

The future of crowdfunding

As has been noted throughout *The Comprehensive Guide to Real Estate Crowdfunding*, crowdfunding has developed into a successful capital raising source in the commercial real estate industry. Research from GowerCrowd has shown that real estate crowdfunding transactions increased from \$7 billion in 2019 to \$15 billion in 2020 – tremendous growth for an industry less than a decade in the making and demonstrates the demand for real estate as an asset class among individual investors.

So, as the real estate crowdfunding market begins to mature, what might we expect in the future? Let's start by looking at common real estate crowdfunding business models and then draw some parallels to the financial services industry that evolved quickly following the deregulation of stock commissions in the mid 1970s, which paved the way for how we buy and sell public securities today.

Digital Syndicators, Asset Aggregators and Hybrids

Real estate crowdfunding has two basic business models, but the lines are beginning to blur between the two and there are certainly variations. On one side of the spectrum, there is digital syndication. In this scenario, a company creates a two-sided marketplace. The platform sponsor is soliciting real estate sponsors – people who need to raise capital – and also marketing to investors to raise capital.

Examples of these types of crowdfunding companies are CrowdStreet and RealCrowd. Typically, in this scenario, the crowdfunding sponsor collects a fee for “digitally syndicating” the investment offering. The practice of someone acting as an intermediary to find investors for someone else’s project has been around for hundreds of years, but it has now gotten easier thanks to technology. Though digital syndication is relatively new, the act of syndicating real estate deals is age old. The syndicator in either context is a financial intermediary who collects a fee but may not be around for the life of the investment.

At the other end of the crowdfunding spectrum lies asset aggregation. With this business model, the crowdfunding sponsor raises capital and buys assets that are owned by the platform and/or platform’s sponsor, typically structured as a fund or a REIT. The platform sponsor sources and acquires real estate assets in the open market and raises capital from investors to help fund the cost of purchasing the properties. In this business model the real estate crowdfunding platform is taking title to the underlying assets and intends to manage the assets for the life of the hold period.

Examples of these types of crowdfunding companies are Modiv and FundRise. But there are differences in how they can be structured. For example, when you invest in Modiv, you own Modiv, meaning all of the real estate *and* the fintech crowdfunding platform. The employees work for the platform – not a third-party, external manager – which may help keep incentives aligned.

When you invest in FundRise, you own the real estate (the fund), but fees are paid to the external manager. The investor doesn’t actually own FundRise (the company) and the employees work for FundRise, not for the fund, which acts as the external manager.

Hybrid business models attempt to blend syndication and asset aggregation - resulting in the best and worst of both models. This business model typically matches investors to third party

sponsors (syndication) but do so via a fund they create to retain assets under management (aggregation). While this business offer may offer the greatest range of selection, the vehicles they use are effectively fund of funds which can be subject to double layers of fees. Hybrid crowdfunding platform examples include RealtyMogul and EquityMultiple.

All of these approaches can have pluses and minuses, so be sure to conduct your own due diligence to best understand which approach is most suited for your investing strategy. Keep in mind that any investment, including those in commercial real estate, a REIT or crowdfunding platform, is speculative and involves substantial risks, including illiquidity and complete loss of invested capital and there are no guarantees dividends will be paid.

The Evolution and Convergence of the Financial Services Industry May Provide Hint to the Future

When looking at the evolution of the financial services industry, there are a number of parallels to the crowdfunding industry.

Let's start with the May Day Act of 1975 which allowed the U.S. government to deregulate stock commissions. Prior to that, stock commissions were set at predetermined levels and the system was regulated, just like AT&T used to regulate the telecom industry and the Civil Aeronautics Board regulated airline prices.

Shortly after the May Day Act, Charles Schwab started the Charles Schwab Company. Schwab was a discount brokerage offering trading at a lower cost. Around the same time, Merrill Lynch increased their stock commissions.

Many industry pundits believed that discount brokerage wouldn't be able to last. They argued that it was expensive to trade stocks, professionals were essential for trading and there were inherent costs and expenses that couldn't be reduced. They foretold the end of discount brokerage.

Fast forward to today and their predictions obviously did not become reality. In fact, investors are now accustomed to paying zero commissions when buying and selling stocks. Investors can trade stocks easily with very little cost with the likes of Schwab, Vanguard, Fidelity and Robinhood. The use of technology made this possible - driving down costs and increasing investor access - two qualities that we are witnessing in real estate crowdfunding today.

There was a plethora of discount brokerage shops that started in the late 70s, 80s and into the early 90s, not unlike what's happened in real estate crowdfunding. But what started happening? Some consolidated. Others went public or listed on a stock exchange. And then there was further consolidation. While there are fewer discount brokerages today, that business model is an industry standard and widely accepted.

There has also been a similar evolution in the mutual fund industry. John Bogle, the founder of Vanguard, started offering a no-load (i.e., commissions) mutual fund in the late 1970's. Prior to that, there were mutual funds where an investor might be paying 3% or more in upfront commissions (also known as front end loads), reducing the amount of the investor's dollars actually being invested.

