Study on Operation Mode and Risk of Equity Crowdfunding Platforms in China

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Chunya Zhao[1]*, Rui Liu[2], Lei Zhou[2]
[1]School of Business, Suzhou University of Science and Technology, Jiangsu, China
[2]School of Business, Suzhou Vocational University, Jiangsu, China
***Corresponding author, e-mail: 996244915@qq.com**

Abstract

The rapid development of the mobile internet has brought enormous entrepre-neurial opportunities to various industries. The rise of angel investment and equity crowdfunding has enabled entrepreneurs to obtain funds and resources quickly. Crowd-funding was first appeared in the United States. Fundavlog is the first crowdfunding plat-form named by Michael Sullivan. On this platform, the promoters make related financing through the way of playing videos. There are four modes of crowdfunding, including debt crowdfunding, product crowdfunding, equity crowdfunding and public welfare crowd-funding. After that, giants in China such as Jingdong Group, Taobao Group and Suning Group also entered the equity crowdfunding industry. JD Crowdfunding Platform launched "JD Dongjia", using the "lead investment + follow-up investment" model to achieve the combination of product crowdfunding and equity crowdfunding.

Keywords

Equity crowdfunding; Internet finance; Operation mode; Lead investor

Introduction

Crowdfunding is public fundraising or crowdfunding. It is a new type of financing for the purpose of matching the investment and financing sides. It uses the Internet information platform to promote and fully utilize the function of social media on the Internet. It is a relatively active branch of Internet finance and has gradually become an important investment and financing channel for individual investors and entrepreneurs. The milestone for the modern start of the modern crowdfunding model was the establishment of the integrated crowdfunding platform IndiGoGo and the Kickstarter creative solution crowdfunding website platform in 2008.

Crowdfunding model platform in China includes Internet equity crowdfunding, non-public equity financing, and other platforms for Internet equity crowdfunding business. From 2011 to 2013, during the gestation period, the earliest Internet non-public equity financing platform in China, Angel Exchange and Venture

Capital, went online as a starting point. 2014-2018, the high-speed growth period, starting from 2014. Before 2014, there were less than 10 new platforms added each year. From 2014 to 2016, although it experienced a special rectification of Internet finance in 2016, the number of new operating platforms each year is more than 30.

Drivers of China's Equity Crowdfunding Development

The status of China's crowdfunding platform

As of the end of 2018, China Crowdfunding has reached a total of 854 domestically launched crowdfunding platforms, including 3 online platforms in 2011; 11 online platforms in 2012; 20 online platforms in 2013; 2014 The number of platforms has surged, and a total of 169 new platforms were established throughout the year; the number continued to increase in 2015, with a total of 289 platforms launched online, accounting for 33.84%; and 283 equity crowdfunding platforms established throughout 2016 33.14%; In 2017, due to the outbreak of Internet financial risks and stricter supervision, the overall number of platforms tended to decrease. As of the end of 2018, there were 251 platforms in operation.

Financing demand drives crowdfunding development

The rise of crowdfunding financing models, on the one hand, benefits from the maturity and progress of software and hardware technologies in the era of information digitisation. Intelligent hardware and software, network humanities and arts have become popular in entrepreneurship, and crowdfunding websites have also evolved into a comprehensive platform that integrates information release, capital transactions, social networks and entrepreneurial services. On the other hand, China's financial system as a whole is underdeveloped, with long transaction cycles, complicated processes, and high financing costs. Angel investors and venture capital institutions are overly conservative. It has spawned the demand for low-cost and convenient financing for entrepreneurs and small and micro-enterprises. In addition to the financing function, the crowdfunding model also meets the needs of entrepreneurs and small and micro-enterprises for market research, product release, and market promotion to a certain extent(Belleflamme, Omrani & Peitz, 2015).

The operating mode of China's equity crowdfunding Platform

The main participants of the crowdfunding platform

The equity crowdfunding platform is a way to realize equity crowdfunding activities. There are mainly three types of people involved in the actual operation of equity crowdfunding; promoters (fund raisers), investors (GP and LP), equity crowdfunding platforms; platforms are sponsors and support Internet terminal for liaison and transactions. Figure 1 clearly illustrates the relationship between all parties involved in equity crowdfunding activities (Kuppuswamy & Bayus, 2018).

