The Blockchain and Real Estate: False Promise or Revolution?

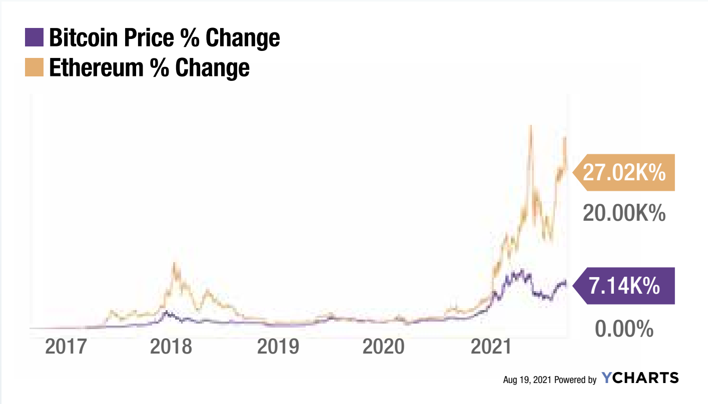
When I think about how excited I am about all the potential of crypto and the Metaverse and couple that with the frustration I experience everyday trying to conduct my real estate business, a world filled with arcane systems and processes, I cannot help but think there is tremendous opportunity here. In real estate the fruit is as low hanging as it could possibly be. Transaction costs are out of control. And it's not just the brokers, who in the residential space are taking an exorbitant 5%-6% of every deal—somebody please disrupt this!—it's also the escrow offices, insurance companies and lawyers who help facilitate transactions. Its systems are antiquated. Has anyone tried to use the MLS lately? Or understand what the zoning code will allow you to build on property? In general, its business processes are confusing and disproportionally non-digital.

To be fair, real estate is a tough industry for innovation. It's heavily regulated, has multiple touch points with government—think about county title record systems, zoning and planning processes, building and safety departments, just to name a few—and relies heavily on the banking sector, which brings its own arcane regulatory overlay. And because of our Federal system, the laws are slightly different in all 50 states. I guess I shouldn't be too surprised that we haven't seen much in the way of progress.

Before passing too much judgment, let's review what is happening in this space.

First of all, there's been a lot of news about people purchasing real estate using crypto or borrowing against crypto to buy properties. Believe it or not, there's even a group of residential agents out there—the Crypto Realty Group—proclaiming to be the experts in this and offering to train other agents (for a fee of course) all about crypto and blockchain. But in truth there's nothing all that innovative about this. It's just another expression of crypto's obvious potential utility as a medium of exchange. And given the run we've seen in crypto prices these trades haven't really worked out great. In other words, people buying real estate with crypto should've just kept their crypto.

Trading Crypto for Real Estate Has Thus Far Been a Bad Idea



There's also been a lot of attention about the potential for blockchain and smart contracts to address the problem of high transaction costs in the real estate industry. In fact, for a long time now the nuanced and progressive stance for supposed innovators within real estate has been something like "I don't know about Bitcoin and those cryptocurrency things but I'm a big believer in the potential of the blockchain though." Right…

Sorry in advance to all my friends in the business but the transaction cost story is something I am watching closely and routing for. I'm convinced that the 5%-6% homeowners are paying to real estate agents just has to go to zero. However, that story has been the premise of companies like Redfin or Zillow for years now and we haven't seen any decline yet. We'll have to see. Similarly, almost every loan should be able to be funded and processed for 90% less than what people are currently paying. Mortgage broker fees should go to zero. Same for escrow costs and most transactional lawyer bills. There will probably always be a need for lawyers for larger or complex projects but these are by far an exception. Most real estate transactions are being done with standard contract forms and non-negotiable loan documents. In transactions like these, costs should go to zero.

Well financed startups like Propy are going after this opportunity. Propy's main product, a transaction management system for buying and selling homes, looks more like a nice software solution than anything crypto or revolutionary. However, they are experimenting and the results look promising. In June of 2021, one of Propy's main investors sold an apartment he owns in Kiev as an NFT[1] using Propy's system. Basically, in this structure an LLC owns the property and whoever owns the NFT has rights to the LLC. Each time the NFT trades there is no official title transfer, at least as far as the government is concerned. Title is transferred instead via contract (i.e., the membership in the LLC changes). It's a cool idea but unclear whether it's truly scalable. Here in the US, investors have been playing around with this structure for years as a way to try to avoid property tax increases and many state governments already require disclosure and a tax reassessment every time there is a change in ownership.

