Real Estate Crowdfunding

The Opportunity

The real estate market has been the most reliable wealth generating vehicle for those who are able to afford large "buy and hold" investments. Providing a combination of above average returns on investments, along with tax advantages, its market has been a favorite tool for hedge funds and affluent families. Until recently, the doors to this "big boys" club had been closed for the vast majority of American families.
Fortunately, technological progress and recent changes in securities laws have changed this situation. The JOBS (Jumpstart Our Business Startups) Act signed by President Obama in April of 2012 has made it possible for entrepreneurs, including real estate developers to crowdfund their projects by raising capital in small amounts from a broad number of individuals, providing access to a much wider pool of potential investors and faster deal flow.

These new laws offer additional opportunities for everyday citizens by lowering the minimum amount of investment to $1,000 - $5,000. Individuals can mitigate risks by co-investing alongside hundreds of other stakeholders, including large investment funds. They have an option to choose between debt and equity deals based on their financial goals, investment horizon, and risk aversion. Unlike in REITs, an investor can fund specific properties and contrary to a typical individual real estate hassle involving property maintenance and management, the crowdfunding model offers passive investments, a large number of available assets, real time information, and teams of experts to vet potential projects, administer the deals, and handle the day-to-day operations.

Legal Framework

Real estate crowdfunding transactions are regulated by the Securities and Exchange Commission (SEC). Four major laws applying to the industry include: Title II of the JOBS Act Regulation D Rule 506(c), Title IV of the JOBS Act Regulation A+, Title III of the JOBS Act, and Intrastate Exemptions.

- Until recently, entrepreneurs were not allowed to ask for funding from private investors unless they had pre-existing relationships. Title II of the JOBS Act Regulation D Rule 506(c), which went into effect in September of 2013, has lifted the 80-year-old ban on general solicitation, allowing private companies to promote their fundraising activities using the internet, social media and traditional advertising channels. There are no limitations on the amount of funds that may be raised, nor the number of investors.

  At the same time, sales of these shares are limited to accredited investors, thus leaving behind more than 90% of Americans. To be considered an accredited investor, an individual must have an annual income of at least $200,000 ($300,000 if financial statements are filed with a spouse) in each of the two most recent years and reasonable expectations to keep the same level in the future, or to have a net worth which exceeds

$1 million excluding the equity in their primary residence. A crowdfunding portal is responsible for taking "reasonable steps" to verify the accredited status of investors.

- **Title IV of the JOBS Act Regulation A+**, also called mini-IPO, has become a new step in the modernization of outdated securities laws. It went into effect in June of 2015, replacing Regulation A. For the first time, entrepreneurs are allowed to publicly raise funds from non-accredited investors. As in Regulation D, public solicitation and advertising are allowed. The regulation includes two sets of rules: tier one, and tier two.
  Tier I increased the offering limit from $5 million to $20 million within a 12 month period. There are no restrictions on the amount of money each individual can invest, as well as no ongoing financial reporting requirement. However, long-standing Blue Sky Laws have been left in place, which means that issuers will continue to face additional expenses, and significant delays by state regulators.
  Tier II applies to offerings of up to $50 million within a 12 month period. It eliminates state-by-state registration, but requires annual audits, semi-annual updates, and reporting. Non-accredited investors may invest no more than 10% of their annual income or net worth, whichever is greater.
  Reg A+ also allows issuers to "Test the Waters" (TTW) - prior to filing an offer with the SEC, they may engage in general solicitation to gather information about potential investor interest. While no sales are permitted until the SEC qualifies the offering, an issuer can test the probability of success without incurring significant expenses.
- **Title III of the JOBS Act**, the crowdfunding exemption from registration under the Securities Act of 1933, was approved on October 30, 2015 and will be in place in 180 days after the approval date. It allows companies to raise funds up to $1 million dollars per 12 month period from an unlimited number of investors (both accredited and non-accredited).

  Offerings will be conducted through SEC–registered funding portals or brokers-dealers. The company must set a target offering and a campaign deadline, and must allow investors to back out of any commitment up to forty-eight hours before the deadline. As on Kickstarter, the "All-or-Nothing" rule applies, so if an issuer fails to reach their goal, the investors will receive their money back. Depending on the size of the offering, an issuer is required to provide GAAP financial statements for two years certified by the company's CEO (for raises up to $100,000), financial statements reviewed by an independent auditor (for offerings between $100,000 and $500,000), or audited financials (for deals between $500,000 and $1 million. First time issuers are exempt from the requirement). The company must disclose information about its directors and those who own 20% or more of its shares, as well as file annual reports with the SEC.
  There are restrictions for investors based on their net worth and annual income. Those who earn less than $100,000 can invest up to $2,000 or 5% of their income (whichever is greater) per year. Investors with an annual income and net worth above $100,000 are allowed to invest up to 10% of the lesser, but no more than $100,000 per year. Investors are prohibited from selling their shares for one year after the deal has been closed.

- Considering almost a three year delay in the SEC ruling on the Title III of the JOBS Act, more than half of all U.S. states have adopted their own **Intrastate Crowdfunding Exemptions**. Most of them are based on the federal law with specific requirements (often more liberal than the Title III). They allow issuance of public offerings by local private companies, but limit the sale of the shares to residents of the state. An example of the Intrastate Crowdfunding Exemption, The Florida Crowdfunding Act, can be found here: **http://www.flsenate.gov/Laws/Statutes/2015/517.0611**.

