

INTRO TO MODERN REAL ESTATE INVESTING FOR INDIVIDUAL INVESTORS

Introduction

It's an exciting time to be a hands-on investor. Online platforms are delivering more and better solutions for individuals who seek access to a broad array of assets, and new options for diversification.

This whitepaper takes a look at the modern real estate investing space, and key considerations for individual investors as they choose from a growing set of online real estate investing platforms. If you have any questions along the way, please don't hesitate to reach out to us at info@equitymultiple.com.

A Note on Nomenclature

Real estate investing has changed dramatically since the JOBS Act of 2012 - this landmark legislation opened the door for platforms like EQUITYMULTIPLE to offer private, passive commercial real estate investments to individuals, vastly expanding access to an asset class that was previously available only to ultra-high-net-worth individuals and institutional investors (such as pensions, endowments, and hedge funds). But the new investing paradigm - and value to individual investors - is still poorly understood. This is partly because the term "real estate crowdfunding" remains the dominant term for the industry, and "crowdfunding" is inextricably linked with Kickstarter and IndieGoGo; you may associate it with a couple kids raising money for a t-shirt company when in reality most "real estate crowdfunding" platforms only offer investments to accredited individuals, and source investments from experienced real estate firms. (For this reason, we often refer to our product as "modern real estate investing", rather than "real estate crowdfunding").

That said, the term "real estate crowdfunding" refers broadly to online platforms that offer private real estate investments to individual investors, typically with investment minimums that are a tiny fraction of what it would cost to acquire a commercial property on one's own. Companies like eTrade made it easy to buy a stock online, and companies like Betterment created platforms for buying ETFs and amassing a passive index-tracking portfolio. EQUITYMULTIPLE and other 'real estate crowdfunding' platforms similarly lower the barrier to entry for individual investors seeking exposure to commercial real estate. ***This whitepaper will refer to 'real estate crowdfunding' and 'modern real estate investing' interchangeably.***





What is “Real Estate Crowdfunding”?

Though different models and value propositions to investors have evolved, there are some consistent industry themes. Here are some typical features of modern real estate investing platforms:



Relatively low minimums

While pre-JOBS-Act commercial real estate investing was typically carried out between one or several ultra-high-net-worth individuals, a family office, and/or a hedge fund at a starting check size of \$100k or much higher, this new investing paradigm allows individuals to access the same kinds of projects for as little as \$10k, and sometimes less.



Online Transactions

Like roboadvisors and ecommerce, modern real estate investing platforms are bringing offline transactions online. This means that individual investors can create a real estate portfolio more efficiently, and can invest in projects across the country from their home. Of course, this mode of real estate investing still carries risk, and platforms vary widely in their quality and offerings. We'll get into this more in a bit.



Discrete Properties

Unlike REITs (real estate investment trusts), modern real estate investing platforms allow for fractional investments in distinct properties.

Different Kinds of Real Estate Crowdfunding Platforms

Commercial Real Estate Equity Crowdfunding

Individual investors can invest a relatively-small amount (typically as low as \$5k) in a discrete, private-market real estate project. The combined capital from individual investors finances the capital needs of a real estate investment firm (a “Sponsor”) or developer. In most cases, the platform provides at least some vetting of investments and Sponsors.

Real Estate Debt Crowdfunding

Individual investors essentially act as lenders, with combined investments amounting to a private loan for a real estate investment firm or developer. Individual investors would earn a flat annual rate of return (much as a bank would). This model has been used for financing both single-family homes and commercial properties.

