Is the Crowd Indifferent to Financials?

Observations on 2015 Crowdfunding Campaigns

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Introduction

CrowdRating (www.crowdrating.co.uk) started rating equity crowdfunding campaigns in April 2015 and between then and the end of the year rated over 250 separate campaigns across four UK based platforms: Crowdcube, InvestDen, Seedrs and Syndicate Room. As a result of preparing the ratings we gathered financial information not only on the amounts wanted and raised, but also the underlying financial projections of the companies at the point they were running the campaign.

This additional layer of information has provided some interesting insights that we want to share with the equity crowdfunding market generally, with the specific purpose of helping entrepreneurs and investors to gain insight.

At the point of writing (February 2016) final numbers for the entire UK crowdfunding market have not been published, but our own analysis suggests that somewhere in the region of £200 million of new equity capital was raised during the 2015 calendar year. The vital capital has enabled hundreds of companies to move forward with their growth plans. Our research also suggests that, overall, more than half of campaigns end with a successful fundraising in place, showing that this market is definitely one that all entrepreneurs who are looking for up to £5m of equity capital should seriously consider.

This report highlights some of the factors that we think entrepreneurs should bear in mind when contemplating undertaking a campaign and that investors should also be aware of before investing.

We have examined areas such as pre-money valuations, turnover and profits growth plans and more. Some of the conclusions are surprising. For example, there are few obvious *financial* reasons why campaigns succeed or fail. Conversely, there are signs that certain aspects of a business (management team, product) have a greater impact on the odds of successfully funding a campaign.

The overall message is that investors will recognise if a campaign has a really strong management team in place and equally if it doesn't have a great product or service. However, they are largely indifferent to valuation or the anticipated financial performance of a company that is fundraising. The message from the crowd of 2015 is that they believe that backing the right team with a great product is the way for a company to win investment.

We look forward to discussing the findings of this report with market participants. If you have any comments on our findings, please email us at enquiries@crowdrating.co.uk.

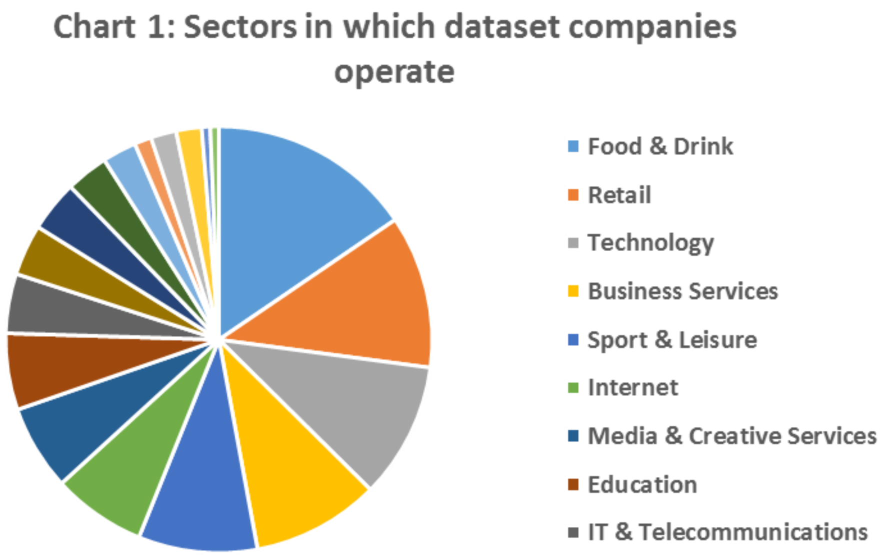
The data set

Our initial data set was all the campaigns we have rated since we started CrowdRating in spring 2015. From these we extracted the 194 that included full financial information. Then, as the final success or failure of the campaign is one of the key metrics used here, we only looked at the campaigns which had completed their funding by December 2015, leaving 155 for our analysis.

CrowdRating's Ratings Engine is based on up to 90 questions typically asked by early-stage angel and VC investors. It scores campaigns consistently whichever platform they are on. It accounts for the stage of the business to ensure that earlier stage companies are not treated on the same basis as more mature ones. The scoring mechanism is based on the questions asked by investors with pre-populated answers, with each answer providing an individual score.

