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Does success bring success? The post-offering lives of equity-crowdfunded firms☆

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ABSTRACT

Using an augmented dataset with combined information from Crowdcube, Crunchbase, and Companies House, we study the population of 212 successfully funded initial equity offerings on the UK's largest crowdfunding platform Crowdcube from inception (2011) to 2015. We find that 18% of these firms failed, while 35% pursued one or more seasoned equity offerings in the form of either private equity injection (9%) or follow-on crowdfunding offering (25%), while three firms were acquired. Among the determinants of the post-campaign scenarios, we find that the degree of investor participation in the initial offering plays a relevant role. In particular, firms with more dispersed ownership are less likely to issue further equity, while those that reach the target capital more quickly are more likely to launch a follow-on offering. Further, none of the companies initially backed by qualified investors subsequently failed.

"The goal of the campaign isn't the campaign; it's life after the campaign".
[Chris Hawker, United Inventors Association of America, Director]

1. Introduction

The great deal of attention devoted by regulators to equity crowdfunding, where a large number of small investors bid for the shares of firms listed on a web platform, is mirrored in a growing academic literature. Most studies focus on campaigns, whose identified success factors include the characteristics of the business and its top management team (Ahlers et al., 2015) as well as the properties of the offering and its funding dynamics (Vismara, 2016, 2017). The ultimate goal of crowdfunding, however, is to build an enduring business. A successful campaign is therefore only a starting point. In this study, we investigate for the first time in literature what happens after a successful equity crowdfunding campaign.

External investors back projects in equity crowdfunding to receive a monetary return on their investment. Previous research has indeed shown that non-financial motives and the presence of physical and experiential rewards do not play a significant

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role in this context.[1] Shares of firms listed on crowdfunding platforms, however, are difficult to trade. The development of a secondary market is prevented by both the small potential free float and serious concerns about investor protection. For instance, the JOBS Act in the United States prohibits a secondary market during the first year of issuance. In the absence of liquid secondary markets, crowdfunders have the opportunity to realize returns on their investments only in the presence of post-offering deals, such as mergers and acquisitions (M&As) or initial public offerings (IPOs).

The assessment of post-campaign outcomes is crucial to the future of equity crowdfunding markets. Entrepreneurs can be tempted to shirk and engage in self-dealing in the aftermarket, if not to pursue outright fraud (Cumming et al., 2016a). Independently of moral hazard problems, crowdfunded firms may also fail soon after the campaign because of the risky nature of the projects or overconfidence of their proponents. Investors lose their money in the event of the failure of the company in which they invested regardless of the reason for such failure. At the equilibrium, the risk of such an eventuality is thus priced into the asset class.

Risky assets such as the shares offered in crowdfunding promise high returns. Coherently, the inspection of the business plans of crowdfunding firms reveals that most companies provide optimistic estimates.[2] However, the Financial Conduct Authority (FCA) in the United Kingdom has raised the concern that these estimates are based on a "misleading or unrealistically optimistic impression of the investment" (FCA, 2015, p. 8). Given that companies' lives after the campaign have thus far been unexplored and that understanding which successful campaigns have the ability to become successful investments is of primary importance for investors, an empirical answer to this question is long overdue.

Our empirical setting is based on the population of 212 firms that successfully raised equity capital on the UK crowdfunding platform Crowdcube during 2011–2015. We construct an augmented dataset by relying on Crowdcube, Crunchbase, and Companies House as data sources. We then track these companies until the end of April 2017 and, in line with the scenarios discussed above, categorize them as (1) seasoned equity offerings (SEOs) if they received additional equity capital infusions, (2) M&As if they were targeted in an acquisition, (3) active if they were operating independently and no additional capital was raised, and (4) failed if they ceased operating. Among SEOs, we then distinguish between (a) public offerings if the company launched a follow-on crowdfunding offering and (b) private offerings if the company received financing from business angels (BAs) or venture capitalists (VCs). Fig. 1 depicts the possible scenarios faced by a company after its first successful crowdfunding offering.

We find that 38 of our 212 sample firms failed (17.9%). This is a low percentage compared with the 56% failure rate to return capital reported for BA investments in the United Kingdom (NESTA, 2009). Among our crowdfunding companies, 74 (34.9%) raised further capital in SEOs, of which 54 (25.5%) raised additional public equity on the same platform and 20 (9.4%) secured private equity from BAs or VCs, while three (1.4%) were targeted in M&A deals. In addition, 20 firms (9.4%) conducted multiple SEOs within two years of the initial offering. The SEOs all represent up rounds in terms of implicit valuations.

Among the determinants of the likelihood of going through each of the post-offering scenarios, we find that the degree of investor participation in the initial offering plays a relevant role. We measure investor participation along three dimensions. First, we find that initial offerings backed by a larger number of investors are less likely to be followed by a successful outcome such as SEO or M&A. This evidence seems consistent with a reduced monitoring effect (Brennan and Franks, 1997), as the greater dispersion of outside investors weakens their incentive to effectively monitor the firm's managers, thereby decreasing the likelihood of a successful outcome. Second, we find that firms that raise the target funding more quickly exhibit a higher likelihood of launching a follow-on offering, in line with a stronger propensity to return to the platform by those entrepreneurs who received a favorable market assessment during their first experience. Third, we find that none of the firms whose offering is backed by a qualified investor has subsequently failed, consistent with the idea of qualified investors possessing superior information that allows them to pick firms with more promising business models.

The remainder of this paper is organized as follows. In Section 2, we elaborate on the theory. Section 3 presents the institutional setting for equity crowdfunding in the United Kingdom. Section 4 explains our decision to use Crowdcube as the empirical setting and describes the data, variables, and methodology used in the study. In Section 5, we report the results. Section 6 performs a number of additional tests aimed at checking the robustness of our main evidence. Section 7 concludes and discusses the implications of our findings.

2. Literature review

2.1. Failures

Like any entrepreneurial finance setting, equity crowdfunding markets are not exempt from information asymmetry issues. For instance, BAs and VCs rely heavily on due diligence predicated on face-to-face interactions and personal relationships. In IPOs, underwriters are in charge of pricing and allocating shares. Typically, crowdfunding investors have to rely on individual due diligence, which may generate a reluctance to invest in crowdfunding projects, with potential investors willing to do so only if

[1] In a direct comparison between reward-based and equity-based crowdfunding, Cholakova and Clarysse (2015) find that non-financial motives play no significant role in the latter. In a multi-platform study of equity crowdfunding campaigns, Vismara (2016) finds that offering rewards to investors does not increase the probability of success.

[2] In Crowdcube, for instance, companies are required to provide a "financial snapshot," which summarizes the key numbers of their business plan in a clear and consistent format across all pitches.

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