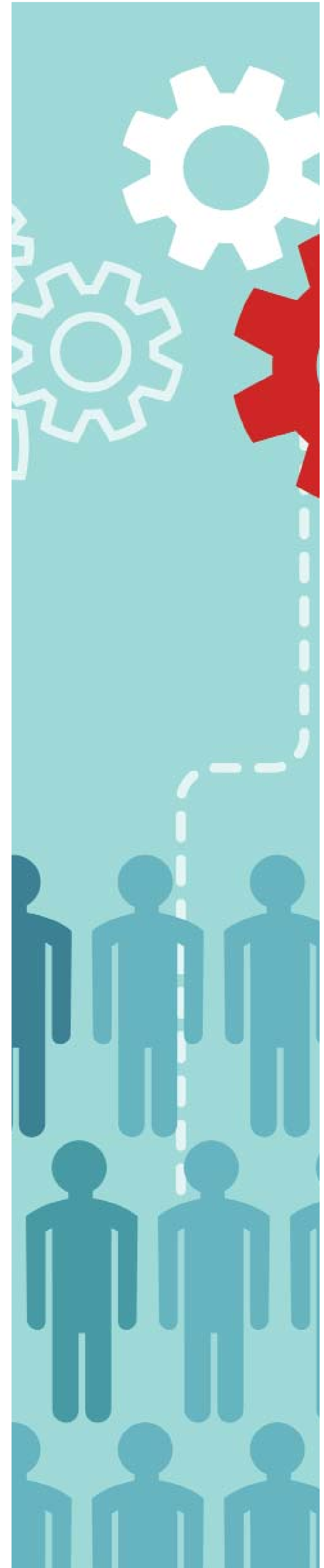
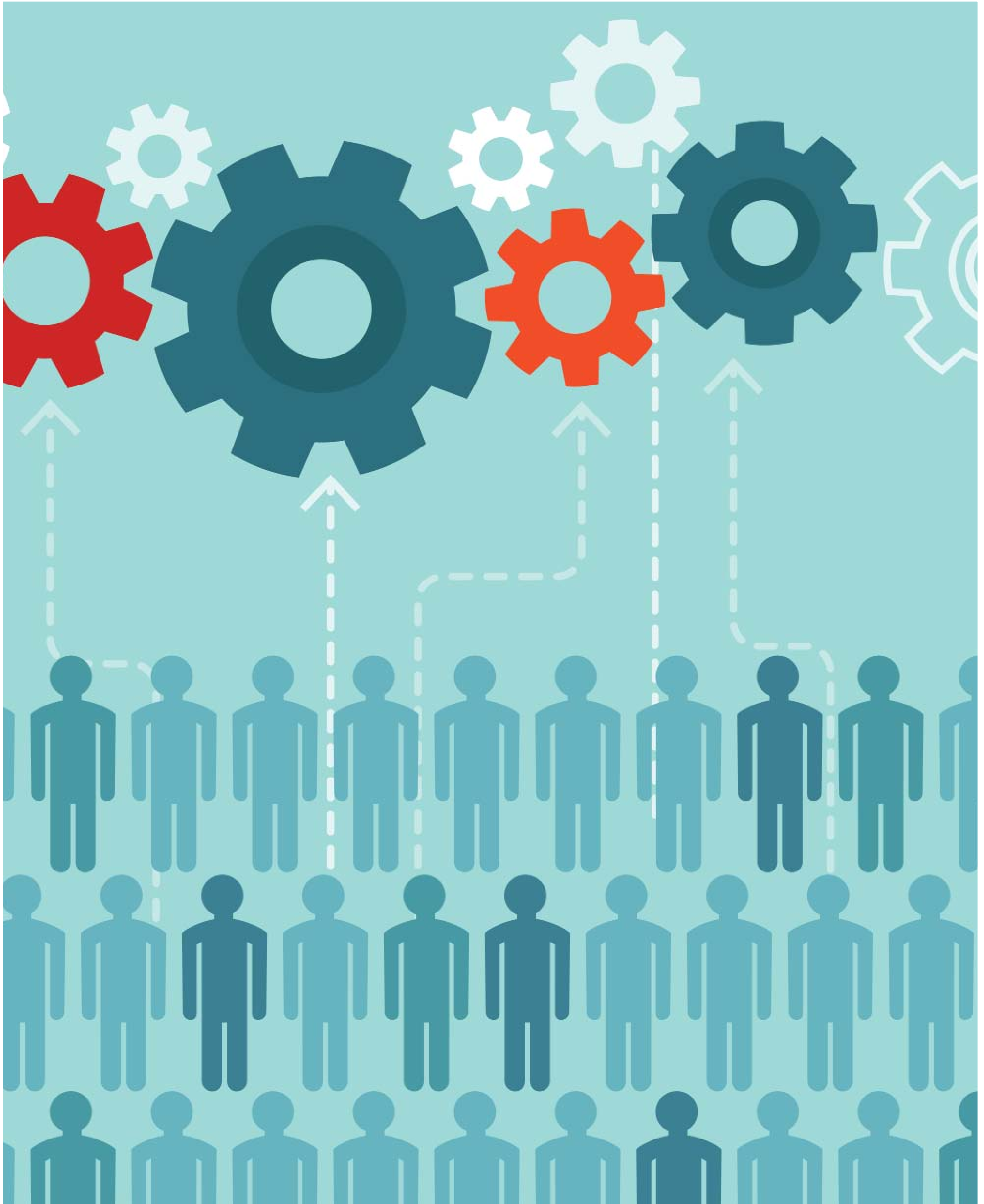
by **Leighton Peter Prabhu** and **Yan Barcelo**