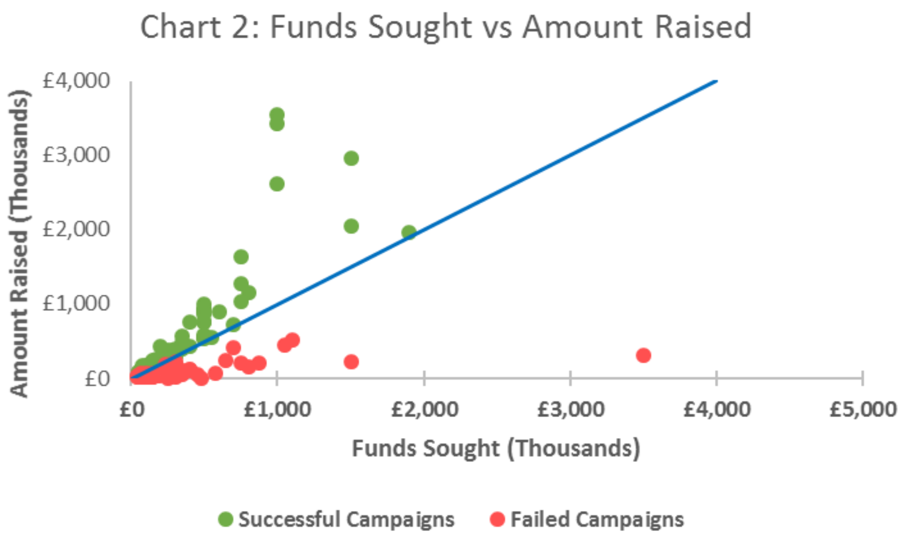
At the date of writing none of the companies in the refined dataset had formally failed (i.e. none of them had filed a notice of administration or liquidation at Companies House), and to our knowledge none of them had returned to the crowdfunding market for another round of funding. As such, we believe it is safe to assume that whether they raised money or not, they have either traded at least satisfactorily or have raised capital from another source which has enabled them to continue trading. That being said we do believe that a small number may be "walking dead" i.e. they have not actually failed but are not noticeably trading anymore.

The companies selected range from start-ups with no revenue to established companies with turnover in the millions. The companies operate in sectors ranging from food & drink to technology and although located mainly in the UK, some were based in continental European countries. There were no obvious biases in the data set, although it is worth mentioning that the largest sector by volume of campaigns was Food & Drink with 24 campaigns.

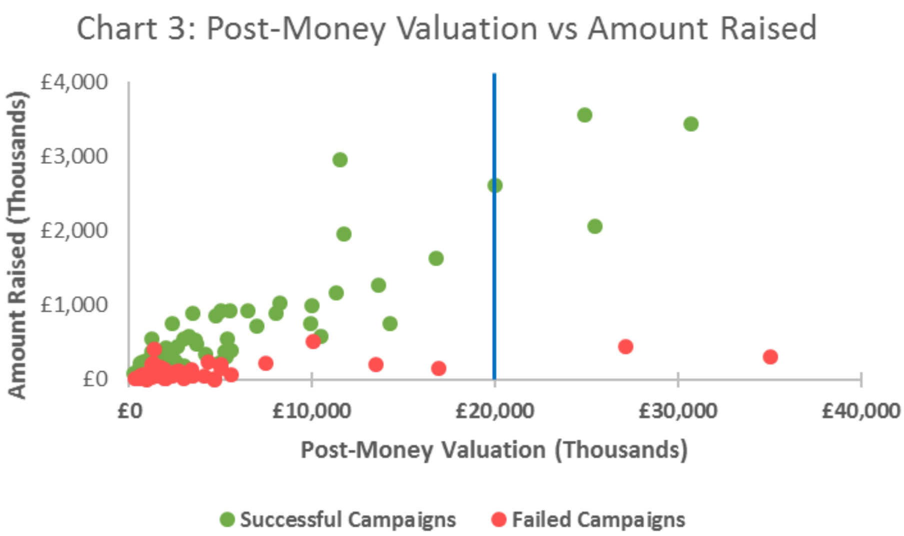


Our Findings

The first thing we looked at was whether specific financial parameters affect the success or failure of campaigns. We found no correlation between success or failure of a campaign and the amount of funds being sought (*Chart 2: Funds sought vs Amount raised*). Prior to undertaking this research we mooted that a campaign might have been more or less likely to succeed if the company was seeking certain sums, or perhaps below or above certain thresholds.

