

**Crowdfunding's potential in the South  
African entrepreneurial ecosystem:  
Is there a role to play in catalysing Venture  
Capital?**

A Research Report  
presented to

The Graduate School of Business  
University of Cape Town

In partial fulfilment  
of the requirements for the  
MCOM in Development Finance Degree

by  
Adam Bennot  
December 2014

Supervised by: Dr. Stephanie Giamporcaro

The copyright of this thesis vests in the author. No quotation from it or information derived from it is to be published without full acknowledgement of the source. The thesis is to be used for private study or non-commercial research purposes only.

Published by the University of Cape Town (UCT) in terms of the non-exclusive license granted to UCT by the author.

## Plagiarism Declaration

1. I know that plagiarism is wrong. Plagiarism is to use another's work and pretend that it is one's own.
2. I have used a recognised convention for citation and referencing. Each significant contribution and quotation from the works of other people has been attributed, cited and referenced.
3. I certify that this submission is my own work.
4. I have not allowed and will not allow anyone to copy this essay with the intention of passing it off as his or her own work

Signed by candidate

## Acknowledgments

I would like to express my sincere gratitude to all the people who have helped in completing this research report by providing their time, insight, encouragement, love and support:

First and foremost, to my amazing family (Bill, Connie, Ben, Ethan and Melody), friends and colleagues (Eben Welby-Solomon) who offered their unwavering support and encouragement, without which this journey would not have been possible.

To the respondents who so glacially offered their time, insights and contacts. This report would not have materialised without your expertise and opinions

Lastly, but certainly not least, I would like to thank Stephanie Giamporcaro, my supervisor, for all her input, recommendations and encouragement. Your guidance was greatly appreciated.

# Table of Contents

Plagiarism Declaration .....	1
Acknowledgments.....	2
Table of Contents.....	3
List of Tables .....	4
List of Figures.....	4
<b>1 Introduction.....</b>	<b>5</b>
1.1 Research Area .....	5
1.2 Research Problem Statement .....	8
1.3 Research Purpose and Significance.....	9
1.4 Research Questions and Scope.....	10
1.5 Research Assumptions.....	10
1.6 Research Ethics .....	11
<b>2 Literature Review.....</b>	<b>12</b>
2.1 Introduction .....	12
2.2 Overview of Early-Stage Entrepreneurial Finance in South Africa .....	12
2.3 Entrepreneurial Ecosystems .....	15
2.4 The Dynamics of Crowdfunding.....	16
2.5 Crowdfunding in South Africa and other Emerging Economies .....	21
2.6 Crowdfunding within the Venture Capital Ecosystem.....	22
2.7 Networks and Signalling.....	24
2.8 Evaluation Criteria Used by Venture Capital Firms for Investment Decisions.....	26
2.9 Venture Capital in South Africa.....	31
2.10 Conclusion.....	33
<b>3 Research Methodology.....</b>	<b>33</b>
3.1 Research Approach and Strategy.....	33
3.2 Research Design, Data Collection Methods and Research Instruments.....	35
3.3 Population and Sampling .....	36
3.4 Data Analysis.....	39
3.5 Research Limitations.....	39
<b>4 Research Findings, Analysis and Discussion.....</b>	<b>40</b>
4.1 Research Findings and Analysis .....	40
4.1.1 An Overview of the Venture Capital Landscape in South Africa.....	40
4.1.1.1 <i>Supply of Money</i> .....	40
4.1.1.2 <i>The Quality of Entrepreneurs and their Ventures</i> .....	41
4.1.1.3 <i>Risk Tolerance</i> .....	43
4.1.1.4 <i>Private Equity</i> .....	43
4.1.1.5 <i>Success Stories</i> .....	44
4.1.1.6 <i>Valuations</i> .....	45
4.1.1.7 <i>What the Venture Capital Ecosystem Needs</i> .....	45
4.1.2 Opportunities for Crowdfunding in the South African Entrepreneurial Ecosystem. ....	46
4.1.2.1 <i>Market Validation</i> .....	46
4.1.2.2 <i>Product Validation</i> .....	48

4.1.2.3	<i>Source of Seed Capital</i> .....	48
4.1.2.4	<i>Risk</i> .....	49
4.1.2.5	<i>Social Investment</i> .....	50
4.1.3	Key Challenges Facing Crowdfunding in South Africa.....	50
4.1.3.1	<i>Cultural Issues</i> .....	50
4.1.3.2	<i>Infrastructure</i> .....	51
4.1.3.3	<i>Government</i> .....	52
4.1.3.4	<i>Small Consumer Market</i> .....	52
4.1.4	Equity-Based Crowdfunding Model.....	54
4.1.5	Crowdfunding and Venture Capital Synergies.....	56
4.1.6	How Crowdfunding Could Influence VC Investment Criteria.....	59
4.2	Research Discussion and Conclusion.....	62
4.3	Recommendations for Future Research.....	69
5	References.....	70
6	Appendix A – List of Organizations Interviewed.....	77
7	Appendix B – Interview Guideline.....	78
8	Appendix C – Introductory Email.....	82
9	Appendix D – Informed Consent Form.....	83

## List of Tables

Table 1:	Summary of reviewed literature venture capital investment criteria.....	30
Table 2:	Interview details.....	38

## List of Figures

Figure 1:	Source of finance.....	12
Figure 2:	Expert ratings on financing for new and growing businesses in South Africa (5 point scale).....	14
Figure 3:	Isenberg’s model of an entrepreneurship ecosystem.....	16
Figure 4:	Growth in worldwide funding volume.....	18
Figure 5:	Growth in the number of Crowdfunding Platforms (CFPs) by category.....	19
Figure 6:	Successfully funded projects and amounts of funds raised.....	20
Figure 7:	Market potential for crowdfunding across regions.....	21
Figure 8:	Financing trend to VC-backed Kickstarter and Indiegogo hardware projects.....	24
Figure 9:	Decision process model of VC investment activity.....	29
Figure 10:	Number of VC transactions concluded.....	32
Figure 11:	Contribution by stage of deal.....	32

Figure 12: Crowdfunding can inform management team criteria (Responses) .....	60
Figure 13: Crowdfunding can inform financial criteria (Responses) .....	61
Figure 14: Crowdfunding can inform product criteria (Responses) .....	61
Figure 15: Crowdfunding can inform marker criteria (Responses) .....	62
Figure 16: Venture funding lifecycle .....	64
Figure 17: Decision process model of VC investment activity with crowdfunding .....	67
Figure 18: Lifecycle of early-stage venture .....	68

## 1 Introduction

### 1.1 Research Area

As an emerging economy, it is vital that South Africa create an environment that encourages entrepreneurship and which promotes the development of small businesses. It is well recorded in literature that entrepreneurial activity plays a significant role in the economy by way of stimulating economic growth, creating jobs and alleviating poverty (Kessler, 2007; Vuuren & Groenewald, 2007).

South Africa, however, continues to struggle in terms of creating an enabling entrepreneurial environment. According to the Global Entrepreneurship Monitor (“GEM”) survey, South Africa ranked 35th out of 68 countries which participated in the survey in terms of entrepreneurial activity (Herrington & Kew, 2013). In addition, Eeden, Vivian and Venters (2003) estimate that the failure rate of start-ups and small, medium and micro enterprises (SMME’s) in South Africa range between 70% and 80%.

While there are various factors that drive entrepreneurial activity, such as skills development, cultural norms, the regulatory environment, an important factor concerns the availability of start-up capital for early-stage businesses (Gompers & Lerner, 2004; Gorman & Sahlman, 1989; Herrington & Kew, 2013). Research has shown that one of the major barriers faced by

South African start-ups is gaining access to finance (Ojah & Mokoaleli-Mokoteli, 2010). Herrington and Kew (2013:38) state: “Most entrepreneurs find it problematic to obtain funding at all levels in the entrepreneurial pipeline, especially those intending to start businesses and those in the early stage.” Indeed, many experts have noted that there is an insufficient supply of entrepreneurial capital, especially venture capital (“VC”) (Herrington & Kelley, 2012).

Numerous studies have examined the factors that lead to successful fundraising for entrepreneurial ventures, especially in the context of VC (Baum & Silverman, 2004; Dushnitsky, 2010; Kirsch, Goldfarb, & Gera, 2009; Macmillan, Siegel, & Narasimha, 1985; Shane & Stuart, 2002).

VC is a sub-group of Private Equity (“PE”) which focuses on providing financing, generally in the form of equity, to early-stage or start-up ventures that show high growth potential. VC funds are managed by investment firms and raise capital from institutional investors such as High Net Worth Individuals (“HNWIs”), mutual funds, pension funds and insurance companies (Macmillan, Siegel, & Narasimha, 1985).

VC makes up a relatively small portion of the PE activity in South Africa. According to Lingelbach (2009), the South African VC industry has been operating for over two decades. However, the level of VC has drastically declined from a level of 25% of total PE investments in 2000 to 2% in 2007. The major challenge faced by South African VCs is how to attract institutional investors who have preferred later-stage PE investments due to their lower risk profile (Banerjee, 2008).

There is a significant amount of uncertainty involved in assessing the quality of early-stage ventures. Due to the lack of historical data or even working prototype, VCs have to rely on limited signal of quality to determine if a new enterprise will be successful (Lerner, 2002; Ueda, 2004). However, notwithstanding a fine-tuned due diligence process, VC investments are exposed to a greater degree of risk. Although the financial rewards for successful investments tend to be superior, in the case of an emerging economy like South Africa, VC is characterised by higher risk and lower returns, compared to VC in the U.S.A. and Europe (Banerjee, 2008). In their study of VC-backed ventures in the U.S.A., Zacharakis & Meyer

(1998) found that 40% of all VC-backed businesses fail to produce a profitable return for their investor funds.

The high degree of failure that characterizes VC investments are due in large part to the uncertain nature of early-stage ventures. VCs are often required to act on partial information about the entrepreneur or in relation to a particular new venture. The VC decision-making process and investment criteria are indeed critical to reducing the information asymmetries that characterise these kinds of investments. Of particular importance in decision-making, given the lack of reliable information regarding early-stage ventures, are signals of quality, such as third party endorsements and the entrepreneur's background (Mollick, 2013).

Most recently, crowdfunding has emerged as an alternative funding system for early-stage ventures and currently is experiencing rapid growth. Crowdfunding is an online ecosystem of venture funding, which allows entrepreneurs to access informal and formal networks for capital raising. Entrepreneurs seeking resources can use crowdfunding as an innovative resource allocation mechanism to fill early-stage capital requirements by pre-funding production and sales (Mollick, 2014). Rather than seeking funds from professional investors such as VCs and angel investors, entrepreneurs target amateur investors or consumers to pre-finance their product or service. As opposed to relying on experts views, crowdfunding lets millions of individuals decide which entrepreneurial project/s he/she wishes to back. Like professional investors, amateurs or consumers are using signals of quality to assess whether or not early-stage entrepreneurial ventures can succeed (Mollick, 2013).

Increasingly, crowdfunding is becoming a viable source of seed capital, allowing entrepreneurs to raise the initial funds which are necessary to start their new business ventures (Schwienbacher & Larralde, 2010). As at 2014, numerous projects have already raised over US\$1 billion through Kickstarter, the premier online crowdfunding platform. Examples of successful projects include: TikTok, a kit that turns iPod Nanos into wristwatches and which raised over US\$900,000, Double Fine Adventure, a video game by Tim Schafer and which raised more than US\$1.4 million in one day, and Pebble Watch Project, which raised more than US\$ 10 million from 69,000 individual backers.

Crowdfunding might not only be an alternative source of financing, but it could prove useful to VCs and angel investors looking for deals. For example, the Smart Watch start-up, Pebble, which was initially rejected for VC funding, was able to secure a large amount of VC funding after its Kickstarter campaign. In 2013, VCs invested over US\$200 million in 23 different crowdfunding hardware projects (CBInsights, 2014). Entrepreneurs can use crowdfunding platforms to demonstrate demand for the proposed product, and this can then lead to funding from more traditional sources of finance (Mollick, 2013). Furthermore, crowdfunding might facilitate legitimacy development of early stage ventures (Mollick, 2014). Entrepreneurs can engage future customers and investors in the funding, launch and growth of their ventures, leading to strong network ties in the market and increasing enterprise legitimacy (Burtch, Ghose, & Watal, 2011; Mollick, 2014).

## 1.2 Research Problem Statement

South Africa faces numerous economic, social and political challenges, of which a key problem is the considerable and growing unemployment. As early as 1995, the government has prioritised small business and entrepreneurial activity. Trevor Manuel, the former Minister of Trade and Industry, stated that “small, medium and micro enterprises represent an important vehicle to address the challenges of job creation, economic growth and equity in our country” (Herrington et al. 2009:12). However, despite government efforts and interventions, South Africa struggles to promote early-stage entrepreneurial activity, and lags behind other developing countries. In 2013, South Africa’s Total Entrepreneurial Activity rate (TEA), a measure of entrepreneurial was 10.6%, which is significantly lower than the average of 16% for other middle- to low-income countries (Herrington & Kew, 2013). The TEA rate measures the percentage of the adult population (ages 18 through 64) who are in the process of starting or have just started a business. Studies have conclusively shown that the lack of access to finance, particularly early-stage seed or VC, has been an acute cause of low-level entrepreneurial activity (Herrington & Kelley, 2012; Omydiar, 2013).

The simple truth is that entrepreneurs are unable to access VC financing because the VC industry in South Africa is virtually non-existent compared to VC in the U.S.A. and Europe. VC is a risky business. Despite extensive due diligence and numerous investment criterion designed to improve the investment decision-making process, VCs often lack necessary

information that is needed to make informed investment decisions about a particular entrepreneur or early-stage venture. This lack of information leads to a greater risk of adverse selection and a higher degree of non-performing investments. In South Africa, this problem is magnified, due to the perceived higher risk and lower reward nature of the VC investments.

Recently, crowdfunding has emerged as a novel way for entrepreneurs and early stage ventures to secure financing without having to turn to more traditional sources of new venture finance. Some have argued that crowdfunding might replace or “crowd out” alternative sources of early-stage financing, such as VC. Recent cases have, however, emerged where crowdfunding has, in fact, been a source of deal flow as well as a market tester and catalyst for VC. Crowdfunding might, indeed, be the key to unlocking VC financing in South Africa. This exploratory research focuses on investigating this emerging phenomenon and it seeks to contribute knowledge in this area.

### 1.3 Research Purpose and Significance

The purpose of this research is to examine the potential influence crowdfunding could have on the early-stage financing ecosystem in South Africa. Particularly, how it could affect entrepreneurial deal flow as well as inform the venture capital decision-making process. The primary aim of this research is to explore the due diligence practices and perceptions of venture capital fund managers, angel investors and entrepreneurs to ascertain the extent to which crowdfunding can be incorporated into the South African entrepreneurial ecosystem and inform the investment process. The researcher, therefore, intends that this research enhance venture capital investment decision-making capabilities while adding to the existing body of knowledge on early-stage investing. Ultimately, it is hoped that the results of this in-depth study will accelerate the development of the venture capital industry in South Africa and unlock early-stage seed capital whilst promoting entrepreneurial activity and possibly providing insight and guidance to entrepreneurs faced with the challenging task of accessing financing.

The researcher anticipates that the finding of this research will likely be of interest to players in the VC and early-stage new venture financing industry, including fund managers, investors, entrepreneurs and crowdfunding providers. The findings might impact the investment process, which has direct implications for capital providers, fund managers and

fund seekers. Furthermore, this research might be of interest to researchers and those in academia concerned with this field, who might then conduct similar studies or decide to expand the research in new directions. By investigating crowdfunding's potential within the VC investment decision-making process, it is anticipated that the findings might be fed back into the marketplace and inform future VC investments in South Africa.

#### 1.4 Research Questions and Scope

The researcher used existing academic literature to formulate the primary research question.

##### **Primary Research Question:**

*What is the potential of crowdfunding in South Africa for influencing the early-stage entrepreneurial financing ecosystem?*

The primary research question is broken down into a number of sub-questions which were created during the literature review and which can help direct the research towards finding valid answers for the primary research question.

##### **Sub Question 1:**

- *Can crowdfunding provide a viable source of entrepreneurial seed capital?*

##### **Sub Question 2:**

- *Can crowdfunding inform the venture capital investment decision-making process?*

##### **Sub Questions 3:**

- *Can crowdfunding influence venture capital deal flow?*

#### 1.5 Research Assumptions

The researcher has made a number of assumptions in conducting this research; it is assumed that the interviews conducted are sufficient to derive a view that is representative of the VC ecosystem in South Africa. Individuals with extensive experience in relation to the subject matter, as well as sufficient knowledge of the trends in the wider industry were interviewed. The researcher assumed that the views and opinions shared during interviews were honest and unbiased accounts of organisational and/or personal views. This sample, while not

random and limited in size due to time and accessibility considerations of interviewees, is assumed to represent the entrepreneurial ecosystem as a whole, due to the wide range of VC firms and entrepreneurs interviewed.

The researcher assumed that interviewees answered questions honestly and in an unbiased fashion. It is also assumed that interviewees understood the questions being asked. In the event that these assumptions are not sufficiently met, the internal validity of the data gathered will be questionable, and any conclusions deduced from this data will not be valid. The researcher did not have any particular concerns about the interviewees answering questions untruthfully.

## 1.6 Research Ethics

As the research involved the participation of human subjects, it was crucial to follow certain ethical principles and guidelines. In the first instance, the researcher obtained the required clearance from the University's research ethics committee to pursue the research involving the said human subjects. Prior to the commencement of each interview, the participants were asked to sign an informed consent form (attached hereto and marked "Appendix D"). With regard to the telephonic interviews conducted, consent was obtained verbally.

Notwithstanding the aforementioned, it was made clear to each interviewee that information derived from each interview would be treated with utmost confidentiality. All information and quotations used will thus be used anonymously. In line with the above, an Ethical Clearance Certificate was signed by the researcher and submitted in compliance with the UCT GSB requirements for the research report.

Prior to commencing each interview, permission was requested to record the conversations and in no instances was this permission denied by any interviewee. The researcher agreed that no data and/or transcripts would be released into the public domain without the prior written consent of the respondent in question. Participants are also entitled to review the final draft of this research report, should they choose to do so, and he/she will be given a copy of the final report, if he/she requests one. A list of the interviewed companies has been provided and is attached hereto and marked "Appendix A".

## 2 Literature Review

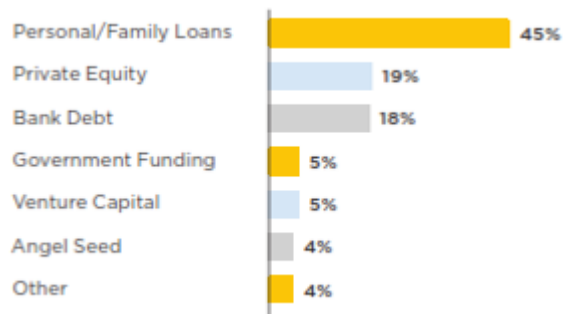
### 2.1 Introduction

Crowdfunding is a rapidly growing phenomenon within the early-stage financing space that has grabbed the attention of academics and finance practitioners alike. While, there is a vast body of literature on the traditional sources of early-stage capital, such as venture capital, literature on crowdfunding is more limited, and there is no literature regarding the influence of crowdfunding on venture capital. This literature review will focus on a few concepts. Firstly, what is the state of early-stage entrepreneurial activity in South Africa? Secondly, how does crowdfunding work, and how is it different from traditional investment models? Thirdly, how does crowdfunding fit into the venture capital ecosystem? Fourthly, what is the role of network ties in crowdfunding and venture capital and how are networks used for assessing entrepreneurial quality? Fifthly, what is the investment process and evaluation criteria used by venture capital firms for investment decisions; and how do VCs assess the quality of early stage entrepreneurial ventures? Lastly, what is the state of venture capital in South Africa?

### 2.2 Overview of Early-Stage Entrepreneurial Finance in South Africa

Approximately 7 million South Africans are unemployed; this represents 36% of the labour force (Herrington & Kew, 2013). According to the J.P. Morgan & Dalberg (2010) report on small- and medium-sized enterprises (“SMEs”) in South Africa, there are 5.6 million small businesses which create 11.6 million jobs. This represents 64% of the labour force and 40% of Gross Domestic Product (“GDP”) of South Africa. These statistics provide clear and compelling evidence of the vital role which SMEs play in stimulating economic growth; however, many lack much-needed access to finance (Omidyar, 2013). A recent study by Omidyar (2013) shows that there is an insufficient supply of equity capital to fund new ventures. The study further shows that personal savings and family loans are the predominant source of finance for SMEs in South Africa.

