Crowdfunding and its Application for Real Estate Project Developers in the Netherlands

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Crowdfunding and its application for real estate project developers in the Netherlands

A qualitative research exploring the conditions in which real estate project developers in the Netherlands can use crowdfunding

Bachelor thesis for the Bachelor of Science in Human Geography and Planning, University of Groningen

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Abstract

The aim of this research is to explore the relation between developers, entrepreneurs who provide the organization and capital for the initiating, developing and realizing real estate projects, and crowdfunding, the efforts by individuals or groups to gather relatively small contributions from a relatively large group of funders using the internet, without standard financial intermediaries. After the financial crisis there is a decreasing supply of traditional financing possibilities for developers. This research investigates the opportunities for crowdfunding as an alternative source of financing for developers to develop in real estate.

By adopting a qualitative method, 6 interviews were conducted from developers with different backgrounds to gain insight in (1) the motivations for developers to engage in crowdfunding and (2) the application of crowdfunding by developers. Qualitative analysis shows that regarding the first question, although developers recognize the potential of crowdfunding, limited incentives exists to use crowdfunding as they do not see the rewards outweighing the efforts for adopting such a new financing structure. Regarding the second question, developers expect that crowdfunding in real estate development will mainly be possible if professional parties can be attracted through offering profitable financial schemes. Concluded is that if an appropriate institutional context is formed and professional crowdfunding platforms emerge, disadvantages of crowdfunding experienced by developers can be reduced so that developers are more interested in using crowdfunding as an alternative financing method.

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1. Introduction

Immediately after the global financial crisis entrepreneurs were confronted with a lack of access to capital through traditional financing institutions, which led to an increasing demand in alternative financing methods such as crowdfunding. This emerging phenomenon is according to Bruton et al. (2015:11) the: "most widely adopted form of alternative financing". Although crowdfunding originates from the arts and creativity-based sectors, it has since then expanded and differentiated rapidly all over the world. By now it has found its roots in many other industries, such as art, theater, video-games, technology and recently also the real estate sector, in which many projects have been successfully financed through crowdfunding. Where it originally started out as offering rewards and royalties in exchange for contributions, it has now grown to structured loans and equity investment for the ordinarily investor in support for venture entrepreneurs (Bruton et al., 2015; Cholakova & Clarыssee, 2015; Mollick, 2014). Although the real estate sector does not seem an appealing market for crowdfunding to catch on due to relative large sums of money involved and immobility of the product, there has been an increase in popularity for crowdfunding in this sector (Hol & Daamen, 2014).

Especially in the US there has been an interest for crowdfunding in the real estate sector. According to a report from Massolutions (2015), $1 billion was invested through crowdfunding in the US real estate market in 2014, with a prospect of $2,5 billion at the end of 2015. Reality Mogul, Fundrise, Prodigy Network and iFunding are a few examples out of a fast emerging number of crowdfunding platforms specialized in real estate, where each platform tries to occupy different niche markets in offering different benefits. Some platforms offer peer-to-peer loans where others buy mortgages or support direct investments in real estate (Grout, 2014).

Agrawal et al. (2013:3) suggests that with the adoption of the JOBS Act in 2012 by the US Congress, which eased restriction on equity crowdfunding, "could have significant economic consequences for early stage finance". Although the exact consequences of this changing institutional framework are still unclear, it enabled crowdfunding with equity investments to be a viable tool in attracting seed capital (Cholakova & Clarysee, 2015; Mollick, 2014), and is according to Vogel & Moll (2014:5) one of the two developments that "has elevated the profile and potential for raising money for private, real estate investments through crowdfunding", where the other one is the investments of $50 million from venture capitalist into real estate crowdfunding platforms.

Also in the Netherlands crowdfunding is becoming an increasingly more attractive alternative form of raising funds. In the last five years, the amount of money raised through crowdfunding has grown from half a million euro in 2010 to 63 million in 2014 (Douw & Koren, 2015). The Dutch financial regulatory agency, the AFM, states that the crowdfunding sector is currently at the end of a starting market, prospecting a strong growth towards potentially a mature market, mainly driven by the developments in loan-based and equity-based crowdfunding (AFM, 2014).

1.1. Research objective

Against this background, it is interesting to look at the role of crowdfunding for the suppliers of real estate, the developers. After the global crisis in 2008, traditional financing institutions became more cautious in providing large shares of debt capital for the development of real estate. Banks are facing stricter credit guidelines after the Basel-III regulations and are more prudent in providing loans to developers, for they identify increasing risks with real estate as collateral for their loans (Huibers, 2012; Uittenbogaard & Veldman, 2013; Van Gool et al., 2013). Furthermore there are less public resources available from government parties for real estate development (Hegeman, 2013; Uittenbogaard & Veldman, 2013). Overall, Mackaaij & Nozeman (2014) assert that there is a decrease in supply of financing possibilities for developing in real estate, suggesting the necessity for developers to search for other, 'non-traditional' methods of financing. It is therefore interesting to look at crowdfunding as an alternative financing option for Dutch developers, either in the financing of realizing real estate projects or through selling equity to investors.

So far crowdfunding has been utilized in a handful of real estate projects in the Netherlands. "De Luchtsingel" in Rotterdam, VechtclubXL in Utrecht and Sodafabriek Schiedam all managed to raise approximately €100.000 with the help of the crowd (Hol & Daamen, 2014; Sodafabriek, 2013). Although crowdfunding so far has only been successful in small scale projects, Hol & Daamen (2014) and Vermeer & Joore (2014) suggest that there are opportunities for crowdfunding in the Dutch real estate sector.

As the attention for crowdfunding in real estate is rapidly rising (Bellaflamme et al., 2013; Mollick, 2014), it is useful to look at the consequences that this new method of financing might have in the real estate sector. As we have seen with the American subprime mortgage crisis which caused the global crisis of 2008, new financing products are able to cause unexpected consequences (Sanders, 2008). This research contributes to our understanding of the emerging phenomenon of crowdfunding, as applied by developers in the real estate market.

Crowdfunding itself is a relatively recent concept and it is therefore not surprising that related literature is not in abundance, with many papers covering this new phenomenon currently existing in working paper forms. Empirical research in crowdfunding was originally mainly concentrated on the art industries, where crowdfunding emerged first (see Agrawal et al., 2011; Ordanini et al., 2011), and as the popularity increased, has subsequently been carried out using data from crowdfunding platforms covering different sectors (see Agrawal et al., 2013; Cholakova & Claryssee, 2015; Gerber et al, 2012; Mollick, 2014). Most of the literature has tended to focus on the role of investors, where fewer has focused on the different motives of entrepreneurs and the specific dynamics of crowdfunding platforms.

As of yet there is very few empirical literature available for the application of crowdfunding specific to the real estate sector. In the Netherlands, Hol & Daamen (2014) have recently examined two real estate projects in which crowdfunding has been applied successfully and conclude that they so far only see perspective for small scale project that offer high social value. As most of the crowdfunding literature is based on the analysis of crowdfunding platforms, no research currently exists yet using data from crowdfunding platforms specialized in real estate

Furthermore, literature exists in which alternative financing methods for developers are examined. Mackaaij & Nozeman (2014) identify an increase in alternative financing methods used by developers since the financial crisis. They acknowledge crowdfunding as an alternative option, but observe that it has not been used by developers in between 2008 – 2013. The motivations behind this observation were not investigated.

