Supporter / Investor

Risk category: GENERAL

#9 - Illiquidity, late returns & increase in default

Definition

In case of equity crowdfunding, future returns are expected from investments. However, it may take long to materialize if at all, in case of difficulty to scale the business. The chance that a company or individual will be unable to make the required payments on their debt obligation might happen to lenders and investors in virtually all forms of credit extensions. Market rules imply that higher levels of risk lead to higher required returns, and in turn, to higher interest rate. It is important to consider that, in the event of a default, investors may lose out on periodic interest payments and their investment in the bond.
Also due to value fluctuation, alternatively, assets may be subject to capital erosion over time.

The future of an investment, on the other hand, might also be represented by an **exit option** – which happens when a bigger and larger company, a venture capital or a "business angel" absorbs or buys the start-up out. The likelihood to accept this event is not to be declared, nor can it be forecasted at the moment of the investment. This change on the horizon can surely require for adjustments and further tuning of the individual financial prospect and forecast.

Mitigation strategy

Diversifying the investments is a good practice to prevent losing large amounts or the risk of capital erosion.
Before investing it would be necessary to do an appropriate financial measurement to estimate the riskiness of the debt operation, also assessing the ability of a company to meet financial obligations.
Default risk can be detected using standard measurement tools, including FICO scores for consumer credit, and credit ratings for corporate and government debt issues - provided by nationally recognized statistical rating organizations (NRSROs).
In case of lending, it might be considered to charge rates of return that correspond the debtor's level of default risk ot to opt for fixed-income securities, i.e. an investment providing a level stream of interest income over a period of time.
In relation to the exit option, the investors should require transparency and openness on when and how they will be able to withdraw their initial investment, along with any associated gains and overhead or the "tag-along" practice.

Focus on:
The absence of a secondary market

For investors it would be relevant to have an early-stage equity secondary market as to be allowed to realize returns by selling shares in other companies or to reinvest in other firms, to either increase their share or buy into a round they may have otherwise missed out on.
Given that at the present time there are no secondary markets in place or only very few platforms have this option, it is necessary to consider having enough liquidity, as equity investments are blocked for 7-15 years and as no secondary markets are open to trade or sell shares/bonds.
Very experienced investors might consider adopting BDLT solutions. In fact, ledger technology (DLT) and blockchain offer the adequate infrastructure for secondary markets, enabling SMEs to exchange equity CF shares with security token to create liquidity. In other words, they eliminate the financial intermediary by providing an interface to connecting SMEs and investors.

Interreg Mediterranean
BLUE CROWDFUNDING
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