What are the advantages and disadvantages of the traditional ways of funding?"*

Chapter 5 will provide an analysis, comparison between crowdfunding and the traditional ways of funding. This chapter represents the answer to the main research question "*Is crowdfunding an alternative to traditional funding?"* The conclusion of this chapter is also the conclusion of this study.

Research Methodology

This research starts with the exploration and explanation of different aspects related to crowdfunding and traditional funding. It examines how crowdfunding works. The concept of crowdfunding is also examined in the context of the related concept of crowdsourcing. The study examines the global market for crowdfunding and the rationale of businesses to search for crowdfunding, given the challenges of capital access for the new projects and businesses. The market for crowdfunding is examined in the context of different crowdfunding models.

The main method used is reading and analysing different resources like (Web) articles, papers, books and online reference material. Typologies, models, arguments, claims and examples were extracted from articles and books written by authors in the domain and scholars. In this study, scientific databases like EBSCOhost, Academic Search Elite, Social Science Research Network (SSRN), were used to search for articles. Many articles used as references in this thesis were found using “Google Scholar”. Also, articles from well-known newspapers and magazines in the financial domain like The Financial Times, Forbes, were used. The promoter of this thesis, Professor Benoît Depaire, also was of great help providing useful articles.

In finding the necessary articles and materials for answering the sub questions of this thesis, the following keywords were used: crowdsourcing, crowdfunding, investment, funding, entrepreneurship, traditional funding, bank, venture capital, corporate investor, angel investor, grant.

The papers of Brabham and Howe were the most significant for the “Crowdsourcing” chapter. For the “Crowdfunding” chapter, the most useful studies were the ones written by Hemer (2011), Schwienbacher and Larralde (2010), Lambert and Schwienbacher (2010), and Bradford (2012). The most important resources used for the “Traditional funding” chapter were from Denis (2004), Mason and Stark (2004), Chesbrough (2002), Terry et al. (2004).

CHAPTER 2 CROWDSOURCING

This chapter represents the answer to the sub question *"what is crowdsourcing?"* Its objective is to dive into the crowdfunding roots in order to have a better image on the phenomenon.

Introduction

Jeff Howe introduced the term of crowdsourcing in Wired Magazine in 2006 and he proposes the following definition:

"Simply defined, Crowdsourcing represents the act of a company or institution taking a function once performed by employees and outsourcing it to an undefined (and generally large) network of people in the form of an open call. This can take the form of peer-production (when the job is performed collaboratively), but is also often undertaken by sole individuals. The crucial prerequisite is the use of the open call format and the wide network of potential laborers."

More recently in his book (2008) or his blog, Howe offers the following two definitions:

"The White Paper Version: Crowdsourcing is the act of taking a job traditionally performed by a designated agent (usually an employee) and outsourcing it to an undefined, generally large group of people in the form of an open call.

The Soundbyte Version: The application of Open Source principles to fields outside of software."

In other words, a company posts a problem online, a vast number of individuals offer solutions to the problem, the winning ideas are awarded some form of a bounty, and the company mass produces the idea for its own gain.

Daren C. Brabham was the first to define "crowdsourcing" in the scientific literature in a February 1, 2008, article:

"Crowdsourcing is an online, distributed problem-solving and production model."

The Financial Times Lexicon defines crowdsourcing as "a business model or function that relies on a large group of users as third parties for outsourcing certain tasks. The popular use of the internet makes communication and coordination progressively cheap: tasks that would have been impossible to communicate and coordinate before have become extremely easy

to set up and coordinate. Crowdsourcing can add significant value to a product or service, and can also generate valuable connections between the users and the company."[3]

Brabham (2009) argues that the crowdsourcing model is a successful, Web-based, distributed problem solving and production model for business, is an appropriate model for enabling the citizen participation process in public planning projects.

Reading the above definitions, the conclusion is that all definitions are saying the same thing but with different words; some of them are shorter and to the point, and others contain more explanations, are more explicit.

Taking into consideration all the definitions from the above, my working definition came up: *Crowdsourcing is the online outsourcing of a task to (a group of) private individuals in the form of an open call.*

Crowdsourcing and the Internet

As Howe (2008) argues, the trend is appearing now because of the use of the Internet, not because the Internet made crowdsourcing possible, but because it made it more effective. Through the Internet, much more people can be reached, resulting in the reinvention of existing tools and concepts, such as creating a virtual version of the traditional idea box, but also in new opportunities like online collaboration. Especially the possibilities of the latest Internet generation, Web 2.0, have enormous effects on the opportunities of organizations to interact with other parties because it facilitates online collaboration and sharing among users (Albors et al. 2008).

Web 2.0 is the second stage of development of the Internet, characterized especially by the change from static web pages to dynamic or user-generated content and the growth of social media.[4]

This term was introduced in 2004 and it comes from the software industry, where new versions of software programs are labelled with an incremental version number. Like software, the new generation of the Web includes new features and functionality that was not

[3] http://lexicon.ft.com/Term?term=crowdsourcing
[4] http://www.oxforddictionaries.com/definition/english/Web-2.0

available in the past. However, Web 2.0 does not refer to a specific version of the Web, but rather a series of technological improvements.[5]

Some examples of features considered to be part of Web 2.0 are:

- Blogs - also known as Web logs, these allow users to post thoughts and updates about their life on the Web.
- Wikis - sites like Wikipedia and others enable users from around the world to add and update online content.
- Social networking - sites like Facebook or MySpace that allow users to build and customize their own profiles and communicate with friends.
- Web applications - a broad range of new applications make it possible for users to run programs directly in a Web browser.

Web 2.0 technologies provide a level user interaction that was not available before. Websites have become much more dynamic and interconnected, producing "online communities" and making it even easier to share information on the Web. Because most Web 2.0 features are offered as free services, sites like Wikipedia and Facebook have grown at amazingly fast rates. As the sites continue to grow, more features are added, building off the technologies in place. So, while Web 2.0 may be a static label given to the new era of the Web, the actual technology continues to evolve and change.[6]

Roughly speaking, Web 2.0 is a Web-as-participation-platform that facilitates interaction between users. This structure is crucial for entrepreneurs to be able to easily reach networks of investors or consumers (Lambert and Schwienbacher, 2010). Through a case study, Schwienbacher and Larralde (2010) highlight the importance of efficient communication and networking, arguing that this is an inherent component in the process.

Also, Howe (2008) says that crowdsourcing emerged due to four important developments:

The first one is that private individuals are given increasingly more opportunities to work on tasks that contribute to economic production, but are performed in their spare time and are not considered part of their jobs. While people have the potential to excel at multiple fields and tasks, the industrial revolution has caused people to perform ever more specialized jobs. Firms have taken up all the tasks that were once performed by individuals, families and

[5] http://www.techterms.com/definition/web20
[6] http://www.techterms.com/definition/web20

communities. As futurist Alvin Toffler already predicted in 1980, consumers do not want to remain passive, they will become “prosumers”, fact that is also argued by Prahalad and Ramaswamy in 2004, who argue that the role of the consumer has changed “from isolated to connected, from unaware to informed, from passive to active” (Hemer, 2008).

The second development is the open source software movement. Friedman (2007) says that the free software movement was and remains inspired by the ethical ideal that software should be free and available to all, and it relies on open-source collaboration to help produce the best software possible to be distributed for free. The primary goal of the free software movement is to get as many people as possible writing, improving, and distributing software for free, out of a conviction that this will empower everyone and free individuals from the grip of global corporations. Also, Friedman (2007) argues that we are now seeing venture capitalists actually funding open-source start-ups—paying software companies to put out some program for free in the hope that a community will develop around it, so that the start-up company can sell additional bells and whistles to the community for profit. This trend in the software industry inspired many entrepreneurs to apply its principles to fields other than software.

The third development consists of the increasing accessibility of information and decreasing cost of production tools, like digital cameras and editing software. This is most clearly seen in the creative industry, including film making, photography, music, and fashion.

The important thing, from the consumer's point of view, is that the blended models of community-developed software are driving more competition and producing cheaper, if not free, software for the public. (Friedman 2007)

The fourth and last development is the emergence of online communities, in which the online population is organized. Consumers are increasingly using online tools to share ideas and to interact. Although the definition of community in this context is ambiguous, the fact that an online platform is available for people to contribute to various activities, is an important development in this context. (Howe, 2008)

As a conclusion of the four developments mentioned above, we can say:

Consumers are invited to contribute their creativity and problem solving skills by generating and evaluating new product ideas, and discussing and refining these ideas into more detailed product concepts. This way, crowdsourcing approaches users with an open call, encouraging them to participate in ways that they are interested in and communicate with each other

instead of only to the company, which makes the whole process more natural. This means more tacit knowledge can be captured while more users can be involved.

Open innovation is related to crowdsourcing in the sense that they both focus on using external sources for innovation, and combining internal R&D with the knowledge of external sources. Increasingly more companies feel the need to apply open innovation principles, as their R&D budgets are increasing at a faster rate than sales (Howe 2006).

