Frank Demmler: It’s not your parents’ funding environment

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(By Lee Stabert on May 17, 2016)
FRANK DEMMLER is Vice President of Entrepreneurial Services at Innovation Works (Ben Franklin Technology Partners of Southwestern PA). In his 30-year career, he has worked with over 3,000 entrepreneurial efforts, leading to the formation of over 500 companies. These businesses have gone on to create more than 12,000 jobs and raise more than $2 billion dollars of investment capital.

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If you’re over 40, like me, it seems like the world of investing has turned upside down in recent years. If you’re under 40, these changes might seem natural for an increasingly connected world. In either case, the next wave of crowdfunding is poised to present big challenges and bigger incentives for startups and investors alike.

In April 2012, the Jumpstart Our Business Startups (JOBS) Act was passed, creating a legal framework for crowdfunding, replacing laws that had been in existence since 1933. The resulting crowdfunding culture — which has garnered widespread mainstream attention — provides entrepreneurs unprecedented access to a huge pool of potential investors. It’s no surprise then that this trend has given rise to even newer solutions that pull accredited investors into the fold as well.

Today, both laymen and accredited investors have legal, effective ways to support companies they believe in, whether it’s for the personal gain or the public good.

New Incentives for Investment

One fundamental difference between mainstream crowdfunding and traditional fundraising is that the former does not involve the sale of equity in the company. Instead, crowdfunding campaigns often appeal to a social mission or personal interest, offering the investor SWAG ranging from promotional items like coffee mugs to pre-paid orders for in-development products. Platforms like Kickstarter and Indiegogo are now household names, delivering investment opportunities to a larger base of users with less to spend than traditional investors.

Whether it’s a board game or new technology for doctors, startups can now use the general public as a sounding board for their boldest ideas. When Oculus Rift sought investment from accredited investors, the risk appeared too great. When the company shifted gears and ran a Kickstarter campaign, 9,522 backers provided $2,437,429 in funding.

The act of crowdfunding itself provides a wealth of information that traditional investors can use to evaluate the viability of products and services. What better proof is there than customers willing to buy something that doesn’t yet exist?

It also offers traditional, accredited investors a sample of customers who have already used the product; helps demonstrate the company’s ability to produce and deliver on its claims; and provides a sense of how company management performs under pressure. And because crowdfunding campaigns have a fixed duration, they can provide a more predictable timeline to market: If it works, great. If it doesn’t, move on to Plan B.

Investor Matchmaking

The new digital landscape also offers opportunities to traditional, accredited investors. Typically, a website — such as AngelList or IdeaCrossing — will establish itself as a market maker by meeting SEC requirements. These websites have garnered significant coverage in the media as of late; some specialize in specific sectors such as entrepreneurship in emerging nations or social impact startups.

Once an individual is confirmed to be an accredited investor — with annual income over $200,000 and/or a net worth of $1 million, among other requirements — they can register on these sites and connect with companies.

The rise of this model has spawned some interesting trends: Often times, a well-known angel investor will commit dollars to the company, then promote their support of the company to their connections. Ideally, this will result in a wave of additional support. Without such a benefactor, these websites still offer startups significant value through a centralized, digital system that integrates fundraising documents and other key information.

Retail Crowdfunding

Where investor matchmaking services and mainstream platforms fall short, retail crowdfunding may fill in some gaps, allowing unaccredited investors to buy actual stock in emerging companies. These opportunities, unsurprisingly, come with a laundry list of requirements: Companies can only raise up to $1 million. No one individual can invest more than $100,000. Individual investment caps are also placed on individuals at different income levels. To make matters worse, these limitations apply to all private investment, not just the current company's offering.

For technology-based early-stage companies in particular, retail crowdfunding presents complexities and bureaucracy that may stifle its efforts to secure follow-on funding. (It's estimated that it can cost between $50,000 and $100,000 to satisfy these requirements.) For companies that don't anticipate needing more than $1 million in investment annually, retail crowdfunding may prove a viable option.

Ultimately, the new legislation and landscape offer entrepreneurs another way to raise money and build their companies — that's a good thing. But planning, documentation, reporting and communication are poised to become make-or-breaks for startups moving forward. It's a brave new world.