Though a better understanding on this phenomenon is needed and therefore this paper is focused on an explorative study on the main actors behind the development of real estate objects, the developers. As crowdfunding as a financing method is still in its early stages, this research tries to gain insight in the motives and conditions for which a developer would like to engage in this new phenomenon, in order to examine what role crowdfunding can play in the financing of real estate objects for developers, so that consequences for the parties involved can be taken into account and a right institutional context can be shaped if necessary. This leads to the following main question of this research:

> *What are the motives for developers to use crowdfunding as an alternative financing method in the financing of real estate projects in the Netherlands and how can developers apply crowdfunding?*

In order to answer this main question, the following sub-questions have been formulated:

1. *What is crowdfunding?*
   a. *What is the definition of crowdfunding?*
   b. *Who are the different actors involved in crowdfunding?*
2. *What is the role of financing for a real estate project developer in development process?*
   a. *What is a real estate project developer?*
   b. *What does a developer do in the development process?*
   c. *Which financing methods do developers use?*
3. *How can crowdfunding be used by developers in the development process?*
   a. *What is the position of crowdfunding next to other financing methods used by developers in the financing of real estate?*
   b. *What is the role of developers in the crowdfunding process?*
4. *How do real estate developers see the role that crowdfunding can play in the development process in the Netherlands?*
   a. *What are motives for developers to engage in crowdfunding?*
   b. *How would developers shape the crowdfunding process?*

1.2. Research model

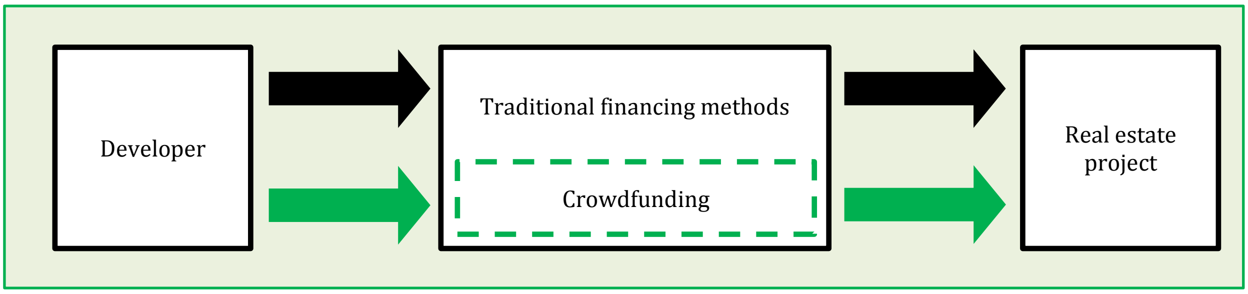

Figure 1.2: Research model, displaying the objective of this research (Author)

The research model presented in figure 1.2 forms the basis of this research and explains visually the relationships of the concepts that are used. The model can be interpreted as follows. In order for developers to realize a real estate project, financing is needed to fund the project. Next to traditional ways to obtain financing, this paper is concerned with the possibilities of another method for securing capital: crowdfunding.

For answering the research question, firstly literature research will be conducted to examine what crowdfunding is (sub-question 1) and what the role of financing is for developers in the developing process (sub-question 2). This will lead to the construction of an analytical framework that is concerned with how crowdfunding can be used by developers (sub-question 3). Secondly, qualitative data will be gathered through interviews with developers to determine the role that crowdfunding can play in their business models (sub-question 4). Ultimately, this research will show insight into the possibilities that crowdfunding offers as an alternative financing method for developers, as well as how crowdfunding can be applied.

1.3. Thesis structure

In the next chapter, the theoretical framework is laid out in three different sections. First, the concept of crowdfunding is described by going into the different actors involved in the crowdfunding process. Second, explained is what is meant with a developer and the developer's task in the development process, as well as an overview of the financing methods for developers. Last, both sections are combined to explain the theoretical role of a developer in the crowdfunding process. This theoretical framework forms a basis for the interviews conducted with developers, which is further explained in the 3th chapter covering the methodology. The findings are presented in the 4th chapter, followed by a discussion and conclusion in chapter 5, together with the limitations and recommendations for further research.

2. Background Literature

2.1. The concept of crowdfunding

In the last decade, new forms of alternative financing are emerging for entrepreneurs to "exploit opportunities they identify, but for which more traditional financing is not readily available", such as micro financing, crowdfunding and peer-to-peer lending (Bruton et al. 2015:10). The term crowdfunding finds its origins in the broader concepts of crowdsourcing[1] (Bayus, 2013) and has been distinguished by scholars as its own unique way of collecting capital (Agrawal et al., 2013; Bruton et al., 2015; Mollick, 2014). As it is still a fairly new topic in the field of academic and popular literature, a widely accepted definition has yet to emerge. Many academics devoted to this topic seem to favor the concept of crowdfunding defined by Schwienbacher & Larralde (2010) in their research (Bellaflame et al, 2013; Hol & Daamen, 2014; Vermeer & Joore, 2014). According to them, crowdfunding is:

> *"An open call, essentially through the internet, for the provision of financial resources either in form of donation or in exchange for some form of reward and/or voting rights in order to support initiatives for specific purposes" - Schwienbacher & Larralde (2010:4)*

Mollick (2014) however argues that this definition is too broad as it does not specify enough how crowdfunding can distinguishes itself from other financing tools, which according to Mollick (2014) is necessary when examining crowdfunding as a form of entrepreneurial finance in academic research. He defines crowdfunding as follows:

> *"Crowdfunding refers to the efforts by entrepreneurial individuals and groups – cultural, social, and for-profit – to fund their ventures by drawing on relatively small contributions from a relatively large number of individuals using the internet, without standard financial intermediaries." - Mollick, (2014:2)*

However, this leaves out two important aspects from the definition of Schwienbacher & Larralde (2010), which are the motives of both the initiators and the funders to engage in crowdfunding. These are according to many authors (Bellaflamme et al, 2013; Gerdner et al, 2012; Mollick, 2014) the most subject to variation and therefore let out of the definition by Mollick (2014) in order to not limit the concept of crowdfunding.

Since the concept of crowdfunding is fairly new, the scope of crowdfunding is yet unclear since different forms and new applications of this phenomenon are emerging constantly (Bruton et al., 2015; Mollick, 2014). In this research, both definitions are combined to capture the essence of crowdfunding. Crowdfunding starts with an initiator, a group or an individual, who has an idea for a project or product and seeks to attract funds. In order to receive funds, crowdfunding is chosen as a financing method. Through creating a crowdfunding project, the entrepreneur seeks to obtain relative small funds from a relative large group, the so called 'crowd'. These are ordinarily investors that are involved in the funding of a concept as opposed to specialized investors. This is done through online channels to attract a large audience. In return, the funders can receive a reward for his efforts.

[1] "Crowdsourcing involves using the 'crowd' to obtain ideas, feedback, and solutions to develop corporate activities" (Bellaflamme et al., 2013:588)

2.1.1. Actors in crowdfunding

In figure 2.1.1 the three main actors involved in the crowdfunding process and their relationship are shown. The actors are the initiators, the funders and the intermediaries, where the initiators are the entrepreneurs that initiate a project, the funders are investors, pre-buyers or donators that provide the funds, and the intermediaries are the channels which provide a medium for the initiators and funders to come together and find a match for one another (Agrawal et al., 2013; Collins & Pierrakis, 2012; Hol & Daamen, 2014).

In order to understand what crowdfunding can contribute next to traditional methods of financing, this section goes over the different actors involved in the crowdfunding process by looking at what advantages and disadvantages crowdfunding has to offer for them.

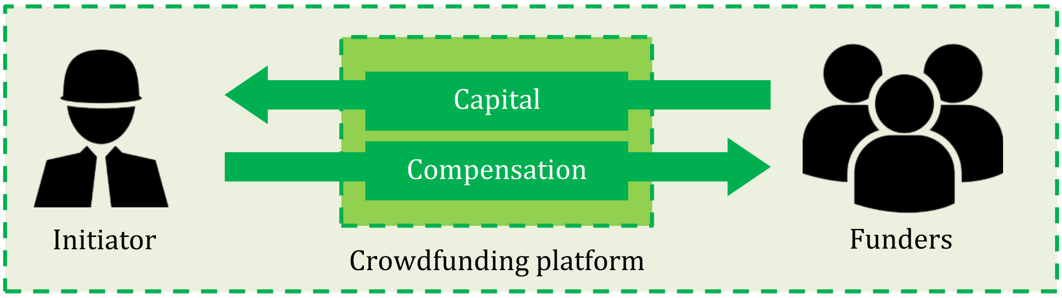

Figure 2.1.1: The actors involved in crowdfunding (Agrawal et al., 2013; Collins & Pierrakis, 2012; Hol & Daamen, 2014)

Initiator's motivations

There can be many reasons for an initiator to engage in crowdfunding. Generally these are based on financing, marketing, research or social motivations. Depending on the nature of the project and the different goals of the initiator, different motives can be present simultaneously.

