

The role of equity crowdfunding in the start-up business network

Abstract

In recognizing that obtaining appropriate financial resources is one of the most critical external processes for startups, we have seen a rapidly evolving industry comprising a variety of new sources and formats. Among these new formats, online equity crowdfunding is considered an increasingly popular source of capital for young entrepreneurial firms. Prior research has focused on the factors affecting the funding success through equity crowdfunding platforms, however a detailed and empirical understanding of other benefits accrued is still lacking, particularly in relation to the network effects from new investor connections. This research aims to answer the following research questions: *what is the role of investors in the business network of the start-up? What are the main resources provided to the start-up by business partners and investors?* Through a case study approach of an Italian start up supported through birth and scale up stages by equity crowdfunding, this study provides interesting insights on the main benefits for the startup, the role of investors and the resource shared in terms of both financial resources, knowledge and competencies.

Keywords: Equity Crowdfunding, Start-up, Networks

1. Introduction

The creation of a start up is a process through which entrepreneurs imagine the opportunity for novel products, refine their ideas and try to access resources from others (Cornelissen and Clarke, 2010). As Wu (2007) points out, startups' resources include those of the entrepreneur, in terms of experiences and know-how, human, financial and physical capital, as well as complementary resources provided by external entities. Obtaining appropriate financing resources is one of the most critical external processes for startups (Brown *et al.*, 2018; Belleflamme *et al.*, 2015), leading to a rapidly evolving industry comprising a variety of new sources and formats (Ma and Liu, 2017). Among the options providing early stage financial resources, many entrepreneurial new ventures are looking to crowdfunding as an alternative to traditional capital raising (Cumming and Vismara, 2017).

Crowdfunding is defined as the raising of capital from a large number of people who donate or invest money, primarily using online platforms in an environment of high mutual visibility among participants (Valanciene and Jegeleviciute; 2013). Despite the "disintermediating" role of crowdfunding, networks can play a pivotal role within the crowdfunding process by creating short and long-term ties in both pre-crowdfunding and active crowdfunding stages (Brown *et al.*, 2018).

Through crowdfunding relationships a startup can access the resources of heterogeneous partners. This process enables startups to develop the initial business relationships with customers and suppliers through which it can access and obtain the resources necessary to sustain its operations (Aaboen *et al.*, 2011) and, in addition to form new networks with investors. The equity crowdfunding phenomenon provides new opportunities for entrepreneurs, who can now target a broader group of external equity investors than would be through the entrepreneurs existing networks or through traditional sources such as banks. To date scholars have mainly focused on success factors in raising capital through equity crowdfunding (Ralcheva and Roosenboom, 2016), seeing "crowdfunding in general - and equity crowdfunding in particular - as potential routes for entrepreneurs to overcome possible financing constraints" (Walthoff-Borm *et al.*, 2018: 515). Retaining equity and providing detailed information about risks have been shown to be success factors for firms using this platform (Täuscher, 2018).

Taking these premises about crowdfunding into consideration and the growing interest in this instrument for developing companies, this paper focuses on two research questions: what is the role of investors in the business network of the start-up? What are the main resources provided to the start-up by business partners and investors? The research focuses on the Italian context, which although was slow to adopt this format compared to other European countries, sees crowdfunding as a growing phenomenon that in 2018 generated a collection of over 111 million euros¹. Equity crowdfunding campaigns specifically, have collected 41,038 million euros in 2018. The research

¹ <https://www.crowdfundingreport.it/#totale-raccolto>

presents the case of Xnext, an Italian SME that developed a new generation of X-ray inspection systems that overcome the difficulties of conventional X-ray machines. In line with these aims, the paper is structured as follows: after the literature review, the theoretical framework, the methodology and the case study are described. Then a third section is dedicated to empirical findings and conclusions.