Funds, or ‘eREITs’

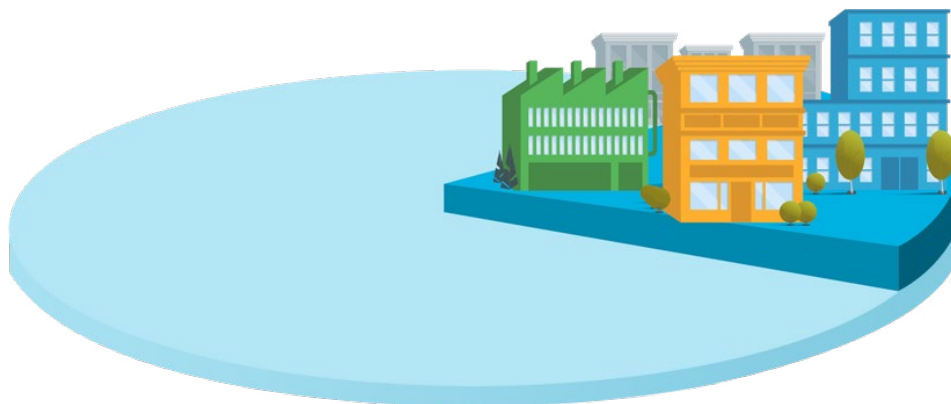
A blind or semi-blind fund, wherein individual investors buy shares of a trust that acquires numerous properties. These vehicles function similarly to the private REITs that have been around for decades.

Posting Platforms

A platform that provides little or no in-house vetting of individual investments, allowing sponsors to post offerings and letting investor demand meet supply from sponsors seeking to raise capital.

We’ll get into the merits of these different models in a little bit.

Note: EQUITYMULTIPLE provides a combination of the first two varieties of real estate crowdfunding.



Further Reading



Why should individual investors participate in real estate crowdfunding?

Why invest in commercial real estate?

This may be familiar to many readers, but it's always worth repeating: portfolios with substantial exposure to private real estate tend to fare better across market cycles than those that do not. This tends to hold true for several reasons:

Public market valuations are driven by sentiment; real estate markets are driven by demand

Public markets (namely the U.S. stock market) tend to fluctuate alongside the collective perspective of investors, and are thus inherently volatile. If investors expect rising interest rates, geopolitical turmoil, or tighter regulations, share prices may well drop in certain sectors or across the economy writ large. On the other hand, people will always need places to live, work, and congregate, so real estate values tend to move more predictably with demographic shifts, and suffer less precipitously during down markets. This is not to say that real estate isn't ever speculative, or that real estate values don't suffer during recessions. But, due to the inherent necessity of the asset class, real estate tends to exhibit less volatility over time. Put differently: real estate is a tangible asset that, barring a disaster, retains its inherent worth through market cycles, and thus provides downside protection.

Attractive Returns

The National Council of Real Estate Investment Fiduciaries (NCREIF) Property Index - perhaps the most commonly-used benchmark for aggregate performance of private commercial real estate - reported an average annual return of 8.8% in the years 2000-2015, 200 basis points better than the S&P 500 over this same period.

Tax Benefits

Tax law dictates that real estate investors may deduct the depreciation of a real estate asset as a passive loss, offsetting other passive income, on an annual schedule of 27.5 years for residential, and 39 years for other commercial properties. The new tax law that went into effect in 2018 shortens CRE depreciation schedules to 25 years across the board (meaning that an investor may use 1/25 the market value of an asset to offset other passive income). This same accounting technique is available to passive investors who invest through platforms like EQUITYMULTIPLE. Additionally, income earned through pass-through entities - such as the LLCs EQUITYMULTIPLE establishes for each distinct real estate investment - is entitled to a 20% deduction, per the new tax law. (Please note that EquityMultiple does not provide tax advice, and each individual's tax situation will vary depending on numerous other factors - we advise all investors to consult a tax professional).

Further Reading 1



Further Reading 2



Why invest via Real Estate Crowdfunding platforms vs. REITs

We often get the question “so, how are you different from a REIT?” Real estate crowdfunding is similar to real estate investment trusts (REITs) in that both vehicles allow individual investors to passively access the commercial real estate asset class for far less than the price tag of direct property ownership, but there are substantial differences between these two modes of real estate investing.

