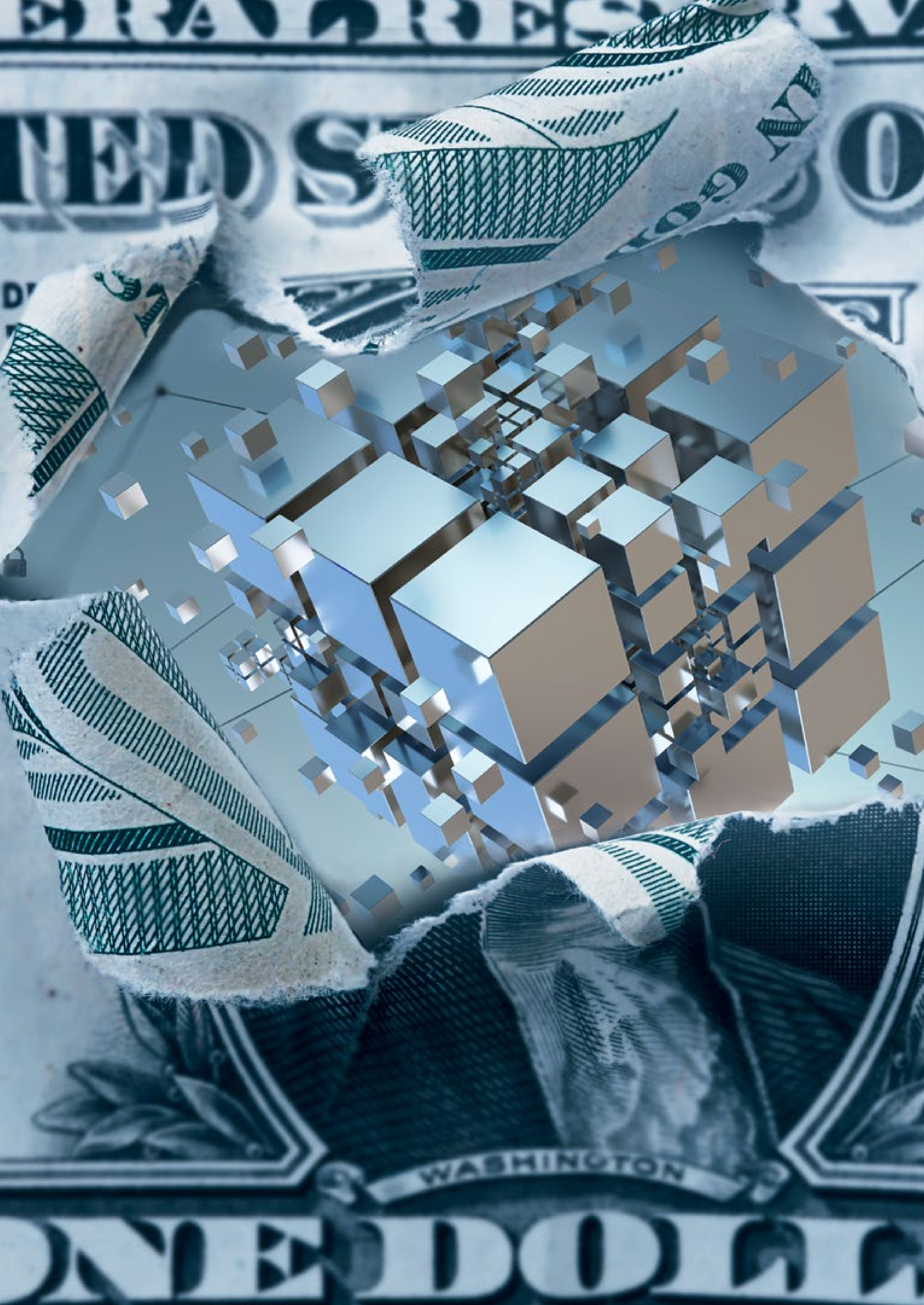
WASHINGTON

The TOKENIZATION TAKEOVER

Serve the next generation of investors by offering blockchain-based digital mortgages

Tokenization of commercial real estate opens opportunity for greater demand and enhances options for capital markets. Tokenization describes the technical process involved in converting an asset's analog shares into digitally securitized shares. This simply means that existing paper shares have been replaced (in whole or in part) with digital tokens and registered on a blockchain capitalization table.

Commercial mortgage professionals will be able to provide many relevant services in this new environment — including sponsor and investor representation, marketing, consulting, transaction specialization and valuations. There is growing demand for advisory services and financial structuring. >

By Edward Nwokedi
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Digitized commercial real estate is the result of property owners registering assets on blockchain-technology platforms as fractional ownership shares — either for the entire asset, a debt instrument or any associated equity. Real estate assets that are placed on the blockchain become digitized, fractional ownership shares, and are considered by the Securities and Exchange Commission (SEC) to be digital securities.

All U.S. digital securities are regulated by the SEC just like stocks and bonds. Buyers of digital securities must be classified as accredited investors under Regulation D. Before any digital-security transactions can be approved, the issuer must verify that every buyer meets the qualifications. These requirements are put in place by the SEC to protect novice investors from fraud and financial losses.

Accredited investors, by definition, are U.S. citizens with an income of at least $200,000 per year in each of the past two years, or those with more than $1 million in assets, not including their primary residence. These are the only investors who can legally purchase digital securities. Like stocks, digital securities can be risky and must be practiced from a position of knowledge and experience.

Investor advantage

Tokenized shares of commercial real estate are placed on a blockchain by the registered owner for trading purposes. This digitized model provides liquidity options for commercial real estate shareholders that did not exist before. Having more liquidity options opens a new world of profit-making strategies.

