IPF Research

Real Estate Crowdfunding: Gimmick or Game Changer?

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Real Estate Crowdfunding: Gimmick or Game Changer?

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Real Estate Crowdfunding: Gimmick or Game Changer?

EXECUTIVE SUMMARY

Emerging as a product of FinTech applied to real estate, real estate (RE) crowdfunding has emerged as a fast-growing segment of the global crowdfunding market. It accounts for 5.4% of the total volume ($145.29 billion) of crowdfunding capital raised in 2015. Its early impact will no doubt be over-hyped; the industry is in its infancy and continually evolving, as are the regulations governing it. However, whenever technology meets an industry it has the potential to disrupt the established ecosystem of roles, responsibilities and rewards of stakeholders. It is essential, therefore, to understand the factors driving the industry in order to identify and respond to the potential opportunities underlying its growth.

This report considers the growth of RE crowdfunding and its regulation in the largest global real estate crowdfunding markets, namely the US, China and the UK.

Key findings of the report are:

- RE crowdfunding platforms have brought the merits of RE investing to the attention of the crowd, tapping into unmet investor appetite from high net worth individuals (HNWIs) and retail investors.
- The RE crowdfunding market emerged in response to a gap in the provision of capital to parts of the RE market and a strong appetite from investors for higher-yielding returns. The specifics of market opportunities vary across countries, depending on the structure of the wider debt market, bank legacy portfolios following the global financial crisis and differences in the implications of regulatory requirements for lending strategies.
- From an investor perspective, the fundamentals underlying the growth of RE crowdfunding are shared across countries. Investors are drawn by access to real estate investments at low-threshold entry levels, the greater investment discretion offered and the attractive returns and lower fee structures.
- The evolution of the RE crowdfunding industry in the UK is distinct from that in the US. In part, this is due to retail investors being permitted to participate, with non-institutional investors accounting for more than 75% of funds raised by RE crowdfunding platforms. This has been facilitated by a broadly supportive regulatory environment. In the US, institutional investors account for as much as 73% of capital raised in 2015.
- Currently, the RE crowdfunding market is dominated by debt investments secured on small scale development and investments operated by SME sponsors. However, the development of eREIT funds in the US and capital raising by major corporations in China has expanded crowdfunding activity into products that are more similar to those offered by the established CRE industry. This suggests that RE crowdfunding may have a more disruptive effect in the future.
- Potentially, this represents an opportunity for existing stakeholders to capitalise on their brand and develop more transparent products, with streamlined fee structures using new innovations in this marketspace. However, there is a need for speed. In contrast to the evolutionary path of other industries that have been digitised, the required technological infrastructure and consumer engagement with it already exists. As FinTech meets real estate investment, the pace of this market evolution may prove more of a sprint than a marathon.

1. INTRODUCTION

In its broadest definition, crowdfunding represents online fundraising activity using a portal to connect fundraisers and funders, creating an avenue for alternative finance. Within the finance industry, the merger of finance and technology – FinTech – has led to the growth of challenger banks.

Real estate (RE) crowdfunding is a product of FinTech applied to real estate. While its early impact will no doubt be over-hyped, it is essential to understand the industry and the factors driving its growth in order to anticipate change in the near- and medium-term, and embrace it.

The commercial real estate (CRE) industry has not been immune to the transformative effects of technology, with disruptive forces affecting the demand and use of space across all sectors, as well as the way real estate services are delivered, with new technology-led market entrants leading to a re-evaluation of how RE is bought, sold, leased and priced.

RE crowdfunding has the potential to transform how CRE is capitalised and increase the accessibility of CRE to a wider pool of investors. It may also result in disintermediation of stakeholders and impact the structure and pricing of more traditional modes of investing. Certainly, whenever technology meets an industry it has the potential to disrupt the established ecosystem of roles, responsibilities and rewards of stakeholders. Often the immediate, direct impact is over-hyped and the establishment responds with, at best, complacency and, at worst, protectionism.

Experience of the publishing and music industries warn us that the real impact may be mid- to long-term. These industries failed to embrace early technology and defended against online retailers who did so, only to have their products digitised. Technology merely facilitates the emergence of new approaches that might better meet customer aspirations. It is the consumer – the investor – who is driving change. The opportunity is open to established stakeholders as well as new market entrants.

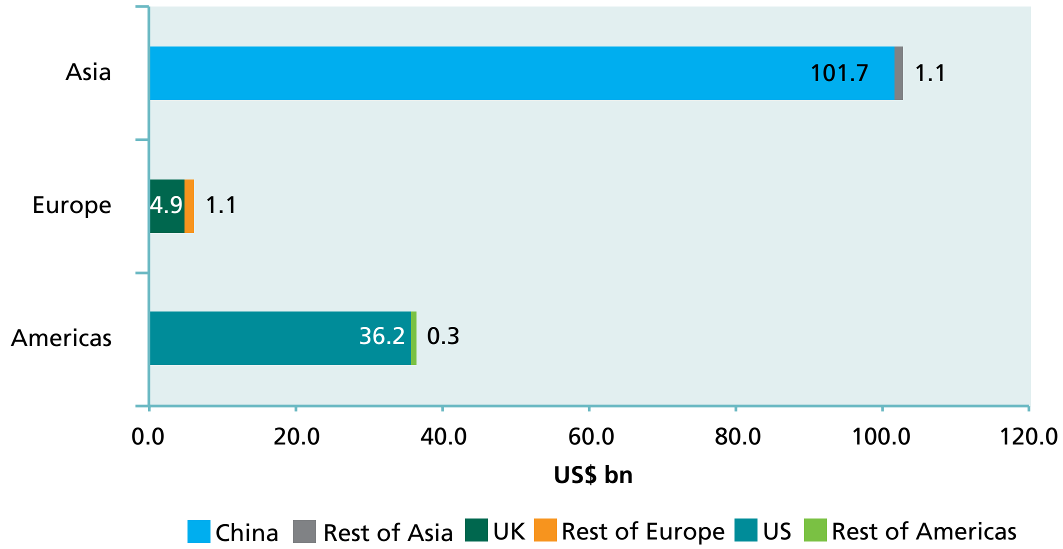
This report considers the growth of RE crowdfunding and its possible implications for the CRE industry. The report is structured to include the following components:

- The scale of the industry, including RE debt and equity, in the context of the development of the wider crowdfunding market is assessed.
- The place of crowdfunding in the context of the wider CRE market, comparing the characteristics of RE crowdfunding investment with more established modes of investing.
- The evolution of RE crowdfunding is considered, with particular regard to differences in the structure of RE crowdfunding markets across selected countries in terms of the market opportunity arising from unmet investor and/or sponsor demand in the context of the prevailing regulatory environment.
- An examination of the structures of existing and emerging business models and an evaluation of the relative risks and responsibilities for investors and RE crowdfunding platforms.
- The potential implications of the emergence of this new industry are considered over a short- and longer-term horizon.

2. RE CROWDFUNDING IN THE WIDER CROWDFUNDING INDUSTRY

Globally, the crowdfunding market, including all forms of debt and equity platforms, is estimated to have reached approximately $145.29 bn by the end of 2015, growing by some 1,160% over the two years from the end of 2013[1]. In terms of regional totals, Asia accounts for the highest volume of capital at £102.8 bn, followed by the Americas at $36.17 bn and Europe at $5.99 bn (Figure 2.1). Within each region, one country dominates, with China accounting for over 99% of activity in Asia, the US accounting for a similar 99% of crowdfunding capital volumes in the Americas and the UK representing approximately 81% of such investment in Europe[2].

Figure 2.1: Total Crowdfunding Market Volume 2015



Source: IPF (2016); Cambridge Judge Business School Crowdfunding Reports 2016

Population size and wealth indicators are important drivers of market size. For example, on a per capita basis, the US has the highest investment in crowdfunding globally, with China ranking second (Figure 2.2). However, China is a large and diverse country and investment rates for the major cities are significantly higher than in less developed regions. The shadow banking sector is generally larger in China as the official banking sector attempts to catch up with growth. Indeed, the existence of a market opportunity to fulfill unmet consumer and/or business borrower demand with appropriate product is a key determinant of the emergence of RE crowdfunding. This may partly explain the lagged growth of the continental European market as consumer and small business lending was less constrained in the immediate aftermath of the global financial crisis (GFC).

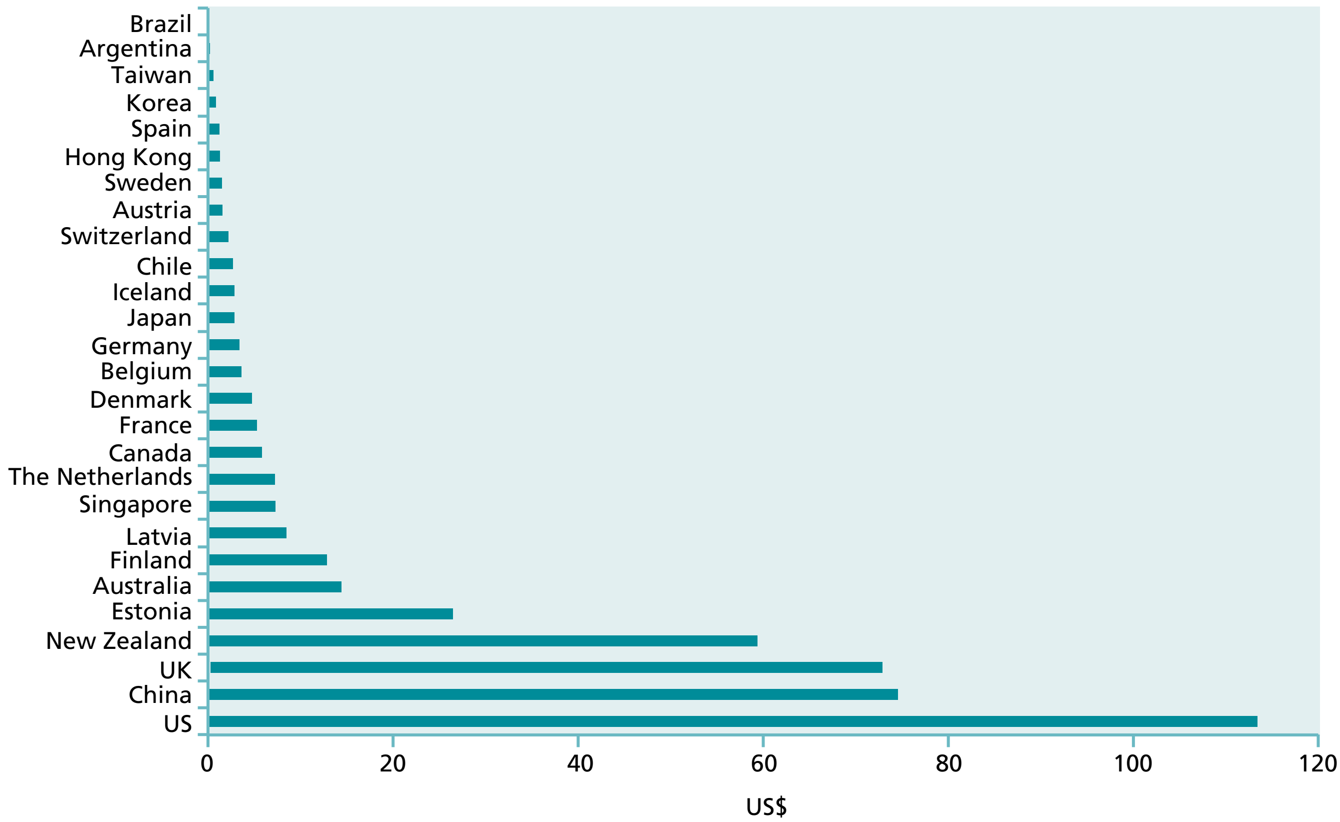
Equally, the regulatory environment and cultural engagement with technology are enabling factors. For example, Estonia, Finland and Latvia demonstrate a relatively high rate of crowdfunding investment for Europe, reflecting their higher adoption of new technology, while in other markets, such as Spain, there is a lower overall engagement with online transactional activity.

