FUTURE OF BROKERAGE

7DS ASSOCIATES

FOREWORD

After 5 years behind the management curtain of Coldwell Banker Bain, and 8+ years on the sales side of the real estate industry, I know how it feels to sit behind your desk. From risk management to recruiting and retention to understanding financial statements to tempering the emotions of agents and clients, the daily tasks of a Broker require emotional intelligence and business acumen not always found in the same person. This is why it is such a challenging position to hold.

Why is the role of Broker so difficult? Beyond the balancing act are some other hard truths:

> **Agents are independent contractors.** As the Broker we are legally responsible for their actions, but we can't tell them what to do. With employment and labor laws as they are, independent contractors get to choose the manner in which they do business.
>
> While we are required to enforce legal compliance, we cannot require that agents do any tasks that drive business. The agent has to be motivated enough to follow up with her clients, connect with her sphere of influence, stay up to date on local issues affecting homeownership, etc.
>
> **Recruiting and retention, two sides of the same coin, create tension.** Adding to agent count is a requirement of our jobs as employees of the brokerage. But bringing top agents on from other offices requires making deals. We have to offer them more money, whether via higher splits, lower fees, paying for their marketing or office space or any one of things in our bag of tricks. But God forbid a current agent find out about the "deal" and hold us hostage for the same or better. Prepare to dance with the devil.
>
> The other alternative is hiring newly licensed agents. The risks versus rewards are high for a number of reasons. Training and mentoring are huge investments in time and resources. Many new agents don't see a sale for the first 90-120 days. When they do, we have to make sure they're not breaking the law and exposing the company to liability. The brokerage is spending money, and the agent isn't adding to the company dollar. And then less than half of them renew their licenses after the initial licensing period.
>
> **Brokers are responsible for decisions impacting the entire business.** Sometime the decisions are wrong, and we have to answer to a corporate team and the agents. But the fear of failure can't paralyze us from making decisions for the good of the business, agents, and consumers.
>
> Being caught in the middle of divergent forces is our responsibility every day. Corporate leadership and agents rarely see eye to eye on what is important and how business should be handled. Our role is to be able to see then sell both sides of the argument to audiences with opposite mindsets.

With shrinking margins across the country and across traditional brokerages, the financial rewards are lower and the stresses of the job are higher. We face increased competition for talent from the rising powerhouses of 100-

percent transaction-fee shops and agent teams. Technology has changed how the public receives and processes information, and how we have to work to meet their demands. And compliance issues keep getting more complex.

After years in the industry and months of research and financial analysis, 7DS Associates is ready to describe a better future for brokerages, agents, and consumers. Throughout this white paper we lay out our findings. Brokerages will be more profitable. Agents will be more productive. Consumers will be better protected.

There is a better future; and we look forward to sharing our findings with you.

Sunny Lake, Partner, Brokerage Consulting

1. THE FUTURE OF REAL ESTATE BROKERAGE

The challenges facing the brokerage as we enter the second decade of the second millennium are unprecedented. Margins are shrinking, agent teams are eating out the brokerage from within, and brokerages struggle with value propositions. Technology enables ever more disruptive businesses. Regulatory burdens are becoming heavier, not lighter.