Because of a changing business environment, companies realized they needed to work together with other parties, such as customers, rivals, academics, and firms in unrelated industries, to improve their innovativeness (Chesbrough, 2003). 'The role of R&D needs to extend far beyond the boundaries of the firm. Companies must integrate their ideas, expertise and skills with those of others outside the organization to deliver the result to the marketplace, using the most effective means possible' (Chesbrough, 2003).

Through the Internet, much more people can be reached, resulting in the reinvention of existing tools and concepts, but also in new opportunities like online collaboration.

Online communities are groups of people who have a common interest and interact with each other online. As the definition of crowdsourcing that is used in this study already states that a platform is provided online for which users provide content, the most important characteristic of an online community for this study is that there is interaction between the members. But to be clear, not all crowdsourcing cases include interaction between participants, which means that not all crowds can be called communities.

Conclusion

As said before, in order to know what crowdfunding is, we have to know from where it comes. Different authors, in their books or articles, say that crowdfunding is a category of crowdsourcing. This chapter's scope was to find and explain the roots of crowdfunding.

Crowdsourcing involves real users, connected through the Internet that collaborate to solve problems that computers can't, for free or, in some cases, for some incentives. Private individuals are given increasingly more opportunities to work on tasks that contribute to economic production, but are performed in their spare time and are not considered part of their jobs. Consumers are increasingly using online tools to share ideas and to interact.

Raising funds by tapping a general public (or the crowd) is the most important element of crowdfunding. This means that consumers can volunteer to provide input to the development of the product, in this case in form of financial help[7].From this perspective, crowdfunding is a subset of crowdsourcing, since the latter encompasses also financial help.

Crowdsourcing differs in many ways from open-source practices (Brabham, 2008); some of these differences can be transposed to crowdfunding. An important distinction is that in the case of open-source, the idea belongs to the community who can then exploit it on an individual basis (there is no restriction on who can use it); in the case of crowdsourcing, the generated idea ultimately belongs to the company who will be the only one to exploit it. This distinction with open-source practices becomes even more obvious when related to crowdfunding, since capital cannot be shared. Unlike an idea or a software code, capital is not a public good in the economic sense that assumes non-rivalness and non-excludability. Under these conditions, a public good is a good that can be used by many consumers at the same time, without duplicating costs. (Lambert and Schwienbacher, 2010)

[7]For example, the companies that use crowdsourcing to solve different issues that could lead to reducing some costs, give a reward to the provider of the solution for the issue.

CHAPTER 3 CROWDFUNDING

Introduction

This chapter's first objective is to answer the sub questions "What is crowdfunding?" A definition will be presented, after that the steps of the process will be explained. As one knows, most of the times people don't give money just for the love of art, there are also some rewards they receive in change, fact that will also be discussed in this chapter. But, to have a complete image on crowdfunding, we have to know about the crowdfunding platforms also. A presentation of the types of crowdfunding and platforms will help understand better the phenomenon and to answer the sub question "What are the crowdfunding platforms and how do they work?"

A definition from the Financial Times Lexicon:

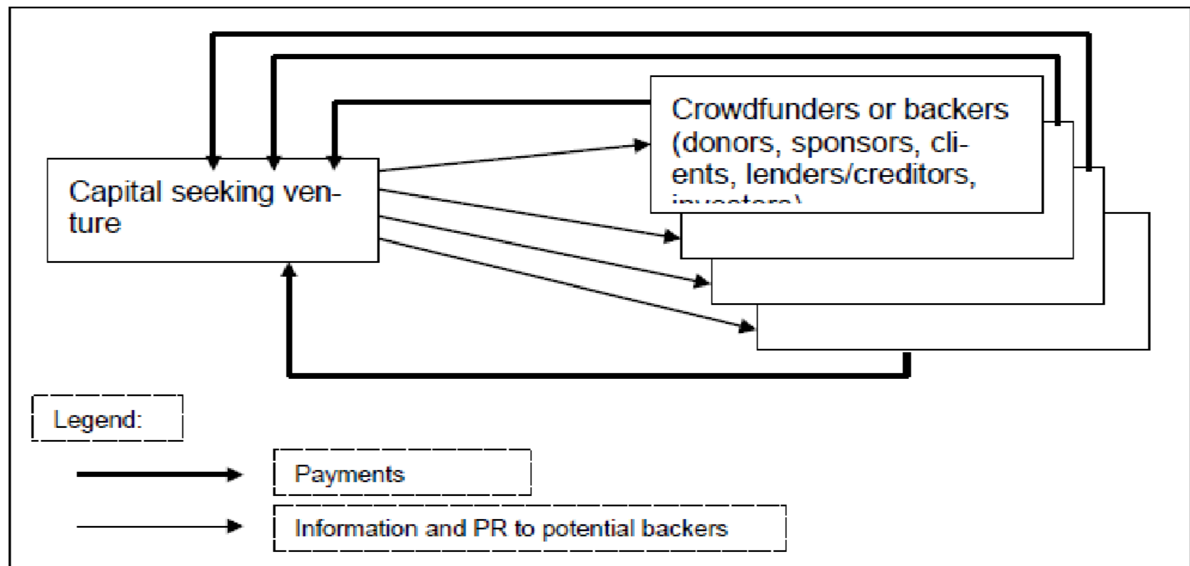
"A new and emerging way of funding new ideas or projects by borrowing funding from the crowds.
In these markets, any individual can propose an idea that requires funding, and interested others can contribute funds to support the idea. These markets have recently emerged as a viable alternative for sourcing capital to support innovative, entrepreneurial ideas and ventures.
A novel aspect of crowdfunded markets is the nature of the publicly observable popularity indicators typically recorded and published within the marketplace. For instance, the information on prior investments in crowd-funded markets typically includes a time stamp and the specific amount contributed, or both. These values contribute to what is often referred to as a project's current funding status. This status encompasses prior funding decisions made by others regarding a particular project, indicating the total funds raised, the number of contributors, and the duration over which that funding has taken place".[8]

Crowdfunding is a new mechanism of funding a project, for creating a new product or a start-up, by getting small amounts of funding from different people all around the world. It has emerged and developed on the Internet, where there were created special platforms, crowdfunding platforms. It is based on the concept of crowdsourcing, but the difference between these two is the final objective, in the case of crowdfunding is to obtain money.

[8] http://lexicon.ft.com/Term?term=crowdfunding

Crowdfunding process

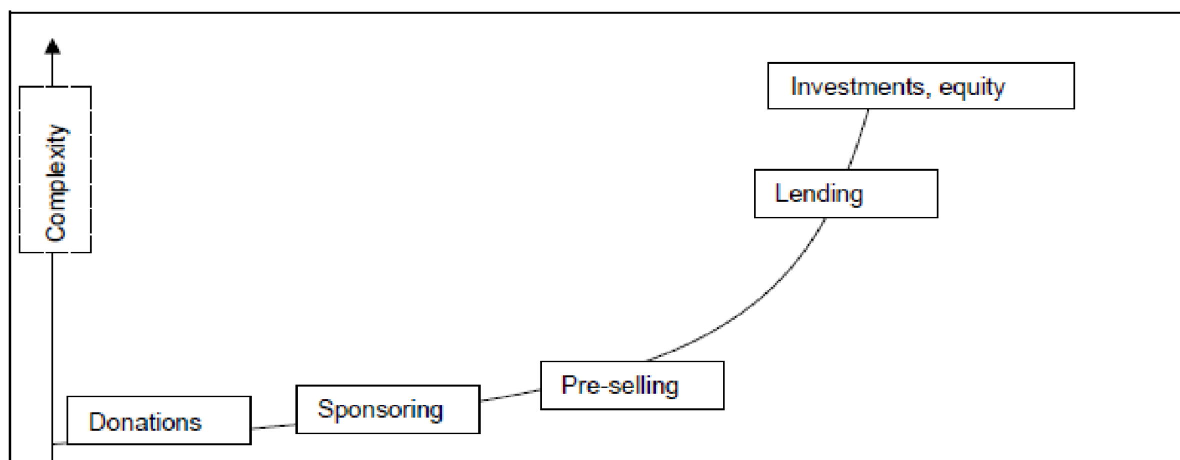
Figure 3.1: Basic actors in the crowdfunding process



Source: Hemer et al. (2011).

As shown in figure 3.1, the creators post their projects on the crowdfunding platforms searching for capital to fund their projects. If a project is considered interesting, good, by the crowd, it will receive attention and, of course, funding. The individuals funding projects, the crowdfunders or the backers, depending on the form of capital funded, are called donors, sponsors, clients, lenders/creditors, or investors.

