

Crowdfunding: Emerging Funding Source to MSMEs

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ABSTRACT

Micro, Small and Medium Enterprises are the backbone of Indian Economy by being the largest employer of workforce next to agriculture and contributing considerably to the national income. MSMEs are highly dependent on formal financial institutions for their funding, but unable to get their due share on account of various reasons. Access to capital being the major impediment in the growth of MSMEs, they look for alternative sources, with Crowdfunding evolving as a new source. Crowdfunding is the process of asking the general public to contribute funds to a new project through donations (with or without rewards), lending or equity participation predominantly campaigning through internet. Success stories in abroad and in India indicate Crowdfunding's popularity as an emerging source of finance for innovative and socially conscious projects. In spite of numerous advantages, crowdfunding collections are yet to be legalized in India. Future of crowdfunding is expected to be glorious.

1. Introduction

Businesses provide solutions to the needs of the public – by supplying goods or services appropriate to the requirements of the customers/users. Among various forms of business enterprises, sole traders, partnerships and companies are popular – first one on account of ease of formation, second one on account of the synergy it brings along, and the last one for its capability of augmenting huge resources. Based on scales of operations – measured in terms of labour employed, investment in permanent assets, and/or the capital outlay – the enterprises are classified as Micro, Small, Medium, and Large Enterprises. In India, there is an exclusive ministry for micro, small and medium enterprises – known as Ministry of MSME, Government of India. As of June 2018, Shri Giriraj Singh is the Minister for MSME as Minister of State – Independent Charge. According to the official website of the ministry (msme.gov.in): “MSMEs

not only play crucial role in providing large employment opportunities at comparatively lower capital cost than large industries but also help in industrialization of rural & backward areas, thereby, reducing regional imbalances, assuring more equitable distribution of national income and wealth. MSMEs are complementary to large industries as ancillary units and this sector contributes enormously to the socio-economic development of the country^{CF1}.

The Micro, Small & Medium Enterprises Development (MSMED) Act, 2006, classifies the MSMEs into the following two categories, viz., (i) Manufacturing Enterprises, and (ii) Service Enterprises. The classification into Micro, Small and Medium is determined based on the amount of investment in plant & machinery / investment thus:

Sector Classification	Nomenclature	Investment in P&M / Equipment
Manufacturing Sector	Micro Enterprises	Investment not exceeding twenty five lakh rupees (i.e. around 37,500 USD)
	Small Enterprises	Investment exceeding twenty five lakh rupees but not exceeding five crore rupees (i.e. around 750,000 USD)
	Medium Enterprises	Investment exceeding five crore rupees but not exceeding ten crore rupees (i.e. around 1,500,000 USD)
Services Sector	Micro Enterprises	Investment not exceeding ten lakh rupees (i.e. around 15,000 USD)
	Small Enterprises	Investment exceeding ten lakh rupees but not exceeding two crore rupees (i.e. around 300,000 USD)
	Medium Enterprises	Investment exceeding two crore rupees but not exceeding five crore rupees (i.e. around 750,000 USD)

Source: MSMED Act, 2006 (India)^{CF2}

2. Most Significant Challenge faced by MSMEs

Kannan & Sudalaimuthu^{CF3} summarized five major issues for MSMEs in general, which listed “access to finance (physical as well as documentary access to formal financing sources)” as the foremost of the challenges for MSMEs in most parts of the world, as also in India. “Access to timely and adequate credit is critical for MSMEs growth and development; Banks have a vital

role to play in addressing several problems faced by the sector today. Banks have to view themselves not just as providers of credit but as partners in the growth of these enterprises, through a process of hand holding of first generation entrepreneurs, while they find their feet in the business”, iterated K.C. Chakraborty^{CF4}, Former Deputy Governor, Reserve Bank of India (2012).

“As per the National Sample Survey (NSS) 73rd round, for the period 2015-16, there are 633.8 lakh unincorporated non-agriculture MSMEs in the country engaged in different economic activities providing employment to 11.10 crore workers. The MSME sector faces a major problem in terms of getting adequate credit for expansion of business activities. Latest data on credit disbursed by banks shows that out of a total outstanding credit of INR 26041 billion as in November 2017, 82.6 per cent of the amount was lent to large enterprises. **The MSME received only 17.4 per cent of the total credit outstanding.** Growth of credit to Micro and Small enterprises increased by 4.6 per cent, while credit to Medium enterprises decreased by 8.3 per cent”.^{CF5} Thus, even after decades, MSMEs face access to finance as the most significant challenge that impedes their growth potential.

