The Evolution of Entrepreneurial Finance – 10 years after the Global Financial Crisis.

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Introducing the Special Issue

In the period following the global financial crisis, as banks and private equity investors withdrew from early stage entrepreneurial finance markets in the UK and developed economies (Wilson and Silver, 2013; Mac an Bhaird, 2014), there was a profusion in supply of alternative sources of early stage entrepreneurial finance (World Bank, 2013). These new financing options for firms alleviated the adverse effects of pro-cyclical provision of entrepreneurial finance (Mac an Bhaird et al, 2019). The large increase in provision of non-traditional sources of finance for the real economy was viewed as revolutionary (Harrison, 2013), and potentially transformative (Bruton et al, 2014), and its sustained use over more than a decade suggests that it is more than a passing fad.

The amount of finance procured from these sources has grown significantly in a very short time period, and is estimated to surpass investment from traditional sources of funding in the near future (Barnett, 2015). These developments have significant implications in relation to the supply of, and demand for entrepreneurial finance, including well-established issues which primarily stem from information asymmetries, such as agency, signaling, moral hazard, and adverse selection. The emergence of new sources of alternative finance introduces additional concerns in relation to regulation, investor protection, ownership and governance, among other issues (Bruton et al., 2014). The significant increase in the supply and use of alternative sources of finance have been facilitated to a large extent by the expansion of the internet and use of social media. The increase in supply of, and demand for alternative sources of finance has been accompanied by a burgeoning literature on the subject, due primarily to the availability of data which is accessible from the online platforms and websites.

Over a decade has passed since the increased provision and use of alternative finance in its various forms and amounts, providing us with an opportunity to assess and analyse its adoption, and to appraise how its provision may be improved for the benefit of investors and borrowers. At this juncture, we should have adequate evidence to increase the efficiency of provision from alternative sources, in order to improve the supply of finance in private debt and equity markets, and to provide greater diversification and depth in financial markets.

The International Journal of Entrepreneurship and Innovation has been to the forefront in publishing innovative studies on topical issues at the nexus of entrepreneurship and innovation (e.g. Volume 19, Issue 1, “Green innovation – connecting governance, practices and outcomes”). This special issue continues in that tradition, publishing state-of-the-art studies on a variety of issues related to innovations in entrepreneurial finance. This special issue is significantly different from other journal special issues on this subject (e.g. Harrison, and Baldock, 2015; Owen et al., 2019) in the range and breadth of issues investigated and analysed. The studies represent a broad geographic spread, including New Zealand, the UK, France, and the USA. A broad range of financing innovations are also considered, including blockchain, peer to peer lending, equity based crowdfunding, and mobile payment systems. Each article provides a unique contribution to our knowledge of entrepreneurial finance, and a brief summary is provided in the following section.

Introducing the Special Issue Contributions:

The first two articles provide a unique perspective on the motivations of investors in alternative financial markets. These are important contributions, as the profile and motivations of investors in the crowd is very much the ‘black box’ of crowdfunding. There is a paucity in our understanding of investor motivations, investment criteria and characteristics, with a few notable exceptions on investor motivations (Gerber and Hui, 2016). This evidence is particularly valuable, as it provides potential borrowers and platforms indications as to how funding campaigns may be tailored to target interested investors, thus increasing the probability of reaching funding requirements.

Pierrakis’ (2019) study provides us with a unique view of the characteristics, investment criteria and motivation of investors on the largest platform for peer to peer (P2P) lending in the UK, Funding Circle. Sourcing data from a large scale survey, Pierrakis (2019) identifies the personal characteristics, investment criteria and motivations of investors who advanced 34,700 loans to businesses. Perhaps unsurprisingly, the primary motivation for investors is to make a financial return and the most important investment criteria are company quality and commensurate risk. For the investors in Pierrakis’ study, non financial or intrinsic motivations do not feature highly in business lending by individual investors. Interestingly, the funding platform studied by Pierrakis no longer facilitates individual lending decisions by investors. Rather, the lending platform assigns loans based on investors’ risk and return preferences, which, Pierrakis notes, that by assigning loans in this way, the ‘wisdom of the crowd’ is not being utilized. Evidence from Pierrakis’ study can be used to better design and target funding campaigns, although the data is not linked to loan profiles or loan performance. (Loan performance data is available, although matching data on the profile of investors is typically not provided.) The next step for researchers is to analyse investor motivations and characteristics along with the profile and performance of loans invested in, to better ascertain their influence.