[1] Data is extracted from the following reports, available at http://www.jbs.cam.ac.uk/faculty-research/centres/alternative-finance/publications/:, Zhang, B., et al., "Harnessing Potential: The Asia Pacific Alternative Finance Benchmarking Report, 2016; Breaking New Ground: The Americas Alternative Finance Benchmarking Report The University of Cambridge Judge Business School and the Polsky Center for Entrepreneurship and Innovation at the University of Chicago Booth School of Business; Zhang, B., Baeck, P., Ziegler, T.,Bone, J. and Garvey, K. (2016) Pushing Boundaries: The UK Alternative Finance Industry Report, University of Cambridge Judge Business School and Nesta, February; Zhang et al., (2016) Sustaining Momentum: 2nd Annual European Alternative Finance Industry Survey, The University of Cambridge Judge Business School.

[2] Currency conversion rates employed are those inferred from analysis of the Cambridge Judge Business School reports (Ibid) and reflect rates prevailing at end-2015; UK GBP to US $1.52 and Euro to US $1.10.

2. RE CROWDFUNDING IN THE WIDER CROWDFUNDING INDUSTRY

Figure 2.2: Crowdfunding Volumes per Capita (US$), 2015



Source: IPF (2016); Cambridge Judge Business School Crowdfunding Reports 2016

Given the dominance of China, the US and the UK within their respective regions and the greater granularity of data available, this report will focus on developments within these three countries. However, these countries should not be taken as proxies for their regions, as every market will evolve according to its maturity, regulation and the nature of the market opportunity in terms of unmet investor and/or sponsor demand.

The market may be sub-divided into equity- and debt-based platforms and, while clearly identifiable business lines have emerged, these continue to evolve and morph (Figure 2.3). Crowdfunding models were initially developed for donation-based and reward-based funding during the early 2000s (Figure 2.4). Using technology platforms, individuals could list fundraising campaigns through portals, such as justgiving.com, and avail themselves of secure online payment facilities to more efficiently and effectively achieve sponsorship from their peers or any other individual viewing the site and permitted to make a donation – 'the crowd'. Similarly, those seeking to raise funds for a project, notably in the arts, technology and the environment, were able to market projects and campaign to a wide population of potential donors amongst the crowd, using platforms such as kickstarter.com. In return, donors were generally offered some form of non-financial reward.

2. RE CROWDFUNDING IN THE WIDER CROWDFUNDING INDUSTRY

Figure 2.3: Classification of Crowdfunding

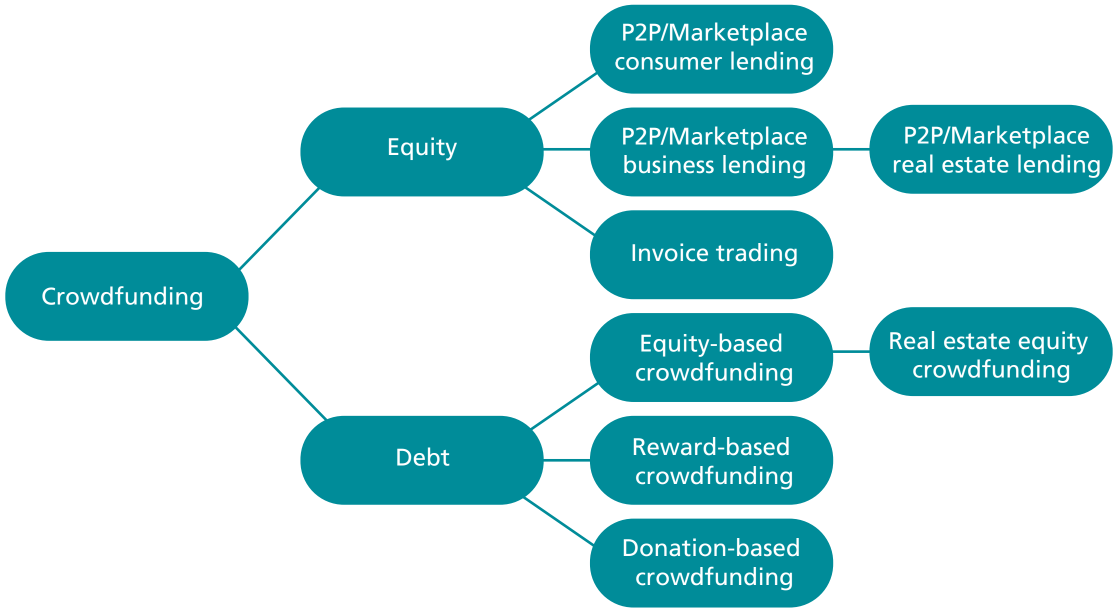
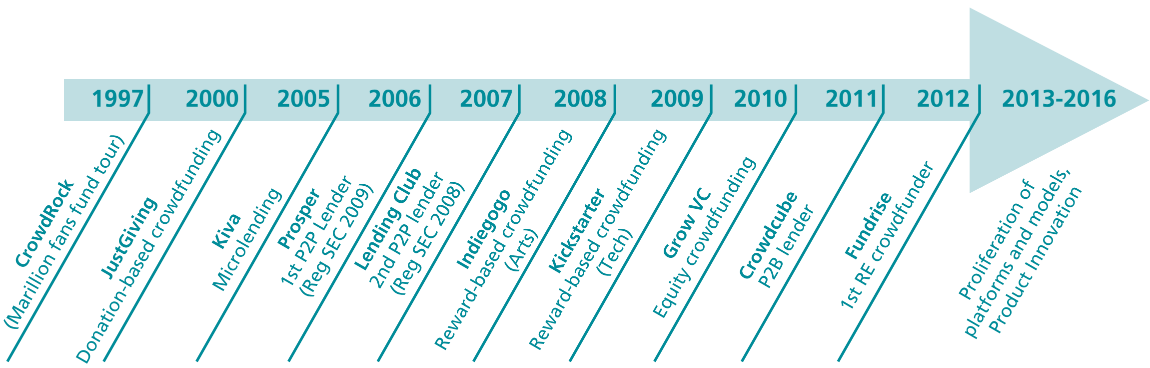


Figure 2.4: Evolution of Crowdfunding

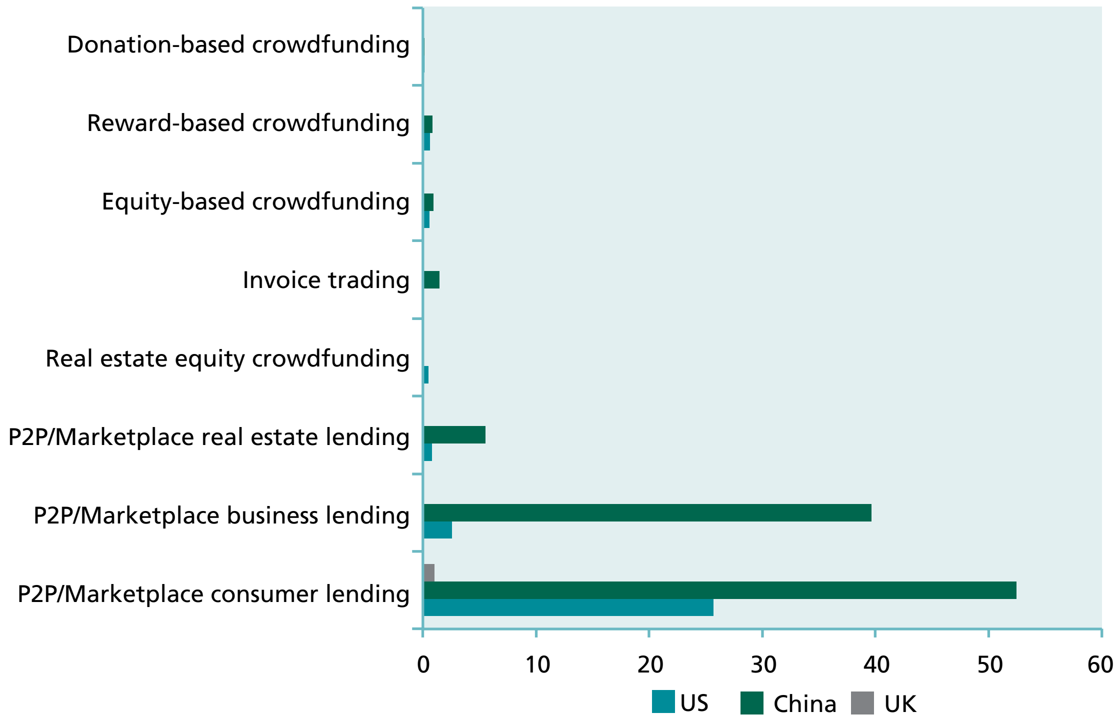


Similarly, not-for-profit social enterprise campaigns and projects can use crowdfunding platforms, such as crowdshare.com, to raise funds and support for community projects. Although often regarded as the purest form of crowdfunding, which is considered by some as a people empowerment movement, not simply a form of alternative finance, it is now a minor segment of the wider industry that includes P2P and P2B (peer-to-peer and peer-to-business) lending, equity investing and invoice trading[3]. Figure 2.5 illustrates these categories in terms of market share and volume of capital raised.

[3] Profitable and well-established organisations sell current invoices (usually written to low risk, but often slow-paying public bodies and large corporates) to investors at a discount, to achieve greater cash flow stability and improve access to capital.

2. RE CROWDFUNDING IN THE WIDER CROWDFUNDING INDUSTRY

Figure 2.5: Volume Capital by Category, 2015 (US $bn)



Source: IPF (2016); Cambridge Judge Business School Crowdfunding Reports 2016

The success of campaigns, particularly by start-ups and tech entrepreneurs offering their end products as a reward in return for product development funding (as exemplified by campaigns such as the makers of Pebble Watch), preceded the development of a crowdfunding equity model. Assisted by regulatory change (see section 4), new platforms emerged, providing individuals and new businesses with the opportunity to raise funds for projects online from the crowd in return for equity. This was heralded as the dawn of the 'democratisation of finance': the ability to generate funding or invest in early-stage products and start-ups, or the expansion of established private companies, was previously the reserve of private placement, angel investors and venture capital activity[4].

RE debt has emerged as a tranche of P2P/P2B lending, while RE equity crowdfunding has emerged as a segment of equity crowdfunding.

2.1 Equity-based crowdfunding

At 1.3% ($480 m) and 2.7% ($132 m) respectively, RE equity crowdfunding accounts for a very small proportion of the crowdfunding markets in the US and UK and is not permitted under current legal structures in China. Moreover, the scale of CRE equity crowdfunding is incomparable to the wider institutional investment market in two ways:

[4] Venture capitalists may comprise angel investors (discretionary HNWI investors), firms or funds who invest in early stage or start-up companies that are deemed to have high growth potential, or which have demonstrated high growth in exchange for an ownership interest, normally as convertible debt or an equity share.