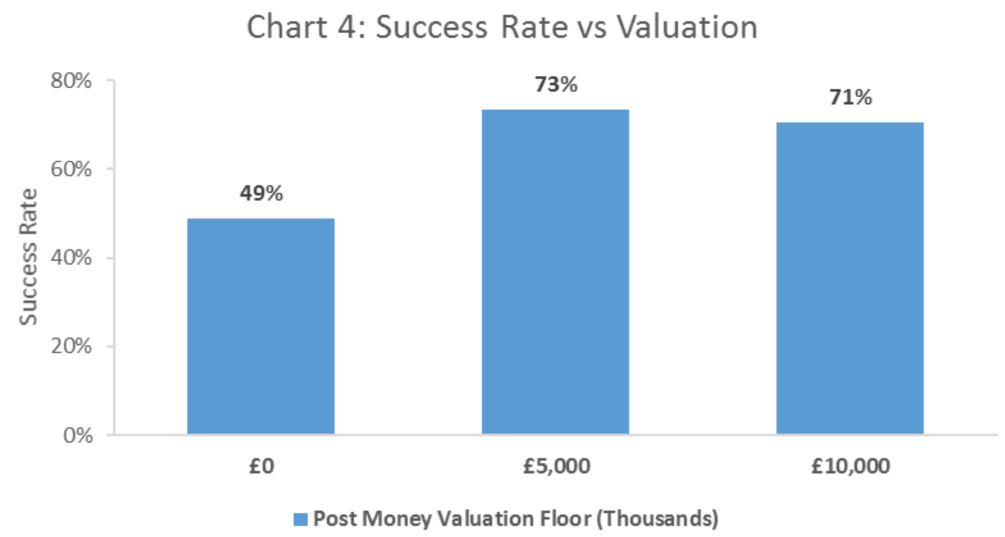


We then examined whether valuation had an impact on the success or failure of a fundraising. We found that, if anything, the higher the post-money valuation the more likely a campaign is to succeed however much is being raised. (*Chart 3: Post money valuation vs Amount raised*).

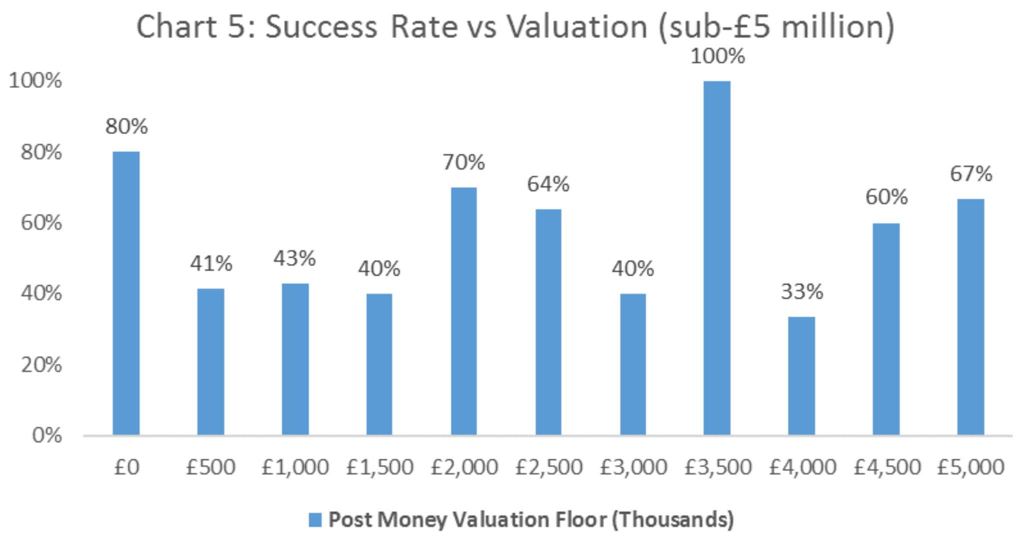


The implication of the data is that equity crowdfunding investors are largely insensitive to the amount of funding being sought and the valuation the company puts on its equity. This would suggest entrepreneurs should therefore push hard to get as high a valuation as possible since investors are just as likely to back a campaign whether the valuation is low or high.

