THE RED DOT

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The Truth About iBuyers

Brokerage Edition

Observe. Orient. Decide. Act.

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Observe.

Introduction

One of the most important developments in the past few years has been the emergence of "iBuyers" – companies who leverage technology to buy and sell homes directly from and to consumers.

The pioneer was Opendoor.com, which launched in 2014, but it was quickly followed by others such as Offerpad and Knock, who have attracted tens of millions in venture financing.

Zillow's entrance into iBuyer space, first in 2017 as an intermediary, and then in 2018 as a direct buyer/seller itself, validated the entire space.

So why give iBuyers the Red Dot treatment? It isn't as if iBuyer is an unknown phenomenon. I've been writing about Opendoor since before its launch, after all.

Ultimately, the Red Dot is about helping you formulate strategy and make decisions. It was worth pulling together all of the disparate strains I've been writing about and talking about over the years into one document. Furthermore, I believe that most observers and industry experts simply get important things wrong because they're looking at iBuyers through the prism of the real estate industry.

Since the iBuyer phenomenon has the greatest chance of creating true disruption in the underlying process of buying and selling homes, it is worth looking at in some detail.

Robert Hahn
August, 2018

Executive Summary: Brokerage

One of the most hyped, most discussed, and most misunderstood developments in real estate in the past few years has been around the so-called iBuyers.

Yet, the real estate industry remains almost obstinately obtuse about iBuyers, choosing to focus on all the wrong things. As a result, they are simultaneously petrified at the threat of iBuyers, dismissive of them *and* utterly ignorant of the true problem it represents.

So, in this issue, I'd like to pull together all of my observations about the iBuyer phenomenon over the years, confront the true problem it represents, and place the iBuyer into context for real estate in the 21st century.

How iBuyers Work

The iBuyer solicits a homeowner to request an offer.

They use data analysis to value a home sight unseen.

They then make an offer to the homeowner, usually charging some kind of a fee and/or making a bid lower than what the AVM estimate says the home should sell for, and if accepted, they buy the house for cash.

They turn around and sell the house, usually after some maintenance, repairs, etc., and make a profit on the fees charged and on the spread between the purchase price and the sale price. It's a classic buy-low, sell-high strategy.

Industry Perception of iBuyers

The real estate industry has perceived iBuyers to be something like technology-powered house flippers. That is a business model and an archetype that has existed for decades, after all, and the industry knows how to understand it.

To be fair to the real estate industry, the iBuyers themselves operate and behave as if they are house flippers. They do pay "below market" or charge fees to cover costs and in many cases—especially Redfin and Zillow—tell consumers that the way to maximize the price is the traditional list-and-sell process. All of them talk about doing repairs or updating the property once purchased, then putting it back on the market, which is exactly what a house flipper does.

Having said all that, my overall hypothesis is that this framing of the iBuyer as a tech-enabled house flipper with tons of capital is incorrect. That may turn out to be the ultimate end, since intentions and reality have a way of conflicting, but it ignores some important truths about iBuyers. Those truths are not about iBuyers per se, but about the reality of the broken process for selling and buying homes in North America today.

And that reality has a far greater potential impact than house flipping ever has or ever will on the industry.

The Truth about iBuyers

In my view, the truth about iBuyers is that they come in two different varieties based on the initial problems that they were trying to solve.

Let's start with the consumer-oriented iBuyer companies, as they are the ones who were and will be proactive, while the industry-oriented iBuyers will be reactive, although potentially more successful in the long run.

We discussed how the iBuyer model works. What's more interesting is *why* the iBuyer model works.

Why It Works, Part 1: Consumer Experience

We may as well begin with the father of the iBuyer movement, Keith Rabois. Here he is in an interview with Techcrunch back in April of 2014:

> "For most people, homes are their biggest asset and it's completely illiquid," Rabois said. "This is a really expensive transaction for many people. What we're going to provide is **instant certainty, liquidity and convenience for normal people** to sell their homes." [Emphasis added]

There are three related but separate pain points here, and all three are important.

But much of the delay, much of what takes so much time, has very little to do with the real estate agent. She does not control most of those factors.

Uncertainty

First, you have uncertainty. Since this was one of the most important issues that Keith Rabois talked about, it's worth pointing out that selling a home is filled with uncertainty.

A good real estate agent will do what she can to help with the uncertainty—expert pricing backed up with good solid comparables, effective marketing, solid negotiations, etc.—but even with all that assistance, uncertainty is part and parcel of every traditional home sale transaction.

Inconvenience

Selling a home is painful. I wrote about having to stage my house, then tiptoe around my own living room, and then having to leave the house for an hour when buyers wanted to come by and see the place. But that really minimizes the actual experience of living through that process.

Constantly having to secure one's valuables, make sure the house is clean and in ready-to-show condition, then find somewhere to go for an hour or so is not a small thing. If you have children, the annoyance factor and the difficulty goes up, way up.

Time-Consuming

Finally, the traditional process is time-consuming. It just takes a long time.

It is not at all uncommon to see 90-day close terms in sales contracts, which means that in addition to the time it takes to prepare and market the home, the homeowner is looking at an additional three months of simply waiting to close.

One important note here: oftentimes, the real estate agent has done a fantastic. In a hot market, the real estate agent might have gotten all that done in a matter of a few days.

But much of the delay, much of what takes so much time, has very little to do with the real estate agent. She does not control most of those factors. Most importantly, the entire mortgage process is not under the agent's control.

Why It Works, Part 2: Liquidity

Why is the experience so uncertain, so inconvenient, and so time consuming?

The answer is that the buyer is usually a family or an individual who is purchasing a home. That means the buyer usually needs a mortgage.

Let us observe that ever since the housing bubble collapsed in 2007, availability of credit has been an issue. Individuals and families have a much harder time getting a mortgage today. In contrast, it is far easier for institutions to get financing for business purposes.

One of the reasons why iBuyer works is that *companies have access to capital while families do not*.

That isn't my analysis; I cannot and do not take credit for that insight. I am merely repeating what Glenn Kelman of Redfin said during the Q1/2018 earnings call.

This imbalance in access to capital is one reason why iBuyers work, and it forms the basis for why iBuyers may be a far more important than traditional real estate investors.[1]

Why It Works, Part 3: Technology & Data

The third leg of why iBuyers work is technology—specifically, the ability to put a value on a property sight unseen.

The mortgage industries have used Automated Valuation Models (AVMs) for years. AVMs are continually improving in accuracy. The advent of the internet further means that data is widely available, inexpensively stored, and easily portable.

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[1] An interesting aside here is that RESPA likely does not apply to the capital raised by iBuyers as they are non-natural persons and the loans (assuming capital is raised as debt, not equity) is likely classified as a business purpose loan. See, https://www.hunton.com/images/content/3/0/v2/30111/beware-business-purpose-regulatory-implications-investment-morta.pdf

The iBuyer phenomenon relies on modern AVMs, and the companies are always seeking to improve the accuracy of their data models. Every iBuyer company I researched for this paper has a data science team, and at least one CEO mentioned that the first employee of his company was a data scientist.

It makes sense that an iBuyer would have to rely on its AVM to price a home so that it can make an offer—even an offer conditioned on an inspection—to get the process rolling.

There are two separate, but related, issues here to be considered.

Just How Inaccurate is the AVM?

First, let us avoid buying into the industry myth that the AVM is completely and wildly inaccurate. Given that every AVM vendor—including Zillow—states that the AVM is no substitute for an actual local expert's appraisal or price opinion, just how wide is the gap between a local expert and a computer model?

In 2017, Redfin released a paper that it had commissioned with SSRS comparing Redfin's AVM with Zillow's Zestimate and Homes.com's AVM. For our purposes, what is significant is that Redfin's estimates, which took the listing price into account, were extremely accurate.

Not only were 63.66% of Redfin's estimates within 3% of the ultimate sale price, 79.69% of their estimates were within 5% of the ultimate sale price.

- Redfin's median error rate of 2.06% is *better than* the 4.5% median error rate of listing agents.
- The 79.69% of Redfin's estimates that were within 5% of the ultimate sale price is *better than* the 56% of the final list price of listing agents.

Therefore, we might conclude (or at least suggest that there is room to believe) that **Redfin's listing-price informed AVM estimate is *superior* to a local expert's final listing price**.

It may be that an MLS-powered AVM, which uses listing price as a data point in constructing the model, is more accurate than a human listing agent. At a minimum, we could say that the modern brokerage AVMs like Redfin's is at least comparable to using a fallible human being's judgment about a property and its comparables.

Does the Inaccuracy Actually Matter?

The related question is whether the inaccuracy actually matters at all, if we're in the single digit percentages.

In one study, a human lising agent has a 4.5% median error rate. The Zesimate has a 6.3% error rate. The different is 1.8%.

A couple of percentage points matters a great deal to a buyer who is taking out 30 year mortgages on a single property. To an iBuyer who is looking to buy hundreds or thousands of properties, that may be an acceptable error rate – just the risk of doing business in the way they're doing it, which they have already accounted for in their pricing models.

The inaccuracies really might not matter much at all.

The Truth about Consumer-Oriented iBuyers

Thinking through those three reasons why an iBuyer works, what emerges is that the consumer-oriented iBuyers are not actually in the business of flipping houses. They're in the business of attacking the broken process of home selling and home buying.

They have gone about trying to attack this problem of a broken process *by deploying huge amounts of capital*.

While technology can and does substitute easily for low value, high volume purchases (e.g., airplane tickets, taxi rides, etc.), it cannot and does not substitute for high value, low volume purchases like homes.

However, for owners of capital—banks, insurance companies, hedge funds, etc.—buying and selling assets is a low value, high volume purchase.

I believe the consumer-oriented iBuyers are actually doing that: making it easier for owners of capital to make money from buying and selling residential properties.

The Truth about Industry-Oriented iBuyers

Similarly, the industry-oriented iBuyers like Redfin and Zillow are actually trying to apply technology and capital to the problem of the broken process. But the end goal is to preserve the role of the real estate broker/agent as a necessary part of the process, and to defend the agent's value proposition.

So, the industry-oriented iBuyers are actually making it easier for brokers and agents to make money from helping people buy and sell residential properties.

Closing the Loop

If we think of iBuyers not as companies helping consumers buy and sell houses, but as companies helping owners of capital and brokers and agents respectively make money from real estate transactions, we can start to analyze them correctly.

Closing the Loop Defined

In many cases, the industry's closed transaction is only half of the equation for the consumer. For a consumer, if he sells his home, he has to live somewhere. In order to buy a home, he has to sell his old house.

Closing the Loop therefore is defined as the minimum required for the consumer to get into *and out of* the housing market.

The biggest challenge in Closing the Loop is timing. In most situations, we are talking about three separate parties: the seller who has to buy a new home, the buyer of his old home, and the seller of his new home.

That three-way juggling and coordinating act is difficult enough when all of the parties involved are paying cash. It becomes exponentially more difficult when there are at least two financings involved.

Technology vs. Capital

In trying to solve for that difficult problem of coordinating the timing of everything, technology can and does help, but its impact is fairly limited. Capital is what is required.

This is not to suggest that technology is unimportant; it is critical. It is to suggest that capital is far *more* important because of the peculiarities of the housing market and housing finance.

Major iBuyer Companies

So we know how iBuyers work, why they work, and we know that the truth about iBuyers is different from the perception of them by the industry.

Let's take a look at some of the major players in the iBuyer space and what makes them interesting to us.

The Pioneer: Opendoor.com

The story of iBuyer starts with Keith Rabois, who had an idea back in 2003 about revolutionizing the way that Americans buy and sell homes.

- Rabois is one of the most successful and connected entrepreneur around.
- The initial "friends and family" round of financing was for $9.9 million and the list of investors reads like a Who's Who of Silicon Valley.
- Opendoor launched in Phoenix in 2014 and Dallas a short time after and nothing will ever be the same again. It operates in 12 markets today. Phoenix, Dallas, San Antonio, Las Vegas, Atlanta, Nashville, Charlotte, Raleigh, Orlando, Tampa, Minneapolis-St. Paul and Houston.
- Opendoor claims to have served 20,000 home sellers and buyers.
- Opendoor is the leader in the iBuyer space today.
    - Market share leader in Phoenix, the ground zero for iBuyers.
    - Improved holding periods to 75 days on average for April, from 110 days a year prior.
    - Opendoor's spread is down from ~8% to ~5% in April of 2018.
- Opendoor focuses on ease of use for consumers, including an unattended home tour app, a Trade In product, and a 30 day money back guarantee.
- Opendoor has partnerships in place with 19 of the top 25 homebuilders, including six of the top ten.
- Opendoor recently raised $325 million in additional funding, bringing the total to $645 million in equity and $1.5 billion in debt. Opendoor's valuation is "north of $2 billion" today.

- Opendoor is a licensed brokerage, a full participant in the MLS, and cooperates and compensates other brokers and agents.

Offerpad

DelPrete described Offerpad as the "very definition of me too" but praised them for being able to execute on copying what Opendoor does quickly and efficiently.

- Offerpad trails Opendoor quite significantly at least in Phoenix.
    - Activities less than half of Opendoor's
    - Slower growth
    - Spread is wider compared to Opendoor
- Not necessarily a bad thing to be a fast follower

Redfin

Redfin is the first brokerage to get into the iBuyer game, launching Redfin Now as an experiment in Q1 of 2017.

- Redfin's iBuyer initiative is not a large operation. Roughly 15 homes or so purchased, $3.1 million in revenue in Q1/2018. Capital limit raised from $10 million to $25 million.
- Redfin keeps describing Redfin Now as "an experimental new service where we buy homes directly from homeowners and resell them to homebuyers."
- Redfin Now is tightly coupled to Redfin's traditional brokerage offerings.
- Faces challenges trying to straddle the line between representation and being a counterparty to the homeowner.
- Redfin Now is about offering the consumer the choice between more money later through a traditional process, or less money right now with no uncertainty.

The overall impression one gets is that Redfin Now is not a real business unit in and of itself for Redfin. It's a convenience add-on, and perhaps a bit of a lead generation device (what Glenn calls a "website feature" for Redfin.

Zillow

Zillow, the undisputed heavyweight champion of online real estate portals, entered the iBuyer space in May of 2017 with its launch of Instant Offers as a test in two markets: Las Vegas and Orlando.

- Zillow's expansion of Instant Offers into Zillow Homes in April of 2018 changed Zillow from a marketplace for iBuyers to an iBuyer.
- Zillow's iBuyer program is an elegant construct of interlocking and interdependent strategic elements. Three key advantages:
    1. Data Advantage
    2. Distribution Advantage
    3. Monetize Listing Leads
- Zillow challenge is in Closing the Loop as it has very little control over the buyer's experience.
- Zillow has purchased 30 homes since launching Zillow Offers but has yet to close a sale. 11 of the 30 are under contract, however.
- Based on Zillow's listing price for homes they purchased, Zillow's spread is 2.5% on average, implying a 0.5% spread with the average price-to-list ratio in Phoenix. This is intentional.
- Zillow is experimenting with Zillow Offers, similar to how Redfin is experimenting with Redfin Now. The goal is not to create a multibillion dollar business out of Zillow Offers the way that Opendoor has. The goal is to *preserve* the multibillion dollar business that Zillow already has.

While Redfin has greater control over the entire value chain, Zillow has a far larger footprint. It will do more to defend the value proposition of the traditional real estate agent than Redfin ever could.

Knock, Knock….

There is one startup that warrants a much closer look. It cannot be said to be a major player just yet, having raised $32 million in its Series A round of funding in January of 2017. In fact, it cannot even be said to be an iBuyer really. But it more than any other points the way to the future.

That company is Knock.

- Rather than buying the seller's old home, Knock buys the seller's new home, then lists the seller's now vacated old home.
- The cost is only 6%, and the seller will get market price for his old home.
- Lower risk leads to lower cost of capital for Knock.
- Licensed as a brokerage, a full participant in the MLS. Fully cooperates with and compensates other brokers and agents. Uses W2 employee agents like Redfin.
- Current operating in four markets: Atlanta (where it began), Charlotte, Raleigh-Durham, and Dallas-Fort Worth.
- Founded in 2015, raised $32 million Series A in 2017.
- Business model is more complicated to explain to a consumer than a straight iBuyer.