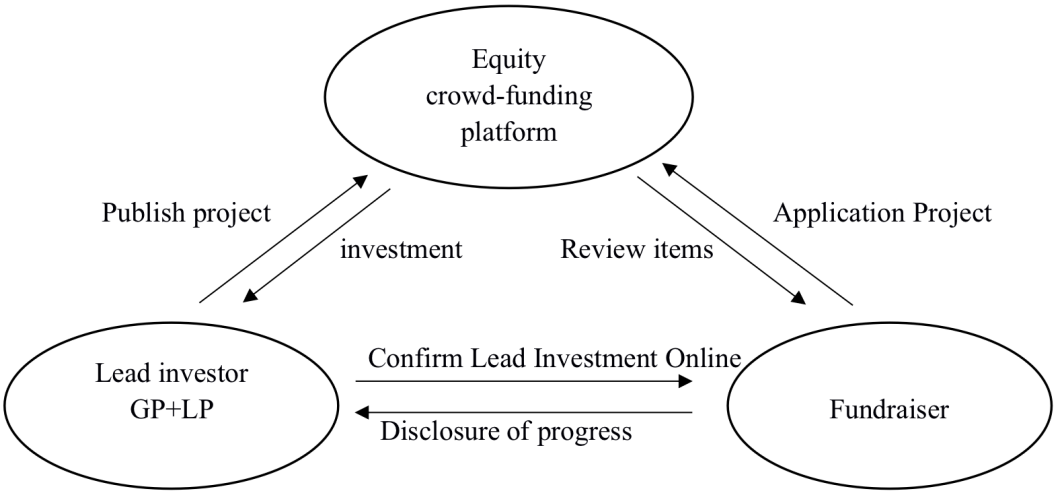


Figure 1. Function of equity crowdfunding platform

GP + LP mode

The equity crowdfunding platform needs to go through the project screening stage, and then interview the financier, so the platform plays a screening role for entrepreneurs and their projects. Then, the platform will lead the match to determine the lead investor. The lead investor is the basis for most equity crowdfunding platforms to carry out follow-up activities, and complete the process from investment to exit to obtain income. The equity crowdfunding investment process shown in Figure 2:

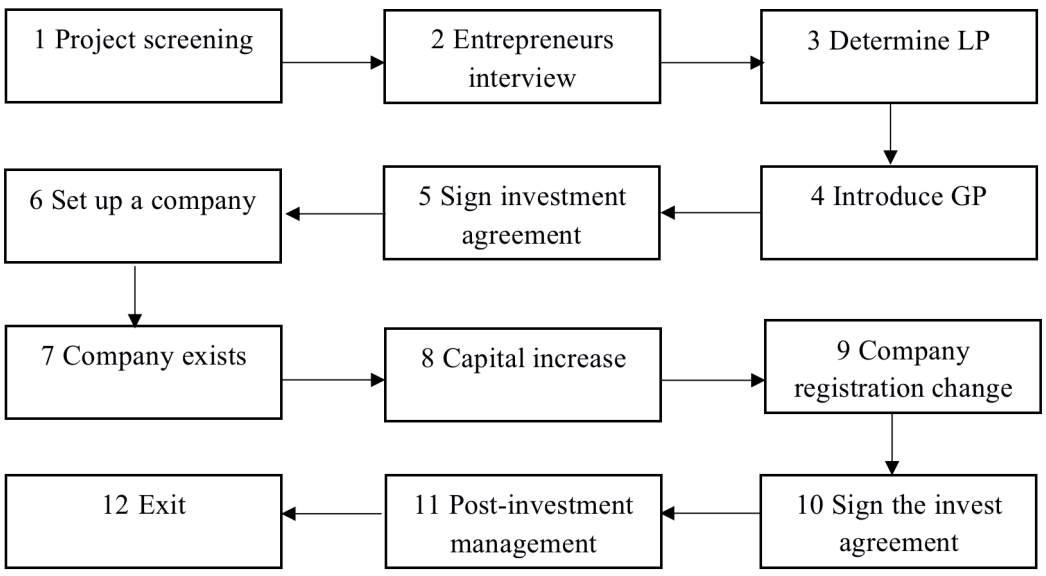


Figure 2. The investment process of Equity-based Crowdfunding

From this we can see: There are different kinds of types of subjects in GP .GP determines the decision-making power of the fund. Although there are huge people and the large amount of funds, the rights of LP are left to the management of the GP, which is jointly managed by the GP and the LP. The formation of limited partnerships and financing companies can manage new projects. The LP approach adopted by equity crowdfunding has dispersed the concentration of equity (Mollick, 2014).