While REITs are blind or semi-blind funds, with management and acquisition decisions made opaquely by the fund’s managers, real estate crowdfunding allows individual investors to direct their own real estate investment decisions, invest small amounts in discrete properties, and effectively build their own custom fund of income-producing real estate. Hence, REITs may be appropriate for investors with less mature portfolios, who want a truly hands-off approach to real estate investing, whereas real estate crowdfunding is more appropriate for those investors who want to dictate which markets, property types, and strategies comprise their real estate portfolio.

Critically, most REITs are publicly traded. On the plus side, this means that these assets are highly liquid, which is great for investors who need more immediate access to money. However, because REITs are publicly traded, they tend to correlate more closely with public equities markets. Hence, real estate crowdfunding can provide a better hedge against public market fluctuations, and reduce the overall risk exposure of a portfolio already heavily allocated to public equities.

Real Estate Crowdfunding vs. Property Ownership

So if a real estate crowdfunding platform presents a compelling investment, predicated on the acquisition of a discrete property, why not instead acquire that property (or something comparable) on your own? Well, at the risk of stating the painfully obvious: because you don’t have to acquire and manage that property. Most investors do not have the local connections, in-depth knowledge, and access to capital to acquire individual properties. And, even for those that do, acquisition of commercial property would both heavily concentrate their real estate portfolio on a single asset (increasing their exposure to risk) and constitute a huge sink on their time and mental energy. In other words, commercial real estate is complex and intensive of time and capital - it is a full-time job. Real estate crowdfunding allows individual investors to invest passively and tap into the expertise of real estate investment firms (the Sponsors raising capital through platforms like EQUITYMULTIPLE) and, thanks to low deal-level minimums, diversify across markets, property types, hold periods, and risk/return profiles.

Real Estate Crowdfunding Vs. Other Forms of RE Investing

	Public REITs	Private REITs	Direct Property Ownership	Real Estate Crowdfunding
Liquidity	✓	✓		
Low Correlation to Stock Market			✓	✓
Tax Benefits			✓	✓
Transparency			✓	✓
Control (Ability to ‘Self-Direct’)			✓	✓
Low Minimum Investment				✓
Passive (someone else deals with management and operations)				✓
Low Fees	✓			✓

Private Transactions & Modern Portfolio Theory

Real estate crowdfunding fall within the broad realm of “alternative asset classes” – investments that are transacted via private markets and offer access to “alpha”, i.e. yield driven by skill of management (as opposed to “beta”, or tapping into broad-based growth in the economy or sectors of the economy, as an index fund would).

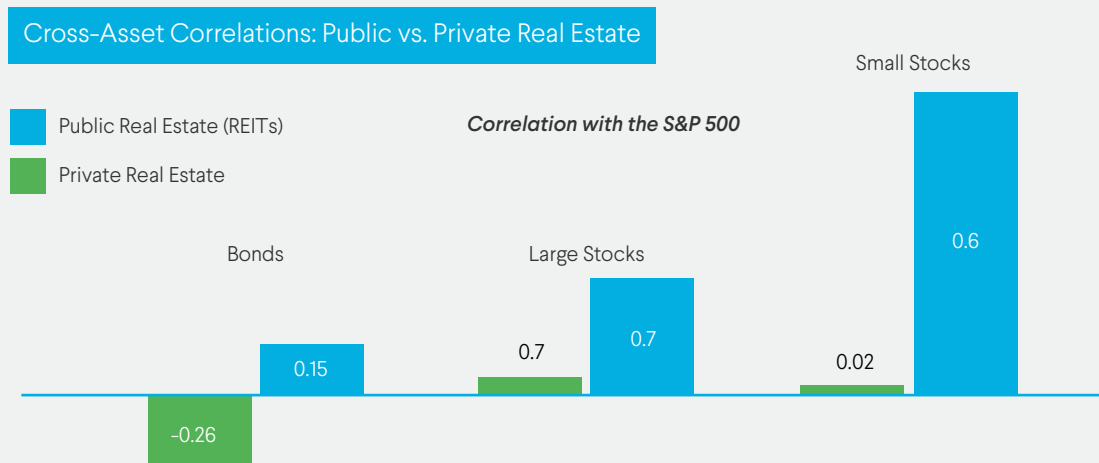
Modern Portfolio Theory, which was popularized by Harry Markowitz in the 1950’s and still provides much of the undergirding of portfolio management practice, recommends that investors seek asset allocation that not only minimizes volatility, but also minimizes cross-asset correlations, thus reducing portfolio risk. When applied to the current universe of available asset classes and their empirical performance and correlations, Modern Portfolio Theory prescribes greater allocation toward private real estate and other “alts” for several reasons:

