THE RED DOT

Vol 1, Issue 2: June 2018

Zillow, Redfin, Realogy: Q1/2018

The Shape of Things to Come

Technology Edition

Observe. Orient. Decide. Act.

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Observe.

Introduction

Three of the most important companies in real estate are also the three public companies who have to report earnings every quarter, and answer questions from Wall Street analysts who follow them.

I have often looked forward to earnings season just to be able to see what Zillow, Realogy and now Redfin have done, are doing, and are planning. They provide such a window into where things are today and where they're headed tomorrow.

The Big Three have reported earnings for Q1 of 2018 and did not disappoint. Well, they may have disappointed their investors, as all three suffered significant losses, but we're not a report for investors. We are a report for the industry, so we look for different things.

These three companies give us all hints as to what is happening today, and therefore paint the shape of things to come.

Robert Hahn
May, 2018

DISCLOSURE: I have had a business relationship with Zillow in the past, but that relationship ended in June of 2017. I was a former employee of Realogy (then Cendant), but that ended in 2008. 7DS Associates does not have any business relationship with Redfin. I have not used any nonpublic information in writing this report.

Furthermore, I do not hold any long or short positions on any of the companies discussed herein as far as I know. Some of my mutual funds may or may not own their shares – I have no idea, since I barely even look at their statements. Sunny Lake Hahn, my wife and also Partner of Brokerage Consulting for 7DS Associates, does own some shares of EXPI, which is mentioned in this report. Her Washington real estate license is affiliated with eXp Realty.

Executive Summary: Technology Company

I have long watched the quarterly earnings reports from three companies in the real estate sector: Zillow, Redfin, and Realogy. I have found that digging into the details of the SEC filings and listening to (or reading the transcript of) the earnings calls that these companies conduct with Wall Street analysts are filled with interesting insights.

Periodically, the public information reveals something significant happening. The recent earnings results and earnings calls for Q1 of 2018 is one of those times.

I believe that between Zillow, Redfin, and Realogy, we can discern both the present realities of the residential brokerage business in North America, as well as the shape of things to come in the future.

Zillow: The Revolution Will Not Be Televised

Q1/2018 is another instance when Spencer Rascoff, Zillow's longtime CEO, reveals what Zillow is thinking, and therefore what the future of real estate looks like. And once again, the industry as a whole completely misses the forest for the trees.

Zillow's Key Numbers

Revenues:	$299.9 million, up 22%
Cost of Revenue:	$23.9 million, up 18.2%
Gross Profit:	$275.9 million, up 22.4%
Gross Margins:	$92.0%, up 0.3%
Total Expenses (excl. cost of revenue):	$287.3 million, up 28.1%
Net Loss:	($18.6) million, down 303.6%

Zillow's traffic was up 5% YOY to an average of 175.5 million average monthly unique users, which is double the next two largest websites *combined*.

As to Premier Agents:

- The number of Premier Agent® accounts, including accounts of brokerages and other teams, spending more than $5,000 per month grew by 58% year-over-year and increased 58% on a total dollar basis.

- Total sales to Premier Agents, including brokerages and other teams, who have been customers for more than one year increased 38% year-over-year.

- Sales to existing Premier Agents, including brokerages and other teams, accounted for 70% of total bookings.

The Big iBuyer Announcement

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.

The first thing to point out is that Zillow is not like any other iBuyer.

Zillow's Advantages

Zillow has a **massive data advantage** over every other iBuyer in terms of knowing how much to bid on a property.

That domination of buy-side is not just an advantage in data, but an obvious advantage in *distribution*. What's more, Zillow's distribution channel may be a profit center for Zillow.

Zillow also has a distribution advantage in terms of making offers for houses, with tens of thousands of Premier Agents, who will gladly offer the consumer the option of selling right now to Zillow.

Quantity has a quality all its own.

Listing Leads

Fact is, Zillow's Homes segment (which is what they're calling their iBuyer program) would become a ginormous waterfall of cash from the sale of listing leads should be obvious to anyone who understands the real estate industry.

Listing Merchandising

Zillow will use Zillow Homes as a way to test listing merchandising products. (That is, paid promotion of listings by the listing agent or the home seller.)

Spencer said the program is speculative. But companies in other countries have long monetized listing merchandising.

Once Zillow has figured out how to most effectively promote a listing with minimum disruption to the user experience, that product will make a fortune as well.

