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How do investors invest in crowd-investing? A qualitative study in Mexico

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ABSTRACT

Objective: The purpose of this paper is to understand for the first time how inexperienced investors invest in high-risk new ventures in Mexico through a crowd-investing platform.

Research Design & Methods: The study follows a qualitative approach based on case studies. We developed our case study design from theoretical propositions which also guided the case study analysis. The in-depth interviews with investors revolved around investors' motives for investing and the way they evaluated investment opportunities in new ventures.

Findings: The study shows that novice investors in Mexico invest in crowd-investing not because of financial motivations but because they want to learn how to finance private companies and to live an exciting experience. In addition, their investment decisions are based on intuition to recognize the right people for the project and on their business experiences to assess the growth potential of the new venture.

Contribution & Value Added: To date, there is limited research on investors' behaviour in crowd-investing markets. This research presents academics and practitioners with valuable insights into factors that influence the decision-making process of crowd-investing investors.

Article type:	research paper
Keywords:	investment decisions; crowd-investing; equity crowdfunding; investor behaviour; business angels; fintech; Mexico
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INTRODUCTION

Mexico has a large and growing community of technology and software developers, the largest market outside of the U.S. for Techstars Startup Weekend, and close to 120,000 new engineers graduating every year. A productive breeding ground for start-ups, indeed.

Given that access to capital is one of the biggest obstacles Mexican entrepreneurs currently face, crowd-investing has the potential to create an entirely new capital market in Mexico to fund the growing number of innovative ventures.

Crowd-investing is becoming a popular funding mechanism for companies in the very early stages of development (Cholakova & Clarysse, 2015). It is a real phenomenon that is transforming the way new ventures raise capital (Angerer, Brem, Kraus, & Peter, 2017). This emerging entrepreneurial finance scheme supports firms that lack collaterals and financial history to access traditional sources of financing (Kim & De Moor, 2017). Firms with growth potential as opposed to lifestyle firms (Ibrahim, 2015). In particular, crowd-investing financing aims to finance innovative new ventures (Ibrahim, 2015), high-tech endeavours (Brown, Mawson, Rowe, & Mason, 2018), and knowledge-based firms (Wilson, Wright, & Kacer, 2018).

Crowd-investing is a design via online platforms that allows a large number of individuals to contribute with small amounts of money for fractions of ownership in recently created business (Ahlers, Cumming, Günther, & Schweizer, 2015; Brown *et al.*, 2018; Mochkabadi & Volkmann, 2018). New regulations on financial transactions online and the proliferation of crowd-investing platforms have attracted numerous investors to the new asset class. Although very unique in Mexico, it is a legal and viable alternative financing tool for founders. Many young and innovative ventures have risen capital in crowd-investing platforms. Estimates show that a large share of early-stage equity comes from online platforms (Cummings, Rawhouser, Vismara, & Hamilton, 2019; Kim & De Moor, 2017).

However, the method possesses its challenges. Crowd-investing is commonly related to high information asymmetries between founders and investors (Kleinert & Volkmann, 2019), ambiguity (Piva & Rossi-Lamastra, 2018), and high levels of uncertainty (Ibrahim, 2015). Under these circumstances, investors may decide not to invest because they cannot assess the quality of the investment opportunity. Thus, new ventures signal their value to investors to successfully raise money via a crowd-investing platform (Ahlers *et al.*, 2015). These signals are essential for investors for making investment decisions.

Additionally, crowd-investing investors are ill-informed and inexperienced investors (Estrin, Gozman, & Khavul, 2018). The immense majority of investors have no previous experience investing capital in private companies (Abrams, 2017). They have limited means too and do not have the time to discern low-quality firms from high-quality firms (Moritz, Block, & Lutz, 2015; Walthoff-Borm, Schwienbacher, & Vanacker, 2018). Thus, avoiding investing in low-quality or fraudulent start-ups becomes a challenge for crowd-investing investors. In this regard, the platforms' work of pre-selecting only high-quality new ventures is a necessary step for a successful crowd-investing. Platforms assure that new investments are real and no frauds and that they are attractive for investors (Angerer *et al.*, 2017).