3. Sources of Funding to SMEs

The Working Paper^{CF6} on “Finance for MSMEs in India: Sources and Challenges” summarized the sources of finance used by MSMEs in different stages of the life cycle thus:

- **At Start-up Stage:** Personal and family sources, from friends and from public sector banks
- **At Survival Stage:** Public banks and moneylenders, followed by personal funds and private banks
- **At Growth Stage:** Public banks, personal and family sources, and to a lesser extent from private and cooperative banks
- **At Sustenance Stage:** Personal funds, cooperative banks, public banks, and private banks

In summary it can be stated thus: personal funds and savings account for 64.4% of sources of finance for MSMEs at start-up stage; public banks and moneylenders account for 27.3% apiece, and private banks and personal savings for 18.2% each at survival stage; public banks contribute 48% of finance at growth stage; and at sustenance stage, public banks, cooperative banks, borrowings from friends and moneylenders follow the personal funds and savings as major sources of finance for MSMEs as reported in the ADBI Working Paper 581.

4. The New ‘Player’ in Funding Arena

The investors are normally attracted to the large industrial houses when they think of investing their funds. It is because of the transparency and depth of information available to them, which enables them making informed decisions on their investments. Moreover, the investor confidence is ensured by the control mechanisms that are operated by institutions like SEBI (Security Exchange Board of India), SEC (Securities Exchange Commission) of USA, etc. This scenario leads to a situation where the small and medium enterprises are to depend more on the financial institutions, especially the commercial banks, for their funding needs. Financial institutions need to follow many regulations and procedures while lending – which small enterprises find it difficult to fulfill. This creates a gap in financing which was indicated in MSME Survey (that only 17.4% of bank funds were available to MSMEs in India). A New breed of financing option is emerging to fill this gap, which is popularly known as ‘Crowdfunding’.

5. What is Crowdfunding?

As an aftermath of financial crisis 2008, small business enterprises found it difficult to raise funds for their capital needs. They were not serviced by formal sources of finance on account of their size or type of business engaged in. In that scenario, crowdfunding evolved as an alternative source of capital for aspiring entrepreneurs. By the term ‘crowdfunding’ we mean “solicitation of funds in small amounts from multiple investors through a web-based platform or social networking site for a specific project, business venture or social cause”^{CF7}.

6. Crowdfunding Models

There are four types of crowdfunding in vogue. They are: (1) Donation-based, (2) Reward-based, (3) Lending-based, and (4) Equity-based. While the first two are philanthropic crowdfunding, the last two are for financial returns. The philanthropic (donations and rewards models) crowdfunding really gave birth to crowdfunding idea. Under this model, funders donate via a collaborative goal-based process in return for products, perks or rewards. It is found to be more effective for digital goods such as software, films and music, thus raising large amount of funds per campaign. On other hand, the financial returns (equity and lending models) crowdfunding are more recent in presence. They are basically cause-based campaigns by businesses seeking capital and sell ownership stakes online in the form of debt or equity. In this model, the backers or investors become creditors for interest-gains or shareholders for dividend-returns. We review each of these models in a brief manner in the following paragraphs:

1. **Donation Model:** This is “a means for charities, or those who raise money for social or charitable projects, to gather a community online and to enable them to donate to a project. While most established charities facilitate this through their own website, crowdfunding is popular for small organisations and people raising money for personal or specific charitable causes”.^{CF8}
2. **Reward Model:** “The most popular form of crowdfunding to date has been the reward model which has grown significantly in the funding of creative, social and entrepreneurial projects. The model allows people to contribute to projects and receive non-financial rewards in return, usually operating a tiered system where the more you donate the better the reward you receive. The model often closely resembles philanthropy with the donation far exceeding the monetary value of the reward or the reward costing the fundraiser little, such as experience or recognition-related rewards”.^{CF8}The types of rewards include: (a) Give a copy of the ‘thing’ – through pre-order the book or record or app or gizmo to be published/released in the near future; (b) Share the story – by sending updates, videos, blogs, photos, thus sharing the story for social interest of the backers; and (c) Creative experiences – through visits, going out for coffee or a meal, or giving a call from a celebrity or socially known personality.



