EQUITY CROWDFUNDING AND PEER-TO-PEER LENDING IN NEW ZEALAND: *The first year*

JAMES MURRAY, Senior Lecturer, Department of Business, Christchurch Polytechnic Institute of Technology

Equity crowdfunding and peer-to-peer (P2P) lending in New Zealand is authorised under the Financial Markets Conduct Act 2013 *(FMCA) with the relevant sections taking effect from 1 April 2014. Over the following year, one P2P lender and five equity platforms gained licences, and 16 companies also launched equity crowdfunding campaigns raising over $6m.*[1] *While this represents a tiny fraction of New Zealand's financial market, financial crowdfunding has grown rapidly in overseas markets (Baeck et al. 2014) and it would become part of the mainstream financial services industry if similar growth were to occur in New Zealand.*

Types of crowdfunding

Crowdfunding is designed to raise funds through small contributions from a large number of individuals (the crowd). While modern internet and communications technology makes it easy for individuals and companies to contact people directly, in practice, the use of intermediary crowdfunding platforms can be more efficient in providing a central marketplace. Furthermore in New Zealand the FMCA stipulates that financial crowdfunding must take place through a registered platform.

There are four types of crowdfunding: donation, reward, lending and equity. *Donation campaigns* seek funds for charitable and social projects. Funds are provided with no expectation of financial or material returns. *Reward campaigns* seek funds to support a personal or small business project. This can include businesses raising funds to create new products or services, which are provided to supporters as a non-financial reward. Reward crowdfunding is not subject to any special laws or regulations but when projects involve the pre-sale of goods or services they are subject to existing laws and regulations affecting sales and credit transactions. The main focus of this paper is financial crowdfunding through *peer-to-peer* (P2P) *lending and equity crowdfunding*. P2P lending services link borrowers to lenders, equity crowdfunding links companies to new shareholders, and as both facilitate investment activities they are subject to financial regulation in New Zealand.

Crowdfunding regulations

New Zealand's securities laws are based on the idea that issuers need to disclose sufficient information for public investors to make informed investment decisions (Griffiths 2013). However, this can be a barrier to small businesses raising funds as the costs of producing a prospectus and committing to ongoing disclosure are high relative to the amount raised. Internationally, equity crowdfunding exists where the securities laws allow exemptions, or where laws have been changed to allow crowdfunding. For example, in Australia, specific crowdfunding rules are yet to be introduced; under existing securities laws equity crowdfunding is restricted to qualified investors and a limited number of the general public, resulting in a somewhat smaller crowd.[2]

While it was theoretically possible to undertake that type of private-equity crowdfunding in New Zealand before the FMCA took effect, it was costly and risky to do so. Issuers making a private offer could provide less disclosure, but if that offer was mistakenly made to one member of the public then the entire offer was deemed to be an offer to the public and therefore void in the absence of a registered prospectus and investment statement. Similarly P2P lending was not possible in New Zealand before the FMCA, as the broad wording of the *Securities Act 1978* classified P2P loans as public offers.[3]

Regulatory changes were made to authorise financial crowdfunding following the introduction of the *Financial Markets Conduct Act 2013*. The FMCA replaces most existing financial legislation, including the *Securities Act 1978*, which covered the primary issue of securities, and the *Securities Markets Act 1988*, which covered secondary trading (Griffiths 2013). The key change that makes financial crowdfunding viable is exempting issuers from producing prospectuses and investment statements[4] when making a regulated offer through an equity crowdfunding platform or P2P lender. These changes are not simply a relaxation of financial regulations but reflect a trade-off between different forms of regulation. Reduced disclosure recognises that standard financial disclosures by new and high-growth companies have little value, so they have been replaced by mandatory use of licensed crowdfunding platforms and a $2m limit on the amount that can be raised.

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P2P lending

P2P lending has some superficial similarities to banking in that the crowdfunding platform is an intermediary seeking funds from investors for borrowers. However, P2P lending platforms differ from banks in that they do not take deposits and do not provide asset transformation or maturity transformation. Instead the platform acts as a broker between borrower and investor. It is important for investors to understand that although these are registered financial service providers, P2P platforms are not registered banks and cannot provide the same safeguards that banks provide to depositors.