According to many academics the main reason for initiators to start a crowdfunding campaign is to receive financing for their project (Bellaflamme et al, 2013; Bruton et al., 2015; Mollick, 2014). Through the internet, crowdfunding offers a global search radius for funders to match with a project, which increases the amount of potential funders and makes the relative costs to obtain capital low. This is supported by Agrawal et al. (2011), who observed that the average distance between initiators and investors on the crowdfunding platform Sellaband was 3000 miles, therefore suggesting a decreasing role of geographical proximity.

It is already well known that obtaining funds is especially challenging in the early stages of a project (Cassar, 2004). Crowdfunding offers entrepreneurs an extra solution in solving the equity gap that exists between the starting capital that is available through family, friends and informal investors, and the capital provided by formal investors and banks. Although crowdfunding can raise sufficient capital in smaller-scale projects, it is most widely used in addition to traditional financing methods. (Agrawal et al., 2013; De Buysere et al., 2012; Mollick, 2014; Schwienbacher & Larralde, 2010).

Furthermore, crowdfunding can be used as a marketing instrument, as it attracts the community in the early stages of the development of the product. The initiator seeks publicity for the project to draw attention and create brand awareness. Sometimes the press can catch on to a product and generate hype around the project (Gerber et al., 2012; Mollick, 2014; Schwienbacher & Larrade, 2010). Initiators can also use crowdfunding as a valuable form of collecting market research. By interacting with the funders they can receive feedback concerning the project to improve the product. Furthermore this information can also be used to gain insight into the demand for a project (Schwienbacher & Larrade, 2010; Mollick, 2014). Lastly, some initiators might use crowdfunding for social reasons, such as doing something good for the society, contributing to a community, increase their network or improve your organizing abilities (Gerber et al., 2012).

Although there are a number of advantages for initiators to engage in crowdfunding, Agrawal et al. (2013) suggest that disadvantages exists which can deter initiators to use crowdfunding. Firstly it is important to give a detailed explanation about the project in order to gain the trust of the funders. However, revealing too much information about a project is not always desirable. Secondly, smaller investment shares are less encouraged to actively participate in developing a successful project compared to big investors, of whom a large sum of money is on the line. Thirdly, large numbers of investors results in higher investor managements costs (e.g. by answering comments, sending rewards), compared to a few investors.

In short, Agrawal et al. (2013) indicate that initiators who do not experience considerable disadvantages from revealing information and being involved with a larger number of investors can find great potential through crowdfunding.

Funder's motivations

In supporting an initiator to reach its goal, a funder will expect something in return for his investment. Crowdfunding differs from traditional financing methods due to the special initiator-funder relationship it offers, depending on the context of the investment (Bellaflamme et al, 2013; Mollick, 2014). There are four major business models in which a project can be funded and the funder seeks to achieve his own goals: donation-based, equity-based, lending- or debt-based and reward-based (Cholakova & Clarysse, 2015; De Buysere et al., 2012; Hol & Daamen, 2014; Mollick, 2014).

The reward-model offers non-financial rewards (products or service) in exchange for supporting a project. Funders are attracted by pre-selling a product which gives them early-access, a better price or other extra benefits. In the donation model, the funder can be seen as a philanthropist who invests without wanting a direct return. The lending-based model refers to a peer-to-peer credit contract with repayment plus interest, where the initiator lends money from the funders. An equity-based model provides a shareholding contract where the funder receives a payoff according to a revenue scheme. This form is the most subject to regulation since it is concerned with forms of financial speculation, and thus widely debated across many countries about the fraud potential and the protection of investors (Bruton et al., 2015).

Outside these four contexts, the underlying motives of individuals are highly heterogeneous. Although they are all investing financially in a project and therefore expecting a successful outcome, funders are willing to invest beyond financial motivations. After analyzing motivations of funders on three crowdfunding platforms, Gerber et al. (2012:1) suggest that individuals "are also motivated to participate because of social interactions realized through crowdfunding platforms, such as […] the feeling of connectedness to a community with similar interests and ideals". This is supported by Bellaflamme et al. (2013:589), who suggests that crowdfunders "usually have a high willingness to pay and are more motivated by more than merely consuming the product", which they refer to as the consumer experience when pre-ordering a product or the investment experience under a profit-sharing model.

Agrawal et al. (2013) list the disadvantages of crowdfunding that can scare away funders. These are mainly based on the lack of information for the investors combined with minimal oversight and regulation, which can lead to a high investment risk which scares away funders.

Platforms

The interaction in crowdfunding is facilitated by online channels, where initiators can present their project in order to come in contact with potential investors and attract funds from the crowd. Usually the intermediaries are platforms specialized in crowdfunding that operate in various niche markets. Platforms are mainly businesses who seek profit by for example asking a fee for presenting a project or a share of a successfully funded project. Their aim is to attract a large number of funders and initiators to maximize the size and number of successful projects (Agrawal et al., 2013; Collins & Pierrakis, 2012).

2.1.2. The crowdfunding process

To summarize, crowdfunding is concerned with attraction of funds by initiators from a relative large number of funders who contribute relative small amounts of money. The transaction of crowdfunding normally takes place through specialized platforms where initiators present a crowdfunding campaign to achieve financial-, marketing-, research or social goals. The motivation for funders to support a project can go beyond the financial incentive and exists through donation-, rewards-, loan-, or equity-based models.

2.2. Real estate developers in the development process

In order to understand the specific conditions and motivations for developers to engage in crowdfunding, this section will explain what a real estate developer is, what his role is in the development process and how the financing structure of real estate looks like.

2.2.1. Real estate developers

According to Ramselaar & Keeris (2011) a project developer is an entrepreneur who provides the organization and capital for the initiating, developing and realizing real estate projects, and does so by aiming for profit. Essential in this definition is that the developer that takes the financial risk in the project. This can include companies for whom development is a core business, such as independent developers, or where developing is a means for other activities, such developers affiliated to construction companies, institutional investors or businesses with a complete different core business, for example ING Real Estate or Schiphol Real Estate.

2.2.2. Developers in the development process

The task of the project developers is to coordinate and regulate the development process. Figure 2.2.2 describes the four stages describe four stages a developer normally goes through from the start to finish: initiative-, development-, realization- and the selling & operation stage (Gehner, 2003; Nozeman & Fokkema, 2008; Van Gool et al., 2013). In addition, Nozeman & Fokkema (2008) add redevelopment to process to emphasize the cyclic nature of the process.

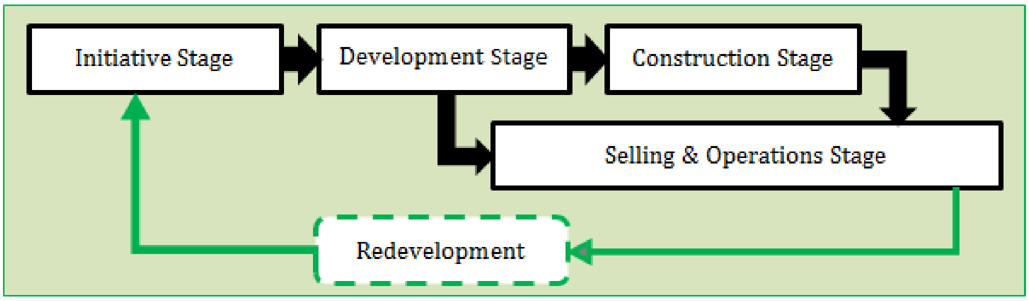

Figure 2.2.2: Stages in the development process (Gehner, 2003; Nozeman & Fokkema, 2008; Van Gool et al,. 2013)

The **initiative stage** starts with a concept for a real estate project. When the project seems feasible, the plan is being expanded further in the **development stage**. Due to the financial crisis, project developers have become more careful with the actual start of the building process. Many costs can arise when it takes a long time for a completed building is sold or let; therefore developers are cautious with being ahead of the demand and try to promote its project early in order to come in contact potential sellers or tenants (Hol & Daamen, 2014; Uittenbogaard & Veldman, 2013). The construction of the real estate starts in the **construction stage**. In the **selling and operation stage** the developer can either keep the real estate and lease the property or sell it to an owner or investor, if this hasn't happened already. Commercial real estate or rented properties usually go to investors and owner-occupied properties to the owner/user. Instead of constructing a whole new property, a developer can choose for **redeveloping** existing real estate. In this case, the development process starts again at the initiative stage.