Figure 3.2: The major forms of capital provision ranked by process complexity



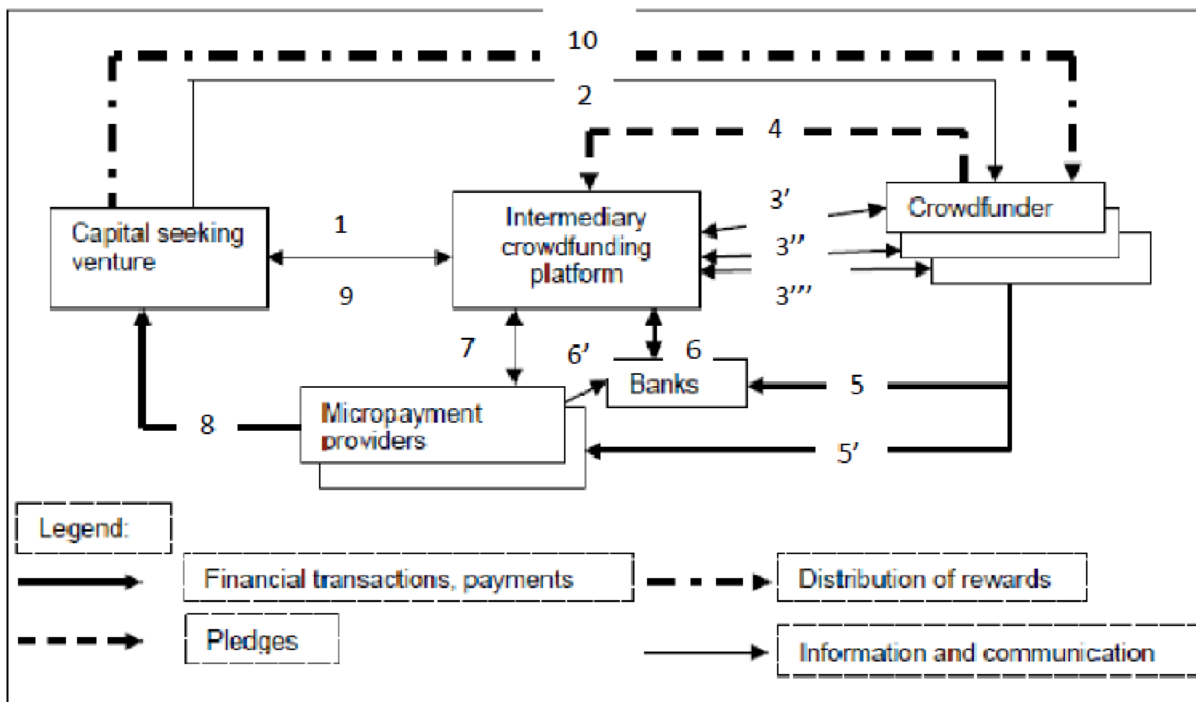
Source: Hemer et al. (2011).

Crowdfunding can take the form of donations, sponsoring, pre-ordering or pre-selling, fees for membership in clubs, crediting or lending and Private Equity (PE) investments.

In Figure 3.2, Hemer et al (2011) suggest that delimiting terms should be used like crowd donations, crowd sponsoring, crowd pre-selling (or crowd pre-ordering), crowd lending and crowd equity (or crowd investing), in order to highlight the important differences between these crowdfunding instruments.

These different forms of capital provision can be ranked in a graph, starting from very simple processes (donations) through to more complex and highly regulated forms (investments) as illustrated in Figure 3.2 (Hemer et al, 2011). The forms mention above will be discussed further in this chapter.

Figure 3.3: The crowdfunding process involving intermediaries



Source: Hemer et al. (2011).

Figure 3.3 illustrates how the platforms function as intermediaries between the capital-seeking ventures, financial service providers and the crowdfunders themselves.

The platforms offer to the creators the “place” to present their ideas to gather from the crowd the funds needed (1, 2, 3’, 3’’ and 3’’’). Besides this, the creators receive also some indications and advices regarding how this process goes or must go. The platforms act as an

intermediary between the backers and the creators when the pledges are made (4). Not to forget to mention that the payments are made through a payments processor (5’) or bank (5) chosen by the platform administration. The money given by the individuals are kept in bank accounts until the deadline of the project is met (6, 6’, 7, 8); this way and the creators and the backers are safe. After the deadline is reached, the creators receive the amount gathered (9) and the backers receive their rewards (or motivations, depending on the project) (10). All these services provided by the platform have a price, of course, a percentage from the amount gathered.

Rewards and motivation

One aspect that must be taken into consideration is the compensation, acknowledgement or reward for the crowdfunder.

Crowd donations

When it’s about a crowdfunding donation, the donor receives some kind of reward for his support, although a donation means to give something without waiting for something in return; is an altruistic act. These rewards can be immaterial acknowledgements (a thank you e-mail, the artist’s autograph, the name of the crowdfunder mentioned on the cover) or an invitation to the artist’s workshop, opening or a small gift of low value.

In some of the cases, because the crowdfunder is promised to receive something in return for his donation, this act looks like sponsoring.

Crowd sponsoring

In this case, the person who initiates the project and the crowdfunder agree on a defined reward which the initiator is obligated to give. Often these rewards take the form of services like PR or marketing for the sponsor.

Crowd pre-selling

Often the crowdfunders make donation to help produce something (a book, a film, a music album, a theatre performance, software, some new technical product, an agricultural product, a service concept etc.) just to receive in return the early version of the product or service he

made the donation for. This means that, in this case, crowdfunding is an order in advance and a purchasing, a pre-selling.

Crowd lending

The rewards for the lenders in this case, are the payback and the interest at the end of the lending period of time.

Another type of reward can be a share revenue, but this comes with a risk. The creditor does not receive interest, but he receives an agreed share of earnings. The risk here is that, in case of bad performance, the lender receives nothing.

Crowd equity

This type of crowdsourcing is the most complicated one because the crowdfunders invest equity; the rewards can be shares of the venture or dividends and/or voting rights.

The bakers give money to fund a project, but often without a detailed evaluation of it. Most of the times they are not interested in material rewards, but in intrinsic ones like personal identification with the topic, contribution to an important project, pleasure of taking part at the project, satisfaction if the project is successful, meeting new people, interacting and working with a team that has similar priorities.

Crowdfunding Platforms

CF platforms are the intermediaries that act as facilitators for crowdfunding. At present lots of new platforms are being founded on all continents, each one attempting to offer novel features and business models. A great deal of experimentation is taking place, this includes testing new service features both for the initiators of capital-seeking ventures and for the potential crowdfunders (e.g. consulting, project evaluation or due diligence, building communities, public relations and advertising, project management, interim management etc.), new models to guarantee the platforms' own funding (e.g. new commission or honorarium schemes), setting up and managing co-investment funds, searching for other (qualified) investors and brokerage of capital etc. (Hemer, 2010)

A typology by form of investment

Lambert and Schwienbacher (2010) in their study distinguish different forms of investment: donation, active investment, and passive investment. Pure donation constitutes 22% of crowdfunding; the rest represents investments (i.e., the crowdfunder expects to receive a return or reward), ventilated between active investment and passive investment. Both count respectively for 32% and 60%.

Schwienbacher and Larralde (2010) also follow the structure of Lambert and Schwienbacher (2010):

Donations

Several crowdfunding initiatives seek to attract donations rather than offer financial rewards or any other form of recognition to investors. The argument for this is that it may facilitate fundraising in contexts where companies are structured as a not-for-profit organization. This is due to the fact that such organizations are more inclined to produce high quality products than for-profit organizations, since profit maximization objectives are at times better achieved with standardized, lower quality products that can be more widely distributed. This may however go against the objectives of donors. One could also argue that a profit organization is more inclined to produce high quality products since that’s the main prerequisite, to make profit, and that is their main goal, in contrast to non-profit organizations.

The fact that many crowdfunding initiatives seek to attract donations rather than offer financial rewards or any other form of recognition to investors, is consistent with empirical findings presented by Lambert and Schwienbacher (2010), who finds that 22% of their sample of crowdfunding initiatives relies on donations. (Schwienbacher and Larralde, 2010)

Passive investments by the crowd

Most initiatives offer some form of rewards to their investors; these rewards can take various forms. Most of them however do not offer any possibility to investors to become actively involved in the initiative, such as voting for selected characteristics of the final product or provide working time to the company. Entrepreneurs seeking passive investments by the crowd therefore are solely interested in raising money but not using the crowd as active consumers or giving up some control. (Schwienbacher and Larralde, 2010)

Active investments by the crowd

Other entrepreneurs offer investors to become active in the initiative, next to offering rewards to them. This may provide valuable feedback to the entrepreneur on potential market demand and product characteristics that the market may prefer most. (Schwienbacher and Larralde, 2010)

A typology by form of rewards

Bradford (2012) categorizes crowdfunding into five types, distinguished by what investors are promised in return for their contributions: (1) the donation model; (2) the reward model; (3) the pre-purchase model; (4) the lending model; and (5) the equity model.

Some crowdfunding sites encompass more than one model; it is especially common to see the reward and pre-purchase models on a single web site. Other sites rely on only a single model. (Bradford, 2012)

1. Donation Sites

The contributions on donation sites are, as the name would indicate, donations. Investors receive nothing in return for their contributions—not even the eventual return of the amounts they contributed. However, although the contributor’s motive is charitable, the recipient’s motive need not be. Donations may fund for-profit enterprises. Pure donation sites are rare, and those that exist focus on requests by charities and other non-profit institutions, rather than requests by businesses. Some of the reward and pre-purchase sites also allow

unrewarded requests for donations; studies (Belleflamme et al., 2012, Lambert and Schwienbacher, 2010) found that only 22% of all crowdfunding initiatives (of all types of crowdfunding) were requests for donations, with no rewards offered. (Bradford, 2012)
Two examples of donation sites are: GlobalGiving.org which enables donors to directly contribute to development projects worldwide (http://www.globalgiving.org/) and EpicStep.com (http://epicstep.com/) which is a donation platform for financing billboards.