Figure 1: Source of finance

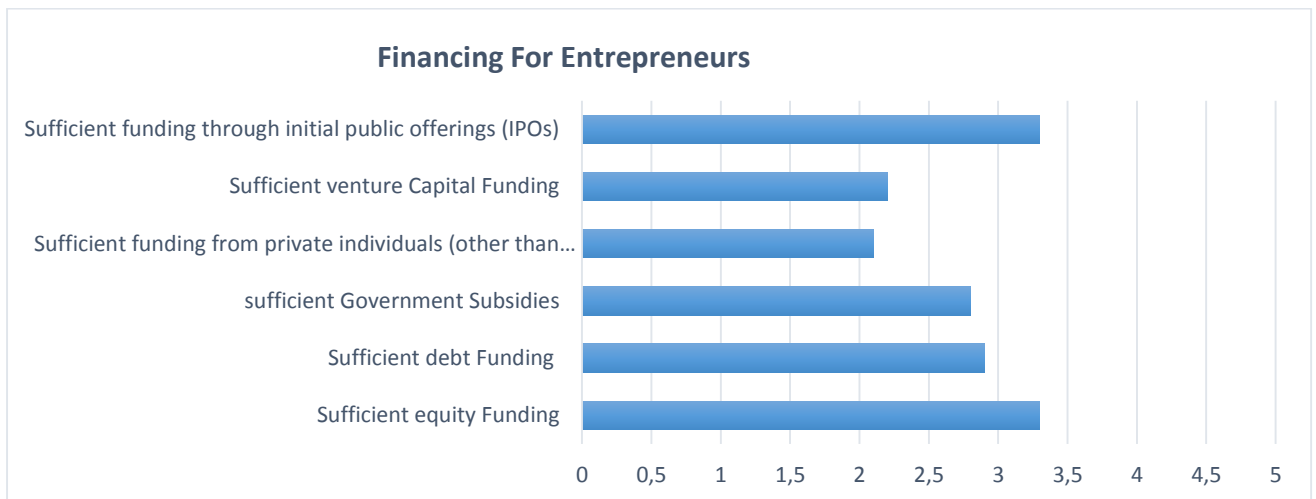


Source: Omidyar Network (2013)

Entrepreneurship is an important driver of economic growth, creating jobs and economic competitiveness (Huyhebaert, Gaeremynck, Roodhooft & Van de Gucht, 2000). However, according to the Global Monitor Entrepreneurship Report (“GEM”), South Africa is plagued by low, early-stage entrepreneurial activity - as measured by the Total Entrepreneurial Activity rate (“TEA”) (Herrington & Kew, 2013). In 2013, South Africa ranked 35 out of 68 countries with a TEA Rating of 10.6; this is well below the average rating of 16 (Herrington & Kew, 2013).

One of the key reasons for the low level of early-stage entrepreneurial activity is the lack of adequate funding for new businesses (Herrington & Kew, 2013). According to the GEM report, experts in South Africa agree that there are insufficient funds from private individuals and venture capitalists (see Figure 2 below). A score of 4 or 5 indicates a positive sentiment for entrepreneurial development while a score of 1 or 2 indicates a negative sentiment for entrepreneurial development. Of the various funding sources available to entrepreneurs, venture capitalist financing and private individual funding scored the lowest (Herrington & Kelley, 2012).

Figure 2: Expert ratings on financing for new and growing businesses in South Africa (5-point scale)



Source: Herrington & Kelly, 2012

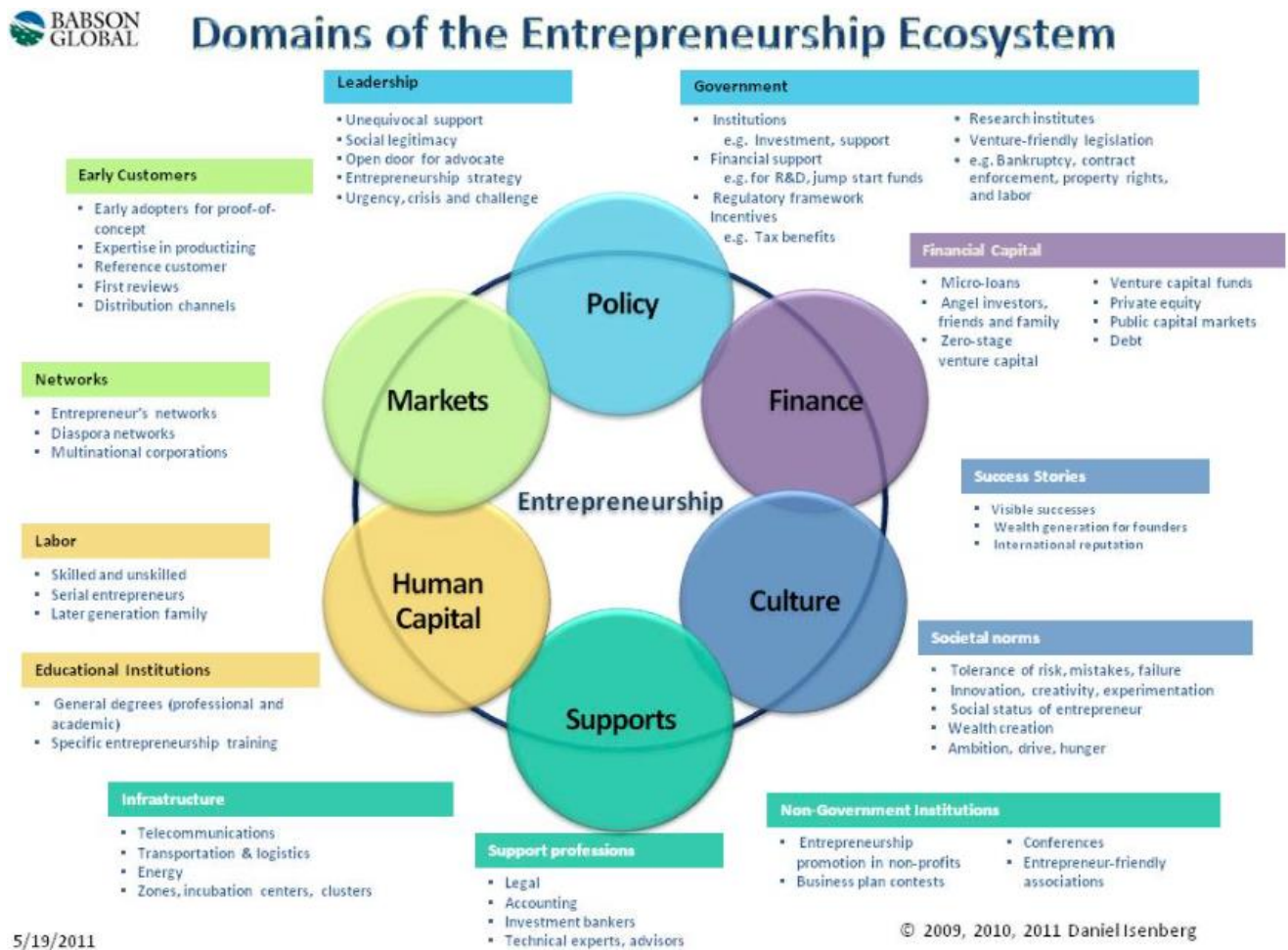
There are a number of other salient reasons for the low level of early-stage entrepreneurial activity in South Africa. Firstly, there is a high cost of capital. Despite debt financing from banks being one of the most widespread sources of funding in South Africa, it is often unsuitable for entrepreneurs (Omidyar, 2013). Paul Harris, the founder of the First Rand Group, states that the risk-reward structure of banks makes them hesitant to invest in start-up ventures (Omidyar 2013:5). The reason for this is that early-stage entrepreneurial ventures are typically unprofitable and lack tangible assets to leverage as collateral to debt funders (Denis, 2004). Secondly, government bureaucracy and favoritism has created a challenging business environment for early-stage entrepreneurial ventures. The complex legislative environment in South Africa, combined with the harsh penalties imposed for non-compliance, creates significant constraints for new entrepreneurial ventures (Rogerson, 2008). The reason for government funding for new business ventures is predominantly job creation, the promotion of innovation and, ultimately, economic growth (Huyhebaert et al., 200). However, government bureaucracy and red tape often does the opposite and unintentionally discourage entrepreneurs from starting new business ventures (Rogerson, 2008). Lastly, the poor quality of education in South Africa is choking new business growth. The distinct lack of entrepreneurial courses in schools indicates that high school graduates are not equipped with the necessary knowledge and skills to start new business ventures (Herrington & Kew, 2013).

## 2.3 Entrepreneurial Ecosystems

Whilst entrepreneurship combined with innovations are important drivers of economic growth, entrepreneurs alone cannot be responsible for creating tomorrow's jobs (Vogel, 2013). Recently, as opposed to focusing primarily on the individual entrepreneur as the unit of analysis, academics have increasingly examined the interaction between multiple actors that make up "entrepreneurial ecosystems." For an entrepreneurial venture to grow and be successful, the right ecosystems must be in place. To achieve scale, startups require low barriers at their inception as well as a legal and regulatory framework that rewards entrepreneurial activity and ensures fair competition. (Vogel, 2013).

According to Vogel (2013:6), an entrepreneurial ecosystem is defined as "an interactive community within a geographic region, composed of varied and interdependent actors (e.g. entrepreneurs, institutions and organisations) and factors (e.g. markets, regulatory framework, support setting, entrepreneurial culture), which evolves over time and whose actors and factors co-exist and interact to promote new venture creation". Isenberg (2011) identifies six domains within the entrepreneurial ecosystem. These include appropriate finance, quality human capital, an enabling culture, a variety of institutional support structures and open markets for products (Figure 3). Isenberg's emphasizes that each country's entrepreneurship ecosystem is unique.

Figure 3: Isenberg's model of an entrepreneurship ecosystem



5/19/2011

Source: Isenberg, 2011

## 2.4 The Dynamics of Crowdfunding

In recent years, crowdfunding has emerged within the entrepreneurial ecosystem as an innovative way for entrepreneurs and early-stage entrepreneurial ventures to secure financing without having to resort to more traditional sources of new venture finance. Various studies have examined crowdfunding's underlying practices and mechanisms, showing it to be a viable and scalable alternative to public and private venture finance.

To date, general definitions have been provided for crowdfunding, which are based on the idea that it is a network of people who collectively pool their money, via the internet, in order to finance and support projects initiated by others. Belleflamme, Lambert, and Schwienbacher (2012:2) defines crowdfunding as “an open call, mostly through the

internet, for the provision of financial resources, either in form of donation or in exchange for the future product or some form of reward and/or voting rights”. However, Mollick (2013) argues that this definition is too narrow, and it excludes certain areas that scholars have labelled as “crowdfunding,” namely internet-based peer-to-peer lending and fundraising initiatives by music fans. Mollick (2013:3) states that crowdfunding should be defined as “efforts by entrepreneurial individuals and groups – cultural, social and for-profit – to fund their ventures by drawing on relatively small contributions from a relatively large number of individuals using the internet, without standard financial intermediaries.”

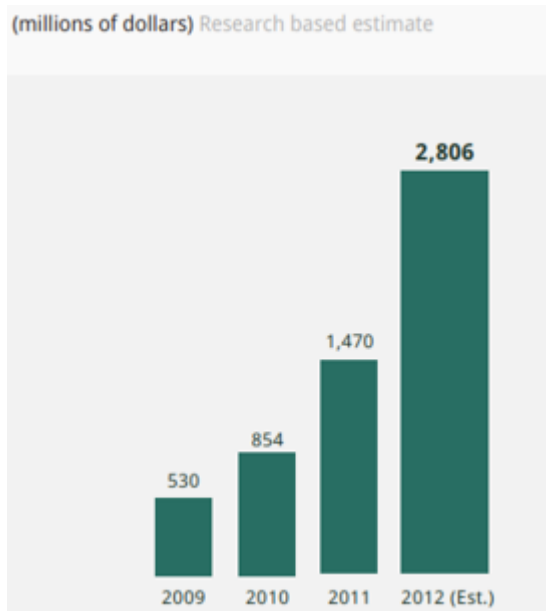
Crowdfunding draws its inspiration from the crowdsourcing movement which Howe (2008) defines as “the act of taking a job traditionally performed by a designated agent and outsourcing it to an undefined, generally large group of people in the form of an open call”.

The internet has allowed for the rapid diffusion of crowdsourcing by facilitating online collaboration among parties; crowdsourcing is, therefore, in essence, not a new concept. In 1884, the American public helped fund the Statue of Liberty through small donations (Hemer, 2011). The English public helped complete the first edition of the Oxford English Dictionary by identifying and coming up with definitions and examples of all the words in the English language (Lanxon, 2011). Furthermore, in the 18<sup>th</sup> century, Beethoven and Mozart financed concerts and the publication of manuscripts by advancing subscriptions from interested parties (Hemer, 2011). Despite these historical examples of crowdsourcing, Kleemann, Vob, and Rieder (2008) argues that Web 2.0 is a prerequisite for crowdsourcing. In truth, it appears that the internet might not have engendered the crowdsourcing phenomenon but, rather, that it has made it more efficient, whilst triggering a trend of rapid growth (Howe, 2008).

In recent years, crowdfunding has experienced rapid growth. In 2012 alone, there were over 800 active crowdfunding platforms worldwide, listing over 1 million projects that had raised US\$ 2.7 billion (Massolution, 2013). In 2013, Masssolution forecasted an annual increase of 81% in global crowdfunding volumes to US\$ 5.1 billion. Kickstarter, one of the first and most popular crowdfunding platforms, has raised over US\$1.3 billion and funded over 68,000 successful projects (Kickstarter, 2014). According to the World Bank (2013), crowdfunding has the potential to deploy US\$ 93 billion of investments in emerging economies by the year 2025; this is almost twice the global volume of venture capital investment. The exponential

growth of crowdfunding justifies further research to understand its impact on the entrepreneurial ecosystem, particularly with regard to other forms of early-stage financing.

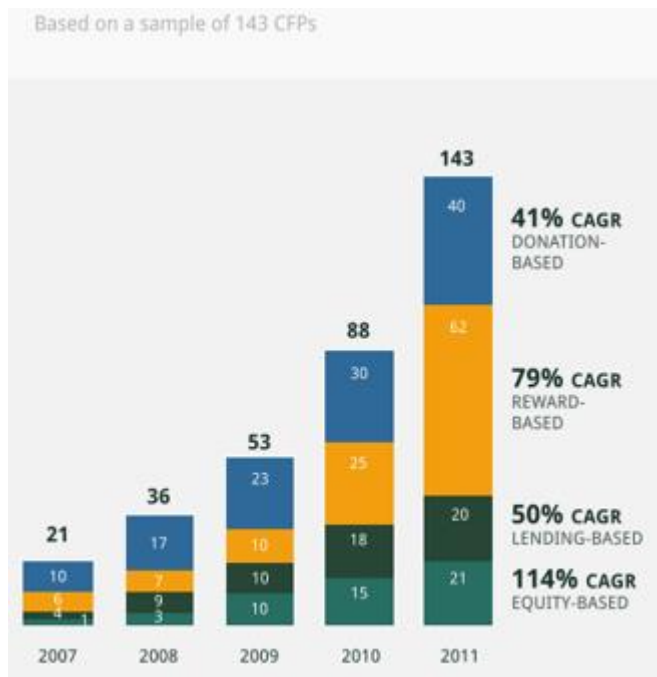
Figure 4: Growth in worldwide funding volume



Source: Massolution (2013)

Presently, there are four different crowdfunding models which specify the way in which individuals fund projects. Mollick (2014) argues that the goals of the entrepreneurs and supporters distinguish the type of crowdfunding model. Equity and lending-based models utilize more conventional investment mechanisms. Lending-based models create a contractual debtor and lender relationship between the founders and supporters, whilst equity-based models, not unlike venture capital, create an investor and entrepreneur bond. In donation-based models, project creators are social entrepreneurs who receive donations from supporters who serve as philanthropists. Whereas, in reward-based models, the most popular model, entrepreneurs are labelled as “founders” and funders represent future customers. The donation-based model is associated with social enterprise models, whereas the equity, lending and reward-based models are aligned more closely with conventional venture capital, since they represent risk capital for entrepreneurial activities and feature tangible or monetary exchange (Mollick 2013).

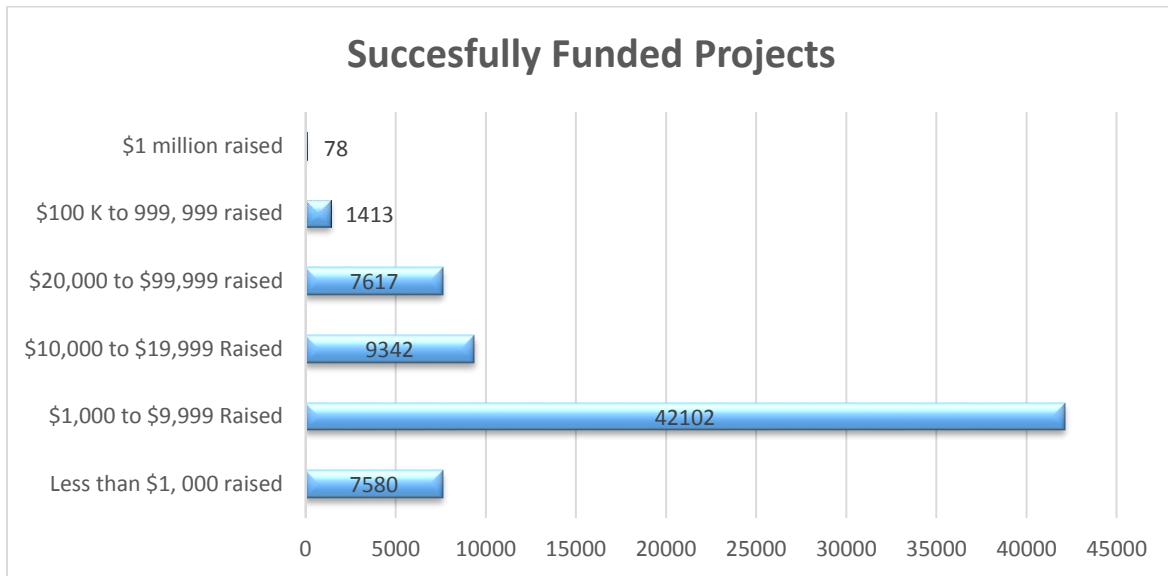
Figure 5: Growth in the number of Crowdfunding Platforms (CFPs) by category



Source: Massolution (2013)

Those who engage in crowdfunding have a wide variety of goals. Increasingly, crowdfunding is becoming a viable source of entrepreneurial seed capital (Schwienbacher & Larralde, 2010). For example, through Kickstarter, which is the leading crowdfunding platform, 78 projects have raised over US\$1 million and 1413 projects have raised between US\$100 thousand and US\$1 million. Of the fifty highest funded projects on Kickstarter, 45 have turned into ongoing entrepreneurial firms.