The overall takeaway from Knock is that it is actually more like a brokerage than an iBuyer.

What Knock has done is to answer the consumer frustration question, without the balance sheet risk that other iBuyers have to take on, by flipping the iBuyer model around: buy the *new* house, not the *old* house. But they're not buying the new house on their own account; they're buying it for a client. In effect, they are offering their clients an "improved" bridge loan.

It's simply brilliant.

Convergence is Inevitable

I believe that all iBuyer models will eventually converge to the same place and end up with roughly the same business model.

The reason is the importance of Closing the Loop for the consumer.

The most striking thing about the iBuyer phenomenon is that there are thousands of people who are effectively willing to pay thousands of dollars in order to skip even half of the pain, inconvenience and delay of the traditional real estate process.

Remove all of the pain, inconvenience and delay, and the total addressable market might not be 5% or even 10%. It might be the vast majority of consumers as happens with automobiles.

They have gone about trying to attack this problem of a broken process by deploying huge amounts of capital.

In that world, the counterparty to most real estate transactions is an institution: the iBuyer, who becomes a new intermediary between the ultimate parties.

There already exists such an intermediary: the market maker.

The Market Maker System of Real Estate

The market maker system evolves from the convergence of iBuyers as more liquidity is injected into the system.

A seller can sell his house to an iBuyer and buy his house from an iBuyer. The iBuyer in turn sells that old house to someone else, who has sold her house to an iBuyer. And the cycle continues.

Sets the Price

One of the effects of iBuyers is that they begin to influence the price.

Any offer to purchase has to be higher than Opendoor's; otherwise, the seller would simply take Opendoor's offer. And given the amount of its sales activity, the sales comps will start reflecting Opendoor's pricing on the sale side.

Over time, the Bid and Ask prices of iBuyers become one of the most important comps for all buyers and sellers.

The market makers effectively set the price of houses, hence the name: they make the market.

The Role of the Agent

There will always be a role for those agents who work with unique properties that computers have a difficult time pricing. Unique properties will just have to go "off-market" and be handled with the traditional, time-consuming process.

Everything else can be sold to a market maker and bought from a market maker.

Consumers will still demand an expert help them through the transaction. But like stockbrokers, the real value of the agent becomes psychological and *advisory*.

That is actually a critical role. Even if market makers take much of the pain, inconvenience, and delay out of the process, the consumer still has to decide to buy or to sell. Expert advice and counsel have enormous value still.

It is, however, an enormous change to go from a salesperson to a consultant. Most of the agents currently working in real estate will have a difficult time making that transition.

A Word on Market Conditions

Much of the criticism, dismissal, and concern trolling of iBuyers revolves around the idea that iBuyers will all go bankrupt when the market shifts from one of the hottest seller's markets in history to a buyer's market.

The iBuyer is not a local speculator who took out huge personal loans to buy and flip a few houses. The iBuyer is an institution looking to create liquidity through the application of large amounts of capital.

Just like market makers in financial and commodities markets, the iBuyers will simply adjust their Bid/Ask spread. In a buyer's market, the spread would widen as buyer demand drops and housing inventory rises. iBuyers would pay less to homeowners and try to maximize their profits or minimize their losses. Nothing fundamental changes.

Zillow and Redfin Would Explode

Two beneficiaries of the market shifting to a buyer's market, or even a more normal market, are Zillow and Redfin. Most of their traffic comes from buyers today already. Both companies were founded and came of age during the collapse of the housing market. As Glenn Kelman once said, "We were born in the dark."

But if they were tiny startups during the Great Recession, both companies are dominant online portals today, with 187 million and 25 million average monthly visitors. The term "Zillow" overtook the term "real estate" on Google as the most searched term in real estate. They're public companies, worth billions of dollars, with access to capital.

If the market shifts to a buyer's market, those two would explode.

Other iBuyers Likely Benefit as Well

In today's extraordinary seller's market, the motivation of a homeowner to sell their house to an iBuyer is relatively low. After all, they could get multiple offers within 48 hours of listing their home.

That psychology changes if the home starts to sit on the market for a month, three months, six months. The holding costs start to add up. The uncertainty piles up by the day.

The iBuyers will need to manage their inventory risk and adjust pricing. But the psychology of the seller may undergo a shift in a buyer's market that it has not to date.

Summary of Recommendations for Brokerages

Please turn to the Recommendations section at the end, for a much more detailed discussion of each of these.

- ### Don't Be Afraid

  The first recommendation is to take iBuyers seriously and see them for what they are.

  After having read this paper, what the broker should understand is that the iBuyer phenomenon was not created by venture funds putting billions of dollars into tech companies. **It was created by consumer frustration**

with a broken process. The iBuyer entrepreneurs chose to try and *solve* that process, instead of trying to *cope with it*.

On the other hand, since brokerages and their agents are at the very heart of that broken process, they have the best opportunity to offer the best solutions.

- ## Work With, Not Against, iBuyers

Brokerages should be looking to work with as many iBuyers as they can.

Working with an iBuyer does not mean simply presenting their offers to your clients or bringing a buyer to one of their properties.

Explore deeper and more meaningful partnerships with iBuyers in your area: deep integration between your systems, sharing data across companies, cross-training your people and theirs, etc.

- ## Shamelessly Copy Knock

For brokerages who have access to capital (see below for more on this), I recommend shamelessly copying Knock as much as you can.

Knock does not purchase the seller's house and put it on its balance sheet. Where Knock *does* spend its own money is in buying the new house for the client. But it does so only after that client has been fully preapproved and executes a purchase agreement to buy the new house from Knock upon the sale of his old house closing.

This is something that just about every brokerage can do if they have any kind of access to capital. So copy Knock shamelessly. Imitation is the highest form of flattery.

- ## Unlock the Value of Your Data

Let me be clear about what I'm saying here when I say "your data." I do NOT mean your listings.

Listings are advertisements of a home for sale. The value of advertising is to generate a sale of the thing being advertised, period.

So when I talk about unlocking the value of your data, I mean all of the *non-advertising* data you and your agents will gather throughout the transaction process.

That data may not be immediately useful, but once you have collected enough of them and made that data usable by machines… now you've got something of real value.

- ## Think Really Hard about Closing the Loop

Just like the iBuyers themselves have to think hard about Closing the Loop, the brokerage on the ground has to really focus on it.

Even in a traditional sale and a traditional buy scenario, the broker in the middle should be thinking really hard about the consumer experience through that process.

While many brokerages think that this is precisely what they and their agents do, a cursory examination of their actions versus their words shows otherwise.

- ## Start Preparing Today for the Market Maker Future

Strategically, if consumer demand is driving things towards convergence, and convergence naturally evolves into a market maker system, then as a broker you need to decide what your role will be in that future.

Then you need to start preparing for it.

For example, take a look at your training today to see how much of it is geared towards helping an agent become an advisor and how much of it is about sales.

That's a bit of a rhetorical question, since you and I and everyone else in the industry knows that "training" in real estate is really sales and lead generation training.

Take steps today that would start to prepare your agents to become advisors and counselors instead of salespeople. Some suggestions:

- **Product knowledge**
- **Market knowledge**

- **Process knowledge**

Much of that knowledge is gained through simple experience, but few brokerages try to capture that knowledge and pass it on to new agents. Instead it's lead generation and sales techniques until the cows come home. If the market maker system becomes reality, those agents will be at a huge disadvantage in proving their value. Plan for that inevitable future.

- Capital, Not Technology

For larger brokerages and national franchises, it is worth seriously investigating relationships with capital providers: banks, insurance companies, hedge funds, public markets, etc.

The brokerage industry is obsessed with technology, and it's a mistake.

Where opportunity exists today is not in building new and better AVM technology or in trying to drive traffic to your franchise website, but in building relationships that will allow your company to be the one bringing huge amounts of capital to solve the consumer's problem.

I'm going to assume that any company large enough to consider going down this route have the necessary people to figure it out. Feel free to contact me if you'd like some assistance tailored to your situation.

Conclusion

The iBuyer exists because of consumer frustration with the broken process of buying and selling houses. The industry could completely misunderstand the phenomenon if it continues to think that iBuyers are a flash in the pan, venture funding fueled experiments that will fold the minute the market changes.

Consumer frustration will remain the same no matter the market.

If iBuyers solve that consumer frustration by application of huge sums of capital, then they will first converge in order to Close the Loop on the consumer experience, and then evolve into a market maker system of real estate.

Brokerages, MLS and Tech companies in real estate have to decide whether they are going to ignore the problem of consumer frustration, defend the status quo, or try to solve the problem. Ignore the problem, and you become irrelevant. Defend the status quo, and you will get run over. Only those who are part of the solution will survive to see 2030.

At the same time, the iBuyer phenomenon presents some amazing opportunities to transform your businesses if you are willing to let go of fear, over-reliance on the status quo, and move with confidence into the uncharted future with consumer experience as your North Star. There is far more opportunity here than crisis.

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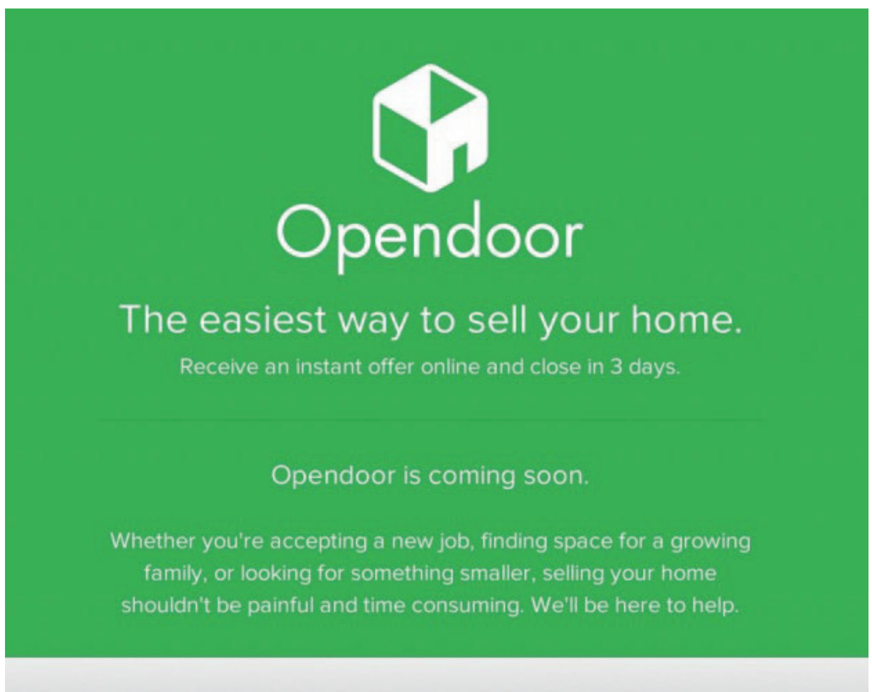
Orient.

Main Section

One of the most hyped, most discussed, and most misunderstood developments in real estate in the past few years has been around the so-called iBuyers.

Inman News named iBuyer its 2017 Person of the Year, noting that while iBuyer isn't a person, it "represents a phenomenon sparking the most revolutionary change in how homes are sold since the advent of the MLS."

At Notorious, I've been talking about iBuyer since even before Opendoor officially launched. The first article is dated July 17, 2014 and featured this screenshot of their homepage at that time:



Over the years, I've called Opendoor the "most important company in real estate" and have featured them in presentations about a possible "market maker system of real estate" black swan scenario. With the entrance of Zillow into the iBuyer game, and the proliferation of other companies in the iBuyer space, it is no longer clear whether Opendoor is the most important company in real estate, but it remains the case that the iBuyer phenomenon as a whole remains the most important trend to watch in the long run.

Yet, the real estate industry remains almost obstinately obtuse about iBuyers, choosing to focus on all the wrong things. As a result, they are simultaneously petrified at the threat of iBuyers, dismissive of them *and* utterly ignorant of the true problem it represents. It's as if the real estate industry is terrified of a bogeyman, wants to be reassured that it is a figment of their imaginations, while not wanting to know that the hallucination is the result of a gas leak in the house.

One reason for framing the iBuyer as a tech-enabled investor is that the impact of house flippers and investors is relatively limited.

So, in this issue, I'd like to pull together all of my observations about the iBuyer phenomenon over the years, confront the true problem it represents, and place the iBuyer into context for real estate in the 21st century.

How iBuyers Work

While there are dozens of articles now on how iBuyers actually work, and different companies have different approaches, the basic remains the same.

The iBuyer solicits a homeowner to request an offer.

They use data analysis to value a home sight unseen. Much has been made about the huge teams of data scientists who sift through enormous amounts of data and tweak their algorithms constantly to make an estimate of what a home is worth, and again, there are real competitive advantages to having more and better data. Nonetheless, without completely ignoring the sophistication of the data analysis, all iBuyers utilize some kind of an AVM (Automated Valuation Machine) to generate an estimate.

They then make an offer to the homeowner, usually charging some kind of a fee and/or making a bid lower than what the AVM estimate says the home should sell for, and if accepted, they buy the house for cash.

They then turn around and sell the house, usually after some maintenance, repairs, etc., and make a profit on the fees charged and on the spread between the purchase price and the sale price. It's a classic buy-low, sell-high strategy.[2]

Industry Perception of iBuyers

Perhaps because the pioneer of iBuyer was Opendoor, which focused on the selling experience at launch, the real estate industry has perceived iBuyers to be something like technology-powered house flippers.

This is par for the course in any industry where a disruptive challenger arises. The incumbents put the challenger into their conceptual framework so they can understand it. After all, automobiles were called "horseless carriages" at their introduction and Uber was and remains framed as a tech-enabled taxi service.

The real estate industry, therefore, looked at the direct-purchase model of Opendoor and immediately framed it as an investor flipping houses. That is a business model and an archetype that has existed for decades, after all, and the industry knows how to understand it.

Much of the initial reaction to Opendoor in the industry was to dismiss it as a WeBuyUglyHouses.com with venture capital money. Even today, most of the criticism and skepticism of iBuyers center around two main issues: paying "below market" prices and inventory risk.

One reason for framing the iBuyer as a tech-enabled investor is that the impact of house flippers and investors is relatively limited. Just a tiny percentage of homeowners ever sell to an investor or to a house flipper because their circumstances dictate a need for cash fast, or because their houses are in such poor condition that only an investor or a house flipper would buy them.

To be fair to the real estate industry, the iBuyers themselves (with one key exception, detailed below when we talk about Knock) operate and behave as if they are house flippers. They do pay "below market" or charge fees to cover costs and in many cases—especially Redfin and Zillow—tell consumers that the way to maximize the

[2] Please note that at least one company, Knock, is operating in a slightly different model, as we will discuss below.

price is the traditional list-and-sell process. All of them talk about doing repairs or updating the property once purchased, then putting it back on the market, which is exactly what a house flipper does.

And, as Mike DelPrete of Adventures in Real Estate Tech pointed out to me, the numbers so far bear out the idea that iBuyers are tapping into the same kind of very limited seller demand that investors and house flippers have. He points out that the data so far shows low single digit percentages of market share in Phoenix, the oldest and best suited market for iBuyer activity.

Having said all that, my overall hypothesis is that this framing of the iBuyer as a tech-enabled house flipper with tons of capital is incorrect. That may turn out to be the ultimate end, since intentions and reality have a way of conflicting, but it ignores some important truths about iBuyers. Those truths are not about iBuyers per se, but about the reality of the broken process for selling and buying homes in North America today.

And that reality has a far greater potential impact than house flipping ever has or ever will on the industry.

The Truth about iBuyers

In my view, the truth about iBuyers is that they come in two different varieties based on the initial problems that they were trying to solve.

On the one hand, you have companies like Opendoor, Offerpad, and Knock whose motivation has to do with solving the consumer problem with the broken and overly complex process of buying and selling homes.