Now that Zillow is in the iBuyer game, there's no reason why only Opendoor or Offerpad can pioneer the market maker model of real estate. Zillow can do the exact same thing, but probably at far larger scale, with far more advantages.

Zillow: The Market Maker

In his call, Spencer mentions "injecting liquidity into the real estate marketplace."

I have long maintained that Opendoor is the most interesting company in real estate, because I thought what Opendoor wanted to do was to create a system in which housing can trade much like stocks and bonds and commodities.

Now that Zillow is in the iBuyer game, there's no reason why only Opendoor or Offerpad can pioneer the market maker model of real estate. Zillow can do the exact same thing, but probably at far larger scale, with far more advantages.

After all, the function of a market maker in any marketplace is *to provide liquidity*.

Zillow 5.0: Lead Validation

Zillow 5.0, mentioned in Spencer Rascoff's letter to shareholders is a potential game changer. Everyone seems to just glosses over this, shrugs, and moves on to talking about iBuyer.

In real estate, the biggest failure point historically has been at that first break point of conversion from a lead to a customer, simply because agents do not respond in a timely fashion, if at all.

Zillow moving "down the funnel" to handle everything up until the actual moment that a consumer is ready to talk to an agent benefits both Zillow and the Premier Agent subscriber. The agent is not getting low-quality leads she has to spend the next six months incubating and qualifying. Zillow is not taking a brand hit from the consumer whose inquiry went unanswered. Win-win.

However…

Throughout this transformation, perhaps nothing transforms more than the relationship between Zillow and the Premier Agent.

Ten years ago, in one of the first posts on my new blog, I talked about something I called "The Home Depot Effect."

Going forward, Zillow becomes not just the website where the buyer shopped for a house, found the house, and found the "installer" who helped him buy the house, but also the company that (a) responded quickly to his inquiry, and (b) maintained an ongoing dialogue, qualifying his ability to purchase, interests, necessary criteria, etc. until he was ready to purchase. At that point, Zillow hands him off – in a warm-handoff phone call – to a local real estate agent who can help him tour the homes, and help him through the purchase process.

The relationship of the buyer is not to the agent, or to the broker, but to Zillow.

Throughout this transformation, perhaps nothing transforms more than the relationship between Zillow and the Premier Agent.

Today, the Premier Agent is an advertiser on Zillow. For a certain amount of money, Zillow promises a certain number of impressions (CPM-based pricing) of that Premier Agent.

Tomorrow, the Premier Agent becomes something far closer to the windows installer for HomeDepot.

What truly underscores the change in relationship is that in the process outlined by Spencer Rascoff, *it is Zillow who makes the determination of who gets the validated lead*.

Today, it is the Premier Agent who gets to decide which Zillow lead gets a response and in what timeframe and what questions to ask to validate and qualify the lead.

Tomorrow, *Zillow* gets to decide.

Zillow is Way, Way Ahead of the Curve

Zillow 5.0 is a very serious, very real effort to transform Zillow. Along the way, it will transform the real estate industry.

Redfin: The Rabid Squirrel

REDFIN™
Your New Way Home

It's a mistake to underestimate Redfin.

Redfin's Key Numbers

Revenues:	$79.9 million, up 33.4%
Cost of Revenue:	$74.2 million, up 38.7%
Gross Profit:	$5.7 million, down 10.7%
Gross Margins:	7.1%%, down 33.1%
Total Expenses:	$42.9 million, up 24.3%
Net Income:	($36.4) million, down 29.8%

Some of the other Key Metrics look pretty healthy:

	Q1/2018	Q1/2017	%Δ
Monthly average visitors	25,820	20,162	28.1%
Real estate transactions			
Brokerage	7,285	5,692	28.0%
Partner agents	2,137	2,041	9.6%
Average number of Lead Agents	1,327	935	41.9%
Value of transactions (Sales Volume)	4,4 billion	3.5 billion	27.5%
U.S. Market Share (by Value)	0.73%	0.58%	25,9%

Method to the Madness, 2017 Earnings Call

Because Redfin started life as a brokerage, it realized the importance of the "deep funnel" long before Zillow did. So Redfin has been refining the entire funnel for ten years.

The key to understanding Redfin is that *everything* that Redfin does is related to increasing the close rate. That requires lead generation, operational excellence, and focus on consumer experience.

Q1 is a bit early to know whether Redfin's initiatives from late last year have borne fruit, but Kelman was confident.

Everything that Redfin does is related to increasing the close rate.

