Real Estate Digital Security Offerings

A Cost-Benefit Analysis

A New World of Real Estate Financing is Emerging

As blockchain technology gains traction around the world, assets that were traditionally reserved for private investors are becoming increasingly accessible. **Digital Security Offerings (DSOs)** - digital representations of real-world assets - are enabling real estate managers to distribute their properties' ownership and capital structure to investors around the world.

The practice is becoming increasingly popular, as it provides numerous benefits to both issuers and investors. To date, there have been 22 issues worth $37 million dollars backed by multifamily and commercial real estate, which is the third most popular asset class to utilize DSOs. DSOs offerings may provide a 3-5% issuance cost savings versus public equity offerings.

In order to best understand how digital securities operate in the real estate ecosystem, we must explore the difference between traditional public equity capital raises, crowdfunding, and digital security offerings.

The real-estate market is a fragmented and decentralized industry with most transactions are done privately and heterogeneously. Hence, the real estate industry is a fertile ground for innovation and disruption.

Crowdfunding and Traditional Public Equity

Real estate crowdfunding is a way for investors to access the real estate asset class without having to buy a property directly or invest in a publicly traded real estate investment trust (REIT). Participants earn a portion of the revenue generated by the property in the form of dividends, which can then be reinvested if they seek to acquire more equity and increase their returns over the course of the investment life-cycle. Essentially, crowdfunding allows issuers to raise capital without having to go public or give away large portions of control.

It is relatively common practice for issuers to offer senior and junior debt backed by the real estate asset, instead of equity. Crowdfunding platforms have been useful in distributing these types of investments. These structures enable issuers to retain full control over the project's key decisions, while usually offering above-market returns for their investors.

Until distributed ledger technology (DLT) became widely available and scalable at the issuer level, most private real estate deals were done through the same old, largely manual private placement processes.

Although private issuers will generally be restricted to accredited and institutional investors, they can benefit from a more efficient distribution process by adopting digital security offerings. We will explore both the monetary and procedural advantages of DSOs in the context of real estate crowdfunding transactions.

DSOs Reducing Issuance Costs and Increasing Flow

Issuance costs are the most prominent concern amongst real estate asset owners. These costs represent the main barrier to fractionalization ownership stakes for investors to acquire. Since public equity raises can be quite expensive (see below) and resource intensive, private real estate managers often lean towards private placements or settle for regular crowdfunding, which do not offer them instant access to investors in different jurisdictions and asset tradeability (i.e. access to secondary markets). DSOs can be a great way to obtain many of the benefits of public markets without incurring the large issuance costs associated with IPOs.

A study by Deakin University outlining the evolution of issuance costs for Real Estate Investment Trusts (calculated with data from all REITS listed on the NYSE, AMEX and NASDAQ from January 1996 to June 2010) shows a mean direct cost of 8.30% of total gross proceeds from the offering. Underwriting alone can cost issuers an average of 6.54% of total proceeds. ***See table 1 at the end of the article.***

Although the cost of raising external public equity has generally decreased over time (from 8.71% during 1996-1999 to 7.15% during 2007-2010), it is still significantly higher than what a digital security offering can cost. In the case of a $50 million deal, an issuer could incur a total of $4,150,000 in issuance costs. An important detail to note is that REIT management expenses (MER) of 1% to 1.5% are charged directly to investors and thus are not included in the aforementioned issuance cost breakdown - instead, they come out of investors' returns. DSOs can offer the same type of widespread access to investors as regular offerings, without costing issuers such a high percentage of their total proceeds. A typical DSO platform's pricing structure can be as follows:

Item	**Type of Fee**	**Price (in USD)**
Issuance Fee	Flat Amount	Up to $50,000
Capital Raising Fee	Percentage of Proceeds	3-5%
DSO Tech Fee	Flat Amount	Up to $50,000
Life-cycle issuance	Ongoing fees	$10,000 per year - NPV of

management[1]		$150,000
	Total ($50 million deal)	**$1,750,000-2,750,000**
	Total as a Percentage of Proceeds	**3.50 - 5.50%**

The trend is quite evident - DSOs can cut the cost for issuers by up to half that of a traditional public equity issue, while offering greater flexibility for market participants. Pricing structures for digital security offerings vary widely across the ecosystem. Multiple platforms are competing for issuers, but some offer highly specialized services, such as sticking to only one protocol, while others fluidly adapt to their issuers' desired issuance model. Overall, the cost savings and transactional advantages of digital securities are clear.

Empowering Investors & Removing Market Inefficiencies

Investors do not have enough open and transparent access to real estate opportunities. While the entire real estate market is worth about $253 trillion, only $2 trillion is available to investors through REITs[2].

A major drawback of REITs is the lack of granularity facing investors. While different investors usually have different risk tolerances, REITs offer a blanket solution, where fund managers select which projects to invest in. In turn, investors have to decide whether to trust the management or not. This is a source of allocation inefficiencies, since risk-averse investors often have to take on more risk than they are comfortable with, and risk-seeking investors have to settle for lower returns than they would normally desire.

DSOs provide the ability to match portfolios to risk levels, while preserving a high degree of transparency. Real estate marketplaces offer a variety of deals, from high-risk development projects (with higher returns, usually around 25%) to low-risk dividend-paying offerings that can often beat equities' returns. These deals usually have a higher level of reliability in their cash flows, since they typically come from rent payments (which are more consistent than equities' dividends). In essence, DSOs are disrupting REITs by offering a cheaper alternative to fundraising that is more efficient for both investors and issuers.

Conclusion

Real estate managers will soon begin to adopt digital securities at a large scale. Tokenization will benefit both commercial and residential real estate investors, enabling them to immediately solidify their returns by having access to secondary

[1] Liquidity and Corporate Action fees paid to DSO issuance platform
[2] Source: Savilles 2017, NaREIT

markets, and will give them access to new investment opportunities without having to undergo some of the resource-intensive processes associated with manual crowdfunding frameworks.

Issuers also benefit from lower flotation costs. When deciding between staying private or doing an IPO, REIT managers can now pick a third option: digital security offerings. By turning their existing offering into a tokenized security, issuers can access a wider, international pool of investors at a much lower cost than they would typically incur by listing on public markets.

Table 1: Breakdown of Issuance Costs for Publicly Traded REITs Over Time

Year	Total Issuance Cost	# of IPOs	Average Proceeds	Gross Underwriting Fees (%)	Other Expenses
1996	8.38%	4	248.89	6.44%	1.94%
1997	8.75%	27	203.05	6.70%	2.05%
1998	8.60%	15	130.86	6.36%	2.24%
1999	10.69%	3	102.33	7.71%	2.98%
2002	9.38%	4	202.05	6.94%	2.44%
2003	8.64%	7	282.03	6.97%	1.67%
2004	8.58%	29	222.59	6.53%	2.05%
2005	8.01%	11	296.93	6.23%	1.78%
2006	8.13%	6	366.23	6.08%	2.05%
2007	7.06%	4	403.89	6.31%	0.75%
2008	7.16%	2	220.00	6.63%	0.53%
2009	6.93%	9	288.90	5.68%	1.25%
2010	7.63%	5	171.80	6.45%	1.18%
Average	**8.30%**	**9.69**	**241.50**	**6.54%**	**1.76%**