Crowdfunding's Potential for the Developing World

infoDev
Growing Innovation

THE WORLD BANK

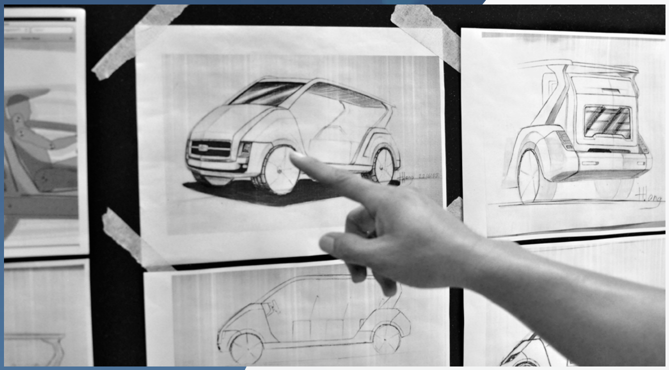
Disclaimers

Rights and Permissions

To cite this publication:

Crowdfunding's Potential for the Developing World. 2013. *info*Dev, Finance and Private Sector Development Department. Washington, DC: World Bank.

EXECUTIVE Summary



Crowdfunding is an Internet-enabled way for businesses or other organizations to raise money in the form of either donations or investments from multiple individuals. This new form of capital formation emerged in an organized way in the wake of the 2008 financial crisis largely because of the difficulties faced by artisans, entrepreneurs and early-stage enterprises in raising funds. With traditional banks less willing to lend, entrepreneurs started to look elsewhere for capital.

Crowdfunding began as an online extension of traditional financing by friends and family: communities pool money to fund members with business ideas. In less than a decade, crowdfunding has gained traction in a number of developed economies, including Australia, the United Kingdom, the Netherlands, Italy, and the United States. This exciting phenomenon is spreading across the developed world and is now attracting considerable interest in the developing world as well.

Crowdfunding takes advantage of crowd-based decision-making and innovation, and applies it to the funding of projects or businesses. Using social networks, social profiles, and the viral nature of web-based communication, individuals and companies have raised billions of dollars in debt, equity, and donations for projects over the past five years. Kickstarter, for instance, the market leader in pledge or donation-based crowdfunding, has channeled over US$815 million from 4.9 million backers (29 percent of which have invested in more than one project) to nearly 50,000 projects throughout the world since 2009.

Building a crowdfunding ecosystem depends on key enablers to build trust

Credible crowdfunding systems require more than entrepreneurs and willing investors. They also need a supportive ecosystem and enabling factors, including forward-thinking regulations, effective technological solutions, and cultures that can adapt to this new investment vehicle. This includes the concept of a "constellation of trust" that enables all parties to participate. The key factors that have facilitated crowdfunding in developed countries include:

- A regulatory framework that leverages the transparency, speed, and scale that advances in technology and the Internet can deliver to early-stage funding marketplaces.
- Strong social media market penetration and Internet usage, which is necessary to harness demographic and technology trends to drive collaboration and cultural shifts.
- A regulated online marketplace that facilitates capital formation while providing prudent investor protections through education and training.
- Collaboration with other entrepreneurial events and hubs including business plan competitions, incubators, accelerators, universities and co-working spaces to create a channel for opportunity and oversight.

All of these factors are necessary to build the culture of trust which is essential for the funding of companies, projects and causes mediated primarily through web-based interactions. Sometimes crowdfunding project backers have no pre-existing relationship to the company or project being funded – they may be hundreds or thousands of miles away. Nevertheless, this trust often flows through some form of community, whether based on geography, culture, ethnicity, or shared interests. Some crowdfunding platforms are successfully raising money from diaspora communities and managing north–south and south–north monetary flows.

Trust does not just happen – it is a socially mediated phenomenon which relies in great part on the intrinsic trust people place in shared connections on social networks, community affinities, and the ratings of others on trusted, mainstream websites. This group behavior of trusting others based on presented information and social signals (and sometimes including first person knowledge) is only possible in a highly transparent system with near real-time feedback mechanisms, that is, on the web.

The developing world has the potential to leapfrog developed countries

With support from governments and development organizations, crowdfunding could become a useful tool in the developing world as well. Crowdfunding is still largely a developed-world phenomenon but its potential to stimulate innovation and create jobs in the developing world has not gone unnoticed. Substantial reservoirs of entrepreneurial talent, activity, and capital lay dormant in many emerging economies, even as traditional attitudes toward risk, entrepreneurship, and finance stifle potential economic growth and innovation. Developing economies have the potential to drive growth by employing crowdfunding to leapfrog the traditional capital market structures and financial regulatory regimes of the developed world.

While many developing economies may have the potential to capitalize on this new funding mechanism, those that wish to implement crowdfunding ecosystems need to learn from the initial developed world experience to understand how crowdfunding functions, the "light touch" role that government and regulation should play, and the technological infrastructure requirements involved. Developing countries that manage this process successfully may be able to leapfrog the developed world, in both a regulatory and economic sense, by creating frameworks for early-stage finance that facilitate entrepreneurship, the fostering of innovative technology enterprises and the emergence of new competitive industries.