Figure 6: Successfully funded projects and amounts of funds raised



Source: Kickstarter (2014)

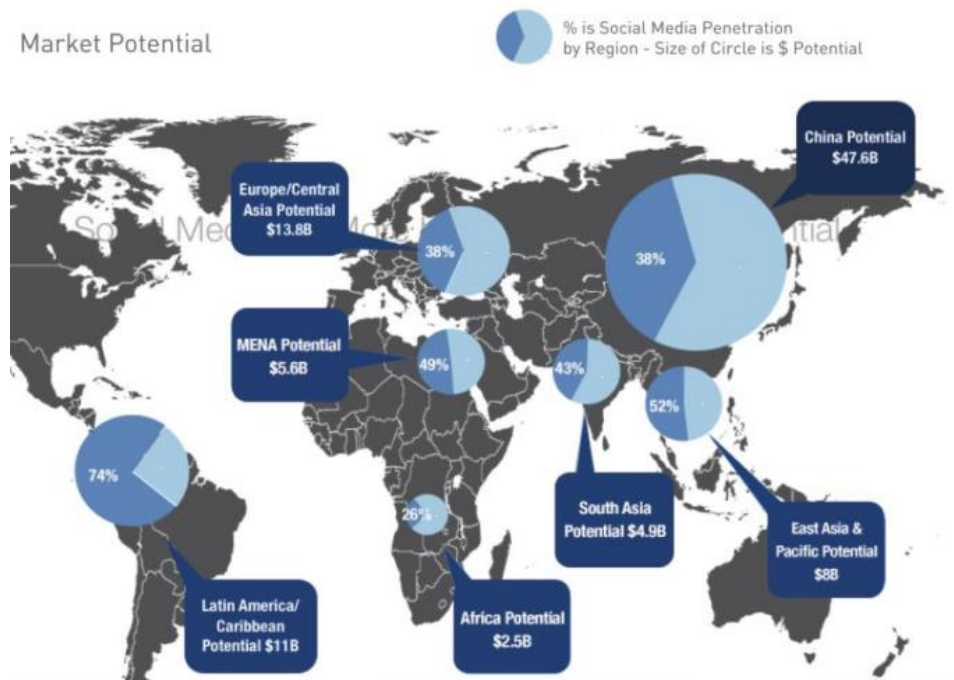
Beyond just capital there are there are other benefits and resources that crowdfunding can offer funding seekers. Firstly, crowdfunding can be used for the marketing of products and/or services and receiving customer feedback; this creates interest in the early stages of development (Frydrych, Bock, Kinder, & Koeck 2014). Indeed, some successful projects create an “ecosystem of complimentary products”, which help in building a competitive advantage even before the project is released (Mollick, 2013). A good example of this is a video game console, Ouva, which led other developers to build applications before the console was released to the public. Secondly, crowdfunding might be able to demonstrate market demand for a proposed project; this can lead to funding from more traditional sources of venturing financing such as venture capital (Mollick, 2013). For example, venture capital firms initially rejected Pebble, a “smart watch”; however, after its widely successful Kickstarter campaign, it was able to secure large amounts of VC investment (Dingman, 2013). Thirdly, raising capital from traditional venture capitalists tends to be dependent on geography. By contrast, crowdfunding might enable capital allocation that is not constrained by geography (Frydrych et al., 2014). However, Mollick (2014) argues that localism and offline social relationships will continue to matter as issues of trust continue to impact crowdfunding inactivity. Lastly, crowdfunding might enable entrepreneurs to facilitate organizational legitimacy. According to Frydrych et al. (2014:252), “crowdfunding leverages

interactive Information Communication Technologies (“ICT”) to create a dynamic environment that could nurture and build organisational legitimacy.” Establishing legitimacy might facilitate faster and efficient capital acquisition and give ventures access to external stakeholders and resources (Mollick 2014).

## 2.5 Crowdfunding in South Africa and other Emerging Economies

There is currently very little research in relation to crowdfunding in emerging markets. The World Bank’s (2013) Report was the first academic piece of literature on this subject within an emerging market context. The World Bank (2013) Report states that crowdfunding is starting to spread globally, and its potential in the developing world could be significant for employment, innovation and growth. The report further states that Africa will have US\$2.5 billion out of the US\$95 billion in yearly crowdfunding investments in emerging markets by the year 2025. (See figure 7). This is due, in part, to the small amount of social media penetration in Africa which is most likely attributed to limited internet connectivity.

Figure 7: Market potential for crowdfunding across regions



Source: World Bank (2013)

Although it is still in the early stages, crowdfunding has been shown to provide entrepreneurial seed capital whilst creating employment opportunities in South Africa (Horga, 2013). However, there are some key factors that have limited the success of crowdfunding platforms in South Africa. These include the lack of awareness and trust and limited mentorship and support mechanisms (Horga, 2013; Chazen, 2013).

## 2.6 Crowdfunding within the Venture Capital Ecosystem

Securing financing is a crucial step in the entrepreneurial process. Currently, it is unclear as to the extent to which crowdfunding will displace or disrupt traditional VC. Many have argued that crowdfunding could increase the pool of entrepreneurial capital, particularly at the earlier stages, and enhance the visibility of a venture to other investors such as angels and venture capitalists (Drover & Zacharakis 2013).

Historically, venture capitalists and angel investors have dominated the early-stage financing space. However, following the U.S.A. JOBS Act, which legalized equity-based crowdfunding in the U.S.A., there has been widespread debate as to whether or not crowdfunding might “crowd out” and/or replace venture capitalists and angel investors (Dawson, 2014). Drover and Zacharakis (2013) argue that it will not, as VC focuses high growth potential ventures, investing on average around US\$7.1 million per deal, which is significantly more than the average amount of capital crowd funded projects raise (see figure 5). Furthermore, the aforementioned traditional funding sources provide more than just start-up capital. They often also provide entrepreneurial expertise, governance, networks and legitimacy (Ferrary & Granovetter 2009; Gompers & Lerner 2004; Gorman & Sahlman 1989).

There are some significant and notable differences between crowdfunding and venture capital that also raise questions concerning the degree to which crowdfunding will impact on the VC ecosystem. According to Mollick (2014), firstly, rather than being “oligopolistic,” crowdfunding is a democratic process. Secondly, compared to the close-knit VC community, crowd funders are loosely organised or not organised at all. Thirdly, as opposed to the closed community of Silicon Valley, crowdfunding is characterized by open communications between those seeking funding, and potential funders in broadly accessible online communities (Mollick 2014). Lastly, crowdfunding might also facilitate investment that is based on a social utility factor. According to Mollick (2014:3) the equity crowdfunding

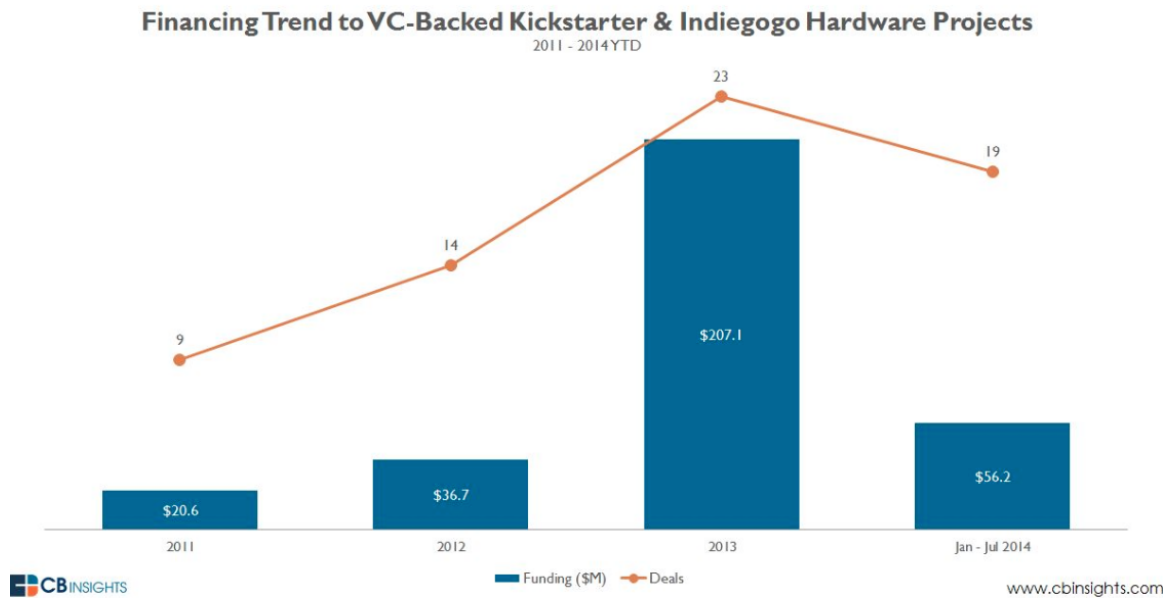
model, although similar to VC, might “incorporate significantly more social and psychological processes than those found in traditional VC.” Investors, although financially motivated, might obtain utility from the sense of community that characterizes the crowdfunding process. Indeed, many equity crowdfunding contracts contain non-voting rights and are long term (10 years) (Frydrych et al., 2014).

Further research is required to examine the degree to which crowd funded start-ups will feed the VC pipeline. Drover and Zacharakis (2013) identify five factors that might limit VCs sourcing deals from crowdfunding platforms. Firstly, entrepreneurs who are funded by VCs are primarily connected through personal networks, which adds confidence and shows legitimacy and credibility. Secondly, the visibility associated with crowdfunding results in exposure to a large pool of people, including those who might attempt copy the idea. Given the proprietary nature of many enterprises, such knowledge might adversely affect the entrepreneur and hence decrease the prospect of acquiring VC backing. Thirdly, crowdfunding’s large pool of potential investors makes for an extremely unconventional and complicated balance sheet. Issues associated with control and voting rights and a large pool of unsophisticated investors might deter a VC. Fourthly, amateur investors will likely trust the entrepreneur for a fair valuation. However, entrepreneurs often place a high and unrealistic valuation on their start-up. The valuation might ultimately be so over-inflated that a VC is no longer interested. Lastly, crowd funders are likely to invest in business to consumer (“B2C”) ventures, which sell and serve the consumer and, whilst consumers are a viable market, VCs invest in many B2B businesses as well.

Despite the aforementioned factors, there have been several instances where crowdfunding has been a complimentary force and acted as a source of deal flow. A recent study by CBInsights (2014), evaluated 443 hardware projects that had raised over US\$100,000 on the crowdfunding platforms, Kickstarter and Indiegogo. According to the report, 9.5% of the projects had gone on to raise VC funding. In 2013 VC invested over US\$200 million in 23 crowdfunding hardware projects, refer to Figure 8 (CBInsights, 2014). The largest VC investment in 2013 was in a virtual reality company, Oculus, which raised US\$75 million. In 2014, Sequoia Capital invested US\$12 million into Lifx, which had previously raised US\$1.3 million on Kickstarter. Additionally, according to industry experts, in 2013, many important projects consumer electronics were funded through crowdfunding platforms, including, electronic watches, 3-D printers, computer hardware, and video game consoles (Jeffries,

2013). Furthermore, crowdfunding demonstrates market demand. Peter Moran, a partner at the VC Firm DCM, states: “that VCs consider whether the public would like a device as an extremely helpful data point for the investment decision-making process” (Brustein, 2014).

Figure 8: Financing trend to VC-backed Kickstarter and Indiegogo hardware projects



Source: CBInsights (2014)

Drover and Zacharakis (2013) anticipate that crowdfunding will disrupt the existing funding ecosystem; however, it will do so primarily for smaller businesses that have more modest growth prospects.

## 2.7 Networks and Signalling

Research has shown that networks are often used for the allocation resources (Cornelli & Goldreich, 2001). Abell and Nisar (2007) state that a network is “a co-operative mechanism that arrives at an allocative decision by consensus and through the pooling of relevant information.” Dubini and Aldrich (1991) define a network as “a patterned relationship between individuals, groups and organizations.” This suggests that a network is a structure through which individuals and organizations are linked and exchange resources and content (Burt, 1992). Tichy (1979) identifies four types of resources that are accessed and exchanged through network ties; these include goods and services, information, political influence and expressions of affect or emotional support.

Networks provide a means through which investors acquire information, thus allowing entrepreneurs to access resources to enable them to pursue business opportunities (Sullivan & Ford, 2014). As Burt (1992:14) articulates: “The network becomes an important screening device. It is an army of people processing information that can call your attention to key bits — keeping you up to date on developing opportunities, warning you of impending disasters.” Thus, the formation and maintenance of a network enhancing one’s ability to collect non-public information (Abell & Nisar, 2007).

Networks are ubiquitous in the VC industry. VCs often syndicate their investments - a process whereby two or more firms partner together for an investment opportunity (Lerner, 1994). The latter leads to numerous relationships, including those with other VC firms, research and development organizations, lawyers and investment bankers (Gorman & Sahlman, 1989). One of the primary rationales for syndication is that it allows VC firms effectively to mitigate the systematic risk surrounding product development and commercialisation (Lockett, Wright, & Sapienza, 2002). Other reasons include gaining access to resources and increasing deal flow.

Prior literature has shown that syndication can enhance the investment decision-making process through improved screening and due diligence (Bygrave, 1988). Investors can pool their specific knowledge and/or complementary skills, reducing information asymmetries and improving the probability of selecting higher quality projects whilst reducing adverse selection (Wilson, 1968).

Not only have networks been important to VCs through syndication, but they have also been used by VCs as a signal of quality. A number of scholars have shown that prominent third party endorsements can assist start-ups in gaining access to resources and that VCs seek these endorsements when deciding to invest (Baum & Silverman, 2004; Stuart, Hoang, & Hybels, 1999). The endorsements are important because they serve as reputational signals of quality.

While previous research has long noted the importance of networks in obtaining VC backing (Hsu, 2007; Shane & Cable, 2002), networks are of particular importance in crowdfunding. A network of social ties provides the medium through which crowdfunding platforms function, allowing a project to tap into a broad base of potential funders. Crowdfunding is, however, a very different source of seed funding when compared to traditional VC, and it is much less

clear how individuals use strategic networks in an online environment (Ferrary & Granovetter, 2009),

Furthermore, critics of crowdfunding have pointed out that signals of quality are less relevant in crowdfunding, which suggests that this form of financing might be ineffective in selecting high potential entrepreneurs (Mollick, 2013). If funders act like VCs and assess the product's quality, the management team and the probability of success (Gorman & Sahlman, 1989), then identifiable signals of project quality should predict project success (Mollick, 2013). High-quality projects attract backers who might promote the project to other potential backers or external media, thus increasing the draw of the project (Mollick, 2013).

If, however, crowd funder look for signals of quality, in the same way, as other providers of entrepreneurial capital, it reinforces the ability of crowd funders to select appropriate entrepreneurs to back. Mollick (2014) suggests that funders do engage in some assessment of signals of quality when examining entrepreneurs who are seeking crowdfunding. In such cases, crowdfunding networks could act as a screening mechanism for the VC decision-making process (Burt 1992).

## 2.8 Evaluation Criteria Used by Venture Capital Firms for Investment Decisions

There is a significant amount of uncertainty involved in assessing the quality of early-stage ventures. Due to the lack of historical data or even working prototype, VCs have to rely on limited signal of quality to determine if a new enterprise will be successful (Lerner, 2002; Ueda, 2004). However, despite their expertise, research has shown that 40% of all VC investments fail to produce profitable returns and only one in every 100 businesses pitched to VC Firms receive funding (Zacharakis & Meyer, 1998).

VC is a subgroup of private equity and refers to seed or early-stage financing made available to more risk-oriented pre-initial public offering business ventures (Banerjee, 2008). VC investments typically do not involve debt, as the target start-up companies have no proven track record, operational history or measurable cash-flow, which are required to service debt financing (Fraser-Sampson, 2010). Indeed, the unproven nature of the investee companies result in the high risk and rewards that characterize VC investments (Patzelt, zu Knyphausen-Aufseß, & Fischer, 2009).

The VC industry is made up of four major players, namely the VCs who are managing the investments, the entrepreneur who is seeking capital for his/her business venture, the investor looking for a return investment and the investment bankers who are seeking to sell companies to the public (Zider, 1998).

Due to the importance of VC in promoting entrepreneurial activity, the investment process has been researched extensively. The “venture capital cycle” begins when VCs use network ties, personal referrals and direct contact with entrepreneurs to find firms of interest, (Gompers & Lerner, 2004). VCs then invest in enterprises based on expected return on investment and fit with their mandate (Gompers & Lerner, 2004). After the initial investment, the VC firm then actively works with the early-stage venture, granting them reputational benefits from the VC endorsement, providing monitoring and governance and providing access to additional resources (Baum & Silverman, 2004; Hsu, 2004; Ferrary & Granovetter, 2009; Lerner 2012).

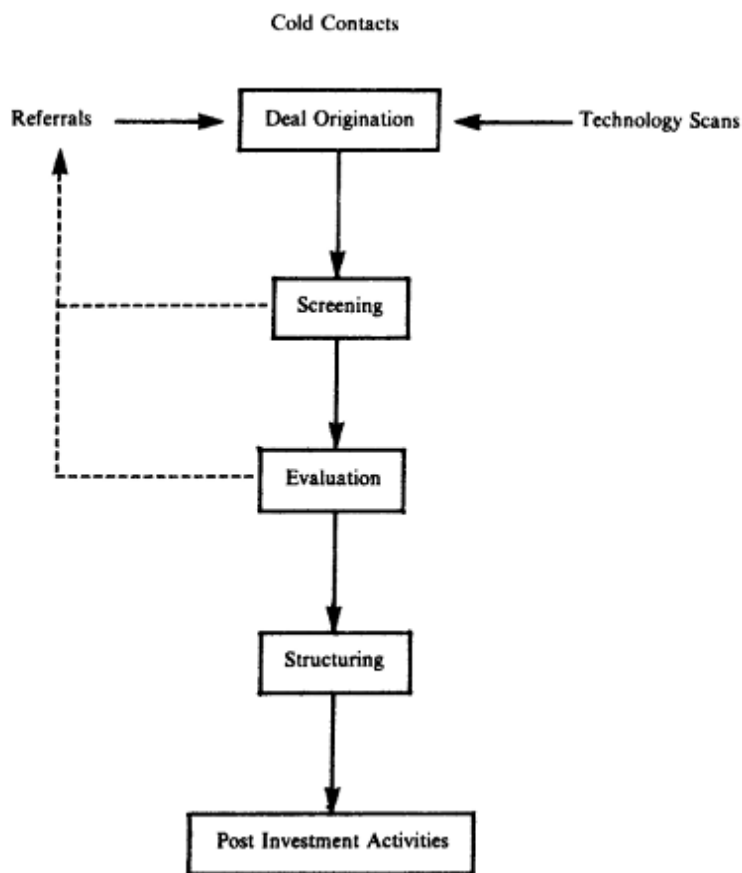
Determining the economic value of a new venture is one of the major challenges for VCs (Deventer & Mlambo, 2009). Ge, Mehoney and Mehoney (2005:5) express the opinion that this is due to “the idiosyncratic characteristics of new ventures (e.g. their short operating history and limited accounting information) and the inefficiency of the venture capital market, which leads to fundamental theoretical and economic measurement challenges for extant financial valuation approaches, which rely heavily on accounting information that early-stage new ventures typically cannot provide.” Researchers have found that, as the success of an early-stage venture is uncertain, investors often need to act on partial information. Potential signals of quality are of particular importance in the selection process, given the often unreliable and incomplete data which surrounds new ventures (Beckman, Burton, & O’Reilly, 2007). These signals include trusted third party endorsements, the founder’s backgrounds and the quality of the pitches made by entrepreneurs (Kirsch, Goldfarb, & Gera, 2009). The VC decision-making process, therefore, relies heavily on the identification of non-financial methods and factors.

During the decision-making process, VC firms gather information which is needed to make, insofar as it is possible, an informed decision as to whether or not to invest in a new venture (Deventer & Mlambo, 2009). However, VC firms face significant adverse selection risk when deciding on an investment. According to Fried & Hisrich (1994), VC firms use the decision-

making process to assess the probability of success or failure of a new venture, thus reducing the risk of adverse selection. Notwithstanding this, numerous studies have shown that VC investment decisions are plagued with difficulties due to the information asymmetries between the entrepreneur and investors, leading to potentially serious moral hazard (Amit, Glosten, & Muller, 1990; Barry, 1994; Gompers, 1995). In the former, on one hand, investors do not fully understand the value proposition and the viability of the start-up and, on the other hand, the entrepreneur has a clearer understanding of his/her business idea. The presence of information asymmetry leads to perceptions of higher risk (at least from an investor's point of view) and thus a higher cost of capital (Gompers, 1995). In the latter case of moral hazard, once the entrepreneur has raised the required capital from the investor(s), he/she has no incentive not to use the money for the benefit of the entrepreneur and not necessarily the start-up business (Gompers, 1995). It is, therefore, critical that the VC Firm makes use of the correct criteria and valuation methods when assessing a potential VC investment, in order to minimize the potentially harmful effects of adverse selection and moral hazard.

The VC investment decision-making process has long been of interest to scholars, from the earliest studies (Wells, 1974; Tyebjee & Bruno, 1984; Macmillan, Siegel, & Narasimha 1985; Fried & Hisrich, 1994; Muzyka, Birley, & Leleux, 1996) to more recent studies (Roberts & Barlery, 2004; Kahnin, 2006; Franke & Gruber, 2008). According to Tyebjee and Bruno (1984), VCs' investment process contains five steps (see figure 4 below). The first step is deal origination, where the VC firm is made aware of potential investment opportunities. Next is the screening process, where VCs eliminate candidates who do not meet their investment criteria. Thirdly, the viability of each screened venture is determined through an evaluation process. Fourthly, the deal is structured through a process of negotiations and, lastly, management and control structures are put in place to protect and manage the investment. Fried and Hisrich (1994) expanded Tyebjee and Bruno's (1984) five-stage model to include two screening and two evaluation phases.

