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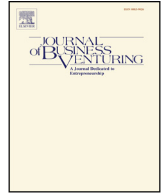

Equity crowdfunding: First resort or last resort?

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ABSTRACT

Prior research has focused on the factors that affect funding success on equity crowdfunding platforms, but a detailed understanding of the factors that drive firms to search for equity crowdfunding in the first place is lacking. Drawing on the pecking order theory, we argue that firms list on equity crowdfunding platforms as a "last resort"—that is, when they lack internal funds and additional debt capacity. In line with the pecking order theory, the empirical evidence shows that firms listed on equity crowdfunding platforms are less profitable, more often have excessive debt levels, and have more intangible assets than matched firms not listed on these platforms. We discuss the implications for theory and practice.

Executive summary

Equity crowdfunding is an increasingly popular source of external finance for young entrepreneurial firms. In the UK, for instance, an estimated 20% of all early-stage equity investments occurred through equity crowdfunding platforms in 2015 (Beauhurst, 2015). Extant crowdfunding research has primarily examined the factors that lead to funding success on crowdfunding platforms. In this paper, we examine the factors that drive firms to search for equity crowdfunding (regardless of their ultimate funding success) and thus list on equity crowdfunding platforms.

For this purpose, we draw on the pecking order theory (Myers and Majluf, 1984). In this theory, the costs related to information asymmetry drive entrepreneurs to first employ internal funds whenever available. When internal funds are lacking, entrepreneurs will search for debt financing and choose only external equity financing, including equity crowdfunding, as a last resort. Building on this theoretical perspective, the study advances three hypotheses that operationalize the theory.

The hypotheses are tested using data from 277 firms that searched for equity crowdfunding between 2012 and 2015 on Crowdcube—a leading UK equity crowdfunding platform—and two matched samples of firms that did not list on crowdfunding platforms but were similar in terms of firm industry, age and size. A first matched sample is based on a random set of firms (that do not necessarily have a need for external finance); a second matched sample is based on a set of firms that raised debt (and thus had a demand for external finance).

We find general support for our hypotheses using both samples. Specifically, firms that are more unprofitable and thus lack internal funds are more likely to search for equity crowdfunding. Moreover, firms with excessive debt levels and more intangible assets (i.e., firms with limited debt capacity) are also more likely to search for equity crowdfunding. Overall, these findings are consistent with the pecking order theory.

This study contributes to the entrepreneurial finance literature in at least two important ways. First, we add to the crowdfunding

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literature. Extant crowdfunding research almost exclusively focuses on the subset of firms that were listed on crowdfunding platforms and examines the drivers of funding success on these platforms. We provide first-time evidence on the factors that explain why some firms search for equity crowdfunding while others do not. By doing so, we further address a broader issue in entrepreneurial finance research. Specifically, studies have often focused on firms that raised a particular source of financing but have ignored the firms that searched for and failed to raise that source of financing as well as the firms that did not search for that type of financing (Cumming and Johan, 2017). By investigating firms that searched—successfully or not—for external equity on crowdfunding platforms and matched firms that did not search for funding on these platforms, we thus provide unique insights into the demand for external equity funding and equity crowdfunding in particular.

Second, we examine and extend the boundaries of the pecking order theory with the emergence of equity crowdfunding. While its unique characteristics might enable equity crowdfunding to reverse the pecking order (Bellavitis et al., 2017), in the traditional pecking order theory, equity crowdfunding is just a new source of external equity finance that is used as a last resort. Moreover, studies have had difficulty in disentangling information asymmetry problems (the true driver of financing behavior in the pecking order theory) from entrepreneurs' willingness to retain control, both of which might lead to an observed pecking order (Sapienza et al., 2003). The equity crowdfunding context allows scholars to examine possible pecking order considerations in a context characterized by severe information asymmetry problems (Ahlers et al., 2015) but limited control issues because entrepreneurs generally search for equity crowdfunding from a broad pool of small investors and therefore largely retain control over their firms compared with other forms of equity finance.