IN JUNE 8, 2013, WAFU, a Quebec manufacturer of Japanese-style sauces and dressings, was among the first Canadian companies to obtain equity capital thanks to a then-nascent phenomenon in Canada: crowdfunding. The company carried out a crossborder deal via US-based crowdfund-ing platform CircleUp, which specializes in consumer packaged goods.

After being listed for the standard three-month period on CircleUp, Wafu was unable to reach its target of $500,000. But it nevertheless managed to collect $230,000 from accredited investors, who took an 8% interest in the company, thereby valuing it at about $3 million. The smaller capital intake was put to good use. “Since then, we’ve been able to grow much more quickly,” says CEO Gil Michel-Garcia, a lawyer with extensive experience in private equity financing who characterizes himself as a foodie. “At the time, our sales stood at $1.5 million. Today, they’re about $3 million.”





Booming market

Wafu is only one small player in a global crowdfunding market that has been growing. In the UK, the alternative finance market (which includes crowdfunding and online lending) vaulted from 350 million euros in 2012 to 2.34 billion euros in 2014, a compound growth rate of 159%, according to research by EY and the Cambridge Centre for Alternative Finance (CCAF) at the University of Cambridge. In the US, a 213% growth rate has seen numbers jump to US$36.2 billion in 2015 from US$4.4 billion in 2013.

The crowdfunding market encompasses many approaches to raising money. The most well-known are donation and reward crowdfunding, where participants simply donate money to a company or offer it in exchange for a reward — for example, the first units of a yet-to-be developed product. This is how the US company Oculus, a startup that planned on manufacturing a virtual-reality headset and hoped to raise US$250,000, finally raked in US$2.4 million from more than 9,000 individual "investors" in 2012, in exchange for the promise of delivering a headset to each. "Two years later, Facebook bought Oculus for US$2 billion, and the initial 'investors' didn't get any of that money — just [the right to receive] a headset, as was agreed," recalls Lauren Leibowitz, membership administrator at the Florida-based National Crowdfunding Association.

To avoid being left out of any future Klondike scenarios, investors are now clamouring to acquire shares of a promising company through equity crowdfunding platforms. Until recently, such sites were reserved for accredited investors, but since May in the US, they have been accessible to retail investors too. This is a crucial development.

Though equity crowdfinance is the segment receiving the most headlines, peer-to-peer (P2P) lending to individuals and companies stands as the largest investment category, encompassing 90% of the total market, notes Robert Wardrop, executive director of the CCAF, in the UK.

On the margin

Canada is still a very marginal player. In 2015, according to another CCAF study, its market stood at only US$207 million, a fraction of its US counterpart. And of that, more than 50% was donation- or reward-oriented — "quite an anomaly," says Wardrop.

