

How Big Will the Debt and Equity Crowdfunding Investment Market Be? Comparisons, Assumptions, and Estimates

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Abstract: The 2012 JOBS Act enabled both accredited and unaccredited investors to use the Web and social media to make investments in entrepreneurs and small and medium enterprises (SMEs). This was done in the hopes of creating a market that could provide funding to smaller entrepreneurial businesses, from an increased number of smaller debt and equity investments by less wealthy individuals. This paper provides a variety of estimates of the size of what that market might be. It begins by reviewing estimates of donation and perks-based crowdfunding markets. It models the size of the potential crowd fund investment (CFI) market as a small proportion of three current and arguably similar markets: angel investment, entrepreneurial and small business investment, and small business loans. A 1% estimate implies market sizes of approximately \$184M, \$400M, and \$1.59B, respectively. A 2.5% estimate implies market sizes of approximately \$460M, \$1B, and \$3.98B. Both sets of estimates are less than fractions of a percent of household assets in the United States.

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Introduction

The Securities Act of 1933 and 1934 made it illegal for companies to publicly solicit funds from investors without registering a public offering with the Securities and Exchange Commission (SEC). Exemptions to these laws were granted over time to ease the burden of capital formation on startups and small businesses. The JOBS Act of 2012 legalized crowdfund investing (CFI), a new funding mechanism for startups and small businesses, with the intent of further easing the burden. Crowdfund investing aims to support entrepreneurs in raising capital from their immediate and extended social networks, and at the same time, offers small investors the chance to purchase an equity stake (or to fund debt) in small, private businesses. It will begin to take effect on Jan. 1, 2013, or as soon as regulations are in place.

Under the new regulations, companies will be able to raise up to \$1 million per year on Securities and Exchange Commission (SEC) registered intermediary websites, provided the company hits 100% of their funding target within a specified window. CFI is intended to address the gap from initial to larger and institutional financing options, otherwise known as the “funding void,” or “Valley of Death.” To minimize risk, an individual can invest only a limited amount each year in these campaigns. CFI could not exist without changes in securities laws, which essentially prohibited crowdfunding for investment purposes. Under the existing laws, entrepreneurs could only raise money from accredited investors and up to 35 unaccredited investors¹. While platforms like Kickstarter and Indiegogo, have recently flourished, they have focused on donation or perks-based crowdfunding. After the JOBS Act becomes law, it will be legal to use a public media – such as the internet, social network platforms, newspapers, television, radio – to direct people to crowdfund investing platforms for raising money for private companies.

Crowdfunding in concept is an ancient phenomenon - people pooling resources to help one another. This is how communities self-funded prior to the Industrial

¹ See Rules 505 and 506 of Regulation D of the Securities Act of 1933.

Revolution and how charities raise money today. Crowdfunding in its current form rose out of the microfinance revolution of the Grameen Bank and the microlending platform of Kiva. Both of these organizations demonstrated how small amounts of capital can have a big impact on economic and social outcomes. Kickstarter showed the world how pooling small amounts of capital can create bigger opportunities; companies like Pebble Watch (an e paper watch for Android and iPhone) successfully raised over \$10 million from over 68,000 contributors.

Current estimates of similar markets

In attempting to estimate the size of the future CFI market, it is helpful to consider the size of the currently legal donation and perks-based crowdfunding markets. Crowdsourcing.org estimates that as of April 2012, there were 452 active Crowdfunding platforms worldwide. These platforms supported \$1.5B of investment and more than one million campaigns in 2011, again worldwide.² The Crowdsourcing.org estimate splits CFI into four categories, equity, lending, reward, and donation, and includes all categories in its historical estimate (equity and lending was not yet legal at the time of the estimates). It also makes worldwide estimates, though CFI at this point occurs mainly in Europe and North America, in roughly equal proportions.

How much money might be invested in Crowdfunded entities?

We provide simple estimates of the potential size of the CFI market, based on a small proportion of three current and similar markets in the United States: angel investing activity in the first half of 2012, demand for financing by businesses started in 2010, and small business loans of less than \$100,000 in 2010. The small proportion could come from 1) displacement of investments in these categories, 2) funding of previously neglected applications, 3) newly generated opportunities that would not have occurred otherwise, or 4) some combination of these sources. For

² *Crowdfunding Industry Report: Market Trends, Composition, and Crowdfunding Platfirms*. <http://www.crowdfunding.nl/wp-content/uploads/2012/05/92834651-Massolution-abridged-Crowd-Funding-Industry-Report1.pdf>

example, 1% is a static assumption and point estimate; one could plausibly argue that CFI would start from a smaller number and with rapid adoption, quickly obsolete and overtake the 1% assumption. The adoption process is beyond the scope of this paper, however, and we base our initial our estimates upon the simple 1% number. For comparison, we repeat the estimates below with an assumption of 2.5%.

