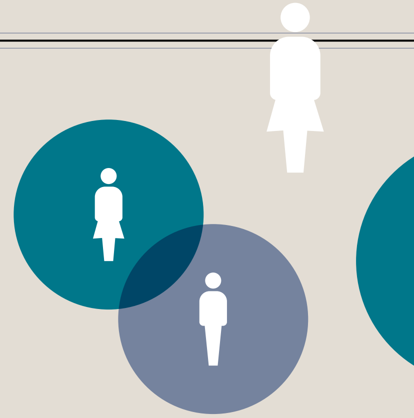

BORROWING WITHOUT THE BANK

PEER-TO-PEER LENDING WEBSITES HAVE THE POTENTIAL TO TRANSFORM THE FUNDING LANDSCAPE. MARTIN O'DONOVAN EXPLAINS HOW THEY WORK

A new form of broker is emerging that combines the distribution power of the internet with the wisdom of crowds: the crowdfunding platforms or peer-to-peer (P2P) lending websites. Zopa was the first P2P lending site; it started in 2005, with individuals lending small amounts to other individuals. Since then, the concept has expanded to embrace peer-to-business (P2B) lending and equity investment.

The concept is simple. A small business wanting to raise, say, £100,000 of funding to scale up its operations advertises its need on a crowdfunding website. It provides a basic business description, the purpose for which the funds will be used and some outline historical accounts. The site itself may generate some sort of credit score for the business. Individuals with money to invest select the businesses they favour and bid to lend an amount and at a minimum rate. Once the offer period is over, the site will set a strike rate, which is the lowest rate for funding the entire £100,000, and the lenders bidding at rates below this will be successful. An individual with, say, £1,000 to invest will probably spread it among 10 to 20 businesses, meaning that investment amounts can be quite modest, often in the range of £25 to £100.

Dealing with thousands of lenders is only possible if the crowdfunding site has sufficiently robust systems to run the auctions effectively and to record the interest and capital repayments and allocate them correctly across the wide investor base. In theory, it is a win-win situation, with businesses getting the funding they need without having to remunerate an intermediary bank. But businesses have to pay a platform fee and an arrangement fee, while the investor gets what looks like a massively higher yield than those provided by conventional bank and building society deposits. Recent data from leading P2B crowdfunding website Funding Circle implies that rates for investors average 9.1%pa and tend to be in the range of 7% to 11%.

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Risk and return

The issues of risk and return are key for investors, but, realistically, how many of them will be able to analyse risk and assess whether the return justifies that risk? The presumption and hope must be that by spreading your investment, you will never lose too much. The actual default experience at Funding Circle to date runs at 1.1%pa, but it advises investors to expect 2%pa overall, subject, of course, to the mix of high- and low-risk loans. For borrowers, crowdfunding is a viable alternative if you can present an attractive case, have a track record in business and generate turnover above a minimum size, but some form of security or personal guarantees might well be expected. Depending on which site is used, loans from six months to five years are possible, normally at fixed rates, with amortising capital repayments for the longer terms. Most crowdfunding sites are, by definition, themselves fairly recent start-ups, but their track record is growing all the time; Funding Circle has lent £57m to date.

Other platforms exist, including ThinCats.com, which started in January 2011 and has since made £10m of loans using a model that involves a network of 'sponsors' who assess borrowers in person. Relendex takes bids from individuals to lend via secured loans against properties that generate commercial income. Other crowdfunders that cater for businesses include Squirrl (a platform for funding assets that are provided by suppliers to customers, for example, vending machines) and personal loan providers Encash and Wonga.

The provision of funding via the internet is, in many ways, a by-product of the financial