The Brokerage of Tomorrow

Close rate is particularly critical in today's inventory-constrained housing market, but Redfin thinks it is generally important. So do I. It points the way towards the brokerage of tomorrow.

As Kelman said, **success as a brokerage will be determined by the success rate of its consumers**. That is why Redfin is obsessed with close rate. It is why Zillow is moving down the funnel.

The challenge is that tying (correctly) success as a brokerage to the success of its buyers and sellers requires three things:

1. Lead generation capabilities.
2. Operational excellence throughout the funnel.
3. Ability to adapt to changing consumer needs.

Redfin has all three, with varying levels of proven success.

Redfin Now and the Market Maker System

In the call, Kelman's comments reveal that Redfin is fully aware of the liquidity issue in real estate, and that it is experimenting with becoming the provider of liquidity – the definition of becoming a market maker.

Redfin Now and Listing Lead Generation

Redfin Now isn't just about buying and flipping homes. It's also about listing lead generation.

Redfin Now has always worked in this manner: offer the homeowner the choice between listing the home, or taking the "cash on the barrel".

It's not easy to out-innovate Zillow. But Redfin did it with Redfin Now, a year earlier. Therefore, Redfin has a year's head start on everybody else, Premier Agent or not, on how that "offer the consumer a choice" thing works in practice.

What's more, Redfin has a major advantage even over Zillow.

Redfin Has End-to-End Control

Redfin is a complete vertically integrated operation from start to finish, and beyond. Redfin can actually execute on its obsession with close rate, operational excellence, and consistent service delivery because it controls every aspect of the real estate experience from search to home tours to the transaction process to the closing to post-closing follow-up.

Redfin controls the entire funnel, end-to-end. They're not perfect, but if Redfin makes mistakes, it can correct them quickly. Other brokerages cannot.

The 1% Listing Fee, Redfin Concierge, and Operational Excellence

The 1% Listing Fee strategy is working. Redfin's growth – especially in the all-important listings business – is two to three times faster when consumers find out about the 1% listing fee.

Kelman also calls the 1% Listing Fee "a product that sells itself."

The notion that consumers believe the "you get what you pay for" when it comes to real estate brokerage services is something that needs to be questioned. Redfin is doing that questioning today.

In any event, if the 1% Listing Fee is truly a product that sells itself, there are some possible consequences to that becoming widespread.

A Brief Note on Consequences of 1% Listing Fee

One unexpected and highly speculative consequence for real estate is that discounting leads to an *erosion of cooperation and compensation*.

Furthermore, at lower commission rates, pressure to double-end the deal grows.

Either way, low listing fees erode cooperation and compensation, and impacts the MLS.

Wrap-up of Redfin

Major takeaways from Redfin's Q1 results and earnings call is that **Redfin is painting the future of brokerage**. It is uniquely positioned with unique capabilities that allow Redfin to navigate the changing environment, innovate and experiment (with some of those experiments not working out) and perhaps to steer the industry into directions where it has an undeniable advantage over all other brokerages. Redfin's end to end control over the consumer experience is unmatched. Its operational excellence is unmatched, at least by brokerages.

Redfin has always known about "the deep funnel" and now they're experimenting with the potential market maker system of real estate. They're learning hard lessons today that they can leverage tomorrow.

Like Zillow, Redfin is also far ahead of the curve.

And it's not close.

Realogy: The Walking Dead

If Zillow and Redfin paint the picture of what the future of real estate might look like, Realogy paints a picture of what the present reality of brokerage is in North America.

In a real way, we can say that Realogy is the poster child, the archetype, the flag bearer of traditional brokerage in North America. It is what every brokerage not named Redfin aspires to be one day.

And it is a dead man walking.

The Numbers

Realogy NRT unit, the company owned brokerage, is the one we really care about. Its key numbers are:

	Q1/2017	Q1/2018	
Closed Transaction Sides	66,570	66,097	-0.7%
Avg. Home Price	509,197	525,020	3.1%
Avg. commission rate	2.45%	2.45%	0.0%
GCI per side	13,261	13,666	3.1%
(in millions)			
Revenue	897	917	2.2%
Commission Paid to Agents	605	645	6.6%
Company Dollar	292	272	-6.8%
Company$ Margin[1]	32.6%	29.7%	-8.9%
EBITDA	(21)	(45)	-114.3%

In the course of a year, the NRT did *fewer* transactions, but they took home more money: 6.6% more, against revenue growth of 2.2%.