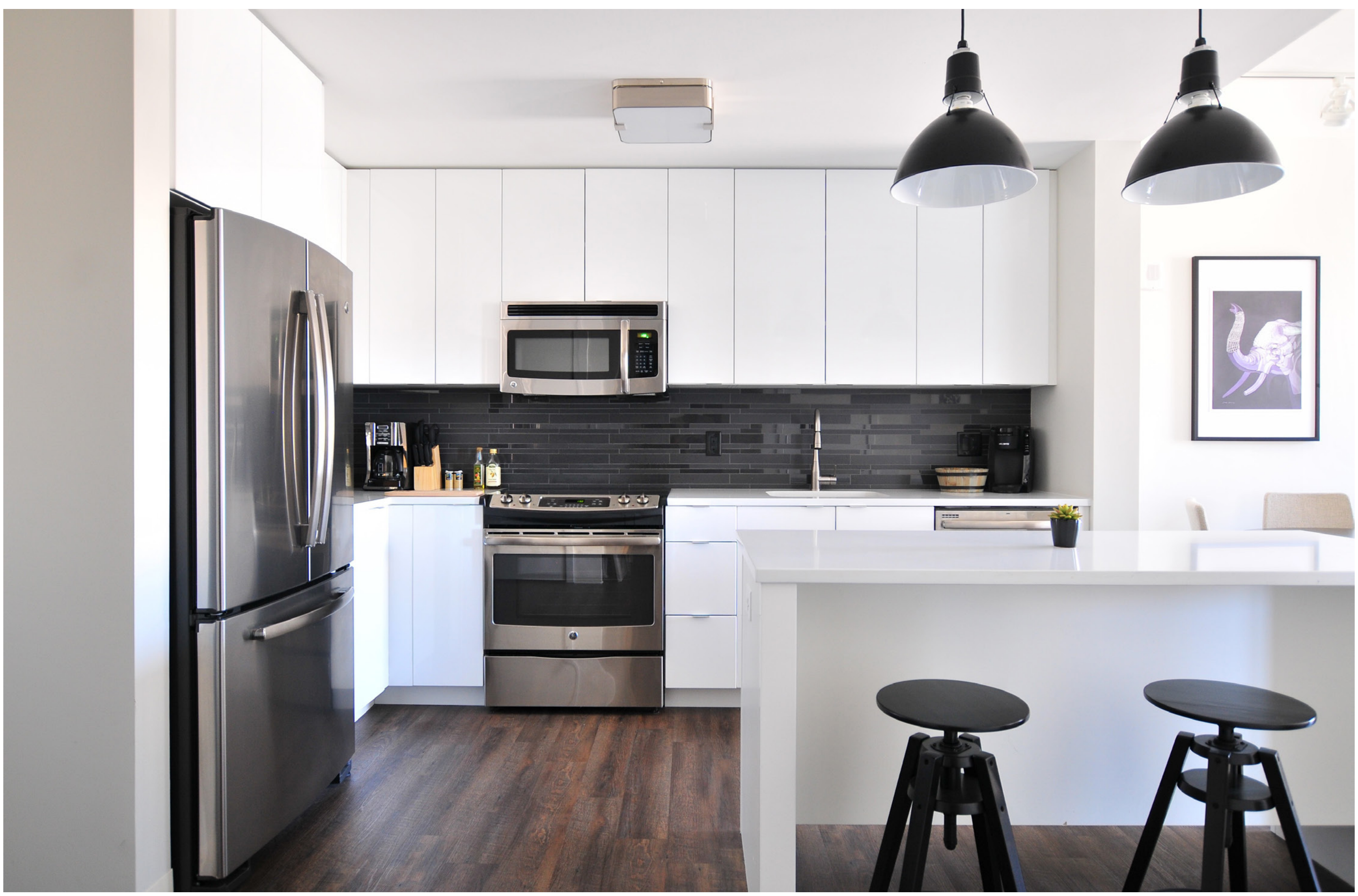
There are two powerful forces at work in the real estate industry of the 21st century.

On the one hand, the agent-centric model pioneered by Re/Max in the 70's and early 80's has been supercharged by the development of the agent team. The agent team represents one of the major threats against the split-based brokerage. **The logical endpoint of the agent-centric model is the 100% transaction-fee only brokerage.**

On the other hand, technology-powered brokerages such as Redfin (which went public recently) represents a major threat against split-based brokerages who rely on their agents for lead generation. The revelations in Redfin's S-1 are sobering for the brokerage industry.

Brokerages are squeezed between these two forces and struggle to maintain any sort of unique value propositions, which in turn results in a squeeze on profitability.

After years of studying the industry, taking into account recent developments, we believe that the future of real estate brokerage is a new **employee-agent model with an element that has been previously missing,** firmly allied with best of breed technology companies. It is the future out of necessity: it is the only path brokerages can navigate between two powerful forces of economics on the one hand and technology on the other.



2. THE AGENT TEAM IS EATING THE BROKERAGE

It is not at all unusual to find large agent teams today, where several Buyer Agents work under a single Lead Agent. Some particularly strong listing agents have created “super teams” with *several dozens* of Buyer Agents who span large geographic areas. Some agent teams that cross state lines, requiring multi-state licensees.

With a team in place, the listing agent no longer has to send surplus leads back to the brokerage; he can send such leads to his buyer agents for a cut of the buy-side commissions. Rather than allowing the brokerage to leverage his listings, the agent team leader leverages his listings himself.

The economic impact is quite significant.

The table below is a summary of the economic impact on the Lead Agent, the Buyer Agent, and the Brokerage. It assumes the Lead Agent on a 90/10 split with the brokerage, and the Buyer Agent on a 60/40 split with the brokerage. It also assumes that the Lead Agent and the Buyer Agent are on a 50/50 split with each other. We assume a 25% broker override for broker leads. Total commission is $20,000 for both sides combined.

	No Team	A. Team Splits, Then Broker Takes	B. Broker Takes, then Team Splits
Total Commission	$20,000	$20,000	$20,000
Lead Agent	$9,000	$13,500	$13,500
Buyer Agent	$3,500	$3,000	$4,500
Brokerage Income	$7,500	$3,500	$2,000

In effect, the agent team takes the place of the brokerage in terms of monetizing the flow of leads from the listings. The agent team structure *transfers income from the brokerage to the Lead Agent.*

Operational Advantage of Agent Teams

If the economics strongly favor the creation of the agent team, the Lead Agent's control over the listing provides the agent team with an enormous advantage in operations.