Jingdong Dongjia's model

Jingdong Dongjia is an equity crowdfunding platform that has obtained a public offering license. Its operating model adopts the most typical lead + follow-up (GP + LP) model. The financier will declare the project to the Jingdong Dongjia platform. The lead investor selects the intentional investment project. There is a three-day quiet period after the investor selects the project. During these three days, the lead investor can abandon the investment at any time. After deciding to invest in the project, GP organizes a third-party investigation agency to conduct due diligence on the project and issue a due diligence report. After that, GP assists the financier to improve the "Finance Project Business Plan", and discusses with the floating capital to determine the valuation method. However, the initial valuation, investment terms and financing amount are determined (Li, 2018). For example, the financier transfers 10% of the equity and raises 1 million funds. Therefore the initial valuation of the project is 10 million. GP as a lead investor generally claims 20% of the shares. That is to invest 2 million yuan.

Subsequently, the GP assisted the financier in the project show and raised the remaining funds from the LP. After determining the LP for most of the funding sources, the platform will show the progress of the project on its webpage. The platform then opened the subscription of investors and confirmed payment; The subscription was successful. When the project is financed successfully , the GP will also assist the financier to improve the necessary information disclosure of the financing project. The third party will be transferred to the company to conduct an on-site investigation, and finally complete the transfer of funds from the platform to the financier and complete the delivery. The GP investors bears the obligation of post-investment management of the project, while enjoying the right to collect management fees and excess income. However, there are many LPs in equity crowdfunding, and the uncertainty is high. Someone may withdraw at any time, and the management of the GP is very difficult. After the project of the Jingdong financier passes the review, Jingdong will sign a financing agreement with it. When the project is successfully financed, the financier will pay service commissions to Jingdong according to the amount and method agreed in the agreement; the financier unconditionally agrees that Jingdong has the right (but no obligation) The service commission to be collected will be invested into the financing project company at a discount according to the valuation of the financier company after this round of financing (Tan, 2017).

Equity crowdfunding investor income

Equity crowdfunding companies are generally in the angel or venture capital stage, have higher operating risks. The exit methods include transfer, merger, repurchase, or exit when the company enters the next round of financing , But because of the small audience and poor bargaining power, the transaction price has a range of changes. If the financing enterprise fails to continue operations and declares bankruptcy after the financing

is successful, the investor will bear the loss with the full amount of capital. This situation is common in equity investment.

The Risks and Sources of Equity Crowdfunding

Because the investment experience of equity crowdfunding investors is relatively poor, and the right to speak is relatively weak in the cooperation with GP, equity crowdfunding investors will face more risks. It can be summarized as follow:

The risk of rational investment

Most investors have no ability to make investment judgments. In most cases, invest invest according to the intuition and others' recommendations.Under the recommendation of marketers, regardless of investment risks, they blindly seek high returns and choose high-risk investment projects.

Project operation risk

Theoretically, too many shareholders will bring the risk of project management. The inevitable result of equity crowdfunding is that there are a large number of shareholders, and it is difficult to reach a consensus resolution. Although it is connect through the Internet, it still needs to return to the actual operational process. GP legally and compliantly manages investor relations and is equity crowdfunding. One of the high risks in the investment process.

Joint fraud risk

The risk of joint fraud mainly occurs between the project party and the crowdfunding platform or between the project party and the lead investor. The revenue of the crowdfunding platform mainly receives commissions by matching financing for the project side. Therefore, both the crowdfunding platform and the project party have common interests.This kind of fraud will be masked by the characteristics of equity crowdfunding, such as long return cycle, high return uncertainty, and investors 'own risk. It is generally difficult to blame and recover losses.

Equity crowdfunding lacks a relatively complete exit mechanism

First, the crowd-funded enterprises have poor liquidity, and it is difficult to circulate through public transfers to achieve the withdrawal of existing shareholders. They only rely on internal buybacks or transfers by acquaintance agreements; However, it is difficult for startups and small and micro-enterprises to realize equity custody transactions or public offering of the New Third Board in a short time; The procedures are relatively complicated, the number of shareholders of equity crowdfunding is relatively large, and operation is not very convenience .There are significant barriers and limitations for the withdrawal of natural partnership shareholders of limited partnerships.

