

Preface

As a new volume in the book series on China's Internet finance and small business financing, it seems to be an appropriate time now to discuss and analyze another remarkable financial innovation in China in the recent years, which is the well-publicized crowdfunding. In fact, I personally touched this subject well before I scholastically studied it, and even now, I can still remember my first time to see a physical and real-life crowdfunded project in China a few years ago. It was a summer weekend in Shenzhen, a city located next to Hong Kong and widely perceived as the Silicon Valley of China, when and where I was invited to give lectures at the HSBC Business School of Peking University (PKU) as a visiting professor. On that sunny Saturday afternoon, one of my PKU alumni took me to join a seminar at a PKU club called Wei Ming Café (or Unnamed Café in Chinese, following the name of the famous Wei Ming Lake in PKU's Beijing campus), which was crowdfunded by 200 PKU alumni with RMB 50,000 from each individual. The café is well sited on the top of a high rise, overseeing the Shenzhen River and Hong Kong on another side of water, and all the investors of the café are entitled to use this facility for their various activities as part of their return package as a shareholder of this crowdfunded property. I was truly impressed by the design, decoration, and view of the club; however, as a professor of finance, I was more excited to personally see a real and concrete example of crowdfunding in China for the first time.

Similar to other financial innovations such as online lending, the primary functionality of crowdfunding is to provide an online platform, through which both the party that seeks financing and the party that is able and willing to supply funds can interface with each other in order to transfer the funds from the hands of the investors (or the surplus economic units) to the hands of fund recipients (or the deficit economic units) at previously agreed-upon terms. As the business model of the crowdfunding enables the demand side and supply side of a funding process to interact directly and cuts out the intermediary functions that were previously provided by many financial institutions, crowdfunding could considerably simplify the funding and investment process and significantly reduce the financing cost for

the project initiators that seek funding for their start-ups and/or innovative projects in terms of either money or time.

Unlike these earlier Internet-based innovations, such as online lending or online payment, however, crowdfunding is a relatively late comer in China and possibly involves the transfer of equity ownership of the funded projects, instead of only funds transfer as did by debt financing. By its very nature, debt type of financing, including online lending, may not be an ideal way of financing for these start-ups and innovative projects at early stages, as (1) the start-ups and innovative projects at early stages are, typically, still in their phase of “burning money” with heavy focus on research and development, without immediate cash inflows. As a result, it could be difficult for these start-ups to timely fulfill their obligations to pay the periodical interest incurred by the debt financing; (2) both start-ups and innovative projects are facing tremendous uncertainty and risk, and in some sense, their success is pretty much a matter of probability. It is truly not uncommon for observing many early-stage investments to fail badly due to various reasons. As a result, repayment of the fund principal to fund lender at the maturity may become a “mission impossible” for the unsuccessful start-ups and the innovative project initiators if the projects are funded by debt financing; (3) the fund providers of debt financing are typically the investors with lower tolerance for risk taking, which is, likely, the primary reason for why they did not invest in the equity securities that typically provided higher returns but with higher risk. As a result, using the funds from the relatively conservative investors to finance the highly risky projects may bring tremendous risk that could be “unexpected” or “unbearable” by these conservative investors and may not be “morally” justified, either. Therefore, as an approach involved in equity stakes, crowdfunding paved a new alternative path of financing for small business, in general, and start-ups, in particular.

The value of crowdfunding for project initiators, investors, and crowdfunding platform operators, at the micro-level, could be very profound. For the project initiators, especially for these start-ups with relatively smaller size in financing needs, and the projects with relatively less “significance” in value comparing with these projects with “breakingthrough” innovations in technologies, it is usually difficult for them to obtain equity financing at such early stage of their growth cycle. Even the financial innovations such as the development of angels and venture capitals may not be adequate to address the financing issues of these start-ups, as the cost of information collection, risks inherited in these projects, and the possible returns that these projects are expected to provide for these early-stage investors may not be well justified for a positive decision. As a result, many “valuable” but less “significant” innovations may not be able to even get a chance to be “born,” not mentioning to grow and flourish, even though they are, indeed, an indispensable and integrated component of advance in technologies and progress of society.