Increased Volatility Among Public Assets

In the 50 years prior to 2000, there were only 81 days of 3%+ movement in the S&P 500. Between 2000 and 2016, there were 119 such swings. As compared with private real estate, this represents the widening of a volatility gap that has existed for decades: both public markets and real estate markets move cyclically, but public equities tend to exhibit greater volatility over time.

A Lower Degree of Correlation

Practitioners of Modern Portfolio Theory have long advocated for REITs as a method of de-correlating from public equities. While it is true that REITs do offer some diversification benefit vs. stocks, they are typically a publicly-traded asset and, hence, have exhibited significantly higher correlation with public markets than have private real estate investments¹.



So, for a hypothetical investor who already holds 80% in stocks and 20% in bonds, but would like to allocate 10% away from stocks and to real estate, Modern Portfolio Theory dictates that allocating to private real estate (such as investments available via real estate crowdfunding platforms), which correlate less closely to public markets, will reduce overall exposure to risk, even if the investor can expect to earn roughly the same return from REITs as from private real estate.

Proof in the Performance of Institutional Investors

Theory is one thing, but is there any empirical evidence to back the assertion that holding a meaningful portion of private real estate and other alternative assets actually boosts returns over time? Yes, actually. Numerous studies have looked at the performance of prominent endowments (such as Yale University's), and noted that those with substantial holdings in private real estate and other private assets outperform those who don't over time². Historically, individual investors have had little opportunity to access high-quality institutional commercial real estate, and other private investments (such as pre-IPO startups). Since the JOBS Act passed in 2012, however, a number of platforms have emerged to "democratize" certain private asset markets that individual investors have long lacked access to. Modern real estate investing platforms, and other new private asset investing platforms, allow individuals to mirror the portfolio allocation decisions of endowments and other institutional investors, and allocate a meaningful portion to real estate and other private assets.



Further Reading 1



Further Reading 2



Further Reading 3





What new risks are inherent in this new asset class?

To this point, we've been painting a fairly rosy picture of modern real estate investing platforms and, indeed, this new investing paradigm presents an exciting opportunity for individual investors looking to access the asset class.

However, all investments carry risk. Real estate crowdfunding fundamentally exhibits the same set of risk factors as commercial real estate investments always have, which will vary from offering to offering and exhibit some consistent themes. Each platform in the nascent 'real estate crowdfunding' space presents risk factors differently, however, so it can be difficult at times for investors to efficiently and comprehensively understand the risk factors of a specific offering.

For a more comprehensive review of commercial real estate investing risk factors and theory, please review this article from [our learning series](#). Here are some other specific risk factors that are inherent to the emergent real estate crowdfunding asset class:

Information Opacity

In theory, real estate crowdfunding platforms should present investment opportunities comprehensively and transparently – the investment thesis, risk factors, Sponsor track record, summary pro forma, and other key elements of each investment should be laid bare in great detail. Each real estate investment carries its own specific risks, and it's important that investors understand the return potential and risk factors as they make decisions.