2. RE CROWDFUNDING IN THE WIDER CROWDFUNDING INDUSTRY

- Firstly, global CRE equity crowdfunding totalled a mere $0.6 bn in 2015, and is dwarfed by the volume of investment in the wider CRE market, which totalled approximately $704 bn in the same year, of which 80% was undertaken in the US market[5].
- Secondly, the CRE equity crowdfunding market in the UK is not representative of the institutional CRE investment market. To date, the equity crowdfunding market has primarily focused on the buy-to-let and small-scale residential development market.

Although the private rented sector (PRS) is a growing market for institutional investors, offerings through crowdfunding portals tend to be single- rather than multi-family units and on small-scale developments for sale, resulting in a limited overlap with institutional investors. However, in the US, the RE equity model is more evolved although, at 0.2%, it remains miniscule relative to the CRE market in terms of investment volumes, it is more comparable in terms of sector scope and investment product. Indeed, the continued development of this market in the US may hold many lessons for the future direction of the UK (see section 4).

2.2 Debt-based crowdfunding

CRE debt emerged as a sub-sector of P2B/marketplace lending and as a niche segment of the CRE lending market. Although the term 'crowdfunding' is used to describe crowd-sourced donation and equity-based fundraising, facilitated by online platforms, it has also been extended as an umbrella term to capture P2P/P2B/marketplace lending activity.

In the US and the UK, the availability of unsecured consumer loans and business finance for SMEs reduced sharply in the wake of the GFC, due to illiquidity in the bank sector, high risk aversion and a shift towards low-risk secured lending. In an historically low interest rate environment, this resulted in many investors seeking yield, which created an opportunity for challenger banks and new business models to emerge. A proportion of these FinTech businesses harnessed technology platforms that allowed access to the crowd as a means of funding loans and, in addition, as a source of business generation. In China, the unmet demand for consumer and business loans from the banking sector and an increasing pool of consumers seeking to invest their wealth created a similar impetus. P2P/marketplace consumer lending is the largest segment of the crowdfunding market, accounting for some 79.4% ($25.69 bn) of the market in the US, 51.7% ($52.44 bn) in China and 28.4% ($1.38 bn) in the UK. P2P/marketplace business lending represents the next largest share and, at 27.5% ($1.34 bn) in the UK, rivals consumer lending in scale.

Initially, unsecured lending developed as a peer-to-peer model, with platforms undertaking screening of borrowers and their requirements. Platforms employed data mining to develop algorithms that efficiently assessed risk and enabled real time decision-making and pricing of streamlined loan applications. This enabled the market to expand rapidly and extend to business lending. In turn, the size of the market attracted institutional lenders, keen to access a new conduit of lending opportunities. Institutional lenders are now the dominant source of funding for these models in the US. This has given rise to the term 'marketplace lenders' in place of P2P and P2B, to better reflect the fact that, while the loan opportunities are sourced online, the crowd is no longer the predominant source of funding.

[5] Op Cit and JLL (2016) Global Market Perspective, Q1[6] DMU (2016) The Commercial Real Estate Lending Market in the UK, End 2015; Judge Business School (2016)

2. RE CROWDFUNDING IN THE WIDER CROWDFUNDING INDUSTRY

Mirroring the unsecured loan market, the availability of bank development finance reduced sharply in the wake of the GFC and this shortage became acute for SME developers and contractors seeking smaller loans. Although the availability of debt finance has recovered, it remains constrained for SMEs due to the weak appetite for development loans under £10 m and for SME sponsors who carry a higher credit risk than large institutional and corporate borrowers. This gap in the market presented an opportunity for crowdfunding platforms to enter the market.

At 91.6% ($7.2 bn), CRE debt crowdfunding represents the largest share of global RE crowdfunding. Perhaps reflecting the lower diversity of the CRE lending market in the UK, it accounts for over a quarter of all crowdfunding lending activity. However, at 1% ($0.93 bn) of all lending in the wider CRE market in 2015, it represents a small proportion of the market. However, given RE debt crowdfunding has a strong focus on bridging and development loans, its share of development lending may be more meaningful; it equates to 8.3% of development lending captured by the DMU survey in 2015[6].

Although the origins of CRE debt crowdfunding share similarities with the P2P/marketplace unsecured lending market, it is fundamentally distinct. For a loan to be secured on an asset requires the platform to underwrite the RE as well as the borrower. Moreover, the structure of unsecured lending is distinct from that of development lending. The former is usually structured with capital plus interest being repaid on a monthly basis over a fixed loan term and repaid capital and interest can either be withdrawn or automatically reinvested[7]. In contrast, development loans are usually repaid as capital plus interest at the end of the loan period, usually following the sale or successful refinancing of the project. This introduces the risk of market timing, which is a characteristic of development finance[8]. Although returns are dependent on the successful outcome of the project, lending at moderate loan to GDV (Gross Development Value) ratios affords some protection. The loan is secured on the underlying asset and sales proceeds from the recovered asset should cover loan proceeds should the borrower default. Although varying with the business model employed (see section 4), a crowdfunding platform will often be responsible for managing and monitoring the execution of the sponsor's business plan. Thus, the role of the RE crowdfunding platform is not merely as broker, but also involves asset management responsibilities.

[7] http://www.moneysavingexpert.com/savings/peer-to-peer-lending

[8] APL/CREFCI Europe/INREV/ZIA (2016) Commercial Real Estate Debt in the Real Economy

3. THE FUNDAMENTALS OF RE CROWDFUNDING

The fundamentals underlying the growth of RE crowdfunding are shared across countries. From an investor perspective, RE crowdfunding increases the accessibility of CRE investment in two ways:

- Firstly, it enables investment opportunities in both debt and equity to be marketed online and viewed by the crowd, not merely those investors known to the selling agent.
- Secondly, by providing co-investment structures, smaller investors are afforded discretion over their investments. Equally, in bringing divisibility to individual investments, investors are able to diversify their investments and reduce the specific risk associated with RE assets.

Both REITs and Unit Trusts offer such diversification through mutual funds with low minimum investment thresholds but do not offer investor discretion. The absence of discretion makes these types of investment less attractive to high net worth individuals (HNWIs) and sophisticated investors, although appropriate for retail investors. They do provide liquidity, however, whereas RE crowdfunding is usually subject to a minimum holding period – usually six months to two years for debt investments and between one and five years for equity investments, depending on the business plan.

In the positive, crowdfunding has widened the investor base for CRE, developing awareness of the benefits of CRE investing, knowledge of the investment characteristics of the sector and increasing accessibility[9]. It also increases accessibility to capital for RE companies and operators and brings greater transparency and efficiency to pricing, especially of CRE debt.

Proponents of RE crowdfunding suggest that RE crowdfunding delivers stronger net returns than more traditional forms of RE investing including direct and indirect investments, specifically non-listed funds and REITs[10]. This superior performance is attributed to the lower fee structure characterising RE crowdfunding and the disintermediation of financial consultants and agents. However, while disintermediation is an important characteristic of RE crowdfunding, the direct or inferred comparison often drawn with MSCI All Property indices and/or REIT data is erroneous as the underlying investments are incomparable for a multitude of reasons:

- There are fundamental differences between the risk profiles of CRE debt and equity investment, with debt generally offering a fixed income return and, through having a higher order of return of capital, is lower risk than equity. It is inappropriate, therefore, to draw inferences between MSCI RE investment returns and/or equity REITs and RE crowdfunding returns that include debt.
- Any comparison of returns must be related to risk, which varies with the market, sector, location, quality, income profile, lease structure and income profile of any asset. The MSCI indices represent an underlying portfolio of institutionally-owned standing investments across all CRE sectors. This is distinct from the assets underlying RE crowdfunding investments, which vary significantly across regions and platforms and are evolving as the industry matures. In the UK, both debt and equity RE crowdfunding platforms are dominated by investments in the residential sector or loans secured on residential assets (see section 4.3).

[9] Athwal, N (2015) How Crowdfunding has Changed Real Estate Investing, Forbes, 2 December, http://onforb.es/1NHDmrl
[10] Manaktala, N. (2015) Democratising Finance: Digital Real Estate Investing Demystified, Deal Index, July

4. THE STRUCTURE OF RE CROWDFUNDING BY MARKET

The evolution of CRE equity and debt crowdfunding markets is distinct across countries, being shaped by differences in market regulation, variation in the market opportunity arising and by investor appetite.

4.1 China

China represents the largest RE crowdfunding market by investment volume and number of platforms operating. The crowdfunding market has grown rapidly, from $5.6 bn in 2013 to $101.7 bn at end 2015, while RE crowdfunding (debt only) increased from $0.234 bn to $5.5 bn over the same period, representing 5% of the wider crowdfunding market. Underpinning this growth is a hitherto unmet demand from SMEs for finance and a strong retailer investor appetite for investment products that deliver a higher risk-adjusted return than bank deposit rates, exacerbated by the threat of currency devaluation.

4.1.1 Regulatory Environment, China

The fast-paced development of the crowdfunding market has been largely unregulated until recently, with the People's Bank of China (PBOC) being keen to encourage the development of alternative finance, which they regard as essential for the success of China's transition to an entrepreneurial economy. However, the rise in the number of platforms failing to deliver returns to investors (at worst, due to fraudulent activity or, at best, due to poorly managed platforms) has resulted in the authorities intervening in the market. For example, P2P lender E'zu Bao is responsible for $7.6 bn of losses while Zhongjin Asset Management misused $5.3 bn[11].

During 2016, authorities investigated the sustainability of crowdfunding platforms and, according to the China Banking Regulatory Commission, up to 30 of the nearly 3,000 platforms operating needed to close either due to poor management and/or high loan default rates or fraudulent activity.

The Chinese authorities are seeking to remain supportive of the industry while introducing a regulatory policy framework to better protect investors. This includes the introduction of the requirement for custodian accounts to be registered with established financial institutions for third party funds held by RE lenders, as well as stricter marketing guidelines. In addition, the States Asset Commission has introduced draft rules for equity investment fundraising, which it is restricting to accredited investors.

4.1.2 Characteristics of RE Crowdfunding Industry in China

RE crowdfunding reflects the wider market, with an absence of regulation leading to a proliferation of platforms designed around different opportunities in the market, varying in quality and management. Broadly, platforms are established around three opportunities:

- Firstly, the strong demand for housing and the need for development finance by SME contractors have created three related crowdfunding approaches: Developers employ crowdfunding to raise finance through pre-sales and, in return, offer discounts of up to 30% on the purchase price of the completed unit. This attracts certain groups of house buyers, as well as speculators, whose activity may inflate pricing and crowd-out consumers. Similarly, developers use crowdfunding platforms to market and sell completed units. The growth of lending for downpayment loans by P2P lenders is related to this activity. The ability to make a down payment on a home pre-development results in a discount to value upon completion.

[11] Alois, JD (2016) China: A Fast Growing but Chatic Internet Finance Industry, 29 April http://www.crowdfundinsider.com/2016/04/84966-china-a-fast-growing-but-chaotic-internet-finance-industry; Alois JD (2016) The Number of Peer to Peer Lenders in China Declines 21 February; http://www.crowdfundinsider.com/2016/02/81990-the-number-of-peer-to-peer-lenders-in-china-declines/

4. THE STRUCTURE OF RE CROWDFUNDING BY MARKET

However, the percentage of downpayments required is set by the PBOC and downpayment loans are not legal in China. The Chinese authorities have intervened in the market and enforced regulations, resulting in the cessation of this activity.