Unlike banks, P2P platforms let lenders choose who borrows their money, allowing them to select higher risk, higher expected return investments. Harmoney, New Zealand's first (and currently only) licensed P2P lending platform, assesses each borrower's credit risk and allocates a risk grade from A1 to F5. Each grade corresponds to a fixed interest rate, from 9.99 per cent for A1 borrowers to 39.99 per cent for F5.[5] Lenders are informed about each borrower's general demographic profile, risk grade and intended use of funds. Lenders using 'Manual Invest' select which borrowers they want to lend to and allocate funds in $25 multiples. Lenders using 'Quick Invest' can specify their risk-return preference and Harmoney will allocate funds to borrowers on their behalf. P2P platforms benefit borrowers who either cannot borrow from conventional lenders or would be charged higher rates (Hollas 2013). While both consumer and business P2P lending is found in other countries, Harmoney in New Zealand only serves resident personal borrowers. Personal borrowers may seek funds for business purposes but Harmoney's $35,000 loan limit means it is unlikely to provide much benefit to any but the smallest businesses.

The P2P market is still in its initial growth phase with new providers looking to enter and develop the market.[6] There is demand for mortgage finance in the $100,000 to $499,999 range (HorizonPoll 2015). Although it is unlikely that many investors will be willing to invest for the full term of a conventional mortgage bridging loan, for home owners purchasing a new house (but have not yet sold their existing house) this sort of loan could interest P2P lenders.

Potential new entrants to the consumer P2P lending market will be competing with Harmoney (which has first-mover advantage), but could compete by targeting a different market sector or by providing different features. For example, Harmoney's model involves setting interest rates according to the borrower's risk profile, but rejection rates are very high. United States P2P lender Prosper has until recently used an auction approach to set interest rates. The auction approach allows greater flexibility in setting the interest rate and therefore increase the chances of the loan being funded, although it is likely to produce higher-cost loans than when P2P lenders use set interest rates (Chen et al. 2014).

As at April 2015, there were no licenced P2P lending platforms providing business loans in New Zealand. Possible new entrants to this market could come from: consumer P2P lenders moving into business loans; equity platforms adding a P2P service; or from a stand-alone provider. Harmoney's CEO has stated that they are more likely to move into the mortgage market than business lending (Vaughan 2015). For now it appears the most likely development is for an equity platform to add P2P lending. In the United Kingdom Crowdcube offers both equity crowdfunding and P2P business loans and their New Zealand operation may choose to follow this format. Also, My Angel Loan Limited has announced their intention to register as a P2P platform for business loans (My Angel Loans 2015).[7]

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Equity crowdfunding

Investing in companies through equity crowdfunding is risky, as there is no secondary market for shares[8] and valuations for growing companies is speculative. Funds could be wasted though poor management or wealth expropriated through future share issues at less than fair value (Cumming and Sofia 2013). On the other hand, equity crowdfunding is not just about financial returns. A common feature of equity offers is the inclusion of non-financial benefits, similar to those used in rewards campaigns. For example, The Patriarch Investment Company, raising partial funding for a film, offered a range of rewards across seven different investment levels. Rewards included copies of the script, visits to the film set and an invitation to the opening night. However, the list of their top 20 shareholders (Companies Office 2015) shows nobody invested the $100,000 required for an associate producer credit on the film.

One of the non-financial benefits of equity crowdfunding for companies is that it provides an opportunity for greater interaction with stakeholders by making it easier for them to become shareholders. This can enhance business ties with suppliers, make customers stronger brand ambassadors and can appeal to people wanting to support local businesses (Cortese 2011). Potentially, companies with strong consumer bases also have a ready-made crowd who can be approached for funding.

With a $2m funding limit, New Zealand's equity crowdfunding market provides small- and medium-sized enterprises with an alternative to fundraising from venture capital and angel investors but it will not compete with the stock exchange's main board for large capital raisings. While the relationship between the equity crowdfunding market and the exchange's new NXT market remains to be seen, crowdfunding can complement the NXT rather than compete with it.[9] It is interesting to note that three of the companies seeking equity crowdfunding have post-money valuations of around $10m as the NXT is aiming for companies with market capitalisations of between $10m and $100m.