This erosion of profitability is **The Problem** of the traditional brokerage since emerging from the Housing Collapse.

Unrelenting Agent Split Pressure

Schneider says (and I have to admit I love the language here), "Well, commission split is the dominant thing at the moment just because that's where kind of the **violence in the P&L has been**."

Fact is, there is relentless pressure on commission splits, and has been for years now. This is hardly a new problem.

Back in 2013, I wrote a Black Paper on the then-newly public (once again) Realogy's 2012 earnings call.[2] Richard Smith, then CEO, and

[1] Please note that in the overall Realogy P&L, there's a line for "Gross Commission Income" of $902 million, which is less than the $917 million for NRT's Revenues. I've computed "Company$ Margin" using NRT's Revenues.

[2] I do not believe that paper is available for download anymore. But since you're a premium Red Dot subscriber, please contact me if you would like a copy sent to you.

Tony Hull, CFO, talked about pressures on commission splits back then as well.

Suffice to say that over all of these years, Realogy and NRT executives have been focused on trying to "moderate" commission splits.

None of these proactive measures, none of the things Realogy and NRT have tried in the past, have worked to stop the unrelenting pressure on margins from agent commission splits.

In his first earnings call as Realogy's CEO, for Q4 and full-year 2017 results, Ryan Schneider addressed the agent commission issue head-on

Productivity Technology, Corporate Control, and Data-Based Recruiting

In the Q1 call, Schneider gets into a good bit more detail on what the new strategy around commission splits might be

As far as I can tell, I think what Schneider means is that:

(1) Realogy will use technology to deliver more value, which means the agents will be willing to pay more (in the form of lower splits);

(2) Corporate will take control over commissions negotiation; and

(3) Realogy will recruit fewer top producers who demand high splits, but make it up in volume.

Let's discuss these in reverse order.

A Different Mix of Agents

It isn't at all clear that split-based competition (or "cost-based competition" if you will) is somehow less intense for these mid-level agents than they are for the top producers.

The trend in real estate in recent years is the emergence of truly low-cost brokerages who are happy to offer even marginal agents, never mind the mid-level producers, extremely high splits.

So, yes, Realogy can use data analytics and "different AI tools and things like that" to target agents who are not at the top of other brokerages' lists… but even those mid-level and entry-level and marginal agents are being targeted by the low-cost operators today.

How does AI change *that* dynamic? I can't see that it does.

Corporate Control?

The second strategy implies that the managing brokers at local NRT offices will no longer be allowed to negotiate commissions with agents they are trying to recruit

I suppose we will see how this works in action, but taking decisions and initiative out of the hands of local management strikes me as a wonderful way to alienate your local management, who are often the only thing standing between agents and the exit door.

How that is a winning strategy to keep commission splits in check is as yet beyond me.

Value Through Technology

So finally, we come to #1: deliver more value, "especially with technology and data products," and agents will accept a lower split.

"More value for more money" strategy is not exactly new and different. In fact, it can't get more conventional wisdom than "more value for better splits." That is quite literally *the* strategy of every single split-based brokerage in North America today, from the largest like the NRT and HomeServices to the smallest boutiques.

But there are two nearly insurmountable problems for Realogy, and by extension, every single traditional brokerage in this "value through technology and data" strategy.

Technology? Data? Day Late, Dollar Short

If this were 2008, this "value through technology and data" strategy might be all kinds of interesting.

Alas, it is not 2008 but 2018 and the "technology and data" game has been going on for the past ten years with Realogy mostly sitting on the sidelines

And over the past ten years, the emergence of true technology companies in real estate – exemplified by Zillow and Redfin – has completely altered the economics of technology development.

Consider this: Zillow spent $93.9 million in just Q1 on Technology. Redfin spent $12.8 million on the same.

My take is simple: if you're late to the party, you need to spend way more than the incumbents to compete.

So why isn't Realogy doing that?

I have a thought.

The 1099 Conundrum

The issue is that Realogy's agents are 1099 independent contractors, whereas Redfin's agents are W-2 employees, and Zillow's Premier Agents are paying customers.

That difference makes all the difference in the world when it comes to technology investment.

Realogy has to take agent adoption and agent acceptance of any of its technology initiatives into account. And the numbers are not encouraging. The numbers are not encouraging because the logic of technology adoption is not in Realogy's favor.

It makes sense for Realogy to create technology and data products that makes it harder for agents to leave Realogy, but why does it make sense for the agents to embrace the same? Why would an agent want to limit how much freedom she has to move around?