Source: Colins et al. (2013)

3. **Lending Model:** This is “largely an evolution of the peer-to-peer model of lending, pioneered by firms such as Lendingclub and Zopa. Projects or businesses seeking debt apply through the platform uploading their pitch, with members of the crowd taking small chunks of the overall loan”.^{CF8}
4. **Investment or Equity Model:** This model is “the application of crowdfunding to investing for equity, or profit/revenue sharing in businesses or projects. This form of the model has been the slowest to grow due to regulatory restrictions that relate to this type of activity. Some European platforms have been pioneers of the equity crowdfunding model, allowing anyone to take a small stake in an unlisted or private business through crowdfunding”.^{CF8}

7. Opportunities for Crowdfunding

Presently growing swiftly, the crowdfunding has further opportunities for sustained growth in the near future in the world, more particularly in India, due to the following reasons:

- **Increased social media presence** – More than ever earlier, the social media presence for the public is increasing rapidly, and the awareness and use of social media is continuously on the rise in India and elsewhere in the world. Crowdfunding being an internet-based fund-raising campaign, this factor (of increased social media presence of the knowledgeable-public) would positively contribute to the advancement of crowdfunding further.
- **Wider choices available to the investing public** – Crowdfunding offers numerous choices for the investing public, creating a ‘connect’ between the individual-selves and the fund-raising campaign. This is likely to bring more amount of ‘satisfaction’ among the investors that their investment is getting used in their ‘personally desirable projects/themes/ideas’.
- **Small businesses showcasing their products** – Crowdfunding brings hitherto-unavailable opportunities

to small and medium enterprises a platform to showcase their products and services with an unimaginable reach all over the globe. This will provide them a greater motivation to get involved in their goals and have a positive belief on their successes.

- **Unbiased Real Feedback** – Backers supporting a project through a crowdfunding platform indicates that the product/service has a ‘social endorsement’ thus vouching for the success of the product/service. On the other hand, the lack of fund-backing indicates that the said product/service requires much improvement or at least a better social appeal. Thus, the fund-seekers who are the project-creators get a valuable feedback on their product/service which is absolutely unbiased (as backer does not know the seeker personally by any means) as well as real and genuine. This will eventually help the society to get socially tenable products/services on offer from the budding entrepreneurs.

8. Top Crowdfunding Sites in the World

According to hongkiat.com^{CF9} top-10 crowdfunding sites in the world are:

- **Kickstarter** – with a total of USD 220 million raised from 61,000 projects so far
- **Indiegogo** – ‘indie’ is the short form of ‘independence’ and ‘go-go’ is the green signal
- **RocketHub** – facilitates tracking the progress and status of the project by the fund-seeker
- **GoFundMe** – a truly donation-based crowdfunding platform that raises money online for a cause, even personal
- **Razoo** – raised more than USD 97 million for four major categories of fundraisers, viz., nonprofits, individuals, corporations, and foundations
- **Crowdrise** – fund for animal welfare, arts, cultures, diseases, education and even religion

- **PledgeMusic**—crowdfunding effort to bring in new talent into the music industry
- **Sellaband**—funded more than USD 4 million to music bands via the site
- **Appbackr**— lets the backers fund the apps that are currently on sale or in the stage of development
- **Crowdfunder**— allows US startup and small businesses to raise funds by selling equity, debt and revenue-based securities

Most of these funding sites charge a nominal fee (ranging from 4% to 10% of funds raised), and offer different rewards,

perks and benefits to fund-providers (who are usually called 'backers'). Some of them provide marketing support too.