Another feature of some issues (11 of the 16 offers) is the use of non-voting shares. Non-voting shares help the company avoid the provisions of the Takeovers Code.[10] Code companies face restrictions on any transaction involving shareholders owning more than 20 per cent of the company, so avoiding the code is logical for small companies where most of the shares are still closely held. However, investors buying non-voting shares are placing a high level of trust in the founding shareholders acting ethically. The code's application to small business is under review, so the sale of non-voting shares may become unnecessary.

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The platforms

In the year to April 2015 New Zealand licenced five equity crowdfunding platforms, see Table 1. The Snowball Effect Limited and Pledgeme Limited were the first equity platforms to be licensed and they have also been the most active. The Snowball Effect was the first to launch a campaign and, in the year to April 2015, had the largest number of completed campaigns and raised the most equity.

Pledgeme is an established donation and reward crowdfunding platform which added equity crowdfunding. Its history in project crowdfunding gives it an established presence and crowd that the other platforms do not have. However, that is not necessarily an advantage as Pledgeme will need to find the right balance between the different forms of crowdfunding. It is possible that the introduction of equity crowdfunding will undermine rewards crowdfunding as people who had previously funded rewards campaigns may start to withhold funding unless offered an investment stake (Cholakova and Clarysse 2015). By offering both, Pledgeme is hedging the risk that rewards crowdfunding loses market share.

Equitise Limited is the only other platform to launch an equity campaign in the first year. Equitise is an Australian company which is also planning to offer public equity crowdfunding services in Australia when regulations allow it. My Angel Investment Limited also plans to operate on both sides of the Tasman. However, for now, both companies are only offering services in New Zealand. Crowdarm Limited (operating as Crowdcube) is a joint venture between Crowdcube Limited and Armillary Private Capital. Crowdcube operates an established equity crowdfunding platform in the United Kingdom. Armillary is an established New Zealand investment services provider and is behind the Unlisted share trading platform. So, although the equity platforms are currently prohibited from offering secondary trading, Crowdcube can offer this through an associated company.[11]

TABLE 1: New Zealand's equity crowdfunding financial service providers

Platform	Authorisation Date	Campaigns (as at 31 March 2014)			
		Successful	Unsuccessful	Ongoing	Total
Pledgeme	30 July 2014	2	2	5	9
Snowball Effect	30 July 2014	5	0	1	6
Crowdcube	4 November 2014	0	0	0	0
Equitise	22 December 2014	0	0	1	1
My Angel Investment	16 March 2015	0	0	0	0
		7	2	7	16

Sources: http://www.fma.govt.nz/, http://www.business.govt.nz/fsp and company websites.

Comparison of The Snowball Effect and Pledgeme platforms shows they are serving distinct market segments. Statistics reported in Table 2 show companies using The Snowball Effect are larger, more established and seek larger amounts; however, the relative size of the ownership stake offered shows no significant difference between the two groups.

TABLE 2: Comparison of Snowball and Pledgeme campaigns[12]

	Pledgeme	Snowball	
	Mean value	Mean value	t-statistic
Offer period (days)	36.33	35.20	0.1504
Minimum funding target	$174,333	$520,000	4.7578**
Maximum overfunding cap	$441,029	$1,280,000	2.5439*
Minimum ownership offered	9.33%	7.14%	0.7746
Maximum ownership offered	19.15%	15.01%	0.9521
Pre-money valuation	$2,247,859	$6,723,678	3.0243*
Company age (days)	761.44	2135.60	2.2707*
Sample size	9	5	

Sources: www.snowballeffect.co.nz, www.pledgeme.co.nz, and offer documentation.
, significant at the 5% and 1% level, respectively.*

