The Issue

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Crowd Funding in Real Estate – An emerging change in how people make investment decisions

Is the allure too dangerous?

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Have you ever wanted to invest in real estate but didn't have enough money, or couldn't find the right deal, or didn't know how to do it? While the three rules of buying real estate may be location, location and location, the rules of investing in it are a bit more complicated.

Real estate investment has been around for centuries and the methods are as varied as the individuals and businesses that participate in it. However, recently it seems real estate investing is everywhere; on the radio, on TV, conversations with colleagues at work and especially on the internet. What's driving this is the popularizing and democratization of real estate investing through "crowd funding." While the term is new to real estate investing, the concept of crowd funding is not. Its popularity seems to have arisen just because it is an activity conducted on the internet and the promise of yet another industry disrupted by the internet. Although the term "crowd funding" conveniently describes the practice of groups of people pooling their investment money for a common purpose, most would agree that pooling is not new to real estate given the long history of REITs. Nor is just being delivered via the internet a sufficient reason to make an investment decision.

The Regulatory Environment

Real estate investments fall under the same rules and regulations as stock investments. The practice of people pooling their money to fund a project that is either out of the financial reach of each of them individually or beyond one individual's risk tolerance is not new. Prior to the internet the private pooling of funds was limited to word of mouth among sophisticated investors, people who could afford to lose their money and were willing to take the risk.

In fact, because of the many varied forms of investor pooling and the fact that the participants often do not know each other and are relying on the skill and expertise of another person to produce a profit for them, this activity is highly regulated by the government.

Under the Securities Act of 1933[i] any offer to sell securities must either be registered with the United States Securities and Exchange Commission (SEC) or meet certain qualifications to exempt them from registration. There is also an intrastate exemption, which requires that the offer and sale take place entirely within a single state in which all the investors reside. In many respects state laws mirror the federal laws regarding full disclosure and transparency.

A primary intent of the original 1933 Act was to restrict aggressive promotion of securities, particularly to unsophisticated investors. The Act limited sales to qualified or accredited investors. These were people with over $1 million in net worth (excluding their primary residence) or who make over $200,000 per year. Small (read "unsophisticated") investors were protected by being barred from solicitation. Thus abuses that lead to the 1929 stock market crash were corrected (there were other provisions of the 1933 Act that were vitally important but not necessary to understand the risks of crowd funding in real estate).

Things worked relatively well for eighty years. Then the internet, disrupting entire industries, introduced "crowd funding" to real estate investment. To update the law, in 2012 Congress passed the Jumpstart Our Business Startups (JOBS) Act which was intended to encourage funding of small businesses in the U.S. by easing various securities regulations (for our early analysis of the JOBS Act see our blog "Trending News: Equity Crowd Funding Update", Oct 2013). In October, 2015, the SEC adopted final rules to permit companies to offer and sell securities through crowd funding and proposed amendments to existing rules to facilitate intrastate and regional securities offerings.[ii]

Note the careful wording, there is a distinction between having access to an offer of exempt securities and actually purchasing the securities. The new law relaxed the rules regulating the offering of securities. It did not relax the anti-fraud provisions and the qualification of the investors.

Crowd Funding of Real Estate

Although crowd funding is closely associated with tech startups, the practice has found a niche in real estate investing. Residential house flipping is a good example. Between September, 2013, when equity crowd funding was first permitted under the new SEC rules, and September of last year (2015), investors put about $870 million into crowd funding platforms tracked by New York data provider Crowdnetic. Nearly a quarter of that amount, $208 million, went into real estate projects. That's more than bio-tech, alternative energy, tech wearables, online gaming and social media startups combined.[iii]

In traditional real estate investing, there are private and public investments of both debt and equity. That makes four general possible types; private debt, private equity, public debt and public equity. Pooling of investors to make the overall investment (aka crowd funding) has traditionally been called syndication.

Like any other type of crowd funding for profit, real estate investment opportunities are regulated by both state and federal laws. Similar to Kickstarter and Kiva, there are many online investment websites, like Realty Mogul, Patch of Land and others, specifically for the real estate industry.

Syndication Process

The first ingredient for a real estate syndication is a syndicator, promoter, or sponsor, all terms meaning the same thing. This individual or company is in charge of finding, acquiring and managing the real estate. They have a history of real estate experience and the ability to underwrite and do due diligence on the real estate. The other party is the investor group, the individuals who invest with the syndicator. They get all the benefits of investing directly, but they are not involved with acquiring the property, arranging financing, and day-to-day management.

Just like traditional syndicates, online crowd funding websites pool capital from different persons in order to form investment groups. The internet merely allows those syndicate participants to be much more diverse and allows them to find investment opportunities more easily.