Therefore, in a market with asymmetric information, inexperienced investors, intermediaries filtering high-quality investments, and new ventures signalling high-quality, we need to understand how investors evaluate investments. Our common goal of this crowd-investing research is to study how investors approach investments, find investment opportunities in platforms, and evaluate them.

The study follows a qualitative approach based on case studies. We developed our case study design from theoretical propositions which also guided the case study analysis.

We conducted case studies of crowd-investing investors in Mexico to examine the financing of new ventures. We analysed the data that emerged from the interviews to relate concepts to two research questions. First, why do investors invest in crowd-investing in Mexico? Second, how do these investors evaluate investment opportunities in new ventures? The result of the study shows that investors invest in crowd-investing because of non-financial reasons and that the evaluation of investments by these investors is instead more a subjective, informal, and emotional process. The rest of the document is structured as follows. We start with a literature review of the two research questions. We then describe the data gathered for the study and report about the case study framework used to analyse the data. Next, we present the results of the research and a discussion of the findings. Finally, we consider conclusions of the study, discuss practical implications of the findings, report limitations of the study, and suggest future research.

LITERATURE REVIEW

Following, we developed three sets of literature review related to investors investing in crowd-investing. In the first set of our literature review, we discuss the motives for investing in crowd-investing. We stress the great variety of investors investing in crowd-investing and highlight that their motivations to invest in crowd-investing are both financial and non-financial. The second set of our literature review addresses the evaluation process of investors in crowd-investing. We draw attention to the evaluation criteria that investors commonly take into account to make investment decisions of groups. Finally, the third set relates to third-party endorsements. We stress the importance of herding behaviour in crowd-investing investments.

Motivations for investing in crowd-investing

The characterization of investors in the literature is based on demographic characteristics such as age, gender, education level, work experience, income level, wealth, occupation, and geographic location (Daskalakis & Yue, 2017; Geiger & Oranburg, 2018; Hervé, Manthé, Sannajust, & Schwienbacher, 2017; Moysidou & Spaeth, 2016). There are also aspects of investors relative to investment decisions such as financial literacy, risk aversion, investing experience, entrepreneurial experience, and whether they are business angels (Niemand, Angerer, Thies, Kraus, & Hebenstreit, 2018). Lastly, there are features of investors related to their investment activity, such as the number of investments in crowd-investing, and the amount invested (Block, Hornuf, & Moritz, 2018; Hervé *et al*., 2017; Horvát, Wachs, Wang, & Hannák, 2018).

This wide variety of investors have heterogenous motivations for investing in crowd-investing (Mollick & Robb, 2016). Although investors have a primary intrinsic motivation, they also hold other motives to invest. The widespread assumption is that financial returns drive investment decisions in crowd-investing, so investors are financially motivated (Cholakova & Clarysse, 2015). However, the literature identified a handful of non-financial motives as well, such as personal or social motivations. For example, investors invest in crowd-investing because they are passionate about particular ideas, products, innovations, and industries (Freedman & Nutting, 2015).

They also invest because they want to help others like entrepreneurs, family members, friends, vulnerable strata, and towns (Bruton, Khavul, Siegel, & Wright, 2015; Kim

& De Moor, 2017; Moritz *et al*., 2015). Finally, investors invest in crowd-investing too because they want to network with start-up associations, to get recognition from active participation in the community, and to achieve reputational benefits (Abrams, 2017; Cumming, Vanacker, & Zahra, 2019; Cummings *et al*., 2019). Despite all these motivations, according to (Cholakova & Clarysse, 2015), non-financial motivations play no significant role in the desire of investors to invest.

Investment evaluation criteria

Crowd-investing opens access to risky investment opportunities to non-professional investors with no experience investing in very early-stage investments. Still, they should evaluate the available investment opportunities, recognize the high risks of early-stage ventures, and protect themselves from those risks.

The existing literature on crowd-investing describes two opposite approaches used by crowd-investing investors for investing in new ventures: a formal one more in line with the way traditional investors such as business angels and venture capitalists invest in firms, and an informal one for first-time investors. Typically, traditional investors in crowd-investing focus on standard factors driving early-stage venture investments like the team, the product, the venture and the campaign (Estrin *et al*., 2018). The non-traditional investors focus more on particular unidimensional factors (Estrin *et al*., 2018).