2. Reward and Pre-Purchase Sites

The reward and pre-purchase crowdfunding models are similar to each other, and often appear together on the same sites. The reward model offers something to the investor in return for the contribution, but does not offer interest or a part of the earnings of the business. The reward could be small, such as a key chain, or it could be something with a little more cachet, such as the investor's name on the credits of a movie. The pre-purchase model, the most common type of crowdfunding, is similar. As with the reward model, contributors do not receive a financial return such as interest, dividends, or part of the earnings of the business. Instead, they receive the product that the entrepreneur is making. For example, if the entrepreneur is producing a music album, contributors would receive the album or the right to buy the album at a reduced price upon completion. (Bradford, 2012)
Kickstarter and IndieGoGo are the leading reward/pre-purchase crowdfunding sites. Kickstarter requires its projects to offer what it calls "rewards," typically of the pre-purchase variety. IndieGoGo, unlike Kickstarter, does not require campaigns to offer what it calls "perks," although it does recommend them. Both Kickstarter and IndieGoGo take a cut of the money collected. Kickstarter uses an "all-or-nothing" funding model and does not allow projects to be funded unless they reach their stated funding goal. If a project reaches its funding goal, Kickstarter collects a 5% fee; if not, Kickstarter does not charge a fee. IndieGoGo allows project creators to draw on pledged funds immediately, whether or not the funding goal is reached, but the fee depends on whether the funding goal is met. IndieGoGo charges a 4% fee if the funding goal is reached and a 9% fee if it is not.

3. Lending Sites (Peer-to-Peer Lending)

The lending model of crowdfunding is often called peer-to-peer lending. Peer-to-peer lending involves loans. Contributors provide funds on a temporary basis, expecting repayment. In some cases, investors are promised interest on the funds they loan. In other cases, they are only entitled to receive the return of their principal.

a. Sites Not Offering Interest

Perhaps the most prominent example of a crowdfunding portal site that does not offer interest is Kiva (http://www.kiva.org/). Kiva provides funds to microfinance lenders, or field partners in 66 different countries worldwide. Entrepreneurs post loan-requests on the Kiva site. Lenders only receive their principal back; the field partners use any interest received to cover their operating costs (Bradford 2012).

b. Sites Offering Interest

Two U.S. based examples of such sites are Prosper and Lending Club. These are also known as peer-to-peer platforms. Lenders purchase notes issued by the sites which use those funds to lend through WebBank or Paypal to borrowers. In this respect, they function more as investors (persons who commit money or capital in order to gain a financial return[9]) than lenders (persons who provide money temporarily on condition that the amount borrowed to be returned, usually with an interest fee[10]). Lenders get paid if borrowers pay back, and the investors gain if they invest their money well. Transaction fees and interest on loans depend on the borrowers' credit risk. Loans that charge interest typically are viewed as securities and, therefore, for regulatory purposes fall within the domain of securities regulation (Bradford 2012).

4. Equity Sites

Equity crowdfunding offers investors a share of the profits or return of the business they are helping to fund. The equity model is the model that most clearly involves the sale of a security. Because of the regulatory issues it raises, the equity crowdfunding model is not common in the United States (Bradford, 2012). These exist mostly in Europe and to some extent in Australia. Equity crowdfunding sites offer investors a share of the profits of the business they are funding. Indeed, at present, these sites exist mostly outside North America. A prominent German site that has been successful with the revenue sharing model is SellABand.com (https://www.sellaband.com/). This site gathers funding through donations as well as investments to fund independent musicians seeking to complete albums. (Devashis, 2012)

[9] http://www.thefreedictionary.com/investor
[10] http://www.thefreedictionary.com/lender

This typology by form of rewards is related to the previous one, the typology by form of investment, taking into consideration what the funder does with his money (meaning donation or investment) and if he wants something in return (e.g. a reward) or not.

Bradford's paper is dated 2012, but on 23rd of September 2013, in the United States, a new law and regulation went into effect, Title II of the JOBS Act. Further, we will see what JOBS Act is and how it relates to crowdfunding.

Crowdfunding and the JOBS Act

On April 5, 2012, the Jumpstart Our Business Startups (JOBS) Act was signed into law by President Barack Obama. The Act requires the Securities and Exchange Commission (SEC) to write rules and issue studies on capital formation, disclosure and registration requirements.[11] The JOBS Act aims to increase access to capital by liberalizing the rules around crowdfunding, providing relief to young companies from certain regulations, and expanding the pool of investors by changing the rules around general solicitation.[12] Also, one of the things that Congress wanted by signing this act, was to allow startups to be able to engage public channels, and public advertising to be able to solicit investment.

In this Act, we are interested on Title II Access to capital for job creators and Title III Crowdfunding. After more than one year since the Act was sign into law, only Title II went into effect. It is estimated that Title III will be implemented by SEC in 2014.[13]

Title II

Companies who file Form D[14] with the SEC can generally solicit to the public. Within 15 days from soliciting they must disclose additional information about the solicitation. Only accredited investors can actually invest in fundraising rounds where companies generally solicit, and companies are required to perform strict verifications that all investors are accredited, or face being banned from fundraising for 1 year.

For Startups & Small Businesses:[15]

1. They can now generally solicit and advertise publicly
2. Only accredited investors can actually invest in generally solicited companies

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[11] http://www.sec.gov/spotlight/jobs-act.shtml
[12] http://lexicon.ft.com/Term?term=JOBS-act
[13] www.forbes.com
[14] Notice of Exempt Offering of Securities
[15] www.forbes.com

3. File Form D with the SEC before beginning soliciting
4. Disclose details about the general solicitation to the SEC within 15 days from first solicitation
5. Strict verifications done by companies are required to confirm that each investor is accredited
6. The penalty for not adequately meeting and following general solicitation requirements with the SEC is being banned from fundraising for a full year

For Investors:[16]

1. Only accredited investors can invest in companies who generally solicit
2. Qualifying as accredited means having $1 million in net worth, or making over $200,000 a year for the past 3 years
3. Investors will need to prove accredited investors status, which can be done through written confirmation by a CPA, attorney, investment advisor, or Broker-Dealer, or income-related IRS forms

Title III

According to current regulations, businesses may not raise money with non-accredited investors. Title III will create rules and a path for non-accredited investors to begin investing in companies, but the SEC has yet to finalize any rulings.

Although lending and donation-based crowdfunding websites have experienced tremendous success in raising capital for small enterprises, Title III goes a step further in allowing investors to purchase an equity stake in the start-up itself.

Title III additionally compels the issuer to disclose information about the securities being offered. Before any crowdfunding offering, the issuer must disclose either the public price of the security or the means of determining that price. Required information includes the number of classes of the security and their respective rights, as well as how the security's terms may be modified. The issuer must further disclose the identities of current shareholders who control greater than twenty percent of any class of the issuer's outstanding securities as well as a description of how the exercise of the controlling shareholders' rights could negatively impact the purchasers of the securities to be offered. (James, 2013)

[16] www.forbes.com

Even if Title III could provide start-ups with a much-needed capital injection through crowdfunding offerings, potential crowdfunding investors may face serious hazards. Purchasing a start-up's securities may expose small unsophisticated investors to unknown financial risks and higher incidents of issuer fraud. (James, 2013) The reality is that until SEC completes making the rules in this respect, the effects of crowdfunding are uncertain.

Europe has started crowdfunding for equity under the local laws and exceptions of several countries, but scaling it outside each country's borders is not happening yet. Equity crowdfunding is operational in the UK, France, Sweden and the Netherlands. Seedmatch in Germany can only raise 100,000 Euro but has managed to combine its efforts with angel networks to add debt to its platform with the result that it can now raise 250,000 Euro per start-up.[17]

"Europe needs its own JOBS Act, to encourage the return of small businesses to equity markets to raise the money for expansion", says Fabrice Demarigny, the chairman of the NYSE Euronext's [18] strategic planning committee, in an interview for the Financial Times.

[17] http://www.equities.com/editors-desk/crowdfunding/jobs-act/1000-days-for-a-eu-jobs-act

[18] A leading global operator of financial markets and provider of innovative trading technologies, NYSE Euronext (NYX) is the holding company and the first cross-border exchange group created by the combination of NYSE Group, Inc. and Euronext N.V. The Company's exchanges, located in Europe and the United States, trade equities, futures, options, fixed-income, and exchange-traded products.

Conclusion

The crowdfunding scene is currently characterized by high dynamics. More and more projects from various domains try to get funding through crowdfunding. The number of crowdfunding platforms has grown rapidly.