2. Literature review

2.1 The role of new actors in startup development

New business development, including the establishment of initial relationships, is considered a topic that still needs further exploration (Waluszeski *et al.*, 2019). An increasing number of entrepreneurship research have focused on how new ventures, or start-ups, emerge and develop over time (Baraldi and Havenvid, 2016, Ciabuschi, Perna, and Snehota, 2012). Focusing on the Industrial Network Approach, new ventures are born and grow through business relationships and it is thanks to those relationships that firms can initiate, develop and sustain their business (Håkansson and Snehota, 1995). Considering the startup context in particular, research stresses how networks affect further development, particularly highlighting how business networks generate opportunities for any startup providing ideas, knowledge and material resources as well as the identification of customers, suppliers, business partners (Aaboen, Dubois and Lind, 2013). Starting up is primarily a relational act (Aaboen *et al.*, 2017), a process of embedding the new business venture in a business landscape characterized by existing resource constellations, activity patterns and actors' interdependencies. A start-up "is not born in a vacuum", but it arises from a specific context of social, economic and technical connections (Baraldi *et al.*, 2018, in press).

Several studies have proposed that connecting to existing business networks and acquiring a position in the network is a necessary condition for the survival, development and ultimate success of a business (Aaboen *et al.*, 2016). From an IMP perspective, the opportunity is related to the variety of multidimensional relationships available within business landscape. In order to benefit from a relationship, actors have to relate to each other over time and in a number of dimensions (Håkansson *et al.*, 2009). The initial phase of a startup's journey is about relating to an existing landscape of business organizations, customers, suppliers and other institutions in order to become a member of the business network. How firms develop over time is then very much dependent on how they interact in the network and how they manage to establish relationships with different types of external actors (Hellman *et al.*, 2018). In considering this, we recognize that the development of the startup is not only founded on vertical relationships but also on horizontal relationships, thereby acknowledging other actors that contribute to their development (such as innovation hubs, incubators, science parks, etc.). In addition to this, a startup needs financial resources and thus the development of relationships with financial actors, such as investors and business angels, that can provide financial resources, as depicted in recent studies (e.g. Baraldi *et al.*, 2017).

For entrepreneurs, internal finance and debt finance are crucial to form and grow a venture (Walthoff-Bormet *et al.*, 2018). Sometimes entrepreneurs are unwilling to attract capital because of fear of losing their independence. In addition, banks, venture capital and angel finance are often difficult to access. New forms of finance are required. It is in this last respect that the next section delves into the crowdfunding literature to provide an overview on the concept, its variables and applications and the main potential benefits.

2.3 The concept of crowdfunding and equity crowdfunding in startups

Extant literature on crowdfunding is growing, since it has been recognized as an effective alternative to traditional capital raising (Cumming and Vismara, 2017), especially for early stage startups but also firms at the 'after startup stage' (Paschen, 2017). Crowdfunding is defined as the raising of crowd capital, *i.e.* a capital from a large number of people who donate or invest money, primarily using online platforms in an environment of high mutual visibility among participants (Belleflamme, Lambert & Schwienbacher, 2014). In particular, crowd capital represents the amount of "organizational resources acquired through crowdsourcing (Prpić *et al.*, 2015: p. 80). As outlined by Paschen (2017: p. 179), crowdfunding encompasses the outsourcing of an organizational function to a strategically defined network of actors (the crowd) in the form of an open call. Participants have real time awareness of the progress of the campaign and supporter responses, and

this visibility reinforces the sense of belonging to a crowd, producing associated social benefits (Davies, 2013). Crowdfunding can involve the financing of projects that may or may not be profit-oriented, by a large number of individuals or ‘crowd-funders’, who often provide relatively small contributions remotely, typically facilitated through the internet (Lagazio and Querci, 2018). The main strengths of crowdfunding is the accessibility of capital, opportunity to test marketability and lastly community benefits both locally and globally (Valanciene and Jegeleviciute, 2013).

In particular, *equity crowdfunding* (also referred to as investment-based crowdfunding, securities-based crowdfunding, or crowd-investing) is the fastest growing model where the venture raises money from a crowd in exchange for an ownership stake in the firm (Pachen, 2017). We focus on this final model given its popularity within the startup community and relevance to the growth of business networks. In equity-based crowdfunding, funders receive stakes in the venture in return for their investment and consequently dividends according to the level of the corporate success (Kraus *et al.*, 2016; Mollick, 2014, Niemand *et al.*, 2018). It is “a form of financing in which entrepreneurs make an open call to sell a specified amount of equity or bond-like shares in a company on the Internet, hoping to attract a large group of investors” (Ahlers *et al.*, 2015: p. 955). Depending on the type, investors can include venture capitalists, angel investors or sector specialists (Paschen, 2017) and can obtain equity, bond-like shares, securities revenue or profit sharing. Thus, this format can involve a large number of individuals each providing small amounts of finance to businesses in exchange for an ownership stake in the company (Brown *et al.*, 2018). The exchange of equity sets this model apart from other more transactional typologies, as it establishes an ongoing relational link between the startup and its investors, which now have a common share in its success.