Platforms should provide rigorous in-house diligence to provide investors comfort and save them time (at EQUITYMULTIPLE we pride ourselves on our underwriting standards). Nevertheless, it's important that investors have a firm grasp of each investment's attendant risk factors. The bottom line: make sure the platform is presenting investment details fully and transparently. If anything is unclear, ask questions. If a platform is unwilling or unable to answer questions, this should raise a big red flag.

Liquidity Risk

Unlike REITs, modern real estate investing platforms do not offer a high degree of liquidity; debt-based investments typically carry a term of 6–18 months, while common equity investments can carry a term of 5 years or longer. This can be a significant drawback for investors who require more access to cash or who are closer to retirement.

Staying Power: What happens when the top-market euphoria ends?

Since the JOBS Act passed in 2012, the U.S. economy has exhibited steady growth and broad stability, and as of this writing is in the second-longest period of consecutive monthly job growth in history. Real estate markets have fared well during this prolonged period of expansion – with transaction volume peaking in 2015 – but indicators now reflect the possibility that the next stage of the cycle may be approaching, with gateway markets showing signs of frothiness, and rising interest rates looming.

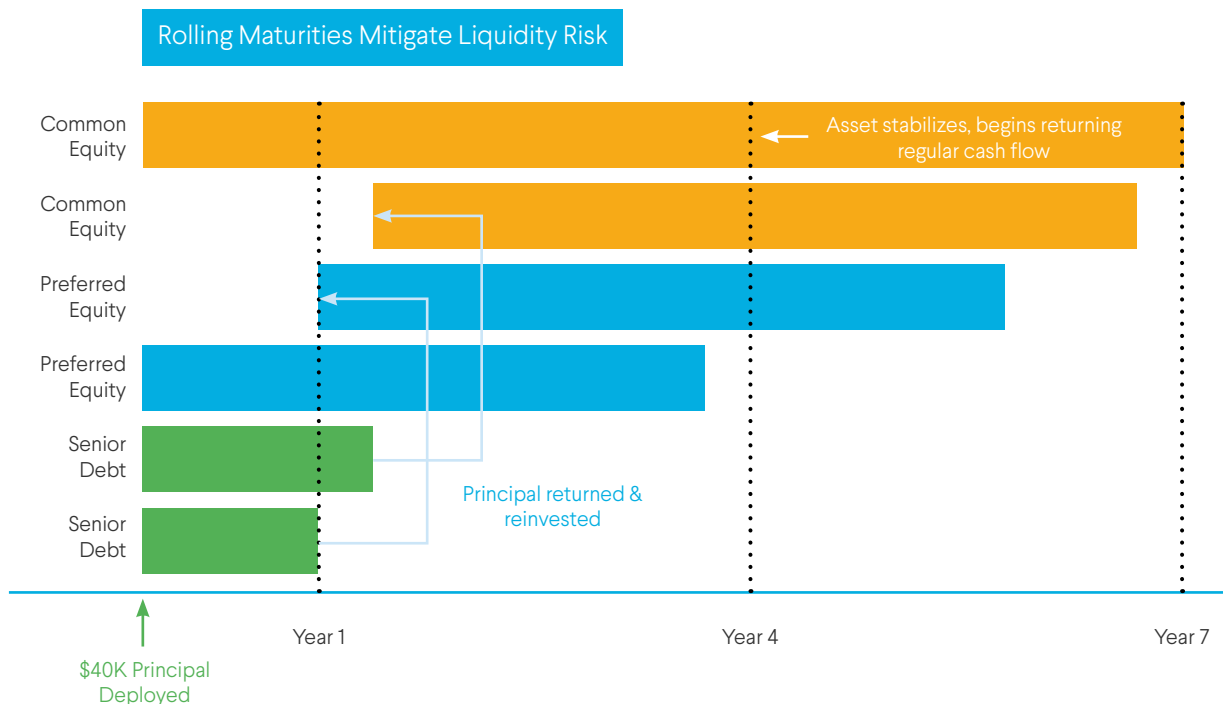
We will see a market correction – it's not a question of “if”, but a question of “when”. There will still be opportunity to find yield in commercial real estate, but those investments may be a bit less abundant in name-brand markets and core real estate subasset classes. Those platforms that continue providing solid value to investors through market cycles will be those with robust, diversified investment pipelines. Similarly, investors should seek platforms with a focus on providing investor protections, and pursuing assets that will perform relatively-well during a downturn (such as self storage or workforce multifamily with a large and varied tenant mix). At EQUITYMULTIPLE, for example, we are increasing our focus on preferred equity investments to give our investors added security in the event of a market correction.