On the other hand, you have companies like Redfin and Zillow, whose motivations have more to do with solving the industry problem with consumers (potentially) not using a real estate agent to sell their homes.

The outward form looks the same, but the differences in motivation dictate some important differences in approach.

Let's start with the consumer-oriented iBuyer companies, as they are the ones who were and will be proactive, while the industry-oriented iBuyers will be reactive, although potentially more successful in the long run.

We discussed how the iBuyer model works. What's more interesting is *why* the iBuyer model works.

Part 1: Consumer Experience

We may as well begin with the father of the iBuyer movement, Keith Rabois. Here he is in an interview with Techcrunch back in April of 2014:

> "For most people, homes are their biggest asset and it's completely illiquid," Rabois said. "This is a really expensive transaction for many people. What we're going to provide is **instant certainty, liquidity and convenience for normal people** to sell their homes." [Emphasis added]

Back in 2014, when I first wrote about Opendoor, I related a story that convinced me that this model was going to be successful. Let me quote myself here at some length:

> I sold a house last year, using a real estate agent. But going into it, I knew that the process of selling a home is filled with pain, annoyance, and inconvenience. We had to stage the house, and having staged it, we couldn't let our children mess things up. Every time there was a showing, we wanted to be out of the house, as buyers don't want the homeowner hovering around when they're trying to imagine the house as theirs.
>
> So my instruction to my listing agent was to try to pre-market the house, or pocket-listing the thing, for a week or two. And if we got an offer **within 10% of our asking price**, we would take it, just to save ourselves the headache of selling.
>
> I don't think we're some sort of unique strange creature. I think quite a few homeowners are more than willing to accept a "lower price" in exchange for less pain and faster closings. And if you stop and think about it a moment, time truly is money for homeowners.
>
> If the typical real estate transaction takes 90 days from contract to close, the seller is paying the carrying costs during those 90 days, from the mortgage to utilities to property taxes to whatever else. Those three months could mean thousands of dollars in additional costs for the seller.
>
> Plus, there's the whole uncertainty of whether the buyer will actually get the mortgage approved, whether inspections will

> come in clear, whether the property will appraise, etc. etc. and so on. Who the hell wants to deal with any of that, especially if you're selling the home so that you can buy your next home? [Emphasis in original]

There are three related but separate pain points here, and all three are important.

The listing price is only the starting point; every real estate agent tells you that.

Uncertainty

First, you have uncertainty. Since this was one of the most important issues that Keith Rabois talked about, it's worth pointing out that selling a home is filled with uncertainty.

The listing price is only the starting point; every real estate agent tells you that. The final sales price might be far lower, or far higher, depending on all kinds of factors—many of which you, the home seller, do not control.

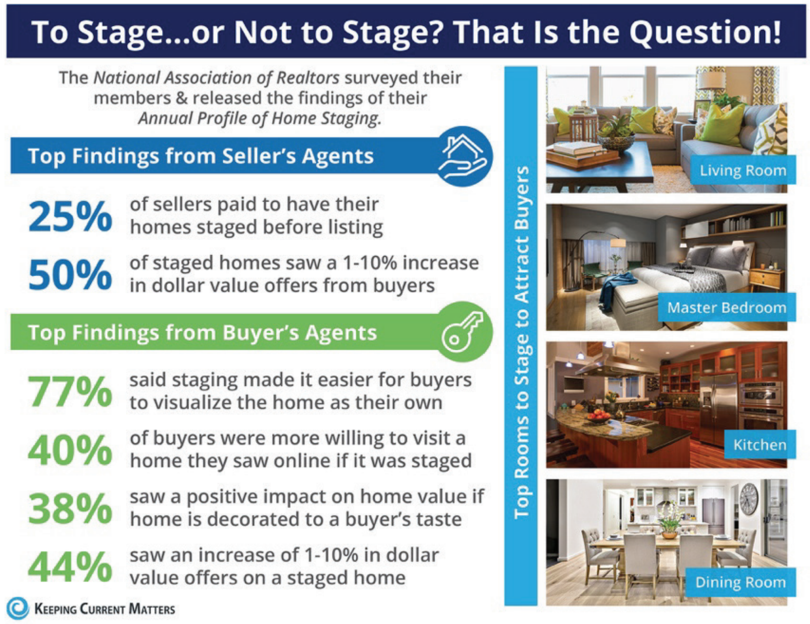
When will it sell? Who will buy my house? What concessions will they want from me? Is this going to be easy, or filled with problems?

A good real estate agent will do what she can to help with the uncertainty—expert pricing backed up with good solid comparables, effective marketing, solid negotiations, etc.—but even with all that assistance, uncertainty is part and parcel of every traditional home sale transaction.

Inconvenience

Selling a home is annoying. I wrote about having to stage my house, then tiptoe around my own living room, and then having to leave the house for an hour when buyers wanted to come by and see the place. But that really minimizes the actual experience of living through that process.

Staging a home for sale is seen as a great idea within the industry, as this infographic from KCM Crew illustrates:



However, *living* in a house that has been staged is a cost that real estate agents and home stagers simply do not discuss enough. It really could not be much different from living in a museum.

It is so bad, in fact, that some people go through the hassle and expense of moving out of their home for the first several days of the home being on the market.

Furthermore, the sole academic study on the subject of staging concludes that staging does not affect pricing, but *might* affect time on market.[3]

Additionally, most buyers do not want the homeowner present at the house. Listing agents therefore always advise the seller to leave the house while buyers are touring it. Constantly having to secure one's valuables, make sure the house is clean and in ready-to-show condition, then find somewhere to go for an hour or so is not a small thing. If you have children, the annoyance factor and the difficulty goes up, way up.

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[3] A Lane, Mark & Seiler, Michael & L Seiler, Vicky. (2015). *The Impact of Staging Conditions on Residential Real Estate Demand*. Journal of Housing Research. 24. 21-35.

Time-Consuming

Finally, the traditional process is time-consuming. It just takes a long time.

First you have to prepare the home for marketing. That means cleaning, repairs, staging and maybe upgrades from something cheap and easy like new paint to something more involved like new carpets to something major, like a new roof. All of that prep takes money, but it also takes time.

But much of the delay, much of what takes so much time, has very little to do with the real estate agent. She does not control most of those factors.

Then you have to market the home, typically through your agent. The full panoply of MLS, online marketing, flyers, open houses, network marketing, etc. etc. go into play, each with its own set of questions and stress: How much traffic is my listing getting on Zillow? How many calls? How many showings?

You go through the whole showings process, which is annoying (see above). Then you sit and wait for offers, then the back-and-forth with the buyers. That could be quick in a hot seller's market, or it could be drawn out in a buyer's market.

At last, you execute a contract with a buyer. Hooray! Except now you enter the contract-to-close process which could be extremely time consuming depending on inspections, financing, any contingencies of the buyer (e.g., they have to sell their house first before they can buy yours), and a hundred other things that could go wrong.

It is not at all uncommon to see 90-day close terms in sales contracts, which means that in addition to the time it takes to prepare and market the home, the homeowner is looking at an additional 3 months of simply waiting to close.

One important note here: oftentimes, the real estate agent has done a fantastic job of marketing, negotiating, and getting to contract. In a hot market, the real estate agent might have gotten all that done in a matter of a few days.

But much of the delay, much of what takes so much time, has very little to do with the real estate agent. She does not control most of those factors. Appraisal is not something the agent controls directly. The buyer is not a factor the agent controls—ask the average experienced Realtor about the time a buyer went and bought a new car while waiting for the sale to close.

And most importantly, the entire mortgage process is not under the agent's control.

Why It Works, Part 2: Liquidity

Why is the experience is so uncertain, so annoying, and so time consuming?

The answer is that the buyer is usually a family or an individual who is purchasing a home. That means the buyer usually needs a mortgage.

The home is the most expensive thing that a typical family will purchase in their lifetime. Nothing else comes close. Very few buyers have enough money to buy a home and they are forced to borrow money to do it. Naturally, that means going through the lending process to satisfy whoever is loaning you hundreds of thousands of dollars that they will get their money back, plus interest.

One of the reasons why iBuyer works is that companies have access to cheap capital while families do not.

The development of the mortgage system is the bedrock on which American homeownership rests. When the typical mortgage required 50% down payment, and offered a 5 year term for an interest-only coupled to a balloon payment at the end, as was common at the turn of the 20th century, relatively few families could afford to buy a home at all.[4] The reforms of the New Deal in the 1930s—the 30 year mortgage, amortization, lower down payment requirements, government guarantees, etc.—opened up homeownership to vast numbers of middle and lower-income families. Homeownership became the American Dream because of those changes to financing.

Without getting into a whole other paper about the history of mortgages since the Great Recession, let us observe that ever since the housing bubble collapsed in 2007, availability of credit has been an issue.

[4] See, *History of The 30 Year Mortgage – From Historic Rates To Present Time*, https://bebusinessed.com/history/history-of-mortgages/

This article on Financial Samurai documents what it's like even for someone who is a financial advisor. He ends with this observation:

> Do not believe your eyes and ears when you hear the media talking about loosening lending standards. They are probably reporters who are just highlighting hearsay. I'm down in the trenches and reporting to you guys first hand what's going on.
>
> Sure there will be some banks that will be more lenient than others. But based on my own refinancing experience and this current mortgage application experience, I've never had it so tough.

The writer follows up with this article in which he interviews a loan officer to find out why it's so hard to get a mortgage. There's a lot there, but this is one factor for sure:

> 1) **The government is clamping down hard.** Since 2009, the government has created enormous regulation for banks in order to not repeat the housing crisis again. For example, the CPA letterhead and signature requirement was introduced recently in Feb, 2014, and it's causing massive headache for tons of small business owners in America. CPAs are charging usurious fees to audit because they can. Meanwhile, the government makes us send a new 7-10 page Good Faith Estimate every single time we change a single number.
>
> The rules were created by the Consumer Finance Protection Bureau and were mandated under the Dodd-Frank Act to ban many of the loose practices during the housing bubble e.g. NINJA loans. To be considered a qualified mortgage, a loan amount cannot exceed a total debt-to-income ratio of 43%. In the past, plenty of borrowers were up to 70%+ . Average mortgage refinance or new mortgage lengths have doubled in the past four years as a result.

Whatever the reason, fact is that individuals and families have a much harder time getting a mortgage today. In contrast, it is far easier for institutions to get financing for business purposes.

One of the reasons why iBuyer works is that *companies have access to cheap capital while families do not*. Naturally, that creates an opportunity for some well-capitalized institution to provide liquidity.

That isn't my analysis; I cannot and do not take credit for that insight. I am merely repeating Glenn Kelman of Redfin. Here's what he said during the Q1/2018 earnings call discussing Redfin's iBuyer program, Redfin Now:[5]

> So why don't we talk about Redfin Now first. There are people who just want to be done with it. There are investors who live in another city. But part of this is a credit arbitrage opportunity that they can't get the loan to buy the next house, because they still own the last house. **And even though there are fairly strict lending guidelines for consumers, there are not for companies. So if you have this asymmetry in the market where companies can get easy access to capital but consumers can't, we become the provider of liquidity and that is one of the services that we offer**. 10 years ago when there was a hot market, people would just get a loan for their next house while they still own the last house but that's just harder to do now. [Emphasis added]

This imbalance in access to capital is one reason why iBuyers work, and it forms the basis for why iBuyers may be a far more important than traditional real estate investors.[6]

Why It Works, Part 3: Technology & Data

The third leg of why iBuyers work is technology—specifically, the ability to put a value on a property sight unseen.

The mortgage industries have used Automated Valuation Models (AVMs) for years. This presentation from AI Connect (a conference of the Appraisal Institute) states that computer-assisted mass appraisals were used since the 1970s. The computing revolution of the late 80s and the 90s led to widespread proliferation of AVMs, and mathematicians, computer programmers, and statisticians have been hard at work in improving AVMs.

[5] The quote comes from the June Red Dot on Zillow, Redfin, and Realogy.

[6] An interesting aside here is that RESPA likely does not apply to the capital raised by iBuyers as they are non-natural persons and the loans (assuming capital is raised as debt, not equity) is likely classified as a business purpose loan. See, https://www.hunton.com/images/content/3/0/v2/30111/beware-business-purpose-regulatory-implications-investment-morta.pdf

When Zillow launched in 2006, it did so with no listings at all. Instead, it featured a new consumer tool called the Zestimate, which purported to show the user the value of any house in the United States. The brand new Zillow.com crashed on its first day because its servers could not handle the traffic.[7]

In effect, what Zillow had done was to take the AVMs that banks and investors had been using for years and put them on the internet for the consumer.

Without question, the Zestimate was and remains one of the most controversial technologies to hit real estate. Real estate brokers and agents have hated the Zestimate from day one and much of their ire was directed at just how inaccurate the Zestimate was (and remains in many parts of the country, particularly the non-disclosure jurisdictions). Yet, accurate or not, the Zestimate started to set consumer expectations that real estate professionals would need to overcome, and changed consumer behavior.

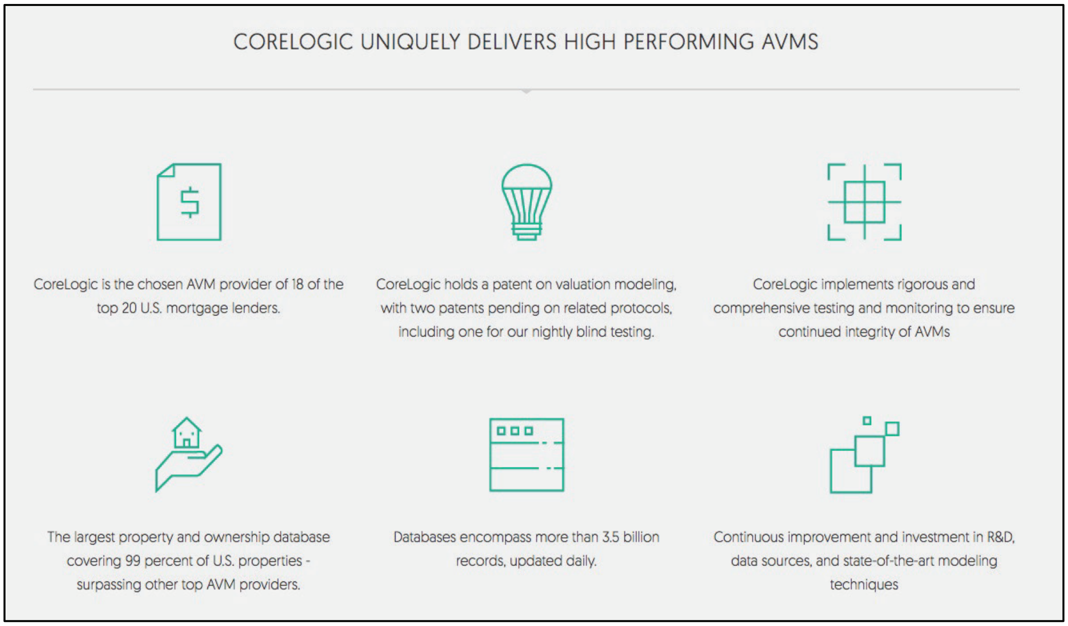
One sign of the continual improvement in AVMs is that Fannie Mae recently announced a program in which it would accept an AVM in lieu of an appraisal in certain instances.

Nonetheless, over the years, Zillow has improved the accuracy of the Zestimate to where its median error rate is 5% nationwide: half of all Zestimates were within 5 percent of the sale price. And Zillow is in the middle of the Zillow Prize, a contest with $1 million prize to the winner, to improve the Zestimate.

That's just Zillow and its public AVM, the Zestimate. Other companies whose AVM products serve the financial services industry have also been hard at work improving their accuracy rate. One of the leaders is CoreLogic.

One of CoreLogic's advantages is that it is one of the leading providers of the software platform and public records data to MLSs in the United States. They often negotiate for the right to use MLS data in its products, including the AVM, for greater accuracy.