9. Crowdfunding Platforms operational in India

India, recently buoyed by schemes like 'startup India', caught up the concept of crowdfunding very quickly, and makes the best use of it as of now. A number of websites operate different types of crowdfunding in India. A summary of some of the popular crowdfunding platforms are presented in the form of a table below:

Name of the Platform	Since	From	Category	Fee charged	Upfront charges	Volume (Million Rupees)	Monthly visits
Rangde ^{CF10}	2008	Bengaluru	Lending	2%	Nil	759.00	NA
Faircent ^{CF11}	NA	Gurgaon	Lending	NA	NA	0.62	NA
Milaap ^{CF12}	2011	Bengaluru	Hybrid	5%	Nil	3,596.00	1.21 M
Impactguru ^{CF13}	2014	Mumbai	Hybrid	4.5% to 5.5%	Nil	1,050.00	257 K
Ketto ^{CF14}	2012	Mumbai	Donation	6%	2,000	2,500.00	256 K
Crowdera ^{CF15}	2014	California	Donation	Nil	Nil	NA	NA
Wishberry ^{CF16}	2010	Mumbai	Rewards	10%	3,999	1,160.00	98 K
FuelADream ^{CF17}	2016	Bengaluru	Rewards	9%	3,000	NA	60 K
Catapoolt ^{CF18}	2013	Mumbai	Rewards	10%	1,499	NA	5 K
BitGiving ^{CF19}	2013	Delhi	Rewards	10%	Nil	NA	51 K

Source: Respective websites

10. Top Benefits of Crowdfunding

Crowdfunding brings with it a number of visible and invisible benefits. Significant of them are briefly discussed thus:

1. **Capital availability to small businesses:** Since crowdfunding provides a platform for all kinds of entrepreneurs and businessmen to woo the individual investors, it enables the possibility of capital availability to all types of businesses – be it tiny, micro, small or medium.
2. **Creating new and talented entrepreneurs:** Crowdfunding provides opportunity to those who have bright ideas but suffer due to inadequacies of capital (who incidentally are not fully taken care of by the formal finance systems). It enables them by providing capital that is required for new and innovative ventures, thus making the dreams of young and innovative entrepreneurs to become reality.
3. **No restriction of capital to the chosen few:** One of the inherent limitations of the formal finance system (especially through security markets) is that it feeds the rich with more riches and does not take care of the poor. That means, the large business enterprises are able to attract investments through securities markets with their expansion plans and ability to provide richer returns to investors. This leaves the petty ones go unnoticed by the investing public. Crowdfunding

platform seeks to alleviate this issue by not restricting the "capital for the chosen few".

4. **Provides automatic financial acumen to the investors:** Finance & Investment theory insists on 'diversification' as a basic strategy to minimize risks in investment. Crowdfunding investors automatically adhere to this – since they invest in small amounts in different projects, thus facilitating automatic diversification of their investment portfolio.
5. **Reduction in 'agency costs':** Agency costs are the costs that are incurred by the fund-seekers in order to attract the funds from the investing public. Crowdfunding platforms drastically reduces this; many crowdfunding websites do not charge any fee for this service, and some charge nominal amount of fee and/or one-time upfront fee from the fund-seekers.
6. **Support to 'socially conscious business ideas':** Crowdfunding, by its very nature, makes the public directly participate in donating/lending/investing the ideas of entrepreneurs seeking funds. The support to 'socially conscious and environmentally supporting' business ideas is found to be phenomenal in crowdfunding platforms – as the investing public sees the best of both worlds, i.e. they invest for socially sensible projects and also satisfy their desire for investment returns.
7. **Viable alternative to 'Jobs' problem:** All over the world the problem of unemployment and

underemployment is observed; this is because an employer's willingness to employ some depends on employees' ability to cater to the needs of the employer, and his capacity to cover employee costs. Crowdfunding creates more entrepreneurs and helps the cause of providing jobs to some. By this, it helps to minimize the unemployment issue.

8. **Contributing to GDP growth:** Another interesting benefit of Crowdfunding is it helps in GDP growth – by enabling small investments from the public who do not otherwise possess the might to participate in investing activities. Without any public expenditure by the Government, crowdfunding brings the possibility of augmenting finance sources for the needy and enables growth in production of goods and services and GDP growth.
9. **Reduction in 'small business failure':** Failure of small businesses, especially due to non-availability of adequate capital, is getting reduced upon the advent of crowdfunding options. By providing adequate funds to small businesses (who are 'neglected' by formal sources of finance), crowdfund investors give life and longevity to small enterprises.
10. **Near 'nil-rate' of frauds on crowdfunding investments:** Fund-seekers are required to present their detailed business plan and the amount of funds required for the full project on the platform – based on which the investors decide on their investments. Some crowdfunding platforms refund the funds to providers, if fund-seeker fails to raise the required level of funds. Crowdfunding platforms reported 'zero-rate of frauds' in spite of their ability to amass huge levels of funds for numerous projects all over the world.