By contrast with the investors in Pierrakis' (2019) study, intrinsic motives are highly important for investors in the following article. Miller, Scahill, and Warren (2019) analyse a very interesting case study which details the financing of an innovative therapy in the medical sciences sector by a start-up biopharma company. The subject of their research has a particularly risky profile for investors, as the therapy being developed is innovative and new, and in the early stage of development. New biopharma firms have difficulty in attracting finance given the considerable amounts of capital required, the very long timeframe to developing new medicines and treatments, and the very high failure rate. This case study indicates how alternative finance can overcome the many difficulties in resourcing new, innovative health technologies. The authors propose an Investment Motivational Model, which could be used by investors and platforms in categorising funding campaigns and targeting specific types of investor. They find that philanthropy is an important motivation for investors with a personal connection with a person suffering from a specific ailment, and this motivation is higher for crowdfunders than for business angels. The case in Miller, Scahill, and Warren's (2019) study specifies a number of interesting advantages that raising equity finance through online platforms has over other sources of finance, particularly public offerings, with a much lower cost of raising finance, reduced disclosure requirements, and a more expeditious financing process. The authors note that this is the first company in New Zealand to combine angel finance with equity based crowdfunding, confirming previous findings that crowdfunding is used in combination with other forms of finance, rather than as a singular or substitute source of funding (Mac an Bhaird et al., 2019). Miller, Scahill, and Warren (2019) fill a lacuna in the literature by increasing our understanding of the philanthropic motivations for investment and the importance of social good, rather than exclusively financial return. Thus, contrary to Pierrakis (2019) and Cholokova and Clarysse (2015), intrinsic motivations do have an important role in investor motivation. The authors emphasise that this finding may be applicable to the context, however, as it concerns a medical cure for a genetically inherited disease, which has a distinct philanthropic focus.

O'Dair and Owen (2019) investigate the potential for blockchain to provide external investment and generate revenues for emerging independent artists in the music industry. They perceive benefits to blockchain additional to the ease of accessing royalty payments, stating that it can serve to reduce the amount of corporate intermediation in the process, thus distributing greater wealth to the originating artist. They highlight the potential disintermediation benefits of blockchain, particularly peer cooperation and the establishment of networks through which flow information and resources. Using three short case studies, the authors describe how blockchain has been used to resource collaborative music projects with varying degrees of success. Investigating the new financial intermediaries, they pose the question of whether blockchain is a new, cooperative approach for music ventures, or whether it is a case of 'old wine in new bottles', reinforcing corporate record label structures. The authors consider the potential that blockchain offers for a peer to peer collective, to replace the current system of a large corporate-led approach. Blockchain has a number of specific advantages such as reducing transaction costs and facilitating micropayments. Blockchain is inherently disintermediating, facilitating transactions between parties unknown to each other. There is also potential for Initial Coin Offerings (ICOs) through blockchain. It makes it easier for creative artists to collect royalties, with real-time payment, whereas the current system can take considerably longer with intermediate agencies taking a percentage commission along the way. The authors contend that the use of blockchain not only provides emerging artists with the potential to secure a revenue stream, it also provides the potential for a centralized copyright database, with consequent potential for apportioning royalty payments. They provide a framework for the adoption of blockchain technology with the music industry, although they are not prescriptive about how it will develop. Use of blockchain has resulted in raising very significant amounts of resources, although it has not resolved the issue of large commissions being retained by the intermediary. O'Dair and Owen (2019) find that, contrary to the expectation that blockchain removes intermediaries, providing a direct connection between artist and their followers, some form of intermediation will remain.

