Real Estate Investment Meets the Crowd

The Case of ArborCrowd and Real Estate Crowdfunding

JEL Classifications: G23, O31, L85, R3, R33

Case studies by the Schack Institute of Real Estate place students of real estate and related disciplines in the role of the decision maker. Students are asked to evaluate strategic alternatives, consider a wide range of opportunities and risks, and propose a course of action. Cases develop students’ capacity for analytical thinking and strategic decision making, as well as specific technical and quantitative skills.

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The industry is evolving. The next stage in this evolution has a larger role for the retail investor, giving them access to deals and offering new ways for them to get involved. We were committed to being on the front end of that innovation.

Adam Kaufman, ArborCrowd Co-Founder & COO

Against the backdrop of recovery from the Great Recession, the Jumpstart Our Business Startups (JOBS) Act of 2012 laid the foundation for a new source of real estate capital: crowdfunding. Not long after its enactment, platforms emerged marrying traditional notions of syndication and the Internet, affording well-qualified retail investors a novel path to diversification into real estate.

When Adam Kaufman – the son of Ivan Kaufman, the Chief Executive Officer and Founder of Arbor Realty Trust, Inc. (“Arbor”), a publicly traded mortgage real estate investment trust, as well as the co-founder of a real estate private equity firm – returned to the family business after working on Capitol Hill and at a digital advertising technology firm, he had his work cut out for him. His big idea was to create a crowdfunding platform, taking advantage of his family’s long involvement and unquestioned expertise in real estate to guide the new company to be a leader in the space with access to quality sponsors and deals.

ArborCrowd was not among the first movers into crowdfunding. But in the mind of its co-founder, a carefully crafted strategy would present investors with a unique value proposition. At inception, ArborCrowd would be the only company in the dispersed world of real estate crowdfunding to be launched with such direct and deep ties to a respected legacy real estate firm. Others might have hired real estate professionals to try and guide them, but ArborCrowd had access to a depth of ingrained real estate knowledge that experienced, survived and thrived in all market cycles. In addition, no other crowdfunding company would have the same instant brand recognition and access to deals. “Our long history in commercial real estate brings us a built-in pipeline of deals. That’s a crucial differentiator,” Adam observed.
Crowdfunding Gets Its Start

Throughout the history of real estate, a range of models has been employed to bring individuals and groups of investors into the highly institutional side of the industry. Many of the great names in commercial real estate, such as Harry Helmsley, Lawrence Wien, and Larry Silverstein, achieved success building syndications that invested in iconic properties, raising money through chains of people they knew, and people who knew people they knew, known colloquially as “friends and family.”

According to New York University Schack Institute Professor Tim Savage, institutional real estate investors find themselves in a position to own, at least in partnership, the underlying property, rather than owning a derivative of that property. Direct property ownership may help align the incentives of the investor and sponsor, affording superior returns on investment. Partnerships are also common on a smaller scale, albeit with less formal networks, smaller assets, and more limited investment and operating capabilities than their larger counterparts.

Fractionalization of real estate became more formal with the introduction of real estate investment trusts (REITs), public companies traded on stock exchanges and bound to strict guidelines on investment activity, sources of income, and income distribution to shareholders. Though the foundation for REITs was laid by the U.S. Congress in 1960, they did not become popular until the mid-1990s, as several real estate companies went public when capital markets dried up during the savings and loan crisis.

REITs can produce attractive returns during long bull runs. They also provide for portfolio diversification. But during periods of volatility, short-term REIT performance “can break your heart,” according to investment adviser Paul Merriman. In many cases, a drop in a REIT’s share price can exceed the decline in the cash flow performance of the underlying assets. As a result, more direct forms of real estate investment can enhance portfolio diversification beyond REIT ownership.

The JOBS Act was signed into law by President Barack Obama on April 5, 2012 with bipartisan support from Congress. The structure had the potential to address some of the challenges associated with REIT’s exposure to the vagaries of the public market as well as the informality of more traditional relationship-driven real estate partnerships. In the case of crowdfunding, an individual investor could access a range of opportunities even without the scale of a large institution.
The JOBS Act’s broader objective was to encourage funding of small business by relaxing various securities regulations. A section of the law addressed crowdfunding, creating a mechanism for companies to raise capital through share sales to accredited investors who met wealth or income thresholds. The pool of potential investors would later be expanded to include non-accredited investors, but limits would be in place on how much a person could invest.