11. Key challenges for Crowdfunding

In spite of so many advantages possessed by crowdfunding as a financing option, they are not free from certain limitations. Key challenges of crowdfunding, specifically in Indian context, are presented briefly thus:

- **Low level of trust in online transactions:** The entire operations of crowdfunding depends solely on internet. Transacting online has security issues, and people do have their own apprehensions on the same. This low level of trust in online transactions may hinder the growth of crowdfunding, especially in India.
- **Not so investor-friendly industry:** The industry is not very investor-friendly. At the nascent stage, it is not felt much; but could develop into a problem in grown up stages.
- **Platforms not making any financial promise:** The contributors of funds (backers) are not given any financial promise by the crowdfunding platforms. They must be made theoretically safe to operate.
- **Creating an offline base:** Crowdfunding platforms need to work on building an offline base; then they can go ahead creating mass awareness and encouraging participation as e-commerce only got a boost.

12. Legality of Crowdfunding

Understanding the popularity and significance of crowdfunding as an emerging alternative financing model, President Barack Obama passed the JOBS (Jumpstart Our Business Startups) Act in 2012 – thus making crowdfunding investing legal in the United States of America. In India, the three types of crowdfunding (donation, rewards, and lending models) are ongoing without much legal hassle, whereas the equity crowdfunding is yet to receive legal sanctity. SEBI has released a consultation paper in June 2014. It was mentioned in that paper: "The consultation paper has been put forward for discussion only and does not necessarily mean that a crowdfunding regulation would be introduced in the form as proposed in the consultation paper or in any other form^{CF7}". As of June 2018, no law has been passed on Crowdfunding in India.

13. The Future of Crowdfunding

"There is no doubt that crowdfunding is rapidly being looked upon as a serious way of raising funds for startups and new businesses. India may soon bring in the requisite laws to support this in a big way, as efficient crowdfunding system can really play the role of catalyst in bringing the startup ideas into reality". Thomas John^{CF20} Crowdfunding as a means of funding new projects is witnessing leaps and bounds in the recent years all over the world, and more particularly in India. In 2011, Reserve Bank of India approved Milaap to crowd source funds from overseas. Many other crowdfunding platforms await approvals yet. Sooner or later, requisite laws to support crowdfund raising activities may be brought in India – since efficient crowdfunding system can play a catalyst in realizing innovative and environ-friendly startup ideas. If a sizeable portion of working population in India invest a paltry ten rupees per month per person in crowdfunding, India would be able to generate more than USD 1 billion funding every year – without any involvement from any government agencies or expenditure. Such is the possibility of crowdfunding power in future!

14. Conclusion

According to CRISIL, MSMEs account for 90% of enterprises in India, and are the second-largest employers after agriculture in the country.^{CF21} The survey conducted by SIDBI and CRISIL identified "access to capital" as the foremost limiting factor^{CF22} among the five factors identified as impeding the growth of MSMEs in India. Crowdfunding is found to emerge as a new source of financing for the small and medium enterprises particularly. Advanced countries like USA made crowdfunding legal, in India equity crowdfunding is yet to be formalized, though Securities and Exchange Board of India is thinking of formalizing in the near future. There are many crowdfunding platforms that have seen roaring success in the world, a few in India too. More specifically peer to peer lending platforms are on the growth in India, helping many innovative projects to gain much needed capital fillip.

15. Limitations and Further Scope of the study

The study focused on the evolving scenario of crowdfunding being possibly exploited as one of the financing options for the

fund-starved MSME sector. As such it confined itself to emergence of crowdfunding in India in the recent years, and the status of the fund-raisers in the current period. The study does not study the impact of crowdfunding on the MSME growth and the startups in India. Future studies can focus on this aspect. Furthermore, the study took into account the secondary sources

of information available (from published reports and official websites) as of 2018 and does not take into account any kind of primary source. Future studies may work on this lacuna and a detailed research based on primary data from MSMEs vis-à-vis crowdfunding could be a possibility by the same or other researchers.

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