  The same time as voting for the Title III, the SEC proposed amendments to the federal intrastate offering safe harbor exemption (Rule 147). The proposed amendments would eliminate the requirement that offers must only be made to residents of the issuer's state, and permit general solicitation, including offerings conducted over the internet. Actual sales will continue to be made only to residents of the state of the issuer's principal operations, but the amendment would ease eligibility requirements, permitting out-of-state issuers with local operations to utilize the exemption.

Real Estate Crowdfunding Portals

The changes in securities law and lack of financing options for real estate developers and investors have stimulated an emergence of real estate crowdfunding portals. The industry has experienced a tremendous amount of growth. Two years ago, there were only ten websites which offered access to commercial real estate deals through crowdfunding. Now, there are more than one hundred of these portals.

The term "real estate crowdfunding" encompasses a large umbrella of deal types, including equity offerings for accredited investors and the general public, debt deals and 'peer-to-peer lending' opportunities, underwritten offerings (which are pre-funded by a platform, then syndicated out to investors), direct-to-investor private placements, and capital raises for real estate portfolios and other funds.

A potential investor or sponsor has to choose between **debt and equity deals**. Real estate loans through **peer-to-peer marketplaces** are usually less risky for investors and offer a monthly cash flow. At the same time, debtors do not benefit from property appreciation and earn a lower ROI (usually between 6% and 10% per annum). Debt crowdfunding has become a popular funding option for fix-and-flip investors, as well as those looking for bridge financing given that the process is quick and straightforward.

Equity crowdfunding is more complex. While it offers an annual return on investment averaging between 8% and 12% and certain tax benefits, transactional risks are higher and the holding period is dependent upon the type of property investors choose. Some crowdfunding websites invest in ground up developments with distributions delayed for three-to-five years. Others fund smaller fix-and-flip properties to achieve a larger number of transactions and a quicker cash flow. There are three distinctive models currently dominating equity real estate crowdfunding:

- **Direct Investing** allows individuals to invest directly with a real estate firm (a "sponsor"). Crowdfunding portals act purely as the intermediary which facilitate the raising of capital. Investors co-invest in real estate opportunities alongside the sponsor which eliminates risks associated with the long-term viability of the intermediary. Since the crowdfunding portal's involvement is limited, this model offers lower fees for investors. The sponsors benefit by establishing direct relations with a new pool of investors.
- Within an **Indirect Investing** model, investors participate via a Special Purpose Vehicle (SVP) or LLC created by the crowdfunding portal specifically for each property. The portal acts as an investment manager facilitating all transactions throughout the life of the investment. Sponsors don't have to manage a pool of individuals, instead reporting to the SPV, and investors receive their returns from the crowdfunding portal. However, developers do not gain access to investor data and cannot leverage relationships for future offerings and investors are charged additional fees for the portal's service.
- **Software-as-a-Service** (SaaS) "white label" model marries technology with existing real estate businesses. Crowdfunding portals sell the software to sponsors which allows them to raise funds and manage investor relationships directly through their own website.

The Real Estate Crowdfunding Industry: What's Next?

Real estate crowdfunding was a $1 billion industry in 2014 and is expected to grow to more than $2.5 billion this year, according the industry research firm Massolution. Although there is ample room for growth, real estate crowdfunding is no longer new or novel. Some of the currently active portals working with accredited investors will soon be gone because of tough competition. Therefore, potential investors and sponsors must conduct their due diligence and partner solely with companies with industry expertise and established networks of complimentary real estate professionals such as appraisers, contractors, lenders and the like. Others will either merge, or focus on market niches such as mortgage loan origination, hospitality, or residential investments, for example.

According to the Massolution report, 75.7% of 2014 funding volume came from debt deals, whereas equity-linked securities accounted for 18.5% of the volume. 2015 has brought significant changes in securities laws allowing ordinary Americans to invest in private companies for the first time since 1933. The upcoming year will reveal whether this development is going to disrupt the real estate industry by bringing millions of new investors on board.

Even at its current stage, real estate investments through crowdfunding are a smart alternative to relying on traditionally popular real estate investment trusts (REITs) for incorporating real estate into your portfolio. Crowdfunding provides lower barriers to entry, offers more control over a single investment, straight forward deal sourcing and transparency.

Another great benefit is added diversification and insider access to private transactions that were historically limited to affluent families and institutional investors. With the advent of the internet, Americans now have the ability to invest across geographies and various property types, and may choose between a monthly cash flow and long-term portfolio growth. As a result, crowdfunding provides significantly higher rates of return than government bonds or saving accounts combined with lower than a stock market volatility, and the freedom of passive investments.

For real estate developers, crowdfunding can open the financial floodgates. Sponsors no longer have to rely on slow moving and arduous institutional backing as they are now able to reach out directly to the millions of potential investors and lenders. Crowdfunding portals offer lower overhead costs and faster deal flow, making funding available for both single family homes, and multi-million dollar commercial projects.

In other countries (Australia, United Kingdom, Israel, France, Netherlands, and Italy to name a few) equity crowdfunding has already been around for several years, allowing local businesses to raise hundreds of millions dollars. It is now time for the United States to catch up. The real estate industry, being responsible for 13% of the national GDP, can be among the major beneficiaries from the recent advancements in securities law.

Realty eVest's CEO Dan Summers, has more than 30 years in the commercial real estate industry. He has closed more than $1 billion in real estate, while leading three companies to national prominence as CEO. Call (904) 501-7693 or e-mail **dsummers@realtyevest.com.**

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