For the online platform operators, the rise of crowdfunding represents a strategic and timely opportunity for their transition and business development. Many online platforms in China emerged with the growth of P2P online lending in an unregulated market environment in the first decade of the century. As an innovative way to integrate Internet and finance and targeting the uncovered and underfinanced groups

in the society, such as micro- and small businesses, borrowers with smaller fund needs, and consumers with lower income, the fast growth of P2P online lending in the past years went far beyond the expectation of almost everyone in the market. As the core component of the online lending process, the growth of platforms also reached its peak during the same period of time. However, as the risks inherited in the online lending got more exposed over time and the fraud incidents appeared more frequently in the headlines of media, the hammer of the regulators eventually came down. Meanwhile, with the increased regulations is the entry of the capital from “mainstream,” such as state-owned enterprises, commercial banks, and listed companies, with the resources that the “grassroots” platforms are difficult to compete with.¹ As a result, exit from online lending industry and identifying the new outlet became a critical issue for these existing online platform operators, and crowdfunding provided a timely option for them.

From investment perspective, crowdfunding also provides small- and medium-sized investors in China with an alternative investment opportunity in a financial environment where the stock market has been bearish for years, real estate risk has been rising, and commercial banks’ deposit rates have had significant difficulty catching up with rising inflation rates. Some investment opportunities with relatively higher returns, such as portfolio investment provided by some wealth management services or entrusted investment by some commercial banks, all set up relatively high thresholds for participation which disqualified many investors with relatively smaller idle money to invest, and the development of crowdfunding provided a niche opportunity for this specific segment of the investor groups. As a result, crowdfunding not only can satisfy the equity financing needs of SMEs and start-ups, it also more effectively utilizes the idle funds in the economy, improves the efficiency of fund usage, and enhances the basic functionality of the financial market in transferring surplus funds from the holder of the surplus funds to demander of the funds. Essentially, like other financial innovations, crowdfunding helps improve the efficiency of resource allocation in financial market.

At the macrolevel, the development of crowdfunding may help China’s transformation from an economy primarily driven by low-labor-cost, investment, and export to an economy primarily driven by innovation and domestic consumption, when Chinese economy is at a crossroad. In the past years, the passage of Labor Law² and increased income and standard of living in China have made the cost of labor no longer be an advantage for the competitiveness of “Made in China” products, as evidenced by sharply increased overseas investment and relocation of many manufacturing facilities from China to various less developed countries, such as Vietnam, India, and Cambodia, and even to some developed countries, such as USA and western European countries. On the other hand, the sluggish economic recovery and growth worldwide and overcapacity of production in China also made

¹Wang, J.G. and Xu, H., Co-edited, 2015, *Financing the Underfinanced—Online Lending in China*, Springer.

²http://www.gov.cn/banshi/2005-05/25/content_905.htm.

both export and domestic investment hard to continue to play the driving engine role for Chinese economic growth in the next decades, even though the “Belt and Road Initiative”³ proposed by Chinese leaders in the recent years attempts to explore a new outlet for China’s products and production capacity, especially in the areas of infrastructure. As a result, an innovation-driven and domestic-consumption-oriented growth strategy will become vital for China’s sustainable economic growth for the next decades, and small- and medium-sized enterprises (SMEs) and their massive innovations are expected to play a critical role under this new strategy.

Historically, the role played by SMEs in China’s economy was considered somewhat insignificant. Under the traditional ownership structure, the majority of SMEs are privately owned firms that were either set up as a private one since their inceptions or transferred from state-owned during the period of time of ownership reform in 1990s. Compared to large state-owned corporations and their roles as the dominant force in the economy, SMEs were typically perceived as relatively trivial entities whose primary functionality is to fill market niches and cover the few segments uncovered by large state-owned corporations. As a result, SMEs and the financing of SMEs were not perceived as a top priority issue on the agenda of China’s economic development in the past.

However, that page of the China’s economic growth has been turned over, and the role of SMEs, and especially their innovations, in economic growth has been much better understood and recognized by entrepreneurs, scholars, policy makers, and general public in recent years in China. The plain fact that the progress in economic growth is simply and persistently the result of “creative destruction,” as Joseph Schumpeter pointed out several decades ago,⁴ now became well-known common knowledge in China. Innovation from the marketplace internally drives the growth of the economy, while entrepreneurs are the initiators and executors of such innovations. Innovation-driven growth, along with the participation of entrepreneurs and millions of SMEs, will be the key to breaking the vicious cycle.

The participation of SMEs in innovation is certainly important for improvement in economic inclusiveness. However, their impact can go far beyond that. SMEs not only make up the majority of the total number of firms in an economy, and can conduct innovations in many areas that larger corporations cannot cover, but they also have stronger motivation to innovate in the first place. By nature, innovations—especially the fundamental ones—are changes or destructions in existing product and market structure, and the larger firms typically benefit more from the status quo. As a result, large corporations, usually, may tend to be less motivated to innovate than SMEs. Kodak, for example, was widely considered a classic case of a large corporation in a monopolistic position, who resisted new digital technology innovation due to a conflict of interest with its traditional film business, and eventually

³<http://baike.baidu.com/item/%E4%B8%80%E5%B8%A6%E4%B8%80%E8%B7%AF/13132427>.