Like the other models of fundraising, equity crowdfunding is carried out through online platforms, where entrepreneurs submit project applications containing detailed information about the business idea, the entrepreneurial team and so on. However, many factors can positively and negatively affect the launch of projects on platforms, such as the geographic distance between the locations of the project and the platform, media usage, the industry of a start-up and the quality of the startup (Zhang *et al.*, 2019).

When startups create campaigns to collect funds (Lukkarinen *et al.*, 2016) they can obtain different benefits, including the alleviation of capital crunch (bank shrinkage resulting from binding capital requirements) and the collection of the needed money to execute the business idea (Pachen, 2017; Peek and Rosengren, 1995). Moreover, startups evaluate investment proposals by considering the “social proof” dynamics that operate within a platform’s community and the startup ecosystem (Salomon, 2018). However, designing a crowd-based business model can be hard and startups can face different challenges, such as how to determine the crowd’s value to the firm, how to create value for the crowd and the way to effectively capture value from the crowd (Tauscher, 2018). Many crowdfunding platforms have now implemented different features and structures to reduce information asymmetries, enabling investors to better select the most promising ventures (Walthoff-Borm *et al.*, 2018).

3. Research questions and methodology

As previously mentioned, Taucher (2018) argues that among the main challenges startups face in designing and managing their business model, it is necessary to determine the crowd’s value to the firm, how to create value for the crowd and how to effectively capture value from the crowd. Thus, we focus on these challenges by empirically exploring the value of the equity crowdfunding for the network of a startup. Empirical research on the effects of equity crowdfunding on startup development is still scarce, particularly from a relational perspective that takes into account business network changes (Hornuf and Schwienbacher, 2017). This research, then, proposes to examine the following questions: *What is the role of investors in the business network of the start-up?* and *what are the main resources provided to the start-up by business partners and investors?*

Due to the exploratory nature of the topic, the research adopts a qualitative design (Dubois and Gadde, 2002) using a case study approach (Harrison and Easton, 2004; Barrat *et al.*, 2011). An abduction process analysis enables data-driven theory generation (Järvensivu and Törnroos, 2010). We applied a purposeful sampling technique (Patton, 1990; Coyne 1997), to select the case study context. The basic selection criteria followed were: the startups had to be active in the last year (2018); the main activities had to be based in Italy and had to be engaged in equity crowdfunding campaigns. Data on the selected case study were collected using multiple data sources, *i.e.* website, archival documentation and reports provided by the startup and 2 semi-structured interviews to the founders and/or team members of the startup. This triangulation enhanced data credibility (Patton,

1990). The selected startup is considered an emblematic case as it is the first equity crowdfunding campaign promoted by Equinvest in Italy and it is also an *innovative* startup, as defined by Italian Legislation (L. 221/2012).

4. Case study description: Xnext®

Xnext® is an innovative startup whose idea was born in 2012 when two deeply-experienced engineers who had been working together in the aerospace sector during the 1990s decided to combine their know-how and create a disruptive and revolutionary product. The startup was founded in 2014 as a knowledge intensive startup with a mission to solve in-line contamination problems for a cleaner, safer and more efficient world. It provides a patented x-ray technology to assist inline inspections in several industries such as food processing, recycling and security. Since the beginning of this activity, the firm's goal has been to become a world benchmark in x-ray control to improve cleaning and security in the food, medical and travel industries. Nowadays, the startup focuses its attention on food and pharma processing, industrial manufacturing and security. The initial premise of the technology relates to the fact that automation in processing lines can reduce the possibility of human errors and increase productivity. Many food companies in particular are trying to the density of foreign bodies hidden inside non-transparent foodstuff and non-transparent containers, such as pieces of metal, lead, stones, bones and glass and other foreign bodies that have been impossible to detect. Among the technologies developed by the startup, XSpectra® emerged as a particularly innovative product using a brand-new generation of X-ray that provides a novel approach in the interaction of X-ray with the matter being examined. Previously, the attenuation of X-ray interacting with material was computed and the resulting radiographic image reconstructed was used for the identification of non-conformities in materials (such as defects or contaminations).