An agent team can enforce its brand standards, procedures, and training regimen. Unlike a brokerage, which requires its agents to go out and acquire leads, the Lead Agent of a team controls the lead generation of the team. In fact, such effective lead generation – whether through personal networks, effective farming strategies, or online marketing – is a pre-requisite to form an agent team. Furthermore, the team's brand is often the personal brand of the Lead Agent, and in a very real way, he takes how clients are treated far more seriously and far more personally than any office manager of a brokerage.

3. THE NEXT WAVE: TRANSACTION FEE BROKERAGE

Given the structural problems of the agent-centric business model, the next generation of brokerages will be the 100% transaction-fee brokerage. These companies allow the agent to keep all of the commission, often charge no desk fees or other monthly fees, and only charge a flat fee per transaction. And they are taking market share away from the biggest and oldest brokerages in the country every single day.

For example, in Phoenix, 100% companies like HomeSmart and RealtyOne grew significantly while traditional brokerages shrank. HomeSmart gained 140 producing agents in 2016, and RealtyOne grew by 80 producers. Meanwhile, Keller Williams lost 97 producing agents, Coldwell Banker lost 54, Berkshire Hathaway HomeServices lost 28, and Re/Max lost 26 producing agents. This is far from an isolated statistic, nor is it an anomaly. Across virtually every market we have studied, traditional brokerage companies and traditional brands are losing producing agents, while these low-cost 100% shops are gaining agents.

How are they able to do this?

By leveraging technology these 100% brokerages are able to offer agents – particularly experienced team leaders – everything they want from a brokerage, despite the extremely low fees. These companies have taken the Re/Max model to the next level by eliminating desk fees and charging only a transaction fee to the agent. Traditional brokers make a mistake in believing that these low-cost providers are not offering a full range of services to their agents.

The fastest growing non-tiny brokerages in the United States today are RealtyOne and HomeSmart. The fastest growing brands are newcomers like NextHome, which operates at extremely low-cost, allowing them to add small teams as brokerages.

Take a look above at what Tony Hull of Realogy says in a recent earnings call:

> But to the other part of the — we are a full service broker and we want to enhance the value proposition we provide to agents. And obviously we have 47,000 agents who think the value proposition is very strong and the company generates $4.4 billion of revenue.
>
> So we think we have a rock solid foundation. But we always can improve on things like coaching and training and more leads and more lead conversion, better marketing tools and that sort of thing.

Literally every single brokerage CEO could have said -- and do say -- the exact same thing, including the newest generation of 100% transaction-only brokerages. They are full-service brokerages, with the same value proposition to agents, at a fraction of the cost.

In April of 2017, Inman published an article entitled "The rise of the next-generation 100% commission brokerage" in which it profiled a number of rising stars like RealtyOne and HomeSmart.

In the article, Inman quotes Josh Harley, the founder of Fathom Realty out of Dallas-Fort Worth. He believes that the 100-percent model brokerages will come to dominate the real estate industry, and become the new "traditional" brokerage:

"Once our model reaches a 15-percent market share of agents, our model will cross a pivotal point in the adoption lifecycle and the industry will begin to see a significant shift of agents moving to 100 percent companies like Fathom," he said.

Harley is half correct. One future of real estate brokerage is indeed these 100 percent companies. It is not the only future, however. The other future is the zero percent model – otherwise known as employee model brokerages.

Furthermore, Harley does not consider the ultimate end of the 100% brokerage model. We do.

4. PROBLEMS OF LOW-COST BROKERAGE

Our view is that the 100-percent brokerages is the short-term heir apparent and will replace the traditional split-based brokerages, whether through competition or through forcing traditional brokerages to become 100-percent brokerages. Quite a few "traditional" brokerages have been forced to offer deals to their top producing listing agents that are on par with or sweeter than the deals of the 100-percent brokerages.

However, there are two main reasons why we believe the 100-percent brokerage is not the ultimate future of brokerage. First, the economics will ultimately get to a point where there can only be one or two major 100-percent brokerages in any given market, possibly across the country. Second, there are significant political and regulatory problems that will ultimately paralyze the 100-percent brokerages.

The Economic Argument

In cost competition, the company that can be the most cost-efficient ends up taking market share away from everybody else, and that growth fuels their efficiency, which leads to more of an advantage in competing on price. And usually, only one other competitor can come close.

We have seen this dynamic play out in other industries where cost competition is the norm. For example, there is Home Depot and Lowes, and a number of small local hardware stores. Walmart dominates local retail wherever it pops up. In pharmacy, Walgreens and CVS utterly dominate the market.

With brokerage services to agents, which are quite commoditized, the 100-percent companies have an enormous advantage over traditional brokerages. But once traditional brokerages either convert or disappear, then competition becomes about who can offer the same or similar services at the lowest possible cost. Only one company can actually be the lowest possible cost, and everyone else loses.

