A CROWD IS NOT COMPANY?

Sean Feast is worried that Crowd Funding is heading for a spectacular fall – and no-one wants to admit it.

Robert Key, the broadcaster, journalist and writer wrote a brilliant novel in 1947 entitled A Crowd is not Company, a dramatic account of his three years as a prisoner during the war. I have a personal interest having written several books on the subject myself. Forward wind nearly 70 years, and it might be the perfect title for a new book about the rise and fall of Crowd Funding.

Crowd Funding is defined as being the use of small amounts of capital from a large number of individuals, usually to finance a new business venture. It makes use of the easy accessibility of the vast networks of friends and family, and complete strangers, to spread the word via social media websites like Facebook, Twitter and LinkedIn to attract potential investors. It is very much in vogue and has been for some time. Now let me say from the outset that Crowd Funding can be an incredibly useful and successful avenue for a business to raise cash, especially – and almost always – when that business has been declined help by a bank or otherwise failed to secure the total funding it needs. It has the potential, it is claimed, to increase entrepreneurship by expanding the pool of investors from whom funds can be raised. It is useful, certainly, as a tool to be used alongside other funding mechanisms such as invoice finance to support growth. So far so good.

CREATIVE PLAYERS

The phenomenon has given rise to a number of new creative players with equally creative names such as Kickstarter, Indiegogo and Rockethub. Then there are others who have already carved out a niche and reputation including Funding Circle and the improbably-named Thin Cats, both of whom seem to be making waves. So why does Crowd Funding make me uneasy? And why does it seem to be the proverbial elephant in the room that no one dares mention?

Over the last 20 years a great number of major international industries have been turned upside down by technology. Old, entrenched market leaders have been replaced by new models, from travel with the fall of travel agents, to music with the rise of downloads, to retail with new online monoliths Amazon and eBay. The same transformation is now happening in financial services, and crowd funding and peer-to-peer lending are at the centre of this transformation.

Peer-to-peer lending is about dis-intermediating the act of borrowing or investing money, so your money doesn’t get frittered away on servicing expensive branch networks that only a small minority continue to use, or on paying fines to the regulator, or on large-scale advertising campaigns. The benefits therefore are simple, borrowers get a better rate and service than they can elsewhere, and investors get a good return on their money.

As with any investment there are risks associated and there are ways to mitigate those risks.

MITIGATING RISK

The first thing to understand is that different forms of peer-to-peer lending carry different levels of risk. Equity crowd funding platforms naturally carry greater risks than debt based platforms. And within debt based platforms there is also differing levels of risk. Investing through MarketInvoice - which offers short term working capital finance backed by a verified invoice which is in turn owed by a blue chip - is less risky than investing in a five year term loan, where you’re reliant on long term small business success, rather than a submitted invoice being paid in the next 45 days.

As ever, the best way to alleviate investment risk is to ensure you have a diversified portfolio of investments such that if one fails, your overall returns are hit too hard. Given the number of different borrowers and products across peer-to-peer platforms it is possible to have an extremely well diversified portfolio of peer-to-peer investments.

Communication is crucial. Peer-to-peer lenders need to lead the way in offering transparency to their investors - this is another area where they can make significant headway on larger incumbents.

It is vital that investors are aware of the risks and I would expect the regulator to keep a close eye on this, paying particular attention to those who might not have a history of investing.

It is a common misconception that businesses borrowing through peer-to-peer lenders are bank rejects and that they are of dubious credit worthiness. I believe this is wrong on two counts:
Peer-to-peer lenders will live and die by defaults. As the sector grows it will become easier and easier to compare returns across platforms - net of defaults and fees - and the money will follow the best returns …

– Anil Stocker

Firstly, the credit scoring models of banks do not reflect the nature of many modern businesses. Banks like to offer business finance where they can take significant security over business assets. For many modern businesses, like software developers or graphic designers, their business has few assets beyond their computers, and so despite being successful businesses with strong track records, they can’t get bank finance. Peer-to-peer lenders operate credit scoring models which more accurately reflect the modern economy, as such default rates over the last few years have remained below that of the banks - and that’s in a turbulent economic climate.

Secondly, many of the businesses using peer-to-peer finance haven’t been rejected by a bank, they’ve just chosen to take the better borrowing rate. Four out of five of our clients, for example, have never used bank invoice finance before. In my opinion, this is because the products on offer from peer-to-peer lenders are superior, and not just in terms of rates but also in areas like speed, transparency and customer service. Good businesses are choosing peer-to-peer over the banks, and this is a trend that will extend further into the market in the coming years.

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