Figure 9: Decision process model of VC investment activity



Source: Tyebjee and Bruno (1984)

Various existing research has recognized and established the relative importance of a number of relevant VC investment criteria for evaluating entrepreneurial business proposals. The leading investment criteria noted by these studies include the attractiveness and size of the market (Tyebjee & Bruno, 1984), management skills and capabilities (Wells, 1974), product or service uniqueness (Fried & Hisrich, 1994), market acceptance and traction of a product and the degree of competition (MacMillan et al., 1985; Muzyka et al., 1996) are amongst the leading investment criteria used by VCs.

The main investment decision-making criteria identified in the literature is summarised the table below.

Table 1: Summary of reviewed literature venture capital investment criteria

<b>Management Team Criteria</b>	
<b>Author</b>	<b>Area of study</b>
Wells, 1974	Functional skills of management (i.e. marketing skills, financial skills and general skills)
Fried and Hisrich, 1994	Management expertise and capabilities
Wells, 1974 and Kumar, 2003	Management team's determination, commitment, attention to detail, and risk tolerance
Franke and Gruber, 2008	Experience of the VCs evaluating the management team
<b>Market Criteria</b>	
Tyebjee & Bruno, 1984	Access to the market
MacMillan et al., 1985	Market readiness
Muzyka et al., 1996	Size and growth of the market
<b>Product Criteria</b>	
Muzyka et al., 1996	Uniqueness of the product
Zacharakis & Meyer, 1998	Proprietary nature of the product
MacMillan et al., 1985	Functioning prototype of the product
Fried and Hisrich, 1994	Competitive advantage of the product
<b>Risk Criteria</b>	
MacMillan et al., 1985	Identified five risks: bail out risk, management risk competitive risk, investment risk, implementation risk
<b>Returns Criteria</b>	
Poindexter, 1975	The potential IRR of an investment
Zacharakis, 1995	The entrepreneur's enterprise valuation
<b>Exit Criteria</b>	
Tyebjee & Bruno, 1984 MacMillan et al., 1985	When and how a VC exits the investment
<b>Deal Criteria</b>	
Poindexter, 1975 and Muzyka et al., 1996	The equity stake and price

From the literature, it is apparent that there are many of diversities in VC investment criterion. However, it is evident that the management team, their experience, abilities and personalities are the predominant criteria in the venture capital decision-making process. MacMillan et al. (1985:119) states, “There is no question that irrespective of the horse (product), horse race (market) or odds (financial criteria), it is the jockey (entrepreneur) that fundamentally determines whether the venture capitalist will place a bet at all”. Macmillan et

al. (1987) also found the level of market acceptance to be of significance. Indeed, more recent literature suggests that VCs have shifted their focus towards market acceptance of the product (Fried & Hisrich, 1994).

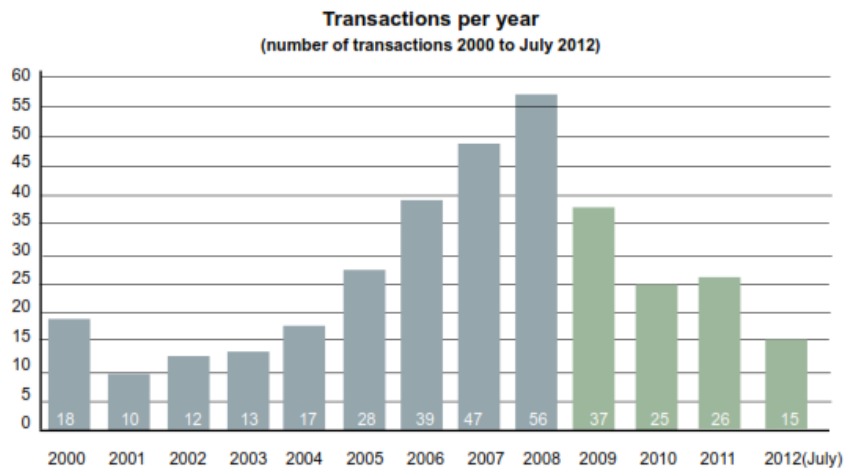
## 2.9 Venture Capital in South Africa

Historically, South Africa has had a weak VC culture. Despite the significant growth of Private Equity (“PE”) in South Africa, VC itself has played a minor part in the total PE activity. VC as percentage of PE investments dramatically decreased from 25% in 2002 to 2% in 2007 (David Charles Lingelbach, 2009). Lingelbach et al. (2008) attribute this to poor public-private co-operation as well as a preference for later-stage investments. Long (2007) argues that this is because the American VC model does not work in the South Africa environment that is characterised by larger demands for capital with higher risk and lower returns.

Only in recent years has there been a growing interest in the VC industry. This is supported by the establishment of the South Africa Venture Capital and Private Equity Association (“SAVCA”), which seeks to promote VC and PE throughout Southern Africa (SAVCA, 2014). The South African VC industry is, however, still in its infancy, and there is no significant growth in the number of new VC funds (Deventer & Mlambo, 2009).

According to a joint survey on venture capital activity in South Africa conducted by SAVCA and Venture Solutions, the number of venture capital transactions per year has decreased drastically since 2008. As seen in figure 10, in 2008, there were 56 venture capital investment transactions. In 2011, there were only 25 deals and up to July 2012 there were only 15 deals.

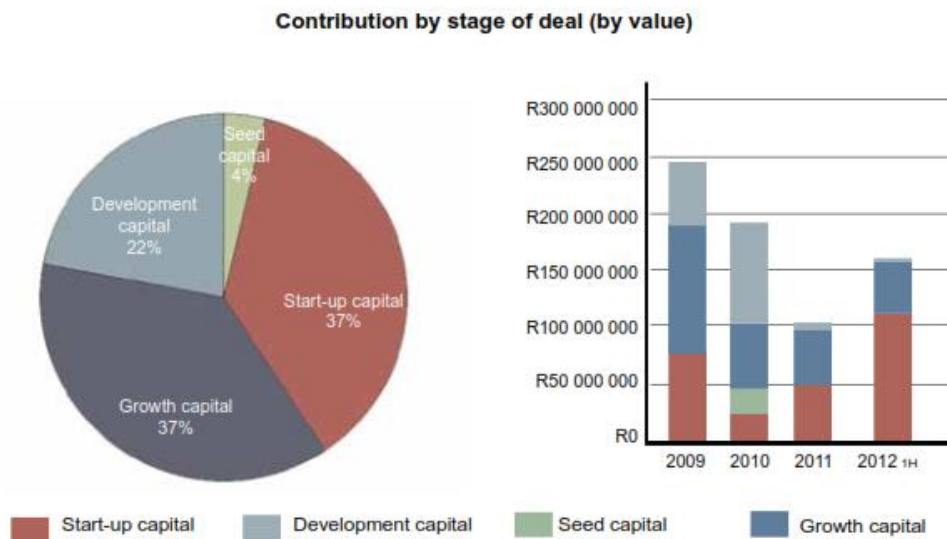
Figure 10: Number of VC transactions concluded



Source: Lamprecht and Walt, 2012

The vast majority of the transactions involved deals in the growth stage and later stage with only 4% of deals concluded in the seed stage (see figure 11 below). According to SAVCA, venture capital is still an emerging asset class in South Africa (Lamprecht and Walt, 2012)

Figure 11: Contribution by stage of deal



Source: Lamprecht and Walt, 2012

## 2.10 Conclusion

Crowdfunding has become increasingly prevalent in capital markets and is likely to continue on its trajectory of rapid growth and market adoption. The literature review revealed the potential for crowdfunding to compliment entrepreneurial ecosystems by providing a viable source of seed capital as well as inform the venture capital investment process. The literature also revealed the uncertainty and difficulty in evaluating an early-stage venture. Venture capitalists and early stage financiers have adopted numerous investment criteria to help them better determine the success of a start-up, but still face significant hurdles in picking winning investments due to the informational asymmetries surrounding early-stage ventures. Very little literature is available on crowdfunding in the context of the South African entrepreneurial ecosystem and how it might complement other forms of early-stage financing. The literature review identified several areas that will need to be understood before crowdfunding can be co-opted into the South African entrepreneurial ecosystem.

## 3 Research Methodology

### 3.1 Research Approach and Strategy

The aim of this study is to explore the potential influence of crowdfunding on venture capital in South Africa. As crowdfunding in South Africa is still in its infancy, this particular area has not been extensively studied and researched. In addition to this, the research question is narrow in scope with only a few industry practitioners who can cast light on pertinent issues surrounding this topic. This exploratory research, therefore, will take the form of a qualitative, inductive study.

According to Bryman & Bell (2007), there are two research approaches that are classified according to the logic they rely on, namely the deductive and inductive approaches. Research that yields theory as an outcome is considered as inductive research, whereas deductive research uses theory to test outcomes. (Bryman and Bell, 2007). In the case of this research, an inductive approach is appropriate because inductive research seeks to make conclusions from general observations, creating a theory in the process (Bryman & Bell, 2007).

According to Bryman and Bell (2007), the aim of qualitative research is to produce a detailed

understanding of human behaviour and the reasons that govern such behaviour. It investigates the “why?” and “how?” of decision making, as opposed to only “what?”, “where?” and “when?” Qualitative research emphasizes words and phrases in the analysis, as opposed to using of quantitative measurements such as statistical analysis. This research approach seemed most appropriate as it allowed the researcher to study categories and themes that emerged from the data, which are contextual and help to explain the phenomenon under study (Leedy and Ormrod, 2005). Furthermore, Creswell (2013) states that qualitative research is best suited for sourcing information on a topic that has limited information available and lacks an established theoretical basis. Semi-structured interviews will be the primary method of gathering information; these interviews will be transcribed and coded. Similar codes will be grouped into themes and generalizations will then be inferred from this information.

The major advantage of qualitative research is that the researcher can record feelings, behaviours and attitudes providing a more in-depth and detailed understanding than quantitative studies. Furthermore, qualitative research approaches have the advantage of exposing the researcher to different perspectives and viewpoints (Bryman & Bell, 2007). The major disadvantage of qualitative research is that there are usually fewer people studied when compared to quantitative; this then makes it harder to generalize a finding to the whole population. To a degree, qualitative research has also been regarded as less rigorous than quantitative research; this is mostly due to the misconception that it is unscientific (Mays and Pope, 1995; and Sandelowski, 2000). Mays and Pope (1995) specifically highlight concerns about being able to reproduce qualitative studies, the ability of the researcher to generalise and the objectivity of the researcher. However, comparing qualitative and quantitative methodologies can be problematic. While both are valid approaches, qualitative research best suited for more descriptive and exploratory research and for testing broad hypothesis.

Data was gathered through a comprehensive literature review, which identified the thinking around key factors related to the VC investment process and crowdfunding’s arrival as a viable source of entrepreneurial capital. Field research was conducted to gather data from practitioners operating in the VC ecosystem through semi-structured interviews, where the interview guideline formed the basis for a discussion guide. These interviews formed the basis for comparison and provided adequate flexibility for respondents to reveal emerging issues that were not shown in the literature review.

Data collected was analysed and classified into various categories/codes that were then grouped into related concepts or themes. Each of these themes was examined considering their influence on the research question, as well as their relationships with each other. The data was then analysed to test the primary research question and the validity of the findings.

### 3.2 Research Design, Data Collection Methods and Research Instruments

The research design will follow a cross-sectional research design in order to determine, within the context of South Africa, how crowdfunding could potentially influence the early stage financing ecosystem in South Africa. Bryman & Bell (2007) identify five primary research designs; these include experimental, cross-sectional, longitudinal, case study and the comparative design. A cross-sectional research design involves the collection of data from a number of instances at a single point in time.

According to Leedy and Ormrod (2005), interviews are useful for collecting information about people's beliefs, perspectives, feelings, motives, and behaviours. There are three types of interviews in research; these include: structured, semi-structured and unstructured interviews. A structured interview requires that all questions and the recording of the answers be standardised in order to provide all participants with the same context of questioning. On the other hand, unstructured interviews are not standardised with the questions asked being tailored specifically for each participant and the interviewer having discretion over how to respond (Bryman and Bell, 2007).

The exploratory nature of this research and the descriptive quality of the data necessitate the need for deeper insights and explanations as well as reasoning and rationale which validate the findings from the qualitative analysis. In order to facilitate a descriptive analysis and to allow for more flexible data gathering, semi-structured interviews are considered appropriate. This will give the researcher more flexibility to explore specific areas identified in each interview. The data for this research was, therefore, predominantly collected through face-to-face or telephonic, semi-structured interviews with venture capitalists, angel investors and entrepreneurs in South Africa.

The interviews were conducted as open discussions, which allowed interviewees to express their views and opinions in an unimpeded manner and ensured a natural flow to the

conversation. This was, however, done within the framework provided by the interview guideline and thus ensured a degree of standardisation across the sample population (see Appendix B). The interview guideline, however, merely provided a general framework to guide the conversation. The guideline, which was formulated based on themes extracted from the literature review, was not altered between interviews. However, when considered necessary, the researcher was able to use discretion during the interviews in order to direct interviewees towards appropriate topics. This in turn allowed for the gathering of in-depth and rich data that was especially important, given the size of the sample population.

At the end of each interview of set of close-ended questions were asked of each of the interviewees in the form of a Likert Scale. The Likert Scale questions were formulated using venture capital investment decision-making criteria identified in the literature and used by overseas VCs in their evaluation process. Respondents were given a scenario based on the VC investment criterion and asked to express whether they strongly agreed, agreed, were undecided, disagreed or strongly disagreed. This gave the research a means to compare the respondents' thoughts consistently on how crowdfunding could inform particular VC investment criterion.

In the event that the respondent was unavailable for an interview, a self-completion questionnaire based on the interview guidelines was sent to the respondent. Only one respondent was unavailable for an interview and therefore completed the self-completion questionnaire, which was formulated using the interview guideline. In order to prepare the interviewees in advance for an engaging discussion about this research, a formal introductory email and positioning statement was sent to each interviewee (seen "Appendix C").

### 3.3 Population and Sampling

Sampling is the process of selecting research participants from amongst the whole population, and it involves decisions regarding which people, behaviours, settings, and events, to study (Bryman and Bell, 2007). The researcher did not follow a random sampling approach but was deliberate in the selection of potential interview candidates.

A database of potential respondents was created, which the researcher used to construct the sample pool. The researcher did not follow a random sampling approach but was once again

deliberate in the selection of interview candidates. In order to gather comprehensive and accurate data, the researcher sought out interview candidates who are considered experts and recognised as influential, knowledgeable people in their respective organizations and professions (Cooper and Schindler, 2003). Indeed all interviewees, except two, were either the owners of or top executives of their respective companies.

The database was created from information sourced from Google, information on existing networks (such as Silicon Cape and SAVCA) and by asking respondents for potential referrals. In addition, an invitation list for the Start-Up Africa event organized by Simodisa at the Cape Town Convention Centre (CTICC) in October 2014 was made available to the researcher and provided a comprehensive set of contact data to choose from - an approach also known as convenience sampling. In addition to utilizing the invitation list, the researcher also attended the event and established several connections with potential respondents. To secure further interviews, the researcher also requested most of the interviewees to recommend other interview candidates - an approach known as snowball sampling (Bryman and Bell, 2007).

In addition, potential respondents were approached at the aforementioned Start-Up Africa event; this means that the sample was selected using a non-probability sampling method (Bryman and Bell,).

In the end, the researcher managed to conduct nineteen interviews and one self-completion questionnaire (a total of 20 respondents) with individuals from 18 different organisations. The interviewees included representatives of venture capital and private equity firms, local incubators and accelerators, crowdfunding platforms and start-ups. The interviews lasted between 20 and 40 minutes, with most respondents being eager to converse and assist in the research being conducted. The names of the respondents and their organisations have deliberately been withheld. Verbatim quotes are matched only by a number, for example "Respondent 3." There is a vast amount of knowledge and experience amongst the respondents, with a number of them being acknowledged by their peers as thought leaders and pioneers of venture capital and entrepreneurial ecosystems in South Africa. The job titles of the respondents have been included in the table below to demonstrate the relative seniority of the interviewee in his/her respective organisation. A list of organisations interviewed is provided in "Appendix A."

Table 2: Interview details

Interviewee	Date	Approx. Duration	Location	Job Title	Transcribe?
Respondent 1	16.10.2014	40 mins	Cape Town	COO	Yes
Respondent 2	17.10.2014	30 mins	Telephonic	CEO	Yes
Respondent 3	20.10.2014	20 mins	Telephonic	CEO	Yes
Respondent 4	21.10.2014	30 mins	Cape Town	CEO	Yes
Respondent 5	21.10.2014	20 mins	Telephonic	CEO	No
Respondent 6	21.10.2014	35 mins	Cape Town	CEO	Yes
Respondent 7	21.10.2014	30 mins	Cape Town	CEO	Yes
Respondent 8	22.10.2014	40 mins	Cape Town	CEO	Yes
Respondent 9	22.10.2014	N/A	N/A	CEO	N/A
Respondent 10	23.10.2014	30 mins	Cape Town	COO	Yes
Respondent 11	24.10.2014	25 mins	Cape Town	CEO	Yes
Respondent 12	24.10.2014	30 mins	Cape Town	Investment Analyst	No
Respondent 13	27.10.2014	40 mins	Cape Town	Consultant	Yes
Respondent 14	28.10.2014	35 mins	Telephonic	CEO	Yes
Respondent 15	29.10.2014	20 mins	Telephonic	CEO	Yes
Respondent 16	31.10.2014	25 mins	Cape Town	CEO	Yes
Respondent 17	31.10.2014	20 mins	Cape Town	CEO	Yes
Respondent 18	06.11.2014	30 mins	Cape Town	CEO	Yes
Respondent 19	10.11.2014	15 mins	Telephonic	Partner	Yes
Respondent 20	12.11.2014	25 mins	Cape Town	CEO	Yes

### 3.4 Data Analysis

All the interviews including the telephonic interviews were captured by an audio-recording device, after which the interviews were transcribed. The large pool of data was analysed using content analysis seeking to break down and sort the data in terms of underlying themes that represent the body of information (Leedy and Ormrod, 2005). In order to analyse and summarise the pool of data, the researcher followed Bryman and Bell's (2007) s guide to content analysis.

Prior to each interview, the researcher did preliminary research on the individual being interviewed. Each interview was recorded using an audio-recording device, which was then transcribed using Microsoft Word. Once transcribed, the researcher repeatedly read the transcripts to get a general understanding of the body of information. After transcribing the interviews, the researcher uploaded the transcripts to Dedoose, a qualitative analysis software. The researcher used Dedoose to code all the information contained in the interviews. A total of 54 codes and sub codes were produced from the nineteen interviews and single self-completion questionnaire. The researcher reduced the 54 codes to a total of 32 primary codes with some having sub codes. The research used Dedoose's software to create a matrix of code co-occurrences, which was used to identify the number of times two or more codes co-occurred. When there was a lot of co-occurrences to a particular code, the researcher examined the data to determine if a theme was emerging, if so, the researcher created a theme. Themes were reviewed and analysed to ensure all the codes were captured according to a particular theme. A total of six themes emerged, which were named accordingly. The report was produced over four weeks following the final interview on November 10<sup>th</sup>.

### 3.5 Research Limitations

There are a number of possible limitations that might have affected the research. Firstly, due to the limited time available and the time-consuming nature of the interview process, the research was limited to 19 interviewees and a single self-completion questionnaire. As a result, the sample size might not have been sufficiently representative of the entire population within the VC ecosystem in South Africa. Secondly, due to the convenience sampling

approach, the research findings might be biased and not representative of the greater VC community; for example, views of South African Development Finance Institutions (“DFIs”) are not represented in this research. Thirdly, due to the interpretive nature of qualitative research, this form of research might be biased due to interviewees’ and researchers’ subjectivity (Leedy & Ormrod, 2005).

The researcher personally performed all the interviews in order to maintain consistency on the subject matter and ensure the reliability of the research.

In an effort to ensure the reliability of the study, the researcher personally performed all the interviews to maintain consistency across the subject matter. In addition, the researcher endeavoured to ensure research outcomes were grounded in data and not merely an expression of the researcher’s opinion.