"We're punching under our weight," laments Craig Asano, executive director of the National Crowdfunding Association of Canada. "Some of the problem hinges on the patchwork of provincial regulations, making it difficult for platforms and companies to operate."

However, things are picking up north of the 49th parallel. From 2014 to 2015, crowdfunding made a 240% leap, to US$207 million from US$61 million, thanks in large part to new exemptions from regulatory requirements. In May 2015, six provinces adopted the Start-Up Crowdfunding Exemption, says Alixe Cormick, founder of Venture Law Corp. in Vancouver. It addresses small early-stage companies and specifies that issuers can raise a maximum of $500,000 in two separate offerings within a 12-month period, while investors can inject up to $1,500 per issuer distribution in any 12-month period. No financial statements are required from issuers and platforms are not required to be registered as securities dealers.

The Integrated Crowdfunding Exemption followed in January 2016, addressing larger SMEs. This exemption raised the bar to $1.5 million for issuers over a 12-month period, and investors can inject $2,500 per issuer distribution subject to a maximum of $10,000 in a 12-month period. The requirements are more stringent: issuers must present audited financial statements if they raise more than $750,000 and platforms must be authorized as restricted or registered dealers.

Before these exemptions, only accredited investors could participate in crowdfunding projects that were offered by exempt dealers. Finally, though there has been a temporary period of activity by platforms that have been suspended, P2P lending has not been regulated in Canada, though programs are in development, notably in BC.

Restrictive stimulation

The Financial Services Authority (FSA) in the UK is recognized as having the most proactive approach to crowdfunding, aiming to stimulate the development of the sector while protecting the investing public. It has even permitted individuals to hold P2P loans as an asset class in their individual savings accounts, the UK equivalent of Canadian RRSPs.

In Canada, the approach has been more reactive, though regulators tried to preserve "the market's efficiency, which we did not want to hamper," says Sylvain Théberge, spokesperson for Quebec's securities commission, the Autorité des marchés financiers. But the recent rules, revealingly, are exemptions to the registration requirements of the existing securities laws, not self-standing rules.

Crowdfunding stands in a no man's land between public issuance and venture capital financing, explains Théberge. In the first instance, securities dealers have a know-your-client

obligation and must supply investors with an investment memorandum for any new issue. In cases where they have been sold an unsuitable investment, for example, clients have legal recourse against their securities dealer. Venture capital investors are assumed to be sophisticated enough to assess investment merits without the protection of a public regulator.

Furthermore, securities purchased in a crowdfunding deal cannot be resold at a moment's notice as in the stock market. Investors must be prepared to hold onto their investments for years. This is totally original territory, with a new set of risks, that regulators have felt compelled to analyze carefully.

Nevertheless, for some, the imperative to protect investors weighs too heavily. "It's a puzzling fact that in Canada and the US you can go to a casino and drain $10,000 in a slot machine, but you can't invest $10,000 in a startup," says Douglas Cumming, professor of finance and entrepreneurship at Toronto's York University, noting that it's an often-repeated point.

Market-based checks and balances

While cases of outright fraud in the crowdfinance market have been rare, the more common issue is whether the investment being offered reflects a reasonable valuation. In particular, since most of the companies are early-stage startups, traditional valuation benchmarks are difficult to gauge.

One platform that seeks to resolve this issue elegantly is UK-based SyndicateRoom, which requires a recognized angel investor to commit to a portion of every transaction listed on the platform. "The main constraint in our market is investors' risk perception, so having an angel investor endorse each deal addresses both valuation and company risks," explains Tom Britton, the platform's cofounder and chief technology officer.

Other crowdfinance platforms must get involved as an arbitrator between the desire of the issuers to aggressively push deal terms and the need to give investors a fair deal, because bad deals will swiftly lead to the downfall of investor faith in the crowdfinance platform itself.

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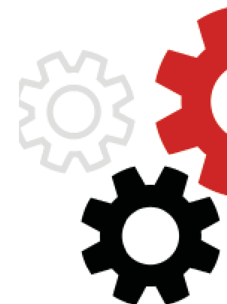

Navigating the maze

Moving to Canada after a successful career in finance in Europe, Peter-Paul Van Hoeken helped small companies here with business planning and financing. And he learned a key lesson: "I experienced firsthand how difficult it is for young companies to attract capital in Canada." That led him to study crowdfunding models in Europe and in May 2015 he launched his own platform, FrontFundr, based in Vancouver.