[7] The full story is told in a Business Insider article, located at http://www.businessinsider.com/zillow-zestimate-feature-2017-10



AVMs are continually improving in accuracy. The advent of the internet further means that data is widely available, inexpensively stored, and easily portable.

One sign of the continual improvement in AVMs is that Fannie Mae recently announced a program in which it would accept an AVM in lieu of an appraisal in certain instances. From the San Francisco Chronicle story linked to above:

> Thanks to a program that started Saturday, some homeowners won't have to pay or wait for an appraisal on certain refinance loans backed by Fannie Mae.
>
> Instead of requiring an inspection by a human appraiser, Fannie will use its automated valuation model on qualifying loans. Fannie Mae already waives property inspections on about 3 percent of all loan applications that come through its automated underwriting system. Under its new "enhanced property inspection waiver" program, that could rise to 10 percent, Fannie says.

There are some significant limits to the new Fannie Mae program, but it is a sign that AVMs are becoming more and more trusted.

The iBuyer phenomenon relies on modern AVMs, and the companies are always seeking to improve the accuracy of their data models. Every iBuyer company I researched for this paper has a data science team, and at least one CEO mentioned that the first employee of his company was a data scientist.

It makes sense that an iBuyer would have to rely on its AVM to price a home so that it can make an offer—even an offer conditioned on an inspection—to get the process rolling.

There are two separate, but related, issues here to be considered.

Just How Inaccurate is the AVM?

First, let us avoid buying into the industry myth that the AVM is completely and wildly inaccurate. Given that every AVM vendor—including Zillow—states that the AVM is no substitute for an actual local expert's appraisal or price opinion, just how wide is the gap between a local expert and a computer model?

A few percentage points matters a great deal to a buyer who is taking out 30 year mortgages on a single property. To an iBuyer who is looking to buy hundreds or thousands of properties, that may be an acceptable error rate...

One study I found online is from TEGoVA (The European Group of Valuers' Association), a trade organization similar to the Appraisal Institute in the U.S. In a paper titled *The Accuracy of Automated Valuation Models,* George Matysiak of the Cracow University of Economics states as follows:

> So, how did the Zestimate accuracy (this is what Zillow call their AVM property price estimate) compare with the accuracy of the initial list price on a property, which the valuer's provided? It is expected that the list price will be fairly accurate, since it is derived by a real estate professional who will be familiar with both the property and the local market (although sometimes the seller may influence the price to be higher than an agent might prefer). Table 1 summarises the Zillow analysis:

Table 1: Accuracy comparison for 296,463 property sales

	Initial list price	Initial Zestimate	Final list price	Final Zestimate
Within 5% of sale price	48%	31%	56%	42%
Within 10% of sale price	71%	55%	80%	71%
Within 20% of sale price	90%	81%	94%	92%
Median absolute error	5.6%	9.2%	4.5%	6.3%

> The accuracies for both the list price and the Zestimate in Table 1 show that the initial list price is within 5% of the final sale price for 48% of the properties, whereas the Zestimate

> achieved this accuracy for 31% of the properties. The initial list price is within 20% of the final sale price for 90% of the properties, whereas the Zestimate achieved this accuracy for 81% of the properties. The overall median absolute percentage error for the initial list price is 5.6% (50% of property valuations were within 5.6% of the sales price), whereas the median value for Zillow's estimate was 9.2%.
>
> Table 1 also shows the accuracy for the final list price (the list price immediately prior to the sale, possibly after several price cuts) and the final Zestimate (Zillow's estimate of the sales price just prior to the sale). Both the list price and the Zestimate are much more accurate when measured closer to the time of sale, which is to be expected; the median absolute percent errors are 4.5% and 6.3% respectively, for the final list price and the final Zestimate.

So at least the Zestimate is less accurate than a human being estimating via both the initial list price and the final list price closer to the transaction.

Leave aside for the moment whether including list price in a valuation is fair play at all. What the above tells us is that local experts are more accurate than the Zestimate. Most people stop there, as that conclusion is enough to denigrate the Zestimate.

But the median absolute percent errors for the final list price by a local expert is 4.5%. The same for Zestimate is 6.3%. That means that 50% of the final list price was within 4.5% of the ultimate sale price, while 50% of the Zestimate was within 6.3% of the ultimate sale price. We're talking about a 1.8% difference between the estimate and the ultimate sale price, in either direction high or low.

That's for the Zestimate, which does not take list price into account.

In 2017, Redfin released a paper that it had commissioned with SSRS comparing Redfin's AVM with Zillow's Zestimate and Homes.com's AVM. This is the paper that led to a bit of a back and forth between the companies and was the basis for the Inman story linked above.

For our purposes, what is more significant is that Redfin's estimates, which took the listing price into account, were extremely accurate:

	Listings Where Both Redfin and Zillow Had a Value Estimate		Listings Where Both Redfin and Homes.com Had a Value Estimate	
	Redfin	Zillow	Redfin	Homes.com
Percentage of Estimates within 3% of Actual Price	63.66%	29.31%	64.03%	16.44%
Estimates' Median Error Rate	+/- 2.06%	+/- 5.95%	+/- 2.05%	+/- 10.26%
# of Listings in Common	5,661	5,661	5,074	5,074

Not only were 63.66% of Redfin's estimates within 3% of the ultimate sale price, 79.69% of their estimates were within 5% of the ultimate sale price.

Note that this was not comparing Redfin's listing agents and their initial and final list price vs. an AVM. This was comparing Redfin's AVM to Zillow and Homes.com's AVMs. And the real takeaway for us is this:

- Redfin's median error rate of 2.06% is *better than* the 4.5% median error rate of listing agents in the TEGoVA study above.

- The 79.69% of Redfin's estimates that were within 5% of the ultimate sale price is *better than* the 56% of the final list price in the TEGoVA study above.

Therefore, we might conclude (or at least suggest that there is room to believe) that **Redfin's listing-price informed AVM estimate is *superior* to a local expert's final listing price**.

This is highly significant for every single iBuyer other than Zillow. Because all of them, from Opendoor to Offerpad to Redfin to Knock (and others), are *licensed as brokerages and are full participants in any local MLS in which they operate*. Ergo, they have access to the listing price data for properties within their market areas and could take that into account for their in-house AVMs for the purpose of making an offer.[8]

It may be that an MLS-powered AVM, which uses listing price as a data point in constructing the model, is more accurate than a human listing agent. At a minimum, we could say that the modern brokerage AVMs like Redfin's is at least comparable to using a fallible human being's judgment about a property and its comparables.

Does the Inaccuracy Actually Matter?

The related question is whether the inaccuracy actually matters at all, if we're in the single digit percentages.

Take the TEGoVA study above.

The human being has a 4.5% median error rate. The Zestimate has a 6.3% error rate. The different is 1.8%.

On a $300,000 house, that 1.8% translates to $5,400.

For a real estate agent working with a family, $5,400 is quite a lot of money. For an institution with hundreds of millions in working capital, $5,400 is a rounding error.

A few percentage points matters a great deal to a buyer who is taking out 30 year mortgages on a single property. To an iBuyer who is looking to buy hundreds or thousands of properties, that may be an acceptable error rate – just the risk of doing business in the way they're doing it, which they have already accounted for in their pricing models.

Being off by 5% on the most expensive asset they own is a big deal for a family relying on that sale to finance their next home, or finance retirement, or medical expenses or what-have-you. So being off by 5% should be a big deal to that family's real estate agent.

But to an institutional buyer, who is surely practicing portfolio management, being off by 5% on a few properties really isn't the end of the world. "Oh, we got that one wrong – lost $10,000 on that deal.

[8] Obviously, none of these iBuyers would have access to the listing price of an as-yet unlisted home that a potential consumer would submit to them. But they would have access to all other homes that were listed in that market, which could and according to the SSRS study does, improve the accuracy of their AVMs.

But hey, we made $300K on all our other deals, so… who cares?" is not an irrational way to think about the issue.

Furthermore, the median error rate is in both directions—high *and* low. So the final list price might have been 4.5% higher than the sale price, or 4.5% lower than the sale price. Same goes for the Zestimate, or Redfin Estimate or Opendoor's AVM.

So, the industry-oriented iBuyers are actually making it easier for brokers and agents to make money from helping people buy and sell residential properties.

That means that in some cases, the error rate *benefits* the iBuyer because the actual value (as reflected in the ultimate sale price) ends up being higher than what the AVM suggested (and the seller accepted).

To put it another way, until the error rates get beyond acceptable ranges, an institutional iBuyer can account for them with risk management and portfolio management techniques. The inaccuracies really might not matter much at all.

The Truth about Consumer-Oriented iBuyers

Thinking through those three reasons why an iBuyer works, what emerges is that the consumer-oriented iBuyers are not actually in the business of flipping houses. They're in the business of attacking the broken process of home selling and home buying.

The way they have gone about trying to attack this problem looks a lot like house flippers on the outside, but I think of them slightly differently. I think of them as trying to attack the problem of a broken process *by deploying huge amounts of capital*.

One of the important insights from my interview with DelPrete was that while technology can and does substitute easily for low value, high volume purchases (e.g., airplane tickets, taxi rides, etc.), it cannot and does not substitute for high value, low volume purchases like homes. In that analysis, DelPrete is joined by people like Spencer Rascoff of Zillow who has insisted time and again that Zillow does not seek to disintermediate the real estate agent because buying a home is expensive and infrequent. Consumers want an expert to help them through such a high value/cost, low volume/frequency transaction.

No doubt about that.

However, for owners of capital—banks, insurance companies, hedge funds, etc.—buying and selling assets is a low value, high volume purchase. In fact, their core business *is* buying low, selling high or making loans and earning interest.

Technology can and does substitute for that.

I believe the consumer-oriented iBuyers are actually doing that: making it easier for owners of capital to make money from buying and selling residential properties.

The Truth about Industry-Oriented iBuyers

Similarly, the industry-oriented iBuyers like Redfin and Zillow are actually trying to apply technology not to the infrequent, high-value transactions of consumers, but to the frequent, low-value (relatively speaking) transactions of brokers and agents.

That is, a typical homeowner might sell his house three times in his entire life. A typical real estate agent might help people sell three homes a month.

Just like the consumer-oriented iBuyer, the industry-oriented iBuyer has to apply capital to the problem of the broken process, but the end goal is not about the process itself. The end goal is to preserve the role of the real estate broker/agent as a necessary part of the process, and to defend the agent's value proposition.

So, the industry-oriented iBuyers are actually making it easier for brokers and agents to make money from helping people buy and sell residential properties.

Closing the Loop

If we think of iBuyers not as companies helping consumers buy and sell houses, but as companies helping owners of capital and brokers and agents respectively make money from real estate transactions, we can start to analyze them correctly.

The most important consideration here is the concept of Closing the Loop; throughout this document, I capitalize that phrase because of its importance. But what is meant by that?

Closing the Loop Defined

For most iBuyers, for industry professionals, for financiers, a transaction is closed when their part is done. That is, for an iBuyer, the transaction is closed when title to the property is transferred and recorded. For a real estate agent, the transaction is closed when her client gets paid in exchange for title or gets title in exchange for payment. For financiers, the transaction is closed when the loan documents are properly executed and recorded.

In many cases, the industry's closed transaction is only half of the equation for the consumer.

A consumer who sells his home has to live somewhere, even if that is in a van down by the river.

A consumer who buys a home often has to sell his old house.

For them, the experience is not complete until *all* of the transactions are closed and they are finally out of the housing market.

Closing the Loop therefore is defined as the minimum required for the consumer to get into *and out of* the housing market. I say it's the minimum since the consumer often has to move, do repairs and maintenance on their new home, get integrated into their new community, etc. and while the industry can assist with those ancillary needs, none of those are necessary to get out of the housing market.

The biggest challenge in Closing the Loop is timing. In most situations, we are talking about three separate parties: the seller who has to buy a new home, the buyer of his old home, and the seller of his new home. Those three separate consumers have entirely different circumstances, entirely different needs, and entirely different timelines.

Real estate agents have to deal with this juggling and coordinating act even when there are only two parties involved with different circumstances. How much worse is it when you have to involved a third party as well?

That three-way juggling and coordinating act is difficult enough when all of the parties involved are paying cash. It becomes exponentially more difficult when there are at least two financings involved.

Technology vs. Capital

In trying to solve for that difficult problem of coordinating the timing of everything, technology can and does help, but its impact is fairly limited. Capital is what is required.

In a real way, the difficulty of coordinating multiple parties with their different circumstances, needs, and timelines is exactly why market makers in the commodity markets exist. It's why things like forward contracts exist.

Oil refineries may need to buy crude on a different schedule than oil producers want, and deliver diesel fuel on a different schedule than trucking companies want. Technology can help coordinate the schedule, but really, it is the market maker deploying huge amounts of capital which smooths out the market and lets it function.

This is not to suggest that technology is unimportant; it is critical. As discussed above, without AVM technology, iBuyer may be too difficult (i.e., expensive) to operate. And because at least one of the parties involved is a consumer, and the overall promise of iBuyers is to make the process more certain, less painful, and simpler, consumer-facing technology is important as well.

It is to suggest that capital is far *more* important because of the peculiarities of the housing market and housing finance.

Major iBuyer Companies

So we know how iBuyers work, why they work, and we know that the truth about iBuyers is different from the perception of them by the industry.

Let's take a look at some of the major players in the iBuyer space and what makes them interesting to us.

The Pioneer: Opendoor.com

The story of iBuyer starts with Keith Rabois, who had an idea back in 2003 about revolutionizing the way that Americans buy and sell homes. According to Venturebeat:

> "My friend Peter Thiel suggested that I come up with an idea to innovate in residential real estate," Rabois said, referring to the PayPal and Palantir co-founder.

> "It's the largest part of the economy unaffected by the Internet. And that was definitely true then, and even with things like Trulia and Zillow, it's fundamentally true today. But the process of (selling a home) hasn't been transformed by technology."

It is a small but important fact that Rabois said "my friend Peter Thiel" because Keith Rabois isn't just your average twentysomething startup entrepreneur with a dream and a laptop. He's part of the so-called Paypal Mafia, which counts in its number some of the most successful technology entrepreneurs in history including Peter Thiel, Elon Musk, and Reid Hoffman. The companies these men either founded or were involved with at senior levels include Paypal, YouTube, Yelp, Yammer, LinkedIn, Slide, Square, SpaceX, Tesla, and some of the largest venture capital firms in the world, such as Greylock Partners and Khosla Ventures.

The initial "friends and family" round of financing was for $9.9 million and the list of investors reads like a Who's Who of Silicon Valley:

> Paypal co-founder Max Levchin, Former YouTube and Facebook CFO Gideon Yu, Eventbrite co-founder Kevin Hartz, Y Combinator's Sam Altman, Quora CEO Adam D'Angelo, Yammer co-founder David Sacks, Angelist's Naval Ravikant, Yelp CEO Jeremy Stoppelman, Box CEO Aaron Levie, Initialized Capital's Harjeet Taggar, Garry Tan and Alexis Ohanian, Former Twitter vice president Elad Gil, Blippy co-founder David King, Flixster co-founder Joe Greenstein, Angel investor Mike Greenfield, Quora co-founder Charlie Cheever, Path's Dave Morin, Facebook vice president Dan Rose, Trevor Traina, Resolute Ventures' Mike Hirshland, Caffeinated Capital's Ray Tonsing, Felicis' Aydin Senkut, True Ventures' Om Malik, Thrive Capital's Josh Kushner, Crunchfund's Michael Arrington (who disclaimer: founded TechCrunch) and SV Angel.

Rabois himself was and remains a partner at Khosla Ventures, and he recruited Eric Wu, formerly of Movity and Trulia, to be the CEO.

Opendoor launched in Phoenix in 2014 and Dallas a short time after and nothing will ever be the same again.