The law allowed a spate of startup companies to bloom, guiding individual, retail investors to opportunities to acquire fractional interests in commercial real estate. Crucially, the JOBS Act allowed sponsors to publicly solicit qualified investors, a departure from the friends and family model that historically characterized real estate syndication. By 2014, venture capitalists and strategic partners seeded several leading real estate crowdfunding websites with more than $50 million, according to former Tuck Business School at Dartmouth professor John H. Vogel Jr. and Benjamin S. Moll, Founder of Arx Urban Capital.

Crowdfunding’s Potential

The pool of potential crowdfunding investors was vast, but it was unclear how effectively new platforms could raise capital to support real estate purchases, new construction, and repositioning.

The Commercial Real Estate Finance Council’s Christina Zausner pointed out that crowdfunding had raised only a fraction of the capital used in real estate, and it had remained only at the edges of the market, not significantly penetrating the market for trophies in primary markets like New York City, San Francisco, Washington, D.C., and Boston.

Some of the challenges: the new crowdfunding platforms might find their clientele to be higher-maintenance and harder to retain once acquired, costs associated with investor procurement and relations could cut into profitability, and crowdfunding might also compete with the more liquid investment opportunity of REITs.

Among the downsides for the retail investor would be the relative illiquidity of their real estate investment. An investor has no right to demand their money back at any time. Instead, it would be locked into the property until the controlling equity decided to sell, which could be three to five years down the road. Alternatively, the sponsor could refinance the property to create liquidity to distribute to co-investors, but there would be costs associated with that strategy. Either way, the timing was outside the retail investor’s control.
ArborCrowd Enters the Fray

I returned to New York and went to work for an advertising technology firm. I wanted to understand how brands were reaching their customers online. By the time I left that firm, I knew I was ready to start ArborCrowd. We had been on the sidelines for a few years. It was time to make our move.

Adam Kaufman, ArborCrowd Co-Founder & COO

When Adam Kaufman began to work with Arbor in early 2016 and moved into the company’s Uniondale, Long Island office, it was with the intention of starting ArborCrowd. “Uniondale was home base,” Adam said. “Arbor was the equivalent of an incubator that was critical to getting us off the ground. We had a very clear mission and objective and we were able to focus because of being in that environment.”

By the time he started ArborCrowd, it had already lived a full and detailed life inside of Kaufman’s head. The goal was to make it tangible, as quickly as possible. “It almost seemed like the most natural transition at that period of time,” Adam said.

The Kaufmans had conversations about crowdfunding, which they had seen in the capital structures of some of the properties Arbor had made loans on. “Arbor and its related companies already had well carved out niches in the real estate loan and equity arenas and there was an opportunity to leverage that experience to enter the crowdfunding space,” according to Adam. “The challenge was to leverage the talent, experience and name recognition of the Kaufman family and its long history with Arbor to form a new company that can differentiate itself in this new market.”

Both Ivan and Adam understood that ArborCrowd would be viewed in the market as an extension of Arbor, and that apart from execution risk, they would have to consider the reputational spillovers if an ArborCrowd investment performed poorly. “There was reputational risk. If a deal went south, it could hurt the larger Arbor brand,” Adam said. “We needed to feel completely confident about every deal to such an extent that we would prefund the transaction with our own equity before offering the opportunity to crowd investors.”

Adam was committed to managing these concerns by developing an investment approach that was on par with Arbor’s culture of rigorous underwriting. “The time was right to enter the market with an institutional approach to a crowdfunding company,” Adam said.
In thinking about his deal pipeline, Adam knew that Arbor and ArborCrowd could benefit each other as Arbor’s commercial mortgage business would be a tremendous source of deals to put on the ArborCrowd platform. However, in addition to needing a loan, many borrowers also needed additional equity to close an acquisition – a gap that crowdfunding could fill. The synergies between the two companies were obvious, with ArborCrowd feeding new business to the Arbor mortgage businesses when deal sponsors were looking for an established debt provider. “The concept was that we could drive business to each other,” Adam said.