Early liquidity means that an owner can sell without needing approval from general partners. Their decision to sell all or part of an asset can be an optional tool. Illiquidity in commercial real estate investments has been a big problem until recently.

Limited partnerships and general partnerships for real estate investments historically have had zero opportunity for liquidity until the asset was refinanced or disposed of. Neither the sponsors nor the limited partners had a way to sell their ownership shares to a third party before the planned disposition. In reality, this problem of illiquidity was an obstacle that prevented many private investors from entering commercial real estate.

Increased liquidity via tokenization is a win for real estate investors. Having the ability to exit an investment before its maturity date is a major benefit and helps to reduce risk. An investor never knows when an unusual circumstance will occur and create a need for immediate liquidity.

Mainstream commerce

Whenever a digital shareholder decides to sell or transfer their ownership shares to someone else, they will do so through the blockchain, sending the shares to a buyer with a whitelisted (verified) address. Blockchain technology is one of the safest protocols for protecting ownership against fraud or theft. To make a change on the blockchain, several computer nodes managing the network must simultaneously acknowledge and agree to the change to permanently record it.

Blockchain transactions and records are rapidly transitioning into mainstream commerce. They are safer and more reliable than traditional processes used by banks and other mortgage lenders.

Blockchain has multiple applications for real estate, from providing liquidity to fractionalization. With a commercial mortgage, for example, the debt can be recapitalized and replaced with digital securities. Today, a mortgage that is originated and serviced by a bank can be replaced with a digital security product that has been fractionalized into 2,000 shareholder units, allowing each owner to proportionally share the collateral and income.

The same process can be used for equity capital as well. In this case, the sponsor’s shares of stock are digitized. Blockchain-based mezzanine loans are particularly attractive for second-position collateralized debt and typically account for 10% to 15% of the capital stack.

Broker benefits

Now is a great time for real estate and mortgage professionals to add blockchain to their service offerings. With commercial-property prices rebounding to pre-pandemic levels and capitalization rates reaching historic low points, fewer brokers are involved in deals. This activity is driven by the low cost of capital and large companies with a lot of cash.

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Incorporating blockchain services with traditional brokerage services is a strategy for growth that currently has limited competition. Whether it's investment sales or transactional due diligence, the digital-asset door is wide open to new channels of business. This is similar to the situation for retailers more than a decade ago. Those without e-commerce capabilities landed in trouble as online sales surged. Some retailers didn't see this shift coming but quickly realized the importance of consumer access to e-commerce. Retailers either pivoted to the e-commerce model or went out of business.

Real estate and mortgage brokerage businesses have begun to consolidate. Larger transactions are becoming more common while brokerage teams are increasing in size. And compensation is declining on a per-deal basis for real estate agents and loan originators alike. Blockchain is helping the real estate finance industry transition toward digital transactions. While this shift appears inevitable, it is not doomsday for the mortgage broker.

Digitization spells opportunity for industry professionals. Opportunities in blockchain-based real estate finance will absorb the labor force that is open to the adoption of new technology and synergistic services. With trillions of dollars in global commercial real estate assets — and capital-market transaction volumes on the rise after a post-pandemic decline — there is still a significant number of services and fees to generate for experts who find their fit in the market. At the end of the day, mortgage brokers are still selling real estate.

Helping the masses of property owners and investors to understand the attributes of tokenized real estate will create demand for professional fees — for example, by producing the correct digital branding and determining the market value of these properties. Technology experts are developing applications for blockchain commerce, and they have knowledge of specific and successful industry practices.

Risk reduction

Your clients want to get a good price for the value of their real estate. Traditionally, many investors exit for a profit by liquidating equity for cash. The model is to buy, develop, stabilize, sell, upgrade and repeat. Of course, some developers and owners hold assets for the long term. Tokenized real estate allows sponsors and developers to liquidate much of their equity position and continue to manage the asset.

Why would this be attractive? Rather than turning over all of their equity, a sponsor can now sell the majority at market value to digital shareholders while still fee-managing the asset and taking long-term waterfall distributions. This strategy provides the greatest return on investment over time and builds an investor's asset portfolio. General partners can charge asset-management fees and share in waterfall distributions after the minimum rate of return (or hurdle rate) is achieved.

On the investor side, it is getting quite difficult to find good deals. The best properties and development projects tend to be limited to larger institutional investors. The typical investor has limited access to high-quality commercial real estate projects for acquisition or development purposes. Market participants agree that these core real estate projects have lower overall risks.

In many cases, however, these opportunities also include a large fee that creates a big barrier to entry. Because of these expenses, investors often can only afford to be involved in a few deals. Blockchain-based real estate, however, allows fractionalized shares that significantly reduce the initial investment size. For example, a $500,000 limited-partner investment can be divided across 20 properties to reduce risk. ("Don't put all your eggs in one basket" is a phrase that comes to mind.)

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Change is difficult and many in the commercial real estate industry lack the knowledge to engage in digital-asset securitization. Remember that the key benefit is optimization of asset value. Obtaining the highest valuation is a primary goal for every mortgage broker and building owner.

In theory, this single benefit makes digital securities superior to traditional investments. High-performing assets in good locations normally attract the highest valuations, but tokenized assets come with the benefit of liquidity. All other factors being equal, assets with strong liquidity will always be in higher demand than those that are illiquid.

This is another reason why commercial mortgage professionals should become motivated about blockchain-based asset tokenization and the promotion of digital commercial real estate deals. As advocates for building owners who seek liquidity, brokers should inform their clients that 100% disposition is not the only option. If you are the first professional to explain how tokenization works, this will separate you from your competitors in your clients' eyes. ●

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