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Crowdfunding: Opportunities and Challenges - Is it My Next Funding Source/Investment Or a Big Risk?

This is a summary of the February 25, 2016 meeting of the ULI Chicago District Council, which gathered at the Union League Club in Chicago to hear an expert panel of professionals discuss opportunities and challenges of crowdfunding in the real estate marketplace.

Topics on this alternative source of capital for developers and investors included the differences between real estate crowdfunding platforms, how developers access crowdfunding sources, risks to both investors and real estate owners, and types of transactions that are attractive to retail investors.

The moderator for the session was Ronan Remandaban, *Co-Founder and CEO* of Liquideed. Panelists were Michael Episcope, *Principal*, Origin Investments; Jordan Fishfeld, *Chief Executive Officer and Co-Founder*, PeerRealty; and Brock Tomlinson, *Real Estate Senior Associate*, Fundrise, who participated from New York via Skype.

Although it is still in the fledgling stage, crowdfunding has already begun to have an effect on the real estate investment community. Its transparency, focus on web-based communications, and accessibility to a wider net of investors is challenging longstanding industry paradigms.

At the same time, the $2.5 billion piece of the market that was projected during 2015—up from $1 billion in 2014, according to research company Massolution—represents a tiny piece of the pie.

In his opening remarks, Jordan Fishfeld said the market surpassed that $2.5 billion projection last year, with a significant portion “on the debt side” and an estimated $200 million to $400 million in traditional equity.

“(This is) really an explosive industry, really exciting opportunity and one of the great things that we’re starting to see is the institutionalization of this marketplace,” he said.

Crowdfunding’s emergence included a milestone last March, when the Securities & Exchange Commission voted to adopt Regulation A+, “giving issuers the option of a ‘mini-IPO,’” according to a **PeerRealty.com timeline** of key 2015 developments.

An upcoming step in crowdfunding’s evolution is the mid-May launch of Title III of the JOBS (Jumpstart Our Business Startups) Act, which will **allow small individual investors to buy shares of startups and small businesses using crowdfunding platforms**.

Michael Episcope, whose firm recently changed its name from Origin Capital Partners, said technology has enabled the reduction of minimum investment thresholds from $500,000 to $50,000.

“The Internet knows no boundaries…we can offer an institutional product to people who can really use it,” Episcope said. “It really does open up endless possibilities.”

Also, by having 2,000 to 3,000 investors, “we can create a tremendous amount of balance sheet value for Origin as well, and create value for team members,” he added. “…we made the conscious decision that we’re going to get onboard and we’re going to help shape an industry, move it forward and be one of the leaders in the industry.”

Until now, individuals—short of having $10 million to $20 million in investable assets—have not had access to “the types of all your real estate that you should,” said Fishfeld.

Now, however, someone with $500,000 in assets and a net worth of $1 million can take part in crowdfunding, which offers an investment diversification that “can help flatten out” the volatility of the stock markets, he added.

Debuting in 2012, Fundrise was one of the first in the real estate companies to embark on crowdfunding, as its founders sought to parlay a development background into their own development, noted Brock Tomlinson.

One of its recent significant developments is the **establishment of the worlds’ first online Real Estate Investment Trust (REIT)**. The so-called “eREIT” raised $20 million in just over one hour, with 47,000 people on a waiting list, said Tomlinson.

REITs generally lower the cost of capital, he added, and the company is in the process of establishing its third fund.

“Our platform is less about individual opportunities… A lot of what we buy never hits the market, because we’re buying things for a fund, we’re fiduciaries for a fund,” Tomlinson said. “So a deal that is maybe $5-$7 million will only be offered to our internal investors.”

One recent offering of $12.5 million overall included $3 million that was “put online” for new investors to participate in, he added. Mostly, though, “what we’re trying to sell is…to build trust with investors,” said Tomlinson. “That’s what this is all about.”

With more than 100 crowdfunding platforms working on thousands of deals, “there has to be a shift in focus from the deal to the operator,” said Episcope. “Anybody who’s in this business

understands that the risk is not in what you invest in, but who you invest with… Do the diligence there and everything else will fall into place.”

Tomlinson echoed the point.

“A lot of our underwriting is vetting the sponsor…especially where we are in the market cycle, we want to make sure that we are working with the best and brightest,” said Tomlinson. “We want to make sure that it has a proper debt yield that will support our position.”

Moderator Ronan Remandaban asked Episcope about the **Iroquois Club**, a Naperville apartment and condominium complex that is being crowdfunded.