⁴Schumpeter, J., 2006, *Capitalism, Socialism and Democracy*, New Edition, Routledge, London.

filed for bankruptcy. Therefore, SMEs are widely expected to play a much more critical and strategic role, instead of a niche one as before, in China's sustainable economic growth in the coming decades.

However, despite the new tasks that SMEs have been expected by the market to undertake, obtaining adequate funding to support innovation and entrepreneurship has been a difficulty for many such small and medium companies. In a monetary economy, conducting innovation without funding would be like driving a car without gasoline or electricity. The difficulties in financing SMEs under the traditional financial system in China remain a huge hurdle that companies must overcome before the Chinese economy can emerge from a non-sustainable growth model to a sustainable one. As a result, financial innovations, including crowdfunding, would be a necessary condition for a successful economic transition in China. In addition to indirect financing with traditional bank loans and focus on the large amount of funding as provided by large state-owned commercial banks, infrastructure for direct financing and funding for smaller amount of financing request, especially equity financing, also needs to be in place. The emergence and development of crowdfunding is simply a timely and tailored response to the ever increased demands for China's growth model transformation, in general, and financing for SMEs and start-ups, in particular.

Another significance of the fast development of crowdfunding in China could be the tremendous opportunities it may bring to the business community worldwide, especially global investors. As the economy with large, and in many occasions the largest, number of cell phone owners, Internet subscribers, online shoppers, online social media participants, undercovered fund demanders, and overliquid fund suppliers, Internet-related industries could become one of the pillar industries in China in the next decades, just like the auto industry in the USA in the last century. Some early comers, such as Yahoo from USA and Softbank from Japan, have sweetly tasted the harvested fruit from their venture capital investment in Alibaba, an award for their visions and insights. It can be expected that the crowdfunding, like online lending, that grew from grass roots may trigger a sequence of the shake-up of China's financial industry, accelerate the integration of Internet and finance, and bring in enormous investment opportunity for the business community worldwide.

However, like all other financial tools that facilitate business transactions, crowdfunding also holds potential risks that the financed projects may fail to achieve what was expected and are unable to provide the financial and non-financial returns that were anticipated by investors, and there also exists a trade-off between risks and returns. In particular, as a way of equity financing, crowdfunding does not promise the return of the investment principal back to the investors, as debt financing did, and the risk inherited in crowdfunding could be even higher than that of online lending. Crowdfunding shattered the monopolies of large financial institutions in financing channels, but cannot nonetheless eliminate the uncertainties inherent to investment itself, such as the information asymmetry between the parties of transactions and uncertainty in the future. In fact, because of the involvement of the Internet and the lack of adequate due diligence as usually conducted by

traditional financial institutions, the crowdfunding and other online business models may exacerbate even higher level of asymmetry and, consequently, the risk. Just as the inappropriate use of financial derivatives, which were originally created to prevent and reduce risks, ended up in the largest financial crisis since World War II, crowdfunding, while it may stimulate financial innovation, may introduce new risks due to it being an Internet-enabled financing solution.

It is therefore imperative to conduct a comprehensive analysis of this burgeoning industry to explore the value that crowdfunding will provide for start-ups, project initiators, platform operators, investors, and businesses while simultaneously identifying root causes of the potential risks of this financial innovation and suggest possible solutions for mitigating these risks. From this perspective, “Financing from Masses—Crowdfunding in China” could be a timely publication that may be valuable for a wide spectrum of readerships.

This book covers the most important areas and issues in the crowdfunding industry in China, including, but not limited to, the definition of crowdfunding, the history of crowdfunding, the scale of the crowdfunding market, the basic business models and a risk analysis of crowdfunding, market analysis of some sub-industries of crowdfunding, some case studies of several mainstream crowdfunding platforms, government regulations and policies related to crowdfunding, financing of crowdfunding platforms, and finally, the outlook for crowdfunding industry in the future. As a book that combines theoretical analysis and real-world practices in China’s crowdfunding industry, it could be of interest and value to a variety of readers, including, but not limited to, the following.

