MINI-CASE

Crowdfunding Kenya[1]

The concept of crowdfunding has a number of parallels in traditional Kenyan culture. Harambee is a long-used practice of collective fundraising for an individual obligation like a travel or medical expense. Another Kenyan practice, chama, involves group fundraising for loans or investments by private groups. In either case, they have strong links to the fundamental principle of a community. In the case of crowdfunding, it is an online community.

Crowdfunding is an Internet-enabled method of raising capital for business startups without going through the arduous, costly, and time-consuming process of traditional equity capital fundraising. The rapid growth in crowdfunding over recent years has been based primarily in the major industrial country markets of North America and Western Europe where there is a highly organized, developed, and deep financial sector, but a sector that often shuts out the small, innovative, non-traditional entrepreneur.

The concept of raising funds from a large crowd or group is not new. It is a technique that has been employed by individuals, organizations, and even governments for centuries. Beethoven and Mozart both raised funds for their work through pre-creation subscriptions. The United States and France both used a form of crowdfunding fundraising to construct the Statue of Liberty. But crowdfunding's real potential may now lie in funding new business startups in emerging markets—markets where the capital sources and institutions available to small and medium enterprises (SMEs) within the country may be limited. If crowdfunding can provide access to capital that many entrepreneurs need, tapping a larger more affordable cross-border financial ecosystem, business and economic and social development in the emerging markets may be able to take a great step forward. Kenya is one country attempting to pilot the effort.

The Capital Lifecycle

The ability of a startup business to access affordable capital through the early stages of its lifecycle has been the focus of a multitude of financial innovations in the past two decades. But the *capital lifecycle*, the institutions and sources of capital available to an enterprise as it evolves, has until recently possessed a number of gaps, putting many startup businesses at risk.

Exhibit A illustrates the capital lifecycle of a for-profit enterprise. An entrepreneur—the founder—puts up his own money in the first stage, the *proof of concept*. This is followed by further *pre-seed* capital typically funded

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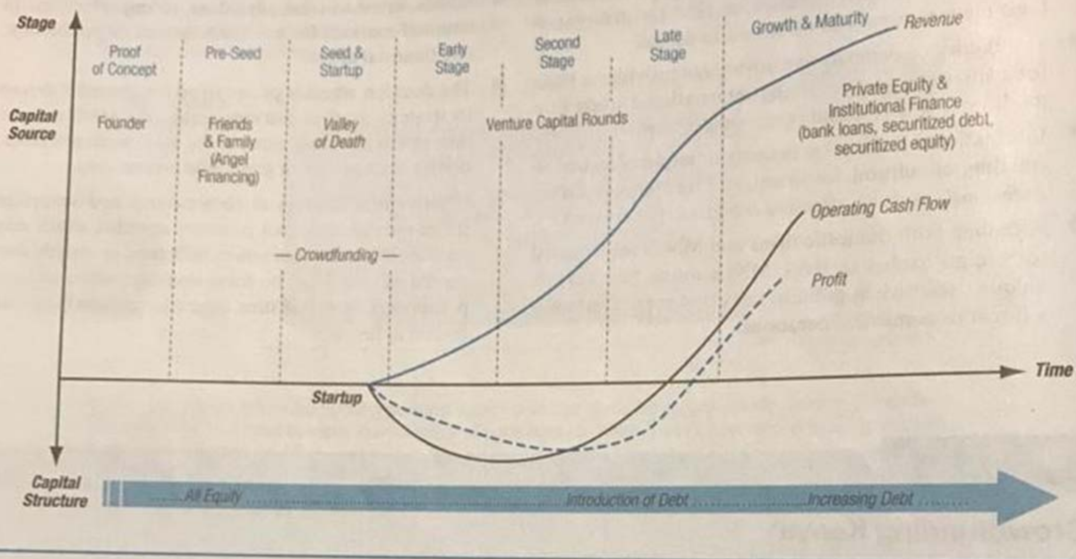
EXHIBIT A **The Capital Lifecycle**



from friends and family, or in some cases, *angel financing* from angel investors. *Angel investors* are individuals or small groups of professional investors who invest at the earliest stages of business development, playing the role of a "guardian angel." The principle is to provide the capital to move the business opportunity further along while still protecting the interests of the entrepreneurial owners. This is often referred to as the pre-seed stage of business development.