What Schneider seems not to realize is that as independent contractors, *agents compete against each other* – even out of the same office.

So one must ask why a top producing agent with hundreds of transactions wants her brokerage using her transaction data, client data, or listing data to create products to help her direct competitors who do far fewer deals.

Realogy: Skating to Where the Puck Is

Even if we assume all of that in Realogy's favor, fact remains that Realogy is working on today's problems using today's solutions. Zillow and Redfin are working on tomorrow's problems using tomorrow's solutions.

Realogy is trying to solve the margin problem, through technology and data. Its metrics are around recruiting and retention statistics, and around commission split statistics.

Zillow and Redfin, meanwhile, are *moving down the funnel* closer and closer to the all-important "close rate" issue.

Control over the consumer experience is where the future of real estate is. It's where the puck is headed. Zillow and Redfin are racing towards that spot with iBuyer initiatives, and deeper funnel products. Realogy, like the rest of the brokerage industry, is skating towards where the puck is today: recruiting and retention, and commission splits.

Addendum: Is Realogy Unique?

Since just about every brokerage in North America is privately held, there are only two other companies we can look at today.

HomeServices of America[3]

Berkshire Hathaway Energy's 2017 10-K tells us that HomeServices had revenues of $3.4 billion, operating income of $214 million (6.2% operating margin), and net income of $149 million (4.3% profit margin). Those numbers are not dramatically different from what Realogy posted for 2017. But the issues driving lack of profitability are similar as well.

Without the Trump Tax Cut of 2017, profits at HomeServices would have *shrunk by $9 million*.

What makes this so unbelievable is that in 2017, HomeServices acquired the third largest brokerage by transactions and volume, Long & Foster.

All of these hints strongly suggest that Realogy is not alone in its troubles with profitability and growth.

[3] I wrote about HomeServices of America in a lengthy blogpost, from which much of this material is taken. You can find that post here: http://www.notorious-rob.com/2018/04/can-we-talk-about-homeservices-for-a-minute/

eXp Realty

The other brokerage who reports publicly in any way is eXp Realty, whose parent company eXp World Holdings trades on NASDAQ under EXPI.

The first thing to note is that eXp appears to be what is effectively a 90/10 split brokerage. Cost of revenues remains tightly correlated to revenues. For the past year, they hovered around 10-11% of revenues each quarter, which suggests a 90/10 split, with some of the compensation happening with shares of eXp stock.

Taken together with what we at 7DS Associates know about private company financials, we can say with certainty that Realogy is hardly unique in the world of real estate brokerages in its profitability problems as a direct result of relentless pressure on agent splits.

The Takeaway from Realogy

The contrast between Realogy's results and earnings call and those of Zillow and Redfin could not be more stark.

Where Zillow and Redfin talk about the problems of the future, Realogy is talking about the problems of the past and present.

Realogy and traditional brokerages are still focused on an agent-centric recruiting-and-retention model of business. The world may be moving on. Consumer experience, buyer success, close rate – these are the things that Zillow and Redfin are obsessed with, while Realogy (and by extension, traditional brokerages) are obsessed with recruiting and retention.

Nonetheless, that doesn't mean that Realogy and traditional brokerages are helpless. There are things they can do today, whether to improve the situation, or to buy time to figure out a strategy for the future.

For MLS and Associations, there are clear things that they must consider given what these three public companies have told us about the future of real estate.

For technology companies not named Zillow or Redfin (or Move), they must seriously consider what these changes portend as well.

We turn to those recommendations next.

Summary of Recommendations for Technology Companies

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

• Get Obsessed with Close Rate & Consumer Experience

Given that my number one recommendation to brokerages, agent teams, and franchise companies is to get obsessed with close rate and consumer experience, it follows that the number one recommendation for technology companies is to get similarly obsessed with the close rate and consumer experience.

It's going to be a pain in the ass, but I think it's required.

Generally speaking, you as the strategist must understand this paradigm shift:

- Yesterday was about lead generation.
- Today is about lead conversion.
- Tomorrow will be about the close rate.

Get as obsessed with close rate as you do with lead generation and lead conversion, because your customers and clients need to be.

• Move Down the Funnel

Closely related to the above is that you need to move down the funnel, whether for yourself or for your brokerage and agent customers.