It may be possible for developing nations to use emerging technology and business processes – including mobile technology, social media, lean-start-up methods of company formation, and crowdfund investing – to implement more efficient and effective entrepreneurial funding systems that are more advanced than the legacy systems prevalent in the developed world. This may influence more active angel investors and open up deal flow to a much wider audience that can more efficiently review broader investment opportunities. By allowing capital to be efficiently pooled around credible entrepreneurs, it may provide different venture capital structures that reach larger numbers of potential investors. A developing country's ability to leapfrog developed nations will depends in part on the speed and commitment with which its stakeholders embrace these new technologies and methodologies for both capital formation and enabling trust.

Countries that want to adopt crowdfunding must not only create enabling policy, but also, in some cases, address policies and regulations that currently make it burdensome to enter into, conduct, and end business operations. For example, incorporation or dissolution of a business entity in many developing nations is overly bureaucratic, time-consuming, and costly.

The crowdfunding market is in its infancy, especially in developing countries, but the potential market is significant. It is estimated that there are up to 344 million households in the developing world able to make small crowdfund investments in community businesses. These households have an income of at least US$10,000 a year, and at least three months of savings or three months savings in equity holdings. Together, they have the ability to deploy up to US$96 billion a year by 2025 in crowdfunding investments. The greatest potential lies in China, which accounts for up to US$50 billion of that figure, followed by the rest of East Asia, Central Europe, Latin America/the Caribbean, and the MENA region.

The risks in crowdfunding and how to mitigate them

While Asia represents a huge opportunity, there may be reasons to believe that Central Europe, Latin America and the Caribbean, the Middle East and North Africa may effectively deploy crowdfund investing sooner. These factors may include a greater transparency, willingness to take risks, support for free market innovation, strong diaspora communities, early stage entrepreneurial activity, and well-functioning educational systems.

Like any investment activity, crowdfunding comes with risk to the investor. CFI is not unique in this regard, but it does have characteristics that require regulatory protection and robust investor education for crowdfunding to contribute meaningfully and successfully to a country's economy.

Crowdfunding markets have been operating in many countries for several years with few reported instances of fraud. However, as the market expands, there will inevitably be attempts to circumvent regulations and defraud investors. Despite this, the biggest concerns regarding risk are business failure and execution or fulfillment challenges. Failure may result from poor management decisions, lack of funds, or miscalculations of market demand. Execution or fulfillment challenges may occur in some successful crowdfunding campaigns when a company is not ready with, for instance, the necessary logistics and manufacturing capacity to meet the demand generated by their campaign.

These risks may be mitigated through regulation, technology, and social and cultural approaches:

- Regulation: Governments should review and update small business regulation from incorporation to bankruptcy. Regulations should balance the need for investor protection with capital formation. A country-specific framework for crowdfund investing should be created to encourage investment in startups and small businesses and attract diaspora remittances. It is important to enact regulation that is not too burdensome, which might otherwise drive companies into the gray economy.
- Technology: In order for crowdfunding to work, individuals must have access to reliable broadband Internet or mobile data networks. Technology to facilitate ongoing communication between investors and entrepreneurs and enabling tools to systematize and streamline the business lifecycle must also be employed and allowed to operate freely.

- Social: Individuals within a country must be actively engaged in online social networks as this is the main driver of crowdfunding activity. The network should be engaged in vetting opportunities to allow crowd wisdom to emerge. Communities should leverage startup events and community-backed finance to support entrepreneurs and develop circles of trust.
- Cultural: The private sector should be engaged to help create channels of viable businesses that can become potential investment opportunities. This should include the creation and utilization of co-working spaces, incubators, and accelerators. By providing physical space, mentorship, peer learning opportunities and formalized product market fit experimentation, crowdfunding, venture creation and other support services, the private sector can significantly enhance the creation of a culture of entrepreneurship.

FIGURE 0.1 GOVERNMENT, NGO & PRIVATE SECTOR RECOMMENDATIONS

Specific strategies to drive crowdfunding

Economic	Social
• Craft exceptions to securities regulations that allow easy registration for equity offerings • Strategically tie crowdfunding to patriotic and cultural messages • Form a crowdfunding market alliance	• Harness top social media experts/bloggers/ tastemakers to communicate with local and diaspora audiences • Hold media and educational events to build awareness and understanding • Hold regular crowdfunding events with trusted third parties to teach successful techniques
Technology	**Cultural**
• Where appropriate, apply lessons learned from developed world • Consider buy, build or white label • Determine gaps in exisitng technology for online financial transactions	• Leverage existing incubator/accelerator/structured co-working spaces as hubs for innovation in funding • Foster professional investor & consumer confidence in crowdfunding through education and communication • Encourage the participation of women and girls

> Crowdfunding has emerged as a **multibillion-dollar** global industry

While each of these risk controls can operate alone, together they offer a reinforcing framework to protect investors and decrease the risk of failure.