The campaigns

There have been some notable milestones and variations on the standard equity crowdfunding model that deserve mention. The first campaign, by Renaissance Brewing Limited, reached its upper limit of $700,000 in around 10 days, around one-third of the time allocated. Pledgeme has hosted the fastest campaign with Yeastie Boys Limited, a craft brewer, raising $500,000 in half an hour following an active social media campaign and investor information sessions to promote the offer. Pledgeme also raised $100,000 for itself within 24 hours. Breathe Easy Limited raised private equity funds before launching its campaign, which helped establish the market value and set the share price. It also meant most of the required funding was already in place and the crowdfunded component is mainly a bonus. Finally, the largest equity campaign, successfully reaching the $2m limit, was undertaken by Invivo Wines New Zealand Limited. This was the first campaign also offered through sharebrokers before the online offer, resulting in pledges of over $770,000 already in place at the start of the online campaign (The Snowball Effect 2015).

As the market grows, competition between competing campaigns will increase. So far, the Snowball Effect has largely managed to avoid running simultaneous campaigns, although its campaigns have overlapped with those from Pledgeme and Equitise.[13] Pledgeme has experienced many overlapping campaigns, from their first two launching on the same day to an apparent rush at the end of the financial year resulting in five simultaneous offers on the one platform. Whether overlapping offers are beneficial or problematic remains to be seen. If they are competing for limited investor funds then there is a problem, but they could benefit from increased investor attention as each company brings its own crowd to the crowdfunding platform.

Opportunities for future research

So far there have been too few campaigns, and too few failed campaigns, to statistically analyse the determinants of success. However, some possible influences can be identified, such as behavioural factors. For example, the two failed campaigns are notable for having the highest share prices. While a strict rational perspective would suggest there is no difference between buying 500 x $1 shares and one x $500 share, we should not be surprised if people were more likely to see the latter offer as more expensive, especially in a market where $1 share prices are common in initial public offers.

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Behavioural factors could also help explain the sequence and timing of pledges. If less sophisticated investors receive signals of offer quality from prior investors then cascade effects (where large pledges to a campaign make subsequent investments more likely and more rapid) should be observable. Success may also reflect conventional and social media activity raising awareness of the platforms and campaigns. Finally, with the absence of prospectuses and investment statements the quality and usefulness of information provided to investors should be examined.

Notes

1. All dollar amounts in this paper are expressed in New Zealand Dollar terms.
2. To distinguish between crowdfunding restricted to accredited investors and crowdfunding open to all investors the former is referred to as private-equity crowdfunding and the latter as public-equity crowdfunding.
3. Nexx New Zealand Limited has been trying to introduce a P2P lending service since 2007, but was not able to do this because the Securities Act disclosure provisions prevented the development of a low-cost model.
4. There is also no requirement for crowdfunding issuers to provide the new product disclosure statements, which are allowed under the FMCA from 1 December 2014.
5. Borrowers are also charged a platform fee of from 2 to 6 per cent of the loan amount. Late payment or default will lead to dishonour fees, and overdue and legal fees.
6. Possible new entrants include Lendme (lendme.co.nz) and Squirrel Money (squirrelmoney.co.nz).
7. My Angel Loan Limited is associated with licenced equity crowdfunding platform My Angel Investment Limited, having the same owners and directors.
8. Licencing conditions expressly prohibit equity crowdfunding platforms from providing secondary trading facilities, however, private sales by negotiation are possible.
9. The NXT market is also designed as a low-cost market for small- to medium-sized enterprises. Under the FMCA companies can raise funds without producing a full prospectus and, unlike the main board (NZX) and alternative market (NZAX), companies will provide periodic disclosure instead of continuous disclosure.
10. The Takeovers Code applies to companies with more than 50 shareholders with voting rights and more than 50 share parcels.
11. Unlisted's future viability is uncertain as under the FMCA it requires registration which will increase its compliance costs. It is currently seeking exemptions which would allow its compliance costs to remain low.
12. Data excludes The Patriarch Investment Company Limited, as this was a special purpose vehicle created immediately prior to its campaign and offering 100 per cent ownership, its data is an outlier in half of the variables examined in Table 2.
13. The Snowball Effect's first two campaigns would have overlapped if the first had not finished early; their campaigns for Invivo Wines and Breathe Easy did overlap.

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