Going forward, brokerages and agent teams will turn their attention increasingly towards the deep funnel, control over the consumer experience, and the close rate. Because they have to, or become irrelevant. As a technology company, then, you will also want to make sure your products and services help brokers and agents work on those things.

- ### Get and Promote the Right Metrics

  One of the oddities about the real estate industry is that so much of its metrics are irrelevant – or fast becoming irrelevant.

  For a brokerage, there are two key numbers that matter: Company Dollar and Net Income.

  First, your product or service *must show some sort of lift* on one of those three KPIs. If your software generates all kinds of efficiencies, but provides no improvement in EBITDA, then what's the point?

  Second, in order to show that lift, you have to start collecting that data. A brief glance through the marketing literature from the real estate technology companies show all kinds of claims, but no one I could find in researching for this makes claims about Company Dollar, Gross Margin, or Profit and *backs them up*.

  So get the right KPIs from your customers, then promote your product or service using the right KPIs.

- ### Evaluate Your Platform Strategy

  If we take as a given that the Game of Thrones to become the Platform for real estate is now afoot, you need to take a serious, hard, and cold-blooded look at your platform strategy.

- ### Think About the Market Maker System

  Finally, while this remain in the realm of speculative fiction, with the Platform issue at stake, you need to at least think about how things might change with a market maker system of real estate.

  Your staff should focus on the problems of here and now. You, as the person responsible for strategy and vision, need to at least start considering a possible future under a market maker system.

Conclusion

If someone had told me a month ago that I could and would write a 70-plus page report based on nothing other than the quarterly earnings results and calls of three companies, I would have laughed.

After some 26,000 words and almost 90 pages… I'm not laughing anymore.

Earnings results from one quarter, particularly the first quarter of the year when the real estate market is very slow, are not definitive guides to much of anything. But these are the three public companies who report, and speak to Wall Street analysts frankly about their plans, their strategies, their challenges.

If one is to spot a trend before it goes viral on Facebook, one has to do some real work teasing out a narrative from the numbers and the hints dropped by public company CEOs. I have tried my best to do just that, and it is fortunate that there was so much to look at, analyze, and discuss in Q1 results.

Q2 results are not too far away; we should all get a clearer idea of how some of these initiatives have impacted things for Zillow, Redfin, and Realogy. What we learn then may force a re-evaluation, or it may confirm what we're seeing today, though darkly as through a mirror.

The shape of things to come is one of deep engagement with the consumer experience. As we go forward and get more facts, more data, and more numbers, that shape can solidify until everyone can plainly see what's going on.

By then, we'll have moved on to trying to discern the shape of things to come in tomorrow's tomorrow.

-rsh

Orient.

Main Section

I have long watched the quarterly earnings reports from three companies in the real estate sector: Zillow, Redfin, and Realogy. I have found that digging into the details of the SEC filings and listening to (or reading the transcript of) the earnings calls that these companies conduct with Wall Street analysts are filled with interesting insights.

Periodically, the public information reveals something significant happening. The recent earnings results and earnings calls for Q1 of 2018 is one of those times.

I believe that between Zillow, Redfin, and Realogy, we can discern both the present realities of the residential brokerage business in North America, as well as the shape of things to come in the future.

For those that are interested in further research, here are the links to the most important references used:

- Zillow:
  - 10-Q, period ending 03/31/18
  - Earnings Transcript (Seeking Alpha)
- Redfin
  - 10-Q, period ended March 31, 2018
  - Earnings Transcript
- Realogy
  - 10-Q, period ended March 31, 2018
  - Earnings Call Transcript

Zillow: The Revolution Will Not Be Televised

Inman's headline about Zillow's Q1/2018 earnings report reads, "Zillow posts bigger net loss than expected in Q1." Accordingly, real estate brokers and agents who suffer from Zillow Hate (which I have often called "Zaterade") piled on talking about losing money and keep raising more and some such.

One honestly wonders if Zillow's management is happy to post on-paper losses just to confuse the real estate industry as to what's really going on.

Spencer Rascoff, Zillow's longtime leader, often signals where the company is headed and what it is thinking. Once in a while, he makes incredibly important pronouncements, as he did back in 2015, when he laid out a new strategy for focusing on the better agents who pay the most.

I wrote about that in a blogpost, "The Future of Real Estate, According to Zillow."[4] Many people in the real estate industry understood what was happening; most people did not.

One honestly wonders if Zillow's management is happy to post on-paper losses just to confuse the real estate industry as to what's really going on.