Related to the team, investors consider factors such as previous founder's entrepreneurial experience, prior funding amount collected by founders, characteristics of the team driving the effort, and financial commitments by founders (Kleinert & Volkmann, 2019; Mochkabadi & Volkmann, 2018; Vismara, 2016a). Also, factors considered by investors related to the product are product innovation, product high-quality, technology, patents, and a developed prototype (Block *et al*., 2018; Mochkabadi & Volkmann, 2018; Mollick, 2014).

Moreover, investors examine factors related to the venture such as its business model, the degree of development of the business, the type of venture, and external certifications like awards and grants (Angerer *et al*., 2017; Block *et al*., 2018). Finally, investors examine factors related to the campaign like the participation of leading and professional investors, the minimum investment amount and the equity offered, the funding goal, the campaign duration, and the number of investors investing in the venture (Geiger & Oranburg, 2018; Hervé *et al*., 2017; Ralcheva & Roosenboom, 2018; Shafi & Sauermann, 2017; Wallmeroth, 2019).

Despite all these factors, Huang and Pearce (2015) note that emotional and social criteria may be more important to crowd-investing investors than financial returns. Emotions, intuition, and impulsiveness are considerations when investors evaluate the options before making an investment decision (Moysidou & Spaeth, 2016). The authors remark that decision making by investors is feeling-driven. Investors invest in crowd-investing when they trust their gut feeling rather than relying on a formal analysis (Huang & Pearce, 2015).

Third-party endorsement

To discern low-quality new ventures from high-quality new ventures in a complex environment, unacquainted investors rely on signals from trusted third-party endorsements (Mollick & Robb, 2016). Third-party endorsements alleviate information problems between founders and potential investors. These signals provide a venture with legitimacy and contribute to the funding success of the new venture. These outside endorsements can come from positive word-of-mouth from specialists in the field and media quotes (Mollick & Robb, 2016), from trusted third parties such as family and friends (Agrawal, Catalini, & Goldfarb, 2014), and from winning a prestigious business award (Ralcheva & Roosenboom, 2018).

Without certification from third-party endorsements, the signals delivered by the crowd become essential (Vismara, 2016b). The wisdom of the crowd asserts that a large number of people with diverse sources of information, views, and expertise can attain better decisions than an individual (Ibrahim, 2015). Investors' pledges can be seen as endorsements as they reflect the investors' commitment towards the venture. To save efforts to process information from a particular investment, crowd-investing investors rely on others' decisions. This herding behaviour is a notable feature of crowd-investing markets (Colombo & Franzoni, 2015; Hornuf & Schwienbacher, 2016; Vismara, 2016b). The literature shows that investors are more inclined to invest in new ventures that have attained a higher percentage of their funding goal (Agrawal *et al.*, 2014). Investors also take into consideration the number of previous backers to make investment decisions. However, the literature does not determine whether herding is rational or not. Whether investors passively follow other choices ignoring the characteristics of the new venture or whether they arrived at the funding decision by analysing such characteristics

MATERIAL AND METHODS

We gather data mainly from investors investing in one of the two leading crowd-investing platforms in Mexico. The two platforms operate in the country using different business models. The platform taking part in this study is ArkAngeles headed by Mr Luis X. Barrios. We approached Mr. Barrios, who helped us get a representative cross-section of crowd-investing investors. Although the investors taking part in this study liked the leading-investor model, they also relate to other crowd-investing platforms. As of May 2019, the platform had 18 months of operation, had funded 37 new ventures, and had 175 active investors. The minimum size of the investment ticket in ArkAngeles is USD1,000.

We interviewed 25 participants who were the primary data sources. The participants in the study were 13 investors, all men, with ages from 22 years old to 50 years old. One of them was an international investor. Ten investors were active, and three were investors in the process of investing. We also interviewed the five members of the platform's top management team and seven backed founders to gain a richer understanding of the investment decisions process.