Chart 4 below shows that for the highest valued businesses, the chances of success were extraordinarily high: over 70% of companies with a post money valuation in excess of £5 million succeeded. More interestingly, perhaps, even those companies with a post money valuation of £5 million or less still succeeded in almost 50% of cases. Understanding why this was the case is worthy of further research although, anecdotally, we think it may be because many of these high valuation companies were also ones with a branded consumer product and which received a lot of investment from highly engaged "customer" or "brand champion" crowd investors. These investors probably backed the company for reasons beyond a simple expectation of a return on investment.



We looked in greater detail at the deals which had a post money valuation of less than £5 million. Chart 5 below shows that, even though 46% of these fundraisings were for seed stage deals, the campaigns did not succeed based on offering a lower post money valuation.



Crowdfunding investors should note that this approach to valuation differs significantly to that of traditional expert investors in early-stage deals such angels and VCs. These types of investors typically invest at as low a valuation as possible to take into account that:

a. companies are more likely to underperform than over perform in the early years of their existence, thus suppressing valuation in the future
b. there are likely to be several rounds of investment ahead which may lead to dilution, or may increase the overall cost of investment and impact overall returns at the date of exit
c. exit often occurs later rather than earlier

Is the crowd more impressed by Management, Product or Investment?

CrowdRating rates campaigns with a consistent question set, based on the questions asked by experienced business angels and venture capital investors.

We examined the ratings given to the 155 companies in our data set to see if there was any obvious reason why companies might succeed based on how they scored relative to one another in the key areas of Management, Product and Investment.

Our analysis shows that the crowd can broadly take a liking, or not, to any company. It is noticeable, however, that successful campaigns tend to have higher average ratings for Management and Product. In contrast, when it comes to Investment, investors appear to be more likely to back a campaign with a lower average rating.

This is perhaps not all that surprising given that, on many platforms, the campaign content tends to be weighted towards information about the management team and the product rather than the financials. For example, campaign videos rarely include extensive discussion about the financial prospects of the business, but tend to focus strongly on the people and the product. Furthermore, those crowdfunding platforms that do provide financial information tend only to provide raw numbers and do not provide any additional analysis. Investors are, therefore, required to do their own analysis in order to fully understand what the numbers mean. This could be a challenge for investors not used to undertaking financial analysis, leading them to focus their attention on aspects of the campaign that are easier to understand.

This finding is supported by the table below (*Chart 6: Success Rate vs Rating*) which shows Gold/Silver/Bronze performance in each category compared with campaign success rates. Gold-rated campaigns were more likely to succeed than Silver and Bronze rated ones in Management and Product categories. In the Investment category, however, those campaigns with Bronze ratings appear most likely to succeed.

60% of campaigns rated Bronze for Investment succeeded, compared to only 52% of those rated either Gold or Silver for Investment. Only 40% of those campaigns rated Bronze for Management and 38% of those Bronze rated for Product succeeded. This suggests that, while we score companies based on facts, the crowd may value more on sentiment.