First, institutional and individual investors both inside and outside China may find this topic relevant and intriguing. Financial institutions such as security firms, investment banks, private equity funds, venture capital firms, commercial banks, other financial intermediaries, and individual investors including angels could gain a better understanding about the crowdfunding industry in China. In particular, SME and start-up financing involves many smaller-amount financial transactions, which will provide investment opportunities for smaller investors who may not be able to participate under the traditional financial regime.

Second, Chinese SMEs and start-ups with innovative projects that are looking for financing should also be interested in this topic. As China adapts its growth model into a more innovation-oriented one, obtaining adequate equity funding becomes a critical prerequisite for success. Understanding what is available, and which method of financing can best meet SMEs’ needs and match the nature of their business, would be of tremendous value for SMEs and start-ups that are operating in China. For example, debt financing may better fit the working capital needs, while equity financing may be more appropriate for R&D and start-ups.

Third, investors and professionals who are running alternative financial entities, such as online crowdfunding platforms, may also take an interest in this topic. Like the running of any other financial operation, running an alternative financing entity not only provides an innovative business opportunity for the parties that are engaged, but also exposes the alternative financial operators to the new risks associated predominantly with these new financial services. As a result, they would

have an urgent need to supplement their knowledge and understanding about this changing industry, especially its risks and the potential downfalls, in order to maximize their bottom line returns and mitigate risk. Therefore, this book will indubitably be an important reference tool for them.

Fourth, bankers in traditional financial institutions such as commercial banks might be interested in this book as well. New alternative ways of financing, especially Internet-related innovations such as crowdfunding, can be reasonably considered as both a formidable challenge and a lucrative opportunity for traditional financial institutions. Opening the door for private equity and the integration of finance and Internet has been recognized as both an indomitable and irresistible trend, and the “anywhere, anytime, anyway, and customer experience” has become fundamental to all service industries, including finance. As this trend grows at an increasingly high pace, the critical question facing the traditional commercial banking system is how traditional banks can promptly meet this challenge, and in a more competitive market environment besides, as evidenced by the newly established joint ventures between these China’s largest commercial banks [Industrial and Commerce Bank of China (ICBC), Agricultural Bank of China (ABC), and China Construction Bank (CCB)] and China’s Internet giants (JD, Baidu, and Alibaba).⁵ Gaining thorough understanding of the status quo of the current financial market and new alternative financial innovations will become a prioritized item for traditional commercial bankers and their major shareholders, domestic and international. This book would certainly provide an important reference for that purpose.

Fifth, members of regulatory agencies could find value in this book as well. In China, the financial industry is strictly regulated, and any new “innovations” will be closely “watched” by regulatory agencies. Even though more explicit legislation regarding certain new alternative financing methods, such as crowdfunding, has not been fully delineated yet, it is merely a matter of time before regulatory agencies bring the hammer down; this is true especially because the general public has become increasingly exposed to the risks associated with new alternative methods as the public gains more knowledge and understanding about these “innovations.” The major dilemma in government regulation, however, is always the extent or degree to which regulations should be set up and implemented. While overregulation can unnecessarily hinder the innovations needed for business development and economic growth, under-regulation may fail to control the risks that will damage said business development and economic growth. As a result, a comprehensive analysis and understanding about the new alternative financing such as crowdfunding is a prerequisite for the regulators, in order to help them achieve the optimal balance between regulation and market innovation. This book could offer some valuable insights.

Sixth, academics inside and outside China could be interested in this book as well. Because the growth model of the Chinese economy has fundamentally changed, and even more changes are expected down the road, the role of SMEs in

⁵<http://news.hexun.com/2017-06-23/189755761.html>.

Chinese economic growth in the next decades has been redefined, and SMEs' status has been repositioned. Understanding how SMEs can be financially funded so that they can survive and succeed is a key to understanding the new growth model of the Chinese economy. Any research on the China's future economic growth omitting the topic of SMEs and their relationship with financial innovation would be incomplete. In this regard, this book would provide such Chinese business researchers with a valuable reference.

In summary, as China increasingly becomes a key player in the world economy, understanding the dynamics in Chinese economy, in general, and the innovations in financial market, in particular, becomes increasingly critical. As the impact of the recent "Belt and Road Forum"⁶ indicated, the influence of the Chinese economy on the global one cannot be underestimated. Therefore, we hope this book "Financing from Masses—Crowdfunding in China" will be a well-timed publication with important value for a wide spectrum of readerships, either as a reference book or as a guideline in understanding, gaining knowledge of, research and teaching, and making business decisions about China's financial market.

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⁶<http://www.beltandroadforum.org/>.

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Crowdfunding in China

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