Finally, the study's findings have important practical implications. Understanding the characteristics of firms that search for equity crowdfunding is instrumental for policy design. The findings also provide new insights into crowd investors, who clearly invest in a risky set of firms. For entrepreneurs that consider searching for equity crowdfunding, the findings suggest that they end up in a pool of firms that try to raise financing as a last resort. Consistent with this idea, we also show that some 40% of firms that unsuccessfully searched for equity crowdfunding have already failed; this percentage is 2.9 times higher than that for firms that raised equity crowdfunding and 7.2 times higher than that for firms that raised debt. Thus, failure to achieve funding goals during the equity crowdfunding campaign often threatens the very survival of the firm.

1. Introduction

For entrepreneurs, internal finance and debt finance are crucial to form and grow a venture (Berger and Udell, 1998; Cassar, 2004; Cosh et al., 2009). External equity finance (e.g., venture capital, angel finance) is usually unavailable (Berger and Udell, 1998) however, or entrepreneurs are unwilling to attract it because of fear of losing their independence (Sapienza et al., 2003). Recently, equity crowdfunding has emerged as a new source of external equity finance that plays an increasingly important role in the financing of young entrepreneurial firms (e.g., Ahlers et al., 2015; Bruton et al., 2015; Cumming and Vismara, 2017; Drover et al., 2017; Short et al., 2017; Vismara, 2016, 2018). This phenomenon provides new opportunities for entrepreneurs, who can now target a broader group of external equity investors.

Research on equity crowdfunding—"a method of financing, whereby an entrepreneur sells a specified amount of equity or bond-like shares in a company to a group of (small) investors through an open call for funding on Internet-based platforms" (Ahlers et al., 2015: 958)—is developing quickly. Scholars have focused on the success factors in raising equity crowdfunding (e.g., Ahlers et al., 2015; Ralcheva and Roosenboom, 2016; Vismara, 2016). For example, Ahlers et al. (2015) show that retaining equity and providing detailed information about risks make firms more successful on equity crowdfunding platforms. Scholars have also examined dynamics on equity crowdfunding platforms (e.g., Hornuf and Schwienbacher, 2018; Vismara, 2018; Vulkan et al., 2016) and outcomes after equity crowdfunding campaigns (e.g., Signori and Vismara, 2018). While all these studies have used samples of firms that are listed on equity crowdfunding platforms, firms do not appear on these platforms at random. Rather, entrepreneurs first need to decide whether they want to seek equity crowdfunding. Therefore, we address the following research question: *Which factors influence firms to search for equity crowdfunding and thus list on equity crowdfunding platforms?*

Different forms of crowdfunding exist, and most crowdfunding research has focused on reward-based crowdfunding (e.g., Butticè et al., 2017; Chan and Parhankangas, 2017; Colombo et al., 2015; Kuppuswamy and Bayus, 2017; Mollick, 2014). However, contrary to many projects on reward-based crowdfunding platforms, which tend to be artistic and often are not associated with an entrepreneurial firm, projects on equity crowdfunding platforms by definition relate to firms (Cumming et al., 2016). Moreover, the equity crowdfunding context provides a context in which prospective funders of firms are likely primarily driven by financial motives similar to traditional financiers of entrepreneurship (Cholakova and Clarysse, 2015; Cumming and Johan, 2013). Thus, the equity crowdfunding context allows us to extend and bound what is known about raising funds through equity offerings. Practically, equity crowdfunding represents one of the fastest-growing components of the crowdfunding market, and policy and regulatory actions have been implemented or are being crafted to support further market growth.

To address our research question, we draw on the pecking order theory (Myers and Majluf, 1984). Although this theory was originally developed in the context of established firms, it is also highly relevant in an entrepreneurial finance context (Cassar, 2004; Cosh et al., 2009). The pecking order theory suggests that because of information asymmetries, entrepreneurs prefer to use internal financing whenever possible; next they will raise external debt financing; and, finally, when their debt capacity is exhausted, they will raise external equity financing, but only as a last resort. Thus, firms are more likely to search for equity crowdfunding, a source of external equity financing, when they lack internal funds and additional debt capacity. To test these claims, we use data on 277 UK

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