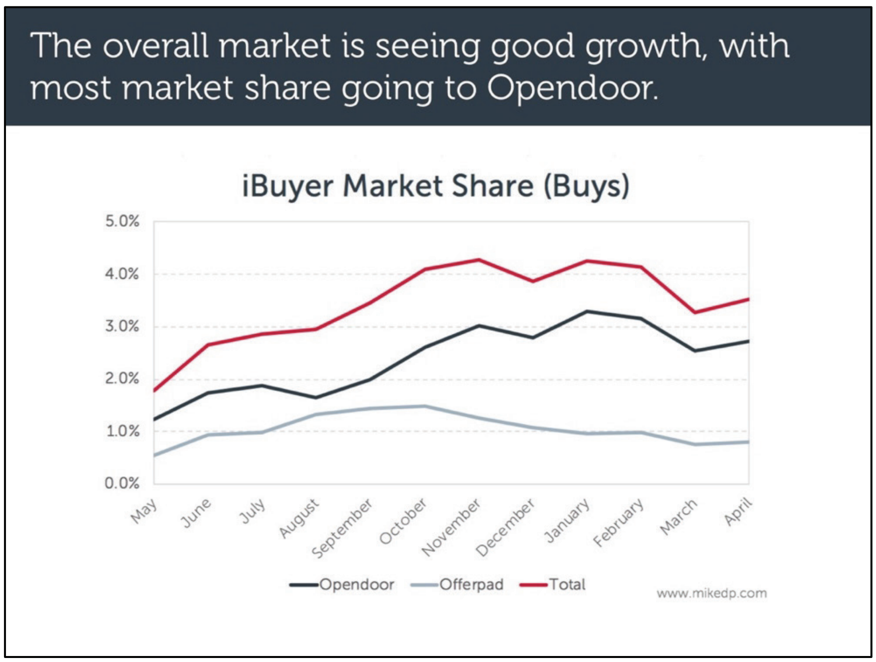
Something I'll mention at the outset here is that while I've been following and talking about Opendoor since 2014, I think no one has done more work or better work analyzing the iBuyer space than Mike

DelPrete at Adventures in Real Estate Tech. Much of what I draw on here comes from DelPrete's work, especially on data.

So what do we know about Opendoor today?

We know that Opendoor operates in a dozen markets: Phoenix, Dallas, San Antonio, Las Vegas, Atlanta, Nashville, Charlotte, Raleigh, Orlando, Tampa, Minneapolis-St. Paul and Houston. According to Cristin Culver, Head of Local Communications for Opendoor, the plan is to be active in 50 markets by 2020. As of this writing, Opendoor claims to have served 20,000 home sellers and buyers.

We know that they are the market share leader in Phoenix, the ground zero for iBuyers, hovering around the 3% of transactions mark as a buyer:



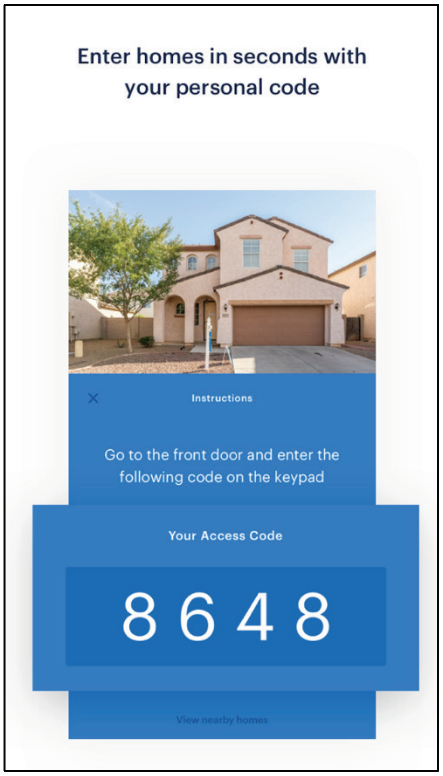
We know that Opendoor has improved its operational efficiencies, driving holding periods down to an average of 75 days for April of 2018 vs 110 days or so a year prior.

We know that its spread (what DelPrete calls Gross Margin – the difference between the buy price and the sale price of a property) is below 5% in April from around 8% in May of 2017. The shrinking spread implies that Opendoor is either paying more for houses (closer to "fair market value") or getting less when selling houses, or both.

Cristin Culver did note that DelPrete's numbers are based on incomplete data, as Opendoor purchases homes under numerous entities and therefore the data is very difficult to track completely. According to her, gross margins (spread) are up for 2018.

Ease of Use

One of the most interesting features of Opendoor is its attempts to make buying one of its homes easier. The best example is allowing potential buyers to tour the home without an agent by using the Opendoor mobile app.



From Opendoor's Buyer FAQ:

> You can tour homes on your schedule, any day from 6am to 9pm, no appointment needed. When you arrive at the door, use the Opendoor app to instantly unlock the home and get inside. Alternatively, you can use our text-to-enter service to get access. If you have any trouble, we're available to help you over the phone at 480.351.6622.

This seemingly simple change makes a world of difference to the buyer. No more trying to schedule meetings, no more coordinating with your buyer's agent, who has to coordinate with the listing agent and the seller – just a walk up, use the app, unlock the door, and tour the house.

In addition, Opendoor offers a 30-day money-back guarantee and a one year home warranty to every buyer. Granted, very few people will go through the hassle and expense of moving, only to incur it again to move out within 30 days, but simply having the option provides a bit of peace of mind.

These things are possible since Opendoor is the owner and the seller of the home. No traditional real estate company can do either the unattended tour or the money-back guarantee.

The Trade-In

One of the other key features to make things easier is the Trade In program. Opendoor describes the program this way:

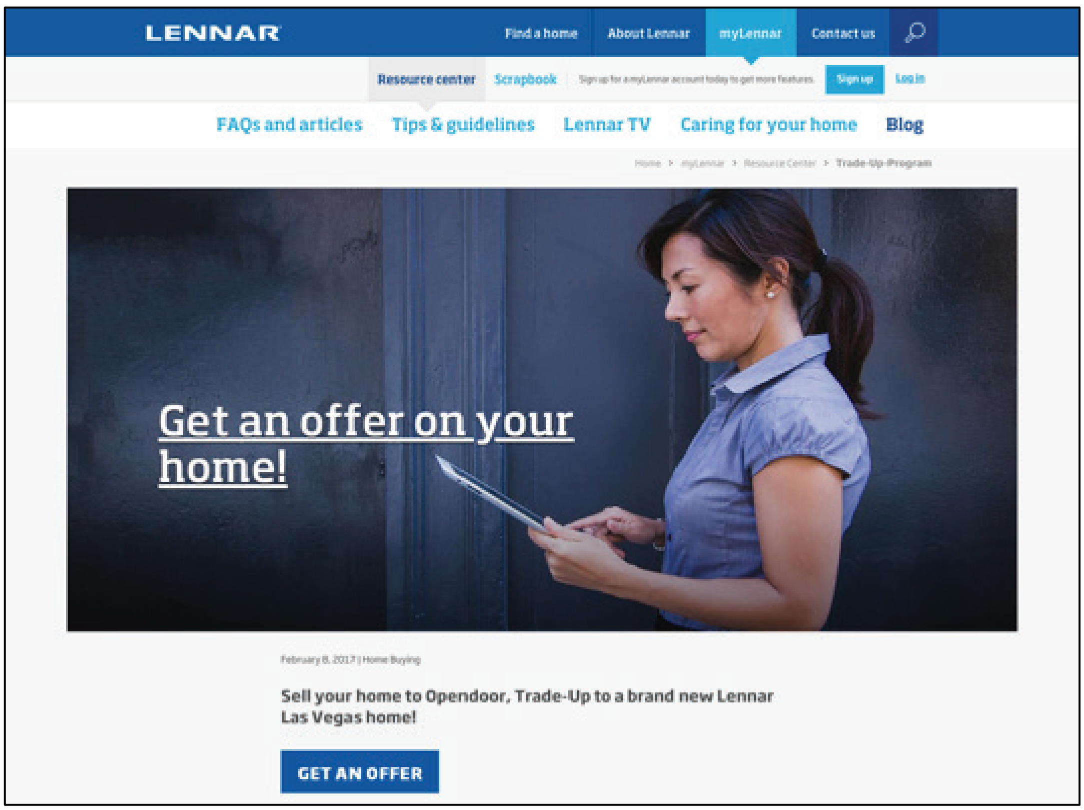
> With Opendoor Trade-In we align the closing dates of your home sale and your new home purchase so you can move straight from the old home to the new one. This allows you to skip the hassle of moving twice, carrying two mortgages, and making contingent offers.

In truth, the Trade In is the effect of Opendoor being able to adjust the closing date on the sale of the buyer's current home even after going under contract (up to 60 days). It is relatively simple then to coordinate that closing date with the closing date on the purchase of a new home. Everyone has to live somewhere, after all.

This is, so far, Opendoor's attempt to close the loop between selling a home and finding someplace new to live. We will address this specific issue in some depth later.

The Partnership with Homebuilders

One of the most interesting recent developments is Opendoor's partnership with homebuilders. It began as a pilot with Lennar Corp, the country's largest homebuilder.



The way it works is fairly straightforward. The buyer walks into a Lennar sales office and finds a home (or a floorplan for a new build). The buyer can request an offer from Opendoor for his current home, and receive that standard all-cash offer (conditioned upon inspection) immediately. The closing would be coordinated with the new home availability from Lennar, so it can be very quick if the buyer is purchasing a spec home already built, or as long as 9 months if the buyer is purchasing a lot and ordering a new home built on it.

BuilderOnline.com reports on the relationship, and quotes Stuart Miller, executive chairman at Lennar Corp:

> "Buyers always encounter the same pain points--their life has changed and they have outgrown their home, or maybe are looking to downsize, but they have trouble figuring out how to approach the market. They worry about ending up with a gap where they need to find a place to live temporarily, or a situation where they are paying a double mortgage on their old and new homes simultaneously," says Miller. "What we have been able to engineer here is the beginnings of a frictionless program. It's a powerful thing that we can do this for our customers without putting them through the aggravation of figuring out the transaction process."
>
> He likens the process to the way that car buyers can trade in a vehicle at a car dealership when it's time for an upgrade. A less stressful home sale will make homeowners more apt to move up to a new home, says Miller.
>
> "When we take friction out of the transaction side of the business and create that transaction with ease in a condensed period of time, we take the fear out of buying a home," he says. "Owners won't feel stuck in a home if they outgrow it, and your house can be a stepping stone into something new as you move up."

From the same story, we learn that Opendoor has a partnership in place with 19 of the top 25 builders, including 6 of the top 10.

Although limited to partnerships with homebuilders, at least for now, Opendoor is now able to Close the Loop on the consumer experience.

Yet, Opendoor—like all iBuyers—cannot help but disrupt the industry because its core value proposition is, "simplifying overly complex processes to just a few inputs on a smart app powered by data science."

Opendoor Raises Even More Money

It is not particularly surprising, then, that when Opendoor closed a $325 million funding round in June, Lennar Corp. led that round. Another homebuilder, Invitation Homes, also joined in this latest funding round as well.

According to TechCrunch, that brings the total capital raised by Opendoor to $645 million in equity and $1.5 billion in debt. Opendoor's valuation is "north of $2 billion" now.

While that is stratospheric unicorn territory for a startup, given that Keith Rabois is a co-founder… access to capital is not likely to be a problem as long as Opendoor continues to prove that the model works.

We're Not Disrupting the Industry!

Something to note here is that Opendoor, from the very beginning, has gone out of its way to insist that it is not disrupting the brokerage industry. In fact, Opendoor (like most iBuyers not named Zillow) is licensed as a real estate brokerage in all states in which it operates, and is a full Participant in the MLS.

Opendoor literally has a section in its FAQ that starts, "I hear Opendoor is trying to cut agents out of real estate. Is that true?" It goes on to say:

> Opendoor works with real estate agents every day—we want to join the party, not break up the party! In fact, we paid millions of dollars in commissions last year. We provide a simple transaction experience and bring a certainty to the process that agents and their clients love.

There are other sections in the FAQ and in Opendoor's overall messaging that seeks to reassure real estate brokers and agents. For example, Opendoor says that if a seller who is represented by a listing agent requests an offer directly from Opendoor, that offer will be "sent directly to the listing agent and continue all communication directly with the agent."

Opendoor also has a Partner Agent program in beta. While details are not available, according to Cristin Culver, agent partnerships are in "rapid growth mode across all markets." One assumes that these partnerships are a response to Zillow's move into the iBuyer space (detailed below), but it is another attempt to reassure the industry that Opendoor has no interest in disrupting their businesses.

Yet, Opendoor—like all iBuyers—cannot help but disrupt the industry because its core value proposition is, to quote TechCrunch, "simplifying overly complex processes to just a few inputs on a smart app powered by data science." We'll address the disruption question in some depth below.

Offerpad

In researching for this paper, I was unable to speak to anyone at Offerpad. Publicly available information on them is thin, to say the least.

What we do know about them is that they were founded in 2015 by Brian Bair, once America's #2 Realtor, and Jerry Coleman, a cofounder of Invitation Homes, have raised $410 million in equity and debt and operates in 8 markets: Phoenix, Atlanta, Orlando, Tampa, Las Vegas, Charlotte, Los Angeles and Salt Lake City with Nashville and Dallas in the pipeline.

DelPrete described Offerpad as the "very definition of me too" but praised them for being able to execute on copying what Opendoor does quickly and efficiently. Looking on their website, the sole difference I found was that Offerpad offers its customers free local moves. In virtually all other respects, it is a clone of Opendoor.

According to DelPrete's data, Offerpad trails Opendoor quite significantly at least in Phoenix. Its activities are less than half of Opendoor's in April and its growth lags behind Opendoor's by quite a bit. (See the graph above under Opendoor).

Offerpad's spread is a lot wider as well, although they are narrowing it from almost 18% in May of 2017 to about 8% in April of 2018.

Nonetheless, Offerpad is a major iBuyer player today, and there is absolutely nothing wrong with being an efficient clone. Imitation may be the highest form of flattery, but if Offerpad can outdo Opendoor in sales, marketing, and customer service, it can then watch for the opportunity to take the lead. As Jack Welch of GE preached, you want to be #1 or #2 in an industry segment, and Offerpad is the clear #2 today.

Redfin

Redfin is the first brokerage to get into the iBuyer game, launching Redfin Now as an experiment in Q1 of 2017. As such, I consider Redfin to be the pioneer of the industry-oriented iBuyer, as Opendoor is the pioneer of the consumer-oriented iBuyer.

The key difference between Redfin Now and other iBuyer competitors is its tight coupling to Redfin's traditional brokerage offering—albeit at the low 1% listing fee, which has been its calling card in recent years.

Market share statistics are not available, nor are any of the details as we have with Opendoor and Offerpad in Phoenix courtesy of Mike DelPrete.

Big part of the reason is that Redfin is not truly *invested* in Redfin Now. Redfin has only purchased 15 homes or so under Redfin Now, and reported $3.1 million in revenue (not profit, but revenue) from Redfin Now in Q1/2018. It also described Redfin Now as "an experimental new service where we buy homes directly from homeowners and resell them to homebuyers."

In the same earnings report, Redfin announced that it was increasing the capital limit for Redfin Now from $10 million to $25 million, $5 million more than was previously announced. That's a drop in the bucket, compared to what others are both raising and putting into iBuyer programs.

But during the Q1 earnings call, Glenn Kelman, Redfin's CEO, was very honest and forthright about what they were seeing and what the challenges are for a brokerage to offer iBuyer services:

> Most of the prospective customers don't actually sell their house to Redfin Now. And the insight here is just that if I could tell you before you're selling your house that we could put together a cash offer. Do you want to see it? You would say yes. But whether you took the offer would be another question entirely. And so I think Zillow has talked about this, it's something that we've noticed too that this iBuyer type of program might be more of a website feature than it is a retail operation that many people want to see the offer even if most people don't want to take the offer.
>
> …
>
> So I think that's the only responsible way, or one of the only responsible way is to offer this product, at least for us. It was uncomfortable for me at first to be on the other side of the table from a customer, because that's what we're doing when we're buying their house. We're saying, we're counterparty, we want to buy this house for $400,000 and the responsible thing that we have to do is also to have a real estate agent say don't take that offer, we can sell it for $430,000 in two weeks or less. And there are going to be some people who take $430,000, and there are going to be some people who take the money now. But we just want customers to have both choices.