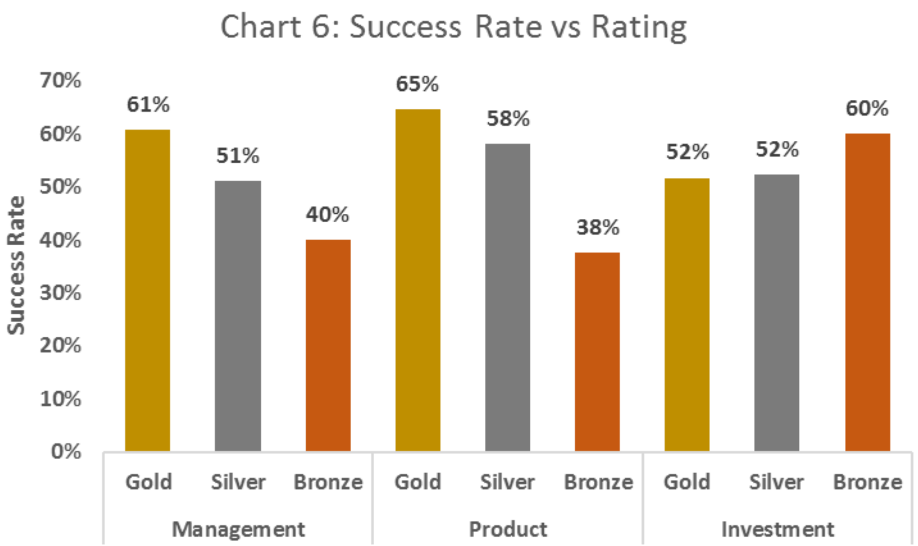
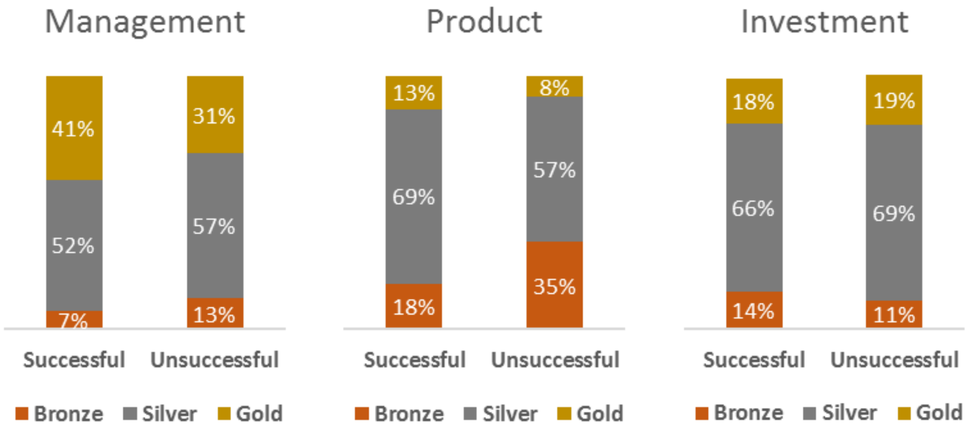


Chart 7 below provides further evidence of this. 41% of successful campaigns had a Gold Management score, but only 7% of those with a Bronze rating for Management were successful. Conversely, just over 1 in 3 (35%) unsuccessful campaigns had a Bronze rating for Product, a score which factors in the market opportunity, product quality and the competition. Only 18% of those with a Bronze rating for Product successfully raised funds.

Chart 7: Distribution of Ratings in Campaigns



These findings raise several key questions.

1. Is our ratings engine scoring investment correctly?

We score in line with how experienced investors would judge a campaign and are confident therefore that the engine works correctly. We regularly review the scoring and question set to ensure it is as comprehensive as possible.
(*Please see Note 2 in the Appendix for further discussion on our scoring thresholds)*

2. Is the crowd indifferent to the numbers?

We think this may be the case because, typically, there is little financial or comparative analysis provided in a campaign. Even discussions on bulletin boards tend to focus on a few key areas of concern rather than providing comprehensive analysis of the financials. In our ratings, we frequently identify weaknesses in the financial projections which an experienced investor would spot and be concerned about, but which the crowd appears to pay little attention to.

With only raw and often summary numbers presented in a campaign, and without any qualitative or quantitative analysis sitting alongside them, this is not that surprising, especially as this kind of detailed financial analysis can be both complicated and time consuming.

We believe that crowdfunding platforms could provide additional factual analysis of the financial projections in a campaign, and that more emphasis should be placed on the numbers to encourage investors to use them in their overall analysis of potential investments.

3. Is the crowd right to be indifferent to the numbers?

This is a particularly interesting area for discussion. In the established investment worlds of business angels and VCs there are different schools of thought on what emphasis you should, as an investor, place on the numbers. Views range from ignoring them completely to stress testing them to the nth degree.

We believe that the industry should consider whether investors would benefit from being given educational tools and additional guidance to enable them to decide to what extent they wish to rely on financial projections. More importantly, perhaps, investors need to be more aware of the implications of the value of the shares they are being sold at the time they buy them and how the price of those shares may vary in the future, depending on the performance of the company, new funding rounds and the eventual exit date.

