Extended Abstract for California Management Review special issue on Crowdfunding

Equity Crowdfunding, Information Asymmetry, and the Rise of Online Syndication

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Information asymmetry influences the flow of early-stage capital in crowdfunding. Prior research on online channels in general and on crowdfunding in particular emphasizes the important role mechanisms that reduce asymmetric information play (e.g., Cabral 2013; Agrawal, Catalini, and Goldfarb 2014a). We document the rise of investor syndicates on a dominant crowdfunding platform and examine how syndicates may overcome certain information asymmetries and therefore influence the geographic flow of early-stage capital. We argue that syndicates are likely to become a key feature of equity crowdfunding because the reputation of the syndicate lead serves as a substitute for information about the venture and the founders that is otherwise best gathered offline.

We describe our plans for the article according to the four criteria listed in the call for papers:

(i) Purpose of the paper

The purpose of this paper is to describe the underlying economics of syndicates in crowdfunding and explain how syndicates may influence the geographic flow of early-stage capital. We will do this in five parts. First, we will explain the economics of syndicates in terms of the incentives and costs for syndicate leads, investors, and ventures. In particular, drawing on our prior work (Agrawal, Catalini, and Goldfarb 2014a, 2014b), we will explain the important roles that information asymmetry and reputation play in this context. The key issues are that
distant investors have little way to assess venture quality, offline relationships are important for building trust between the lead investor and the entrepreneur, and although many entrepreneurs raise capital for the first time (i.e., they do not have a reputation), many investors invest repeatedly and so may develop an online reputation with other investors. Thus, syndicates provide a way to leverage both offline relationships and online reputations. Second, we will use the aforementioned economic framework to describe how specific platforms such as AngelList and Funders Club have implemented syndicates. Third, we will use data from AngelList to describe the magnitude and rate of growth of online syndicate investing in a crowdfunding context. Fourth, we will report data that illustrates how the geographic flow of capital differs between syndicates versus direct investing, even within the context of crowdfunding. For example, the data show that 54% of syndicate deals are based in Silicon Valley, compared to 60% of other AngelList online investment campaigns. Investors are much more dispersed, particularly when investing through syndicates. In addition to presenting such descriptive statistics from a broad sample, we also will provide detailed data from a few specific examples. Finally, we will discuss the implications of syndicates for investors, ventures, and policymakers. In particular, we will speculate on methods that policymakers might consider to influence the flow of investment capital to their region.

(ii) Policy/management issue raised by the paper

The paper will raise three management issues: 1) the conditions under which syndicates will generate opportunities for individuals to generate returns from expertise or relationships that were previously not possible due to a lack of access to capital (i.e., “carry” for syndicate lead);
2) the conditions under which syndicates will create previously unavailable opportunities to co-invest with geographically distant syndicate leads in early-stage crowdfunding transactions; and

3) the conditions under which start-ups will choose to set aside an allocation for a syndicate lead investor.

In addition, the paper will raise a policy issue. We will describe the conditions under which syndicate leads generate local externalities by attracting distant capital to the region. We will then speculate on interventions that may enhance the number and effectiveness of local syndicate leads (e.g., by verifying their reputation, co-investing in their deals, providing incentives for them to invest online through a crowdfunding syndicate rather than offline through traditional means).

(iii) Context in which we examine the policy/management issue (data sources)

We will use data from all investments conducted on AngelList. We already have these data. AngelList explains that, “a syndicate allows investors to co-invest with other notable investors. People who back a notable investor’s syndicate commit to invest in their future deals and agree to pay them a carry.”

We will use these data to document the distribution of syndicate behavior. Specifically, we will show that funding is highly skewed, with a small number of syndicate leads driving a large percentage of funding and backers. We also will describe observables that are correlated with syndicate lead success (defined by dollars raised and backers per lead). We will show that location, expertise, and especially investment history play an important role in predicting which leads generate the most attention. Since not all investment happens through syndicates, we
will compare capital allocated to back syndicate leads to other online investments (on the same platform) to assess how syndicated investments differ from other investments.

(iv) Relevance for practitioners, academic scholars, and the CMR readership

This paper will offer insights for both academic and practitioner readers of CMR. For academics, we will articulate the underlying economics of syndicates and explain the theoretical link between information asymmetry and online syndicate behaviour. We will provide some basic evidence that is consistent with this view. For example, we will compare the geographic movement of capital that flows directly from investors to ventures versus that which flows from investors to syndicate leads to ventures. We will show that the latter is more geographically dispersed. We will assert that this is because syndicate leads solve part of the information asymmetry problem that typically restricts the geographic flow of early-stage capital, even online.

For practitioners, we will discuss the implications of syndicates for potential leads, backers, and ventures that are interested in raising or investing angel capital through crowdfunding. We will also examine the implications of the rise of crowdfunded syndicate leads for policymakers. Because syndicates influence the geographic flow of capital, policymakers who better understand the economics of syndicates may be better positioned to influence the flow of capital into their jurisdiction.