It is immediately after this, in the seed stage, that many firms fail to advance in their development due to a vacuum of available capital and capital providers. This vacuum, often referred to as the *Valley of Death*, is a critical period in which the firm is building and moving toward operational launch. But without operating activities and therefore revenues and cash flows, additional investors and access to capital is scarce. It is this vacuum which crowdfunding has filled in many industrial country markets.

Following their launch, promising businesses often then find they have added sources of capital for the financing of rapid growth—the venture capital rounds. *Venture capitalists* (VCs) are investment firms focused on taking an equity position in new businesses that are showing revenue results, but may not yet be positive in terms of cash flow or profitability. VCs focus their attention on businesses that are considered to have high growth potential but need capital—now—to acquire the scale and assets needed to pursue the growth opportunity.

The final stage of the capital lifecycle is that of the growing and maturing company. It is only now that the business possesses the track record of sales, profits, and cash flow that assure bank lenders of the creditworthiness of the firm. Bank loan-based debt is now accessible. It is also at this time that the firm may consider an *initial public offering* (IPO), to issue equity and raise capital in the marketplace. Firms now gain access to debt, bank loans, after operations have commenced and firms demonstrate operating cash flow capability. However, debt service obligations are not desirable in rapid growth businesses trying to retain as much capital as humanly possible in these early growth stages.

If the business appears to have true value growth prospects, it may catch the eye of *private equity* (PE). Private equity firms invest in greater amounts at later stages of business development. PE investors provide capital to businesses that are fully established and successful, but are in need of capital for growth and business strategy fulfillment. They rarely invest in startup business, searching instead

for investment opportunities that will yield higher rates of return than traditional investments in public companies.

Crowdfunding Principles

I believe that crowdfunding may have the potential to help catalyze existing efforts to create entrepreneurial cultures and ecosystems in developing nations. Development organizations like the World Bank and other institutions will play an ongoing role to act as "trusted third parties" in creating these new models of funding and providing mentorship, capacity building as well as ongoing monitoring and reporting.

—Steve Case, Chairman and CEO, Revolution, and Founder, America Online[2]

Crowdfunding began as an online extension of the pre-seed stage in which traditional financing relies upon friends and family to pool funds to finance business development. It seeks to connect an extended group of interested investors, still based on friends and family—the so-called *crowdfunding ecosystem*—directly with startups in need of seed capital. It attempts to open up these funding channels by bypassing the traditional regulatory and institutional barriers, restrictions, costs, and burdens, that capital raising carries in every country around the globe.

Crowdfunding structures typically fall into any one of four categories: donation-based, rewards-based, loan or debt-based, or equity-based.[3]

1. **Donation-based.** Non-profit foundations often employ crowdfunding methods to raise funds for causes of all kinds. Contributors receive nothing in return for their gifts other than positive emotional and intellectual gratification.
2. **Rewards-based.** In rewards-based crowdfunding efforts contributors receive a perk, a benefit, a T-shirt, a ticket, a back-stage pass, some small form of reward. One highly successful platform using this structure is Kickstarter, a U.S.-based arts and project-based fund raiser. As with donation-based funds, there is no guarantee of the project's execution or success, and no return on the investment other than a small reward, perk, or token benefit.
3. **Debt-based.** Debt-based or lending-based crowdfunding efforts provide capital to individuals and organizations in need of growth capital in return for repayment of principal. Micro-finance organizations like Grameen Bank have long used this structure successfully to fund entrepreneurial efforts particularly in emerging markets. The investor is typically promised repayment of principal, but often—as is the case of kiva.org, no payment of interest is made by the borrower or paid to the "investor."
4. **Equity-based.** Investors gain a share of ownership in the project or company. These are enterprise funding efforts to support for-profit business development, the investor receiving voting rights and the possibility (but not the promise) of a return on their capital. This is an investment, not a gift, and although the investors may be drawn from interested or like-minded groups, returns on investment are expected and therefore the business plan and prospects are evaluated critically.

The last two are fundraising efforts focused on business development, and categorically referred to as investment-geared crowdfunding (IGCF). For longer-term sustainable market-based economies, it is category four—equity-based crowdfunding—that is thought to offer the greatest potential for economic development and employment.

Critical Requirements

There are at least three critical components to a successful equity-based crowdfunding initiative: (1) a well-defined and capable crowdsourcing ecosystem; (2) a defined solid business plan and competitive analysis; and (3) a motivated, capable, and committed entrepreneur.