2.2.3. Financing in the development process

Going through the four stages of the development process, the developer is facing various expenses regarding the land purchase, construction, consultation, insurances, and other costs. The costs made during the development process are summarized by Gehner (2003) and shown in figure 2.2.3. Note that this pattern is not fixed and developers can deviate from this pattern depending on the nature of the project. Nevertheless, two large expenses can be recognized with the land purchase in the beginning of the project and the construction costs later in the process, which together normally take up more than 70% of the total costs (Gehner, 2003; Hörchner, 2008).

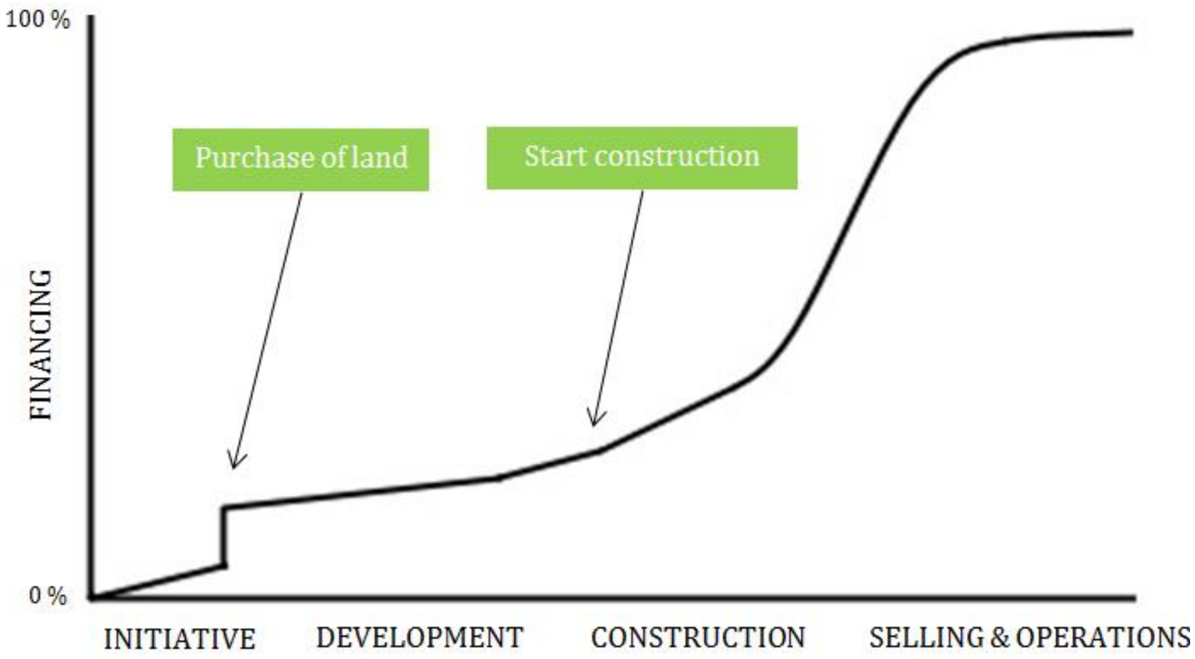

Figure 2.2.3: Financing costs in the development process (Gehner, 2003)

2.2.4. Financing methods for developers

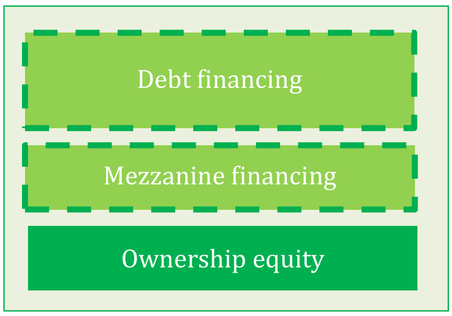

Figure 2.2.4: Different financing options for developers. Note that visual proportions do not represent actual proportions (Hörchner, 2008).

For securing financing, the developer can choose between ownership equity, mezzanine financing and debt financing, where debt financing normally takes up the substantial part of the financing in real estate (Hörchner, 2008). Ownership equity is usually provided by the developer and other sponsors who are initiating a project. Venture capitalists, private investors and institutional investors can provide mezzanine financing, which are forms of subordinated debts that are needed to bridge the equity gap. Other institutions, mainly the banks, deliver the rest of the financing. The basic financing structure for developers is shown in figure 2.2.4.

The providers of debt capital will take their decision based on an assessment of the risks of the project compared to the yield one receives for taking the risk. They seek to obtain as much certainty as possible to receive their investment back through quantifying their risks by analyzing different elements of the project, such as the quality of the real estate object, market research, and the reputation of parties involved. If the risk is high, more equity capital from the initiator will be demanded to reduce the risk of losing capital if the project fails, since debt capital comes before ownership equity in the hierarchy in case of a project failure. On the other side, if the project succeeds, the developer can gain very high returns on ownership equity. Thus the provider of ownership equity takes the most risks but also receives the potential increase in value of the real estate object (Uittenbogaard & Veldman, 2013; Van Gool et al., 2013).

2.3. Analysis framework

This chapter combines the crowdfunding process as explained in chapter 2.1 with the development process for developers in chapter 2.2 in order to examine the relationship between crowdfunding and developers. This is used to construct an analytical framework for the qualitative research.

2.3.1. Crowdfunding in the financing of real estate development

It is commonly known that the context in which a business operates affects and changes its strategy (Hakansson & Snehota, 1989), and so the changing environment also influences the business context of developers. After the financial crisis, the availability of resources for development has changed for developers. Attracting debt capital has become more difficult because of a higher risk management by the suppliers of capital. They demand more certainties regarding the pre-sale or pre-lease of property and a higher contribution of ownership-equity (Mackaaij & Nozeman, 2014). Developers can change their strategy and look for other financing sources:

> *"Developing with cheap money is over. The challenge is to bundle different cash-flows from unusual sources together in an intelligent way" - Uittenbogaard & Veldman (2013:56)*

> *"Today's market is marked by an increasingly diverse mix of active lenders, with the previous dominance of banking institutions eroded by the entry of non-bank financial institutions, such as insurance companies, debt funds and private equity"- Cushman & Wakefield (2014:2)*

> *"In a market where banks are retreating, developers who cannot receive enough funds from banks have to look for other financing sources. A developer can use more ownership-equity or can look for financers who are willing to contribute against higher risks, possibly against higher financing costs. The question is, which parties can and want to finance in real estate?" – Mackaaij & Nozeman (2014:24)*

In addition to financing the project with traditional financing methods, the developer can attract capital through crowdfunding. Figure 2.3.1 shows the relationship between the crowdfunding and the various financing methods used by developers. Crowdfunding could be used to replace debt financing, mezzanine financing or ownership equity. As many different forms of crowdfunding exist, it can subsequently function as one of the three financing options.

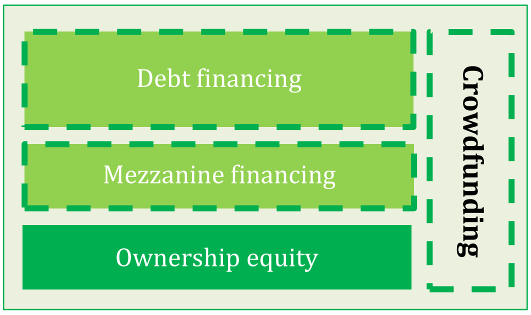

Figure 2.3.1: The financing structure for developers including crowdfunding (Hörchner, 2008)

2.3.2. The crowdfunding process for developers

The essence of a developer is to develop real estate. To accomplishing this, funds are needed for financing the development process of real estate. Next to traditional financing methods, crowdfunding can be chosen as an option, which makes the developer the initiator in the crowdfunding process. Although crowdfunding is centered on the exchange of capital, other motives can be distinguished in the literature for developer to engage in crowdfunding, such as marketing-, research and social purposes (Gerber et al, 2012; Mollick, 2014; Schwienbacher & Larrade, 2010). Attracting funds from investors can be done according to four business models: donation-based, reward-based, loan-based or equity-based (Cholakova & Clarysse, 2015; De Buysere et al., 2012; Hol & Daamen, 2014; Mollick, 2014). Investors can decide to invest for financial or non-financial incentives (Bellaflamme et al., 2013; Gerber et al., 2012). If the crowdfunding campaign is successful, the developer receives the capital for his real estate project and the investors will receive compensation depending on the reward-model.