Interviews with participants were unstructured interviews. The idea of the meetings was to gather enough information to understand how investors get started in crowd-investing, find innovative new ventures to invest, and make investment decisions. The interviews were all carried out by the three authors in person using a video conferencing service to video-record interviews with participants. Participants were on their premises during the meetings. All interviews were confidential. We sent the recorded interviews to a third party for transcribing the audio of the discussions. The transcribed interviews resulted in close to 100,000 words. These texts were the data analysed by the three researchers.

The approach of the study was qualitative and relied on the case study framework (Eisenhardt, 1989; Eisenhardt & Graebner, 2007) to analyse the emerging data from the interviews. The general strategy of the study relied on theoretical propositions which led to research questions and a review of the literature. We started with research questions to identify evidence in the data to address these questions. Then, researchers searched for patterns such as frequency of codes or codes combinations, insights, or concepts emerging from data to link them to the research questions. Finally, as we developed and tested the emerging ideas, we interpreted the findings by contrasting them with rival explanations identified in the literature review. The initial theoretical propositions were modified to reflect these findings. Researchers showed early versions of the document to participants to solicit their comments. The final version of the paper incorporates those comments from participants. Figure 1 shows the conduction of the research.

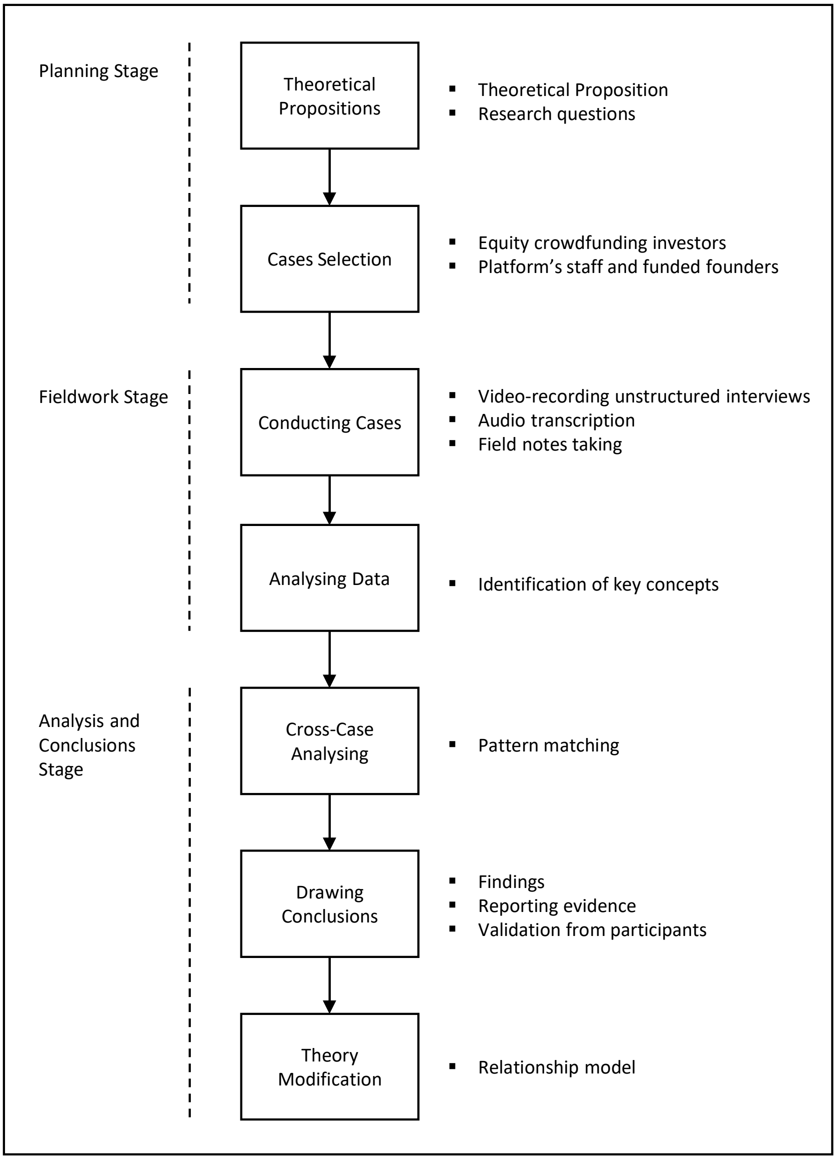

Figure 1. Conduction of research
Source: own elaboration.