## 4 Research Findings, Analysis and Discussion

### 4.1 Research Findings and Analysis

This chapter analyses the findings that emerged from the interviews conducted. The first two sections focus on the venture capital landscape in South Africa and the key factors restricting venture capital growth. The following sections look, on the one side, at the potential benefits and barriers to crowdfunding within the South African entrepreneurial ecosystem, and on the other side, at how crowdfunding practices might shape South Africa’s venture capital industry.

#### 4.1.1 An Overview of the Venture Capital Landscape in South Africa

##### 4.1.1.1 *Supply of Money*

There was broad agreement amongst the interviewees that venture capital in South Africa is relatively immature and underdeveloped industry. Interestingly, most of the venture capitalists interviewed claimed that the reason for the immature VC sector is not due to a lack of capital available for start-ups. Indeed, according to many of the respondents, there is a sufficient supply of equity capital available for start-ups. This contrast to Omidyar’s (2013)

findings highlighted in that there is a lack of equity capital for early-stage ventures. One respondent observed:

*“Okay, so I think that the real issue on the VC side is that there is money available. We have a very strong financial sector, but the actual ecosystem is immature.” (Respondent 15)*

Another interviewee echoed this sentiment and implied that there may be an oversupply of capital.

*“There is no shortage of money in South Africa. It is a misconception amongst entrepreneurs. For good investments, there is money. Good companies always get funding. That’s not the problem. What we see in South Africa is that there is way more money than there is deal flow.” (Respondent 4)*

As captured in the quotation above, contrary to popular opinion, the problem facing many VCs in South Africa is not a lack of funds to invest; the problem appears to be a lack of quality businesses to invest in

#### *4.1.1.2 The Quality of Entrepreneurs and their Ventures*

17 of the 20 interviewees cited the poor quality of businesses seeking VC funding as one of the primary reasons for the small VC market in South Africa. However, there was significant variety of the types of quality issues. Firstly, many of the respondents stated that there is an important lack of technical skills and business expertise among entrepreneurs, creating talent shortages and affecting the ability of entrepreneurs to execute their business plans:

*“The majority of entrepreneurs that we have worked with, they just don’t have the same skills as what I have seen in the developed market. So the first issue is that there is a bit of a talent shortage here on the entrepreneur’s side.” (Respondent 15)*

*“There is a lack of brain power and business acumen. It’s because you can’t trust the entrepreneur to execute because they don’t have the business know-how and knowledge of the local market. So, I think the problem is both lack of technical expertise, lack of business expertise and lack of understanding.” (Respondent 6)*

Secondly, six interviewees identified that many of the deals that they receive are not well-packaged businesses, but rather just ideas or concepts that have poor business fundamentals. In more developed economies, like the U.S., entrepreneurs can get funding for concepts and ideas, however, often the entrepreneurs have strong track records of raising VC funding and going through successful exits. One of the interviewees however expressed the view that entrepreneurs in South Africa are extremely innovative and resourceful. Unfortunately, many of them lack the maturity and business fundamental necessary to build companies that have a solid business case.

*The second thing is that again because of that sort of immaturity of entrepreneurs a lot of them are expecting to raise money based on an idea where if you look around the world that is very seldom and only works if you have a previous exit or a really strong track record or previously raised funding.” (Respondent 15)*

*“The problem is that at the pitch stage, because the relative inexperience of entrepreneurs and start-up teams, the quality of the pitches that we get are not great. The business case doesn’t really make sense or the pitch is about a concept and not really a business opportunity.” (Respondent 14)*

Thirdly, there is a lack of scalable businesses. There are many good small businesses, but they may not be attractive investments because they are not scalable. As one interviewee observed:

*“There is deal flow, but the quality is not always that great. And there are a lot of unscalable businesses that are doing well and that’s nice, but for investors it’s not that attractive.” (Respondent 18)*

One of the interviewees acknowledged that there is a much smaller pool of entrepreneurs in South Africa that have solid teams and strong backgrounds. However there are still *“lots of diamonds to be found and if there weren’t we wouldn’t have companies like Bidvest, Investec and Discovery today, so there are unbelievable entrepreneurs in South Africa”* (Respondent 16). Despite there being some great entrepreneurs, the pipeline for VC has remained quite poor, creating difficulties in sourcing investible opportunities and contributing to VC ecosystem that is significantly underdeveloped and not established.

#### 4.1.1.3 Risk Tolerance

Another significant factor that is restricting the VC ecosystem in South Africa is risk. There was unanimous agreement among respondents that risk tolerance has been a huge barrier to VC in South Africa. Traditionally, the wealth in South Africa has been made from a few conservative industries and is concentrated in a handful of South African families, which has created a perpetual environment where wealth is accumulated through conventional means without taking much risk. Presently, no one in South Africa has made a significant amount of money from a risky asset class like VC. As one respondent stated:

*“VC in South Africa has not taken off, for one fundamental reason - risk tolerance. If you look at where the majority of South African wealth is concentrated; it’s in the hands of 10 families: the Ruperts, the Basons, the Oppenheimers, the DeBeers. And those have come from traditionally very conservative industries: Media, mining, agriculture, minerals, retail, and construction. So very traditional sectors. The way South African wealth has perpetuated itself is families conserving wealth and growing it in traditional manners and not taking risk. So the concept of taking risk, especially in the tech, biotech, renewable energy, software, mobile space is so foreign to the wealthy families in South Africa, that it is something so far beyond their wildest imaginations, that it doesn’t even exist.” (Respondent 10)*

Furthermore, another interviewee noted that as an emerging economy, the economic stability of South Africa is significantly more volatile than a developed economy, which creates a higher degree systematic risk for early-stage investors. In an emerging economy context, external market risk are exacerbating the inherent venture risk:

*“I think investors being risk averse is largely tied to being in a developing country where the economy is more volatile. Investors aren’t wanting to take a 5 or 10 year view on a very early-stage investment because those external factors can materially alter the success of a venture.” (Respondent 20)*

#### 4.1.1.4 Private Equity

The risk averse nature of South African VCs has had profound implications for the ecosystem as whole, creating a sort of hybrid VC industry, which lies between venture capital and

private equity. The high level of risk aversion has led many VCs to adopt a different model, which focuses more on whether or not the business is post revenue. One respondent admitted that “In South Africa revenue plays a much big part of the investment decision-making process” (Respondent 2). This focus on revenue has led to VCs to investing at later stages in the venture cycle. As one interviewee observed:

*“What I think is interesting is that there’s different model of venture capital that’s emerging here that is later stage and that is actively managed somewhere between VC and PE.”*  
(Respondent 6)

Another respondent substantiated this by pointing out that most of the VC funds are more growth equity funds, looking for proven business models:

*“Most of the time VCs in South Africa are more private equity where they’re giving you expansion capital. You have proven your model in South Africa, you want to expand into other countries and they want to give you money for that. There are a few cases where VC’s have given start-ups in South Africa money but it’s few and far between.”* (Respondent 17)

#### 4.1.1.5 Success Stories

Interviewees went further to explain that there are several other critical barriers facing the VC market. Firstly, there is a lack of success stories in the ecosystem. In the U.S., there have been several instances where companies have gone through billion dollar exists. “Investors get excited about that and more likely to put money into VC funds because they’re hearing these incredible returns and great stories, and they want to be part of it. Unfortunately, we don’t have a South African Facebook, or a South African Instagram or YouTube.”

(Respondent 1). There was consensus amongst the interviewees that the difficulty in exiting a VC investment is severely hindering the industry’s ability to engender success stories. VCs have very limited options for exiting their investments in the South African market. The issues of limited exit opportunities were articulated by respondent 10: “The IPO market is pretty much non-existent. The AltX index and JSE are way too expensive for firms to list. Management buyouts, unless you are really cash flow positive, it’s very unlikely that the founders will buy you out, which leaves you with two options: it’s either another VC or a PE firm buying a secondary capital raise, which can happen but it’s difficult here or the most

*likely case for an exit here is M&A.*” (Respondent 10). The above response alludes to the issue that VCs are unable to confidently predict if and when they will be able to exit their positions. The lack of a robust secondary market creates an additional layer of complexity for the investment decision-making process. VCs have to be pickier with their investments as their exit options are far more limited.

#### 4.1.1.6 Valuations

Secondly, there was broad agreement amongst the venture capitalists interviewed that the overvaluation of companies is very problematic. Entrepreneurs are basing their enterprise valuations on similar businesses in the United States, which is extremely unrealistic. For instance, one venture capitalist noted “*overvaluations are a massive problem; Guys are valuing their companies at valuations of 25, 30, 40 million Rand. It’s absolutely ridiculous.*” (Respondent 9). Another venture capitalist was equally frustrated with the overvaluations. “*Entrepreneurs are basing [valuations] on, well, a company based in silicon valley that has the same business model which is valued at a billion dollars or half a billion dollars so they think they should be worth the same here. It’s totally crazy.*” (Respondent 10)

A few of the entrepreneurs did not however agree with the above sentiment. One entrepreneur stated “*the pre-money valuation in South Africa is quite stingy.*” (Respondent 20). While another entrepreneur claimed that VCs tend to base valuations off of conventional later-stage free cash flow valuation methodologies, which, according to the interviewee, are not suitable when assessing the value of start-ups.

#### 4.1.1.7 What the Venture Capital Ecosystem Needs

Interviewees were asked to indicate what they thought the ecosystem needed to resolve some of the aforementioned issues. One of the key themes that emerged from the interviews was that there is a lack of the right support structures needed to enable entrepreneurs to grow and scale their businesses. “*South Africa needs more incubators, accelerators, mentoring and coaching to help entrepreneurs.*” (Respondent 19) Most of the interviewees agreed with the above statement. One respondent expressed the need for more angel investing, which opens up doors for mentoring and networking:

*“I think a lot can be done to make it easier for retired and connected businessman to become angels and get involved. The amount of knowledge, monitoring and networking they bring to the table is massive and extremely valuable.” (Respondent 18)*

Another respondent took it even further by stating that ecosystem players need to eschew trying to build complicated VC funds and instead focus on creating syndicated angel networks:

*“What you really should be doing, is forget VC and look at real angel investors. Look for someone who has run a solid South African company for 20 years, like Transnet or Eskom or Vodacom that has made his millions and now is able to be a super angel and invest alongside similar angels, where they serve on the boards of these companies and actually mentor them and incubate them, instead of just throw money at them and more importantly get them the right clients.” (Respondent 10)*

The statement captured above alludes to the need to bring more angel investors together. Unfortunately, one interviewee observed that South Africa has very few actual angel investors. Many of the so-called angel investors do not meet the required definition of being an angel, which is someone who has \$1 million in liquid net worth. Furthermore, the ecosystem *“needs more serial entrepreneurs to go through successful exit and re-invest in the ecosystem.” (Respondent 6)*

#### 4.1.2 Opportunities for Crowdfunding in the South African Entrepreneurial Ecosystem.

##### 4.1.2.1 Market Validation

When asked about the benefits of crowdfunding, the most prominent theme, which all of the interviewees discussed was that crowdfunding is an excellent tool for market validation. Market validation was mentioned 26 times from the 20 interviews. Captured below are some of the responses of the interviewees.

*“I think crowd funding is a great market tool that entrepreneurs can use to test the market and market receptiveness... show market traction in a very effective way.” (Respondent 20)*

*“I think if crowdfunding is done right, it’s a great way to test market acceptance.”  
(Respondent 19)*

*“[Crowdfunding] is a great way to validate your market and get some traction. You get committed buyers before you start building a product. That’s every entrepreneurs dream. I am actually surprised that more people don’t use it. It has huge potential.” (Respondent 16)*

*“Ultimately, what is exciting about crowdfunding is that it allows start-ups to directly appeal to potential customers and prove a market without having to actually make all those sales. And that great for potentially unlocking opportunities which otherwise would have not been funded.” (Respondent 14)*

*So I think for early stage traction, which entails getting guys to validate, and pre-sell their product and crowdfunding is absolutely brilliant for that. It’s just obviously putting together those campaigns properly.” (Respondent 15)*

*“And then crowd funding is a useful tool for that market validation. Crowd funding for me is market validation. You can test your product market fit; it is great for media and publicity and great to get initial adoption. It is great to find those early adopters.” (Respondent 4)*

From the responses captured above, it is clearly evident that crowdfunding is a powerful tool for market validation and proving there is a core consumer base. According to one respondent, historically, there has not been a very efficient and cost-effective way to test the market. Companies can spend an enormous amount of time and money doing market research, a process that is often inefficient and unreliable. Whereas crowdfunding is a more reliable form of market testing. It allows entrepreneurs to appeal directly to potential customers and prove the existence of a market without having to make any sales. There is no other tool that can effectively do that. Crowdfunding takes the market testing further by creating brand ambassadors who are willing to market the product for the company. Furthermore, access to international crowdfunding platforms gives entrepreneurs a chance to market their product to a global consumer market. However, the key takeaway from the discussion is that crowdfunding needs to be done correctly for it to be effective. As one respondent admitted:

*“I think that there could be a significant resource if it is done properly. I think there is a certain percentage of entrepreneurs that are highly competent that could use it very successfully. But we need to education the other 98% on what it is and how to actually run a proper crowdfunding campaign.” (Respondent 8)*

#### 4.1.2.2 Product Validation

Crowdfunding is also well suited for product validation and providing a funding stream for early stage prototyping. Crowdfunding platforms like Kickstarter, Indiegogo and Thundafund that focus on consumer-driven products provide entrepreneurs with the means to test new ideas at minimal cost. One of the interviewees noted that if crowdfunding can achieve significant scale it will become a great platform for product innovation in South Africa.

Most of the respondents agreed that crowdfunding has huge potential in the B2C market. Entrepreneurs can use crowdfunding platforms to build, test and fund their prototypes to a point where it is viable and at the same time grow their customer base and future sales. Entrepreneurs can use crowdfunding campaigns to get customer endorsements and customer feedback.

*“Crowdfunding allows a whole bunch of people access to scrutinize a business idea and give the entrepreneur feedback.” (Respondent 7)*

*“In a way it is a third party endorsement but it’s the endorsement of a customer.” (Respondent 1)*

However, some interviewees acknowledged that crowdfunding has less potential within the Business to Business (B2B) market, where customer acquisition is less salient. In South Africa, there is a very large B2B market. According to one interviewee, “crowdfunding *will not be valuable for B2B business models, which means an entire segment of the South African entrepreneurial space will be left out.*” (Respondent 13)

#### 4.1.2.3 Source of Seed Capital

Another important theme that emerged from the interviews was that crowdfunding has significant potential for providing entrepreneurial seed capital. According to several interviewees, there are some considerable holes in the life cycle of early-stage venture funding. Crowdfunding is a great way to provide a low cost seed capital to early stage ventures that are not yet at a point where they would be investible from a venture capital perspective. Given that VCs in South Africa tend only to invest in growth stage, post-revenue companies, crowdfunding has the potential to fill a substantial funding gap.

*“I think where crowdfunding could work is – outside of the DFI’s; there’s a gap in the seed stage funding. A lot of the smaller and riskier transactions aren’t getting funded here as the VCs are not really interested in these investments. There really is no seed market.*

*(Respondent 13)*

One interviewee was confident that crowdfunding would result in increased entrepreneurial activity in South Africa due to the availability of increased entrepreneurial seed capital.

*“The one scenario is that it will definitely result in more entrepreneurs entering the market, more of them raising early stage funding.” (Respondent 16)*

However, some interviewees were a more sceptical of crowdfunding’s potential for providing early stage ventures with entrepreneurial seed capital. There was broad agreement that crowdfunding can be used to fund prototyping and concept stage of a product. Regarding, funding for an actual business, some respondents expressed a measured degree of uncertainty.

*“What we see like on kick starter consumers showing interest in a product and it’s more funding the product development and not the business. The reason I am less confident crowd funding will achieve that on a shorter term is that there are so many variables to consider in backing an entrepreneur and a broader venture. The moment you start backing an entrepreneur there are many more complexities that I think crowd funding won’t be able package effectively.” (Respondent 20)*

Despite the reservations of some interviewees regarding crowdfunding being a source of early-stage seed capital, many agreed that crowdfunding lends itself to a wide variety of synergies across many segments of the entrepreneurial ecosystem.

#### 4.1.2.4 Risk

According to three respondents, crowdfunding is an effective mechanism for diversifying and mitigating risk. Funders have limited downside risk as projects only get funded if they reach their funding target. If the project falls short of the required capital target, funders are returned all their capital. This ensures that funders are not exposed to crowdfunding projects that have had unsuccessful crowdfunding campaigns. In addition, crowdfunding allows a larger pool of individuals to assess the feasibility and viability of a project, effectively spreading the risk and costs associated with due diligence across a larger group of people.

#### 4.1.2.5 Social Investment

Interestingly, a few of the interviewees admitted that crowdfunding creates a mechanism for social investing. One interview mentioned “*crowdfunding can provide the right and required capital for social impact projects where there are no expectations for a financial return but people who are funding the project are getting a social return.*” (Respondent 3). Many social entrepreneurs are using crowdfunding to raise capital for their projects because it provides a way to raise soft capital that is still accountable, but not as costly.

Looking in aggregate across both the literature review and the research findings, it is clear that crowdfunding in South Africa has potential to add value to many segments of the entrepreneurial ecosystem. However, South Africa poses some unique challenges and barriers that will have to be overcome for crowdfunding to achieve the required scale necessary to play a significant role in the ecosystem.

#### 4.1.3 Key Challenges Facing Crowdfunding in South Africa

Interviewees highlighted a number of stumbling blocks currently restricting the local crowdfunding space.

##### 4.1.3.1 Cultural Issues

Some interviewees believed that there are cultural challenges in South Africa, which creates a challenging environment for crowdfunding. Firstly, as mentioned early, South Africans are very risk averse. One respondent admitted that “*supporting entrepreneurs and start-ups through crowdfunding is a high-risk business that many South Africans will see as too risky...I mean many South Africans think the stock market is too risky so you can imagine how they would feel about crowdfunding.*” (Respondent 5). The small appetite for risk taking has resulted in a lack of an investment culture where individuals are not supporting entrepreneurship.

Secondly, entrepreneurial pursuit is not a celebrated career choice. Many graduates, especially those that are studying business, are choosing to go into the corporate world

instead of starting their own businesses. One interviewee expressed this view in the quotation captured below:

*In America where narrative like the American dream, entrepreneurship is celebrated. In South African this is not the case, which means entrepreneurial endeavour is not the top choice by graduates from the country.” (Respondent 9)*

In addition, one respondent stated that there is a very small social financing net providing financial support to entrepreneurs. *“The number of skilled, highly educated individuals who have the financing from close friends and family who are contemplating entrepreneurship is fairly limited.” (Respondent 8)*

Thirdly, the lack of trust is barrier that crowdfunding will have to overcome. Due to the high degree of fraud in the financial services industry, many consumers may shy away from crowdfunding platforms. *“Trust will play a vital role in the decisions of potential consumers to make use of crowdfunding platforms.” (Respondent 7)*

#### *4.1.3.2 Infrastructure*

Three of the interviewees believed that crowdfunding will struggle to gain traction in South Africa due to some critical infrastructure issues. One interviewee highlighted that the plethora of payment systems makes it difficult for crowdfunding platforms to collect payment efficiently across regions. Furthermore, most South Africans do not have access to credit cards, which is vital for online payments. One respondent echoed these concerns in the following statement.