Crowdfunding's true singular strength is the ability of a potential investment to reach an extended crowdfunding ecosystem—a linked crowd accessible via the Internet and therefore not limited by geography, currency, or nationality. It is based on the digital reach of the Internet via social networks and viral marketing, rather than on the traditional institutional structure of the financial and investment sectors in countries. However, given that the object of the investment is a for-profit business that is resident in a difficult to fund or finance marketplace, a successful ecosystem will still be defined by some commonality of experience, culture, ethnicity, or diaspora.[4] As many in the crowdfunding sector will note, when you are raising funds for a for-profit investment anywhere in the world, relationships and linkages play a critical role in moving from a token "gift for a good cause" to an investment in a business.

[2] *Crowdfunding's Potential for the Developing World*, infoDev/The World Bank, by Jason Best, Sherwood Neiss, and Richard Swart, Crowdfunding Capital Advisors (CCA), 2013.

[3] "Issue Brief: Investment-Geared Crowdfunding," CFA Institute, March 2014.

[4] *Crowdfunding Investing for Dummies*, Sherwood Neiss, Jason W. Best, Zak Cassady-Dorion, John Wiley & Sons, Inc., 2013.

Secondly, a business plan must be defined. Crowdfunding is not based on the madness of crowds, but rather their strength in numbers, knowledge, and will. If enough small individual investors collectively support a startup enterprise, anywhere in the world, they can fund the development and growth of the business. But to even reach the proposal stage at which point a crowdfunding platform will entertain discussions, the entrepreneur will need to have refined a business plan. This must include prospective profitability, financial forecasts, and competitive analysis. Any business anywhere, needs a plan to generate sales, control costs, and compete if it is to eventually make a profit.

Finally, as it has been since the beginning of time, success will only come from a truly capable and committed founder—the entrepreneur. Even a business which is well-funded, well-defined, and exceptionally innovative will fail without an entrepreneur who is willing to roll up his sleeves, day after day after day, to go the extra mile (or kilometer) to achieve success. Whether that entrepreneur is named Rockefeller, Gates, Jobs, or Zuckerburg, ultimately—commitment, passion, hunger—has to be ingrained in his DNA.

Kenyan Challenge

Kenya was not all that different from many other major emerging markets when it came to business startups: a shortage of capital and institutions and interest in funding new business development. Funding startups, particularly SMEs, was always challenging, even in the largest and most developed industrial countries. Gaining access to affordable capital in a country like Kenya, even with a burgeoning domestic economy, was extremely difficult.

After a series of successive rounds of evaluation and competition, four crowdfunding projects had been identified for its pilot program by infoDev of the World Bank Group, working through its Kenya Climate Innovation Center (KICC) with the support of Crowdfund Capital Advisors (CCA).

- **Lighting Up Kenya.** *Join the Solar Generation creation in Kenya. Help us extinguish kerosene lamps and improve lives.* Co-Founder of Skynotch Energy Africa, Patrick Kimathi is trying to bring clean-lighting solutions (solar lamps) for off-grid indoor lighting.
- **Wanda Organic.** *Nurture the Soil—Climate Smart Agriculture. Help us improve access to bio-organic fertilizer and biotechnology for farmers in Kenya.* Marion Moon, founder of Wanda Organic, wants to enable Kenyan farmers to produce more, increase profitability and family income, improve nutrition, and create new employment in rural economies, while restoring and strengthening the health of Kenya's soil.
- **Briquette Energy Drive.** *Biomass Briquettes are made from agricultural plant waste and are a replacement for fossil fuels such as oil or coal, and burn hotter, cleaner, and longer.* Allan Marega is the managing director of Global Supply Solutions, whose goal is to make briquettes the preferred replacement to charcoal and wood fuel.
- **iCoal Concepts.** James Nyaga, Director of Strategy and Innovation at iCoal Concepts, wants to use recycled charcoal dust to make briquettes that are denser, burn longer, odorless, and smokeless, ultimately reducing indoor air pollution.

The Kenyan projects are among a number of pilot programs testing crowdfunding applications in emerging markets. Only time and experience will tell if crowdfunding delivers sustainable financial development for the global economy.

Mini-Case Questions

1. Where does crowdfunding fit in the capital lifecycle of business development?
2. Is crowdfunding really all that unique? What does it offer that traditional funding channels and institutions do not?
3. What is likely to differentiate successes from failures in emerging market crowdfunding programs?