RESULTS AND DISCUSSION

The relational model shown in Figure 2 summarizes the results of the study. Despite herding is cited to be a prominent feature of crowd-investing markets, we found no evidence that herding has an effect on investors investment decision. Third-party endorsement and its contribution to crowd-investing investments was rather referred to as a non-deal breaker. The variable third-party endorsement appears in the relational model with dotted lines reflecting the null contribution to investments. What follows is a discussion of these findings.

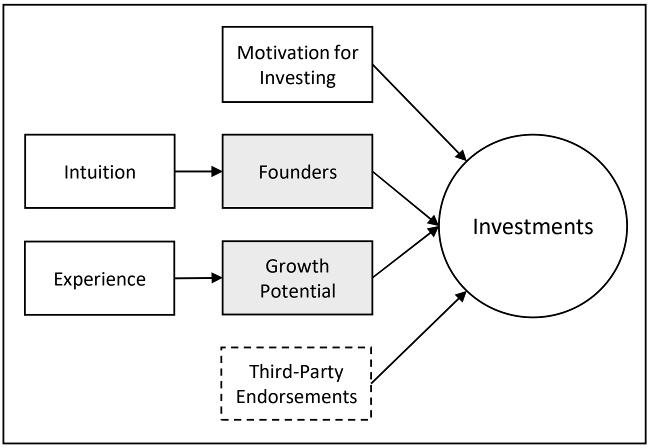

Figure 2. Relational model emerging from interviews
Source: own elaboration with data from participants.

Non-financial motives for investing in crowd-investing

Novice investors in Mexico invest in crowd-investing not because of financial motivations but because they want to learn how to fund private companies and to live an exciting experience.

Learning how to invest in new ventures

Investors want to invest in crowd-investing because they want to learn about the process of investing in new ventures. They are aware that crowd-investing is like a new major area of study which deserves gathering and examining information, and they want to learn by doing. For investors, it is a personal development thing to become a better investor in the future. They develop communications with other investors, platforms, and founders to learn from their experiences. Investors mainly use the information provided by crowd-investing platforms and the information conveyed through comments in social networks and attend crowd-investing events. They enjoy learning by actually investing in companies. They want to be able to assess the growth potential of projects better, and thus their quality. Learning is a significant incentive for investors to enter the crowd-investing market. An investor put it this way:

> "For me investing is a learning opportunity, it is like attending an MBA program, it is great to be with people who are highly innovative, younger than me, who are doing things with much passion and with great technological knowledge."

Literature does not address learning as the primary motive for investment. We believe that the newness of the market and the lack of financial evidence of the results of crowd-investing are the reason why other factors mentioned by scholars such as financial motivations are less relevant for the investors in their decision to participate in crowd-investing.

Living an exciting experience

Crowd-investing investors are more emotional than rational investors. The risk of investing in an innovative start-up is so high that if they were rational, they would not invest. For investors, investing in crowd-investing is emotional. Given that investors have low visibility of the fundamentals of the venture and that the success rate of an innovative venture is slim, investors know that they can lose all their money. Investors are captivated by the idea of doing something different and exciting, much more exciting than buying stocks. Their investment decisions are not premeditated, nor based on rules. Investors are excited about business ideas, the people trying to convert those ideas into big companies, new technologies, and the business potential to improve people's lives. Investors are excited to help foster innovation, and they want to be part of something bigger, of an effort that genuinely improves society with work and products. If investors are captivated by an investment opportunity, they will invest in the new venture. An investor highlights the excitement of investing as follows:

> "Investors know that we can lose everything because the companies we fund are high-risk businesses. That is why it is more exciting to know that we are supporting founders with teams that are very passionate, very motivated, and very prepared. They will provide solutions to day-to-day problems of society, that otherwise, it would not happen."