4. Would the crowd benefit from having to take a financial quiz or test before investing?

If you work in regulated financial services you are required to pass various examinations before you can get involved in investment. Even in business, senior management with responsibility for commercial investment decisions would be expected to be financially literate.

Therefore, we believe the industry should consider providing investors with a quiz or a test on financial analysis to help them to better interpret a campaign's financial information. Pertinent to this discussion is thinking about an answer to the question: should the regulation require that tools be made available to help self-certified investors make investment decisions? Is the regulatory framework fit for purpose when it comes to true amateur "crowd" investors?

It is also important that the opinions of financial experts are available to crowd investors to help them understand this complex area.

In addition, we have made a number of other observations from our analysis of the data. Overall, in the world of equity crowdfunding we conclude the following:

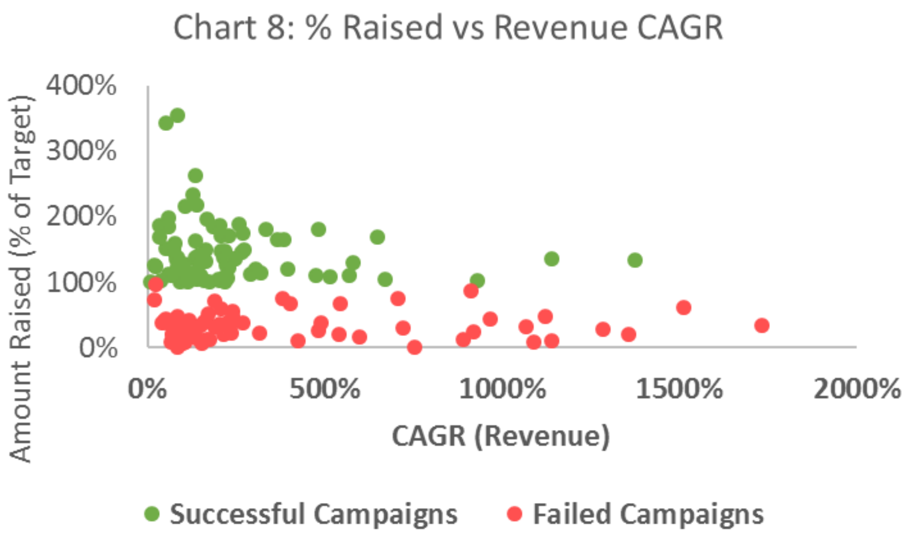
- Management teams are good – the mantra of backing management, management, management seems to have been absorbed by the crowd;
- Companies running campaigns could probably do better when it comes to product. In particular, campaigns could present more detailed analysis of the competitive landscape of the product or service being sold;
- While the crowd, in our view, may not be paying enough attention to what the financial information is suggesting, we do believe the numbers presented in the campaigns in our data set provide a good financial overview and are being prepared with care. Of course, it is a matter of opinion whether they are realistic.

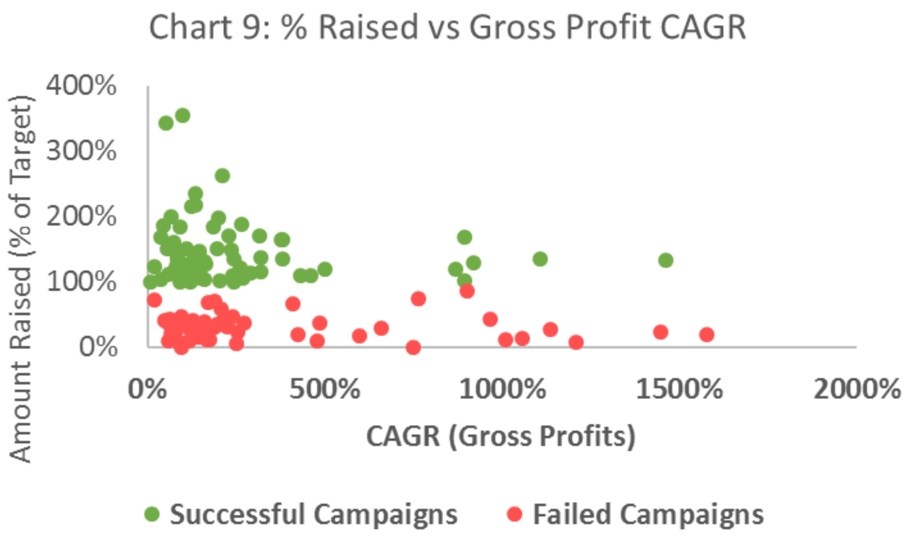
The big issue – should investors pay more attention to financial projections?

