The Future of Real Estate Tokenization Written for Cynics and Thought Leaders

Preface

This discussion could be called "Real Estate Tokenization 2.0 or 3.0" parallel to the evolution we witnessed in the CMBS market some years ago. We remain in the PropTech era of numerous startups, some offering real estate tokens or platforms for tokens, each believing they will change the world and often naïve about other players including established firms already engaged behind the scenes with their own R&D. Blockchain and AI (artificial intelligence), which is really ML (machine learning since AI does not yet exist), is being touted as a source of proprietary advantage over other firms, ubiquitously I might add, along with blockchain. In previous blogs, we tried to explain how blockchain works using decentralized distributed ledgers, allowing for identification, event dating and tracking of all transactions, independent of any centralized authority such as county governments. Blockchain's freedom from costly recording fees and delayed bureaucracy is the foundation by which tokenization and more efficient transactions can occur. The transition is like moving from old fashioned taxi cabs to an Uber-like system, or booking your own flights versus travel agents, or downloading a movie instead of driving to Blockbusters for a cassette tape.

Efficiencies will occur and yet the title industry will not whether and disappear, nor the need for real estate consultants, brokers, appraisers, lenders, or managers, albeit in some cases doing more with less. Based partially on discussions at the Hoyt Institute thinktank in North Palm Beach, FL in May of 2023, with colleagues that included Andrew Baum, Guy Tcheau, Justin Earley, Herwig Konings, Brad Case, Jeff Fisher, Glenn Mueller, and others, this is one vision of where we might go with respect to real estate tokenization.

History of Real Estate Tokenization in Brief

Nearly seven years ago (2018) the world's first real estate tokenization offering was born when the St. Regis Aspen resort in Colorado, sold almost a 20 percent interest to investors via $18 million US dollars of tokens. The resort was reported to be worth $224 million according to businesswire.com. Today if one visits https://stomarket.com you can find the tokens listed as "AspenCoin" with a market cap of about $49.5 million US with tZero as one of the platforms. Each token is worth about $2.75 as of May 23rd, 2023 with the last trade on May 23rd, 2023 and a 24-hour trade volume of 11,000 shares or $30,250 dollars. This compares to the smallest of micro-cap stocks on any exchange, but remember this is a babe in the woods compared to traditional stocks. Solid Block, https://solidblock.co assisted in the technical aspects of this launch in 2018 and today several other firms are providing white board platforms. Today, Forbes estimates the market size of real estate tokens as $200 million US. Those who invested in AspenCoin seem to have done well with $18 million almost tripling in three years.

Many of the other real estate tokenization sponsors have focused on single asset plays, where they tokenize the entire asset, often single-family rentals. See [Arrived]() homes, [Roofstock](), [RealT]()

as examples. Roofstock uses assistance from Collateral Analytics (now Black Knight) to help provide SFR home values, but it is not clear how the others determine good acquisition prices or provide information to investors at this point, aside from rent collections. HoneyBricks is an example of a multifamily token platform that provides a touch more diversification via several properties worth several million USD and up. To be clear, mentioning the examples above is not an endorsement of any of them, and to date, the lack of current valuations at most of the platforms makes it near impossible to report on or calculate total returns.

To date, we might characterize real estate tokenization market as focused on single assets, requiring the investor to pick and choose among the offerings to generate their own portfolio. It is not clear whether investors have the expertise to select an efficient portfolio on their own, or whether we will see larger pools of properties, say twenty class A apartment buildings in Denver become more commonplace as a token strategy. Ultimately, we may see a fund of funds approach, where super token pools are assembled and sold as diversified portfolios or ETF like investments. Blockchain would allow for such funds to be easily assembled with a minimal of transactions costs. For now, liquidity remains low and the information investors require on property values, rents, and other metrics remain hard to acquire for the average investor.

Democratization or Efficiency Gains Overlaid on Existing Framework

Democratization of investing, a claim made in 1960 when the first REITs act was passed in the United States, is based on the idea that one can buy a small interest in real estate. REIT shares provide that opportunity, as Brad Case proclaimed at recent Hoyt meetings, and in that respect real estate tokens offer nothing new, at least within the public markets. Within the private sector, they may offer liquidity which does not exist today. For example, syndications typically start with a Limited Liability Corporation to own real estate and act as a GP, general partner, along with passive LPs, limited partners. The LPs simply know the fund has a finite life and go along with the decisions of the GP. If a LP wants to exit, the GP may help them find a buyer but this is rare. Now, add tokenization to the process.

While the underlying owner does not change, if some or all of the LP interests were now tokenized and listed on exchanges, they may be able to exit anytime they wish. The cost of liquidity will vary with the size and volume of the tokens. Larger super tokens or larger single asset tokens would provide such liquidity.