The logic of price competition is a race to the bottom until we hit a price level beneath which no one can go without losing money. And every other company who cannot hit that price level either goes out of business or shifts completely and resigns itself to being a boutique in a small niche.

The Political Argument

The real issue, however, follows the economic argument. Real estate is a regulated and licensed industry. Every single agent and broker has a career only because of government permission.

The rationale behind government licensing of real estate agents has always been, remains today, and will be in the future, **consumer protection.**

We have already seen that traditional brokerages with their 70/30 splits do a poor job of enforcing training, standards, and discipline on their independent contractor agents. Is that likely to improve under 100-percent companies who have razor-thin margins to begin with, whose business model *requires* large headcounts in order to work?

So it begs the question: How long will the authorities allow such an arrangement to continue?

The answer is: Until there is a scandal.

We have already seen this logic play out in Canada when the province of British Columbia took the entire real estate industry to the woodshed because “shadow flipping” hit the newspapers. The resulting reforms include a number of new responsibilities for brokers such as the affirmative duty to report violations and the responsibility to keep records and report them to the regulator, as well as a general requirement to have “active and direct oversight” over agents. Plus, the fines for violations were increased from $50,000 to $500,000 for a brokerage.

One cannot argue against these rules. The whole point of granting a license to anyone is for consumer protection. To the extent that the consumer is not adequately protected – or *seen* as not adequately protected – the authorities have the responsibility to change the rules, change the regulatory scheme, or do whatever is in their power to protect consumers.

The single biggest problem of any agent-centric model of brokerage is the inability to enforce training, values and discipline on the agents who are independent contractors. That problem is magnified for the 100-percent brokerages whose margins are so thin.

In fact, from a consumer protection standpoint, the best model for real estate brokerage is one that the industry does not take very seriously: the employee model. We turn to that next.

5. THE EMPLOYEE MODEL: A CLOSER LOOK AT REDFIN

The industry has flirted on and off with the employee model over the decades, and most of them have failed for a very simple reason: you cannot pay top producing agents enough to make it worthwhile. And without top producers, a brokerage is not viable. So most employee models are at small boutique brokerages that are really no different from an agent team.

But there is one major exception to the list of tried-and-failed employee-model brokerages: Redfin.

Anecdotal information from people who have worked at Redfin suggests that the technology tools available to Redfin agents are better than anything else available in the real estate industry today. Former Redfin agents who have since gone independent routinely say they miss the agent tools that Redfin provides.

The technology is superior, but combining that technology with its unique employee-based model gives Redfin a nearly insurmountable advantage.

Redfin does not recruit agents based on their past production, size of network, etc. but on their ability to advise consumers and deliver customer service to them. After recruiting, Redfin manages those agents using measurable data, whether customer service ratings via Net Promoter Score, or activity. Redfin managers are actual managers, rather than recruiting specialists with a penchant for ego management.

REDFIN

Redfin is An Agent Team

Redfin agents are required to do things the Redfin way. They must deliver high levels of customer service as defined by Redfin, on a timetable defined by Redfin, through the process defined by Redfin. Redfin agents put customer information into the Redfin database, and use the marketing provided by Redfin.

How is Redfin able to do this?

Redfin's website generates leads. Virtually every single one of the leads that their agents work comes from the company.

What does that sound like? **It sounds like a rainmaker on an agent team.**

That is the best way to think of Redfin: a technology-powered agent team that did $16.2 billion in sales volume from 25,868 transaction sides in 2016 across 84 markets.

Not every customer interaction with Redfin is without issue. Like any company, there will be bad employees, poor managers, and bad experiences. Even Nordstrom, Neiman Marcus, or Four Seasons are not perfect. But those companies, like Redfin, can create and enforce a company-wide culture of customer service that no real estate brokerage beyond the smallest boutique in North America can do today.

Redfin is an agent team acting as a brokerage. And as such, it is beating every single agent team in North America.

6. THE THIRD PATH

Given the above, going down the 100-percent model means the brokerage must be prepared to be *the* lowest-cost provider. That requires completely overhauling the company to drive expenses down as low as possible, which the existing 100-percent companies have already done.

On the other hand, to try to compete with Redfin on technology is a daunting task. For starters, a brokerage would have to at least match the $35 million that Redfin spent on technology in 2016. The brokerage would also have to figure out a way to hire and manage the best engineering talent in the world, who can just as easily go work for Facebook, Google, or Apple.

For the vast majority of brokerages today, neither path offers any real hope. They can't out-HomeSmart HomeSmart, and they can't out-Redfin Redfin. So what are they to do?

This is where 7DS Associates can guide you. We offer a third path, which we believe is the real future of brokerage in North America.