- Secondly, investment crowdfunding models more comparable with those emerging in other regions have also emerged. The majority focus on value-added 'fix and flip'[12] models in the residential sector - examples include Fangbaobao/HouseBaby.com, a subsidiary of leading P2P marketplace lender Tuandai[13]. There are also opportunities to invest in income-producing assets; however, some platforms lack the required management and RE expertise.
- Thirdly, although equity crowdfunding operators (including those for RE) are not currently permitted to undertake equity transactions on their platforms, they are able to act as a broker and introduce investors to an opportunity to co-invest directly in a project with the sponsor.

In addition to the activity of funding SMEs, developers and individual assets, there is a trend for established RE developers to restructure into capital and asset-light entities. In the absence of REITs, crowdfunding is an alternative source of capital to joint ventures with cross-border institutional investors or China's opaque trust finance market, for executing business transformation.

In contrast to other regions, the participation of institutional lenders in loan provision (with the exception of invoice trading) is low; however their ownership of FinTech enterprises, including crowdfunding platforms, is high. Traditional institutions owning platforms include Ping An Insurance and China Misheng Bank. Other large corporates are also leveraging their brand, consumer base and customer analytics capabilities, including the likes of Lenovo, while large established e-commerce companies, such as Alibaba, JD.com, Tenent, Baidu and Qihoo 360, operate crowdfunding platforms as part of their FinTech operations in the market[14].

However, institutional investors have been strong participants in debt offerings listed on crowdfunding or other online finance platforms by major RE companies. In May 2015, the China Real Estate Crowdfunding Alliance was formed by a number of industry-leading members, including a number of China's major developers. China's three largest developers have raised debt capital online through online finance and crowdfunding portals, either through partnership with, or acquisition of, online financial services companies (see Box 4.1)[15].

[12] Value-added investment strategy including asset purchase (often at discount to asset value), redevelopment and/or refurbishment and asset sale post-development.

[13] South China Morning Post (2014) Crowdfunding Clicks on to Property, 15 September, http://www.scmp.com/property/hong-kong-china/article/1592737/crowdfunding-clicks-property-flipping; Sydney Morning Herald (2014) 11 September; http://www.smh.com.au/business/world-business/chinese-speculators-move-online-to-chase-property-profits-20140911-10f92b.html; Lao Zhou and WeiYangx (2016), 25th March http://www.crowdfundinsider.com/2016/03/83214-real-estate-related-crowdfunding-p2p-lending-surge-in-china-opportunity-or-crisis/

[14] http://www.fincera.net/index/blog_details/id/5.html

[15] http://www.mingtiandi.com/real-estate/finance-real-estate/could-greenlands-online-finance-platform-replace-reits/ http://in.reuters.com/article/china-property-financing-idINKBN0OS0CR20150612 http://www.forbes.com/sites/michaelcole/2015/06/24/could-asias-richest-man-make-reits-obsolete/#17cd5d2b5cda

4. THE STRUCTURE OF RE CROWDFUNDING BY MARKET

Box 4.1 Crowdfunding Employed for Major Chinese Property Company Capital Equity Raisings

Following its capital raising of $32 m in 30 minutes through Alibaba's Ant Financial service and Ping An's wealth management sales platform in April 2015, China's largest developer, the Greenland Group, subsequently launched its own online investment product, followed by Greenland Crowdfunding in December the same year. The company is focused on innovating RE-backed debt securities and offerings across a range of investor classifications and RE equity and debt vehicles, blending crowdfunding and internet finance with investment management. In the absence of a functioning REIT market and strong appetite from yield-hungry investors attracted to established companies and trusted brands, online crowdfunding may offer a viable alternative to REITs for the RE industry in China. Moreover, the company is intending to offer its online capital-raising capabilities as a service to other developers and RE companies.

China Vanke, the nation's second largest developer, raised $2.6 m online in November 2014. Subsequently, it won the right to launch China's first REIT in June 2015, structured as an exchange-listed closed-end fund (not tax exempt).

In June 2015, the largest commercial developer, Dalian Wanda Group (Wanda), joined with 99 Bill (an online payments provider the company had previously acquired) to offer an investment in the next phase of five Wanda Shopping Plaza developments through the entity Stable Earner 1. While the quality of the project attracted institutional investors, retail investors contributed 10% of the $800 m capital raised over three days. Moreover, the company began deploying the capital within the same week.

Wanda has suggested that while its offering was launched as a debt product, investors may receive share capital, which might be traded on a secondary market as well as enable participation in the upside of the developments. If this is achieved, the developments in RE crowdfunding may result in the establishment of exchange-traded REITs in China being bypassed.

4.2 United States

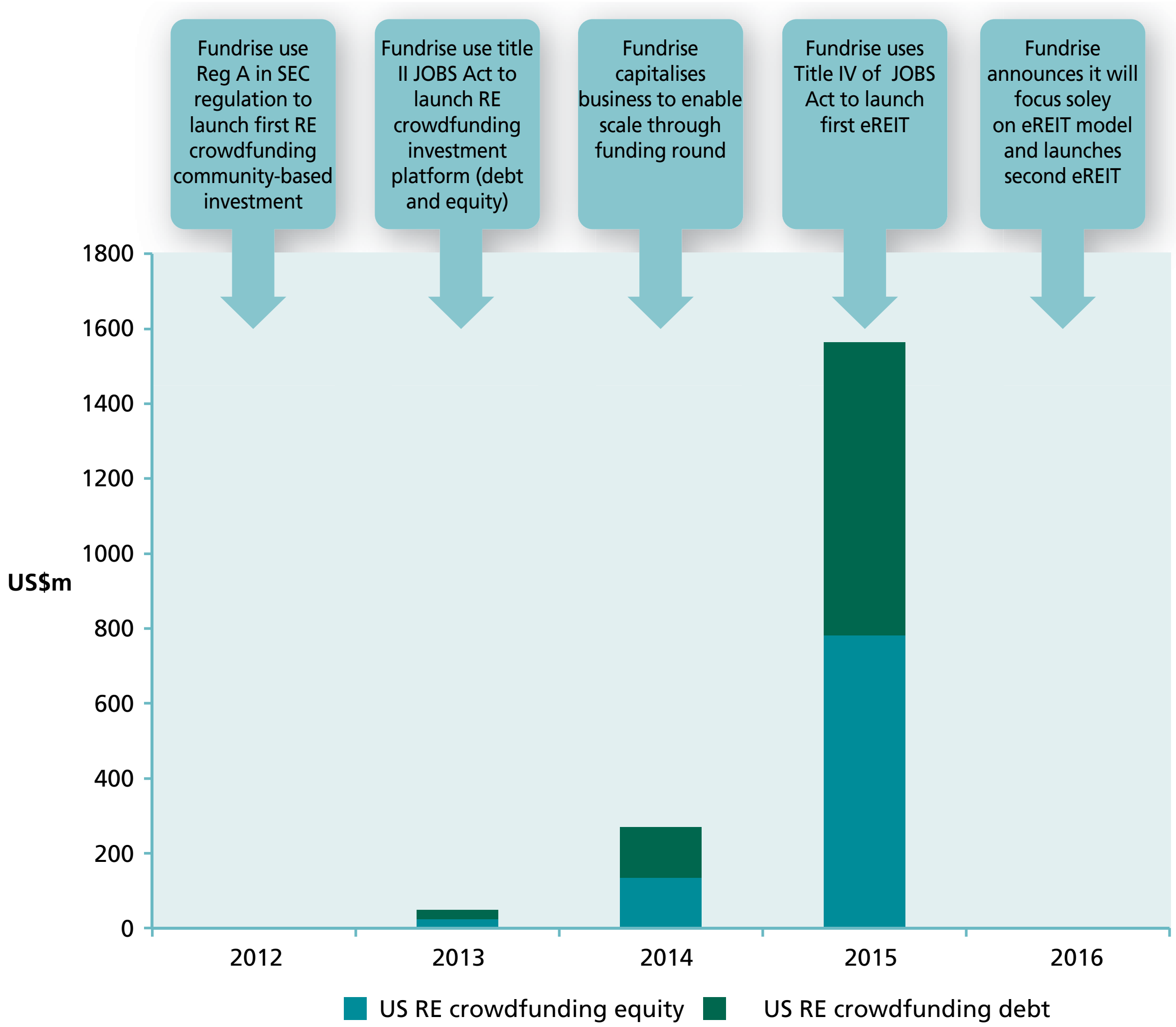
In the US, RE crowdfunding first emerged as a community funding-based concept in Washington DC in 2010. Frustrated by the inability to gain institutional funding for a neighbourhood project, the developer (Fundrise) began exploring ways for the community to invest in and own what it perceived as a transformative project for their neighbourhood. In the absence of an existing crowdfunding regulatory regime, Fundrise worked with the Securities and Exchange Commission (SEC) to explore how a multitude of accredited investors from the community could be enabled to invest in the project, including the use of a portal. Widely acknowledged as the birth of RE crowdfunding, Fundrise claimed this as the democratisation of RE investing, widening access to RE investing beyond the institutions and HNWIs to 'the crowd', albeit retail investors were precluded.

4. THE STRUCTURE OF RE CROWDFUNDING BY MARKET

4.2.1 Regulatory Environment, US

Since 2010, the regulatory framework governing RE crowdfunding has continued to evolve, with step changes in regulation being mirrored in the evolution of RE crowdfunding, exemplified by the changing business structure of Fundrise itself (Figure 4.1). In 2012, RE crowdfunding was supported by Title II of the US JOBS Act[16]. It permitted crowdfunding platforms to raise up to $1 m in funds annually from HNWIs and accredited investors[17]. Title II also required crowdfunders to be registered with the SEC.

Figure 4.1: Evolution of Fundrise and Regulatory Development



[16] Jumpstart Our Business Startups Act

[17] Defined as having a net worth in excess of $1 m or who have an income of at least $200,000 for the previous three years.

4. THE STRUCTURE OF RE CROWDFUNDING BY MARKET

Under Title II, retail investors were excluded from investing in RE crowdfunding. As the market evolved and matured, establishing a compelling performance history, the regulation came under review with the SEC attempting to balance the need to protect non-accredited investors from taking risks they may not fully understand and, at the same time, enabling greater access to innovative and higher-yielding RE investment products. The SEC passed Title III of the JOBS Act in October 2015, becoming effective in May 2016. Essentially, the new regulation allows non-accredited investors to participate in RE crowdfunding, subject to a number of limitations, including a hard cap of $1 m for individual project fundraisings. Accredited and non-accredited investors may invest subject to limits based on their income and wealth[18]. During the 12-month period, the aggregate amount of securities sold to an individual investor through all crowdfunding offerings may not exceed $100,000. The regulatory compliance burden has largely been transferred to the crowdfunding portals, which are required to undertake due diligence on issuers, educate investors, make sure investors are investing within their income limits and provide data to the SEC[19].

The regulation also requires crowdfunding offerings to be made through an intermediary. Crowdfunding portals must be registered with the SEC and be a member of FINRA (Financial Industry Regulatory Authority), which is the regulatory body with responsibility for overseeing the registration of crowdfunding portals and ensuring compliance with the federal securities laws and FINRA rules.

Title IV Regulation A+ became effective in June 2015 and may, arguably, have a bigger impact on the market than Title III. It enables crowdfunders to raise up to $50 m per year through securities offerings, with retail investors permitted to participate.

4.1.2 Characteristics of RE Crowdfunding in the US

Following Title II in 2012, the number of RE crowdfunding platforms grew rapidly from 2013 to 2015 with over 100 platforms established by end-2015. A number of market leaders dominate, including Fundrise, Realty Mogul, iFunding, Realty Shares, Patch of Land and Prodigy Network[20]. Early crowdfunding opportunities emerged in the single-family residential fix and flip market, which would not be considered an institutional investment. The GFC left a financial dislocation in its wake, particularly for smaller developers seeking subordinated debt or offering preferred equity stakes. While this remains a major focus for some crowdfunding platforms, the scale and quality of RE crowdfunding investments is expanding as the market evolves and matures.