These platforms, which act as intermediaries between entrepreneurs and funders, are experimenting new business models, and the users have from where to choose. As we could see in this chapter, there were presented two typologies of crowdfunding platforms: one by form of investment and one by form of reward. The typology by form of investment refers to: funders that only want to give an amount money for a project that he/she likes without waiting for something in return (donations), funders that fund a certain project for a small reward but without participation in the project (passive investment), and funders that give money for a project and receives for this a return or a reward, but he/she also participates in the project (active investment). The typology by form of reward includes five types of crowdfunding, distinguished by what investors are promised in return for their contributions: the donation model; the reward model; the pre-purchase model; the lending model; and the equity model. In conclusion, as we can see above, there are platforms for any type of entrepreneurs, for any type of investors, depending on what they wish to do or to obtain.

The projects funded via crowdfunding will show what works and what does not, and the market performance of the crowdfunding platforms will sort out the feasible business models (Hemer, 2011). There is the possibility for the projects seeking funding through crowdfunding platforms to "meet" failure, but this is for the crowd to decide whether to fund or not. The success of some projects also helps us make an image on what the crowd wants to see, to fund and to have.

Crowdfunding is not a panacea for small businesses' financing issues. It will not completely eliminate the capital gap. It will, however, open investment to new sources of capital and provide a platform that allows investors with unused capital to connect with entrepreneurs who need it. (Bradford, 2012)

Perhaps the most striking feature of crowdfunding is the broad geographic dispersion of investors and this contrasts the idea that entrepreneurs and investors should be co-located because of the distance-sensitive costs, says Agrawal et al. (2011).

CHAPTER 4 TRADITIONAL FUNDING

Introduction

First, this chapter will provide a description of the traditional ways of funding, which is the answer of the sub question "*What are the traditional ways of funding?"* Further, an analysis will be made in order to answer sub question "what are the advantages and disadvantages of the traditional ways of funding?" Also, the analysis will help in answering the general research question.

Denis (2004) says that one of the most important issues facing entrepreneurial firms is their ability to access capital. Because such firms are typically not yet profitable and lack tangible assets, debt financing is usually not an option.

Debt financing is the act of a business raising operating capital or other capital by borrowing. Most often, this refers to the issuance of a bond, debenture, or other debt security. In exchange for lending the money, bond holders and others become creditors of the business and are entitled to the payment of interest and to have their loan redeemed at the end of a given period. Debt financing can be long-term or short-term. Long-term debt financing usually involves a business' need to buy the basic necessities for its business, such as facilities and major assets, while short-term debt financing includes debt securities with shorter redemption periods and is used to provide day-to-day necessities such as inventory and/or payroll.[19]

Terry et al. (2004) argues that a characteristic of many start-up companies is the absolute need to secure enough capital to achieve success. This is an ongoing challenge, so even though a company may have received some initial financing early in its development, risk of failure exists until the time the company is self-sustaining through the internal generation of cash flow.

The earliest stage of financing is normally referred to as the "seed" stage. The seed stage is characterized by a relatively small investment (typically below $250,000) that is made to explore the feasibility of a new idea or service. Seed capital is synonymous with "friends and family" financing, alluding to the traditional source of seed funding. A company in the seed stage may or may not have a formal business plan, and a complete management team is usually non-existent. (Terry et al., 2004)

[19]http://www.businessdictionary.com/definition/debt-financing.html

The next stage of financing is more formal, and is often referred to as first stage, or, in accounting terms, the development stage. This stage is populated by companies that have proven the concept of their technology or service, and are poised to develop a management team and formal marketing and production efforts. Since the first stage is somewhat transitional, the source of funds can come from either angel investors or from venture capitalists, and is usually dependent on the amount of capital needed, with angel financing normally ranging from $500,000 to $1.5million. Larger investments usually fall to the venture capitalists with much more capital at their disposal, but there are many instances in which a venture capitalist will fund a much smaller need if the upside potential is high. (Terry et al., 2004)

Denis (2004) says that the existence of multiple sources of financing raises the question of whether the source of funding matters for the entrepreneurial firm. This question is analogous to similar questions addressed in the corporate finance literature. For example, a large literature is devoted to studying the importance of the source of debt financing. This literature generally concludes that banks are "special" in that they provide services such as monitoring that are not provided by other debt claimants, while non-bank private debt serves an important role in accommodating the financing needs of firms with low credit quality. Consequently, entrepreneurs tend to rely on three primary sources of outside equity financing: venture capital funds, angel investors, and corporate investors.

Sources of funding

Family and Friends

Members of the family or friends or friends-of-friends are one of the first options when starting searching for capital. A large amount from the start-up capital for the small businesses is provided by family and friends or business owners themselves.

Bank loans

Borrowings from banks are an important source of finance to companies. Bank lending is still mainly short term, although medium-term lending is quite common these days.

There are two basic types of loans: business loans and consumer loans. Many small businesses are funded through personal loans or other loans based on personal assets.

When a company applies for traditional financing from a bank, the requirements are often more rigorous than other loans. Eligibility for a traditional loan is generally determined by the projected income of the business over the life of the loan. (Mason and Stark, 2004)

But not to forget to mention that, for an established business with a good track record of earnings — and good credit –a traditional loan is generally easy to acquire.

In addition, while businesses can generally get larger amounts from traditional banks, the funds from traditional banks generally come with more restrictions and covenants. Common loan restrictions: maintenance of accurate records and financial statements; limits on total debt; restrictions on dividends or other payments to owners and/or investors; restrictions on additional capital expenditures; restrictions on sale of fixed assets; performance standards on financial ratios; current tax and insurance payments.[20]

Companies that banks consider higher risk will have more restrictive covenants. Companies that banks consider to be lower risk will have fewer restrictive covenants. Risk is determined on a number of factors by the bank including: credit worthiness, financial statements, cash flow, collateral business insurance, and the business plan. Other factors may also be used to determined restrictive covenants, but depends on the bank and the situation, the case.

[20] http://www.njsbdc.com/blog/sources-and-types-of-financing/

Angel investors

"A wealthy individual who invests in a start-up company his or her own money. Also known as business angel, the individual provides equity or quasi equity funding [21] to growth oriented private companies with the aim of achieving a financial return through capital gain at exit. As well as money, they also provide value-added services."[22]

The term "angel investor" comes from Broadway, during the end of the 19th century where the rich investors secured means to the directors to finance production of new musicals and plays. Besides financial benefits their motivations rested also in their love for the theatre and the opportunity to meet and socialize with famous actors, screenplay writers and producers. These investors secured high-risk capital and were motivated by something larger than money. Even today, screenplay writers, actors, producers and musicians often depend on the altruism of others to promote their projects and careers. (Ramadani, 2012)

Angel investors refer to individuals that invest their capital in small start-ups, entrepreneurial companies, and they are looking for a higher rate of return than would receive from traditional investments. But the typical business angels are often former entrepreneurs or executives who cashed out and retired early from ventures that they started and grew into successful businesses.

The angel investors, most of the times, they invest their capital at an early stage of development of a company and the amounts are not so big.

These kinds of investors share many common characteristics. They are searching for businesses with high growth potentials, strong management teams, and good business plans to aid the angels in assessing the business's value. They typically invest in ventures involved in industries or technologies with which they are personally familiar. Most of the times they co-invest with trusted friends and business associates. In these cases, there is usually one influential lead investor whose judgment is trusted by the rest of the group of angels. The angel investors who have business experience, in many situations they invest more than their money, they want to be involved actively in the company, to share their

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[21] Quasi-equity financing (also known as mezzanine financing or subordinated debt) is another form of financing frequently used by SMEs. It typically involves a mix of debt and equity financing, which allows investors to achieve gains through capital appreciation and interests on debt-repayment. Quasi-equity financing is often more attractive to companies with more limited growth potential and/or companies that prefer not to relinquish full or partial control of the business by selling shares.

[22] http://lexicon.ft.com/Term?term=angel-investor

knowledge, to take part in the "action". They often take bigger risks or accept lower rewards when they are attracted to the non-financial characteristics of an entrepreneur's proposal.

Venture capital

"Private equity or institutional funding for start-up companies considered to have strong growth prospects. There can be several phases of investment, through to the stage when the company is able to go public. Venture capital firms may also provide management assistance and other services. This is equity or quasi equity funding provided by professional investors to young, high growth oriented companies, typically to finance their early market development and growth. As well as funding, investors usually provide value added services. Funding is often provided in stages, providing sufficient cash to reach the next milestone".[23]

Venture capital represents financial capital invested in starting up a new business having in return equity in the company invested in. This type of financing is used because the new company, from reasons of size, stage of development and assets, cannot search for capital from other traditional sources.

Venture capital differs from other traditional financing sources in that venture capital typically: focuses on young, high-growth companies; invests equity capital, rather than debt; takes higher risks in exchange for potential higher returns; has a longer investment horizon than traditional financing; actively monitors portfolio companies via board participation, strategic marketing, governance, and capital structure.

This capital providing to young companies has a potential for rapid growth, but is a long term investment that gives the new business the time to grow into a profitable organization. With all these, it has a high degree of risk. A long-term and successful growth for most businesses is dependent upon the availability of equity capital. Lenders generally require some equity cushion or security (collateral) before they will lend to a small business. That is why if a lack of equity happens, this will limit the debt financing available to businesses. Besides, debt financing requires the ability to service the debt through current interest payments. These funds are then not available to grow the business.