Justin Earley of First American made a good case for the continued need for title insurance, even in a world of fractionalized or tokenized real estate with interests that trade on blockchain platforms. Wise owners will still seek some protection of interests that are only recorded in the cloud. At the same time, he and others concur there are many other efficiencies with blockchain technology and smart contracts. Aside from potential liquidity, tokenization, and smart contracts, such as those provided by forms of Ethereum, allow for the tracking and monitoring of every financial transaction from the payment to contractors and vendors, to rental contracts that are then available to appraisers and lenders and could facilitate faster appraisals and financial transactions. Essentially, tokenization and blockchain tools would allow for private markets to morph towards the transparency of public markets.

Regulation Evolving

Among the more progressive countries/regions we see Luxembourg, Singapore and now Hong Kong encouraging and facilitating the use of digital currency and new financial efficiencies. For example, as of May of 2023, the Hong Kong Monetary Authority is allowing a central bank digital currency (CBDC) platform to release real estate tokens using digital Hong Kong dollars (e-HKD) in a pilot program based on real estate asset tokenization. The sponsor, Ripple working with Taiwan's Fubon Bank has stated that tokenization can reduce friction in the equity release process and speed throughput for banks.

Already recognized as the European hub for investment funds, Luxembourg is becoming a leader in the development of digital assets in the financial market. For the past few years, Luxembourg has been promoting innovation and adapting its legislative framework to welcome the integration of blockchain at various levels. Tokenization of real estate assets is already a reality in Luxembourg.

In 2019 Singapore passed regulation to allow for security tokens of all types to be issued. It sees itself as a possible hub for trading real estate tokens on a global basis.

In the United States, it seems that regulation will be at the state level and that for the most part, according to Guy Tcheau of Principal, it will likely be "regulation by litigation", meaning a lack of clear regulation and litany of minefields for early sponsors until we eventually get regulation clarity. Until then, the more progressive states will likely become centers for token issuers.

Real Estate Tokenization 3.0

While there are 242 real estate tokens listed at Security Token Group, most are small single assets that will never achieve much liquidity, nor is there enough information for investors to make an informed buy or sell decision. I envision a third party such as Black Knight/Collateral Analytics or CoStar or RCA/MSCI or RealFoundations, Moody's or others providing a Yahoo Finance type of platform that may look something like this, all hypothetical:

Token	**Honeybricks Denver MF Fund 20 denoted as "HBDF20"**		
Sponsor	**Honeybricks** Rated A+ by the analysts listed below		
Description	18 class A multifamily properties with a total of 2550 units. Click **here** for photos and more information.		
Market Cap	**$1.1475** billion US dollars		
Current Valuation Estimate NAV	$1.1350 billion source: Col Anal	Current LTV estimate Lender: JPMC	49.5% For terms click **here.**
Property average rent per square foot in US dollars	$4.50	Peer property rents per square foot in US dollars	$4.65 For peer property list and map click **here.**
YOY Value Trend	3.2%	Token Bid Price	$5.15
YOY Rent Trend	4.1%	Token Ask Price	$5.35
Cash on Cash Yield	3.9%	Last Trade	$5.30
Average Daily Vol	11,300 tokens	Hi and Lo (12 Month)	$5.68 and $5.15
Analysts Rating			
JLL	Buy	CoStar	Hold
CBRE	Buy	MSCI	Hold
CW	Buy	Moody's	Sell
Colliers	Hold	RealFoundations	Hold

When will such a display of information become available? Hopefully within five years. The triggers will be the size of the offerings and the quality of information provided by sponsors. When enough token funds exceed one billion US dollars or some of the super-token funds exceed one trillion US dollars there is no question that such information will be required by the market. A key transformative moment will be when a major player like Blackstone, that raised $30.4 Billion USD recently for real estate investments allows investors to take tokens as a form of ownership. If even one fifth agreed to accept tokens as the format of ownership, that would instantly lay $6 billion USD on the market in tokens, several times what now exists.

Real estate tokenization 3.0 will arrive when we have not only bid and asks, but enough volume to allow short selling. This would be transformative for the private side of real estate and the public and private sectors would morph into singularity.

Real estate tokenization 3.0 could also include tranches. Imagine the fund above, now allowing for investors to choose among four products, as shown below. Each would have a bid and an ask. In fact, a good financial engineer, by matching investor preferences with products, can easily create a total sum of tranche values that exceeds the aggregate NAV by a few percent. When working with a one-billion-dollar fund, that is an instant $2 million in value creation.

HBDF20 Tranche C	Cash flow and taxable income pass through only with no residual value	Current Yield = 5.5%
HBDF20 Tranche Z	Residual value based on a sale between year 8 and no later than year 10	Expected Yield = 7.5%
HBDF20 Tranche M	Preferential dividend mezzanine piece at 5%	Expected Yield = 5%
HBDF20 Tranche W	All cash flows and returns on the equity portion after the mezz piece.	Expected Yield = 6.5%

Conclusions

Blockchain is too valuable a tool not to exploit. Market transparency and transaction efficiencies now lacking in the private real estate market will be enhanced greatly by smart contracts and blockchain tracking. Real estate tokenization may not provide significant new funding any more than crowdfunding has, but it could transform the private sector allowing for liquidity and more informed and efficient markets.

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