2.3.3. Conceptual model

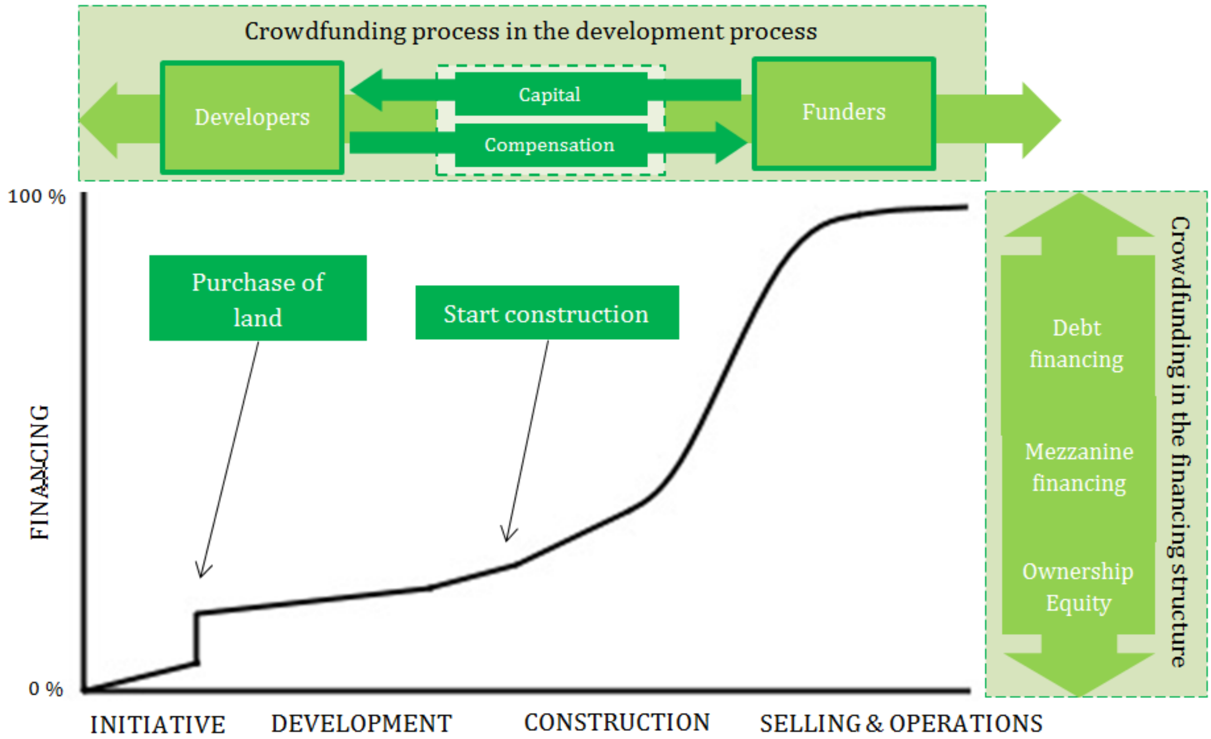

Figure 2.3.3: Conceptual model explaining the relation between crowdfunding and developers (Author)

The conceptual model in figure 2.3.3 is based on the literature and offers a basis for the interviews. This model is explained as follows. In realizing real estate projects, developers coordinate the whole operation from start to finish in the development process. During this process, financing is needed to fund the project, in which the purchase of land and the start of the construction can be distinguished as two largest expense posts. Concerning the financing structure, developers can use crowdfunding as an additional source of financing, next to or as a replacement for ownership-equity and other forms of debt-financing. If crowdfunding is used, the crowdfunding process will occur parallel to the development process, and might even extend beyond; if for example institutional investors purchase the real estate and are in charge of the management of the crowdfunders.

In summary, although the literature offers insight in some facets of crowdfunding for developers, either from the perspective of the crowdfunding process or from the perspective of developers, both facets together provide only a limited understanding of the position of this emerging phenomenon for developers.

The aim of this research is to increase the understanding of the relationship between these two concepts by examining the relevant issues connecting crowdfunding and real estate development. In this theoretical framework, the concept of crowdfunding (sub-question 1) and the financing structure for developers in the development process are explained (sub-question 2). Next, these two concepts were combined in the analysis framework to explain their relationship (sub-question 3). In order to understand how developers can use crowdfunding in the Netherlands, interviews are being conducted among Dutch developers to explain how do developers see the role that crowdfunding can play in the development process in the Netherlands (sub-question 4). These interviews are focused on the two research-questions:

(1) the motives for developers to engage in crowdfunding in order to explore the reasons why a developer would use crowdfunding; and
(2) how developers would apply crowdfunding in real estate, to examine the shape of a real estate crowdfunding campaign initiated by developers.

In the next chapter, the methodology of data selection and data analysis is explained.

3. Methodology

Clifford et al. (2010:3) describe qualitative research as “a set of techniques that are used to explore subjective meanings, values and emotions such as interviewing, participant observation and visual imagery”. Corbin & Strauss (2015) assert that this approach allows for the exploration of areas not thoroughly researched and offers insight in how meanings are formed and transformed.

Crowdfunding is a very recent phenomenon and so far little research has been done in its application to the real estate market. As this research is concerned with exploring the motivations of developers to engage in crowdfunding, a holistic and comprehensive method is most suited. Thus a qualitative approach will be taken in the form of semi-structured interviews. In contrast to structured or unstructured interviews, this form has some level of prearranged order while at the same time allowing for flexibility in the way questions are asked (Longhurst, 2010).

3.1. Case selection

When selecting participants from a population, a researcher has to consider the heterogeneity that exists in the population (Rice, 2010). There are multiple ways to distinguish different developers, such as the market they are active in (residential real estate, commercial real estate or other nice markets) or whether they are active in different geographical areas or scale levels, such as local, regional and national. However, the most used distinction is according to their main business activity (Fokkema, 2008; Nozeman & Mackaaij, 2014; Uittenbogaard & Veldman, 2013). Fokkema (2008) distinguishes four different groups of developers: independent developers, constructing developers, developers affiliated to institutional investors or developers affiliated to companies with a different core business.

Round	Developers contacted	Interviews arranged	Rejections	No answer
1	8 new	1 (person)	2	5
2	17 new, 6 re-contacted	3 (person), 1 (telephone), 1 (email)	1	18

Table 3.1.1: Process of contacting developers during this research (Author)

Developers are business people from organizations. Therefore the information they provide might be sensitive business information and lead to a reserved attitude. Although this issue cannot be fully addressed, even with other non-business related participants (Longhurst, 2010), confidentiality and anonymity of the information obtained was assured to the respondents before the interviews. However as much as discreteness was guaranteed during the process of contacting the developers seen in table 3.1.1, many rejections were received. This combined with the limited timeframe in which this research was carried out made it impossible to interview at least one out of each category. Although this will have an impact on the reliability of the results, it is not expected to influence the results greatly as the developers are regarded as an expert in the real estate sector more than representing their specific companies. Table 3.1.2 shows the six interviews that were conducted, together with the respective locations of the respondents in figure 3.1.3.