*“The first thing is there is limited access to credit cards which limits your pool of funders. The second thing in SA and across Africa is your fractured payment systems. Each country has such different systems. In the US with over 380 million people with a homogenized payment system. In Africa you got a billion people with 56 different payment regimes. And everyone time you use a US credit card from a US bank to a south African one out four get blocked. So payment systems are a major inhibitor.” (Respondent 7)*

Another structural issue that emerged from the interviews was the lack of internet penetration. One interviewee alluded to this problem in the following caption:

*“I think the power of crowdfunding is to get small donations from every day people but in a country where internet access and credit card access is tough. Just from a basic performance level it might be tough to get that access and that payment because of our infrastructure.”*  
(Respondent 2)

One of the interviewees however argued that even though Africa has a long way to go in providing broad internet access at an affordable cost, *“we are having the kind of reach and the low cost penetration that makes [crowdfunding] viable in SA.”* (Respondent 8)

#### 4.1.3.3 Government

Some interviewees indicated that there is an unsupportive regulatory and legislative environment in South Africa. A common concern was that exchange controls and intellectual property (“IP”) restrictions will be a significant hindrance to the budding crowdfunding industry in South Africa. One of the interviewees argued that due to the exchange controls and IP restrictions companies are limited to the South African market. An entrepreneur contemplating using a global crowdfunding platform like Kickstarter will have to deal with red tape created by the exchange controls and offshore IP restrictions. Additionally, a local crowdfunding platform like Thundafund will struggle to grow its user base beyond the South African market. One interviewee acknowledged that the government has a vital role to play in creating an enabling environment for crowdfunding:

*“We need more enabling legislation from the government regarding exchange controls and IP restrictions. We also need tax support and tax incentives. So there is a lot of development that can happen on the government side of things.”* (Respondent 8)

#### 4.1.3.4 Small Consumer Market

Interviewees unanimously indicated that there is a small consumer market in South Africa that will make it difficult for crowdfunding to achieve the necessary scale to be sustainable. Captured below are some of the responses:

*“So, I am sure you have heard the story. South Africa 50 million people, 2 million only pay taxes. So if you are in the B2C business in South Africa or Africa broadly speaking your are*

*going to have a tough time because the actual consumer market is so small.” (Respondent 10)*

*“Then another big problem is the consumer market is a lot smaller. You can target South Africa and with a bit of a stretch you can target Africa, but even that is a relatively small market. So the upside is smaller. So you have to do more work for less upside.” (Respondent 14)*

*“Just based on the high unemployment rate and low per capita income crowdfunding being able to galvanize the average Joe in South Africa faces challenges.” (Respondent 2)*

The size of the South African consumer market was a common concern that cast doubt on the sustainability of the crowdfunding business model. As rightfully pointed out by two of the respondents, the only way the crowdfunding model can work in South Africa is if it reaches critical mass like Kickstarter or Indiegogo, otherwise the business model simply is not economically viable. One interviewee alludes to this in the caption below.

*If you look at the mechanics of it, crowdfunding platforms have a 2 percent and 6 percent management fee, however you only get the management fee if the project is fully funded, which limits your upside, so the model is only really sustainable if you can convert a lot of you projects into funded projects.” (Respondent 10)*

The above statement illustrates that unless crowdfunding platforms reach significant volumes and funded projects, they will not be able to sustain themselves. This view was supported by another interviewee who simply claimed:

*“The only way a crowdfunding model can work in South Africa is if it reaches the volume and scale of the Indiegogos and the Kickstarters and that is extremely difficult to do in a small consumer market like [South Africa].” (Respondent 9)*

Another interviewee however pointed out that global crowdfunding platforms like Kickstarter and Indiegogo give local entrepreneurs and project access to international funders and a global consumer base, effectively mitigating the issue of having to depend solely on the local consumer market.

Taking into account these arguments, the South African market poses a challenge to the crowdfunding model, potentially limiting its growth.

#### 4.1.4 Equity-Based Crowdfunding Model

The discussion about the potential for an equity based crowdfunding model in South Africa elicited some of the more varied responses. Interestingly, the crowd funders and entrepreneurs who were interviewed were optimistic about the potential for an equity crowdfunding model, whereas the venture capitalists were extremely sceptical.

The general consensus amongst the venture capitalist interviewees was that the mechanisms that underlie the equity-based crowdfunding model are not suitable for early-stage investing. One respondent argued that *“the moment crowd funders start becoming shareholders in start-ups they will expect a certain equity stake, influence, voting rights and to have some material upside. Crowdfunding just doesn’t have the mechanisms that can deal with all these kinds of complexities.”* (Respondent 20).

One of the problems that emerged was the high cost of governance that equity crowdfunding will force upon an early-stage ventures:

*“Overall I just don’t believe the model takes into consideration all the legal ramifications or the issues that could arise in a company that has 1000 shareholders who all own 0.0005%.”*(Respondent 19)

*“You can’t as a company dealing with this massive amount of equity investors even if you set up relatively sophisticated things that funnel the money the cost of governance is still ridiculous. You’ve got loads of shareholders but you are a tiny start-up that doesn’t have the admin resources to be able to manage it.”* (Respondent 3)

Another problem that respondents identified as being a barrier to equity crowdfunding was the quality of deals going through crowdfunding campaigns. Some interviewees argued that the great entrepreneurs and start-ups were very unlikely to use a passive crowdfunding to raise equity capital for two reason. Firstly, from an investor’s perspective, good start-ups don’t have any issues raising capital from VCs and angel investors, which means a lot of the deals on an equity crowdfunding platform are not going to of a high quality resulting in a low return on investment for investors.

*“The really good companies shy away from [equity crowdfunding] because if you are a really good company with a solid business proposition and a solid revenue model, why would you crowd fund your idea?” (Respondent 10)*

*“So what you have is the top VC attract the best entrepreneurs and the entrepreneurs on the platform will not be as high a quality, which is bad from an investor going through a crowdfunding platform.” (Respondent 15)*

Secondly, from an entrepreneur’s perspective, there is very little value add that a passive equity crowdfunding platform brings to the table other than capital. A number of respondents pointed out that entrepreneurs are not only interested in raising capital; they often look for investors who can provide them with mentorship and support, governance, networks and legitimacy.

For the above problems, many of the venture capitalists didn’t foresee the equity-based crowdfunding model gaining any significant sort of traction. Indeed, one respondent felt that the only thing equity-based crowdfunding has the potential to do is cause a lot of investors to lose money.

The entrepreneurs and crowd funders interviewed disagreed with the above sentiment. However, rather than addressing some of the practical issues with the equity-based crowdfunding model, many of responses tended to focus more on the emotional side. For instance, one interviewee noted:

*“Take an asset class which has historically been closed to the man on the street for 150 years and you give him or her access to an asset class that has only be accessible to the rich and famous for a long time. Also I think there will be mechanisms that will be able to protect the man on the street as well especially where there is risk of people putting their pension funds in high risk start-ups.”(Respondent 8)*

In the caption above, the respondent argues that equity crowdfunding will unlock an asset class, which has historically only been available to accredited investors. However, for intellectual property reasons, the interviewee was unable to disclose the sort of mechanisms that would protect investors and entrepreneurs from some of the issues identified previously. One mechanism that was acknowledged by a few of the respondents had to do with limiting or restricting the voting rights of equity holders who invest through a crowdfunding platform.

#### 4.1.5 Crowdfunding and Venture Capital Synergies

There was a significant degree of variance amongst interviewees as to how crowdfunding could influence the venture capital market in South Africa. Some respondents noted that there is an excellent opportunity for complimentary relationships, whereas other respondents saw little-added value to the VC market. Some of the complimentary factors that emerged are as follows: Firstly, some respondents saw crowdfunding as a pre-venture capital source of funding for early stage ventures. As mentioned early, VCs in South Africa primarily invest in post-revenue businesses, this means there is a significant funding gap at the seed stage. Crowdfunding can fill this gap.

*“In my view crowdfunding will interact with the VC system as a mechanism to fund start-ups that are not ready for VC. I think VC will come much later. So, crowdfunding will come in play at the friends and family stage and somewhat in the Angel region as well.” (Respondent 18)*

Secondly, there was broad consensus that crowdfunding demonstrates market traction to Investors. VCs can use crowdfunding to validate market demand and prove the existence of a core consumer base when conducting their due diligence:

*“When you do your detail due diligence, you always look at your customer market fit, market demand, market size and competitive landscape. You do an analysis and look at the USP. If something has been listed on a crowd funding platform and it has significant traction that is an additional data point as part of your due diligence on your market. You’ve already proved customer adoption and product market fit. That is a massive tick. From your due diligence perspective it is great.” (Respondent 4)*

*“I think that any investor loves market traction. We love validation of the market. We love the moment were someone actually puts out there cash for it. So the fact that comes through a so called crowd sourced manner or mechanism is great for VC due diligence” (Respondent 3)*

The above statements show that crowdfunding enables VCs to evaluate and mitigate some of their market risk by helping them determine the actual customer acquisition cost and the market demand for a product or service. Thirdly, some of the interviewees acknowledged that crowdfunding is an excellent way to fund a prototype and bring the product to the point where it would be an attractive investment opportunity for a VC:

*Crowdfunding is great for funding a prototype and fine tuning the value proposition and business model. You can test your product and do whatever you need to do...tweak it and make it better before you go to VC funders.” (Respondent 18)*

Two other interviewees agreed with the above sentiment:

*“See the reward-based model as an option for an entrepreneur to fund a prototype. If you do the crowdfunding in the right way, I am relatively sure an investor will come in and say you know what you have great market traction, I will actually fund you.” Respondent 19)*

*So I think that the more we get entrepreneurs using crowdfunding to get a prototype out there with paying customers having validated some of these early stage assumptions around the business model, the easier it is going to be to get investors to actually invest in the businesses.” (Respondent 15)*

The above captions illustrate the potential for crowdfunding to demonstrate the product, value proposition and business model in a way that that minimizes a VCs risk and lowers the cost of due diligence. In other words, a successful crowdfunding campaign signals to a VC that a product has been properly developed, costed and packaged, which demonstrates market readiness to a VC.

Fourthly, a few interviewees observed that crowdfunding can be used to show the capability of the management team, a highly important investment criteria of VCs. One respondent noted:

*“A team that pulls off a successful crowd funding campaign shows that they can set out their strategy, produce and market their product, find customers and ultimately deliver on it as well and have those elements follow through. It’s not just a level of talking the talk but actually walking it.” (Respondent 20)*

Several respondents, however, felt that though a successful crowdfunding campaign may indicate that the management team is capable of marketing their product, that doesn't imply that they can successfully manage a business. As two respondents argued:

*Will tell VC about the management's ability to sell and idea but it won't tell them anything about the management team's ability to run a business." (Respondent 18)*

*"All it means that there is something that sounds cool or sounds interesting but it still doesn't give them the ability to go and do a due diligence on the key things. It still doesn't let them know the team the management team...if they are dynamic team. So often many of the things that you see are an incredible opportunity or business but the team is the right one to execute." (Respondent 3)*

Lastly, for the reasons above, a couple of the interviewees admitted that crowdfunding could be used as a source of deal flow for VCs

*"I think [crowdfunding] definitely result in more entrepreneurs entering the market, more of them raising early stage funding and result in more deal flow for the VC's." (Respondent 17)*

*I would think that it would be a very effective deal flow generator because again if they have gone through that process, they have already shown that they can do it that there is a market. (Respondent 7)*

However, several of the VCs that were interviewed disagreed with the above sentiment, claiming that early stage deals are primarily sourced through referrals and personal networks. One of the respondents acknowledged:

*"A crowdfunding platform is interesting but I will never go source deals on a crowdfunding platform." (Respondent 4)*

One of the respondents argued however that the way crowdfunding is being used by VCs as in the United States as extra data point in their due diligence is a difficult model to replicate in South Africa. Most businesses in the U.S. that get crowdfunding are B2C businesses. Unfortunately, South Africa with its small consumer base is "missing the C part of the equation." According to the interviewee, "for the model to work you have to get at least one million people buying the product just to breakeven and finding a million people in South Africa just is not feasible." (Respondent 10) Another Interviewee echoed this sentiment:

*“If you are in the B2C business in South Africa or Africa broadly speaking and you crowd fund a project, unless you can reach significant scale from a consumer perspective it’s very hard for a VC to give you money.” (Respondent 3)*

Furthermore, VCs in the U.S focus a lot more on customer acquisition, so it makes perfect sense that a VC would use a crowdfunding platform to source deals because crowdfunding is an effective customer acquisition tool. For example, the interviewee argues that Amazon, one of the biggest e-commerce companies in the world, took 11 years to make a profit, however investors loved the company because of its high customer acquisition and large user base. In South Africa, however VCs are focus more on revenue and so a start-up that is using a crowdfunding platform to acquire customers is meaningless unless it is generating cash flow.

Another respondent identified another problem with the crowdfunding model that would make a VC reticent to invest in a crowd funded company. Most start-ups are raising soft or grant like capital through a crowdfunding campaign. The interviewee argues that typically a company that is dependent on grant funding signals to investors that it is not built on a solid proof of concept and often does not have a well-developed revenue model. The interviewee states:

*“So the majority of your funding is basically a grant and if you have an enterprise that has raised even a couple of million rand in grant funding, the business model or the revenue model in the entrepreneurs mind is still not well established. You have exceptions to the rule, but in my limited wisdom, you can crowd fund a project of an enterprise, but to crowd fund an entire enterprise a VC wouldn’t touch it.” (Respondent 5)*

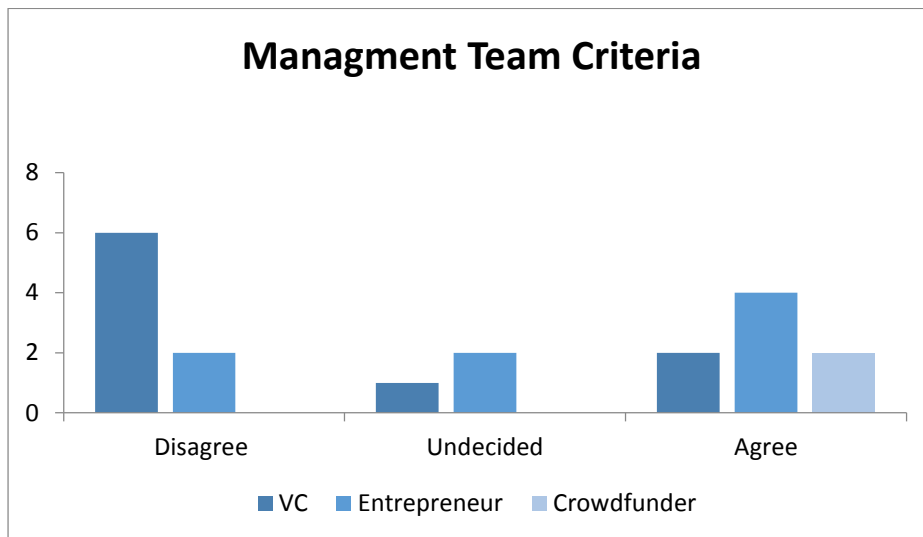
#### 4.1.6 How Crowdfunding Could Influence VC Investment Criteria

Using a Likert scale, interviewees were asked how crowdfunding could influence each of the investment decision-making criteria of VCs identified in the literature review. The population sampling was made up of nine venture capitalists, nine entrepreneurs, and two crowdfunding platform owners for a total of 20 interviewees.

As shown in figure 12, the findings show that there was significant variance amongst the respondents on how crowdfunding provides a signal regarding the management team. six out of the nine venture capitalists interviewed disagreed with the statement that crowdfunding

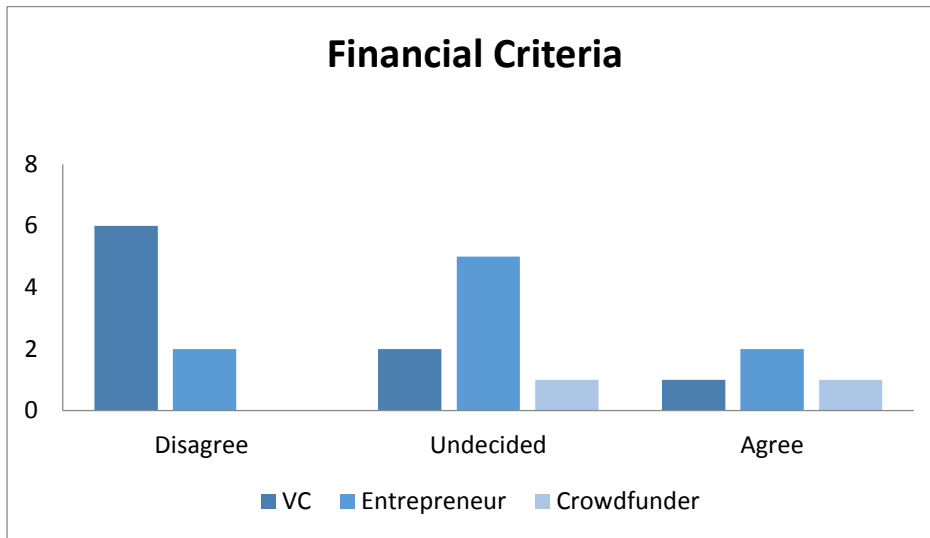
offers a signal of quality around the management team, whereas only two out of the nine entrepreneurs disagreed with the statement. None of the crowd funders interviewed disagreed with the statement. Alternatively two out of the two crowd funders and four out of nine of entrepreneurs interviewed agreed that crowdfunding provides a signal of quality around the management team, whereas only two of the VCs agreed.

Figure 12: Crowdfunding can inform management team criteria (Responses)



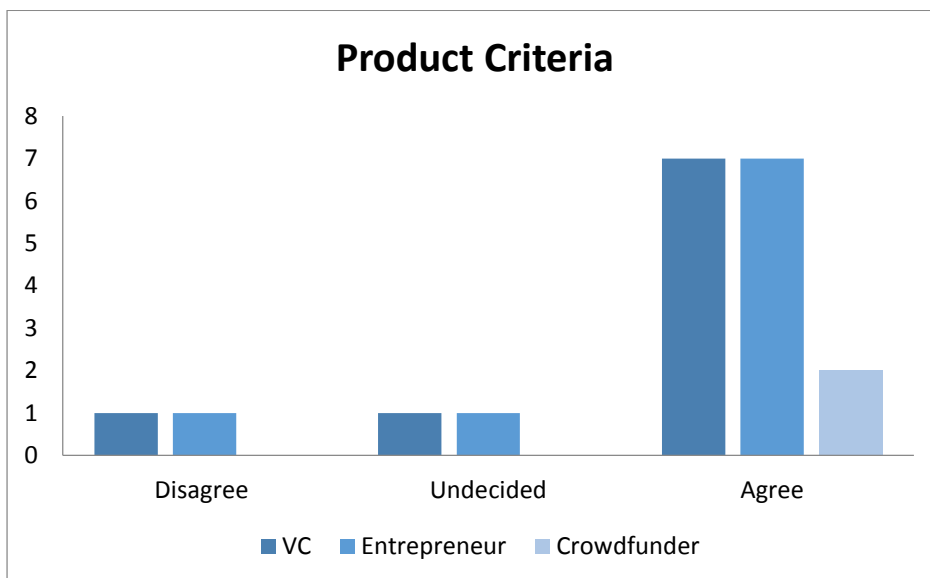
Respondents were equally divided about how crowdfunding could provide a signal to VCs regarding an early-stage venture’s financial profitability. Six of the VCs interviewed disagreed with the statement that crowdfunding provides an extra data point around the financial profitability of a business, whereas only two entrepreneurs disagreed with the statement. The majority of entrepreneurs however were undecided as shown in figure 13 below.

Figure 13: Crowdfunding can inform financial criteria (Responses)



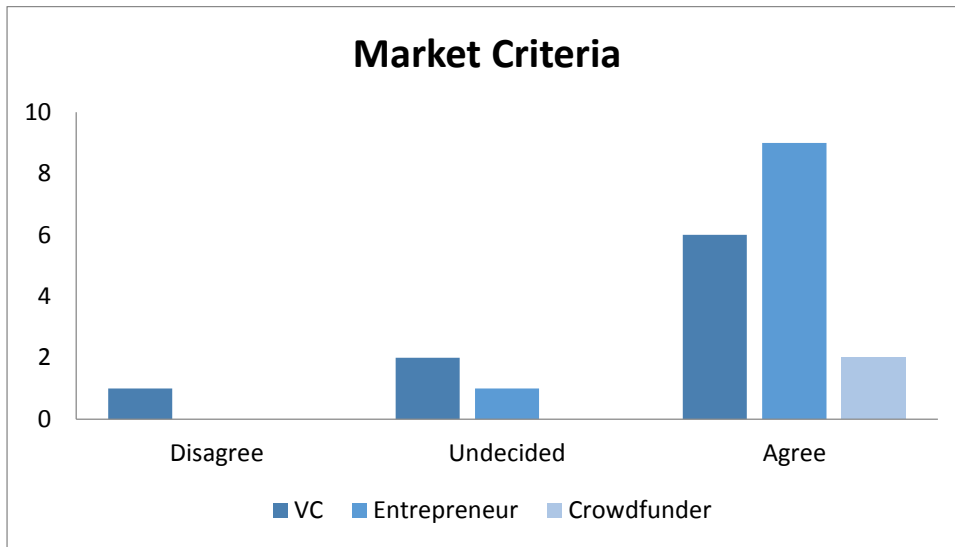
The findings show that the majority of respondents overwhelmingly agreed with the statement that crowdfunding provides a signal of quality around the product. Seven out of the nine venture capitalists and seven out of the nine entrepreneurs agreed that crowdfunding can be used to for product criteria. Both crowdfunding platform owners also agreed with the statement. See figure 14 below.

