Should I invest in equity or debt?

Understanding the different risk/reward profiles and the capital stack is crucial for due diligence.

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All real estate investments ultimately have to do with land and/or the structures on it. However, **you can invest** in real estate in **two completely different ways: debt or equity**.

The two have **vastly different risk and return** profiles, so understanding the differences (and where they fall in something called the "capital stack") is crucial to picking the best investment for you.

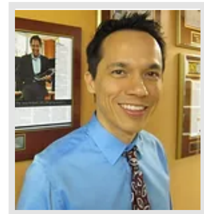
Debt

When you invest in **debt,** you make a **loan to the borrower**. In return for the use of your money, they pay you back the original loan **(principal)** plus **interest** for the use of your money.

Some examples of debt investments are mortgages, bridge loans and hard money loans. The **contract** to repay a debt **is called a promissory note;** which is why some people call debt investing: "note investing".

You can loan money for **short-term** (a few months to a year) or make **longer term** loans lasting years or decades. Payment terms might require the borrower to pay both **interest and principal** on every payment (like mortgages). Others (like hard money loans) are typically **interest-only**, meaning that the borrower pays only interest on the payments and then pays the entire principal back on the final payment when the loan comes due.

About Ian Ippolito



Ian Ippolito is an investor and serial entrepreneur. He has been interviewed by the Wall Street Journal, Business Week, Forbes, TIME, Fast Company, TechCrunch, CBS News, FOX News and more.

Ian was impressed by the potential of real estate crowdfunding, but frustrated by the lack of quality site reviews and investment analysis. He created The Real Estate Crowdfunding Review to fill that gap.

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Equity

When you invest in **equity,** you are a part **owner of the property** and get to **share in the profits**. These profits come from **rental income** and/or property price **appreciation.**

Often equity investment **returns** are **structured to split the profits** between you and the sponsor based on certain milestones (which is called an "equity waterfall"). For example, you might invest in an apartment complex that awards you 100% of the profits up to 7% IRR. Then the investment agreement might say that you split the profit 75%/25% up to 14% IRR. And then all profit above that might be split 80%/20%.

It's **important** that you **understand how the split works** and feel comfortable that it is protecting you as an investor and is not overly generous to the sponsor.

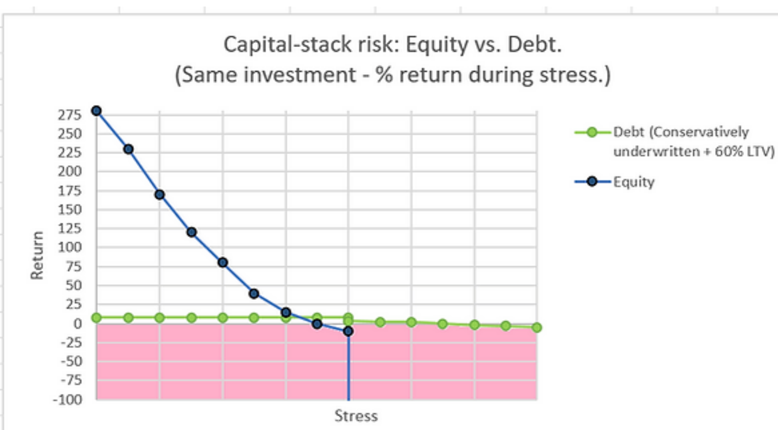
So what's the difference?

In general, **debt is safer than equity on that same investment**. This is because if something goes wrong, and the property is foreclosed and sold, the **debtholders get paid first.** In a liquidation situation like this, **equity holders** often have no recourse. Even in situations where they do, they're still in a much **higher risk of taking losses** or completely being wiped out then a debt investor in the same project.

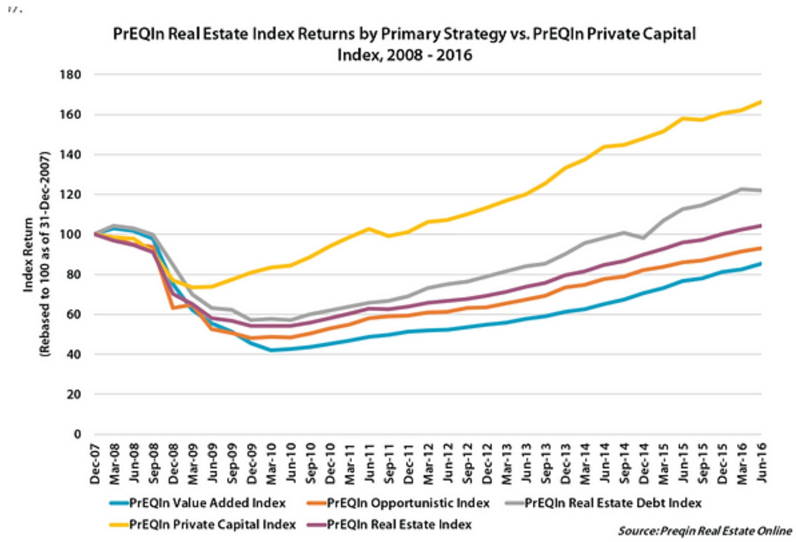
The flip side of this is that since **debt** is safer it **has a lower return** than equity.

Also, **debt investments** have **no upside potential**, while **equity does**. If a real estate project is **wildly successful** the **debt investors do not get to participate** in the unexpected success and are limited to simply getting the agreed-upon interest rate. However, the **equity investors** do get to participate in the **extra windfall.**

Here's a hypothetical investment showing what the two scenarios look like. When things go well you'd much rather be in equity. When they go badly you'd much rather be invested in debt.:



Note: this doesn't mean that every debt investment is less risky than every equity investment. Investing in Bernie Madoff's debt is more risky than investing in equity in core, income-producing real estate. So you have to use judgment and look at the individual investment. However, the entire universe of debt, is safer than the entire universe of equity, so it's a useful rule of thumb:



The capital stack

All types of debt and equity are not created equal. Even in a single real estate project there are often different classes of debt and equity which have different rules for getting paid in normal times and liquidation scenarios.

The structure is called the "capital stack". Before investing a single dollar, it's crucial you understand the project's capital structure and where your investment falls in that stack.

Here's an exa

Senior debt is the safest and largest component. As the safest, it also has the lowest expected return.

Mezzanine debt is **less safe** because unlike ordinary debt, it doesn't have the physical property as collateral (but simply equity in the controlling company). In a default you have a much higher chance of both your return and principal being wiped out then senior debt. So it has a **higher return**.

Preferred equity is next and then **common equity**.

Not all real estate **projects** have the **complete stack**. For example, a **hard money loan** investment is just the **senior debt** portion at the base of the above and usually has no other types of debt or equity involved. **Other projects** might have an even **more complex stack**.

No matter what the structure, it's **important** that you fully **understand what it** is in the project you are considering your investment in. Once you know that, it's vital to understand **where** in the stack **your** particular **investment would be**, and what that means to the risk and reward. Once you know that, you can **gauge if this investment** is structured to **meet your** investment criteria and **goals**, or not.

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