Respondent	Location	Company	Developer type
1 (in person)	[Confidential]	[Confidential]	Affiliated to a company with different core business
2 (in person)	[Confidential]	[Confidential]	Constructing Developer
3 (in person)	[Confidential]	[Confidential]	Constructing Developer
4 (in person)	[Confidential]	[Confidential]	Constructing Developer

5 (by email)	[Confidential]	[Confidential]	Constructing Developer
6 (by phone)	[Confidential]	[Confidential]	Constructing Developer

Table 3.1.2: Overview of interviews conducted for this research (Author)

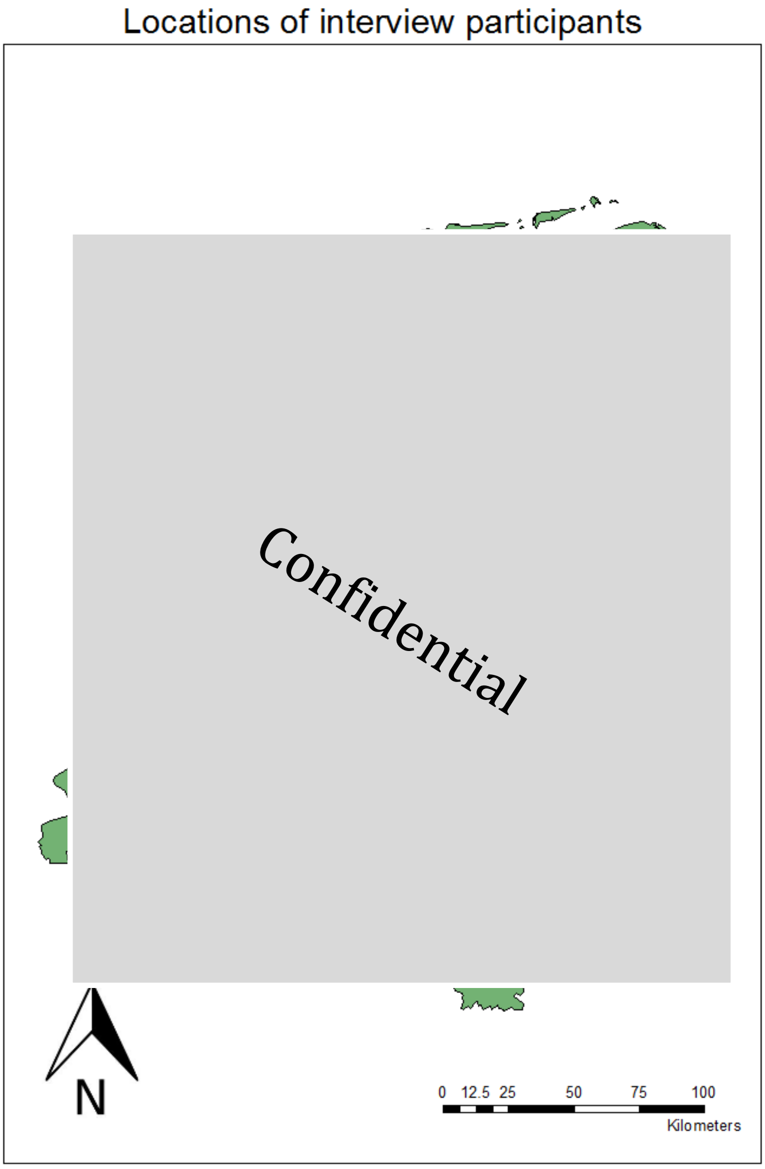

Figure 3.1.3: Locations of the offices of the interview participants (Author)

3.2. Interview procedure

The interview guide that was used is shown in appendix A. Based on literature recommendations (Clifford et al., 2013), the interview guide is constructed to include the main topics relating to the research questions, while at the same time allowing room to explore unexpected discussions as is vital for this research approach. As a qualitative approach is not a linear process, the question phrasing evolved over time, drawing on experience from previous interviews. Moreover, during interview the question order could change slightly per interview, as is usual in a semi-structured interview, where the discussion develops in a conversational way so that the respondent can address topics they feel important (Longhurst, 2010).

The interviews lasted between 30 and 60 minutes and were conducted personally (four), by telephone (one) and by email (one) from April 2015 to May 2015. Each interview was recorded and transcribed immediately to ensure minimal loss of data. Approximately 35 pages of transcriptions were made.

3.3. Data analysis

As this research deals with qualitative data that represents a small group of people and is highly specific to the participants, issues for representation and interpretation arise in the analysis of the data (Clifford et al., 2010). The most common way to still perform ‘good research’ in qualitative research is by using coding (Cope, 2010). This method is described by Cope (2010:440f) as “assigning interpretive tags to text based on categories or themes that are relevant to the research [...] in an effort to understand meanings in a text”. The codes are divided according to the research questions and are subsequently subdivided in themes following the theoretical background. ATLAS.ti, a qualitative data analysis and research software, will be used in the process. The findings are summarized in the next chapter.

4. Results

In this chapter the results of the data analysis will be presented in order to answer sub-question 4: *How do developers see the role that crowdfunding can play in the development process in the Netherlands?* In the first section, the motivations for developers to engage in crowdfunding will be discussed. The second section will go into the methods for developers to apply crowdfunding.

4.1. Motivations to engage in crowdfunding

The respondents indicate that it is more difficult to attract financing for real estate development than before the financial crisis. Banks demand more collateral for their loans and provide less debt equity, requesting more ownership-equity from developers. The respondents indicate that banks on average are still willing to fund around 60%, as opposed to around 80% before the crisis. When this 40% has to be financed through intern ownership equity, this will have a considerable impact on the financial resources of the companies. Therefore desirable is that a part of the 40% has to come out of the market.

> *We still manage to involve banks in the financing of real estate, but that normally stops at 60%. I still need 40% more and the question is who will bridge that gap. I would say, one chooses the path of least resistance, and then you have to look at professional parties. If you name that crowdfunding, then I have no problems with that, but then you have to define what crowdfunding exactly is. – Respondent 4*

To what extent the financial crisis has affected the developers' operations depends on the type of developer and their business model. One respondent says that they are still able to attract enough equity from the bank. Another indicates that their parent company still provides enough capital to develop. However, other developers indicate that less pressure on ownership equity or less dependency on banks are desirable and thus alternative forms of financing such as crowdfunding are seen as positive developments. Especially regarding independent developers, opportunities for crowdfunding are identified by the respondent, since they have less access to financial resources.

> *We are not experiencing financing issues. But what if [parent company] abandons us and [respondents company] is independent? We have to realize projects and I'll need money from the market. Banks are not interested in the risks so I have to find different channels. In that case crowdfunding could be a solution. – Respondent 1*

> *For us and definitely for other developers crowdfunding can be an alternative. Perhaps even more for independent developers, who are essentially living from the development and turnover of real estate. – Respondent 6*

Although the respondents so far do not have experience with crowdfunding in real estate, they are aware of its merits. Generally the respondents indicate that the main reason to use crowdfunding is purely as a financing instrument. Crowdfunding can provide developers another tool to complete projects. Additionally, one respondent indicates that he would only use crowdfunding for the crowdsourcing (research) element:

> *The motivation is to attract customers in an early stage of the plan, when choices are still available, although they are limited. – Respondent 5*

Furthermore, various advantages of crowdfunding are mentioned such as the bigger scope of people who would like to invest, the opportunity for investors to invest in something one can't reach normally and the low threshold for investors to participate. Moreover, respondents point out that the low interest rates banks currently offer makes crowdfunding an attractive alternative investment option for ordinarily private investors as well as businesses who are seeking to invest their money.

However, considerable disadvantages are recognized by the respondents which so far have discouraged them to apply crowdfunding. The main point addressed by the respondents is regarding the management of all the actors who are already (or become) involved in the development process. On the one side you have to deal more with more stakeholders in an already complex process: the 'crowdfunders':

> *We simply don't have the know-how or the people to talk with so many companies and people [crowdfunding platforms and crowdfunders] to fully close the financing.[…] Now we only deal with [parent company], but then with a dozen parties. – Respondent 1*

On the other side you have to take the traditional parties involved in the development process into account: the bank, the largest supplier of debt equity, and occasionally the institutional investors, usually the buyer of real estate. What is their opinion when a share of the funds is acquired through crowdfunding? Respondent 3 gives an example by explaining the negative effect that crowdfunding could have on a project:

> *As a disadvantage I think mostly the image, because I have the feeling that it is a "Plan B". It displays uncertainty. […] What becomes of the projects' image? Can it be negative? You presented your plan to different parties, that didn't work and you use crowdfunding as a "Plan B". […] If institutional investors do not see something in certain real estate objects, it doesn't work, because they are from my point of view the experts. – Respondent 3*

Furthermore, the respondents mention that the characteristics of the real estate sector present challenges. The amount of funds a developer has to raise for an average real estate project through crowdfunding is fairly large. Two respondents summarize:

> *My question is, is it possible to raise such an amount of money? […] How many investors do you have to bring together? A lot of effort for only a small amount of money? On the other side, you have to find that out together. Who will start? – Respondent 6*

> *Is there a basis to create such a new financing structure? If we look at financing structures, we would like to keep it as easy accessible as possible so that it adds value. Which conditions do we have to create to attract the capital, because there is enough capital in the market, favorable enough for our advantage? I don't think it is feasible. With enough energy you can manage it, but the chance to go wrong is much larger. – Respondent 4*

Overall, a lot is still unclear about how the crowdfunding process will unfold. Although some developers are experiencing a lack of financing options and see crowdfunding as an alternative source of financing, the threshold to apply crowdfunding is fairly high.