Previous studies highlight the role of excitement in crowd-investing investment decisions (Bretschneider & Leimeister, 2017; Cholakova & Clarysse, 2015; Daskalakis & Yue, 2017; Mollick, 2014). However, those studies do not consider excitement a primary motive for investing as opposed to the results of this study where the excitement of investing is one of the highest-rated drivers by investors. We believe that the small amount of money required to invest in a new venture makes investors approach investments more like a betting experience.

Evaluation of investment opportunities

Once investors trust investing in crowd-investing, they begin funding innovative new ventures. The results show that the two main criteria used by investors to evaluate investment opportunities are the people driving the effort and the new venture business potential. Business potential defined in this study as a combination of market size, differentiation, and accomplishments by the venture so far.

Founders assessment

Investors assess whether founders are the right people to grow the venture. They are aware that new ventures are a group of people with minimal resources who work the best way they can, relying on their expertise, their technical capacity, the money they have, their persistence, and their luck to turn an effort into a company. Investors agree that teamwork determines if a company is successful or not, so they want to know the mix of the top management team, who the members are, what they do, for how long the team has been working together, and whether they are committed to growing the venture. They look after the right combination of people to assess that the founders will not collapse when facing a storm.

Investors want great teams to back the growth of new ventures, so when evaluating investments, they focus on what the teams have accomplished in the past. Smart, hard-working, and honest are important personal characteristics that investors look after in founders and their teams. They also seek for other traits of founders that are relevant such as vision, commitment, ambition, a hint of madness, and readiness to roll up their sleeves and do the hard work. Intuition referred by the interviewed investors as gut feeling, common sense, sixth-sense, act of faith, plays a crucial role to identify the right team. An investor highlights the importance of intuition in making an investment decision.

> "Based on my professional experience, I can tell you that there is a subjective element, a feeling, which I think is difficult to express, that makes you think if a founder is going to make it. … I met him, and I got a good impression of him. That, I think, was the subjective element that encouraged me to invest in his venture."

The intuition of investors drives team assessment. The finding intuition in this study contrasts with the view that decision making is cognitive in which emphasis is on data and rationality (Moysidou & Spaeth, 2016). On the other hand, intuition is a trait used by business angels. In this regard, investment behaviour of crowd-investing investors looks like business angel's behaviour. We understand that investors are learning how to invest in new ventures, and thus, their decision-making process is mostly subjective.

Growth potential assessment

In addition to team assessment, investors consider the growth potential of the new ventures when evaluating investments. Interviewed investors identified three factors to assess growth potential namely the accomplishments of the new venture so far, the differentiation of its product or the degree of innovation, and the size of the market in which the new venture seeks to participate.

To assess the growth potential of an investment opportunity, investors are interested in what the new venture has accomplished. For example, whether the venture has already a final product and whether the venture has existing customers. The kind of accomplishments that can prove that the venture is not just an idea but a business model that might work and that there is a potential market for the product. Investors believe that financial indicators do not tell much about venture performance when dealing with recently created businesses, so they do not carry out any formal financial analysis on the project. An investor emphasizes the importance of accomplishments as follows:

> "In the seed stage of a venture, the venture needs to prove that it has achieved some success already. These favourable outcomes of the venture will help the venture to have access to more money to grow that success."

Moreover, when assessing growth potential, investors want to identify what differentiates the new venture from the existing ones. Crowd-investing investors look for innovative endeavours that have a competitive advantage in the market. Innovative endeavours that have associated intellectual property protection. Investors look for those two-three characteristics that differentiate the venture from the rest so that the venture can adopt a winning positioning. The more original the solution to a big problem, the more attractive the venture will be for the investor. Concerning differentiation, an investor shares the following comment:

> "So, the idea sounded fantastic, but several companies were doing the same thing or something very similar. It was not possible to distinguish what the differentiating factors of the company were. The moment I realized the offer was a copy of an existing solution, I ignored the investment."

Finally, investors seek big markets which could allow ventures to grow and become big companies. Investors try to validate whether there is a problem to solve, the nature of the problem the venture wants to solve, and the significance and relevance of the market need. The more the population affected by the problem and the more painful the problem, the larger the potential market for the venture. An investor accentuates how important is the size of the market the venture is trying to serve:

> "For example, for this bracelet project there are 10 million blind people in the United States, and there are 25 million in Europe that makes 35 million people with the possibility of buying the bracelet for US$299. So, we have a market size of US$10.5 billion in these two regions alone. When we consider more regions, we could reach 285 million blind people in the world. The market and the possibility to grow are big."