Well, Q1/2018 is another instance when Rascoff reveals what Zillow is thinking, and therefore what the future of real estate looks like. And once again, the industry as a whole completely misses the forest for the trees.

The Numbers

We begin, as always, with the actual numbers themselves. Because we are not reporters content with a company's press release, we start with the actual 10-Q filing.

[4] http://www.notorious-rob.com/2015/08/the-future-of-real-estate-according-to-zillow/

Table 1: ZILLOW'S Q1/2018 INCOME STATEMENT

	Q1/2018	Q1/2017	%Δ
Revenue	299,879	245,775	22.0%
Costs and expenses:			
Cost of revenue (excl. amortization)	23,919	20,232	18.2%
Sales and marketing	137,291	105,940	29.6%
Technology and development	93,933	72,868	28.9%
General and administrative	56,073	45,466	23.3%
Acquisition-related costs	27	105	(74.3)%
Total costs and expenses	311,243	244,611	27.2%
Income (loss) from operations	(11,364)	1,164	(1,076.3)%
Other income	2,446	953	156.7%
Interest expense	(7,073)	(6,723)	5.2%
Loss before income taxes	(15,991)	(4,606)	(247.2)%
Income tax expense	(2,600)	-	
Net loss	(18,591)	(4,606)	(303.6)%

Obviously, those are not the results anybody wants. Increasing losses by 300% is not a "great quarter" to most people.

But, if you look at the cash flow statement, we find that roughly $30.7 million of the expenses was "Share-based compensation expense". That alone more than wipes out the net loss figure above. Go through some other stuff and what we find is that Net cash from operating activities was a very healthy $24.7 million.

Plus, with almost $300 million in revenues with $24 million in cost of revenue, Zillow has gross margins of 92% which is astonishing even for a tech company. Most other technology companies have gross margins in the 70% range.

So we might look at what Zillow's management and board look at: Adjusted EBITDA, which came in at $46.3 million vs. $54.8 million a year ago. A drop of 15.5%, which isn't stellar, but it's not a drop of 300%.

Don't get me wrong – $18.6 million in losses is still $18.6 million in losses. But if the reason for the loss was $30 million in stock option grants, which have to be accounted for, maybe that's a reason for concern... and maybe it's not.

Because it's difficult to overlook the 22% growth in top line revenues to almost $300 million for the quarter – implying $1.2 billion in annual revenues for 2018. Related is the increase in spending on Sales and Marketing as well as on Technology and Development: almost 30% increases to both YOY.

And let me mention this in passing, but Zillow has $397.4 million in cash and cash equivalents sitting there. We'll come back to this.

There are other important numbers for Zillow to look at as well.

Traffic and Premier Agents

Zillow's traffic was up 5% YOY to an average of 175.5 million average monthly unique users. The #2 website – Realtor.com – is far behind at 61 million average monthly unique users.[5] Redfin, the #3 website, is even further behind at 25.8 million average monthly uniques (although, Redfin is growing fast from a smaller base). So Zillow is more than double the next two largest websites *combined*. I'd call that dominance.

Also note that the 5% YOY growth means adding 8.9 million average monthly unique users – that's more actual uniques than either Realtor.com or Redfin added YOY. So don't let the single-digit percentage growth mislead you.

More important, and more interesting, are the Premier Agent numbers.

Zillow used to disclose how many Premier Agents they had. For example, in the Q3/2015 earnings release, Zillow said that they had 96,965 Premier Agents.[6] But it's been a while since they talked about how many Premier Agents they have. Instead, they talk about

[5] Traffic data from News Corp's Fiscal Q3 earnings release: https://newscorpcom.files.wordpress.com/2018/05/q3-2018-press-release_final_05-10-2018-1230pm.pdf

[6] "Zillow Group's agent advertisers totaled 96,965 as of September 30, 2015. The current advertiser count reflects the company's continued strategic focus on growing participation by high-performing agents who provide a superior consumer experience. This number of advertisers is de-duplicated across Zillow and Trulia and excludes Market Leader-only subscribers." From: http://investors.zillowgroup.com/releasedetail.cfm?ReleaseID=940288

revenues from Premier Agents, and talk in percentage terms about Big Spenders.

So we get this from the Q1/2018 release:

- The number of Premier Agent® accounts, including accounts of brokerages and other teams, spending more than $5,000 per month grew by 58% year-over-year and increased 58% on a total dollar basis.
- Total sales to Premier Agents, including brokerages and other teams, who have been customers for more than one year increased 38% year-over-year.
- Sales to existing Premier Agents, including brokerages and other teams, accounted for 70% of total bookings.