4.2. Applying crowdfunding by developers

4.2.1. Crowdfunding in the development process

In the later part of the initiative stage, after you are able to present an attractive plan, and before the start of the construction is regarded as the most suited time to start a crowdfunding campaign. The construction stage consumes the most capital and thus it is desirable to arrange as much financing as possible before this starts, since debt capital through banks is often not available in this phase. Thus crowdfunding is considered most suited as extern ownership equity or mezzanine financing to reach the 40% of financing needed for a real estate project that is required to attract 60% of debt financing provided by banks. The respondents do not foresee what form of loan is most suited for crowdfunding: either as extern ownership equity, mezzanine financing or it can even have same conditions as capital from banks – this is dependent on the wishes of the suppliers of capital.

4.2.2. Crowdfunding campaign in real estate

The outline of a crowdfunding campaign is regarded by the respondents as highly dependent on the investors, the supplies of capital. The respondents agree that it would be difficult to attract funding from informal investors. The capital needed is too high and attracting large numbers of ordinarily investors is considered unrealistic. Instead, private parties such as (local) businesses, REIT's or wealthy private investors are named as the target group. However, the respondents indicate that these parties usually 'know what to do with their money'. Thus to make crowdfunding appealing for this group, you have to offer a complete and professional prospectus. Respondent 4 mentions the downside of this:

> *"The tenant, lease agreements, zoning plans, land registry data, financial position of the organization and the specific financial constructions that are behind the project. With crowdfunding you have to provide this information, but you can't just throw every contract on the internet. This is more important than with other products, since so much capital is involved." – Respondent 4*

Overall, the developers suggest that enough profit for reasonable risks is the most important factor in attracting funds. Although acknowledged is that higher social value can make a project more attractive, it is doubted if it indeed plays a role in attracting investors from alternative investment opportunities, and are perhaps willing to accept reduced profit in return for social value. Only for small scale projects the social value a real estate project offers can perhaps play a role for local investors. But if investors over larger-than-local geographic areas want to be attracted, the profits and risks are what interest investors. Other aspects of the crowdfunding campaign such as the type of real estate, compensation model and the role of a crowdfunding platform are focused on attracting this type of investor:

Type of real estate: Generally any type of real estate object that generates enough return for the investors is considered suited for crowdfunding. Respondent 6 is more specific. He suggests that regarding commercial real estate, it is possible to offer higher yield to the investors than in residential housing. However, the downside is that you have to deal with more parties, which makes the already complex process even more complex. This relates to the issue of managing the investors.

Compensation model: either loan-based or equity-based – whatever offers the most favorable financial conditions. Crowdfunding through donations is not considered suited and non-financial rewards are difficult to offer in real estate.

Crowdfunding platform: most respondents mention that a platform should offer certainty and reduce risks in such a way that it appeals to investors. Examples are named by the respondents such as using certifications, a role of the Dutch financial regulatory agency or connecting reliable parties to your platform. A limitation is mentioned by respondent 2 who indicates that when using a platform, "another link is involved, another party who wants to gain profit", therefore emphasizing the importance of reliability a platform has to show.

Crowdfunding platforms specialized in real estate could play an important role in reducing the issues experienced by the developers, such as mentioned by respondent 4 earlier in this paragraph. Respondent 6 states that:

> *If we would search for finances through crowdfunding, we would out-source the organization. Currently companies exists who can do that better then we can. We also hire an architect to design a building, so you can also employ a company to start a crowdfunding campaign. – Respondent 6*

A professional platform could offer solutions in for example the management of investors, organizing crowdfunding campaigns and a reliable independent organization, so that confidential information does not have to be published on the internet.

4.3. Crowdfunding in the development process

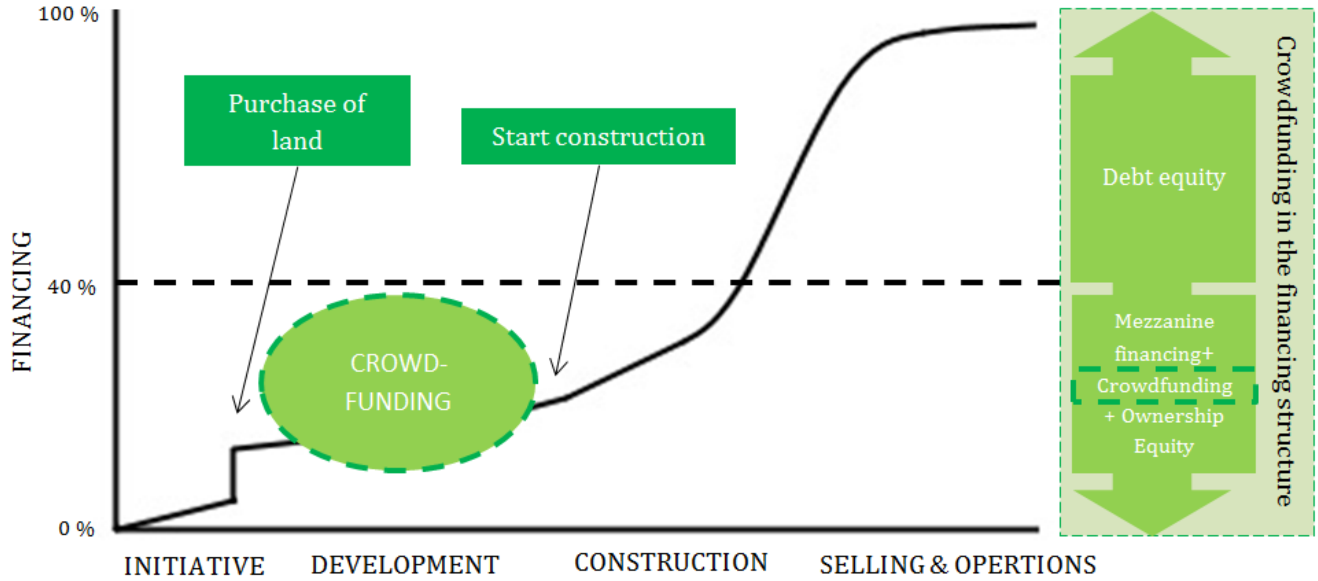

Figure 4.3: The role that crowdfunding plays in the development process according to the interviewed developers (Author, based on Gehner, 2003; Hörchner, 2008)

The role that crowdfunding can play according to the respondents is shown in figure 4.3. Regarding the development process, the respondents see crowdfunding suited around the development stage as an additional source of financing to reach the 40% of ownership capital or mezzanine capital required. Their motives to engage in crowdfunding would be for financial purposes and occasionally for research objectives. Furthermore loan- and equity based models are considered the most suited, as investors are generally only interested in the financial return through crowdfunding.

5. Discussion and Conclusion

5.1. Discussion

Following the observations of Nozeman & Mackaaij (2014), crowdfunding so far has not been used as an alternative source of financing in for real estate development. In previous academic literature various motivations for initiators of crowdfunding campaigns can be distinguished, such as using crowdfunding as a financial-, marketing-, research-, and social instrument (Schwienbacher & Larrade, 2010; Mollick, 2014, Gerber et al, 2012), where the motivation to securing financing is normally considered the most important. This research finds that the financing aspect of crowdfunding is the most important factor for developers to engage in crowdfunding. The core business of developers is to realize real estate and extra financing is certainly desirable considering the reduced availability of financing sources for developers since the financial crisis (Cushman & Wakefield, 2014; Nozeman & Mackaaij, 2014; Uittenbogaard & Veldman, 2013).