According to the University of New Hampshire Center for Venture Research, angel investment in the United States in the first half of 2012 was \$9.2B, across 27,280 entities.³ Annualizing this to \$18.4B, if CFI was 1% of this number, then the annual CFI market would be \$184M.

According to the Kauffman Foundation, approximately 565,000 businesses were started in 2010, the average capital required for each was \$80,000, and 10% eschewed outside financing.^{4 5 6} With 565,000 business starts, of which 90% seek funding, we can approximate the number of business starts seeking funding at 500,000/year, and assuming each needs the average amount of capital, that implies a market of \$40B. One percent of this implies a CFI market of \$400M. This estimate may be generous, as the mean of \$80,000 is surely higher than the median amount. However, given that the Kaufmann data are probably a superset of the CRC data, the two estimates are consistent.

According to the government's 2010 Small Business Advocacy report, lenders extended 20.3M small business loans (\$100,000 or less) in 2010, for an aggregate

³ Jeffery Sohl, "The Angel Investor Market in Q1Q2: A Market in Steady Recovery," Center for Venture Research, October 10, 2012.

<http://www.unh.edu/news/docs/2012Q1Q2AngelAnalysis.pdf>

⁴ Kauffman Foundation. (2010). *An Overview of the Kauffman Firm Survey: Results from the 2004–2008 Data*.

⁵ Fairlie, Robert. (2011). *Kaufmann Index of Entrepreneurial Activity, 1996 – 2010*. Accessed online at <http://goo.gl/7mJaO> on November 8, 2012

⁶ United States Census Bureau. (2007). *Characteristics of Businesses: 2007 – Survey of Business Owners*. Accessed online at <http://goo.gl/MNAHU> on November 8, 2012

amount of \$159.3B (the value of loans up to \$1M was approximately four times greater). One percent of the aggregate amount for \$100,000 or less loans is \$1.59B.

⁷ This number is quite high relative to the first two estimates, though it includes loans to small but ongoing businesses, as opposed to only entrepreneurial firms. However, as small ongoing businesses would be attractive opportunities for Crowdfunding investment, this estimate remains pertinent.

Given the rapid adoption rates of web-based technologies, a higher estimate of 2.5% is also plausible. Such an assumption results in market sizes of \$460M, \$1B, and \$3.98B, for estimates based on similarity to angel investment, entrepreneurial and small business investment, and small business loans, respectively.

Where might CrowdFund investments come from? Is there enough money to cover demand?

We provided three estimates of the size of the CFI market, of \$184M, \$400M, and \$1.59B. Where might this money come from - and is there enough? Fred Wilson, a venture capitalist with Union Square Partners, has made a widely reported estimate that the CFI market will be \$300B. He bases this, “...on families and individuals investing 1% of their assets in crowdfunding.” ⁸ This implies that families and individuals have \$30T in assets. Providing some credibility to the Wilson estimate, the Federal Reserve reports that at the end of Q3 2012, household net worth was \$64.8T. ⁹ While investors might consider much, indeed most, of this unavailable for investment, even a small fraction of a percentage would make billions of dollars funding available for CFI. Scott Shane, the A. Malachi Mixon III Professor of Entrepreneurial Studies Professor at Case Weatherhead School of Management, has

⁷ *Small Business Lending in the United States: 2009-2010.*

http://www.sba.gov/sites/default/files/files/sbl_10study.pdf

⁸ Novellino, T. May 8, 2012. *Vcs crowded out?* Upstart.

<http://upstart.bizjournals.com/news/wire/2012/05/08/vc-fred-wilson-says-crowdfunding-a-game-changer-for-vcs.html?page=all>

⁹ *Flow of Funds Accounts of the United States.*

<http://www.federalreserve.gov/RELEASES/z1/Current/z1.pdf>

estimated that \$139 billion is invested annually in businesses by people in businesses' friends and family network.¹⁰ 1% of this number is \$1.39B, which is close to our most aggressive comparison market, based on small business loans, of the demand for CFI funding.

Conclusion

Equity and debt Crowdfunding investment will shortly become legal in the United States. While estimating the size of the future and currently non-existent market is a hazardous endeavor at best, we have presented a set of data, assumptions, and estimations that may prove useful. The current world-wide CFI market has been estimated at \$1.5B; bear in mind that this number includes debt and equity investment (not yet legal by unqualified U.S. investors) and non-US investment. If the future debt and equity market were 1% of angel investment - through either displacement or funding of new entrepreneurship - the U.S. market would be \$184M. If it were 1% of all the funding of entrepreneurial and small business ventures in the U.S., it would be \$400M. If it were 1% of all the small business loans under \$100,000, it would be \$1.59B. Based on 2.5% estimates, these numbers become \$460M, \$1B, and \$3.98B, respectively. In considering whether these investments could be supported, one can note that small fractions of one percent of household assets in the US would amount to billions of U.S. dollars.

¹⁰ Shane, Scott. *Fool's Gold?* Oxford University Press, 2009, pp. 32-42.