We have already discussed our findings that suggest investors are largely indifferent to valuation in equity crowdfunding campaigns. In addition, our data shows that they may also be indifferent to the financial projections at a more fundamental level, namely the anticipated growth in sales and profits as presented in the campaign.

Charts 8 and 9 below plot the amount of funding a company received compared to the projections it presented for turnover and gross profit growth. While a company is less likely to succeed in raising funding if its projections are extremely ambitious (more than 500% growth year on year would be extraordinary!) this is by no means certain.

What is more telling is that the crowd is as likely to back a campaign even if it projects to double or treble turnover or more, and profits year on year for several years in a row. Very few experienced investors would expect early-stage companies to achieve these sorts of growth rates in their first five years. Most will significantly underperform against revenue projections with a clear negative knock on effect on profitability.

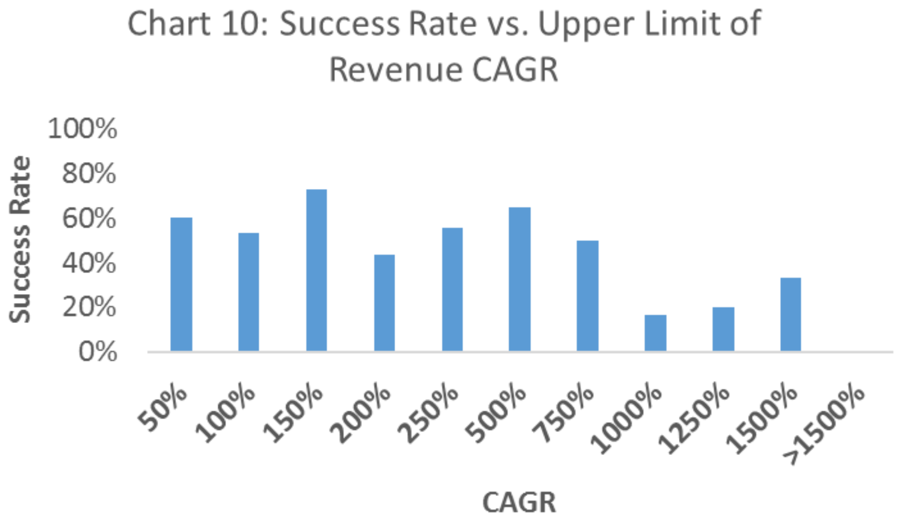


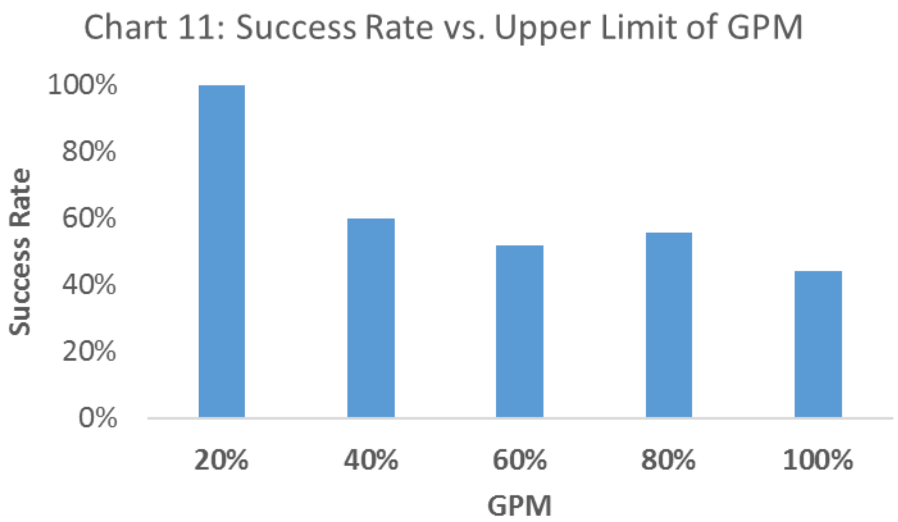


Note 1 (see Appendix)

Charts 10 and 11 below use the same data aggregated into bands to show there is little correlation between a company's chances of fundraising success and the level of ambition of its financial projections.

