Ladies and Gentlemen,

There has been a lot of talk that the crowdfunding law will create a whole new investment class that millions of Americans will use. If Americans invest 1% of their IRA into crowdfunding then about $300 Billion will be available to fund startups. (BizJournals - $300 Billion Market) If they are going to get only equity in return than it could be catastrophic to their investment returns.

Based on number of sources, 50% of startup companies fail in five years. (Startups Business Failure) (Startup Failure Rates). Every year around 500 venture-backed companies are sold or go public (2011 venture backed M&A and IPO) (2011 Venture backed Activity). Based on Kauffman Foundation, in 2011 there were over 500,000 new businesses created every month (US Business Startup in 2011). Statistics on non-venture back companies that exit successfully are limited but even in the most positive circumstances less than 1% of all startups get sold or go public. The remaining companies that don’t go bankrupt become lifestyle businesses for the founders.

Having equity stake in a startup will only be beneficial if the startup is sold or goes public, chances of this happening is less than 1%. The remaining 99% of the investors will lose out. That’s why convertible notes will suit crowdfunding better than equity. The three possible alternatives for startups below show that the convertible notes are superior:

1. In the 50% of the startups that do fail in five years, the convertible notes offer protection to investors by having higher precedents than equity. Therefore if there are assets that could be sold the debt holders will get it back first compared to the equity holders. Of course most startups will have a minimum amount of assets but it is still better than nothing.
2. In the 49% of the startups that become lifestyle businesses. The convertible notes will require the business to pay back the principal plus an annual interest amount. Another alternative is to mandate dividends for equity holders but that will not solve the problem since the principal amount will not be returned. Trading private equity on a secondary market will also just push the problem to the next investor who will not be able to recoup their principal.
3. In the 1% of the businesses that get a Series A round by professional investors, the convertible notes will convert to equity with a discount. This resolves a very important issue of evaluating startup companies that have minimum financial history. Assessing startups is a complicated task and if it is left to the issuers they could overvalue the company. Using this approach,
the appraisal is passed on to a later time when the business is more mature and has better financial data. Professional investors can better evaluate the company at that stage. To protect investors from very large valuation in Series A a valuation cap could be setup during the crowdfunding stage.

In the event that a startup gets sold or goes public without Series A investment, the payout to investors should be whichever is larger; their principal plus interest or convertible notes converted based on the valuation cap.

Startups might prefer convertible notes to equity as well, since the cost of debt is less than the cost of equity. Because founders issuing debt have full control of the company they don’t need to worry about dealing with hundreds of shareholders. The term sheets for convertible notes are simpler and allow for quicker education for both investors and issuers.

As shown above the convertible notes are superior to equity for crowdfunding purposes. Some supporters for equity might have the below two arguments which I address:

1. “Most investors in crowdfunding are not looking to make money but rather want to help their community or a good cause. This has been seen by donation and reward based crowdfunding portals.”

I agree that some investors are philanthropic in nature. They are still helping startups by issuing debt to them. At the same time, investors are hedging themselves in case the startup doesn’t turn out as planned.

2. “With standard term sheets it’s as easy to do equity deals as it is debt. The majority of professional investors use equity, not convertible notes. Since valuation cap already exists on the note, why not just do an equity deal?”

The reason why one should use notes instead of equity is not only for the simplicity reasons. Traditional professional investors invest in high-growth areas such as technology since early stage investing is very risky. Majority of the companies fail even with professional guidance. One out of ten investments becomes a blockbuster hit where most of the returns are made. These investors prefer equity since they want control of the company. In case the founder doesn’t perform well they can take over the business.

In the crowdfunding model the investors will not sit on the board or have much control of the company, they might even be a distraction to the founders. Majority of small businesses are not tech companies that will have 30-50% growth every year but are small mom and pop shops like a deli store. It doesn’t make sense to own equity in a small deli store that will never get sold, but a convertible note will help the deli store achieve
the growth that it needs. Once it does the deli store can pay off its investors.

Some equity-based portals are going to limit securities they offer to convertible debt by themselves. One example is wefunder.com that will only offer convertible notes. They have a detail explanation how it will work at http://wefunder.com/post/17-convertible-notes#read.

Thank You,
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