The growth potential assessment of investors resulted in a simple decision process based on the three factors described above. However, investors relied on their working experience for making this assessment. The investor's experience in a particular business domain allows the investor to see beyond the proposed investment to choose the right new venture. This implies that for people with no working experience may be difficult to assess the growth potential of a venture. Also, there is here again an analogy with the way business angels make investment decisions and the way crowd-investing investors invest. Business angels rely on their experience to make investment decisions (Mochkabadi & Volkmann, 2018). Given these experiences, we argue that investors can identify high-quality investments regardless of their lack of investing experience in crowd-investing.

CONCLUSIONS

Understanding investor behaviour in a nascent market is essential for its success; however, there is little research on investor behaviour in crowd-investing. This research explored investor motives and uncovered the factors that influence the evaluation process of investors – two steps to encourage a detailed understanding of investor behaviour in a crowd-investing context. The interviews revealed that investors' motives for investing are non-financial, namely their desired to learn how to fund private companies and to live an exciting experience. However, contrary to the majority of research describing a more rational, formal, and objective evaluation process, interviewed investors described an informal, emotional, and subjective decision-making process based on their experiences and their intuition. We believe that to the extent that investors in crowd-investing learn to invest in private companies, to that extent, they will rely more on cognitive factors described in the literature. They will move away from an intuitive decision process and closer to a rational one.

We think that our paper carries significant implications for practice and policy. First, founders need to provide signals to investors so that investors can assess the founders' fit to the business they are promoting. Ideally, the founders need to meet with investors to probe they are suitable for the task. Second, founders need to make available information to investors for assessing the growth potential of the new venture. These signals and information will increase the founders' probability to get funded. Third, platforms should also help investors make investment decisions by presenting information on founders and their teams and on the markets where the promoted ventures participate. Lastly, policy makers should consider policies aimed at helping potential investors to learn the ropes of investing in crowd-investing. The outcome of this education is to increase the number of knowledgeable investors investing in innovative new ventures, which stimulates the growth of new ventures looking for crowd-investing.

Crowd-investing is still in its infancy in both research and practice, which induces some limitations to this study. Most notably, the research pertains to the Mexican market only and the institutional and temporal circumstances in which we conducted the study. The market is new, few potential investors are aware of its existence, and relatively few ventures have received support from investors. Despite the newness of the market, we believe that the timing of our research allowed us to carry it out smoothly because of the availability of the participants and their genuine interest in promoting the crowd-investing market in Mexico. Second, despite there are two leading crowd-investing in the country with two different business models, we focus on one platform. We chose the one that desired to involve the academy in the study of crowd-investing in Mexico. Finally, the methodological aspects associated with our qualitative research limited our findings, mainly from the determination and size of the sample. The sample size was relatively small. Although the size was enough for case replications, our results would be more meaningful with a larger sample size. Also, the exploratory nature of this research introduces subjectivity in the analysis of data from the sample. However, to minimize subjectivity in the identification of themes, we based the classification of the relevant contributions of the participants on the collective understanding of the three researchers.

The limitations of this study provide directions for further research. First, a promising avenue for future research is to analyse whether our findings are generalizable to other crowd-investing platforms in the country and other countries with similar circumstances. Second, given that the literature on this topic is minimal, further research should attempt to quantify the drivers of investing in crowd-investing based on the relational model emerged from this study. Finally, given the contradictory findings of the paper concerning existing research studies, further work is needed to better understand the role of the crowd in the decision-making process of investors.

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Appendix A: List of Questions that Guided the Interviews with Participants

1. What motivated you to invest in crowd-investing?
2. How did you find out about crowd-investing?
3. How did you approach investing in crowd-investing?
4. Why did you choose to invest in ArkAngeles?
5. How do you differentiate between good quality investments and “lemon” investments?
6. What specific selection criteria do you use to invest in a new venture?
7. What can you tell us about your investments?

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Contribution share of co-authors equal and can be expressed as one third each of them.

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