Thanks to the proprietary and patented multi-energy analysis, XSpectra® identifies a new class of defects and contaminants otherwise non-detectable by the actual technologies, such as light materials for foreign bodies detection in food safety inspections. Through a crowdfunding campaign, the startup improved the technology and its application to a new industry. In addition, the company merged with a venture capital group that cooperated with it, depicting interconnected relationships.

5. Findings

Xnext® is a high-tech enterprise that developed a package of innovations on three levels: Photonics; Microelectronics; and Algorithms. The combination of these three innovations constitute the strengths of Xnext® and the uniqueness of XSpectra®. Adopting a market orientation, the new venture started when the founders realized the magnitude of big food contamination problems affecting industries around the world (such as melamine contamination in Chinese milk products).

A general insight emerging from the analysis was that the evolution of the startup was strongly linked to business relationships developed during the years. The birth and evolution of the startup was facilitated by interconnected business relationships with several business partners during key stages:

First stage - 2014-2015 The pre-competitive development. In 2014 startup team activated a pre-competitive development agreement with engineers at the Polytechnic University and CNR of Parma. These scientific and institutional relationships allowed the sharing of scientific knowledge and technical skills. In addition, in the coming years Xnet® participated in a recruiting day at Polytechnic University that recruited engineers to expand its structure and grow the business. The start up also cooperated with Polytechnic University and Cattolica University of Milan in order to develop applied research and patents. Through these relationships, the startup provided universities with different scholarships and accessed applied research competencies.

In 2014 the start up activated a relevant relationship with Assolombarda that provided added value services to sustain the growth of the new venture. The Italian industrial association facilitated relationships between the startup and financial business partners, such as banks. In addition, Assolombarda provided training courses on entrepreneurship and different managerial topics. In this first stage of evolution the startup accessed traditional financial resources to sustain its activity.

Second stage - 2015 The acceleration stage. Xnext® established business relationships with UniCredit Start Lab, an acceleration program that aims to support the growth of innovative start ups through grants, mentoring services, networking activities, training and ad hoc financial services. In addition, many years ago Xnext® participated in an event dedicated to the Open Innovation and strategies for the growth of Southern Italy promoted by UniCredit through UniCredit Start Lab. From this event, Xnext® developed a key relationship with Endeavor, an accelerator that creates support systems for high impact entrepreneurs with a global network of mentors and business leaders.

Third stage - 2016 The first equity crowdfunding campaign. The startup began its first attempt at equity crowdfunding by running a campaign in 2016 which had a high subscription rate. 32 investors signed up to the campaign: with over 43% of capital coming from abroad and the remainder from Northern Italy. The campaign drew in a wide variety of investors: from a multinational firm with over half a billion euros in turnover to university students, small entrepreneurs. The campaign supported the startup in the production of a device, covered by an industrial patent, applied in the food and pharmaceutical safety sector and in the field of online controls in highly crowded places.

Fourth stage - 2017 The second acceleration stage. With a solid foundation of financial resources, the startup improved its solutions and explored new markets. In 2017 Xnext® won the Best Startup Award and was selected by the first Italian Scaleup Initiative in China. The international ISIC Program involved the Italian and Chinese Chambers of Commerce, ThinkInChina, Etihad Airways, Innoway and Startupbusiness. The positive results allowed the startup to win several competitions. Xnext® participated to events organized by Italian Start up Association also, and nowadays the CEO belongs to the board of the Italian upstart up. In particular, the Association offers exclusive agreements with qualified partners and the opportunity of discounts for members. The Association provides the Ecosystem map, the notices on tenders and financing, legal-fiscal support.