ArborCrowd’s Strategy and Structure

ArborCrowd’s strategy would have to address several key questions. Most important was the profile of investors to bring on board and which properties to invest in.

The decision to focus on real estate credentials and leverage technology to accomplish that, rather than the other way around, was made at the outset. “You looked at the ratio of engineers to real estate professionals and could see our competitors were more tech firms than real estate firms,” Adam commented.

Adam reached out to partners for the technologies that would enable his platform. Through these relationships, ArborCrowd would be able to automate much of the investment process. Thanks to innovation by Jor Law, Founder of Verify Investor, LLC, there was already an online option that made it cost effective and easy to obtain required verification of accredited investors.

Crowdfunding was limited initially to high-income investors. Beginning in 2015, provisions came into effect that allowed a wider range of retail investors to participate in deals. Adam decided that he would not compete for the very small dollar investor, but would instead focus on accredited investors. “The costs for small investor acquisition could be exorbitant when considering the low dollar amounts they would ultimately invest. We made a decision to forgo pursuing that pool of potential investors,” he said.

ArborCrowd’s minimum investment size would be $25,000, and its investors would need to be accredited, meaning the person would have at least $200,000 of annual income, or $300,000 if he or she filed their tax return jointly with a spouse. They would have to show they qualified for the prior two years and had an expectation of making the same wage or better in the current year. Alternatively, the investor could have a minimum net worth of $1 million, individually or with a spouse, but any equity in a primary residence would not count towards this threshold. The need for being an accredited investor was
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driven by the regulations that permit ArborCrowd to generally solicit these investors through methods such as the internet and media.

ArborCrowd would be competing for the successful doctor, dentist, banker, lawyer or businessperson as well as retirees looking to generate income while preserving their assets. Additionally, many real estate professionals were considered “outsiders” in the tight-knit real estate community and could not even invest in deals offered by the very companies they worked for, creating another potential market. ArborCrowd figured there were some 10 to 12 million potential investors in the United States who met the criteria of being an accredited investor.

Adam viewed the synergies between the well-established Arbor related companies and ArborCrowd as a key strength, both in terms of deal sourcing and as grounding to the core product – real estate. “Other crowdfunding companies had established themselves in the market, but they didn’t have the connection to the deals,” he said. Arbor had been active in the multifamily housing space for more than 30 years, leading to a voluminous number of industry connections and a wealth of experience unrivaled by any other crowdfunding company. Adam knew ArborCrowd would look at hundreds of deals each year and would be in a position to weed out only the best deals for investors. When an investment opportunity was offered to ArborCrowd investors, they could see its investment thesis, returns estimates, and understand the exit strategy.

True to its heritage, ArborCrowd would play in the multifamily housing space, looking for properties in both established and promising up-and-coming markets. Many offerings would be of neglected or mismanaged properties that required investment to optimize cash flow and increase value. This might include installing new kitchen appliances and countertops, windows, hardwood floors, and other amenities to raise the value proposition to the tenant.

Despite having access to a pipeline of deals, ArborCrowd would only offer a single investment opportunity at a time, favoring quality over quantity. This would necessarily constrain growth relative to other platforms. If an investor did not want to put their money into a particular deal, they would have to wait for the next one. “Our competitors were posting deals left and right,” Adam observed. “Without that level of deal flow, we had down times. We weren’t always offering something in the market. Absent the continuity of deals, how could we keep our investors engaged.”
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Raising Money

For ArborCrowd, the early concern was differentiating itself from the diverse pool of crowdfunding platforms that had already entered the market. These platforms had opted for deal volume by bringing multiple offerings to their platforms at any given time. This offered the advantage of giving potential investors a range of choices for how and where they wanted to invest. They kept the opportunities coming as part of a strategy to keep their brands front and center. ArborCrowd had chosen the alternative strategy, offering only one high-quality deal at a time.

