How crowdfunding became a credible way to sound out your market

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No longer just for bands looking to tour, or for startups lacking access to financing, crowdfunding has become a way to sound out the market for innovative businesses

Crowdfunding has enjoyed a rapid rise among startups, generating a new path for entrepreneurs to become an overnight success. Once a niche and assumed risky practice, crowdfunding sites such as Kickstarter and Indiegogo provide a platform on which entrepreneurs, companies and artists raise funds for creative projects, ranging from disruptive new gadgets to contemporary dance performances. Investors, individual or institutional, can buy products and donate to projects.

Over the past 20 years, crowdfunding has evolved from a small personal funding platform – it was, for instance, used to fund British rock band Marillion's reunion tour in 1997 – to a comprehensive validation tool for startups, corporates and artists. Funds raised from crowdfunding last year passed venture capital financing for the first time. The World Bank forecasts global investment through crowdfunding platforms will reach $96 billion by 2025. Goldman Sachs said in a report published in

2015 that crowdfunding was “potentially the most disruptive of all the new models of finance”.

While people commonly think financial constraints are the main reason entrepreneurs turn to crowdfunding, recent empirical evidence suggests otherwise. In a recent research paper, we developed a model to understand why reward-based crowdfunding is so efficient.

We emphasised that, in addition to providing funding, reward-based crowdfunding platforms play an important role in enabling startups to learn about demand for their product or service before making investment decisions. Pre-selling through crowdfunding platforms can be a credible consumer survey; it provides new and valuable information about future sales prospects. Because of that, a startup can hedge its bets by only developing a project after it observes sufficiently high consumer demand — and save on the investment cost if demand is low.

As of January 2017, 61 per cent of the $2.5 billion raised through Kickstarter was collected by startups that produced tech, design or gaming products

This argument explains why firms that develop consumer products involving a high degree of demand uncertainty, such as gadgets and computer games, have the most to gain from crowdfunding. After all, high prior uncertainty implies crowdfunding campaigns are likely to both fail and raise funds multiple times over the target with a high probability. Yet, as of January 2017, 61 per cent of the $2.5 billion raised through Kickstarter was collected by startups that produced tech, design or gaming products.

In our research, we showed that learning about demand mitigates the well-known moral hazard problem, whereby startups may be tempted to divert the funds they raise through crowdfunding platforms, instead of delivering the products as promised. If a startup can see high consumer demand for their product during their crowdfunding campaign, they are more likely to push ahead with its development, expecting it to sell well. Indeed, we showed the higher the funds raised during a short crowdfunding campaign, the fewer incentives there are for entrepreneurs to divert them.

Our model suggests certain project characteristics can incentivise entrepreneurs to deliver: investors should be more confident when campaigns have ambitious targets, are short, and are on prominent third-party platforms.

While demand uncertainty itself is sufficient to create value, startups can learn additional things about consumer preferences from a crowdfunding campaign — such as whether a buyer prefers a red or blue watch, say, or which new levels they like in a smartphone game – which creates even more value.

Pre-selling through crowdfunding platforms can be a credible consumer survey

Crowdfunding success can also open access to venture capital and angel investment; a company's participation in crowdfunding may alleviate the moral hazard and asymmetric information problems that prevent a firm obtaining financing from traditional outside financiers. Indeed, there are many examples of firms doing so, such as Kinsa, which raised about $140,000 for a 'smart' ear thermometer via Indiegogo, after which it received multiple seed rounds and a $9.6 million Series A from a group of investors including Kleiner, Perkins, Caufield and Byers.

Investing can still be risky. There have been high-profile crowdfunding flops, such as Central Standard Timing, which raised $1 million on Kickstarter to produce the "world's thinnest watch" before filing for bankruptcy in 2016. Because entrepreneurs receive funds from a crowdfunding campaign in advance of the completion of their product, there is a risk investors will not receive their desired product.

Yet, cases of failure and fraud are small in number when compared with projects that deliver. Analysis by Professor Ethan Mollick of Wharton School found that 65 per cent of Kickstarter projects delivered on time, while only nine per cent failed to deliver their rewards.

Our model highlights why a low failure rate is unsurprising. The opportunity to learn about demand itself creates powerful enough incentives for entrepreneurs to prefer to invest and deliver, instead of resorting to short-term gains by diverting funds.

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Gilles is a Professor of Finance at Imperial Business School, a research fellow at Centre National de la Recherche Scientifique, a research fellow at Centre for Economic Policy Research (CEPR), a programme director at CEPREMAP (a French equivalent to CEPR), and a member of the American Finance Association, American Economic Association, Western Finance Association, and European Finance Association. He has also worked in corporate finance at BNP Paribas, as an independent consultant for a variety of corporate, financial, and governmental institutions and professional and international organisations, and as an Assistant Professor of Finance at the Sauder School of Business, University of British Columbia. Gilles holds a PhD in economics from the London School of Economics, an MSc in economics from the Paris School of Economics, a degree in mathematics from the University Paris-Diderot, and is a graduate engineer from the Ecole Nationale des Ponts et Chaussées

Read Gilles's Imperial Profile for more information and publications.

About Katrin Tinn

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Dr Katrin Tinn is an Assistant Professor of Finance at Imperial Business School. Her research focuses on applied theory in technological innovation, financial economics, information economics. Her particular research interests include interaction between financial markets and innovation, financing innovation, economic growth, Fintech, and quantitative trading. Her most recent work is on reward-based crowdfunding, and on smart financing contracts on Blockchain. Her research has been published in the American Economic Review.

In addition to academic positions, she has also worked in commercial banking and asset management, the European Central Bank, the International Monetary Fund, and the European Bank for Reconstruction and Development.

Dr Tinn holds a BSc in Economics from Tallinn Technical University, a BA in Art from Estonian Academy of Art, a MSc in Economics from University College London and a PhD in Economics from London School of Economics. Her research focuses on applied theory and her research interests include financial economics, rational expectations, economic growth, technological innovation, information imperfections in financial markets, the relationship between equity markets and aggregate economy, trading incentives of financial institutions, asset market anomalies, international finance and trade, and the role of imperfect information in elections. Her research has been published in the American Economic Review, the top peer-reviewed journal in Economics.

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