CRE Equity Tokenization: A Path for Enhanced Liquidity

Moving real estate assets into a blockchain enhances the efficiency and transparency of trading, according to Shearman & Sterling attorneys Kris Ferranti and Cristiana Modesti.

By **Kris Ferranti & Cristiana Modesti** – Commercial Property Executive

Real estate is a relatively illiquid asset. In general, investors cannot quickly and easily sell their commercial real estate positions in the open market. As a result, commercial real estate is typically traded at an illiquidity discount reported to be as high as 25-30 percent. Compared to traditional investments, this is a staggering loss in value. And for investors that typically invest alongside sponsors through fund or joint venture structures, exiting early is even more difficult. But with equity tokenization, investors could potentially unlock liquidity in this otherwise illiquid alternative asset class.

So what does it mean to tokenize an equity interest in real estate? A digital token recorded on a blockchain platform is embedded with the rights of an ownership interest in an entity that owns commercial real estate. The token represents the ownership interest in digital form and the blockchain acts as the ownership registry. Delaware and some other states have amended their corporate laws to provide statutory authority for the maintaining of records and electronic transmission of entity ownership interests using blockchain technology. Sponsors can tokenize all or a portion of the capital stack and offer digital tokens to investors as a method of funding commercial real estate projects. Sponsors are also looking into ways to tokenize the underlying real estate asset, but that is a separate, less developed topic.

Equity tokenization enhances the efficiency and transparency of trading. A blockchain is an immutable and transparent digital, distributed ledger that stores information on every device (or "node") on its network. There is in theory no opportunity in the blockchain protocol for fraudulent transfers and so third- party intermediaries are unnecessary. Without third-party intermediaries, transaction processes can be streamlined or even automated, allowing for frictionless and low-cost trading. Investors are also able to access real time data on the pricing of previous trades and the make-up of the entire digitized capitalization structure, reducing information asymmetry between trading parties. And tokenization supports the fractionalization of digital tokens, allowing investors to further diversify their portfolios and invest on a smaller scale. With fractionalization and efficient and transparent trading, barriers to entry are significantly reduced for investors who wish to invest in commercial real estate. This is particularly the case for investors interested in direct real estate investment and owning shares in specific properties, as opposed to owning indirectly through shares in REITs or private holding companies that own collections of properties not selected by the investor.

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Another major benefit to tokenization is that investors can sell their share in digital tokens to a wider market that is poised for exponential growth through interoperability—a potentially game-changing feature of blockchain technology. In a fully interoperable blockchain system, an investor is able to exchange its share of a digital token on one platform for an equally valued share of a digital token of another asset on another participating platform. Interoperable blockchain systems are not widely available today; most blockchain platforms are currently siloed within their own ecosystem community. But if utilized, investors would be able to freely and easily share and communicate information and complete trades across all participating platforms without ever exiting or the need for a centralized exchange intermediary. This would be a big deal. The ability for digital tokens to be traded on an interoperable secondary market token exchange, in an efficient and transparent way, would likely mitigate the illiquidity discount described above, increasing the value of the underlying asset. And as a consequence of the liquidity benefits, sponsors of commercial real estate projects would likely have wider access to capital on a greater and more global scale.

But there are some drawbacks to tokenization. For example, certain covenants and obligations typically found in the governing documents of the issuing entity cannot with any practical effect be encoded on a blockchain and enforced through smart contract technology. Smart contracts are enforced through programming code using if/then computer logic. People in the blockchain space routinely use the mechanics of the ordinary vending machine as an example to describe how smart contracts work. If a triggering event occurs, then the programmed action is automatically carried out. Artificial intelligence might at some point expand its functionality, but until then, smart contracts for enforcement purposes are limited to covenants and obligations where the triggering condition to a breach can be objectively determined. Independent third party administrators (or “oracles”) would be needed to monitor compliance of covenants and obligations of the more subjective variety. This is partly the reason most sponsors to date have tokenized only minority, non-controlling (or passive) ownership interests. Passive investors usually have few rights beyond their economic rights, and so there are few covenants and obligations of either party that require monitoring. The digital token investor is essentially along for the ride. This is problematic for investors that want to directly invest in commercial real estate for the control, to at least to some degree, of corporate policies and the direction of management.

In addition, there remain uncertainties of the rules and regulations affecting digital transactions. The regulatory framework surrounding blockchain and digital token offerings is still evolving. Sponsors of commercial real estate projects implementing a tokenization strategy and investors of digital tokens must remain informed about the relevant securities laws and regulations and the government regulators, such as the SEC and FINRA, who are monitoring the space and establishing guidelines.

While tokenization is still in its nascent stages, digital token investors will likely become a permanent fixture in the capitalization structures for commercial real estate projects, especially as investors become more knowledgeable about its benefits and as winners in the space emerge and the regulatory framework matures.

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