Although very limited and only under certain conditions, crowdfunding additionally is recognized to be an option for developers for its research value. Considering that the Dutch real estate sector is changing from a growth-market to a replacement market, where the demand to space becomes more important than simply building real estate, researching the wishes of the users are becoming more important (Uittenbogaard & Veldman, 2013), and thus makes crowdfunding an interesting financing option. The marketing value, as suggested by Hol & Daamen (2014) was not identified, as well as developers pursuing social goals.

However, different developers face different issues in obtaining financing, insofar that the needs to embrace crowdfunding are different. Following the observations of Nozeman & Mackaaij (2014), independent developers are more likely to adopt crowdfunding than affiliated developers since they are do not have access to capital from a parent company.

Concerning the investors in crowdfunding, developers are aiming to attract them through financial incentives. Non-financial incentives, in the literature regarded as a valuable way to attract crowdfunders (Agrawal et al., 2011; De Buysere et al., 2012; Gerber et al., 2012) are not regarded as decisive in medium or large scale real estate projects. Specifically (semi-) professional parties are seen as the target group.

Relating to the different compensation models that exist in crowdfunding (Cholakova & Clarysse, 2015; De Buysere et al., 2012; Hol & Daamen, 2014; Mollick, 2014), donation- and reward models are not regarded suited for real estate. Although Hol & Daamen (2014) see opportunities for donation-models, developer agree that for them, the amount of money needed is simply too high to collect donations. Instead, equity- and loan-based schemes are suited, as long as the project offers sufficient yield.

Furthermore this research finds that developers perceive considerable issues related to crowdfunding. Firstly, similarly as Agrawal et al. (2013) suggest, the managing of crowdfunders and the necessity of revealing business information in order to attract investors are recognized by developers as the main points of concern. Secondly, this research shows that the perspective of other actors involved in the development process are important in the decision whether or not a developer decides to finance through crowdfunding. Mentioned are the banks as largest suppliers of debt equity and the institutional investors as the buyers of leasable real estate.

As this second issue unfortunately lies beyond the scope of this research, Agrawal et al., (2013) suggest a solution to address the first issue, which could also be applied to real estate by drawing on examples of the US model of crowdfunding in real estate. They assert that specialized crowdfunding platforms can play a crucial role in managing the crowdfunding process and offer a framework for rules and regulations to reduce the risks perceived by the investors. A reliably platform could present information in form of a reliable prospectus in a compact way, without having to reveal sensitive information.

Furthermore Agrawal et al. (2013) indicate that a right institutional framework can contribute to shaping a reliably and suited crowdfunding environment that protects investor, specifically regarding loan-based and equity-based crowdfunding. The JOBS Act has in America has accelerated the developments in these forms of crowdfunding (Cholakova & Claryssee, 2015; Mollick, 2014), and also for crowdfunding in the real estate sector in the US (Vogel & Moll, 2014).

For the Dutch context, the AFM (2014) acknowledges the desire for adjustments in regulations concerning loan-based and equity-based crowdfunding. Changes are perhaps in sight (Ministerie van Financiën, 2015), where an important change will be the ability for platforms to ask commissions. This will make the role of a platform as intermediary a more viable business model and support in emergence of professional crowdfunding platforms as already can be seen in the US.

5.2. Limitations

Before coming to the conclusion of this research, first the limitations of the analysis are mentioned. First, since this research is from an explorative and qualitative nature, the results should be regarded as such. Even though a careful interview guide was developed, I noticed that more knowledge regarding the complexity of the development business was necessary to explore more opportunities and be more precise during the interviews. Furthermore the case selection did not go as desired due the high amount of rejections and the tight schedule, which limits the ability to present generalizations, especially regarding the perspective of independent developers and developers affiliated to institutional investors.

Secondly, this research does not encompass data from the investors involved in crowdfunding. They are the suppliers of capital in crowdfunding and their motivations to contribute can be highly relevant for a full understanding of the opportunities this new phenomenon offers for developers, and give further insight in the motivations behind the developers.

However, regardless of these limitations, this research provides interesting insights in the understanding of the relationship between crowdfunding in real estate development.

5.3. Conclusion

Through a qualitative analysis, this paper brings insight into the way Dutch developers look at the emerging phenomenon of crowdfunding as an alternative financing method. In describing the crowdfunding process and the development process, a more detailed picture of the characteristics of this financing tool is presented in order to investigate how developers decide to engage in crowdfunding to attracting capital for real estate projects.

Six developers are interviewed to increase our understanding of this relationship. Although crowdfunding has not been used by the developers so far, advantages and opportunities are recognized in light of the effects of the financial crisis such as the ability to attract additional capital through other, non-traditional channels. However, considerable disadvantages exists that so far withheld developers to establish such a new financing structure. Most of these perceived issues can be addressed firstly by shaping a suitable institutional context and secondly the emergence of professional crowdfunding platforms out of the market. Furthermore, the type of developer and their business models influences the way crowdfunding is considered suited.

If crowdfunding is to be applied, certain guidelines can be recognized. The financial return is considered the most important in attracting investors. As the required capital in real estate is large, professional parties are the main focus point of developers. The crowdfunding campaign should communicate sufficient certainty and yield to reduce the risks to make a project financially appealing, following the developments of equity-based crowdfunding in the US. For small scale projects local investors can be attracted who might be satisfied with less profit in exchange for the social value a project offers.

Regarding the limitations of explorative and qualitative research, Crowdfunding can offer developers an alternative financing source to realize real estate projects, of which this research offers a first step in understanding the relationship.

5.4. Recommendations

As the first connections between crowdfunding and developers are explored, more detailed research is necessary for a better understanding of different areas. It is needed to look more in depth at the options of crowdfunding for different types of developers. The independent developers for example are experiencing the most issues in finding enough funds to develop, which could mean that crowdfunding would be the most interesting for them (Nozeman & Mackaaij, 2014). Additionally the developers affiliated to institutional investors might find interest in the emergence of equity-based crowdfunding. This group keeps ownership of the real estate through a lease-structure and thus does not have the issue of dealing with an investor for buying the real estate.

Furthermore investigating the perception of professional investors could give more insight in the supply side of crowdfunding in real estate. Questions such as under which conditions high profile investors are willing to invest through crowdfunding will also influence the behavior of developers and their application of crowdfunding. And additionally, what is the position of the bank, traditionally the largest supplier of capital to developers, in all this?

Lastly, the high amount of capital and the risks involved in the real estate sector requires a surveillance role of the state and the AFM, the Dutch financial regulatory agency. As the demand of crowdfunding as an alternative financing method is increasing, by initiators, investors and platforms, further research is required to explore the whishes from the state, the market and the general public, in order to give shape to a desirable institutional framework. Until then, the borders of crowdfunding as used by developers are still unclear.

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7. Appendix A: Interview Guide

Introduction

- Can you introduce yourself?
- How would you define crowdfunding?
- Do you have experience with crowdfunding in real estate?

Motivations to engage in crowdfunding

- What would be a motivation for you to use crowdfunding in real estate?
  As a financing-, research-, marketing-, or social instrument
- How do you look at crowdfunding as an alternative financing method in real estate development compared to other traditional methods?
- In which stage of the development process (initiative-, development-, construction-, or selling and operations stage) would you use crowdfunding?

Applying crowdfunding

- Which type of real estate projects do you regard as suited for crowdfunding, and why?
- On what type of investors would you focus a real estate crowdfunding campaign? And on which scale level would that be (local, national or international)?
- What do you think is important regarding the presentation of a real estate project in a crowdfunding campaign?
  In order to attract funders
- What kind of compensation do you find most suited to attract crowdfunders to a real estate project?
  According to a donation-based, reward-based, loan-based or equity-based model
- What criteria should a crowdfunding platform fulfill on which a real estate project can be presented?

Conclusion

- In short, what do you consider the advantages and disadvantages of crowdfunding in real estate?
- Is there anything you would like to add to this interview that you feel is important?