Equity capital represents the invested money that, in contrast to debt capital, is not repaid to the investors in the normal course of business. It represents the risk capital staked by the owners through purchase of a company's common stock (ordinary shares). The value of equity capital is computed by estimating the current market value of everything owned by the

[23] http://lexicon.ft.com/Term?term=venture-capital

company from which the total of all liabilities is subtracted. On the balance sheet of the company, equity capital is listed as stockholders' equity or owners' equity. It is also called equity financing or share capital.[24]

Venture capital is an active form of financing. The lenders, in addition to capital, seek to add value to the businesses in which they invest trying to make them grow and having a greater return on the investment. In order for these to happen, is needed an active involvement; most of the investors want a seat on the board of directors.

Even if the investors are committed to a new business for the long run, it does not mean it is for an unlimited period of time. One of the most important objectives is to achieve a great return on investment eliminating, in time, the investments. A good investor will be considering potential exit strategies from the time the investment is first presented and investigated.

Corporations

Corporations invest on behalf of their shareholders, for financial and/or strategic reasons.
A corporate venture capital investment is defined by two characteristics: its objective and the degree to which the operations of the investing company and the start-up are linked. Although companies typically have a range of objectives for their venture capital investment, this type of funding usually advances one of two fundamental goals. Some investments are strategic; they are made primarily to increase the sales and profits of the corporation's business. A company making a strategic investment seeks to identify and exploit synergies between itself and a new venture. The other investment objective is financial, wherein a company is mainly looking for attractive returns. Here, a corporation seeks to do as well or as better than private venture capital investors. In addition, a company's brand may signal the quality of the start-up to the other investors and potential customers, ultimately returning rewards to the original investor. (Chesbrough, 2002)

Corporations invest in entrepreneurial firms in a variety of ways, including direct investments via corporate venture funds, indirect investments via independent venture funds, and acquisitions of or strategic alliances with start-up companies (Denis, 2004). Although the number of corporate venture capital programs has at times been quite large, these programs account for less than 5% of the funding of entrepreneurial companies (Hellman, 1997). Previous studies have identified two broad reasons for the relative paucity of financing from corporate venture capital programs: structural problems with the programs themselves and

[24] http://www.businessdictionary.com/definition/equity-capital.html

possible conflicts of interest between the corporate investors and the entrepreneurial company (Denis, 2004).

Public or private grants

Grants are a good way to go if both the individual and his business meet the qualifications of the grant, which can be quite strict.

A great characteristic of grants is that the individual does not have to pay them back, nor does he have to share a piece of his company with someone else.

A not so great thing about grants is that they can be tough to find and typically have a long and involved application process. Some of them also have restrictions around what the money can be used to purchase and requires the individual to match the amount of the grant with personal money or other funding. Also, there are a limited number of grants available, so even if the individual qualifies and turn in a fabulous plan, he could still be denied.

In Europe, the European Commission makes direct financial contributions in the form of grants in support of projects or organisations which further the interests of the EU or contribute to the implementation of an EU programme or policy.[25]

The ISIF Asia Program, which provides small grants and awards, was developed to help advance local and regional projects aimed introducing, improving, and applying Internet technology for the benefit of Asia-Pacific users and communities. The grants are not repayable, as no money or interest must be paid back. Grants allocation is decided through a competitive process following a rigorous selection process.[26]

In the United States of America, Grants.gov is the place to find and apply for federal grants. The United States Department of Health and Human Services is the managing partner for Grants.gov, an initiative that is having an unparalleled impact on the grant community. The United States Government does not require payment, of any kind, to receive federal grants.[27]

[25] http://ec.europa.eu/contracts_grants/index_en.htm
[26] http://isif.asia/grant
[27] http://www.grants.gov/web/grants/home.html

Analysis of the traditional ways of funding

Further, I am going to make an analysis of the traditional ways of funding mentioned above. This analysis contains characteristics and criteria in the investment decision process, advantages and disadvantages, issues and risks that must be taken into consideration.

When applying for a business loan in general, the banks ask for the track record, the financial records, but in case of a new business there is none. In this case, a good business plan could help the entrepreneurs receive a bank loan, but this is not for sure also. Two considerations are key ones in evaluating a firm's riskiness: the company's ability to generate sufficient cash flow to service the bank loan and the presence of collateral security to ensure that the bank can recover its funds from the liquidation of the business and/or personal assets if the business fails (Mason and Stark, 2004).

When Bankers have to decide whether or not to give a loan to a new business, there are some risks to take into consideration. One is that they could and give a loan for a business which subsequently fails. The second is that they do not give a loan for a business that has potential to become successful or goes on and with other source of funds and becomes a successful one. (Mason and Stark, 2004)

Another type of risk that the banks must take into consideration, after giving the loan, is the inefficient or poor monitoring of the entrepreneurs and how they use the money. The bank must verify if the entrepreneurs use the money for the project that they applied for and not in other projects (especially riskier ones); also not to reduce their efforts and work on the project, fact that would lead to a failure. (Mason and Stark, 2004)

Regarding the venture capital and the angel investors there are also some issues when evaluating the opportunity. But in these cases, the evaluation methods are different from the ones that the banks use. The venture capital fund managers and the angels investors are investing for capital gain and, in contrast to the bankers, they share in the success of the businesses that they invest in (Mason and Stark, 2004). Opposite to the banks, their investment is also fully exposed in the event that the business fails. Another risk is that their investment will be illiquid if the business does not achieve significant growth. Accordingly, venture capital fund managers and the angel investors might be expected to place greatest emphasis on the capability of the management team, the product/service and the market (Mason and Stark, 2004).

One of the most important criteria, that the venture capital fund managers take into consideration when they have to decide on investing or not, is the ability of management like management skill, quality of management, characteristics of the management team and the management team's track record. Other criteria that they take into consideration when assessing a new venture proposal are the characteristics of the market/industry, environmental threats to the business, the level of competition and the degree of product differentiation (Mason and Stark, 2004). And not to forget that the product and its characteristics are also an important factor in deciding whether or not to invest in the new business.

When deciding to invest or not, the angel investors are more concerned with the risk caused relation with the entrepreneurs. The contracts between them are kind of simple, not like the ones the venture capital fund managers make, with many provisions, in order to protect themselves. Most of the angel investors do not make an evaluation of the market risk, or because they do not have the necessary data or they rely on the entrepreneur to do this, but they, or most of them, do have prior experience in the domain. The angel investors are in search for business where they can fit in the management team, where they can have an important role and actively participate in the process.

A corporate venture capital (CVC) investment is defined by two characteristics: its objective and the degree to which the operations of the investing company and the start-up are linked. Although companies typically have a range of objectives for their CVC investments, this type of funding usually advances one of the two fundamental goals. Some investments are strategic. They are made primarily to increase the sales and profits of the corporation's own businesses. A company making a strategic investment seeks to identify and exploit synergies between itself and a new venture. The other investment objective is financial, wherein a company is mainly looking for attractive returns. Here, a corporation seeks to do as well as or better than private venture capital investors, due to what it sees as its superior knowledge of market and technologies, its strong balance sheet, and its ability to be a patient investor. In addition, a company's brand may signal the quality of the start-up to other investors and potential customers, ultimately reaping rewards for the original investor.

Yates et al. (1991) say that many firms have discovered the value of corporate venture capital (CVC) as an integral or supplemental part of their strategic new business development program, making equity investments for less than 100 percentage ownership of

new or young firms. The complex processes that CVC entails and the sophistication required to execute them effectively has caused many corporations to eliminate CVC programs. In addition, many corporations lack the patience to give CVC programs the long time necessary to grow to a point where they develop significant new businesses.