Attracting and keeping investors was already proving to be among the biggest expenses crowdfunding platforms would face. Within two years of ArborCrowd bringing its first offering to market, a major platform would call a halt to new investments, saying it was having difficulty raising investment capital beyond the seeding from its venture capital partners. For Adam, it was a cautionary tale on the pursuit of rapid growth over deal quality. “Many platforms were growing too quickly while failing to focus on a core product,” he said. “They were making rash decisions and switching between different investment models trying to anticipate what would be the ‘next big thing’ in the industry. We decided it was best to start small, focus on quality deals and to grow organically.”

One of the venture capital investors in the failed platform blamed its demise on its breakneck pace of growth and expressed concern that many crowdfunding platforms of its vintage had the same basic problem: they grew so fast they exhausted their main customers’ capacity to invest in real estate. And because they had grown so fast, they lacked the infrastructure to turn to the institutional investor market to sustain them.

“People got tired,” he said. “They felt depleted because they had spent their real estate allocation. And these are not titans of [the] industry. These are people making a couple of hundred thousand dollars a year who may have $40,000 lying around to invest through a crowdfunding site.”

For ArborCrowd, the risk was greatest in its first two or three deals, when it did not yet have an established track record to show to potential investors. ArborCrowd routinely sought out investment clubs, which tended to be groups of retail investors, to make its case. ArborCrowd also held a trump card: it could and would co-invest in every deal it brought to the platform, which would guarantee deal execution and alignment of interest.

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The First Project

ArborCrowd’s first investment was 1413 York Avenue on Manhattan’s Upper East Side, between East 75th and East 76th Streets. While the address may have conjured images of high-rise doorman apartment towers, this was anything but. It was a six-story walk-up with 22 apartments, built in 1910, with a beauty salon and a café at street level. It recalled the apartment the young Jane Fonda and Robert Redford, who played newlyweds, moved into in the late 1960s in the movie “Barefoot in the Park,” notable for the huffing and puffing the young cast members did as they reached their top-floor home.

While the property might have needed investment, it was very well located, in a neighborhood with a history of supporting some of the strongest rental income trends in the country. The largest and best-known institution in the neighborhood was New York Presbyterian Hospital, and the area benefited from the opening of the Second Avenue Subway just two blocks away. By the time the marketing materials went out to potential investors, management was already receiving rents that were 80 percent higher than the rents prior to the renovations.

ArborCrowd investors were asked to contribute $2.025 million of equity, which would be used to invest in the property and to pay for some fees and deal expenses, and in exchange, they would own just shy of half of the total equity in the property. The targeted internal rate of return was 12 to 15 percent. The payment waterfall allowed for investors to receive all their money back plus a 7 percent internal rate of return before the deal sponsor would be able to earn some upside, known as a “promote.” Once that first 7 percent hurdle was achieved, investors would receive anywhere from 60 to 70 percent of the distributed cash flows from the property after achieving an internal rate of return ranging from 8 to 18 percent, with the sponsor earning the balance as an incentive to perform. There was a $6.25 million loan on the property. Total investment in the property was approximately $10.3 million, including nearly $1.8 million for renovations.

The property had been chosen because of its potential. It was acquired in April 2015 for $7.5 million by the private equity real estate company co-founded by Ivan and one of its partners. ArborCrowd investors were invited to participate in its recapitalization and repositioning. Adam knew the opportunity would be very appealing to investors and it was, enabling ArborCrowd to stake its claim in its market debut.
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An Update on ArborCrowd

As of the fourth quarter of 2019, ArborCrowd has offered 9 deals on its platform with a total equity raise of $30 million and a total deal capitalization of over $370 million.

ArborCrowd's first realized transaction, the Southern States Multifamily Portfolio, comprised of three properties located in Mississippi and Alabama, yielded investors a net internal rate of return of over 29% in 15 months. The returns of this offering, the third to be launched by ArborCrowd on its platform, exceeded initial projections of a 17 to 20 percent internal rate of return over a two- to three-year hold period.

During the fourth quarter of 2019, ArborCrowd announced its second realized transaction, the sale of Quarry Station Apartments in San Antonio, Texas. Investors in Quarry Station Apartments, ArborCrowd’s fifth offering, achieved a net internal rate of return of over 20 percent in 22 months, exceeding its initial projections of 16 to 19 percent over a two- to four-year hold period.

As of the fourth quarter of 2019, ArborCrowd had returned more than $10 million to investors.