Simlinger and Lehner (2019) examine how societal value propositions of digital service innovations transcend individual functional concerns, and thus enhance the disruptive potential of financial technology. Adopting an approach from the marketing literature, the authors examine the overall value proposition of the financial innovation as a primary factor in ensuring its success and adoption. Building on previous research in this journal (Roundy and Bayer, 2018), the authors investigate the effect of wider societal value propositions in driving the disruptive innovation of financial technology. The authors examine five separate aspects of how innovation in financial technology enhances and enables use and engagement between funders and borrowers. They highlight the many benefits of financial innovation, including greater simplicity and speed in accessing finance, increased support and information, greater integration of data and services and creating connections between parties in the financial system. In particular, they highlight the innovative benefits of gamification, aesthetics and simplification in application processes which innovation in financial services promises. They highlight a number of societal benefits heretofore not identified, including financial inclusion and financial literacy. These issues have been largely ignored in research on the benefits of innovations in finance, as the focus has mostly been on operational, functional and performance aspects. The benefits of financial innovation for financial inclusion include reduced or no transaction costs, low cost mobile money transactions, development of peer to peer networks, increased motivation of creativity and ideas, societal engagement and socially responsible behavior. Thus, the authors highlight the importance of channels used by entrepreneurs to access entrepreneurial finance. These channels are particularly useful for entrepreneurs with little or no trading history, even though the cost of finance may be considerably greater than by traditional channels.

The subject investigated in the final article in this issue addresses a number of the principal subjects in entrepreneurial finance – mitigating information asymmetries, valuation, syndication, stage financing – although the topic under investigation is not alternative finance *per se*. Awounou N'Dri and Dubocage (2019) investigate the impact of stage financing and syndication practices on the level of underpricing of venture backed firms undertaking an Initial Public Offering of common stock (IPOs). Using a large dataset of venture backed firms that went public between 1997 and 2013, the authors find that firms financed by syndicated venture capital investment experience a lower level of underpricing. They find that the syndicate size is negatively related with the level of underpricing, although do not find any evidence that stage financing has an impact. The important factor in reducing the amount of underpricing is syndication, as it reduces agency costs and information asymmetry between the various stakeholders.

The authors' findings have a number of parallels for investors in relation to alternative finance. For example, they find that syndicate size is negatively associated with underpricing, which concurs with the findings of Cumming et al (2019), who find that larger sized crowds perform better than small and medium sized crowds in peer to peer business lending. This finding supports the wisdom of crowds concept (Surowiecki, 2005), which suggests that investors can efficiently aggregate information (Iyer et al., 2016) and exploit herding behavior (Mollick and Nanda, 2016), and in this way group heterogeneity improves the capacity of larger sized crowds to manage information asymmetry. In addition, the finding that the level of underpricing is directly and positively associated with the degree of information asymmetry in an IPO has a direct parallel with raising finance through online platforms. The level of opacity in online lending is even greater than that in raising finance from traditional sources, as disclosure requirements are much lower, and investors typically do not have prior knowledge of the firm or project. Thus, the cost of sourcing finance from alternative sources is usually greater than that of finance from traditional sources.

Conclusion

The abrupt contraction in private debt and equity markets in the period after the global financial crisis highlighted once again the adverse effects of the pro-cyclical supply of entrepreneurial finance for firms. This is compounded by the concentration of funders in traditional sources of finance, for example in the United Kingdom four large banks supply 85% of total loan finance to SMEs. Thus, it is particularly important to boost diversification in debt and equity markets, and increase financial deepening. Innovation in the provision of finance through new sources of alternative finance contains much promise in this regard. The articles in this issue provide new evidence as to the provision of new sources of alternative finance, along with suggestions as to how it may be improved.

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