Fifth stage - 2018 The second equity crowdfunding campaign. In 2018, thanks to the network of business partners, a high number of small stockholders participated to the second campaign of equity crowdfunding. In the second campaign the founder said: “*We had different kinds of investors. We had people paying 300 euros, and others contributing with 50 thousand euros*”. Two different categories of investors were established with two different shares - ordinary shares and preferred quotes. The ordinary shares gave the right to vote and was obtained with a higher investment of over 25 thousand euros. Conversely, preferred shares, with an investment below 25 thousand euros, gave the right to a higher return on profits, without the right to vote. The startup devised this structure so as to more easily manage their internal investors. This campaign of equity crowdfunding involved firms, professionals, employees and students. At this point the work for equity scheme was also introduced.

In order to collect not only financial resources but knowledge and competences also, Xnet® planed several meetings to manage the relationship with investors. The meetings allowed to create a debate, to improve commitment of investors and to maintain long term relationships. In addition, through different meetings and events the investors provided commercial resources such as contacts for potential customers. The investors provided financial and legal cooperation also. The investors gave relevant suggestions on how to improve the product or services, on how to access more customers, or on how to extend the ideas to other markets. Suggestions were provided also on the basis of the knowledge about the market or on the basis of previous experience in that same industry. Some investors participated in the previous crowdfunding campaign run by the startup and thus decided to continue supporting the development of the firm.

Through this initiative the startup also improved relationships with employees. The work for equity considers those situations in which the work done for an innovative startup is paid to the employee through shares of corporate capital, through the distribution of financial instruments of the company. Employees could also elect to receive a standard salary instead. The employee, being paid with shares of the company, has greater interest in contributing to the positive performance of the company. Thus, the employee can collaborate, albeit assuming some risk, at the startup and still be paid also participating in the future business success.

6. Conclusions and managerial implications

New ventures are often recognized as being small, new and blurry typology of business. They are entities without any formal relationships as well as track records (Ostgaard and Birley, 1999) and one complex issue for them is how to develop and cope with “counterparts”. According to Lambertz and Schulte (2012) once startups consolidate their market position they leave are no longer classed as startups. Accordingly, it seems that acquiring customers might lead the startup towards the “next” evolutionary process of development. Hence levels of sales or profits might be indicators of a new venture leaving the status of startup.

On the other hand, we argue that the evolution of the start up requires to be investigated adopting a relational perspective. By adopting a business network perspective, we shift the attention to the key role played by business relationship dynamics and actors involved. Among these actors a new relevance can be recognized to investors related to equity crowdfunding. The crowdfunding recently emerged as a new source of external equity finance playing an increasingly important role in the financing of young entrepreneurial firms (Cumming and Vismara, 2017; Drover *et al.*, 2017). In recent years crowdfunding has reached a progressive interest for providers and seekers of capital (Mollick and Robb, 2015; Solesvik, 2016). As depicted by the case, by engaging in equity crowdfunding, startups can access financial resources and other resources provided by the stakeholders they connect with. Going more in depth, as depicted by the case, the main resources shared and combined through equity crowdfunding relate to knowledge.

It therefore follows that:

P1 Equity crowdfunding allows a startup access to heterogeneous resources: financial resources, technical knowledge, commercial knowledge, legal knowledge. As a synthesis, we can say that knowledge is the key resource shared through business relationships.

P2 Equity crowdfunding could support different goals: to facilitate the birth of the startup and to foster the scale up stage.

In addition, equity crowdfunding support startups in finding new business opportunities. The opportunity identification refers to the way entrepreneurs become aware of an opportunity, whether discovered or created. The discovery and exploitation of opportunities is emerging through network crossing borders. It follows that:

P3 Equity crowdfunding could support startups in finding business opportunities.

The efficiency and effectiveness in opportunity management can be reached by the entrepreneur with close contacts with existing network structure and special knowledge around activities and resources structure. As depicted by the case study, equity crowdfunding could also be considered to improve internal business relationships. This new approach supports the commitment of employees.

It follows that:

P4 Equity crowdfunding could be used to increase commitment from different stakeholders such as internal customers (employees).

Limitations and Future research

The study is founded on a single case study with the relative limitations deriving from a single perspective and the reliability of findings. The further steps of the research could analyze other cases. Future research could be focused also on measuring the effectiveness of crowdfunding as an instrument able to sustain the goals of the startups.

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