7. THE PROFESSIONAL SERVICES FIRM

There is nothing in the license laws that prohibit brokerages from treating their agents as W-2 employees, rather than 1099 independent contractors. Brokerages have chosen to treat agents as independent contractors largely for tax purposes, and because removing the carrying cost of having employees at all – which includes not just the salary, but benefits and payroll taxes as well as business expenses – allows brokerages to operate at a (tiny) profit even while giving away most of the revenues as splits to agents.

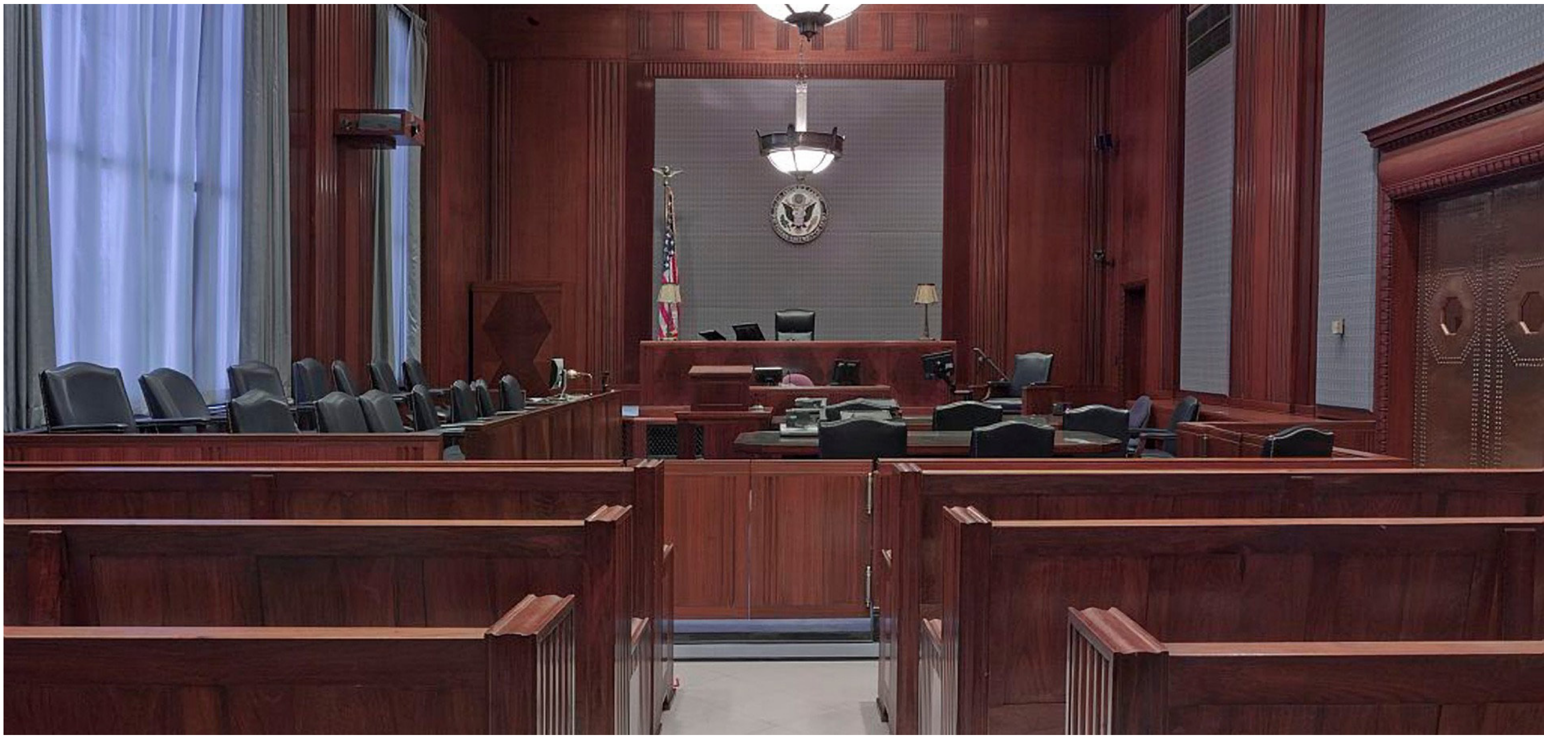
The employee model brokerage, however, suffers from a history of failure. A number of companies have tried, but ultimately could not succeed for a very simple reason: **the top producers make too much money under the split**

model. A top producing agent with a strong listings practice and buyer agents on her team might earn well over a million dollars per year. There is no economically sound way to recruit and retain such high producers, and yet, without them, the brokerage cannot survive.

Yet, we believe that the employee model is the only valid model over the long term.

Redfin proves that an employee model brokerage can work, but only if it controls lead generation. Control over lead generation leads to control over the agent, who can be hired as W-2 employees.

The challenge, then, is to come up with a structure which takes the top producer challenge into account, while giving the brokerage control over lead generation to enable the control over the agent population. We have done just that.