Figure 14: Crowdfunding can inform product criteria (Responses)



Similarly, most of the respondents agreed that crowdfunding can be used to provide a signal of quality around the market criteria. All nine entrepreneurs interviewed agreed that crowdfunding can be used as a data point for market criteria, whereas and six out of the nine VCs agreed with the statement.

Figure 15: Crowdfunding can inform marker criteria (Responses)



The research findings show that there was broad agreement from venture capitalists, entrepreneurs and crowd funders that crowdfunding can provide VCs with extra data points regarding the product and market investment criteria. This is consistent with the research findings identified in the semi-structured interviews. However, interviewees, especially the venture capitalists, were less confident regarding crowdfunding's potential for providing an extra data point for the management team criteria and financial criteria.

#### 4.2 Research Discussion and Conclusion

The primary aim of this research was to explore the investment decision-making practices and perceptions of the venture capitalist and entrepreneurs to ascertain the extent to which crowdfunding can inform into the VC investment decision-making process and be incorporated into the entrepreneurial ecosystem in South Africa.

Venture capital plays a vital role in mobilizing the flow of large scale capital into entrepreneurial ecosystems. Unfortunately, due to the underdevelopment and infancy of the sector, the South African venture capital market is not playing a significant enough role in funding entrepreneurial activity. Over the past few years, there has been a decline in venture capital investment activity, particularly in the early seed stage of the funding lifecycle (Lamprecht and Walt, 2012). The reason for this appears to be an insufficient supply of equity capital to from venture capitalists and private individuals to fund new ventures (Herrington & Kew, 2012; Omidyar, 2013). However, the research findings above show this to be a common

misconception. There was broad agreement among the interviewees that there is plenty of risk capital available to fund entrepreneurs. Why does there seem to be such a big difference in viewpoints regarding the availability of capital? The research finding suggests that even though there is sufficient money available, it is typically invested in later stage ventures that are generating positive cash flow and have a track record. The venture capital players within the South African ecosystem are playing more of a private equity role as their investment mandates limit them to existing companies that are post-revenue, but that require external financing in order to maximise their growth opportunities. Therefore, the problem is not that there is a lack of capital, the problem is that there is a funding gap for seed and early-stage ventures. All the money is being funnelled into later stage investments.

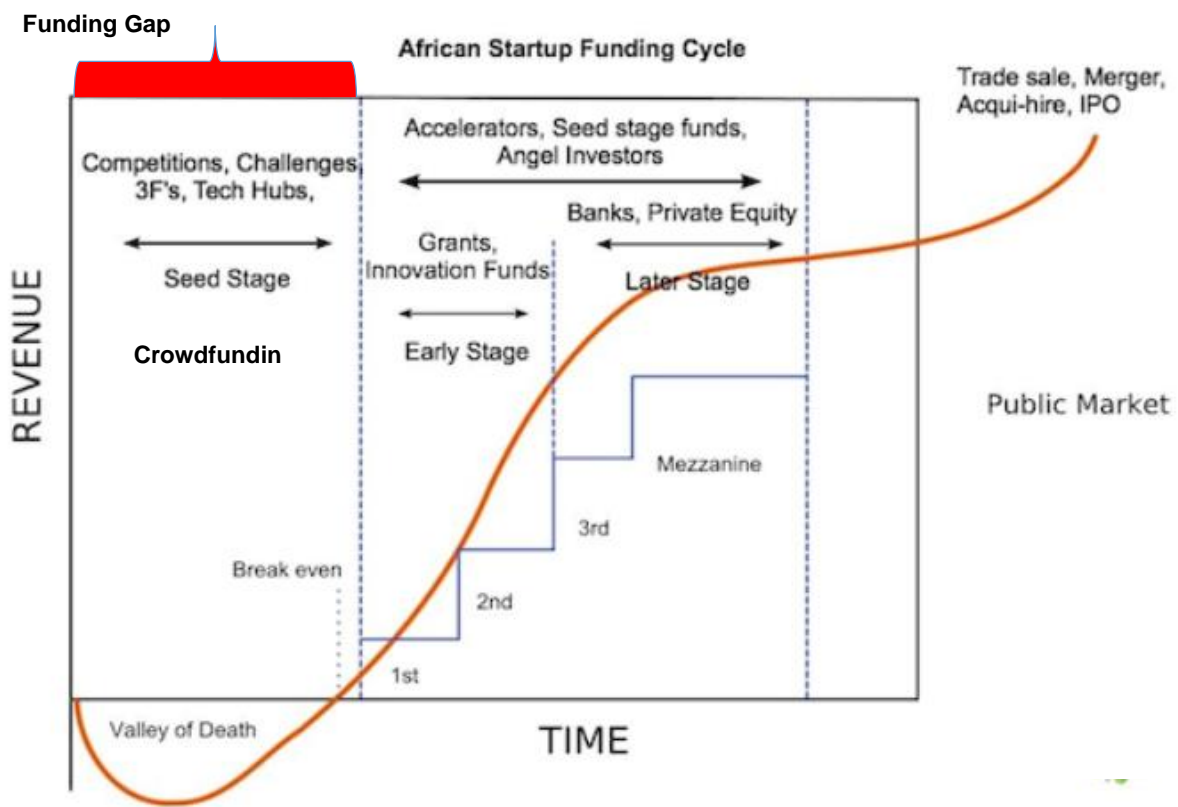
The research findings suggest that there are two primary reasons for this. Firstly, the majority of the interviewed South African venture capitalists indicated that there is a significant lack of technical skills and business expertise amongst entrepreneurs, affecting the quality of deal flow and the ability of entrepreneurs to execute their business plans. Secondly, there was broad agreement amongst respondents that the low level of risk tolerance of investors is forcing VCs to focus on later stage post-revenue business, which are typically less risky due to their operating history.

The research findings suggest that crowdfunding may be able to help solve the funding gap problem in South Africa.

### ***Can crowdfunding provide a viable source of entrepreneurial seed capital?***

There was consensus amongst the respondents that crowdfunding provides a viable source of seed capital for early-stage start-ups, allowing entrepreneurs to raise funds from additional resource other than the more conventional funding sources. Given the significant funding holes in the life cycle of early stage ventures, crowdfunding has the potential to increase the amount of available capital at the seed stages of a start-up. This research finding is illustrated in figure 16 below.

Figure 16: African Start-up funding lifecycle



Source: Modification of Heibron (2013)

There is still a lot of uncertainty around how the equity based crowdfunding model will work in South Africa. Many of the venture capitalists interviewed were concerned that the mechanism's that underlie the model are not suitable for early stage investing.

Crowdfunding's large volume of equity investors makes for a highly complicated balance sheet, which would make VCs reticent to invest in the company at a later stage. Furthermore, issues around control and voting rights and a large pool of unsophisticated investors will create onerous requirements on the management team, taking up precious time and consuming limited resources. Mechanisms will need to be put in place to make equity based crowdfunding a viable option in South Africa, however that is beyond the scope of this research report.

The rewards based crowdfunding model, however, has the potential to disrupt the existing funding ecosystem and mobilize seed capital into early stage ventures without having to deal with some of the challenges of equity-based crowdfunding. Indeed, the reward based

crowdfunding model provides a soft form of capital, not unlike grant funding, at a very low cost, which makes it ideal for early stage ventures that are pre-revenue.

The two biggest challenges that the rewards based crowdfunding model will have to overcome to be sustainable in South Africa are the small consumer market and lack of internet penetration. However, according to a McKinsey (2012) report, South Africa, and more broadly speaking Africa, has one of the fastest growing consumer markets. Furthermore, according to one interviewee, Internet penetration is becoming less of an issue for crowdfunding platforms in South Africa. Therefore, if one is to take a medium to long-term view of crowdfunding in South Africa, the major barriers to its success become less of an issue.

Furthermore, the research findings above suggest that crowdfunding is well suited for product validation and providing a funding stream for early stage prototyping. South African entrepreneurs can use crowdfunding platforms to build, test and fund their prototypes at a minimal cost. One key challenges that VCs in South Africa face is that they are often pitched ideas and concepts with no working product. However, entrepreneurs often need financial resources to develop a working prototype or product. This creates somewhat of a catch-22 in the South African venture capital ecosystem. Crowdfunding has the potential to mitigate this problem by providing entrepreneurs with a source of capital to fund product development.

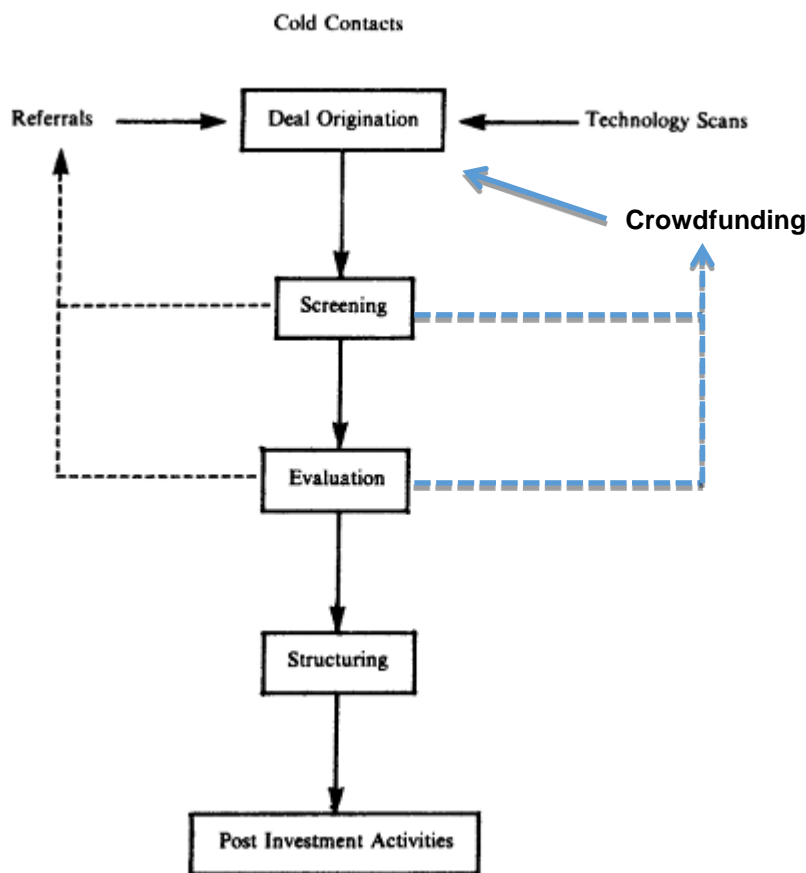
### ***Can crowdfunding inform the Venture Capital investment decision-making process?***

Crowdfunding mechanisms can inform the VC investment decision-making process. Assessing the quality of an early stage venture is a process that requires VCs to make numerous assumptions about a particular venture. Given the uncertainty involved in investing in businesses with limited to no operating history, VCs rely on signals of quality around specific investment criteria in their due diligence process. One of these important criteria is the size of the market. The research findings show that crowdfunding is a powerful tool for demonstrating demand for a proposed product. There was overwhelming agreement among the venture capitalists, crowd funders and entrepreneurs, that crowdfunding can be used for market validation and proving a consumer base, which offers a reliable signal quality to investors, therefore improving screening and due diligence, and effectively mitigating some of the risk surrounding product development and commercialization.

An early-stage venture that has gone through a successful crowdfunding campaign provides a considerable amount of market data for a VC to assess in its screening and due diligence phase of the investment decision-making process. As one of the respondents stated, there is no accurate and cost efficient way for VCs to perform market research on a potential investment without utilizing considerable resources and time, a luxury many VC do not have. Crowdfunding platforms are a possible solution to this problem, because if they can achieve scale like Kickstarter and Indiegogo, it becomes a useful tool for determining market readiness, market demand and market traction. This however assumes a VC is willing to invest in an early-stage venture that went through a successful crowdfunding campaign. Most of the VCs did not see any problems with investing in a start-up that had gone through a rewards-based crowdfunding campaign, as long as the business model was sound, and the start-up met all their investment requirements.

There was less agreement among respondents on how crowdfunding informs the other VC investment decision-making criteria, specifically around the management team (the most important criteria) and financial criteria. There was some agreement that it indirectly speaks to the capability of the management team to raise funds and deliver a product, however it says very little about the management team's expertise, experience, cohesion, and ability to run a business. In terms of financial criteria, as crowdfunding is essentially funding for pre-sales it may provide an additional data point on the projected sales of a start-up, which affects a number of financial factors such as breakeven, profitability, IRR and enterprise value. The diagram below illustrates how an early-stage venture that is crowd funded can be integrated into Fried and Hisrich's (1994) decision process model for VC investments

Figure 17: Decision process model of VC investment activity with crowdfunding



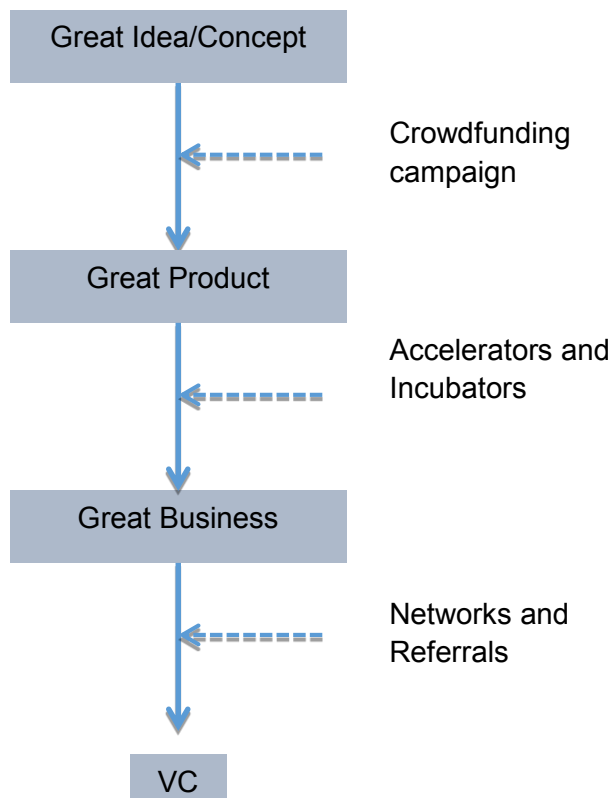
Source: modification of Tyebjee and Bruno (1984)

***Can crowdfunding influence Venture Capital deal flow?***

There has been significant debate over the past couple of years on how crowdfunding could affect venture capital deal flow. Some have stated that crowdfunding will “crowd out” VC investment while others have claimed that it will have no impact on the VC deal pipeline. The research findings of this report suggest that crowdfunding will not directly increase the VC deal flow pipeline in South Africa but rather it could complement the VC ecosystem. As discussed earlier, crowdfunding will allow more early-stage ventures crossing of the seed funding gap and reaching a funding stage where a potential VC firm could invest. Crowdfunding has the potential to come alongside angel networks and act as bridge for start-ups to cross over into the later stage post revenue stage where VCs in South Africa typically invest. However, just because there is an additional resource for start-ups to tap into at the seed stage does not automatically mean there will be more ‘quality’ deals for the VC pipeline. VCs in South Africa are looking for great businesses not just excellent products. In order for

crowd funded deals to translate into increased deal flow for VCs, other support structures in the entrepreneurial ecosystem (accelerators, incubators, networks, mentors) are needed to aid entrepreneurs in turning their great products into great business. As result crowdfunding will act as more of a compliment to the broader ecosystem versus being a direct deal generator for VCs.

Figure 18: Lifecycle of early-stage venture



Source: own diagram

Additionally, the research findings suggest that in no way will crowdfunding displace, disrupt or “crowd out” VC investment in South Africa for three reasons: Firstly, there is a pool of great businesses with working products that will see very little value add from a passive crowdfunding platform that brings only soft capital. VC provides more than just capital; it gives entrepreneurs access to support, governance, networks and legitimacy. For this reason, many early-stage ventures will continue to seek VC backing. Secondly, as illustrated in figure 17, VCs primary source for deals comes from referrals and personal networks. Crowdfunding, may provide an additional avenue for sourcing deals, but it will not replace the deal origination process already in place. Thirdly, according to several respondents crowdfunding will only disrupt the existing funding ecosystem to the extent that it will

provide funding for smaller businesses that have more modest growth prospects. VCs will continue to look for highly scalable, fast growing early-stage ventures.

#### 4.3 Recommendations for Future Research

While the research is limited by the fact that the crowdfunding market in South Africa is at a very early stage of development, it is hoped that this exploratory research provides a useful first stage analysis of how players involved in the South African entrepreneurial ecosystem view crowdfunding, particularly early-stage financiers such as venture capitalists and angel investors. For future research, it would be interesting to study how the equity crowdfunding model could be implemented in a South African context. Furthermore, it would be useful to investigate how crowdfunding platforms might convey organizational legitimacy to other providers of entrepreneurial capital. Lastly, it would be beneficial to research the cost of due diligence for venture capitalists and how VCs reduce these costs.

## 5 References

- Abell, P., & Nisar, T. M. (2007). Performance effects of venture capital firm networks. *Management Decision*, 45(5), 923–936. doi:10.1108/00251740710753729
- Amit, R., Glosten, L., & Muller, E. (1990). Entrepreneurial Ability, Venture Investments, and Risk Sharing. *Management Science*, 36(10), 1232–1245.
- Banerjee, A. (2008). Private equity in developing nations. *Journal of Asset Management*, 9(2), 158–170. doi:10.1057/jam.2008.12
- Baum, J. A. C., & Silverman, B. S. (2004). Picking winners or building them? Alliance, intellectual, and human capital as selection criteria in venture financing and performance of biotechnology startups. *Journal of Business Venturing*, 19(3), 411–436. doi:10.1016/S0883-9026(03)00038-7
- Beckman, C., Burton, M., & O'Reilly, C. (2007). Early teams: The impact of team demography on VC financing and going public. *Journal of Business Venturing*.
- Belleflamme, P., Lambert, T., & Schwienbacher, A. (2012). Crowdfunding: Tapping the Right Crowd. *Journal of Business Venturing*, Volume 29(5), 585–609. doi:DOI: 10.1016/j.jbusvent.2013.07.003
- Brustein, J. (2014). *Kickstarter Successes Pivot From Crowdfunding to Venture Capital*. *Businessweek*. Retrieved September 04, 2014, from <http://www.businessweek.com/articles/2014-08-11/kickstarter-successes-pivot-from-crowdfunding-to-venture-capital>
- Burt, R. S. (1992). The Social Structure of Competition. In *Networks and Organizations: Structure, Form, and Action* (pp. 57–91). Boston, MA: Harvard Business School Press.
- Burtch, G., Ghose, A., & Wattal, S. (2011). An Empirical Examination of the Antecedents and Consequences of Investment Patterns in Crowd-Funded Markets. *SSRN Electronic Journal*. doi:10.2139/ssrn.1928168
- Bygrave, W. D. (1988). The structure of the investment networks of venture capital firms. *Journal of Business Venturing*, 3(2), 137–157. doi:10.1016/0883-9026(88)90023-7
- Bryman, A., & Bell, E. (2007). *Business research methods*. Oxford university press.
- CBInsights. (2014). *A data-driven look at venture capital financing trends of crowd-funded hardware projects on Kickstarter and Indiegogo*. CBInsights.