Similarly, there's an interesting project in San Francisco called 20Mission, where a property owner took an existing co-living property and tried to sell NFT's that essentially amounted to real 75-year leases for each room for just a $1 /month. The project was real and had good backers but from what I can tell on Opensea it doesn't look like any of the lease NFTs have sold. Maybe it's just too early for a real-world application like this. People seem to be more interested in buying digital pet rocks and cryptopunks right now…

Another of most popular ideas is to use crypto, blockchain and smart contract technology to fractionalize[2] or tokenize[3] ownership of property. To be sure, this is an exciting area. Progress here is badly needed and could really move the needle on the long sought after "democratization" of finance. What I'm seeing so far, though, looks more like the next evolution of crowdfunding than some major change in the industry. While the regulatory environment has been opening up in recent years, the current regime, with its requirements around registration, accreditation[4] and lock-up periods, is still just too rigid and unwieldy for major progress.

Crypto companies going after this opportunity are finding themselves in the exact same position as the incumbent crowdfund players, who have been forced to build elaborate organizational structures and policies for everything from KYC[5] requirements to verification of accredited status to finding suitable investments. All this involves the same kind of centralized due diligence and processing that has served as an effective barrier to entry in the first place. These companies cannot afford to have any bad deals on their platform or get in trouble with anti-money laundering laws. It's existential for them. A few bad deals or one fraudster sponsor and you lose all your credibility. As of now, the crowd isn't doing anything except maybe facilitating a broader menu of pre-vetted options for accredited investors. No one has figured out yet how to actually democratize the process.

What's happening in this space actually makes a good case study for libertarian deregulation. Most of the laws and regulations causing challenges today came out of the excesses of the 1920's. In the aftermath of the 1929 crash, lawmakers started looking for ways to prevent shady Wall Street promoters from selling sham securities to unsophisticated investors. They settled on this whole framework of registration and disclosure and opted to use income and wealth as a kind of proxy for "sophistication" and investment

1. NFT stands for "Non-Fungible Token" and is defined by Merriam-Webster as : a unique digital identifier that cannot be copied, substituted, or subdivided, that is recorded in a blockchain, and that is used to certify authenticity and ownership (as of a specific digital asset and specific rights relating to it)
2. Fractionalize, in this context, simply means dividing up the ownership rights in an asset/property into smaller parts
3. When you "tokenize" an asset/property you take things a step further and create a digital representation (in the form of a token) for the fractionalized ownership rights
4. The Investopedia summary of what it means to be an accredited investor in the US: In the U.S, the definition of an accredited investor is put forth by SEC in Rule 501 of Regulation D. To be an accredited investor, a person must have an annual income exceeding $200,000 ($300,000 for joint income) for the last two years with the expectation of earning the same or a higher income in the current year. An individual must have earned income above the thresholds either alone or with a spouse over the last two years. The income test cannot be satisfied by showing one year of an individual's income and the next two years of joint income with a spouse. A person is also considered an accredited investor if they have a net worth exceeding $1 million, either individually or jointly with their spouse.
5. KYC stands for Know Your Client" and is short for the complex series of laws and regulations requiring financials services companies to verify the identity of the individuals and companies they do business with. The KYC regulatory architecture was put in place to prevent money laundering, tax avoidance, terrorist financing and other criminal activities.

acumen. This is where the idea of an accredited investor came from. For what it's worth, I think they got it wrong. While there is some connection between income and wealth and investment acumen the connection is very tenuous. I have met plenty of accredited investors who have absolutely no idea what they are doing.

In response to the complexities of the regulatory framework, companies are forced to innovate incrementally and on less-than-ideal grounds. As a result, what we are seeing today looks more like a bunch of half-hearted attempts than bold innovation.

There are companies like Roofstock and Arrived Homes that are fractionalizing but not tokenizing. Roofstock sells shares of single-family rental properties in $5000 increments but only to accredited investors. Arrived Homes does the same thing but has somehow figured out a way to sell to non-accredited investors and in increments as small as $100. I think one of the new SEC regulations has an exemption based upon keeping the total amount of money raised below some threshold but I'm not entirely sure. With these models there are no tokens and thus no real potential for secondary market liquidity.

As I mentioned earlier, there are companies like Propy experimenting with selling ownership interests in real estate using NFTs. Even though this approach may have its legal problems, its simplicity is appealing and has historical precedence. The idea of individuals trading ownership interests in asset without officially changing the legal title each and every time is basically how the modern stock market works. At the very least, Propy seems to be optimistic at least and recently announced a partnership with Helio Lending to enable real estate NFT's to be used as collateral for loans. It'll be interesting to see what happens here.

Finally, there are companies that are trying to both fractionalize and tokenize—the holy grail of innovation in this space. With this, we can finally overcome the traditional barriers to entry like high investment minimums and long lock-up periods. We can break free from private equity and end the era of their almost complete control and dominance of this space. This is how you democratize access to real estate investments, right? Well, maybe.