How should I incorporate “real estate crowdfunding” assets into my portfolio?

As with any investment, the primary objective should be diversification. We’ve covered the reasons it makes sense to diversify into private commercial real estate. Individuals that invest via platforms like EQUITYMULTIPLE are also advised to pursue a varied set of commercial real estate investments to mitigate risk. All else being equal, deploying \$50k across 5 properties in 5 different markets, alongside 5 different sponsors, will reduce exposure to risk as compared with a single \$50k investment in one property.

Some investors will seek to mitigate liquidity risk by varying the projected hold periods of their positions, while others will use these low-minimum investments to diversify away from preexisting real estate holdings (if an investor already has exposure to retail via a retail-focused REIT, they may seek to invest in industrial assets via a real estate crowdfunding platform; if an investor already owns rental properties in their own market, they may use real estate crowdfunding to diversify into non-residential properties, and in other markets).

Your portfolio of modern real estate investments should be driven primarily by how comfortable you are with the platform and people behind it and, as a corollary, the investments offered on that platform. In the long run, the aggregate track records of platforms will come into clearer focus, and can inform your investment decisions. In the meantime, take a close look at the experience of the people behind the platform, the quality of transparency and customer service, and the robustness of underwriting standards.

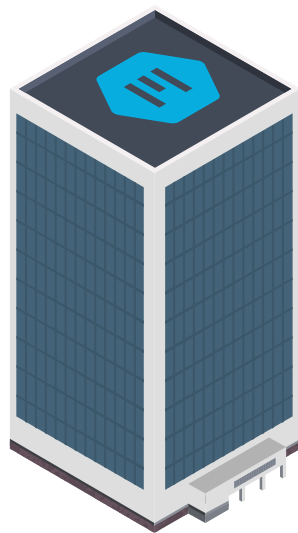


A Final Word: Looking Ahead

Real estate crowdfunding is gaining more legitimacy, both among individual investors who fund investments and the real estate firms looking to tap into a new source of capital. We see this in the growing demand on EQUITYMULTIPLE and investment volumes on other leading platforms, and understand this anecdotally from our customers who were skeptical of the new investment class at first but have grown more comfortable with the new investing paradigm. The nascent industry has posted triple-digit growth in each of the past three years, and we expect to see the same this year, when the dust settles on 2018.

On the other hand, macroeconomic factors are a looming challenge. The longer the market remains strong, the more platforms will be tempted to loosen credit standards to find yield. We will eventually, of course, see a market correction (depending on who you ask, we're well overdue).

In sum, though, we are optimistic for the industry and with respect to prospects for the individual investor. The array of options will expand, while the material performance of platforms will become more apparent, clarifying the decision-making process for investors. In the long run, winning high marks from investors will be less about hitting home runs 100 percent of the time and more about reasonable expectations, sound diligence measures, transparency and great customer service. These are the principles that will continue to guide EquityMultiple as this exciting industry grows and matures.



BUILD A STRONGER PORTFOLIO

End Notes

- 1 <https://gbr.pepperdine.edu/2010/08/private-vs-public-real-estate-markets/>
- 2 <http://www.businessinsider.com/yale-endowment-outperforms-harvard-2014-9>