PROPSHARING AND FRACTIONAL REAL ESTATE INVESTING

Posted on April 19, 2022

Categories: Insights, Publications

Overview

Private equity real estate funds and real estate investment trusts or “REITs” have long been the favoured investment vehicles for North American portfolios of multiple real estate assets. Recently, a new investment vehicle has emerged in the market; “propsharing”, online platforms allowing investors, particularly retail investors, access to fractional ownership interests in individual real estate assets. Fractional ownership is subject to low minimum investment thresholds making it particularly attractive to Generation Z and millennials, largely priced out of Canada’s sky rocketing real estate market. There is also a sense of togetherness and community associated with propsharing, largely evident on the websites and marketing materials of propsharing companies. Propsharing and fractional represents yet another example of Canada’s rapidly burgeoning PropTech sector. For more on PropTech refer to our three part series - Part 1, Part 2, Part 3.

Opportunity

What opportunities does propsharing and fractional real estate investing represent? For small and midcap fund managers and private equity, the opportunity to bring to market tried, tested and true real assets in slick, new marketable packaging. For retail investors, a low financial barrier to an investment product perhaps not otherwise accessible, the ability to handpick each investment property as opposed to investing in a pre-selected portfolio of properties and a sense of belonging to an online direct investment community.

Structure

While investors in private equity and real estate funds and REITs participate in an underlying portfolio of properties, investors in propsharing companies select the asset(s) they wish to buy and acquire units directly in each property as opposed to having a participating interest in a portfolio of multiple assets. Unlike REITs that notionally have an infinite number of units that can be issued to investors, propsharing entitles typically have a fixed number of units so investors understand exactly how much they own of each property and will not later be subject to dilution. To date, the few Canadian propsharing entitles on the market are structured as limited partnerships and corporations. Unlike REIT units, interests in these propsharing entities, whether shares of a corporation or units of a limited partnership have not been “qualified investments” for registered plans including RRSPs and TFSAs under the *Income Tax Act*. For more on REITs, refer to our article on Practical Considerations for Structuring Private REITs.

While much about propsharing is different from private equity real estate funds and REITs, many characteristics of its predecessors remain. Management identifies the assets for purchase, facilitates the acquisitions and manages the assets once acquired (although interestingly there are United States propsharing entities allow investors to select assets). For its role, management collects fees such as acquisition, asset management and disposition.

Crowdfunding Prospectus Exemption and Dealer Requirements

As one of the core components of propsharing is raising capital from a high number of investors, Canadian securities regulators consider this activity to be in the business of trading and accordingly securities of propsharing entities must be distributed through a registered securities dealer or exempt market dealer or otherwise exempt from this requirement. Such registration can be obtained by the propsharing entity itself or the propsharing entity can retain the services of a properly registered third party dealer.

In order to distribute securities, private REITs typically rely on the "accredited investor" and "offering memorandum" prospectus exemptions under National Instrument 45-106 *Prospectus Exemptions* ("**NI 45-106**") and private equity funds typically rely on the "private issuer" prospectus exemption under NI 45-106. While propsharing entities do distribute securities under the "accredited investor" and "offering memorandum" prospectus exemptions, the model is also a natural fit for the rarely used start-up crowdfunding prospectus exemption (the "**Crowdfunding Exemption**") and exemption from the dealer registration requirement (the "**Dealer Exemption**") for portals facilitating online distributions by issuers relying on the Crowdfunding Exemption under National Instrument 45-110 *Start-up Crowdfunding Registration and Prospectus Exemptions* ("**NI 45-110**").

Prior to the implementation of NI 45-110 in June 2021, the predecessor framework of crowdfunding capital raising prospectus exemptions available to issuers through provincial blanket orders was rarely used. First, the amount of capital issuers could raise was minimal, both on an individual investor and aggregate basis. Second, the costs associated with capital raising (comprised of creating or accessing a registered portal, dealer and legal fees) were high relative to the amount of capital issuers could raise.

Propsharing, the Crowdfunding Exemption and Dealer Exemption are in contrast, well suited. First, propsharing capital raising is targeted at a high volume of community-based investors seeking to invest, on average, small amounts of capital into one asset. Under NI 45-110, issuers can raise up to $1.5 million in a 12-month period provided certain criteria under NI 45-110 are met. Investors can invest a maximum of $2,500 per distribution or up to $10,000 if the investor is advised by a registered dealer the investment is suitable. Second, a core component of fractional real estate investing is that it is facilitated through an online platform. Unlike other businesses with physical infrastructure merely seeking to access an online capital-raising portal, in essence, propsharing is a portal. Its target demographic is tech savvy investors demanding an online, simple and accessible user interface. Second, while creating an online investment portal represents a high upfront cost, once implemented, it provides an established capital-raising framework to be leveraged for subsequent financings on a low cost per subscriber basis. Third, from a pure marketing perspective, propsharing and crowdfunding are young, fresh and innovative. Both capture media headlines and investor attention.

It is important to note issuers relying on the Crowdfunding Exemption may also use traditional prospectus exemptions (accredited investor and offering memorandum for example) to raise capital in excess of the $1.5 million/12 month cap under the Crowdfunding Exemption and may work with registered securities dealers as well as exempt market dealers outside of portals to raise capital. Accordingly, issuers can view the Crowdfunding Exemption as either a genuine opportunity to raise a small amount of capital on a project by project basis or an adjunct marketing component to a larger scale capital raise.

Tokenized Fractional Real Estate Investing?

In addition to traditional representations of ownership interests in the form of shares of a corporation or units of a limited partnership, there is potential for propsharing entities to instead issue virtual tokens utilizing blockchain technology to represent ownership interests. In the token model of fractional property investing, the virtual tokens are backed by the value of the underlying real estate asset and income is distributed to the digital wallet holding the virtual token. Virtual tokens can provide enhanced liquidity for investors as they can be traded on a peer-to-peer basis provided there is proper compliance with applicable Canadian securities laws. While there have been many tokenized offerings of propsharing products in the United States, such offerings are in their infancy in Canada although there is existing infrastructure in place for such offerings including properly registered online platforms.

If you have questions regarding structuring a Canadian propsharing entity, capital raising, or dealer registration matters, members of McMillan's Capital Markets Group would be pleased to assist you.

by Alex Bruvels and Jeffrey Gebert

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

mcmillan