GP damages the interests of LP

In the equity crowdfunding investment model, the cooperation between GP and LP, there are many places where GPS may harm LP, because in equity crowdfunding investment, the general investment ratio of GP is only 1% -2% of the total funds raised by the project. Even if only a small amount of capital is required, in practice, it is often the case that the GP does not invest according to the proportion of committed capital, which damages the interests of the LP. In addition, GP fund managers charge a certain percentage of fund management fees every year. The high platform fees and intermediate fees are paid by the case company, which indirectly dilutes the assets of the LP investors (Yao, 2018).

Single exit mechanism

The investor exit mechanism means that when crowdfunding companies cannot continue to develop healthily, they will convert the capital form they invested capital to avoid and reduce losses. Jingdongdongjia platform and most of the domestic equity crowdfunding platforms, the single exit model has seriously affected the development of the crowdfunding industry. Most of the equity crowdfunding projects are initial entrepreneurial projects, and their risk coefficients are relatively high and uncertain. After JD equity crowdfunding projects are successfully launched and funded, their subsequent completion rate is low, and the success rate of other domestic equity projects after launch is also less than 10%, so the actual completion of equity crowdfunding projects is not as good as product crowdfunding. Besides, after the completion of the equity crowdfunding financing project, the uncertainty of its later development is also high risk. Therefore, when the operating status of equity crowdfunding financing projects is lower than the expected estimates of investors and fundraisers, investors need to have the opportunity to invest equity projects. At present, the exit mechanism of the equity crowdfunding industry in China is single or even unable to complete the exit. The lack of a sound exit mechanism in the industry makes investors face the risk of exiting their investment projects when investing in equity crowdfunding projects. From a protection perspective, the lack of an exit mechanism will also adversely affect investors.

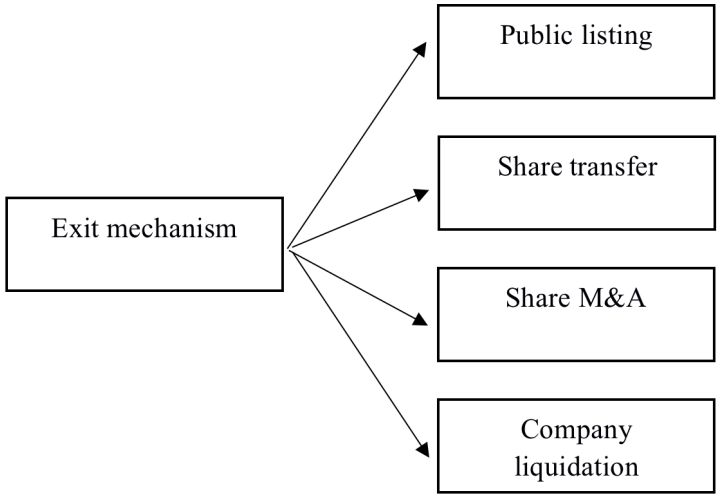


Figure 3. The exit mechanism of Equity-based Crowdfunding

The four common exit mechanisms are shown in Figure 3: Public listing (IPO), share transfer, share merger, share repurchase and liquidation exit. Among the four exit mechanisms, ordinary investors are more inclined to list in the IPO. By selling stocks on the secondary stock market, venture capital is recovered, and investment income is realized in the process. When the financial and profitability of the crowdfunding project company is good, and the market level is not up to the standard, the share repurchase method can generally be selected to enable investors to withdraw their risk funds. Introducing an appropriate exit method in the crowdfunding industry will reduce risks. Choosing an appropriate exit method will ensure the participation of all parties in the crowdfunding. Exiting unsuccessfully or less than ideal equity projects in time can improve project quality and improve future crowdfunding financing Success rate.

Equity Crowdfunding Risk Measures

Conduct Optimize credit management system

Incorporating crowdfunding information into the corporate credit information system and promptly disclosing corporate defaults in the crowdfunding process can alleviate the credit risk of crowdfunding to a certain extent. Through information disclosure, companies intensify financing costs due to untrustworthiness, forcing companies to keep their promises when participating in crowdfunding. In addition, the project founder's project manager and project results are written into the credit information system, so that the project sponsor and project leader can organize the historical performance of the project. It has positive significance for regulating China's crowdfunding financing market.