In summary, corporate venture capital appears to be a legitimate and importance source of funding for start-up ventures. Indeed, corporate venture capital has provided significant endorsement and resource benefits that the start-up could never get on its own. However, despite these nice benefits, corporate venture capital has had a checkered history due to its multiple often incompatible objectives, limited commitment and tenuous relationships. So far these conclusions have emerged primarily from high technology industries such as telecommunications and computing. (Henderson, 2007)

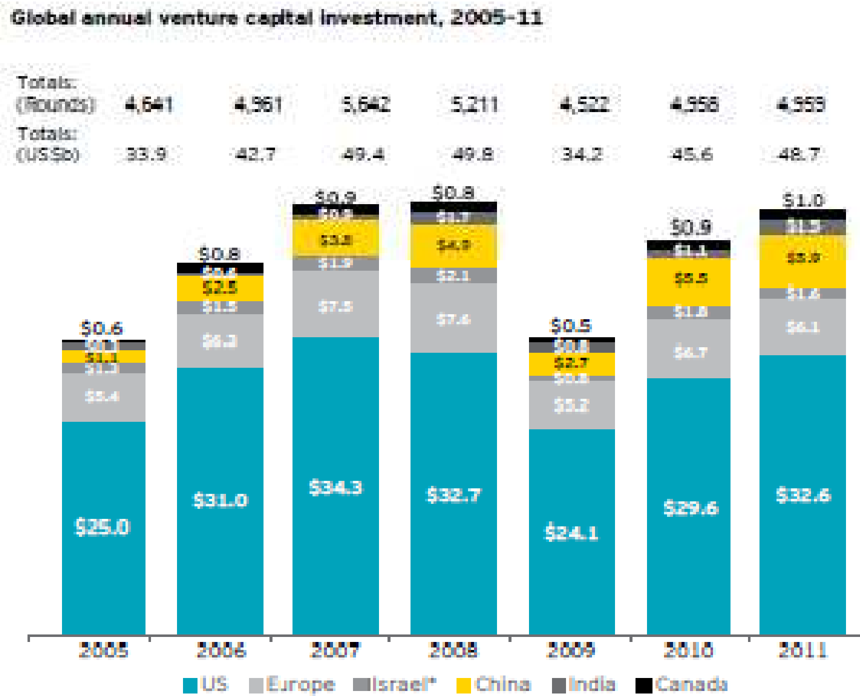
Table 4.1 Characteristics of the different providers of venture capital

	Angel Investors	*Venture Capital*	*Corporate Venture Capital*
Typical background	Ex-entrepreneur	Ex-entrepreneur or financial	Large, tech-savvy multinational
Motivation	Financial and “giving back”	Financial	Strategic and financial
Fund source	Self	Limited partners	Corporate
Investment method	Direct	Direct	Direct and indirect
General partner compensation	Gain from exit or early buyout	Percentage of valuation increase	Salary plus bonus
Average invested per venture	$ 500.000 to $ 1,5 million[28]	See table 4.2	See table 4.4

Source: http://www.qfinance.com/financing-best-practice/assessing-venture-capital-funding-for-small-and-medium-sized-enterprises?page=1

[28] Terry et al. (2004)

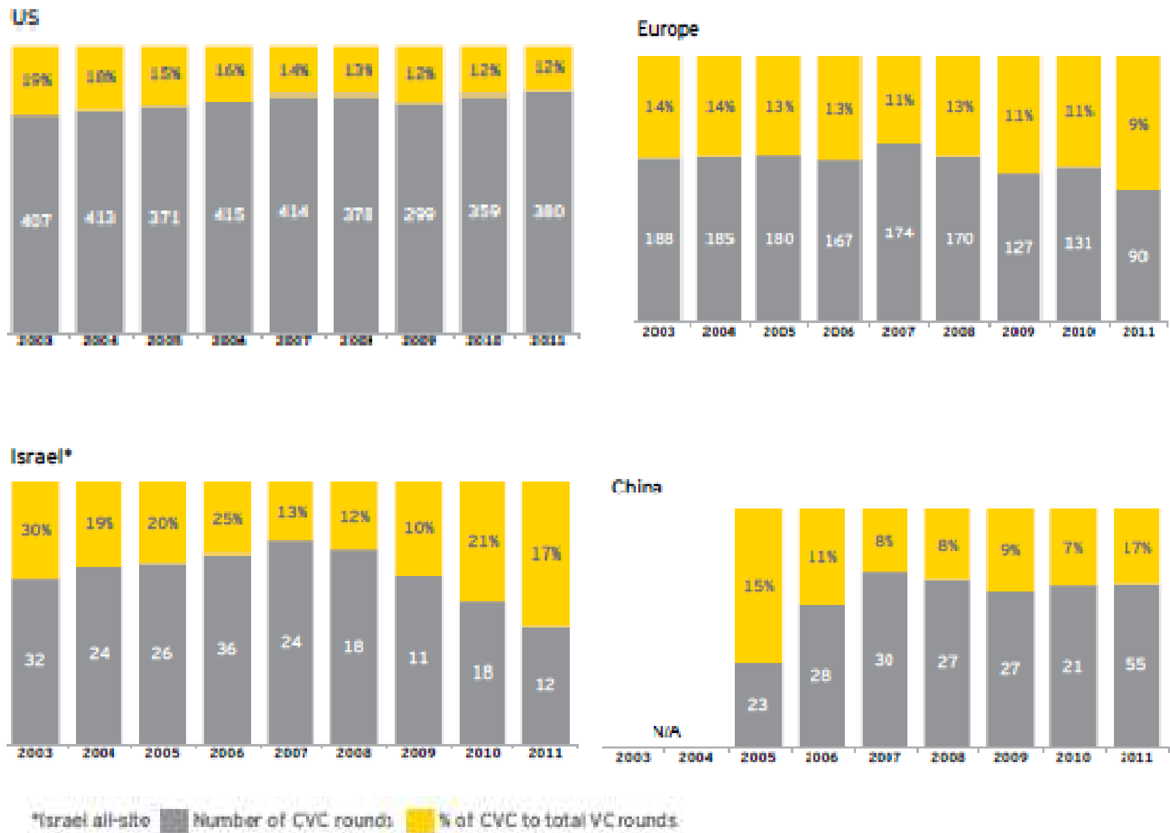
Table 4.2: Global annual VC investment, 2005-2011



Source:http://www.ey.com/Publication/vwLUAssets/Globalizing_venture_capital_VC_insights_and_trends_report_CY0227/$FILE/Globalizing%20venture%20capital_VC%20insights%20and%20trends%20report_CY0227.pdf

As we can see in table 4.2, the US maintains a strong lead, with about 70% of global investment in any given year, driven by Silicon Valley, Massachusetts, Southern California and New York City. Canada, Europe and Israel are stagnating or contracting, while India shows modest growth patterns and China is close to surpassing Europe as the No. 2 venture hub globally — although most of the investments in Asia will go into revenue-generating and profitable companies. (Ernst & Young)

Table 4.3: Corporate participation in financing rounds, 2003-2011 (number of rounds and percentage of all VC rounds)

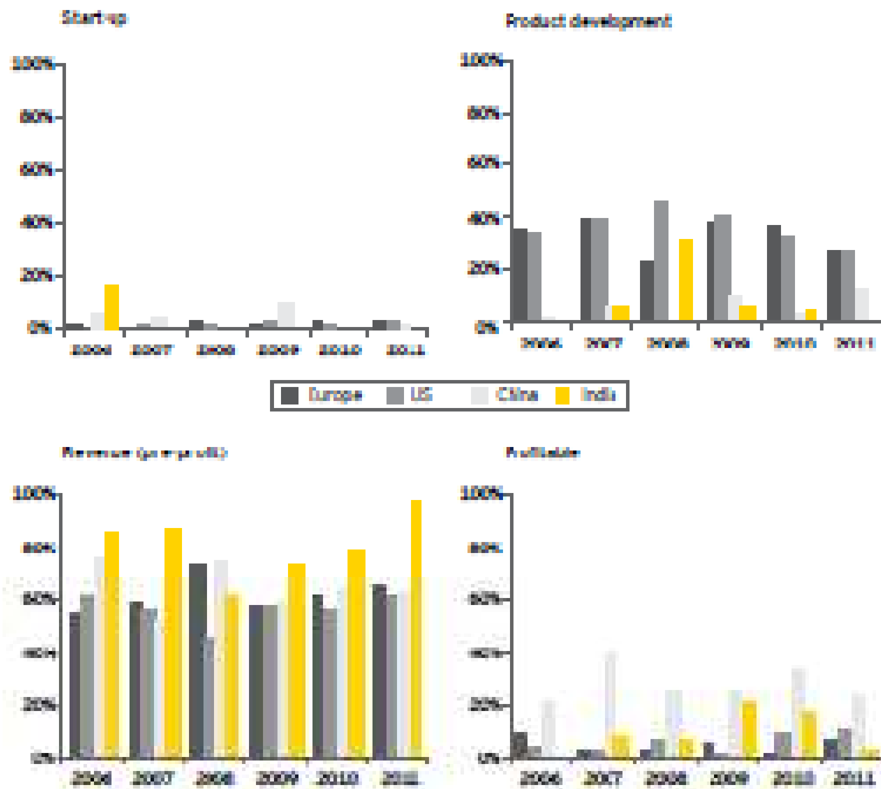


Source: Dow Jones VentureSource, 2012

Source:http://www.ey.com/Publication/vwLUAssets/Globalizing_venture_capital_VC_insights_and_trends_report_CY0227/$FILE/Globalizing%20venture%20capital_VC%20insights%20and%20trends%20report_CY0227.pdf

In table 4.3 is shown that US has the highest number of corporate participation. But if we take into consideration the percentage of CVC to total VC rounds, India has the highest ones.

Table 4.4: Corporate venture Capital investment amount by stage of company development (as percent of total investment), by region, 2006-2011



Source:http://www.ey.com/Publication/vwLUAssets/Globalizing_venture_capital_VC_insights_and_trends_report_CY0227/$FILE/Globalizing%20venture%20capital_VC%20insights%20and%20trends%20report_CY0227.pdf

As we can see in table 4.4, the revenue stage has gathered the most investments. Also the product development stage has gathered some investments, especially in Europe and US. In China, CVC investors are in investing in the profitable stage, more than Europe, US or India.