It's important to read all the details on real estate crowd funding sites because what you actually own after you invest your money on each of these sites differs. Investors in crowd funded properties can pick among retail outlets, office buildings or multi-family residential developments. For example, if you invest on Realty Mogul, you'll see that the company does two types of investments: equity and debt. When you invest in equity, you own actual shares of a company or project. So, you would own part of a house or a building. You make money either through cash flow from rent or proceeds from the sale of the building.

If you invest in debt, you don't own a building. Instead, you own a part of a loan made to purchase it. The owner of the real estate has to make periodic payments on the loan and you would receive your share of this payment or a fixed percentage as structured by the crowd funding site. Sites like American Home Preservation invest in distressed mortgages, loans made to people having trouble making their mortgage payments because of financial hardship.

Crowd funded debt is popular among flippers, investors who buy with a short term vision of making quick renovations and selling the property for a profit. Traditional mortgage lenders won't lend on these types of properties. They want to know a borrower's individual credit history and income, and probably wouldn't allow a borrower to have loans outstanding on several properties at once, a common practice among flippers. So, most house flippers rely on their own funds or a mix of small private lenders, wealthy investors or friends and family for capital. It's hard for them to raise capital beyond their close network. Today's crowd funding platforms enable flippers to tap a much larger investor network.

These crowd funding platforms guard against risk by securing the loans to the property and lending for less than its full value. If a borrower goes bust, the lender takes title to the property, which, in theory, can be sold for more than the loan principal. PeerStreet, for example, will typically only lend about 75 percent of a home's value. Rather than looking at income or tax returns, they look at the value of the property.

And while house flipping might not have the pizazz of the tech sector, according to Eric Smith, director of data analytics for Crowdnetic, it's a relatively safe bet compared with the risky world of startups. Real estate is a tangible asset that provides the security for the hard money, short term loans. For investors, the steep interest rates ranging from 8 percent to 13 percent on an annualized basis translate into attractive yields.

But people without real estate investing experience should exercise extreme caution. Some properties estimate sky-high returns upwards of 13% to 17% after an investor sells his share. A typical investment holding period for each investment ranges from five to 10 years.

If it sounds too good to be true, it might be. There is significant risk associated with crowd funding properties. For one thing, risk on investment projects is evaluated by the prompters of the crowd funding platforms themselves. Unlike traditional stocks and bonds that are valued by external credit rating agencies, real estate crowd funded investments do not offer third party, objective opinions on the associated risk. Also, like all real estate, these projects are relatively difficult to sell in secondary markets. So, once you are in, you are in for the long haul.

Conclusion

Given the advent of crowd funding, it is likely that smaller investors will increasingly use real estate crowd funding sites to follow institutional investors in allocating much of their real estate investment into private pass-through entity syndicates, as opposed to less tax-efficient vehicles such as REITs. Because crowd funding sites provide these investors with pass through structures that have the full benefit of real estate ownership, they can take advantage of the depreciation, interest, and other deductions typically available from commercial real estate investments.

Investors able to offer only $10,000 to $20,000 have traditionally been left to REITs. Now, internet crowd funding has enabled smaller investors to participate more broadly in specific real estate projects. Large numbers of unrelated investors can pool their contributions and make a significant investment through a single legal entity, keeping things easy for the sponsoring syndicators while broadening the source of potential investors.

The significance of the crowd funding movement is that now the advantages of real estate investment are much more widely available to average accredited investors. While these platforms are open to anyone who meets the criteria for an accredited investor, presently one whose income is more than $200,000 annually or has a net worth of at least $1 million, leading crowd funding sites allow investors to participate in significant commercial real estate opportunities for minimum amounts of just $5,000 or $10,000, which allow for greater self-directed diversification than previously available in most private real estate syndications.

These sites can also provide investors with access to specified properties, not just blind pools, and the ability to diversify along multiple property types and across different geographical areas. These investors can now browse through investment opportunities in larger multi-family apartment buildings, retail shopping centers, office buildings, and self-storage facilities. The better sites also allow investors to track their portfolio properties to stay informed about their account value, earnings, and property updates, all from their laptop or tablet computer.

Answering our title question – Is the allure too dangerous? For the unsophisticated investor unfamiliar with complex real estate transactions and little appetite for study, yes. However, the internet and crowd funding have opened up a whole new class of investment for those willing to do their homework and profit handsomely.

[i] The Securities Act of 1933. A Regulation D offering is intended to make access to the capital markets possible for small companies that could not otherwise bear the costs of a normal SEC registration. The regulation is found under Title 17 of the Code of Federal Regulations, Part 230, Sections 501 through 508. The legal citation is 17 C.F.R. §230.501 *et seq*.

[ii] *"SEC Adopts Rules to Permit Crowd funding".www.sec.gov. Retrieved 2015-11-20.*

[iii] *House flippers turn to crowd for funding, Financing platform finds real estate niche*, By James Rufus Koren, Los Angeles Times, February 21, 2016

[iv] Christian Fuentes, a Los Angeles Area real estate agent and house flipper.

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Practice Areas: Real Estate Development & Construction (Lead); Small Business

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