Establish standard access standards for crowdfunding platforms

The crowdfunding platform is the foundation and core of the crowdfunding operation model. Many factors such as the platform's website architecture, management personnel, risk prevention, operation process, qualification certification and other factors directly determine the success of crowdfunding projects and the safety of crowdfunding funds. Start with the three main aspects of registered capital, management staff limitation, and business management system, and report to the regulatory agency for the record at the beginning of establishment, and incorporate it into the formal regulatory system. A higher access standard and a complete access process can eliminate credit risks and operational risks caused by poor platform management and poor management at the source. The access standards are conducive to protecting the rights and interests of both parties in investment and financing, building market confidence, and increasing the enthusiasm of the participants.

Crowdfunding business incubation support

The essence of crowdfunding is entrepreneurial venture capital, but it lacks later management and support plans for enterprise projects. Crowdfunding should be a supplementary channel for financing and a process of supporting startups at the same time. Equity crowdfunding should work hard in post-investment management, because the investors who participate in the project use equity as a return, and the company's operating results during the continuous period are related to the return. Investors can use their industry experience and

resources to participate in business operations, support enterprise product research and development, promote listing and capital market operations. At present, under the "leading investment + co-investment" model of Angel Exchange, the lead investors generally enter the company and pay attention to the needs of the company for a long time.

Improve management and exit mechanisms

Investors in equity crowdfunding cannot monitor the selection of projects, GPs and financiers. Starting with the management and exit process, especially by attaching importance to the agreements you have signed to constrain the financiers. In the dividend distribution phase of management, although the law does not provide for mandatory dividends, crowdfunding shareholders can stipulate mandatory dividend clauses in the company's articles of association, that is, if it exist the after-tax distributable profits, they must be distributed to crowdfunding shareholders every year on the set date; At this stage, the majority of domestic equity crowdfunding platforms have a single exit model that seriously affects the development of the crowdfunding industry. A limited partnership company must clarify the internal transfer mechanism, the distribution mechanism of benefits during equity transfer, and the post-list equity transfer and exit mechanism in the partnership agreement, which can also avoid the investor ’s free sale of equity due to inappropriate equity exit timing (Macht & Weatherston, 2015).

Strict investor review and full investor education

Strict investor review and full investor education. There are risks in any investment. Risk and investment are twins . Therefore, the first thing to do as an equity crowdfunding platform is to disclose the risks of investing in equity crowdfunding and set the threshold for participation in equity crowdfunding. Investors can be reviewed in several ways. The first is the level of income or the assets currently held can reach the middle class or above, and the funds involved in equity crowdfunding can only account for part of their income or assets to ensure investment. Failure will not affect the investor ’s minimum living security; the second is to review the investor ’s ability to identify risks, mainly through the investor ’s past investment case or the occupation in which he is engaged.

Conclusion

Crowdfunding provides low-cost financing methods for small and micro-enterprises with high efficiency and speed. China's crowdfunding industry has achieved rapid development. The four types of crowdfunding models have begun to take shape in the Chinese market, and a series of specific issues such as their operating procedures, capital management, and exit mechanisms have been gradually explored .Through the above analysis, we can initially understand the general situation of equity crowdfunding and the business positioning and operation process of the operation model of China's equity crowdfunding platform. With these comparisons and analysis, we conclude that equity crowdfunding has rational investment risks and project operating risks , Investors' income risks, joint fraud risks, and the main sources of risk. Finally, in response to these risks and the actual situation of China's equity crowdfunding and financial environment, four suggestions are put forward: one is to conduct strict investor audits and adequate investor education, the

other is to improve management and exit mechanisms, and the third is to optimize The fourth is to integrate the rights and obligations of the lead investor in the credit management system. The crowdfunding industry needs to establish a standardized crowdfunding platform access during the operation process, and relevant departments of the standards provide incubation support for crowdfunding enterprises, and jointly establish a perfect exit mechanism. Equity crowdfunding is the new direction of Internet finance development in China and the equity crowdfunding platform is the sailing boat to this direction. The equity crowdfunding platform needs to adjust constantly and improve its own operation model according to market development trends, but also needs to focus on risks, establish a sound risk control mechanism, and gradually explore the process In the meantime, the regulatory authorities have summed up their experience from the state of continuous wait-and-see and formulated management regulations and methods suitable for China's crowdfunding market.

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