- Christopger B. Barry. (1994). New Directions in Research on Venture Capital Finance. *Financial Management*, 23(3), 3–15.
- Cornelli, F., & Goldreich, D. (2001). Bookbuilding and Strategic Allocation. *The Journal of Finance*, 56(6), 2337–2369. doi:10.1111/0022-1082.00407
- Dawson, F. (2014). *The Future Of Crowdfunding: Where To From Here?* *Forbes*. Retrieved September 04, 2014, from <http://www.forbes.com/sites/freddiedawson/2014/07/31/the-future-of-crowd-funding-where-to-from-here/>
- Denis, D. J. (2004). Entrepreneurial finance: an overview of the issues and evidence. *Journal of Corporate Finance*, 10 (2), 301–326.
- Deventer, B. Van, & Mlambo, C. (2009). Factors influencing venture capitalists ' project financing decisions in South Africa. *South African Journal of Business Management*, 40(1), 33–42.
- Dingman, S. (2013). *Canadian's smartwatch startup matches record \$15-million in VC funding.* *The Globe and Mail*. Retrieved September 03, 2014, from <http://www.theglobeandmail.com/technology/business-technology/canadians-smartwatch-startup-matches-record-15-million-in-vc-funding/article11965214/>
- Drover, W., & Zacharakis, A. (2013). Crowdfunding's Impact on the Entrepreneurial Equity Food Chain. *Ivey Business Journal Online*.
- Dubini, P., & Aldrich, H. E. (1991). Personal and Extended Networks are Central to the Entrepreneurial Process. *Journal of Business Venturing*, 6, 205–313.
- Dushnitsky, G. (2010). Entrepreneurial Optimism in the Market for Technological Inventions. *Organization Science*, 21(1), 150–167. doi:10.1287/orsc.1090.0454
- Eeden, S. van, Viviers, S., & Venter, D. (2003). A comparative study of selected problems encountered by small businesses in the Nelson Mandela, Cape Town and Egoli metropolises. *Journal of the Southern African Institute for Management Scientists*, 12(3), 13–23.
- Ferrary, M., & Granovetter, M. (2009). The role of venture capital firms in Silicon Valley's complex innovation network. *Economy and Society*.
- Franke, N., & Gruber, M. (2008). Venture Capitalists' Evaluations of Start-Up Teams: Trade-Offs, Knock-Out Criteria, and the Impact of VC Experience. *Theory and Practice*
- Fraser-Sampson, G. (2010). *Private Equity as an Asset Class* (2nd ed., p. 280). West Sussex, England: John Wiley & Sons.
- Fried, V. H., & Hisrich, R. D. (1994). Toward a Model of Venture Capital Investment Decision Making. *Financial Management*, 23(3), 28–37.

- Frydrych, D., Bock, A. J., Kinder, T. and Koeck, B. 2014. Exploring entrepreneurial legitimacy in reward-based crowdfunding. *Venture Capital: An International Journal on Entrepreneurial Finance* 16(3): 247-269.
- Ge, D., Mahoney, J. M., & Mahoney, J. T. (2005). *New Venture Valuation by Venture Capitalists: An Integrative Approach*. New York: University of Illinois at Urbana-Champaign, College of Business.
- Paul A. Gompers. (1995). Optimal Investment, Monitoring, and the Staging of Venture Capital. *The Journal of Finance*, 50(5), 1461–1489.
- Gompers, P. A., & Lerner, J. (2004). *The Venture Capital Cycle* (p. 569). MIT Press.
- Gorman, M., & Sahlman, W. A. (1989). What do venture capitalists do? *Journal of Business Venturing*, 4(4), 231–248. doi:10.1016/0883-9026(89)90014-1
- Miguel Heilbron. (2013). *African startup funding cycle, different stages of startup funding*. VC4A. Retrieved from <http://vc4africa.biz/blog/2013/01/03/the-african-startup-funding-cycle-different-stages-of-startup-funding/>
- McKinsey and Company (2012). *The rise of the African consumer* (p. 20).
- Hemer, J. (2011). *A Snapshot on Crowdfunding*. Retrieved from [http://www.isi.fraunhofer.de/isi-wAssets/docs/p/de/arbap\\_unternehmen\\_region/ap\\_r2\\_2011.pdf](http://www.isi.fraunhofer.de/isi-wAssets/docs/p/de/arbap_unternehmen_region/ap_r2_2011.pdf)
- Herrington, M., & Kelley, D. (2012). *African Entrepreneurship: Sub-Saharan African Regional Report* (p. 72). Retrieved from <http://www.gemconsortium.org/docs/download/2909>
- Herrington, M., & Kew, J. (2013). *South African Report*. Retrieved from <http://www.gemconsortium.org/docs/download/3336>
- Herrington, M., Kew, J., & Kew, P. (2009). *Tracking Entrepreneurship in South Africa: A Gem Perspective* (p. 169).
- Horga, A. (2013). *Crowdfunding's Potential in South Africa and Emerging Markets*. OECD Publishing. Retrieved from [http://www.oecd-ilibrary.org/taxation/tax-administration-2013\\_9789264200814-en](http://www.oecd-ilibrary.org/taxation/tax-administration-2013_9789264200814-en)
- Howe, J. (2008). *Crowdsourcing: Why the Power of the Crowd Is Driving the Future of Business* (p. 336). New York: Crown Publishing Group.
- Hsu, D. (2004). What do entrepreneurs pay for venture capital affiliation? *The Journal of Finance*.
- Huyhebaert, N., Gaeremynck, A., Roodhooft, F., & Van de Gucht, L. M. (2000). New Firm Survival: The Effects of Start-up Characteristics. *Journal of Business Finance &*

*Accounting*, 27 (5-6), 627–651

Isenberg, D (2011). The entrepreneurship ecosystem strategy as a new paradigm for economy policy: principles for cultivating entrepreneurship. Babson Entrepreneurship Ecosystem Project, Babson College, Babson Park:MA

Jeffries, A. (2013). How Kickstarter stole CES: the rise of the indie hardware developer. *The Verge*. Retrieved January 12, 2013, from <http://www.theverge.com/2013/1/10/3861406/kickstarter-at-ces>

J.P. Morgan, & Dalberg. (2010). *Catalyst for Growth in South Africa* (pp. 253–277).

Kortum, S., & Lerner, J. (2000). Assessing the contribution of venture capital to innovation. *RAND Journal of Economics*, 31(4), 674-692.

Kessler, A. (2007). Success factors for new businesses in Austria and the Czech Republic. *Entrepreneurship & Regional Development*, 19(5), 381–403.  
doi:10.1080/08985620701439959

Kickstarter. (2014). *Kickstarter Stats*. Retrieved September 03, 2014, from <https://www.kickstarter.com/help/stats>

Kirsch, D., Goldfarb, B., & Gera, A. (2009). Form or substance: the role of business plans in venture capital decision making. *Strategic Management Journal*, 30(5), 487–515.  
doi:10.1002/smj.751

Kleemann, F., Voß, G. G., & Rieder, K. (2008). Un(der)paid Innovators: The Commercial Utilization of Consumer Work through Crowdsourcing. *Science, Technology & Innovation Studies*, 4(1), 5 – 26.

Lamprecht, S. J., & Walt, G. L. Van Der. (2012). *2012 SAVCA Venture Solutions VC Survey*.

Lanxon, N. (2011). *How the Oxford English Dictionary started out like Wikipedia*. *Wired*. Retrieved August 19, 2014, from <http://www.wired.co.uk/news/archive/2011-01/13/the-oxford-english-wiktionary>

Leedy, P., & Ormrod, J. (2005). *Practical Research: Planning and Design, 8th edition*. New Jersey: Pearson Prentice Hall.

Lerner, J. (1994). The Syndication of Venture Capital Investments. *Financial Management*, 23(3), 16–27.

Lerner, J. (2002). *Boom and bust in the venture capital industry and the impact on innovation*. Federal Reserve of Atlanta. Issue 4, 25-39

Lerner, J. (2012). Venture capitalists and the oversight of private firms. *The Journal of*

*Finance.*

- Lingelbach, D. C. (2009). *Neither Pirates nor Politicos: The Emergence of Venture Capital in Weak Institutional Environments*. University of Exeter.
- Lingelbach, D. C., Murray, G. C., & Gilbert, E. (2008). The Rise and Fall of South African Venture Capital: A Coproduction Perspective. *SSRN Electronic Journal*. doi:10.2139/ssrn.1459175
- Lockett, A., Wright, M., & Sapienza, H. (2002). Venturecapital investors , valuation and information : a comparative study of the US , Hong Kong , India and.
- Macmillan, I. C., Siegel, R., & Narasimha, P. N. S. (1985). Criteria used by venture capitalists to evaluate new venture proposals. *Journal of Business Venturing*, 1(1), 119–128. doi:10.1016/0883-9026(85)90011-4
- Macmillan, I. C., Zemann, L., & Subbanarasimha, P. N. (1987). Criteria distinguishing successful from unsuccessful ventures in the venture screening process. *Journal of Business Venturing*, 2(2), 123–137. doi:10.1016/0883-9026(87)90003-6
- Massolution. (2013). *The Crowdfunding Industry Report*. Retrieved September 03, 2014, from [http://www.crowdsourcing.org/editorial/2013cf-the-crowdfunding-industry-report/25107?utm\\_source=website&utm\\_medium=text&utm\\_content=LP+bottom&utm\\_campaign=2013CF+Launch](http://www.crowdsourcing.org/editorial/2013cf-the-crowdfunding-industry-report/25107?utm_source=website&utm_medium=text&utm_content=LP+bottom&utm_campaign=2013CF+Launch)
- Mollick, E. (2013). The dynamics of crowdfunding: An exploratory study. *Journal of Business Venturing*, 29(1), 1–16. doi:10.1016/j.jbusvent.2013.06.005
- Mollick, E. (2014). *Swept Away by the Crowd ? Crowdfunding , Venture Capital , and the Selection of Entrepreneurs*. University of Pennsylvania. Retrieved from [http://www.business.utah.edu/sites/default/files/media/mollick\\_swept\\_away\\_byu\\_utah3-5.pdf](http://www.business.utah.edu/sites/default/files/media/mollick_swept_away_byu_utah3-5.pdf)
- Muzyka, D., Birley, S., & Leleux, B. (1996). Trade-offs in the investment decisions of European venture capitalists. *Journal of Business Venturing*, 11(4), 273–287.
- Ojah, K., & Mokoaleli-Mokoteli, T. (2010). Possible Effective Financing Models for Entrepreneurship in South Africa: Guides from Microfinance and Venture Capital Finance. *The African Finance Journal*, 12(1), 1–26.
- Omidyar. (2013). *Accelerating Entrepreneurship in Africa*. Retrieved from [http://www.omidyar.com/sites/default/files/file\\_archive/insights/ON Africa Report\\_April 2013\\_Final.pdf](http://www.omidyar.com/sites/default/files/file_archive/insights/ON Africa Report_April 2013_Final.pdf)
- Patzelt, H., zu Knyphausen-Aufseß, D., & Fischer, H. T. (2009). Upper echelons and portfolio strategies of venture capital firms. *Journal of Business Venturing*, 24(6), 558–572. doi:10.1016/j.jbusvent.2008.05.006

- Paul A. Gompers. (1995). Optimal Investment, Monitoring, and the Staging of Venture Capital. *The Journal of Finance*, 50(5), 1461–1489.
- Rogerson, C. M. (2008). Tracking SMME Development in South Africa: Issues of Finance, Training and the Regulatory Environment. *Urban Forum*, 19(1), 61–81.  
doi:10.1007/s12132-008-9025-x
- Roberts, M. and Barley, L. 2004. How venture capitalists evaluate potential venture opportunities. Harvard Business School.
- Ryan Chazen. (2013). *Re-building trust in South Africa: Enabling entrepreneurship through crowd funding and the democratization of capital*. University of Cape Town.
- SAVCA. (2014). *SAVCA's Objectives*. Retrieved September 03, 2014, from <http://www.savca.co.za/about-us/savcas-objectives/>
- Schwienbacher, A., & Larralde, B. (2010). Crowdfunding of Small Entrepreneurial Ventures. *SSRN Electronic Journal*. doi:10.2139/ssrn.1699183
- Shane, S., & Cable, D. (2002). Network ties, reputation, and the financing of new ventures. *Management Science*
- Shane, S., & Stuart, T. (2002). Organizational Endowments and the Performance of University Start-ups. *Management Science*, 48(1), 154–170.  
doi:10.1287/mnsc.48.1.154.14280
- Sullivan, D. M., & Ford, C. M. (2014). How Entrepreneurs Use Networks to Address Changing Resource Requirements During Early Venture Development. *Entrepreneurship Theory and Practice*, 38(3), 551–574. doi:10.1111/etap.12009
- Stuart, T., Hoang, H., & Hybels, R. (1999). Interorganizational endorsements and the performance of entrepreneurial ventures. *Administrative science quarterly*
- Tichy, N. M. (1979). *Networks in Organizations* (p. 56). Columbia University, Graduate School of Business.
- Tyebjee, T. T., & Bruno, A. V. (1984). A Model of Venture Capitalist Investment Activity. *Management Science*, 30(9), 1051–1066. doi:10.1287/mnsc.30.9.1051
- Ueda, M. (2004). Banks versus venture capital: Project evaluation, screening, and expropriation. *The Journal of Finance*, 59(2), 601-621
- Vogel, P. (2013). *The Employment Outlook for Youth : Building Entrepreneurial Ecosystems as a Way Forward*.

- Vuuren, J. J. Van, & Groenewald, D. (2007). A Critical Analysis of the Influence of Start-Up Factors in Small Businesses and Entrepreneurial Ventures in SA. *Acta Commercii*, 269–280. Retrieved from [http://repository.up.ac.za/bitstream/handle/2263/4288/VanVuuren\\_Critical%282007%29.pdf?sequence=1](http://repository.up.ac.za/bitstream/handle/2263/4288/VanVuuren_Critical%282007%29.pdf?sequence=1)
- Wells, W. A., 1974, Venture Capital Decision Making, *Unpublished doctoral dissertation*, Carnegie Mellon University, Pittsburgh.
- Wilson, R. (1968). The Theory of Syndicates. *Econometrica*, 36(1), 119–132.
- World Bank. (2013). *Crowdfunding in Developing Nations*. Retrieved from [https://www.infodev.org/infodev-files/crowdfunding\\_infographic\\_high\\_res.pdf](https://www.infodev.org/infodev-files/crowdfunding_infographic_high_res.pdf)
- Zacharakis, A. L., & Meyer, D. G. (1998). A lack of insight: do venture capitalists really understand their own decision process? *Journal of Business Venturing*, 13(1), 57–76. doi:10.1016/S0883-9026(97)00004-9
- Zider, B. (1998). *How Venture Capital Works*. *Harvard Business Review*.

## 6 Appendix A – List of Organizations Interviewed

- Montegrays Capital
- SpringLeap
- SeeSayDo
- Angel Hub
- Stone Tree
- The Open Agency
- CodeX
- ThundaFund
- Socius
- Ad Dynamo
- U-Start
- Startup Cherry
- Silvertree-Capital
- Interg8
- Fiji-Online
- Action Hero Ventures
- Knife Capital
- Social Alpha

## 7 Appendix B – Interview Guideline

Name:

---

Email:

---

Phone:

---

Company:

---

### **Background Questions:**

1. What is your gender?
2. What is your age?
3. Briefly outline your educational background?
4. What type of organization are you working for?
5. Briefly describe your job function and role in the organization?
6. How long have you worked for your current organization?

### **Research Questions**

7. Are you familiar with crowdfunding and if so what has been your experience with it?
8. Do you think crowdfunding can offer a viable source of entrepreneurial seed capital, why or why not?
9. What do you think is the potential of crowdfunding in South Africa?
10. What are some of the challenges that crowdfunding will face in South Africa?
11. What do you think are the reasons why the venture capital industry struggles to grow in South Africa?
12. How do you think crowdfunding could influence venture capital deal flow?
13. What aspects of crowdfunding could prove useful to the VC due diligence process?
14. Could venture capitalists use crowdfunding platforms to search for popular ideas that could be turned into good business ideas?
15. Do you think Crowdfunding can be used to demonstrate demand for a proposed product?
16. What do you think about amateur investors “the crowd” trying to pick high potential entrepreneurs/startups?
17. What signals of quality do you think crowdfunding may be able to provide to venture capitalists about particular project/business idea?
18. How do you ultimately see crowdfunding interacting with the venture capital industry in South Africa?

19. What are the potential problems you foresee with the VC industry co-opting crowdfunding?

### Scenario Questions

Below is a list of common investment decision-making criteria that VCs use when evaluating a proposal. I've used the list to create some specific scenarios. Could you please indicate whether you strongly agree, agree, are undecided, disagree, or strongly disagree with the following scenarios?

<b>Management Team Criteria</b>	<b>Strongly Agree</b>	<b>Agree</b>	<b>Undecided</b>	<b>Disagree</b>	<b>Strongly Disagree</b>
Crowdfunding can be used to test the experience and skills of the management team?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Crowdfunding can be used to test how hardworking and flexible the management team is?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Crowdfunding can be used to show if the management team is capable of intense and sustained effort?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Crowdfunding can be used to show the management team' leadership qualities?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Crowdfunding can be used to show that the management team is realistic in its objectives.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
<b>Product and Service Criteria</b>	<b>Strongly Agree</b>	<b>Agree</b>	<b>Undecided</b>	<b>Disagree</b>	<b>Strongly Disagree</b>
Crowdfunding can be used to test if the product/service is unique	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Crowdfunding can be used to test if the product/service has good market acceptance	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Crowdfunding can be used to test if the product or service has a competitive advantage	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Crowdfunding can be used to show that the product/service has been a success	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
<b>Financial Criteria</b>	<b>Strongly Agree</b>	<b>Agree</b>	<b>Undecided</b>	<b>Disagree</b>	<b>Strongly Disagree</b>
Crowdfunding can be used to help determine if the business has a high profit margin	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Crowdfunding can be used to help determine if the investment will provide a high IRR	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Crowdfunding can be used to test if the business has significant potential for earnings growth	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Crowdfunding can provide an extra data point on overall capital requirements	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Crowdfunding can be used to lower the marketing and production costs	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
<b>Market and Environmental Criteria</b>	<b>Strongly Agree</b>	<b>Agree</b>	<b>Undecided</b>	<b>Disagree</b>	<b>Strongly Disagree</b>
Crowdfunding can be used to show if the product/service has open access to the market	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Crowdfunding can be used to test if there is a high demand for the product or service	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Crowdfunding can be used to test the size of the market	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Crowdfunding can be used to test if the product can create a new market	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Crowdfunding can be used to show if there are high barriers to entry in the market	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Thank you for participating in our research. Upon completion of this study, an executive summary will be sent to you.

## 8 Appendix C – Introductory Email

Dear.....

I would like to request your participation in a research study that I am conducting into the potential influence of crowdfunding on the early-stage financing ecosystem in South Africa. Your time and input is greatly appreciated.

I'm a Mcomm student at UCT's Graduate School of Business. This Research Report will be delivered to UCT GSB in December of this year as part of their Mcomm in Development Finance programme.

Should you agree to participate - through this interview of not more than 30 minutes - the final report will be shared with yourself, with the expectation that through this research you will gain value and insight into (amongst other things):

- Crowdfunding's potential influence on the VC ecosystem in South Africa
- The use of crowdfunding in the VC investment decision-making process
- The potential for crowdfunding as a source of deal-flow

The questions that I am trying to answer through this research consist of the following:

1. Can crowdfunding provide a viable source of entrepreneurial seed capital?
2. Can crowdfunding influence Venture Capital deal-flow?
3. Can crowdfunding influence the Venture Capital investment decision-making process?

Please let me know by return of email whether you'd be willing to take part in this research through a 20-30 minute telephonic interview. If so, please let me know of a time that is most convenient for you.

The information you provide will be held in the strictest confidence. We will neither publish, release, nor disclose any of the information on, or identifiable with, individuals or firms. If you have any questions or concerns about your participation, please contact Dr..Stephanie Giamporcaro at the University of Cape Town Graduate School of Business at 021 406 11 80

Kind Regards,

Adam Bennot

Student - Mcomm (2014/2015)

Phone – 074 233 6980

Email – [abennot@gmail.com](mailto:abennot@gmail.com) or [bnnada003@gsb.uct.ac.za](mailto:bnnada003@gsb.uct.ac.za)

## 9 Appendix D – Informed Consent Form

**Principal Researcher:** Adam Bennot

### **Project Overview and Purpose:**

This research study is being undertaken for a thesis that forms part of the requirements to complete a Master of Commerce in Development Finance at the Graduate School of Business, University of Cape Town under the supervision of Dr Stephanie Giamporcaro.

The purpose of the study is to examine the potential influence of crowdfunding on the early-stage financing ecosystem capital South Africa. In specific, the research seeks to explore the influence of crowdfunding on venture capital deal-flow as well as the venture capital investment decision-making process.

Due to the exploratory nature of the research a qualitative approach has been adopted, using interviews to learn more about the practices, views and opinions of venture capital investors as well as practitioners and entrepreneurs within the venture capital ecosystem. The research will aid in expanding the knowledge about early stage venture financing and add to the limited literature focused on venture capital and crowdfunding in South Africa.

There are no known risks or dangers to you associated with this study. Unless you provide an explicit approval, the researcher will not attempt to identify you with responses given during the interview, or to name you as a participant in the study, nor will he facilitate anyone else's doing

I acknowledge that I am participating in this study of my own free will. I understand that I may refuse to participate or stop participating at any time without penalty. If I wish, I will be given a copy of this consent form.

**Signature:** \_\_\_\_\_

**Date:** \_\_\_\_\_

**Please Print Name:** \_\_\_\_\_