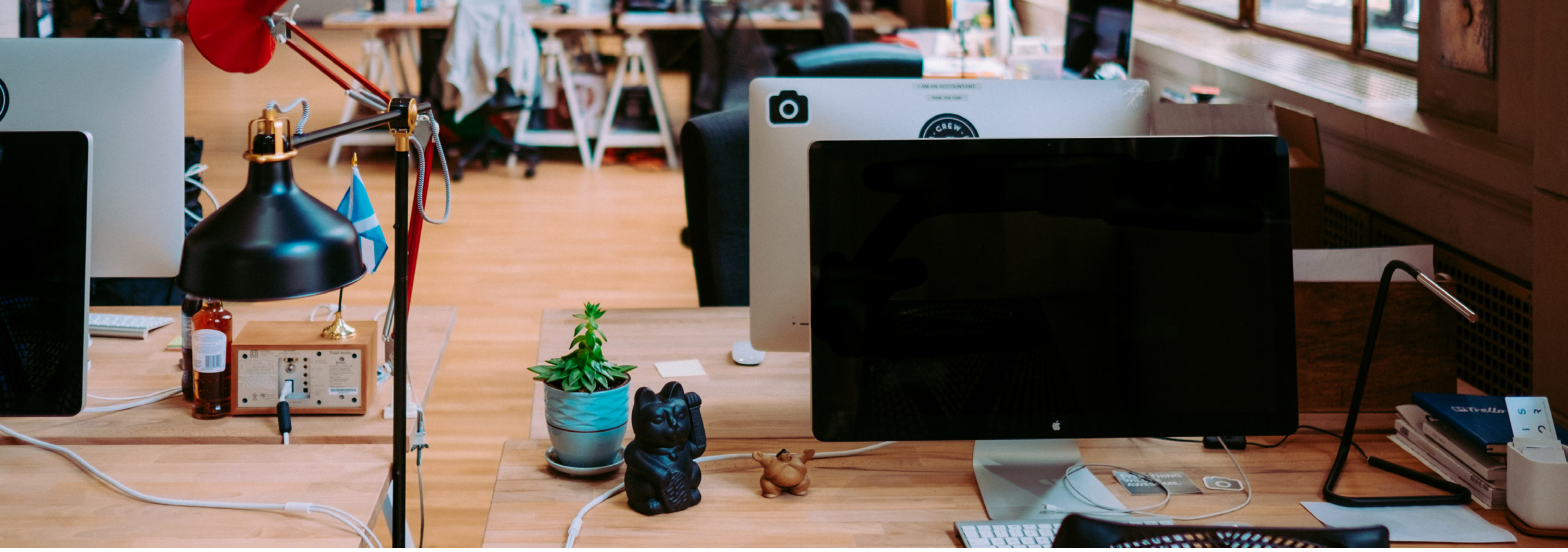
7DS Model of Brokerage: The Firm

In virtually every other industry that offers professional services, such as law, consulting or financial services, the typical organization is a **firm of partners with associates who are employees.**

Our research shows that the firm model can work in real estate. In fact, not only does it work, it turns out to be the most profitable model when done correctly. A brokerage organized as a firm is more profitable than 100-percent brokerages, which is easy given the latter's extremely thin margins, but it is also more profitable than traditional brokerages with low splits.

The 7DS model makes one critical change in the employee model by taking the top producers into account. Those men and women simply cannot be hired as salaried employees from a cost perspective. At the same time, they are absolutely necessary for success of any brokerage model. Our solution is to make them owners of the firm itself – **top producers become partners of the brokerage in much the same way an accomplished lawyer becomes a partner of the law firm.**

We have come to three critical insights that make our model possible: two for the brokerage, and one for top producing agents.



Brokerage Insight: Company Dollar

We believe the most important number in a brokerage's P&L statement is not the topline revenue nor the bottom line profit, and certainly not the agent count. It is Company Dollar – the amount of money left over once the firm has paid the Cost of Revenues, which in the case of real estate brokerage is largely the split to the agent.

The 100-percent companies have zero Company Dollar, and generate revenues and profits from transaction fees as well as ancillary revenue streams, such as mortgage and title. Redfin uses the Gross Profit number instead, which takes into account all of the cost of revenues, including cost of home tours, marketing listings, etc., which would otherwise be paid by the independent contractor agent out of her split. And in 2016, Redfin posted 31% gross profit margins.

The traditional brokerages have Company Dollar that are, based on our research, in the 15% range. For every dollar of GCI revenue, the brokerage keeps $0.15. It then has to pay for all of the expenses, from office leases to salaries of staff to marketing costs and technology, from that 15%. Profit margins are almost non-existent.

Brokerage Insight: Control

The second insight is closely related to the first. The cost of paying a salary and benefits and taxes for an agent is lower than the cost of paying that agent a split, provided that she is productive but not too productive. How does a brokerage do that?