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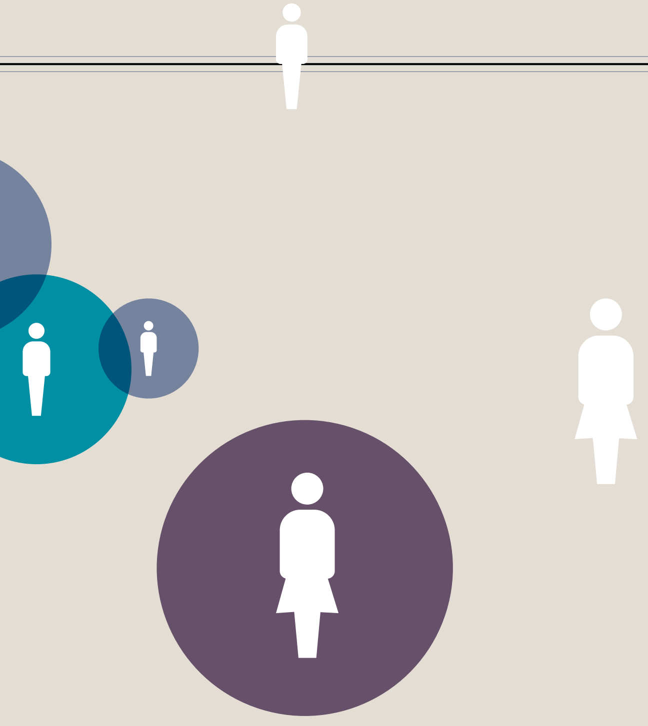

crisis. A shortage of bank funding has acted as a spur to innovation, and the artificially low interest rates that investors earn through conventional channels has encouraged them to seek higher yields elsewhere. Although it is encouraging that individuals have been prepared to embrace innovation, there could be an accident waiting to happen, with a potential mis-buying scandal.

Regulation of the P2P lending sector in the UK is light and somewhat confusing. Meanwhile, the Financial Services Compensation Scheme does not cover any investments made by individuals through crowdfunding platforms. Some sites fall outside the remit of regulation because they themselves are not selling securities or taking deposits; instead it is the investors who are making loans. Other sites require investors to self-certify that they are sophisticated investors or high-net-worth individuals. But Relendex is subject to oversight by the Financial Services Authority because it is actually offering transferable securities in a fund.

This article is based on the research report *Seeds of Change: Emerging sources of non-bank funding for Britain's SMEs*, produced by the Centre for the Study of Financial Innovation and sponsored by the ACT. The article mentions certain platforms to indicate the kinds of services that are available. No recommendation or endorsement by the ACT is implied.

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THE POTENTIAL OF CROWDFUNDING

All treasurers would regard a wide choice of flexible and efficient financial markets to suit businesses of all sizes as a good thing. And the potential of crowdfunding is huge and exciting. Within a few years, the basic proposition will no doubt have expanded its lending volumes; the size of borrower and investment amounts will almost certainly have increased, perhaps with companies becoming lenders, too; and maybe the established lenders and asset managers will see some benefits in routing business via these P2B platforms. The internet is a cost-effective communication and distribution channel, so traditional bank lenders might even deploy their own balance sheets through the crowdfunding sites. Perhaps banks could source borrowers through the internet, apply their credit analysis skills and then seek crowdfunders to lend alongside their own lending, with streamlined administration provided by the internet?

There is no doubt that the concept of creating funds that consist of bundles of small business loans made by P2B investors has taken off. The UK government itself is even proposing to invest £100m of Business Finance Partnership scheme funds in non-conventional investment channels that reach SMEs, including P2P lenders. The crowdfunding concept is also being extended to equity funding. Crowdcube, which claims to be the world's first equity crowdfunding site, was launched in February 2011 and has raised £3.7m for 24 companies, start-ups and established ventures, with almost 20,000 investors on its books. Crowdcube requires comprehensive business plans and financial forecasts, and investors conduct their own due diligence using a discussion forum. On this platform, the company sets its own valuation and approaches investors with a 'take it or leave it' price. More recently, in 2012, Seedrs has started to raise equity capital exclusively for start-ups.

Crowdfunding is also used to provide working capital through invoice discounting. The Receivables Exchange in the US has been providing an internet-based platform to allow institutional investors to buy discounted invoices since 2008. Cumulatively, over $1bn has been raised through this channel. In 2011, MarketInvoice started to apply the concept in the UK and again the pool of investors is small and largely professional. And there are more and more ideas taking shape in supply chain finance. Platform Black and Urica have already established themselves, while Obilisk Supplier Finance is in the process of launching.

Crowdfunding might still be in its infancy, but its advantages and the power and reach of the internet suggest this type of lending has the potential to grow and evolve into new outlets. While it is disappointing that the traditional financial system has left a gap in the provision of funding to smaller companies, it is encouraging that entrepreneurs and an army of individual investors have risen to the challenge to fill it. Let's hope that crowdfunding will flourish and develop.