Origin raised $12.5 million equity on the $38 million deal for 238 of the 264 units on Naperville’s east side. The firm is attracted to the suburb, he said, in large part because the supply of new suburban units over the next couple of years is 300, in contrast to the “slugfest” in downtown Chicago with 8,000 units being added.

Episcope and his Origin partner, David Scherer, have a cumulative investment stake of over 30 percent in their deals and that alignment is one of the most important things,” Episcope said. “When you’re investing, make sure the sponsors are not just putting in a few percent, but that they’re actually in it for the same reason you are.”

One innovation that Origin has emphasized is much more rapid reporting of real estate transactions to investors. Whereas previously investors may get news 45 days after a quarter wraps up, now they may find out a few days or upwards of a week later, said Episcope.

“What an unbelievable client service tool and a way to differentiate ourselves with our clients,” he added. “We’ve heard from (investors) time and again, this is now setting the bar. That is what crowdfunding is bringing to the market—another level of transparency, another level of client service. It’s pushing the entire industry in a new direction.”

Real-time sharing of information, said Fishfeld, enables everyone to price and value assets on an ongoing basis: “For us, that was the key that really drove this concept of providing liquidity to the limited partnership and to the minority position in the real estate market.”

As a technology company, much of PeerRealty's focus, Fishfeld continued, is "on how this technology can really assist the real estate industry in bringing those investments down to Main Street investors and also provide the ability to re-balance and re-allocate throughout the life cycle of your investment."

As for the effect that "bad players" have on the crowdfunding space, Fishfeld noted that the "percentage of fraudulent opportunities is far diminished when you bring light on the industry."

"That's the entire thesis around online capital raising is when it's on the Internet, and you're doing something that the entire world can see, you really have to be careful with what you say and how you present things," he added. "…If anything, I think there's a greater compliance mechanism to ensure transparency of information and truthfulness."

Episcope said there are "bad actors in every business when you're dealing with capital out there."

"We just have to be careful that politicians don't have a knee-jerk reaction," he continued. "…this is a very beneficial move, and beneficial to the consumer, and it's (a matter of) consumer beware out there, and buyer beware, and know who you're investing with."

He also issued a caution about those who aren't necessarily fraudulent, but are "not good at what they're doing" and are prone to overpromising: "People are falling for puffery or mis-marketing."

Overall, he stressed, "consumers benefit in larger ways than they ever have before," and to avoid pitfalls, they should conduct due diligence on those with whom they are entrusting their funds.

During an extensive question-and-answer segment, panelists addressed a range of topics that audience members raised. Among them:

*The existence of various niche crowdfunding portals, any of which can be a fit based on one's focus.

"Find what you're needing and then go out and search the portals that exist in that space," said Fishfeld. "Then look at the deals they've done, talk to the sponsors they've worked with, do due diligence…as you would with any private equity fund."

*Fundrise's role in the crowdfunding component of the Whole Foods Market that is opening in Chicago's Englewood neighborhood later this year.

It **amounted to $500,000 of the $15 million project**, and included some complicated facets revolving around tax credits. “The complexity of the deal didn’t deter us from being involved,” said Tomlinson.

*Management or service fees that are assessed to investors. Generally, fees among crowdsourcing platforms are lower than traditional firms, Fishfeld said.

Beyond that, Episcope warned, “This is not an industry where you want to go bargain hunting on the fee side and get the lowest cost provider. Real estate is an inefficient asset class, and the difference between a great manager and a poor one can be the difference between doubling your money or losing everything.”

For example, said Episcope, investors should realize that a firm that charges sufficient fees is better able to attract and retain quality employees.

*The future of crowdfunding.

The niche is in the “warmup stage,” according to Episcope, who likened it to the Internet’s impact on retail since its advent in the early 1990s. While it has been a disruptive force, particularly in certain categories, the Internet’s retail market share is still only 7 or 8 percent.

“We are growing at triple digits, but it’s from a very small base and we’re going to sort of eke into the market,” he said. “…capital is a commodity and it’s always going to find the lowest cost provider. So that will continue to move online and $2 million today becomes $5 million, becomes $20 million.”

“Somewhere in the chain, you’re going to have to continue to add value,” Episcope continued. “If you’re commoditized, you’re going to have to embrace what’s happening and get ahead of that.”

Tomlinson and Fishfeld concurred, with Fishfeld noting that the category has been legal for only the past four years or so, and “one of the major components of the legislation is still not enacted.”

He added that the broker-dealer network in private REITs, as well as the direct investment space through that broker-dealer network, “are terribly inefficient” and “there’s a lot of opportunity for that marketplace to be disrupted” with investors increasingly able to channel their money directly to an asset.

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