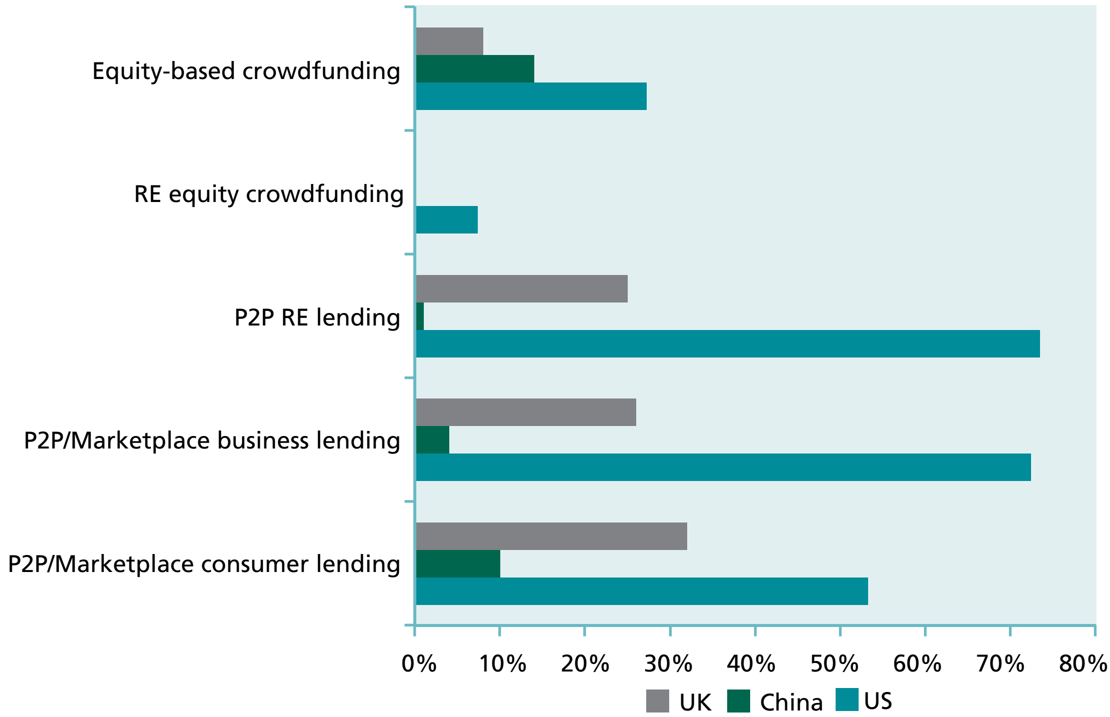
Leading platforms began to specialise in particular segments of the market. For example, until 2016, Fundrise was primarily focused on funding the development and acquisition of multi-family residential and mixed-use assets, while Realty Mogul focuses on higher-yielding CRE, including distribution and the hospitality sector; Realty Shares is focused on providing capital and unlocking smaller, non-institutional RE deals to investors and Patch of Land has been primarily focused on single-family fix and flip loans. While both Fundrise and Realty Mogul offer debt and equity investments, the provision of bridging and mid-term loans dominates their activity, due to stronger demand from investors and sponsors and scaleability of the business in terms of underwriting. Prodigy Network is a sponsor-led platform that develops and manages its own projects and offers equity to the crowd, financing project debt through traditional banking institutions.

[18] If either annual income or net worth is less than $100,000, then a total of the greater of $2,000 or 5% of the lesser of their annual income or net worth in any one year may be invested through crowdfunding platforms. If annual income is greater than $100,000, this limitation rises to 10%.
[19] FINRA (2016) Crowdfunding and the JOBS market http://www.finra.org/investors/alerts/crowdfunding-and-jobs-act-what-investors-should-know; http://crowdexpert.com/articles/new_jobs_act_titleiii_rules_overview_first_thoughts/
[20] Putzier, K. (2015) Crowd favorites, The Real Deal, July 01

4. THE STRUCTURE OF RE CROWDFUNDING BY MARKET

The inability to market to retail investors until 2016 influenced the evolution of the industry, as the growth of RE crowdfunding platforms became constrained by a number of factors. In a recovering RE market, it became harder to source quality product due to the time lag between listing a project and reaching the target funding. Given the importance of timing for development returns, platforms began to embrace interest from institutional investors (Figure 4.2). At 73% of crowdfunding platforms involved in RE lending, the scale of institutional investment through credit lines and co-investment is underpinning the industry. While it has been suggested that institutions are crowding out smaller investors and resulting in a return to the status quo, the presence of institutional investors could increase confidence for smaller investors that may lack professional RE investment expertise. It has also enabled crowdfunders to pre-fund deals and increase the quality and scale of loans. Fundrise bought $5 m in tax-exempt bonds related to the construction of 3 World Trade Centre and offered the opportunity to invest in these through its portal. Many of the leading platforms are now funding larger deals in excess of $10 m and Realty Mogul has been able to fund a $49 m loan. Institutional investment has enabled Patch of Land to rebalance its business from single-family residential bridging loans towards mid-term duration loans for commercial assets and multi-family residential.

Figure 4.2 Institutional Investment through Crowdfunding Platforms as % of Capital Raised 2015



Source: IPF (2016); Cambridge Judge Business School Crowdfunding Reports 2016

4. THE STRUCTURE OF RE CROWDFUNDING BY MARKET

In reverse, LendingHome, an established online mortgage lender that serves as a conduit for institutional investors, launched a crowdfunding platform in 2016 as a means of diversifying its investor base. At the same time, established RE development companies, such as Simon Baron Development, are offering a tranche of their financing requirements on large-scale projects through crowdfunding platforms.

Despite Title III of the JOBS Act permitting retail investment, the increased regulatory and administrative burden for crowdfunders associated with non-accredited investors also requires scale to absorb the costs, although this is impeded by the legislation, which also contains a hard cap of $1 m for projects offered to non-accredited investors. For RE, this tends to preclude investment in prime commercial assets and limits the potential for crowdfunding platforms to blend funds from institutional, accredited and non-accredited investors in individual investment offerings[21].

As a result, crowdfunding platforms have focused on Schedule A of Title IV as a means of accessing non-accredited investors. It has been used by Fundrise and Realty Mogul to launch what they term as eREITs, targeting non-accredited investors. Essentially a public non-traded REIT, investors can invest online through a portal with low minimum investments ($1,000 for Fundrise's eReits and $2,500 for Realty Mogul's MogulREIT I). While Fundrise operates a separate income (debt) and growth (equity) eREIT, Mogul Realty's REIT includes debt and equity investments.

Essentially, as blind pooled diversified funds, investors lose discretion in terms of the selection of investments, an advantage associated with crowdfunding models. However, they gain some liquidity through quarterly redemption opportunities. Both offer lower fee structures than traditional, non-traded REITs but, given the relatively fixed cost of the platform, such fees are dependent on capital-raising reaching the full ($50 m) target. Moreover, Fundrise's model has been criticised for including hidden fees, leading to potential for investor dilution to meet returns[22]. In addition, while not questioning the credentials of the company that is the pioneer of RE crowdfunding, observers have suggested Fundrise's website marketing material may be misleading to non-accredited investors[23]. However, Fundrise has also been applauded for being the first to use the new regulation to create an innovative product that provides non-accredited investors access to the CRE investment market[24].

Certainly, investor appetite for the products is strong. Fundrise and Realty Mogul indicate that investment in these products has exceeded expectations, underlining the strong demand for RE investing opportunities from such investors. Indeed, Fundrise raised its first $1 m closing in four hours, stating it was over-subscribed by 400%. By September 2016, it had raised $90 m from investors, with a waiting list of 60,000 for new fundraising, and has indicated that approximately 75% of its 10,500 investors are seeking to reinvest[25].

[21] Nino, R (2015) http://www.crowdfundinsider.com/2015/01/61469-the-funding-cap-on-title-iii-retail-crowdfunding-is-pointless; Berkin, B (2016) http://crowdfundbeat.com/2016/02/01/why-title-iii-of-the-jobs-act-fails-to-fulfill-the-needs-of-the-new-equity-crowdfunding/

[22] Ippolito, I (2016) Investors pile into Fundrise's new "eReit", The Real Estate Funding Review, January 29

[23] Putzier, K (2015) How Fundrise, crowdfunding's most celebrated startup, cherry-picks its numbers, The Real Deal

[24] Ippolito, I (2016) Investors pile into Fundrise's new "eReit", The Real Estate Funding Review, January 29; Alois, J.D. (2015) http://www.crowdfundinsider.com/2015/12/78593-the-real-deal-throws-shade-on-fundrise-ereit-offer/

[25] Alois, J.D. (2016) http://www.crowdfundinsider.com/2016/08/89118-using-reg-ereits-now-raised-70-million-fundrise/ Mattson-Teig, B (2016) 28 September http://nreionline.com/reits/crowdfunded-reits-gain-momentum?NL=NREI-21&Issue=NREI-21_20160928_NREI-21_825&sfvc4enews=42&cl=article_1_b&utm_rid=CPG0900007968122&utm_campaign=7198&utm_medium=email&elq2=d7e6178ec7ef46f1857f3e19e8c3ac62

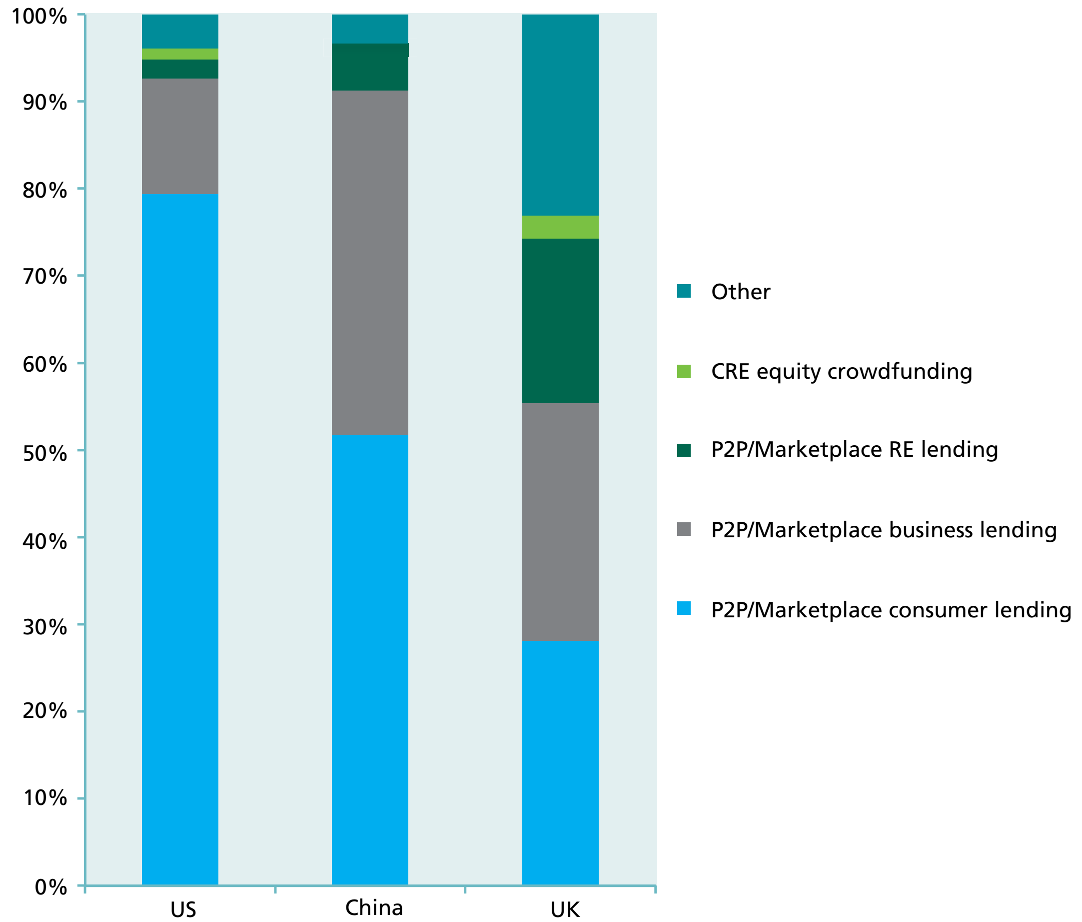
4. THE STRUCTURE OF RE CROWDFUNDING BY MARKET

4.3 United Kingdom

The UK crowdfunding industry is smaller in terms of capital volumes than the US and China, accounting for 3.4% of the global market. Currently, all crowdfunding lending activity through P2P and P2B platforms represents around 1-2% of total stock and gross flows of loans and, hence, are not considered to present a systemic risk[26].