Bogle turned that approach upside down. His approach was to remove the load charge and, instead, run his business cost-effectively so more of each investor's dollars were invested. Again, the pundits said this business model wouldn't work. And again, the pundits were wrong.

Today, low- or no-load mutual fund structures, and their exchange traded fund (ETF) offspring, are the industry standard. In fact, you really have to go out of your way to pay a load on a mutual fund today.

Industry Parallels

Crowdfunding



Why so much background on stock brokerage, mutual funds and financial services?

Turns out, there are interesting parallels.

As a brokerage firm, Schwab started out as a syndicator, like CrowdStreet today. Vanguard was basically an aggregator, like Modiv is now.

Over the past 30-plus years, Charles Schwab began offering mutual funds and other financial products (i.e., asset aggregation). At the same time, Vanguard began offering brokerage services (i.e., syndication). Now you can use their platforms to invest in their products, buy other products or trade stocks. But when these companies started out, they were at opposite ends of the spectrum, and they were not readily accessible. There was a lot of competition and, ultimately, a lot of consolidation. What they provide today is considered mainstream: providing access to investments at a reasonable cost to millions of investors.

That storyline, or parallel path, is what's relevant to crowdfunding. Some industry experts believe that real estate crowdfunding today is following a similar path that discount brokerages and mutual fund companies took. That could result in different business models converging so that platforms will provide both asset aggregation and digital syndication. Competitors may start to consolidate and, eventually, some of them could become publicly traded companies - just like we witnessed in the financial services industry. Over time, accessing commercial real estate at a low cost could become just as acceptable as trading stocks with no commissions.

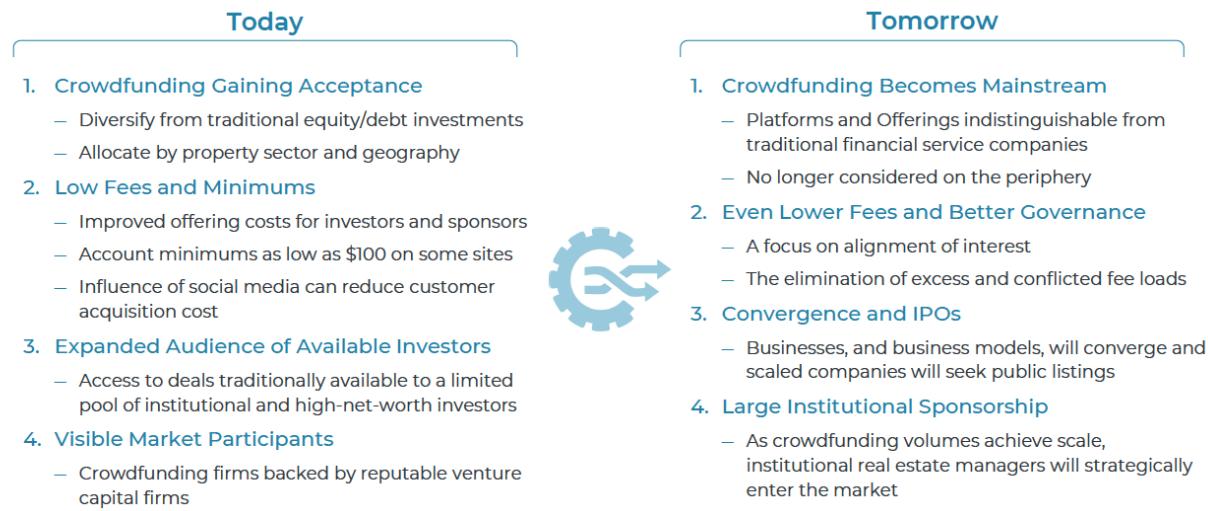
Tomorrow may very well see crowdfunding become even more mainstream.

Mainstreaming could drive down fees and inspire better corporate governance that more closely mirrors what investors expect from mutual funds and stock brokerage accounts. As the line blurs between syndicators and aggregators, consolidation and the creation of larger, public companies becomes a possibility. And as we've seen in the non-listed REIT space, large institutions may

seek to enter the market creating another channel to reach retail investors and grow their assets under management. It also provides more opportunities for individual investors.

“I think the industry is heading towards more personalization,” predicted Matt DiLallo, who covers the real estate crowdfunding industry for Millionacres. “Eventually, anyone might be able to build a real estate portfolio that suits their tastes. For example, I personally think it would be exciting to buy stakes in vacation rentals in some of my favorite vacation spots or invest in a redevelopment project in my town. Crowdfunding could one day make this investment dream a reality for more people.”

Crowdfunding Tomorrow



Time Will Tell

Obviously, none of us has a crystal ball that will reveal what the future holds. With rapid growth, better access for investors and more sophisticated sponsors – as well as the parallels with financial services – the industry appears poised to come into its own. Whether that’s in five, 15 or 50 years, only time will tell. In the meantime, investors have the opportunity to enjoy the potential benefits that commercial real estate may provide, much easier and more cost effectively than just 10 years ago. That is something we can all be pleased with.