With all his deals to date, Van Hoeken has practiced "stacking" to various degrees. "We closed the first deal in Canada," he explains, "that stacked accredited and retail investors, and that combined exemptions in different provinces. It was a small deal, only $50,000, and the reason to keep it small was to find the right balance of investor participation and show the potential to raise capital and ensure that we can close." FrontFundr has now closed seven deals, the most recent one for $500,000.

The size of deals continues to grow. Riipen, an experiential learning startup, has raised $950,000 to date by combining multiple approaches in Canada and the US. Through stacking deals with FrontFundr, the company raised $203,000 from Canadian investors in several provinces, from individual investors, angel investors and even students.

Preparing the ground for a crowdfinance round is crucial. "When you start raising capital, it's essential that you don't show zero [of the] issue for an extended period," warns Van Hoeken. You really need to have investors on board even before formally launching your deal, "somewhere around 30% of the total equity you're seeking."

Crowdfinance is a signal

For startups, crowdfinance can be the first step in a sequence of financing rounds. It can lead to venture capital financing rounds, private equity rounds, an acquisition or even an IPO. First of all, it gives companies "a way to test if there is a market for their product or whether people are interested in investing in the company," observes Marc van der Chijs, managing partner at CrossPacific Capital in Vancouver. "A successful crowdfunding campaign is a good indication for a [venture capital firm] of whether a company is good or not. So it is valuable if a crowdfunding campaign is successful."

On the P2P side, forward-looking banks see value in partnering with the new generation of lenders — DBS Bank in Singapore recently signed a cross-referral agreement with Funding Societies, a leading marketplace lending platform. "We don't see ourselves in competition with banks; rather we help nonbankable SMEs to eventually become bankable, and provide additional capital to SMEs which may not qualify under the banks' criteria, yet are solid credits under ours," says Kelvin Teo, cofounder of Funding Societies and a Singapore-qualified chartered accountant.

While incumbent financial institutions see little immediate threat to their turf, crowdfunding's impressive growth, driven by regulatory liberalization and investor acceptance, should give them cause to carefully monitor the market. Syndicate Room was recently admitted as a member of the London Stock Exchange, placing it as a potential competitor of traditional securities dealers.

High issuance costs

Companies would be wrong to think crowdfinance is a route to quick, easy and cheap capital. At Eureeca, one of the few international crowdfunding platforms, only about 2% of the companies that apply are finally accepted for listing on the platform, after passing through several rounds of due diligence and market soundings.

Once through, the transaction fee paid to the platforms generally hovers around 5% of the capital raised, but other costs add up: legal, accounting and marketing. When Wafu raised its first $230,000, "our transaction costs were about 20% of the amount raised," notes Michel-Garcia. "Below $500,000, it's expensive financing," he adds. "To be efficient, you need to be close to a million dollars."

Successful equity issuers using SyndicateRoom can expect to close a crowdfunding round within 10 to 14 weeks, once the deal terms have been agreed with an anchor angel investor. For companies that borrow in the P2P market, the process is usually faster. To get a $100,000 loan at an interest rate just over 10%, "it took us five to six weeks at the most," says Darren Smith, CEO of Lake of Bays Brewing Co., in Ontario, who borrowed through Lending Loop, a Canadian P2P lender. "It's not much longer than with a bank, which in fact could take longer. That's what we particularly liked about it."

The wisdom of crowds

Of course, the key to any financing deal is to have an irresistibly attractive project, so that investors flock to it. Without the full scrutiny of regulators, crowdfunding risks attracting fraudsters in droves. But fraud has been rare. One case in the US stands out. "The company was selling Kobe beef jerky," recalls Cumming, "but it turns out it claimed to be selling more than the whole supply of Kobe beef in the world." It's not just the crowd's money that is at work, he ventures. "Maybe it is the wisdom of the crowds at work, too.
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LEIGHTON PETER PRABHU, is a CPA, CA. **YAN BARCELO** is a Montreal-based writer