RE crowdfunding in the UK accounts for approximately 13.39% of the global RE crowdfunding market[27]. Moreover, at 22%, RE crowdfunding in the UK accounts for a larger share of the national crowdfunding industry compared to other regions (Figure 4.3). RE crowdfunding within the UK is heavily weighted towards RE debt, which accounts for 88% of activity. In contrast to the US, non-institutional investors account for over 75% of funds raised by RE Crowdfunding platforms. This is facilitated by a broadly supportive regulatory environment.

Figure 4.3: Comparison of Proportional Breakdown of Crowdfunding by Category, 2015



Source: IPF (2016); Cambridge Judge Business School Crowdfunding Reports 2016

[26] Letter of response from Andrew Bailey, Deputy Governor PRA,to Andrew Tyrie, MP, Chairman of the Treasury Committee, 16 June 2016

[27] Zhang, B., et al., "Harnessing Potential: The Asia Pacific Alternative Finance Benchmarking Report, 2016; Breaking New Ground: The Americas Alternative Finance Benchmarking Report The University of Cambridge Judge Business School and the Polsky Center for Entrepreneurship and Innovation at the University of Chicago Booth School of Business; Zhang, B., Baeck, P., Ziegler, T.,Bone, J. and Garvey, K. (2016) Pushing Boundaries: The UK Alternative Finance Industry Report, University of Cambridge Judge Business School and Nesta, February; Zhang et al., (2016) Sustaining Momentum: 2nd Annual European Alternative Finance Industry Survey, The University of Cambridge Judge Business School

4. THE STRUCTURE OF RE CROWDFUNDING BY MARKET

4.3.1 Regulatory Environment, UK

In the UK, crowdfunding platforms are regulated by the Financial Conduct Authority (FCA) and, as such, are subject to the standard FCA rules that apply to all FCA-authorised companies, including the conduct of business rules. Regulatory policy governing the crowdfunding industry was introduced in March 2014 and, as planned, as at autumn 2016, the FCA is in the process of undertaking a post-implementation review of the industry and the adequacy of the rules governing it.

The FCA has a statutory duty to encourage competition, by increasing the number of market players and reducing barriers to market entry. It supports innovation and promotes a level playing field in the market while, at the same time, seeking to protect consumers. In doing so, the FCA distinguishes between the treatment of debt and equity platforms, which it classifies as loan-based and investment-based crowdfunding[29].

For loan-based crowdfunding, the regulatory rules set out the minimum capital requirements, client money rules, succession planning for loan management should the company fail and disclosure requirements, with an emphasis on disclosure to retail investors. Platforms are subject to regular quarterly reporting requirements to the FCA, including prudential data, accounts, client money, complaints and loans undertaken and distributed over the period. Investment is open to all investors, including retail investors.

Investment-based crowdfunding is defined by the FCA as non-readily realisable securities, in either debt or equity, in small- or medium-sized enterprises. The FCA permits retail investors to invest if they meet the credentials of one of the following categories[30]:

1. Certified as a HNWI;
2. Certified or self-certified as a sophisticated investor;
3. Certified as a 'restricted' investor (has not invested more than 10% of their assets in a non-readily realisable security);
4. Where the FCA-authorised firm will comply with the 'suitability' requirements in the FCA rules; or
5. The investor is classified as a 'corporate finance contact' or 'venture capital contact' under the FCA rules.

Although firms must comply with rules on appropriateness where the suitability rules are not applicable, the involvement of restricted investors – 'the ten per centers' – has provided an important capital base for RE crowdfunding. Indeed, 62% of crowdfunding equity investors are retail investors[31]. However, as it undertakes its review, the FCA has indicated that it has some concerns as to the suitability of investment-based crowdfunding for retail investors, as the risk of loss through equity investing is higher to the consumer. Initial indications are that the FCA will strengthen regulation concerning investor classification and assessment of appropriateness, marketing of products, due diligence and disclosure requirements[32]. As part of its review,

[28] Zhang, B., Baeck, P., Ziegler, T.,Bone, J. and Garvey, K. (2016) Pushing Boundaries: The UK Alternative Finance Industry Report, University of Cambridge Judge Business School and Nesta, February

[29] FCA (2015) A review of the regulatory regime for crowdfunding and the promotion of non-readily realisable securities by other media, February https://www.fca.org.uk/publication/thematic-reviews/crowdfunding-review.pdf

[30] Robinson, S and Finnemore, J (2014) FCA published policy statement on crowdfunding regulation, Nabarro, 27 March

[31] Op Cit

[32] Woolard, C. (2015) FCA Strategy Director, LendIt Europe

4. THE STRUCTURE OF RE CROWDFUNDING BY MARKET

the FCA is assessing how platforms have undertaken the appropriateness test and whether these tests are sufficient. In respect of loan-based platforms, the review is considering whether the rules relating to client suitability should also apply[33].

The FCA has also indicated that due diligence, marketing and disclosure rules will be more stringent for investment- and loan-based platforms[34]. Firms are likely to be required to distinguish between money raised through the portal and money raised offline. They will be required to make clear that returns are not guaranteed and that losses are possible. In contrast to bank deposits, the Financial Services Compensation Scheme does not cover investments through crowdfunding platforms. With loan-based crowdfunding investments offering the potential of an Innovative Finance ISA (IFISA), appetite for such investments is expected to increase. Indeed, the RE debt crowdfunding industry anticipates a 52% increase in volumes in 2016 as a direct result. However, the FCA is considering whether the provision of an IFISA wrapper and the trusted brand of ISA leads retail investors to assume the risk associated with crowdfunding investments is on a par with other ISA investments.

Although the FCA suggested in 2015 that the light regulation of the industry seemed to be working reasonably well, a number of high profile industry controversies globally have caught the attention of politicians and regulators[35]. These include the corruption and mismanagement of a number of crowdfunding platforms in China, controversy involving an improper loan sale of $22 m involving Lending Club, one of the largest P2P/market place platforms in the US and the failure of UK P2P platform Funding Knight.

Governance standards in the industry would appear to be good, with Lending Club removing its founder and CEO and efficiently buying back mis-sold loans from the subject institutional investor before re-selling them to a third party institutional investor. Indeed, the Lending Club episode did not involve a material loss and only came to light because of the transparency of the platform, which discovered and self-reported the incident. However, the industry may benefit from greater transparency, a tightening of rules and more independent oversight, although there is a risk that regulators overreact and over-regulate in response to media coverage and political pressure, potentially stifling this fledgling industry[36].

4.3.2 Characteristics of RE Crowdfunding in the UK

The evolution of the RE crowdfunding industry in the UK is distinct from that in the US. In part, this is shaped by permitting retail investors to participate and the size of the market opportunity to provide SMEs with development funding. In the UK, the Prudential Regulatory Authority (PRA) introduced slotting in respect of RE bank lending, which provides a prescriptive mechanism for risk-weighting RE loans. The provision of development lending to SME developers, particularly in the house-building market, which have a higher credit risk than large companies, carries a high-risk weighting. This, in turn, creates a higher cost of capital to support such lending and has reduced the availability of such debt finance. Although the growth of alternative institutional lending, both directly and indirectly, through non-listed funds, has increased the diversity of the market, these lenders are seeking to lend at considerably larger lot sizes[37].

[33] Letter of response from Tracey McDermott, acting Chief Executive of FCA to Andrew Tyrie, MP, Chairman of the Treasury Committee, 16 June 2016[34] Robinson, S. and Digby, O. (2016) FCA call for input on crowdfunding regulation

[35] Treasury Select Committee on Appointment of Andrew Bailey as Chief Executive of Financial Conduct Authority, 20 July, http://www.parliamentlive.tv/Event/Index/1a3542d2-621a-42e0-94d4-76dbdaa9a217

[36] Aitken, R. (2016) Lending Club Scandal Provokes Major UK 'Peer-To-Peer' Investigation, Forbes, 22nd July; Torris, T. (2016) The Lending Club Predicament & The Lessons Learned, Crowdfund Insider, 6 July.

[37] APL/ CREFC Europe/ INREV/ ZIA (2016) Commercial Real Estate Debt in the Real Economy.

4. THE STRUCTURE OF RE CROWDFUNDING BY MARKET

As a result, the opportunity for alternative lenders to meet the demand for bridging finance for even medium-sized house-builders persists despite the recovery of the debt and RE markets. At the same time, the housing shortage and growth of the private rented sector (PRS) present an opportunity to fund income-producing RE investments. In addition to offline alternative lenders, RE crowdfunding platforms have emerged to meet this otherwise unmet demand. They have appeared either as part of secured lending for established P2B lenders or as specialist P2B CRE debt platforms, such as LendInvest, LandBay and AssetzCapital (see Box 4.2). While a smaller proportion of the industry, CRE equity crowdfunding opportunities are also available, either through equity crowdfunding platforms offering seed or venture capital investments, including Crowdcube and Syndicate.com, or as sector-specific CRE equity crowdfunding platforms, including PropertyPartner.com and Homegrown.

Box 4.2 Largest UK RE Debt Crowdfunding Platforms

LendInvest is the UK's largest specialist CRE debt crowdfunding platform. Established in 2008 to offer short-term bridging finance, the company developed the Montello Income Fund for institutional investors in 2010. In May 2013, it moved the business online and operates a diverse funding business that includes institutional funds, bank funding lines as well as a P2B RE crowdfunding model that accounts for 25-30% of the company's lending base. Investors in the crowdfunding platform are able to select their own investments, with LendInvest pre-funding and undertaking due diligence prior to listing and managing the investment. Investments represent senior loans at conservative loan to values, either for bridging finance with a six- to seven-month duration or in the buy-to-let market, which have a longer duration of three years.