Interestingly, Chart 11 also shows that companies with low gross margins seem to have a greater chance of funding success than those with high ones. Traditional angels and VCs tend to prefer to back companies with high profit margins because this allows for pressure on prices or rising costs to be better accommodated as time goes on. One possible reason for this could be that the crowd prefers conceptually simpler businesses, e.g. food and drink production, which typically have narrower margins.





Conclusion

While the time frames are still too narrow to draw absolute conclusions about how investors are behaving in equity crowdfunding, we believe that this research has introduced several themes which are worthy of further and repeated examination.

The most notable of these are:

1. Is the crowd right to place such reliance on the management teams when backing a company?

2. Should the crowd look deeper into products and the market opportunities presented by fundraising companies? More importantly, are the platforms themselves finding enough companies with best of breed business models and products/services to offer to the crowd?

3. Is the crowd right to be indifferent to the financials or is this leading them to make poor investment decisions which will rebound against them in the future?

The debate around all these areas will no doubt intensify as the market becomes more established and we see more data or which companies ultimately succeed or fail commercially and/or as an investment. We look forward to joining that conversation and using our data now and in the future to inform the discussions that take place.

About the authors

Modwenna Rees-Mogg, Co Founder, CrowdRating

Modwenna has 20 years working in corporate finance, business angel investment and venture capital. She started AngelNews in 2003 focusing on media and events in the angel and VC market. From £1,000 of start-up capital, she has grown it into the leading information provider and commentator on the business angel market in the UK. The www.angelnewsletter.co.uk is the broadest commentator on and a thought leader in the angel and wider private investor market (including VCTs and crowdfunding) in the UK.

In recent years the AngelNews Group has also built a private investor conferences business including the Great British Private Investor Summit www.privateinvestorsummit.com and the VCT & EIS Investor Forum www.thevctandeisinvestorforum.com. Modwenna is the author of CrowdFunding: How to Raise Money and Make Money in the Crowd and Dragons or Angels? An unofficial guide to Dragon's Den and Business Angel Investment.

Oliver Harris

Oliver Harris is the Senior Analyst at CrowdRating. He has over 5 years of experience in market research and, with a Masters in Theoretical Physics, a firm grounding in data wrangling and analysis.

Appendix

Note 1:

NB: 'Amounts Raised' over 100% indicate campaigns that overfunded. We are not privy to the subscription rate finally agreed to, but record the % funded shortly after the campaign is closed. As such this figure best represents an upper limit and some campaigns may have dropped beneath the 100% mark post-closing.

Note 2:

Some readers may find it curious that the proportion of campaigns we have included in our lowest band – "Bronze" varies from 10% for Management to 26% for Product, yet our highest band, "Gold" includes 11% to 36% of campaigns. In effect therefore we have published more "Gold" ratings to date than "Bronze" ratings.

We are monitoring these statistics closely and have indeed seen a certain amount of inflation in scores since launch. This is due to a combination of two main factors, namely quality and quantity of data. In terms of quality we have seen a steady underlying improvement in scores as all platforms increase their due diligence and screen out lower potential businesses. We have also seen an increase in the quantity of relevant information that is being provided to us: this is due primarily to our commencement of coverage of campaigns of platforms such as Syndicate Room and InvestDen, which provide greater depth of information to investors. Insofar as some of our scores specifically reflect the depth and quality of information provided to investors, increased information provision in itself will increase scores.

We are currently considering various statistical options to mitigate potential "grade inflation" ranging from adopting a forced curve to periodic adjustment of the thresholds between Bronze, Silver and Gold. We will publish a consultation document later this spring and will welcome comments at this time.

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