The overall impression is that Redfin Now is not a real business unit in and of itself for Redfin. It's a convenience add-on, and perhaps a bit of a lead generation device (what Glenn calls a "website feature") for Redfin.

I interviewed Quinn Hawkins, who heads up the Redfin Now program, and Jani Strand, also from Redfin for this paper. One of the insights from that interview is that despite making major inroads into listings, thanks to advertising and Redfin's 1% listing fee, the bulk of Redfin's business comes from buyers.

The goal isn't necessarily to help owners of capital deploy it better, faster, more efficiently but to help Redfin's agents retain their value proposition.

One of the largest segments of Redfin's customers are those looking to buy a new house, but they need to sell their own house first (or at the very least, quickly after purchasing a new house). Using Redfin Now allows Redfin to line up the closing dates, thereby helping to Close the Loop.

The ideal outcome for Redfin appears to be one in which they get the assignment to list the buyer's current home at the 1% listing fee while they help him buy the new house. It's ideal at least in the sense that the consumer is getting the most money possible for his home, and saving money when buying a new home.

It is impossible to know whether that is the ideal outcome for Redfin, since they will make 1% of the final sale price on a traditional sale vs. an unknown spread on a Redfin Now deal. We know that Opendoor's spread is 5%, which added to the fees that Opendoor charges, might mean more revenues overall, but we don't know what the holding costs are for either company, or the repair and maintenance costs.

But the overall message is right in line with what I wrote above about the industry-oriented iBuyer. The goal isn't necessarily to help owners of capital deploy it better, faster, more efficiently but to help Redfin's agents retain their value proposition.

Hawkins said at one point that the analogy to trading in one's car breaks down because of the amount of money involved. It's one thing to sell your $40,000 car to the dealership and get paid $30,000 for it and a whole other thing to sell your $400,000 house to an iBuyer and get paid $375,000 for it. The dollar values are so much more with houses.

Plus, there isn't a 1% option to have a professional handle your car sale on Ebay Motors. That option exists for houses.

Redfin's main attempt to take the annoyance, pain, and delay out of the home sale transaction is not Redfin Now, but the rest of what it has built: a technology-powered brokerage with employee agents who are incentivized on customer satisfaction. At one point, Hawkins said that getting the most money for your house helps to smooth away the annoyances of consumers. Redfin Now is merely an add-on service to that core, for those customers who are willing to take less money from Redfin in order to have certainty and fewer hassles.

Strand did raise a good point about what sets Redfin Now apart from other iBuyers: Redfin is the only company with 10+ years of actual operational experience as a brokerage on the ground and a highly trafficked website with 25 million-plus unique monthly visitors. None of the others have both.

Zillow

Zillow, the undisputed heavyweight champion of online real estate portals, entered the iBuyer space in May of 2017 with its launch of Instant Offers as a test in two markets: Las Vegas and Orlando.

That announcement was instantly (heh) met with howls of protest and anger from the real estate industry. Note: that article only used some of the more printable reactions.

The original Instant Offers program was structured as a marketplace for investors and other iBuyers, but also include a real estate agent (a Zillow Premier Agent, of course) in the deal. From Inman News:

> The new Zillow product allows prospective homesellers to receive all-cash offers from a hand-selected group of 15 large private investors along with a side-by-side comparative market analysis (CMA) from a local Zillow Premier Agent.

That program did not make Zillow into an iBuyer. Zillow's expansion of Instant Offers into Zillow Homes in April of 2018 did.[9] I wrote fairly extensively on this move in the June Red Dot, so please go read that report's section on Zillow.

[9] Zillow Instant Offers and Zillow Homes has been renamed to Zillow Offers, although people inside Zillow still refer to it as "IO".

The conclusion I drew then is that Zillow's iBuyer program is far more than just an iBuyer program. It is an elegant construct of interlocking and interdependent strategic elements that has the potential of massively disrupting and transforming the real estate industry as we know it.

I thought then that Zillow had three competitive advantages over other iBuyers: Data Advantage, Distribution Advantage, and the ability to monetize Listing Leads.

So let's briefly recap those from the June Report.

Data Advantage

Zillow's massive lead in traffic gives it a competitive advantage in terms of data. Spencer Rascoff, Zillow's CEO, talked about benefitting from knowing the demand side of the marketplace from all of the traffic—as well as things like email and mobile app notification subscriptions—Zillow generates. He talked about knowing that 100,000 home shoppers on Zillow and Trulia are looking at homes in a ZIP code similar to the one Zillow might purchase. Furthermore, he talked about 5,000 people who have requested to be notified when homes that match their criteria come on the market.

All of this data advantage leads to more accurate pricing of homes Zillow buys.

It also leads to the ability to pre-market a home that Zillow purchased, and potentially find a buyer for a purchased home even before the cleaning and renovation work is finished.

Distribution Advantage

Zillow also has a significant advantage in terms of distribution—meaning, channels through which it would make iBuyer offers to purchase. The tens of thousands of Zillow Premier Agents[10] dwarf the number of Redfin agents, Opendoor agents (and Partner Agents), and Knock agents.

Opendoor's Partner Agent program is, in a way, an attempt to counter the distribution advantage that Zillow has. But it is hard to

[10] The last time Zillow disclosed how many Premier Agents they had in Q3/2015, that number was 96,965. It is difficult to imagine that the number of Premier Agents decreased significantly since then, even if Zillow's revenues are increasingly coming from fewer and fewer big spenders.

see how Opendoor competes there. Zillow just has more Premier Agents who might be willing to put a Zillow offer before their clients who want greater certainty than Opendoor, Redfin, and Knock combined have.

What's more, those distribution channels are typically cost centers for other iBuyers. Redfin, for example, does not make Redfin Now available to their referral partner agents, which means every agent who can put a Redfin Now offer in front of a homeseller is an employee of Redfin.

Zillow, on the other hand, gets paid by its Premier Agents. In fact, they get paid a substantial sum of money. It is entirely conceivable that Premier Agents will gladly hand over even more cash for the right to offer Zillow's Instant Offer to their clients as that raises the value of those agents for clients who are more interested in convenience and time over dollars.

Listing Leads

Finally, unlike other iBuyers at least so far, Zillow is able to monetize listing leads by selling them to Premier Agents. As Errol Samuelson, Chief Industry Development Officer of Zillow, said during the expansion, 90% of the people who request an offer from Zillow do not take it. They choose to list with the Premier Agent who sent them a CMA as part of the Zillow Instant Offers program. Since 1/3 of those who requested an offer end up selling their house within 90 days, that is about as qualified an online lead as can be expected.

Zillow will make a fortune just from selling those listing leads to its network of Premier Agents. Just the availability of listing leads will entice brokers and agents to sign up to become Premier Broker and Premier Agents.

As I wrote in June, there's a very good chance that Zillow could lose money on Instant Offers every year, and still make a profit overall from monetizing listing leads.

It may very well be that others would have to copy that model of monetizing listing leads. Redfin would certainly want to list that house—that is their strategy. Opendoor and Knock may have to figure something out.

Zillow and Closing the Loop

The real challenge for Zillow going forward is in closing the loop.

Zillow's efforts here are limited to passing on the home seller to a Premier Agent. Presumably, the Premier Agent will seek to secure the home seller as a home buyer client as well. I further assume that Zillow will do what it can do ensure that the selected Premier Agent can and will provide a high quality experience to the buyer.

But Zillow can do very little indeed to ensure that experience. At least Redfin has operational control over its agents as the actual brokerage with W2 employee agents. Zillow is a lead-generation company and its agents are actually Zillow's paying customers. There's a rather large gap between those two things.

Consumers have gotten so used to "pushing a button, and magic happens" that they now expect it.

From the Horse's Mouth

I interviewed Jeremy Wacksman, the new President of Zillow, who is in charge of the strategy, product development and engineering teams for Zillow Offers. for this paper and learned a few important details.

First, Wacksman pointed out something fundamental. He talked about the big picture that most people in the industry are missing, which is that consumers have gotten so used to "pushing a button, and magic happens" that they now expect it. He used Uber as an example. At Uber's launch, it was magic to push a button and have a car show up a few minutes later with a map showing exactly where the car was. Just a few years later, consumers complain about slow arrival times because they take the magic for granted.

He said that Zillow got into the iBuyer game, first with Instant Offers and now with Zillow Offers, because of that consumer experience of pushing a button and having magic happen will quickly turn into a default expectation. "It's not about flipping houses; it's about pushing a button," he said.

Second, it turns out that like Redfin, Zillow does not rely solely on the Zestimate to make its offers. The Zestimate is an important input into the offer price, according to Wacksman, but Zillow involves a local agent for a more detailed "point of view" as he called it. One thing he insisted on clarifying—likely because of industry fears—is that the Zestimate and Zillow Offers are very much separated.

"There's a wall between what the Zestimate does, and what the Zillow Offer is," he said. Turns out, the Zestimate is not adjusted or tweaked with whatever information comes out of the Zillow Offers process—details about additions, upgrades, inspection results, etc. The Zestimate is only adjusted upon the final sale data, after the transaction has closed.

Third, on Closing the Loop, Wacksman said Zillow was trying to solve one half of the problem by focusing on the seller. He felt that allowing the market to do its thing was fine on the buy-side of the loop. But he saw definite long term opportunities to work with Premier Agents to figure out how to close the entire loop.

Some Interesting Data from DelPrete

Mike DelPrete had some interesting details about Zillow Offers, at least in the Phoenix market.

According to his data, which he admitted was a very small sample, Zillow has purchased 30 homes since launching Zillow Offers earlier this year and has sold none. 11 of the 30 are under contract. Most interestingly, based on Zillow's listing price for homes they purchased, Zillow's spread is 2.5% on average. Remember that Opendoor's spread was 5% in April.

Since the average price-to-list ratio is Phoenix is 98%, that implies that Zillow's spread will end up being just 0.5%.

When asked about this small spread, Wacksman from Zillow responded that Zillow's aim with Zillow Offers today is to "cover our cost." They actually aim for a very small margin on a per unit basis to cover the cost of repairs, maintenance, and risk but they do not view Zillow Offers as a primary revenue driver yet.[11] What Zillow Offers does do, and its principal aim today (apart from learning from the results) is to defend the value of Zillow to its Premier Agent customers.

On the other hand, DelPrete says that Zillow has been buying more expensive houses in Phoenix – 50% more expensive on average than the homes that Opendoor and Offerpad have bought. So in absolute

[11] To be fair, Wacksman mentioned that even on a small per unit margin, with enough units Zillow Offers could be a very large and very attractive line of business. But Zillow was nowhere near making that conclusion today given how new Zillow Offers is.

dollar terms, Zillow's spread might be 8K (based on listing price) vs. 10K for Opendoor.

What to make of these numbers?

Industry-Oriented iBuyer

My take is that Zillow is experimenting with Zillow Offers, similar to how Redfin is experimenting with Redfin Now. The goal is not to create a multibillion dollar business out of Zillow Offers the way that Opendoor has. The goal is to *preserve* the multibillion dollar business that Zillow already has.

Remember that Zillow from the very beginning has positioned Zillow Instant Offers as a way to keep the agent at the center of the transaction. Recall further that 90% of the people who request an Instant Offer list with the agent who sent them the CMA.

In effect, Zillow is using its technology and capital to bolster the value proposition of listing agents. Because 70% of its revenues come from Premier Agents, it is absolutely in Zillow's best interest to ensure that consumers see the value in working with agents, not selling directly to Zillow.

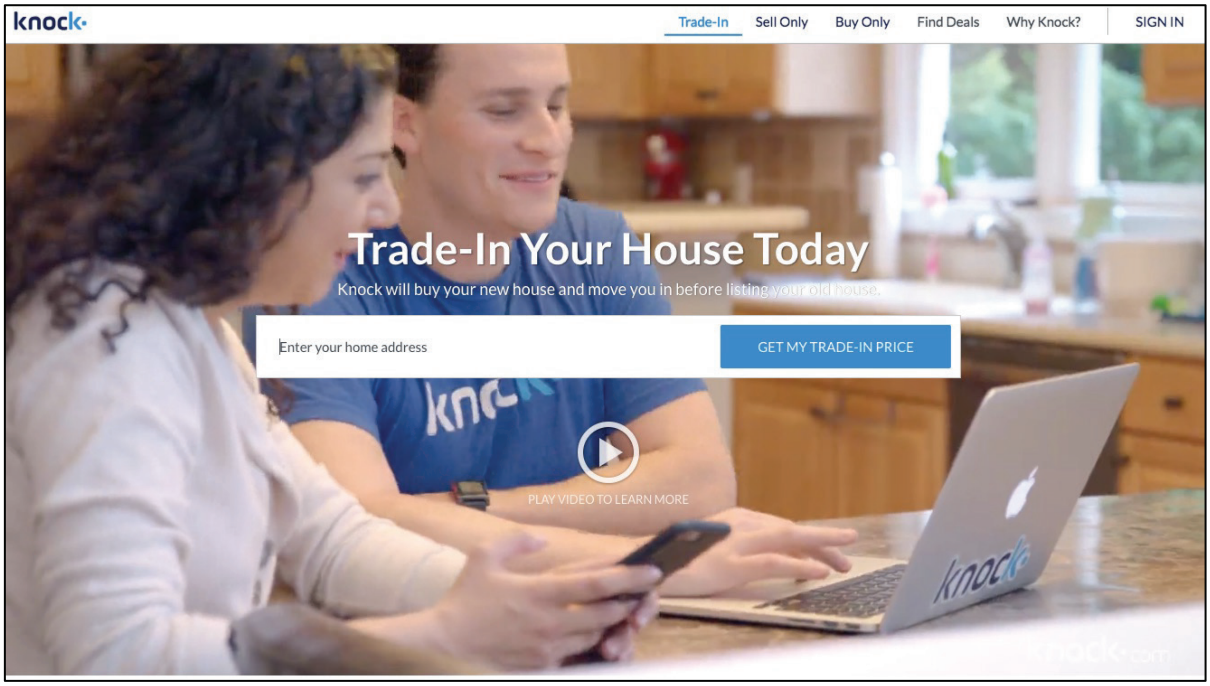
If Redfin's ideal outcome is to get a buyer interested in hiring Redfin to sell his home as well, then Zillow's ideal outcome is to get an agent to pay to represent a consumer on the buy side, and to get an agent (same or different) to pay to represent that same consumer to represent him on the sell side.

For those few consumers who are willing to pay not to have to deal with the hassle and delay of the traditional list-and-sell process, Zillow will deploy capital to help its customers (the agent) offer that option to their consumer clients.

While Redfin has greater control over the entire value chain, Zillow has a far larger footprint and a far larger "agent count" if you will. It will do more to defend the value proposition of the traditional real estate agent than Redfin ever could.

The irony is rich indeed. The company that has been the target of so much of the industry's hatred, the company that brokers and agents still badmouth almost out of habit… that is the company who is working so hard and taking on enormous financial risks to defend the agent's value proposition.

I assume Zillow will suffer the slings and arrows of outrageous fortune all the way to the bank.



knock

Knock, Knock….

Opendoor, Offerpad, Redfin and Zillow are the four major iBuyer companies today. There are others of course, most in startup phase, and they may emerge as major players in the future.

But there is one such startup that warrants a much closer look. It cannot be said to be a major player just yet, having raised $32 million in its Series A round of funding in January of 2017. In fact, it cannot even be said to be an iBuyer really. But it more than any other points the way to the future.

That company is Knock, founded by three veterans of the tech startup scene, including two early employees of Trulia: Sean Black, Jamie Glenn and Karan Sakhuja.

How Knock Works

Other iBuyers offer a simple promise: we'll buy your home in cash and let you set your closing date. Knock does something similar for those who simply want to sell. But Knock takes things to the next step: **Knock will buy your new home for you before you even list your old home.**

I spoke with Sean Black, the co-founder & CEO of Knock, for this paper and his motivation for starting Knock is fairly straightforward and bound to be controversial to the industry.