As an employee, the agent must abide by the training, policies, and processes of her employer. The broker can train and manage the agent in ways that he simply cannot with independent contractors. The broker can require that a salaried agent spend four hours a day making phone calls. The broker can require agents to work open houses and take in leads how the broker wants it done. If the broker has certain standards for customer service and service delivery, the employee must live up to and abide by those standards – or get fired.

All of the struggles around "agent adoption" of brokerage technology platforms disappear. The brokerage as an employer has control over his agent, which is a requirement under the real estate laws of the United States and Canada.

Agent Insight: Operational Support

None of this company dollar and control over salaried agents matters in the least bit, of course, if the brokerage does not control the kitchen table. If it doesn't have listings, it has nothing at all. And we have already established that the top producers who do get all of the listings simply cannot be paid a big enough salary where it makes any sense for either the agent or the broker.

The solution, as we have suggested, is to make them partners in the firm rather than employees or independent contractor agents. Question then is, why would a successful agent selling 50 or 100 homes a year take that offer?

We have had extensive experience working with high producing agent teams, where the Lead Agent is almost always a high energy, dominant and influential personality who generates enormous amount of leads. The agent is the one who wins awards and is the envy of his peers.

It is a very rare agent team leader who knows the numbers for her business. They might know their conversion rate, but ROI on marketing investment? No idea. ROI on technology spend? No idea.

The strain of running a business, as opposed to practicing real estate, is a burden to these top producers. They would love to focus on what they do best: lead generation, working with clients, negotiating deals, and closing transactions. Their time and attention are taken away from those to the necessities of having to run the team.

The Firm is the answer they did not know they have been looking for.

The 7DS Model: Numbers Tell a Story

We have modeled out the brokerage patterned after professional services firms and compared our financial model to those of major franchise companies, as well as large and small brokerages.

While the results are as varied as the brokerage being analyzed, its market conditions, its competition, and different models of setting up The Firm in that local market, what our studies show is that in just about every case – except for the small boutique brokerage where the broker-owner-manager still sells real estate – the brokerage benefits by converting to the Firm model.

In the case of that small boutique with a selling broker-owner, we believe that such brokerage are really more like agent teams where the broker-owner is actually the agent team leader.

For this paper, we wanted to present one comparison between a traditional national franchisee and the exact same office, transitioned to a 7DS firm model.

Traditional Brokerage		**The Firm**	
Number of Owners	1	Number of Partners	5
Number of Agents	40	Number of Associates	20
Closed Units	540	Closed Units	540
Avg. Sales Price	360,000	Avg. Sales Price	360,000
Closed Volume	194,400,000	Closed Volume	194,400,000
Gross Commission Income	4,860,000	Gross Commission Income	4,860,000
Company Dollar	874,800	Company Dollar	4,860,000
Total Expenses	844,500	Total Expenses	2,657,500
Net Income	30,300	**Net Income**	2,202,500

We have made certain assumptions, as necessary in business modeling. For example, to compare apples to apples, we have held the closed units, volume, and GCI the same. We believe, however, that the Firm model actually has *far higher per agent productivity numbers* due to the fact that the brokerage can compel its agents to do actual revenue-generating activities. Therefore, we believe that holding the Closed Units the same, with half of the number of agents, is not only fair but actually underestimates the potential of the Firm model.

We have also held the expenses, other than payroll and client-care expenses, the same: it's the same office which transitions to the Firm model, after all. For the purposes of analysis, the Salary (including benefits and performance bonuses) is about $1.9 million.

What jumps out at us and should jump out at you is that The Firm is over **70 times more profitable**. The reason is simple: the increase in expenses that come from increased payroll is more than offset by the increase in Company Dollar, because The Firm does not give away 80% *or more* of its topline revenues in agent splits.

The Company Dollar increases by 456%, while Total Expenses only increase by 215%. That increases net income – the actual take-home profits of the broker and the partners – by over 7,100%.

