Crowdfunding & Small Biz Lending Risk

by Steve Brown

Crowdfunding platforms are all the talk these days, and what a great idea they are - get some like-minded people together with a few spare bucks to chip in towards a good business idea. Here's a story that would seem to illustrate how well the idea could work.

In China, an entrepreneur borrowed $10,000 from a few friends and opened an eatery in the capital of the Hunan province some 13Ys ago. It has since become the largest restaurant in the world at almost 950,000 square feet and with 5,000 seats for diners. Staff totals more than 1,000 and 300 chefs prepare favorite dishes for patrons. The building resembles Beijing's Imperial City and there are specially decorated rooms for private occasions with the wait staff dressed in traditional garb. The place is booked solid nearly every night so you had better put it on your to-do list soon of you plan to visit China.

The reality of crowdfunding though is pretty different from this simple tale. Crowdfunding was born in the U.S. as a part of the JOBS Act of 2012. It allows small businesses to make a private equity or debt offering of up to $1mm each year to an unlimited number of investors. That sounds good, but there are some limitations on the percentage of net worth investors may put towards any one investment (but nothing like the accredited investor requirements necessary for most private equity investments). The idea is that anyone should be able to invest in a small company, regardless of their own net worth or experience. In a vacuum this may sound interesting, but the reasoning behind the accredited investor requirements is due to the fact that these types of investments tend to be very long term and higher risk. That requires more money to handle the illiquidity and a certain level of sophistication to understand the risks. Will the average investor have the patience for a start-up?

Because of its securities-like history and structure, it makes sense that crowdfunding is regulated by the SEC. The SEC has just proposed rules to govern recordkeeping, registration and compliance and is accepting public comment for 90 days before these new rules are finalized.

Here are some of the high points: If companies want to raise more than $500,000, they must undergo an independent financial audit. Any company that does crowdfunding must also make annual filings with the SEC and either have the transaction facilitated by a broker/dealer or use an online funding portal registered with the SEC.

The whole point of crowdfunding is to avoid the expense and hassle of a full blown public offering and to bring investing quickly and easily to the masses. While it's true there is no required offering memorandum, filing requirements under the rule make the process similar to that of being a broker/dealer. In addition, a company that uses crowdfunding and later decides to make a public stock offering would essentially be making a secondary offering (because there would already be a class of primary investors). In the end, these rules while updated make it unlikely that many companies will try to raise money using this channel.

It also seems unlikely that crowdfunding will be a channel banks would ever use to raise capital given all of this. However, be sure to monitor the comment period, because if it takes off, small business customers may go this route vs. coming in to get a loan. Keep watching and we will update you once things are final after the holidays.

BANK NEWS

Pressures

Research by Grant Thornton finds the top 3 concerns of bank executives and directors this year are persistent margin compression (89%), regulatory compliance burden (86%) and loan competition (78%). Another survey by the Fed found the biggest challenges bankers say they face right now are regulation burden (41%), margin compression (27%) and weak loan demand (14%).

Branches

An ESRI study in 2011 found the average age of a bank branch is 36Ys.

Customers

Research by Celent finds consumers over 60 that access their bank digitally do so most often using a desktop computer (72%), followed by a laptop (62%), traditional cell phone (44%), smartphone (41%) and tablet (36%). Those aged 45 to 60 were most likely to use a laptop (70%), desktop (69%) or smartphone (62%).

Web Search

Studies show an estimated 85% to 90% of all product research happens first through the internet. That is good to know for banks, but of note - only 2% of online customers ever bother to look at the second page of results. Your bank has got to come up on the first page of search results and it has to do so based on the key products and services you are trying to push to be relevant in a digital world

In Charge

A survey by BMO Private Bank finds 70% of men say they are in charge when it comes to which bank a couple will use, while 91% of women said they were in charge.

Regulatory Costs

ICBA reports the average compliance costs borne by community banks so far in 2013 (through 2Q) is $77k.

Directors

A PWC study finds companies that have a board of directors with women among their numbers deliver a 42% higher return on sales, 66% better return on invested capital and 53% higher ROE than boards made up entirely of men.