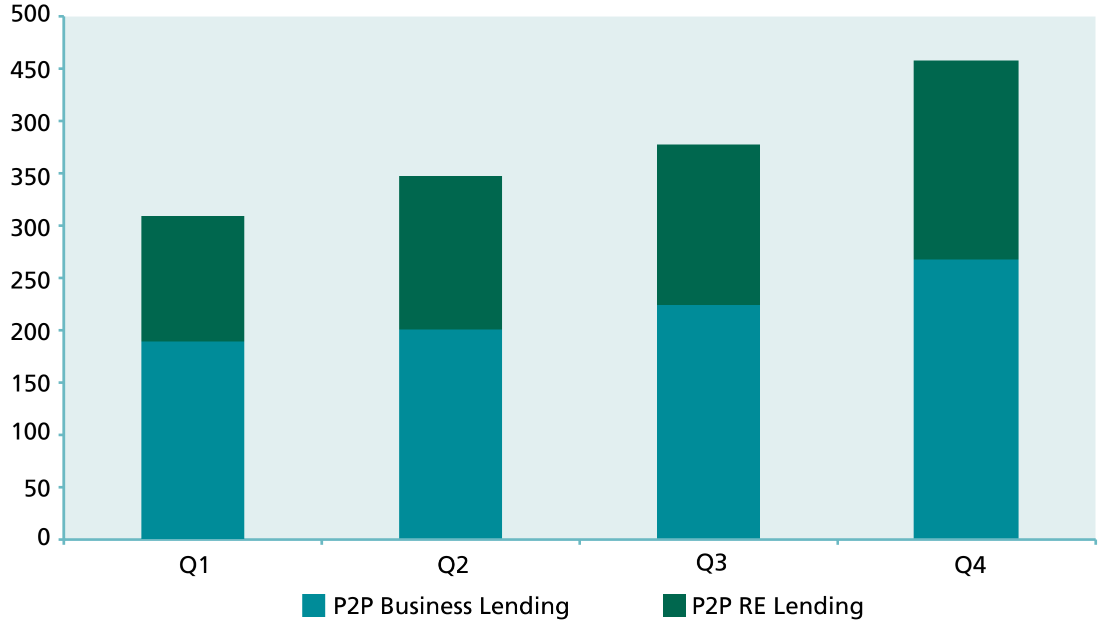
In contrast, LandBay operates a crowdfunding platform that offers two types of buy-to-let loan products to investors and allocates a diversified portfolio of loan securities to investors. In the case of AssetzCapital P2B, CRE loans form only a part of its crowdfunding platform and, while it offers automatic allocation for certain loans, the investor is given discretion for RE loans. This may reflect the larger lot sizes of such loans and, perhaps, the lower volume of RE loans originated as a total of all loans by this platform.

Although RE equity crowdfunding accounted for 26% of all equity crowdfunding, it is a small proportion of the market, totalling £86.6 m in transaction volumes in 2015. However, it is experiencing a high growth rate, contributing greatly to the 29% growth in equity crowdfunding over that year, leading to industry analysts considering it a category in its own right (Figure 4.4)[38]. From the investor perspective, the low interest rate environment has created a demand for higher-yielding investments.

[38] Zhang, B., Baeck, P., Ziegler, T.,Bone, J. and Garvey, K. (2016) Pushing Boundaries: The UK Alternative Finance Industry Report, University of Cambridge Judge Business School and Nesta, February

4. THE STRUCTURE OF RE CROWDFUNDING BY MARKET

Figure 4.4: P2P RE Lending as Proportion of All Business Lending (£m) 2015



Source: IPF (2016); Cambridge Judge Business School Crowdfunding Report, UK 2016

Opportunities to invest fall into two broad categories:

- Firstly, investing through equity crowdfunding platforms that offer seed and venture capital funding in embryonic and mature companies. These platforms may also list RE equity investment opportunities, usually in new build residential developments.
- Secondly, a number of platforms offer equity investments in buy-to-let properties. For example, PropertyPartner.com, HomeGrown, Property Moose, Property Crowd.com and HouseCrowd.com offer equity investment in individual investments across a portfolio of pre-funded properties.

These platforms use varying levels of debt, with Property Partner using buy-to-let mortgages while Property Moose initially offered all equity buy-to-let investments, later using moderate leverage to enable it to access larger commercial and mixed-use assets. IntroCrowd offers investment in strategic land.

Investor appetite is strong: in 2015, 126 investors fully funded Property Partner's £212,900 equity listing for one buy-to-let flat in 35 minutes and raised £843,000 from 318 investors at a rate of £1,405 per second for a multi-family asset, comprising some 42 units and a 60% loan-to-value mortgage, in less than 11 minutes[39].

[39] http://www.thisismoney.co.uk/money/buytolet/article-3097745/126-buyers-crowdfund-buy-let-35-minutes-Property-Partner.html; http://www.propertyindustryeye.com/going-going-42-flats-sell-in-under-11-minutes-to-crowdfunders/

5. THE STRUCTURE OF RE CROWDFUNDING MODELS

Broadly, business models fall into investor- versus sponsor-led platforms. Sponsor-led platforms usually comprise institutions or large RE companies or developers able to leverage their own brand to raise capital from the crowd. Investments may comprise securities in the company, but are more usually structured as securities in a specific project, through a special purpose vehicle (SPV) managed by the platform for equity investments or using an SPV for a management company and nominee structure for debt securities. Examples in the US include Prodigy Network, the Carlton Group and Thor Equities, which announced its intention to launch crowdfunding platform Invest Thor in 2015.

Investor-led platforms source product and undertake due diligence to screen the suitability of both sponsors and investments prior to listing on their sites and, once accepted, detailed project and investment analysis is provided to potential investors. Investments may be made directly or indirectly and, in part, the prevalence of models will be driven by regulatory considerations.

5.1 Direct Models

Within direct models, the platform acts as a broker-dealer and establishes a direct relationship between each individual investor and the project sponsor. While this has advantages for the sponsor, through establishing a direct relationship with a pool of investors that may be harnessed for other projects, it increases the complexity of management, as the sponsor must report to each individual investor and ensure contact details are up to date. For the investor, it has the advantage of reducing fees. However, acting as a broker tends to lower the accountability of the platform and, in turn, the depth of due diligence required/undertaken. The onus falls on the investor to be responsible for more detailed due diligence, whilst the subsequent monitoring and management of the investment, to ensure the sponsor delivers, is passed to the individual investor, who may lack the required skill-set. This approach is most common to equity crowdfunding in China, where platforms are not permitted to control client money. To this end, crowdfunding platforms act as lead generators.

In other markets, sponsors may use crowdfunding platforms to raise capital, with the investment transacted through the platform, but with the investment managed directly by the sponsor. This form of direct investment is a common model for large sponsor-led platforms. Sponsor-led platforms are predominantly operated by large, established, well-capitalised operators in the RE market with a trusted brand and proven expertise. Rather than operate their own crowdfunding platform, they may partner with a crowdfunding platform to avail themselves of the latter's technology capabilities. In addition, crowdfunding platforms are leveraging their technological know-how to provide 'software-as-a-service'. For example, CrowdStreet, CrowdEngine and Katipult enable sponsors to operate their own-branded portals on their web sites, enabling them to leverage their own investor base and exercise control as to whether they open it to the wider market[41].

5.2 Indirect Models

Indirect models shift the crowdfunding platform role from broker to asset manager. Individual investor commitments are held in an escrow account until the target investment threshold for a project is met. Once achieved, funds may be invested indirectly through either an SPV or a nominee structure, depending on whether a debt or equity funding and by reference to jurisdiction.

[41] Manaktala, N. (2015) Democratising Finance: Digital Real Estate Investing Demystified, Deal Index, July

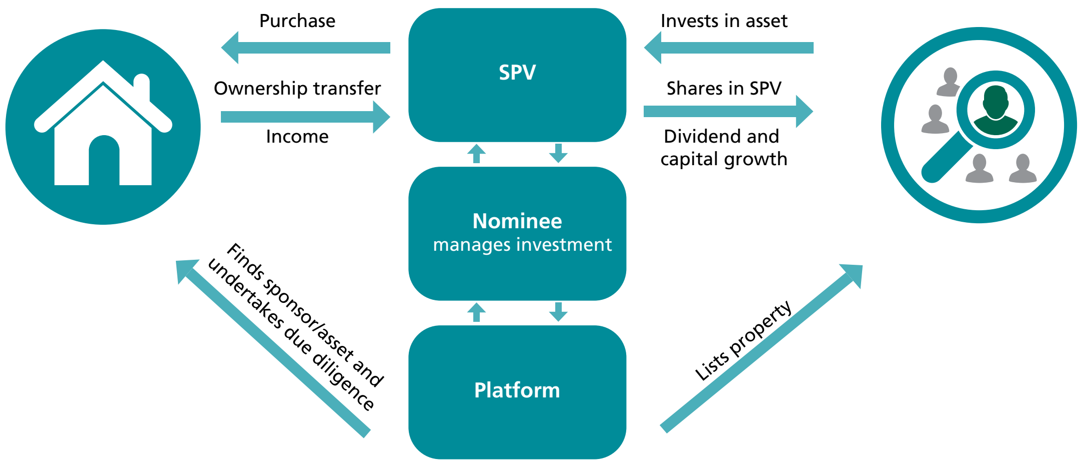
5. THE STRUCTURE OF RE CROWDFUNDING MODELS

5.2.1 Equity

Equity investments require an SPV that allows individual investments to be pooled. In the UK, this is usually structured as a limited company, with share issuance to individual investors on a pro rata basis. The entity is managed by the crowdfunding platform.

In the UK, the regulatory requirement to ensure that investments are independent of platform failure usually results in the management being structured into a management company that is legally independent of the platform (Figure 5.1). This offers the sponsor a simplified reporting structure, with reporting and distributions made to one single entity. The crowdfunding platform acts as investment manager, with a responsibility for performance monitoring, management, distribution and legal requirements involved in establishing and, at the end of the investment term, disposing of the SPV.

Figure 5.1: Basic Structure of RE Equity Crowdfunding



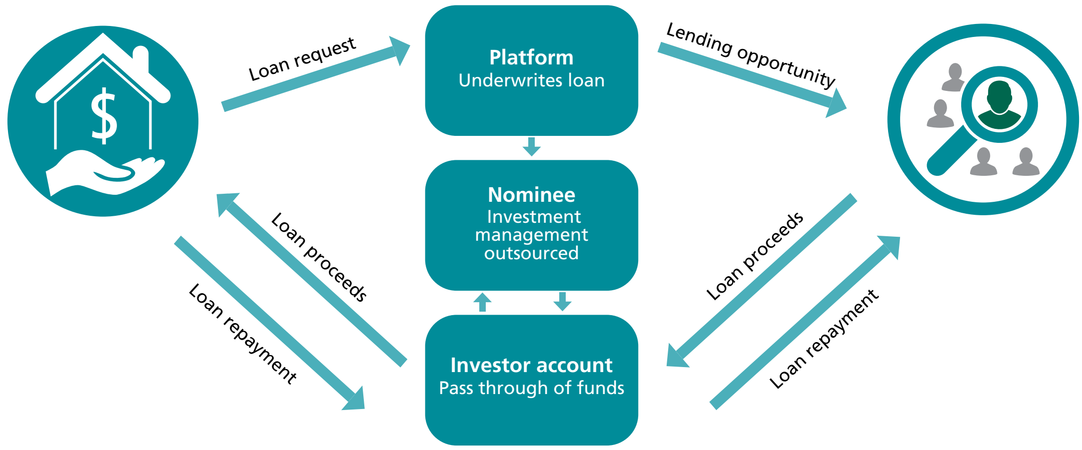
Alternative models allow smaller investors to co-invest with venture capitalists and angel investors; for example, angelsden.com and syndicate.com. Platforms, such as syndicate.com and angelsden.com, list private equity opportunities they have invested in, through both online and offline networks. The business angels pre-screen investments and undertake their own due diligence of opportunities, then open the investment on the same terms to the crowd via a crowdfunding portal, employing either syndication or co-investment.