Knock's goal is to cut the cost and time to sell a house in half, and remove as much of the consumer pain from the process itself as they can. They believe that transaction volume can double if they can achieve that.

Black said that the average American family keeps their family wealth in the family home. They need the equity in their current home if they're to move up and buy a new house. In his view, the traditional investors and the current crop of iBuyers only pay 80-85% of the home's value out of necessity: they need the spread to be profitable.[12]

Knock, in contrast, only costs the home seller 6% -- very much in line with the commission cost of listing with a traditional real estate agent. Knock will get paid 3% and offer out 3% as cooperating compensation, just like a traditional brokerage, with the client's consent.

The process begins, like any other iBuyer, with a homeowner requesting an offer. Knock crunches numbers and comes up with how much equity the homeowner has on his current house. They inspect the house to make sure nothing is amiss.

Knock will manage and pay for repairs and maintenance on this old house, but as an interest-free loan of sorts.

With the home equity number in hand, Knock then gets that homeowner fully underwritten preapproval for a mortgage. That requires verifying assets, income and credit. Knock then works as that homeowner's buyer agent and helps him select a home within his budget, which is more certain thanks to knowing the home equity number and the mortgage preapproval.

Knock then *purchases the new house in cash*, using Knock's own money. The consumer simultaneously enters into a purchase agreement to buy that house from Knock. They also offer up to $10,000 in repairs or upgrades to the new house, manage the contractors, and get it done.[13]

The homeowner now moves into his new house. He doesn't own it yet, as Knock still holds title to the new house. But he can live there rent-free[14] while Knock lists his old house for sale. Knock will

[12] Note that Opendoor's average service charge is 6.5%. Add the 5% average spread in Phoenix and we're not far off from Sean Black's 85% figure.

[13] Knock would be paid the cooperating compensation from the seller of the new home, as it is acting as the buyer agent for the ultimate buyer.

[14] I did a double take when Black told me this. Knock does not charge the consumer rent to live in his new house. They handle it through an addendum on the purchase agreement.

manage and pay for repairs and maintenance on this old house, but as an interest-free loan of sorts.

When the old house sells, the homeowner uses the equity to (a) put a down-payment on his new house, and (b) reimburse Knock for its expenses, both on the new home and on the old home. The preapproved mortgage is executed, Knock receives the proceeds for the new home from the bank, and transfers title to the new owner.

And the homeowner pays Knock its 6% commission just like he would any real estate agent. Knock in turn pays out whatever cooperating compensation it needs to.

Younger, better-educated consumers in the Raleigh-Durham area immediately grasped the value proposition of Knock

From the consumer's standpoint, the cost of using Knock is identical to the cost of using a traditional real estate agent: 6%. In fact, because of what are effectively interest-free loans, the consumer saves money by using Knock.

This, ladies and gentlemen, is Closing the Loop.

Lower Risk, Lower Cost of Capital

What is fascinating about Knock is that as far as its core Trade In business is concerned, it really isn't an iBuyer *per se*. They're more like an interest-free bridge loan lender who doesn't qualify the borrower on two mortgage payments.

Knock's cash outlay is conditioned on having a fully underwritten preapproved buyer who has signed a purchase agreement with Knock to buy that house once his old house has sold. Its risk is far lower than that of other iBuyers who lay out cash to purchase a house, then have to hold it in inventory while searching for a buyer. The ultimate purchase price is fixed when Knock pays for the new house. Knock does have inventory risk since extreme situations could happen (buyer dies, the house is destroyed, etc.) but one assumes that those kinds of events could perhaps be insured against.

Accordingly, Knock's cost of capital and capital requirements are lower.

TechCrunch reported on Knock's Series A round and wrote:

> Knock is aiming to only take 10-20 percent of homes on its balance sheet. Competitors like OpenDoor accept more risk by purchasing all homes and operating fully on balance sheet.
>
> …
>
> Raju Rishi, general partner at RRE Ventures, explained to TechCrunch that Knock's approach doesn't require as much capitalization and that its focus on the six-week window decreases economic uncertainty and the hurdles through which the company's computational models must jump.

Obviously, we don't know (and if we did, we could not tell) what Knock's cost of capital are. But given the above dynamic, it is easy to believe Sean Black when he claims that Knock has the lowest cost of capital among iBuyers in the industry today, which translates to being able to make money without having to charge high fees or relying on a spread between buy and sell prices.

Interesting Factoids

Like Redfin, Knock is a licensed brokerage and a participant in the MLS wherever they operate. Also like Redfin, Knock employs licensed real estate agents as W2 employees who are paid a salary plus a performance bonus.

Knock is currently operating in four markets: Atlanta (where it began), Charlotte, Raleigh-Durham, and Dallas-Fort Worth.

One interesting insight Black provided was that when Knock began in Atlanta and Charlotte, it was difficult to get traction. It remains difficult. But when they opened operations in Raleigh-Durham, they found almost instant acceptance. He attributes the difference to Millennials.

His take is that the younger, better-educated consumers in the Raleigh-Durham area immediately grasped the value proposition of Knock in a way that consumers in Atlanta and Charlotte did not.

They do some limited marketing and advertising, and while Knock does not have the site traffic of Redfin or Zillow (or even Opendoor at this point), Black emphasized that they are relying on the same word of mouth marketing and referrals that traditional agents do. And he believes that anyone who has used Knock's services becomes a raving fan. As support, he offered up that a fifth (20%) of Knock's business in June came from referrals and word of mouth from previous clients. For a company that is barely two years old, with a relatively complex process, that is an impressive figure.

Perhaps because Knock is not in the business of online traffic and lead generation, Black said that they have no problems whatsoever with the portals. Knock submits all of its listings to Zillow, Trulia, and Realtor.com as well as putting them into the MLS.

As a fully participant and a brokerage with licensed agents, Knock cooperates and competes with other brokers and agents in the market.

Caveats and Concerns

Lest I come off as some kind of a cheerleader or paid shill for Knock (and I have no business relationship with Knock in any way), let me spend some time on the downsides.

First, Knock's financial model is difficult to understand. It is getting compensated like a traditional brokerage, but then undertaking capital risk (however slight) when it buys the new home, making what are essentially interest-free loans to customers, and taking on the cost of managing contractors on top of it all.

The brokerage business is not *that* profitable. The average brokerage in North America has 2.5% profit margins. Is Knock actually making any kind of a marginal profit on each deal? Or is it on a land grab willing to lose on every transaction in order to gain market share and consumer awareness?

One assumes that Knock has some sort of arrangement with lenders to get paid on mortgage applications since it takes the step to make sure that its customers are fully preapproved. But Knock's customers are not required to use Knock's lender; that would be illegal. So the overall business model is somewhat opaque.

Second, and more problematically, Knock's Trade In model is difficult to explain to the average consumer. Opendoor and Offerpad's value proposition is simple: "We'll pay cash for your house."

Knock's value proposition is somewhat involved in comparison. "We'll buy your new house for you, but you have to promise to buy it from us and let us list it for sale on your behalf and then settle up with us when that sale closes and oh by the way, we handle the repairs and maintenance but only the ones you approve and you'll reimburse us for those costs at closing."

As DelPrete pointed out in our conversation about Knock, their particular model may be too complicated to explain to most consumers who are uninformed and possibly too lazy to want to get informed. Too much consumer education may be required for most people to understand how Knock works.

It is interesting from that angle that Knock literally has this in its FAQ:

> **What's the catch? It seems too good to be true.**
>
> We get this question literally every day. There is no catch, but don't just take our word for it. You can read dozens of five star reviews from our customers on Zillow or Trulia.com, watch customer videos on our homepage or on our blog or read one of dozens of customer testimonials, case studies and Clark Howard interviews on our testimonial page.

Knock is More Brokerage, Less iBuyer

The overall takeaway from Knock is that it is actually more like a brokerage than an iBuyer. Its core business model does not contemplate bid-ask spreads as do other iBuyer models. Its revenues are likely focused on commission income and possibly mortgage lead sales income.

In my June Report, I recommended that brokerages implement an iBuyer program. The heart of that recommendation was:

> It isn't about buying and selling houses on your own that matters as much as at least attempting to answer the consumer frustration with the process, and offering them a choice – just as Redfin does.

What Knock has done is to answer the consumer frustration question, without the balance sheet risk that other iBuyers have to take on, by flipping the iBuyer model around: buy the *new* house, not the *old* house. But they're not buying the new house on their own account; they're buying it for a client. In effect, they are offering their clients an "improved" bridge loan.

It's simply brilliant.

Technology is required to implement this model, but nowhere near what other iBuyers might need since Knock is not as reliant on getting as accurate an estimate of the subject property as possible.

Capital is required, of course, as is the case with all iBuyer-type models, but the cost of capital is lower and timeframe of capital deployment is somewhat limited: a maximum of six weeks.

There remain many questions with this new model of brokerage. Knock is taking on additional risk that other brokerages are not.

There is one rather large strategic disadvantage, but that disadvantage is both (a) highly theoretical, and (b) possibly a longtime in the future. We'll address that below when we discuss the Market Maker model of real estate.

Convergence is Inevitable

There are, of course, other companies in the iBuyer space, and there are likely to be future entrants as well, fueled by the $3 billion in venture capital invested into real estate just in 2017.

But I believe that all iBuyer models will eventually converge to the same place and end up with roughly the same business model.

The reason is the importance of Closing the Loop for the consumer.

Opendoor, Offerpad, Redfin and Zillow all close half of the loop: sale of the old home. Knock closes the other half of the loop: purchase of the new home. Both have their advantages and disadvantages, but for the consumer, the ideal is to work with a company who can close the *entire loop*.

Remove all of the pain, inconvenience and delay, and the total addressable market might not be 5% or even 10%. It might be the vast majority of consumers as happens with automobiles.

Opendoor and Offerpad both offer a "trade in" option based on setting the closing date on the sale of your old home to the purchase of your new home. But the process of purchasing that new home remains the same as it is today. One assumes that Zillow will be able to offer this "trade in" option as well.

Knock offers a "trade in" option from the other direction, and rather than worrying about trying to coordinate closing dates, Knock simply buys the new home and moves you in. And while you're living in your new home, Knock will list and sell your old home in the traditional way.

Combine the two and you have the ideal solution for the homeowner:

The iBuyer buys my new home for cash. It buys my old home for cash. When my preapproved financing closes, the iBuyer gets its money out of the new home, along with reimbursements for expenses and any fees charged. Then it sells my old home independently of my new home for whatever spread it can get.

Opendoor, Offerpad, and Zillow would need to implement a program to buy the new home. All of them have the capability to do just that, although Zillow likely has the easiest path due to its size and Premier Agent count. Knock would need to rework its capital requirements, rework its financial models, and decide to take on balance sheet risk. It too has the capability to implement a program to buy the old home outright, flip it, and make money on the spread.[15]

Ultimately, the consumer would have these choices:

1. List and sell traditionally, buy traditionally. This is today's brokerage: get and pay the most money, with maximum pain and inconvenience.
2. Sell to iBuyer, buy traditionally. This is today's iBuyer: get less money to sell, pay the most money to buy, with half the pain and inconvenience.
3. Sell traditionally, buy through iBuyer. This is today's Knock: get the most money when selling, pay less money to buys, with less than half the pain and inconvenience but the same delay on selling.
4. Sell to iBuyer, buy through iBuyer. This is tomorrow's convergence: get less money when selling, pay less money when buying, which possibly is a wash, with minimal pain, inconvenience and delay.

The question is what percentage of consumers would choose option 4 if it were available. Is it still the single-digit percentages that most people believe is the total addressable market for a nontraditional process?

I don't believe so.

The most striking thing about the iBuyer phenomenon, as DelPrete points out, is that there are thousands of people who are effectively willing to pay thousands of dollars in order to skip even half of the

[15] Knock's current "Sell to Us" model is not truly an iBuyer model; it's closer to the "If we can't sell it, then we'll buy it" model that has existed in real estate for quite some time.

pain, inconvenience and delay of the traditional real estate process. That's an amazing thing.

Remove all of the pain, inconvenience and delay, and the total addressable market might not be 5% or even 10%. It might be the vast majority of consumers as happens with automobiles.

In that world, the counterparty to most real estate transactions is an institution: the iBuyer. Just like a real estate agent is the intermediary between the parties in a real estate transaction, the iBuyer becomes a new intermediary—but one who provides liquidity by using capital—between the ultimate parties.

There already exists such an intermediary: the market maker.

The Market Maker System of Real Estate

Those who have already read the June Report know that I discussed the potential for a market maker system to arise in real estate. I have thought since 2014 that Opendoor would be the company to pioneer that model, but with Zillow in the mix, I thought they have a better chance of making such a thing reality.

Please go read the whole section on Zillow: the Market Maker from the June Report. I will expand on those concepts here.

Liquidity

We might as well begin where we began in June, with a quote from Spencer Rascoff during the Q1/2018 earnings call. He said:

> One of the other interesting and exciting things about this is that by injecting liquidity into the real estate marketplace, we think we actually can create new transactions and kind of unstick people from their homes. One of the reasons people don't sell is because they are afraid that there's nothing to buy. And if we come in and create more liquidity in the marketplace, we think we can help unstuck people from their homes

As it happens, that idea of "unsticking people from their homes" is precisely Sean Black's vision at Knock even though he's going about things in reverse by buying the new home.

Liquidity would create more transactions, no matter whether it comes from the sell-side or the buy-side. So as the two sides converge, even greater liquidity is injected into the real estate market.

Convergence makes my sci-fi vision of the market maker system into more like regular fiction based on reality. A seller can sell his house to an iBuyer and buy his house from an iBuyer. The iBuyer in turn sells that old house to someone else, who has sold her house to an iBuyer. And the cycle just continues.

Over time, the natural development will be consensus about the Bid and Ask of any particular property. Continual advances in technology and data collection/distribution make that not only feasible but likely. While Zillow and Redfin might have an initial advantage in terms of buyer demand data, as data becomes more and more available (although perhaps not for free), other players would have to either catch up or exit the business.

Sets the Price

One of the effects of iBuyers is that they begin to influence the price. Take Opendoor and Phoenix as an example. DelPrete's data shows that Opendoor purchased over 500 homes in April. Over the past year, Opendoor has purchased well over 3,000 homes in the Phoenix market and sold thousands of them as well.

As a brokerage, that volume is but 3-3.5% of the market, but as an actor in the marketplace, I can't imagine that anyone has bought or sold more homes in Phoenix.

Like stockbrokers, the real value of the agent becomes psychological and advisory.

Any offer to purchase has to be higher than Opendoor's; otherwise, the seller would simply take Opendoor's offer. If the seller's listing agent are looking at incoming offers and they're all below or close to Opendoor's all-cash, no-contingency, no-staging offer, fiduciary duty requires that she recommend to the client that he just take Opendoor's offer.

And given the amount of its sales activity, the sales comps have to start reflecting Opendoor's pricing on the sale side. If you are selling your home in a subdivision, and Opendoor is selling five houses with the same floorplan in the same community, it's going to be difficult to convince buyers to pay significantly more than what Opendoor is asking.

It is true that because houses are not a commodity, there will be far greater variance compared to stocks, bonds, or pork bellies. But like all sales comps, within similar properties, it will be very difficult to price your home far above what an iBuyer has priced a home at.

As convenience drives volume, the impact of iBuyers gets greater. Over time, the Bid and Ask prices of iBuyers become one of the most important comps for all buyers and sellers.

In a market maker system, the market makers effectively set the price of houses. Variances will exist, of course, and market makers have to be nimble in adjusting their Bid and Ask prices based on what they see real-time, but it is not inconceivable that over time, the starting point of any pricing by the buyer, the seller, or their real estate agents, will be what the market maker's Bid and Ask prices are on similar properties.

The Role of the Agent

As I have written and said previously, the role of the agent in this kind of a world changes dramatically.