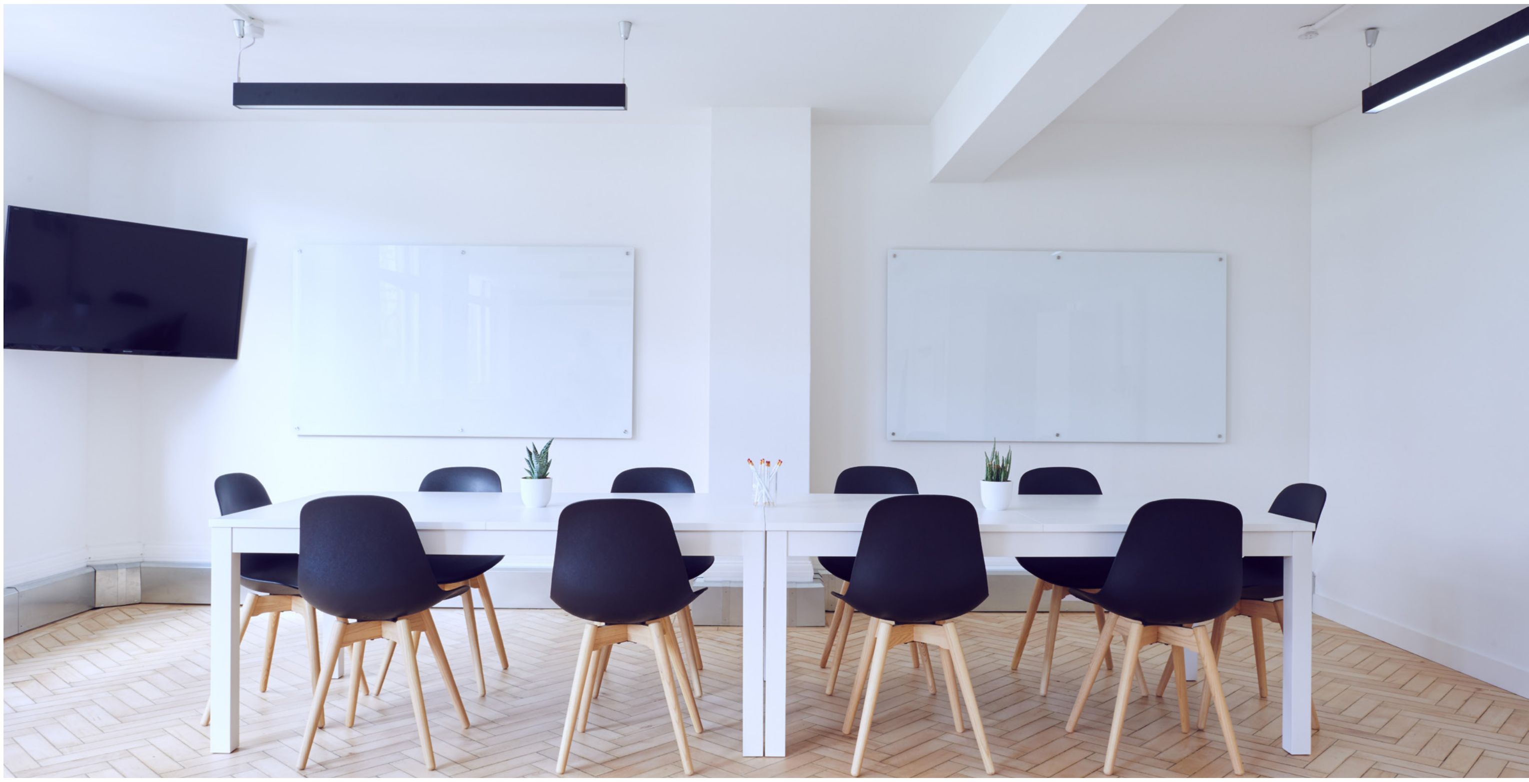
Furthermore, what our analysis shows is that **top producing agents make more actual take-home pay** as a partner in the Firm than as an independent agent with a team.

We have interviewed dozens of top producing agents, most of them with a team. The consistent response we received was that they're happy to have a profit margin between 20 and 35% of GCI, and the average was about 30%. One agent team we looked at with $21.6 million in volume ended up with a net income, after all expenses including the buyer agent splits, of **$144,125**, or 26.7% to the lead agent.

By moving all of the operating expenses to The Firm, the top producing lead agent stands to make more from her share of the firm's profits than she does as the leader of an agent team. In much the same way that a law firm reduces the expenses of its partners through consolidation of expenses, The Firm reduces the per-partner expenses of its rainmaker lead agents. In our models, based on our research, the typical top producer stands to make as much as **40% more in take-home pay** as a partner of The Firm than she does as a team leader. That is attractive enough to get any top producer to pause and consider the proposition.

Importantly, the above numbers do not take into consideration increased productivity. Freed from the need to worry about management and operational issues, the top producer is able to focus on what she does best: lead generation and client service.

These numbers tell a story, and that story is that The Firm is the future of real estate brokerage.



8. THE FIRM: FUTURE OF THE REAL ESTATE BROKERAGE

The advantages of the Firm model for real estate are numerous, and some of these advantages are not obvious at first glance:

- **Value proposition**
- **Culture**
- **Millennials**
- **Consumer Brand**
- **Readiness for Regulatory Change**
- **Total Control over Data**
- **Lower Insurance Costs**

The most important competitive advantage of the Firm over traditional and 100-percent brokerages is quality of service. Because the Firm controls its agents, it can deliver a consistent high level of service to the clients. That in turn results in more business, as every study of real estate ever has shown that referrals are the basis of success.

This is the future of real estate brokerage. We would like to help you make that future a reality. To discuss whether your company should explore the 7DS model of the brokerage as a firm, and how to get ahead of the curve, please contact us:

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Thank you very much.