5.2.2 Debt

A range of business models has emerged within the RE debt crowdfunding including discretionary and semi-discretionary models. Discretionary models enable investors to select the loans in which they wish to invest and are common to bridging loan finance for developments. Semi-discretionary models can also be employed, usually in respect of buy-to-let mortgages. The investor selects their preferred risk parameters, for example fixed or variable rate loans, and the platform auto-allocates a diversified portfolio of loans to the investor. In the UK, the investment is arranged to create a direct link between the borrower and lender, with the investment management outsourced to a nominee structure to enable the platform to act as an operational manager on behalf of investors (Figure 5.2).

5. THE STRUCTURE OF RE CROWDFUNDING MODELS

Figure 5.2: Basic Structure of RE Debt Crowdfunding



The time lag between listing an investment and reaching the required funding target has impeded the ability to originate investments. As a result, many platforms seek to pre-fund deals and later assign the benefit to the investor. Leading platforms consider pre-funding as being an essential component of the sustainability and future growth of the industry, especially in regard to larger and higher quality investments. This creates a legal technicality within UK law as the arrangement is seen to preclude the establishment of a direct relationship between borrower and lender, as defined under Article 36 (8) of the FCA crowdfunding rules. Recognising they were not intended to prevent pre-funding and that it increases the strength of due-diligence undertaken by platforms, thereby reducing investor risk, the rules are expected to be amended in early 2017.

5.3 Emerging Intermediaries

The fragmentation of the RE crowdfunding market is also leading to the growth of new participants in the market. Firstly, as has occurred in the wider crowdfunding market, aggregators are emerging to provide a platform that offers a 'one-stop shop' for investors, presenting multiple deal opportunities from multiples platforms on a consistent basis. This assists market transparency, allowing investors to compare available investments on a like-for-like basis, and some sites also include the option to track past performance of crowdfunding platforms[42]. Aggregators of RE crowdfunding include Property.com, Connected Investors and Deal Index.

In addition, RE crowdfunding fund managers are emerging. In the US, AlphaFlow is raising a private non-listed fund of senior loans in the residential sector across the RE debt crowdfunding space, diversified by geography, asset type, sponsors and RE crowdfunding platform. The fund has a minimum investment of $25,000 and is targeted at accredited investors[43]. This contrasts with the public non-traded REIT funds developed by Fundrise and Realty Mogul, which are open-ended and principally target retail investors. Fund management models are also emerging in the UK. For example, LendingWell provides an aggregator platform for retail investors and independent financial advisors, offering the option to invest in a non-discretionary modelled portfolio or to exercise semi-discretion and set bespoke investment parameters – in essence, a separate account. As investment managers, these participants act as new intermediaries in the marketplace and introduce a corresponding layer of fees for their services.

[42] http://www.huffingtonpost.com/jorge-newbery/crowdfunding-aggregators_b_11405402.html
[43] http://www.crowdfundinsider.com/2016/01/80820-too-many-real-estate-deals-to-choose-from-never-fear-new-methods-are-here/

6. IMPLICATIONS, OPPORTUNITIES AND THREATS FOR THE CRE INDUSTRY

The emergence of RE crowdfunding represents a range of innovative online RE investment products that developed in response to a gap in the market in the supply of capital to certain parts of the RE market. In particular, the provision of development and bridging finance for SMEs, funding for the professional buy-to-let investor and small lot size RE assets in higher-yielding secondary markets remains constrained from traditional lending sources. Equally, RE crowdfunding platforms have brought the merits of RE investing to the attention of the crowd and, in doing so, have tapped unmet investor appetite from HNWIs and retail investors seeking exposure to RE debt and equity investments, as well as providing increased access to capital for sponsors. RE crowdfunding is currently helping to capitalise an expanding investment universe, rather than cannibalising it.

Such investors are attracted by the access to RE at low threshold entry levels, the greater investment discretion that crowdfunding models offer, the attractive returns and lower fee structures, due to the disintermediation of financial advisors and other RE service providers. The increased transparency of investments is attractive to both investors and sponsors. Investors receive detailed performance reporting of each individual investment, while sponsors benefit from the more transparent pricing of debt. Indeed, in the longer term, it is foreseeable that the wider lending sector could transform into a more transparent market, offering comparable pricing and/or competitive bidding.

However, the RE crowdfunding market also has a number of weaknesses, relating to the size and scope of the market. Proponents of RE crowdfunding often make direct comparison of returns with the performance history of the wider CRE market, notably REITs and the direct CRE market. At present, the RE crowdfunding market is not directly comparable with the wider CRE industry, due to its small size and considerably narrower scope. Although capital invested through both debt and equity RE crowdfunding in 2015 represents a global industry of $7.8 bn, this is rather small in scale when compared to the $760 bn invested in CRE. In the UK, although the size and quality of investments are increasing in scale, a large proportion of the market is centred on bridging finance for SME residential developments and buy-to-let loans. Although certain platforms in the US also fund commercial assets, this is predominantly subordinated debt or preferred equity employed to execute value-added strategies on good quality, but non-institutional investments in secondary markets and/or the small scale of such investments by value. Thus, making a direct comparison and inferring a like-for-like basis with established CRE performance indices may be misleading to a retail investor audience unless the differences in the risk attributes of the underlying assets held by REITs, institutional investors and RE crowdfunding products are explained.

Equally, the risks and projected returns underlying the range of available RE crowdfunding investments differ. Investments in senior debt secured on the underlying property presents a relatively low risk for investors as it affords a high degree of capital protection in comparison to subordinated debt and equity investments which afford less capital protection, being more exposed to pricing volatility. While the latter offer higher returns, there has been some concern by regulators as to whether the risks are adequately explained to potential investors and whether the risk exposure is appropriate for retail investors.

6. IMPLICATIONS, OPPORTUNITIES AND THREATS FOR THE CRE INDUSTRY

eREIT-style products in the US, and the use of crowdfunding for capital raising by major development corporations in China, suggests that RE crowdfunding may have a more disruptive effect on the established RE market in the future. These innovations are more comparable with existing CRE investment products, including publicly traded non-listed REITS/unit trusts and the listed REIT market. This shifts RE crowdfunding from being an extension to the CRE industry and, therefore, complementary, to an innovation that is competitive with and potentially transformative for the established CRE industry. Of course, this also represents an opportunity for the CRE industry to benefit from innovations in the market. This requires stakeholders to understand the factors attracting investors and sponsors to RE crowdfunding and respond to the opportunities these represent.

From the investor perspective, RE crowdfunding has highlighted the latent demand from a broad base of HNWIs, sophisticated investors and non-accredited investors for RE investment products. For non-accredited investors, RE crowdfunding offers greater transparency, as well as a reduced fee structure that enhances net returns. Indeed, a major benefit of eREITs relative to traditional public non-listed REITs in the US is their lower, streamlined fee structure. In part, this is due to the disintermediation of IFA distribution channels, but also lower and fewer layers of management and performance fees. In the US, the development of eReits represents a competitive threat to public non-listed RE funds or, in the UK, unit trusts. However, it also represents an opportunity for established managers to develop more transparent products, with streamlined fee structures that target this investor audience, with the advantage of their track record and trusted brand. The opportunity has already been recognised by some fund managers. For example, Blackstone have launched a public non-listed REIT product targeted at non-institutional investors. Although not an eREIT, an important characteristics of the product is its lower fee structure compared to similar products in the market, with Blackstone stating that it will not distribute the product through traditional IFA channels.

The RE crowdfunding industry has also highlighted the demand by HNWIs, sophisticated and accredited investors to gain exposure to a portfolio of discretionary higher-yielding RE investments, through taking an investment share across a range of individual projects that are asset-managed by the platform. In this respect RE crowdfunding is addressing a gap in the market as these investors are not large enough to participate in private non-listed funds, principally targeted at institutional and ultra HNWIs, with high minimum investment thresholds. Investing in individual assets in the direct market can result in high levels of specific risk unless the investor has sufficient capital to build a diversified portfolio. It also requires a high level of RE asset management expertise.

Again, this represents a market opportunity and there are signals that the CRE industry is developing products and services that respond. For example, R^2 Crowd is a RE crowdfunding platform in Canada, offering value-added investments in CRE debt secured by CRE assets, including development and standing investments[44]. The company has a strategic alliance with JLL and its founders form JLL's CRE debt advisory platform in Canada. Similarly, the Chairman of CBRE Group, Ray Wirta, is a founder of crowdfunding platform Rich Uncles in the US[45]. While institutional investors have not yet established RE crowdfunding platforms, their fixed income operations are using crowdfunding as a conduit. Moreover, Aviva France recently announced its joint venture, Prêtons Ensemble with Eiffel Investment Group and insurer AG2R La Mondiale, as a crowdfunding platform offering loans to SMEs[46].

[44] www.r2crowd.com
[45] www.richuncles.com

6. IMPLICATIONS, OPPORTUNITIES AND THREATS FOR THE CRE INDUSTRY

The RE crowdfunding market also emerged in response to a gap in the provision of capital to certain segments of the RE market from traditional lenders.

This market opportunity varies across countries depending on the structure of the wider debt market, the legacy of the GFC and differences in how national regulations implement Basel III requirements to risk weight assets. In the US, the funding gap has been for small investments in secondary markets and for subordinated debt and equity products for SME development projects. This is also true for the UK, but there is also a funding gap for bridging and development finance to SME developers and for professional SME buy-to-let developers and investors. This enables RE crowdfunders to develop relatively low risk investment products that offer investors a higher-yielding investment relative to savings, while providing finance to SMEs at affordable margins.

Indeed, the direct investment structure of RE crowdfunding also disintermediates debt arrangement and advisory fees, reducing the cost of borrowing as well as boosting the returns from lending. The transparency of lending terms across RE crowdfunding platforms also aids competitive pricing. Currently, the CRE crowdfunding market is dominated by SME sponsors, but the capital-raising activity of large companies in China demonstrate that the market represents an alternative source of funding for all investors. Indeed, in the US, a number of large developers have begun testing the market, offering small tranches of debt to the crowd.

Of course, the demand for RE crowdfunding has also emerged in a very low interest rate environment that has driven investors in search of yield. Equally, regulatory requirements in the post-GFC era result in wide margin spreads across the risk spectrum. These two factors underpin the demand and supply of RE crowdfunding. This young market has yet to experience a full RE cycle or a normalised interest rate environment. It remains unknown as to whether investors searching for above-inflation yields will sustain their appetite for higher-yielding asset classes as savings and other fixed income rates increase once the path to interest normalisation begins. Similarly, it is uncertain if the current wide spreads between lending margins across the risk spectrum will be sustained as interest rates eventually rise. If they narrow, this may negatively impact investor demand and if they are sustained, they may not prove commercially viable for sponsors.

Interest rates are expected to stay low and remain below trend beyond the mid-term horizon, even after the path to normalisation is started. As a result, RE crowdfunding is anticipated to continue to experience strong growth over the same period in terms of investment volumes, although the market is expected to consolidate over the same period in terms of number of platforms. The use of technology to create innovative RE products and services is likely to endure into the longer term, as it offers efficiencies for those seeking, managing and investing in RE capital. Established stakeholders in the CRE market have the opportunity to understand the factors underpinning the growth of RE crowdfunding and use that knowledge to enhance their own business models and capitalize on their brand value.

[46] http://www.crowdfundinsider.com/2016/07/87516-insurer-aviva-france-lend-e50-million-smes-crowdlending-platforms/

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