Conclusion

As Sahlman (1990) says, venture-capital organizations raise money from individuals and institutions for investment in early-stage businesses that offer high potential but high risk. Venture capitalists are actively involved in the management of the ventures they fund, typically becoming members of the board of directors and retaining important economic rights in addition to their ownership rights.

The angel investors, most of the times, invest their capital at an early stage of development of a company and the amounts are not so very big. But one important factor in their decision to invest is if they can fit in the management team, where they can have an important role and actively participate in the process.

Corporate venture capital programs raise money not only from the corporations' internally generated cash but also from outsiders and invest it in entrepreneurial start-ups at all stages of development.

As said before, members of the family or friends or friends-of-friends are one of the first options when starting searching for capital. A large amount from the start-up capital for the small businesses is provided by family and friends or business owners themselves. The conclusion is that the family and friends are financial helpful in the first stage of a business development.

The banks can give loans to a new business in any stage of development, but for an entrepreneur with a business in an early stage of development is more difficult because there are more risks to take into consideration.

Grants can be used for businesses in any stage of development. They have a huge advantage, must not be returned or pay interest for, but also have a big disadvantage, finding one to fit the business.

CHAPTER 5 CROWDFUNDING VS TRADITIONAL FUNDING

This chapter will provide a comparison between crowdfunding and traditional ways of funding, as result of the research made in the previous chapters, fact that will help in answering the main research question: "*Is crowdfunding an alternative to traditional funding?"* The conclusion of this chapter also represents the conclusion of the study.

Analysis/Comparison

In the wake of the 2008 financial crisis and ensuing credit crunch, small business start-ups continue to face mounting challenges in locating scarce capital needed to grow and stay solvent.(James, 2013) Even before the recent financial crisis, banks were reluctant to lend to small, young firms due to their perceived riskiness and lack of collateral. The financial crisis widened the existing gap at the seed and early stage with bank lending to falling start-ups and venture capital firms moving to later investment stages where risks are lower. Frequently, start-ups will not qualify for loans from traditional institutional investors, such as banks, because of the risks associated with emerging growth. These challenges force start-ups to solicit relatives and friends for funding, which is usually insufficient to support the majority of emerging businesses. In the absence of traditional seed money, small start-ups have recently seized upon donation-based crowdfunding as a low-cost means of locating potential investors and raising capital. (James, 2013)

The existence of multiple sources of financing raises questions like "what is the best source of funding?" or "what is the option that fits best the new project or start-up company?"

Many ventures remain unfunded, partially because of a lack of sufficient value that can be pledged to investors, partially because of unsuccessful attempts to find and convince investors. Recently, creative founders have made use of a new source of finance – crowdfunding – by tapping the crowd instead of specialized investors (Lambert et al., 2010).

For an entrepreneur, crowdfunding success depends on getting the word out about the opportunity to many potential investors. Unfortunately, this also has the downside of broadcasting their product or service concept at a very early stage, inviting competition. When designing their communications, the creators will need to walk a fine line divulging enough to get potential investors excited, while not over-communicating and tipping off

potential competitors. The potentially large number of investors will require organized and automated communication processes, so the entrepreneurs will need to remain vigilant in their communication policies. Understanding what kinds of things they can communicate with potential or existing investors can spell the difference between adequate communication and disgruntled investors.

With the potentially large number of investors, if the project/service does not perform as expected, the creators have a greater pool of disgruntled investors who could potentially bring legal action against them. Crowdfunding does not necessarily get hundreds of new “friends". Some investors, particularly ones who have invested larger amounts, may be unhappy with the results.

Also, if a creator sells a product and has a large number of orders, he runs the risk of not meeting demand in a timely manner, hurting the reputation and brand. A successful crowdfunding campaign is only the beginning of producing results for the customers.

One of the biggest benefits of traditional investors is located in their brains, not in their accounts, meaning that the traditional investors come with a lot more than money; they also have an interesting list of industry contacts and experiences. Most investors do not throw money on trendy ideas, they invest in entrepreneurs with businesses they understand and can help push in the right direction. Traditional investors might not be trendy as crowdfunding, but they have the knowledge and experience to help the new comers position their company.

Regarding crowdfunding, one should not forget that the amounts received from each investor are small, generating potentially substantial transaction costs. Also, most of the persons seeking for funds need to bring in expertise, which most crowdfunders do not provide. However, a strong advantage of this form of financing is the attention that the entrepreneur may attract on his/her project or company. This can be the most important advantage, especially for artists, entrepreneurs needing to present his/her talent and product to the people; the members of the crowd are potential customers. In other cases, it is a unique way to validate original ideas in front of a specifically targeted audience. This may in turn provide insights into market potential of the product or service offered.

The big difference between crowdfunding and traditional funding is the amount invested, meaning that (many) crowdfunders give a small amount (there are also cases when there are

pledged big amounts, but most of the times are small) but in a traditional way of funding one investors gives a big amount of money. So, the traditional investor bears a risk when investing a large amount; can be a successful investment or not.

As Ordanini et al. (2011) said, the idea that some people may decide to pay for producing and promoting a product (instead of buying it), and bear the risk associated with that decision, represents a further step in the evolution of consumers' roles, that involves a mix of entrepreneurship and social network participation.

Lambert and Schwienbacher (2010) have found that many of the entrepreneurs do not use crowdfunding as a sole source but as an additional source of funding for the traditional ones.

CONCLUSION

This part is the conclusion of the study and the answer to the main research question: *Is crowdfunding an alternative to traditional funding?*

Crowdfunding has evolved a lot in the past years, it gained a lot of attention from everywhere (the crowd, the media, the governments, the investors) but there are still some issues to be solved. For example, in case of equity crowdfunding, the law and regulations are still under construction.

Also, many entrepreneurs would rather find outside investors than go with a crowdfunding campaign due to the length of time, money, and risk that goes with creating a campaign. However, finding potential investors isn't as easy of a process as one may think.

Also, it is possible for crowdfunding not to be the cheapest source of financing, thus the entrepreneur should balance the advantages and the disadvantages of different alternatives for funding its project.

Anyway, crowdfunding may be considered a larger concept than purely raising funds: it is a way to develop corporate activities through the process of fundraising.

As the Eyenalyze founder, Rasmussen, said in an interview, "Crowdfunding is a new space being utilized, but with the younger generations using technology to connect is a must to consider in raising capital".[29]

Since businesses face a scarcity of capital access, they often, have to resort to "bootstrapping"; that is, rely on personal funds or funds from friends and family members, credit card debt, or second mortgages on their homes. The capital funding gap can have a societal impact. For instance, scarcity of funding could result in promising projects going unfunded costing an economy jobs and loss of potential innovations (Bradford, 2012). Also, often those looking for funding opportunities do not have sufficient information about potential sources of capital. This results in a problem of informational inefficiency that is fostered by the failure to match sources of capital with opportunities. The creation of geographical clusters can often help mitigate such challenges (Bradford, 2012). Crowdfunding platforms,

[29] http://foodbeverage.about.com/od/Crowdfunding/fl/Crowdfunding-has-more-value-vs-Traditional-Funding-for-Entrepreneurs.htm

by enabling virtual clusters on the internet, can potentially provide powerful benefits in this regard.

All the attention from the media and from the people, the commissions that are trying to create regulations in the domain, the growing number of entrepreneurs using the platforms for fulfilling their dreams and of the people backing their dreams, one can only conclude that there is indeed a market for crowdfunding.

In May 2013, Reuters [30] reported crowdfunding had helped companies and individuals worldwide raise $2.7 billion from the public in 2012 – an 81% increase on the previous year.[31]

From the standpoint of the (potential) founders and the self-employed, the inadequate supply of funding is a key (economic) problem and can, particularly for entrepreneurs with limited financial resources, lead to projects being cancelled at an early stage. Also, the lack of expansion and growth financing leads under certain circumstances to the termination of existing projects and companies. From an economic standpoint, and above all regarding the growth, the efforts of the crowdfunding platforms are to be welcomed.

As Bradford (2012) said, crowdfunding will not completely eliminate the capital gap. It will, however, open investment to new sources of capital and provide a platform that allows investors with unused capital to connect with entrepreneurs who need it.

For projects, crowdfunding can be an alternative to traditional ways of funding. For a start-up company who wants to use equity crowdfunding, this is not yet possible, or at least not all over the world, until specific laws and regulations goes into force, traditional ways of funding are still the best solution.

To conclude, these findings suggest that any entrepreneur will need to balance the advantages and disadvantages of different alternatives, since crowdfunding will unlikely be the least costly source of financing, and the easiest one to obtain, for most projects or start-ups.

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[30] Reuters is an international news agency headquartered in Canary Wharf, London, United Kingdom and a division of Thomson Reuters. Until 2008, the Reuters news agency formed part of an independent company, Reuters Group plc, which was also a provider of financial market data. Since the acquisition of Reuters Group by The Thomson Corporation in 2008, the Reuters news agency has been a part of Thomson Reuters, forming part of its financial and risk division.

[31] http://www.theguardian.com/money/2013/may/04/crowdfunding-alternative-traditional-investments

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