Look, companies are trying at least. There are interesting projects that range from one off pilot programs like the Aspen St. Regis Token[6] (ASPD) to ambitions exchange platforms like Rhove to tokenized real estate funds like RedSwan to companies trying to be white label service providers for anyone trying to tokenize like Digishares.io. While these projects are exciting they have two fundamental limitations: 1. They are by and large limited to accredited investors (Note: it looks like Rhove is trying to figure this out but hasn't quite gotten SEC approval) and 2. Don't really have any secondary market liquidity, at least not yet.

The token or crypto part of this is a bit all over the map. The Aspen token, originally built on Ethereum, is switching to Tezos[7] because of concerns over transaction costs. RedSwan is using Polymath[8], which runs on top of Ethereum. Digishares, technically agnostic about which crypto to use, recognizes that, as of today, Ethereum is the clear winner. Some companies are even experimenting with building their own protocols and tokens.

Despite all the marketing hype about "revolutionizing" and "democratizing," once you sit down and actually read through all the white papers and FAQ sections associated with these projects, you realize quickly that everyone is very concerned about the liquidity problem. It simply does not exist today and is something that just has to be figured out for any of this to make sense. The way things work today when you invest in real estate it's either directly (too hard for most) or in private placements or private equity funds. And once you invest there you are basically stuck and at the mercy of the deal sponsor or fund manager in terms of timing your exit from the deal. If you end up with a token that is equally illiquid, maybe you'll have made things more administratively efficient with smart contract features but you won't have changed anything fundamental.

Interestingly, the current crop of innovators in this space are all optimistic about and betting on the potential of Alternative Trading Systems[9] (ATS), companies like tZero, Securitize.io and Oasis Pro Markets. ATS companies are positioning themselves to be the exchanges for digital assets of all types not just tokenized real estate. From what I can tell, ATS exchanges are mostly going after accredited investors for now but there does seem to be potential for non-accredited investors to trade digital assets under something called Rule 144 of the Securities Act of 1933. It's complicated, of course,

6. The Aspen St. Regis Token (ASPD) is trading on the tZero exchange: https://www.tzero.com/asset/ASPD. Each ASPD token represents one share in the common stock of the company that owns the property. They sold $18M worth of tokens at $1/share. From what I can tell, trading is light—averaging maybe in the hundreds of shares per day—and the spreads wide (meaning it's very costly to trade) but I'm very encouraged that there is any volume at all!

7. Here's how coinmarketcap.com describes Tezos: a blockchain network that's based on smart contracts, in a way that's not too dissimilar to Ethereum. However, there's a big difference: Tezos aims to offer infrastructure that is more advanced — meaning it can evolve and improve over time without there ever being a danger of a hard fork. This is something that both Bitcoin and Ethereum have suffered since they were created. People who hold XTZ can vote on proposals for protocol upgrades that have been put forward by Tezos developers

8. Here's how coinmarket.com describes Polymath: a decentralized Ethereum project built with the goal of making it easier to create and manage security tokens. The ST-20 Polymath standard (ERC1400) allows users to embed regulatory requirements into the tokens themselves to restrict trading to verified participants, simplifying the challenges of creating a security token

9. Alternative Trading Systems are basically trading venues that are more loosely regulated than an exchange.

but basically, as long as you comply with certain volume, disclosure and notice requirements and don't do anything shady in terms of commissions, certain unregistered securities (i.e., tokens) become tradeable after a 6 month lock-up period. Theoretically at least, if the ATS exchanges can be successful at making markets in digital securities the dream of liquidity could be real. Right now though, it's still very much a dream.

Fractionalized, tokenized real estate interests trading in deep liquid markets across the world and open to investors, regardless of their accreditation status, would indeed be revolutionary. It would fundamentally change the game for real estate entrepreneurs and investors alike. It would break the stranglehold that banks and private equity funds have on the industry. It would allow ordinary investors to finally get access to some of the best investments in the world. And while we are far from the revolution, I don't think it's out of reach. There's just too much opportunity here and too much energy in the direction of progress. In my mind, it's all about token liquidity and deal quality. For this to work, it cannot be just about single-family rental houses or boring corporate net lease deals. We need to see deals with more interesting return profiles, like value-add multifamily or mixed-use urban infill development, and more currently only institutional deals like office, industrial and hospitality.

If you are interested in this space and want to learn more, check out my interview of Brent Reynolds, the CEO of NR International, on Real Vision, which airs on September 20. I think you'll enjoy our deep dive into NR International's new tokenization deal, which involves a large hospitality anchored live-work development in booming Miami.