There will always be a role for those agents who work with unique properties that computers, algorithms, and data science has a difficult time pricing. Just like no technology as yet invented can price a Van Gogh painting, foreseeable technology won't be able to do anything with a one-of-a-kind beachfront mansion.

Unique properties will just have to go "off-market" or "third market" and be handled with the traditional, time-consuming process.

Everything else can be sold to a market maker, and bought from a market maker.

As DelPrete mentioned, because a home is such a major expense and an asset, consumers will still demand an expert help them through the transaction. That is simple psychology.

But like stockbrokers, the real value of the agent becomes psychological and *advisory*. Today's emphasis on negotiation, on marketing skills, on transaction management, etc. will be replaced by asking the right market maker for the best Bid/Ask prices and making smart recommendations to the consumer on whether to accept the Bid price, or go off-market, or which house to buy given similar Ask prices.

That is not an unimportant role. It is actually a critical role. Even if market makers take much of the pain, inconvenience, and delay out of the process, the consumer still has to decide to buy or to sell. Expert advice and counsel have enormous value still.

It is, however, an enormous change to go from a salesperson to a consultant. Most of the agents currently working in real estate will have a difficult time making that transition.

A Word on Market Conditions

Before we leave off the discussion of iBuyers, we should spend a few moments on market conditions and the impact on iBuyer models.

Much of the criticism, dismissal, and concern trolling of iBuyers revolves around the idea that iBuyers will all go bankrupt when the market shifts from one of the hottest seller's markets in history to either a buyer's market or a "balanced" market.

"All that inventory risk! Watch what happens when prices drop 10% -- Opendoor is finished, I tell ya!"

This line of criticism seems obviously flawed to me. While it is true that iBuyers take on properties on their balance sheets and have to manage the risk, all of them are being run by very experienced, very intelligent people who have access to hundreds of millions, or even billions, of dollars. Capital is the requirement to be an iBuyer, after all. Access to capital is why it took Keith Rabois, a member of the Paypal Mafia, to start the iBuyer movement.

The iBuyer is not a local speculator who took out huge personal loans to buy and flip a few houses. The iBuyer is an institution looking to create liquidity through the application of large amounts of capital. They're not going belly up because prices dropped by 10%.

Short of economic disaster, similar to the Great Recession, when even giants like Lehman Brothers went kaput, the iBuyers will simply absorb some losses, adjust their pricing, and continue forward.[16]

Just like market makers in financial and commodities markets, the iBuyers will simply adjust their Bid/Ask spread. In today's inventory

[16] And if that kind of economic disaster occurs, none of us will care all that much about iBuyers and their solvency. We will be worried about our own solvency far more.

constrained, seller's market, every company is trying to lower the spread. Opendoor is down to about 5% spread. Zillow's spread is potentially 0.5%.

In a buyer's market, the spread would widen as buyer demand drops and housing inventory rises. iBuyers would pay less to homeowners and try to maximize their profits or minimize their losses. Nothing fundamental changes.

Zillow and Redfin Would Explode

Two beneficiaries of the market shifting to a buyer's market, or even a more normal market, are Zillow and Redfin. Most of their traffic comes from buyers today already. Both companies were founded and came of age during the collapse of the housing market. As Glenn Kelman once said, "We were born in the dark."

But if they were tiny startups during the Great Recession, both companies are dominant online portals today, with 187 million and 25 million average monthly visitors. The term "Zillow" overtook the term "real estate" on Google as the most searched term in real estate. They're public companies, worth billions of dollars, with access to capital.

If the market shifts to a buyer's market, those two would explode.

Other iBuyers Likely Benefit as Well

But other iBuyers would likely benefit as well if the market shifted to a buyer's market, and they have done their part in being disciplined and smart and adjust with the market.

In today's extraordinary seller's market, the motivation of a homeowner to sell their house to an iBuyer is relatively low. After all, they could get multiple offers within 48 hours of listing their home. Yes, it's annoying and time-consuming, but as Quinn Hawkins of Redfin pointed out, getting the most money for your house tends to soothe the annoyance away.

That psychology changes if the home starts to sit on the market for a month, three months, six months. The holding costs start to add up. The uncertainty piles up by the day. That offer from Opendoor that is 20% below list price starts to look attractive if there are few showings, and your agent is recommending a 10% price drop.

To be sure, the iBuyers will need to manage their inventory risk and adjust pricing. But the psychology of the seller may undergo a shift in a buyer's market that it has not to date.

Decide. Act.

Recommendations: Brokerage

The iBuyer phenomenon presents a challenge to the industry, but for brokerages, it is an urgent challenge. As Jeremy Wacksman of Zillow said, consumers have come to expect magic from pushing a button. Brokerages have to deal with that sooner rather than later.

These are my top recommendations for brokerages.

Don't Be Afraid

The first recommendation is to take iBuyers seriously and see them for what they are. I realize how silly this sounds, but judging by the response from the industry, brokerages are operating out of fear.

The dismissal of iBuyers as house flippers with a website and venture money is not rooted in confidence, but in fear.

The insistence that only a real estate agent can get you the most money for your house is driven by fear of losing listing assignments without thinking clearly about what is going on.

It is difficult for a broker who has been working for 30 years to build up a business from nothing to a company doing billions of dollars in sales volume to see techies raising hundreds of millions from investors to buy up houses. I understand that.

But once you remove emotion from the situation and look at the How and Why of iBuyers, as this paper attempts to do, it turns out that there are massive opportunities as well as challenges with the iBuyer movement.

After having read this paper, what the broker should understand is that the iBuyer phenomenon was not created by venture funds putting billions of dollars into tech companies. **It was created by consumer frustration with a broken process**. The iBuyer entrepreneurs chose to try and *solve* that process, instead of trying to *cope with it*.

In short, the iBuyer phenomenon is a *consumer-driven* phenomenon. No company and no industry has ever succeeded by fighting what consumers want. Ask the recording industry. Ask the local taxicab companies how they're faring.

Truly, the greatest danger comes not from trying to solve the problem, but trying to defend the broken process of today and trying to convince consumers that they're wrong for hating the uncertainty, inconvenience, and delay of today's process.

On the other hand, since brokerages and their agents are at the very heart of that broken process, understand deeply what is and is not broken about it, they have the best opportunity to offer the best solutions.

But to think strategically about the problem requires first that you let go of your fears. So don't be afraid.

Work With, Not Against, iBuyers

With emotion removed, and understanding that the iBuyer phenomenon is a consumer-driven phenomenon, brokerages should be looking to work with as many iBuyers as they can.

While Zillow Offers is the only program that explicitly invites third parties into the iBuyer program, Opendoor, Offerpad, Knock and others all are ready and willing to work with other brokers and agents. They have to, in a sense, since all of them are full participants in the MLS.

Working with an iBuyer does not mean simply presenting their offers to your clients or bringing a buyer to one of their properties. That's what you and your agents would do with any property on the market, or if you knew there was anyone interested in buying your client's house.

I am recommending exploring deeper and more meaningful partnerships with iBuyers in your area. That means deep integration between your systems, sharing data across companies, cross-training your people and theirs so everyone is familiar with how things are done in your two organizations, etc.

Yes, you have to find iBuyers willing to partner with you. You have to have staff and agents who are willing to let go of their fears and work with iBuyers. I think the payoff is worth the effort.

Shamelessly Copy Knock

For brokerages who have access to capital (see below for more on this), I recommend shamelessly copying Knock as much as you can.

As described above, Knock is not really an iBuyer who takes properties onto its balance sheet. It's more like a brokerage blended with an improved bridge loan.

Since Knock does not purchase the seller's house and put it on its balance sheet, its AVM does not need to be as accurate as Opendoor's or Zillow's. In fact, Knock's "Get My Trade-In Price" tool is more of a website feature that generates leads, not the start of a binding offer process.

Where Knock *does* spend its own money is in buying the new house for the client. But it does so only after that client has been fully preapproved and executes a purchase agreement to buy the new house from Knock upon the sale of his old house closing.

This is something that just about every brokerage can do if they have any kind of access to capital. So copy Knock shamelessly. Imitation is the highest form of flattery.

Unlock the Value of Your Data

Let me be clear about what I'm saying here when I say "your data." I do NOT mean your listings.

One of my personal pet peeves about the real estate industry is the idea that real estate listings are data. I've written multiple posts on the topic, including this one:

> "Listing data", after all, is the advertisement of a property for sale. The broker owns the copyrightable parts of it, yes, but… should we completely ignore the fact that if the property were not for sale, the actual sellers would never have consented to the creation of the "listing data package" in the first place? As far as the seller is concerned, the "listing data" exists for the sole purpose of selling his damn house.
>
> Which means that the issue of "listing data rights" and "listing data licensing" ought to be rephrased as "advertisements of homes for sale rights" and "advertisements of homes for sale licensing" for the purpose of precision. If

> those more precise terms sound faintly ridiculous… there's probably a reason for that.

Listings are advertisements of a home for sale. The whole point is to get that information in front of as large an audience as possible. The value of advertising is to generate a sale of the thing being advertised, period.

So when I talk about unlocking the value of your data, I mean all of the *non-advertising* data you and your agents will gather throughout the transaction process.

- Subjective valuation of property condition
- Neighborhood information
- Information about the client
- Seller concessions, buyer concessions
- The professionals involved in a transaction

We can go on and on, but the general point is to collect as many data points—including subjective opinions—about the market as you can.

That includes property data that isn't found in a database. Is there an odor? What's the view like from the upstairs bedroom? How do the trees in the yard look?

But it also includes things like why Charlie the client didn't like 123 Main Street, but loved 456 Broad Street. Is the client a giant foodie who loves to bake? How do they like to entertain? Crazy about cars? Likes to tinker with motorcycles?

What concessions did the seller have to make to have the deal come together? The buyer? What were difficult points in the negotiation over 456 Broad Street?

Is the listing agent on top of everything and a detail-oriented professional? Or is she a newbie who is both lazy and stupid? How was the mortgage broker on the deal? The escrow company?

All of these things are data points that may not be immediately useful, but once you have collected enough of them and made that data usable by machines… now you've got something of real value.

Think Really Hard about Closing the Loop

Just like the iBuyers themselves have to think hard about Closing the Loop, the brokerage on the ground has to really focus on it.

In the June Report, I recommended that brokerages become obsessed about the close rate. This is an expansion of that idea.

Housing is a fundamental need. Sellers need to live somewhere. With most iBuyers focused solely on the sell-side half of the loop, it falls on brokers and agents to close the buy-side of the loop.

This is one reason why I think Knock's model is so powerful for brokerages.

But even in a traditional sale and a traditional buy scenario, the broker in the middle should be thinking really hard about the consumer experience through that process. You might not have billions of dollars to solve that problem for the client, but at the very least you have to really focus on the experience of that client and what if anything you could do to reduce the pain, the inconvenience, and the delay.

An analogy might be something like surgery. Good surgeons do a great job at operating on the patient and fixing what needs to be fixed. Great doctors understand that the patient's experience is not done until weeks or even months after he is wheeled out of the operating room. Closing the Loop for them might include visiting the patient in the recovery room afterwards, asking how they feel, explaining the process, and answering any questions the patient might have. It might include post-op visits scheduled weeks out, and perhaps even checking in with the patient months or years afterwards to make sure he's doing well.

The rest of us call that sort of thing "bedside manner." But as this New York Times article tells us, poor bedside manner could lead to getting sued for malpractice more often:

> Another study, published two years later, looked at the relationship between physicians' history of malpractice suits and their patients' satisfaction. Patients seeing doctors who were sued in the past were significantly more likely to report that their doctor rushed them, did not explain reasons for tests or ignored them. Doctors sued most often were complained about by patients twice as much as those who were not, and poor communication was the most common complaint.

While many brokerages think that this is precisely what they and their agents do, and their self-promotional literature is filled with claims about how they want clients for life, how they treat clients like family, and how customer service is Number One… a cursory examination of their actions versus their words shows otherwise.

Don't be that broker. Don't be that agent. Think really hard about Closing the Loop. Then take actions to actually help Close the Loop.

Start Preparing Today for the Market Maker Future

Strategically, if consumer demand is driving things towards convergence, and convergence naturally evolves into a market maker system, then as a broker you need to decide what your role will be in that future.

Then you need to start preparing for it.

For example, in a market maker system, the role of the agent is to become an advisor and counselor above all, rather than a salesperson. Take a look at your training today to see how much of it is geared towards helping an agent become an advisor and how much of it is about sales.

That's a bit of a rhetorical question, since you and I and everyone else in the industry knows that "training" in real estate is really sales and lead generation training. And mandatory training is a bad joke in an industry filled with 1099 independent contractors who proudly tell the broker to go pound sand.

Nonetheless, I recommend taking steps today, putting in training today, that would start to prepare your agents to become advisors and counselors instead of salespeople. Some suggestions:

- **Product knowledge**: Do your agents know every house in their market areas? The builders? The construction techniques? The kind of siding used and why that might make a difference?

- **Market knowledge**: Do your agents know the latest market statistics? Can they interpret raw MLS data and render an opinion as to what's going on? Do they know macroeconomic factors that might be driving the market? Are they informed as to legislative or regulatory actions in their local markets? Do they know the history of their geographic farms, who built the houses, who lives there now, who has a mean dog, and which side of the street gets flooded when it rains?

- **Process knowledge**: Do your agents understand all of the paperwork? Do they know what each clause in a sale contract does and how, and its relationship with a different part of the contract? Can they read a title report and understand it? Do they understand exactly how an appraiser works, what he looks for, and how to argue an appraisal?

Much of that knowledge is gained through simple experience, but few brokerages try to capture that knowledge and pass it on to new agents. Instead it's lead generation and sales techniques until the cows come home. If the market maker system becomes reality, those agents will be at a huge disadvantage in proving their value. Plan for that inevitable future.

It might be instructive to look at what kind of training your local car dealerships, especially the luxury brands like Audi, Mercedes-Benz, and BMW, provide for their salespeople who are selling $50,000 cars, not $500,000 houses.

Please contact Sunny Lake Hahn, Partner of Brokerage Management, if you would like more specific suggestions.

Capital, Not Technology

For larger brokerages and national franchises, it is worth seriously investigating relationships with capital providers: banks, insurance companies, hedge funds, public markets, etc.

The brokerage industry is obsessed with technology, and it's a mistake.

Technology is important, of course, but a brokerage is not a technology company. You can try to become one, of course, but… well, good luck with that.

Where opportunity exists today is not in building new and better AVM technology or in trying to drive traffic to your franchise website, but in building relationships that will allow your company to be the one bringing huge amounts of capital to solve the consumer's problem.

Smaller brokers are understandably limited in their abilities to bring millions of dollars in capital to solve the consumer's problems. Large brokerages and national franchises should have more of an ability to do just that, which also happens to provide a competitive advantage in terms of recruiting and retention.[17]

I'm going to assume that any company large enough to consider going down this route have the necessary people to figure it out. Feel free to contact me if you'd like some assistance tailored to your situation.

[17] This doesn't mean small and independent brokerages are completely out of the capital game. But that's the subject of ongoing consulting engagements, and therefore not suited to being written up in a public report. Contact me if you're interested in learning more.

Conclusion

The iBuyer exists because of consumer frustration with the broken process of buying and selling houses. The industry could completely misunderstand the phenomenon if it continues to think that iBuyers are a flash in the pan, venture funding fueled experiments that will fold the minute the market changes.

Consumer frustration will remain the same no matter the market.

If iBuyers solve that consumer frustration by application of huge sums of capital, then they will first converge in order to Close the Loop on the consumer experience, and then evolve into a market maker system of real estate.

Brokerages, MLS and Tech companies in real estate have to decide whether they are going to ignore the problem of consumer frustration, defend the status quo, or try to solve the problem. Ignore the problem, and you become irrelevant. Defend the status quo, and you will get run over. Only those who are part of the solution will survive to see 2030.

At the same time, the iBuyer phenomenon presents some amazing opportunities to transform your businesses if you are willing to let go of fear, over-reliance on the status quo, and move with confidence into the uncharted future with consumer experience as your North Star. There is far more opportunity here than crisis.

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