Governments, development organizations and others have a role to play in fostering crowdfunding

Crowdfunding offers the potential for a radical evolution of our largely institutional framework for allocating capital, through foundations, funds, and banks to a more individually driven and direct investment framework. Governments around the world as well as development organizations, venture capital funds, and NGOs are watching crowdfunding closely to see whether it has the potential to solve the "last mile funding problem" faced by many start-up companies. The question is whether crowdfunding and crowdfund investing offer a more efficient mechanism to deliver capital to local entrepreneurs in a way that leverages the existing infrastructure and community resources to support those entrepreneurs.

Policies and strategic recommendations for government, NGOs and the private sector should help support the emergence of crowdfunding ecosystems by addressing the economic, social, technology, and cultural challenges, as illustrated in Figure 0.1.

Development organizations, including the World Bank and *info*Dev, could have an important role to play in enabling responsible crowdfund investing by helping developing-world stakeholders implement productive policies and appropriate regulatory controls. In particular, the World Bank is uniquely positioned to deploy infrastructure, enable capacity, and invest (both directly and indirectly) in ways that could extend the impact of crowdfund investment and reduce the barriers to financing high-growth entrepreneurs and technology-focused SMEs.

Within the Bank, *info*Dev has a particularly valuable role because it has the agility to pilot new concepts at the grassroots, and to scale workable solutions into larger projects that support the World Bank Group's commitment to innovation and entrepreneurship. *info*Dev is well positioned to play a similar role in testing crowdfunding initiatives in developing economies to promote economic growth, competitiveness, and inclusion.

*info*Dev's approach to crowdfunding emerges from its focus on incubating technology-enabled new ventures in the mobile, climate, and agribusiness sectors. These programs provide technology testing facilities, formal or informal mentorship, training courses, and regular multi-stakeholder networking opportunities, as well as traditional business incubation services. When linked with *info*Dev's ongoing efforts, the crowdfunding phenomenon may present an important resource for the entrepreneurs as they attempt to grow their business from "mind to market".

*info*Dev's exploration of crowdfunding may be pursued in the following ways:

- Facilitating skills training for entrepreneurs which overviews main tenets of crowdfunding and adapts "pitch training" to ensure online offerings are compelling.

- Leveraging the *info*Dev brand, through Climate Innovation Centers, mLabs, Agribusiness Innovation Centers and other partners to verify company quality standards and establish trust with the crowd.
- Supporting angel investors or accelerators to serve as anchor investors for the larger crowd.
- Offering Proof of Concept grants to companies to develop their crowdfunding campaign.
- Coordinating local pools of trusted service providers to assist entrepreneurs with development of their crowdfunding campaigns.
- Continuing to provide business development services to entrepreneurs to ensure business models are globally competitive.
- Documenting learning from crowdfunding initiatives to positively impact the crowdfunding enabling environment.
- Showcasing crowdfunding success stories and failures from across the *info*Dev global network to positively influence the global innovation and technology entrepreneurship status quo.

Conclusion

The closed and private nature of investing in small businesses and start-ups will change rapidly as the social web affects the flow of both information and capital to these companies. The rise of crowdfunding as a more distributed way to form capital is aligned with the changes in the flow and distribution of information (via the Internet) and the creation and distribution of manufacturing capabilities (maker spaces and fabrication centers). Existing securities regulations were not crafted for the social web. Governments and policy experts worldwide are considering the possible impact of crowdfunding and crowdfund investing and trying to fashion new regulations, empower new technologies, and equip entrepreneurs with sufficient information to decide if crowdfunding is a viable funding or investment vehicle for these enterprises. The rate of growth of crowdfunding, and its emergence in developing and developed countries, suggests that this phenomenon can become a tool in the innovation ecosystems of most countries.

About *info*Dev

*info*Dev is a global partnership program within the World Bank Group which works at the intersection of innovation, technology, and entrepreneurship to create opportunities for inclusive growth, job creation and poverty reduction. *info*Dev assists governments and technology-focused small and medium sized enterprises (SMEs) to grow jobs, improve capacity and skills, increase access to finance and markets, ensure the appropriate enabling policy and regulatory environment for business to flourish, and test out innovative solutions in developing country markets. We do this in partnership with other development programs, with World Bank/IFC colleagues, and with stakeholders from the public, private and civil society sectors in the developing world.

For more information visit www.infoDev.org or send an email to infoDev@worldbank.org.

About Capital Crowdfund Advisors

Crowdfund Capital Advisors (CCA) is a consulting and advisory firm working with professional investors, governments, development organizations, and NGOs, corporations and chambers of commerce to help them best position themselves to leverage crowdfund investing (CFI) for the benefit of their organizations.

For more information visit www.crowdfundcapitaladvisors.com or send an email to info@theccagroup.com.

This study was made possible thanks to the support of the Ministry for Foreign Affairs
of the Republic of Korea.

infoDev
Growing Innovation

Ministry of Foreign Affairs
Republic of Korea

Email: info@infoDev.org | Tel + 1 202 458 8831 | Twitter: @infoDev
www.infodev.org