What that says to me is that **Zillow's revenues are increasingly coming from a smaller and smaller number of Big Spenders who are continuously increasing their advertising spend on Zillow**. Think about it: 70% of total bookings are to existing Premier Agents, the number of Premier Agents spending more than $5,000 a month went up by almost 60%, and total sales to people who have been Premier Agents for more than a year is up 38%.

Naturally, this means that Zillow is concentrating its efforts on this smaller and smaller group of brokers and agents who see enough ROI from their spend to keep spending more.

Keep that fact in mind. We'll return to this.

The Big iBuyer Announcement

The announcement from Zillow that it will enter the iBuyer market as a direct buyer and seller was, without question, the item that drew the most interest from the Wall Street crowd.

For example, we have this note on Zillow from Fortune that's titled "Data Sheet – Zillow's Audacious House Flipping Plan Scares Wall Street":

> Experiments are fun and interesting. The real estate advertising company Zillow should know. It's running a real-time experiment with its business that can be characterized as anything from courageous (its management's position) to reckless (the reaction of its shareholders.)
>
> …

> Zillow management is undeterred. "We are taking our biggest swings yet," CEO Spencer Rascoff wrote in prepared remarks for Zillow's earnings call with analysts. Zillow's hoped-for profit from its "Instant Offers" business is shockingly small. Rascoff sees Zillow making $3,500 on a $250,000 home, a puny 1.4% profit. But it's a huge market. He says 5% of the volume would be 275,000 transactions, or a "nearly $1 billion profit opportunity annually."
>
> RBC analyst Mark Mahaney calls the audacious plan the "father of all total addressable markets" but nevertheless cites high execution risk in downgrading Zillow's stock.
>
> Big bets are so much more interesting than playing it safe. Especially when someone else's money is involved.

Zillow's iBuyer plan also drew a good amount of attention from the industry, although not in the way I and most other industry observers expected.

Turns out, 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.

Here's what I wrote in a blogpost about Zillow's transformation from media company to media + real estate investor company:

> Maybe it's just me and I don't hang out in places where the fires are raging, but I'm just not getting the sense of outrage and anger and fury that I've seen in the past.
>
> One of three things are happening here:
>
> 1. The real estate industry has accepted Zillow as a natural part of the ecosystem;
> 2. The industry hasn't accepted Zillow per se, but they're freaked out by Opendoor, Offerpad, Knock, and the other iBuyer companies and Zillow is the lesser evil;
> 3. The angry mob is spent from having bashed on NAR over #Logogate just days before the Zillow announcement.

> I'm not sure I'd go so far as #1; there's still plenty of suspicion and distrust and hatred of Zillow. #2 and #3 are possible explanations.
>
> But therein lies the fascinating transformation of Zillow and of the industry.

Well, this is a Red Dot Report, not a blogpost. We go far deeper into the iBuyer announcement, using public statements and public information.

Turns out, 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.

The Wall Street analysts who focus on "execution risk" are missing the forest for the trees. The industry that focuses on commissions and bashing Zillow isn't even in the same zip code as the forest.

Zillow Homes Is Not Just iBuyer

The first thing to point out is that Zillow is not like any other iBuyer. Redfin comes the closest, but we'll talk about that under the Redfin section.

Opendoor, Offerpad, and others like them who have been extremely successful in raising financing and have a lead on execution (i.e., actually improving the house, maintaining it, and then ultimately flipping it) might welcome Zillow to the fray. Zillow's entrance, after, all, provides major validation to the entire concept of the iBuyer.

But they too are missing some important connections.

Zillow's Data Advantage

Everyone recognizes that what sets Zillow apart from other iBuyers is that Zillow has more traffic: 175.5 million average monthly unique users. Well, duh!

What fewer people recognize is the *data advantage* that Zillow has from all this website traffic. Thankfully, Spencer Rascoff, Zillow's CEO, lays it all out for us:

> So, I guess the way that we will benefit from the demand side of the funnel is by selling these homes quickly and at a high price or higher price than if we didn't have access to the demand. **We will also benefit from having the demand**

> **side of the marketplace by being a smarter bidder on the homes that we are buying**. [Emphasis added]

Elsewhere in the earnings call, Rascoff talks about the buy-side demand of the first home that Zillow has purchased:

> But for example, on the first home that we'll be buying, or the first home that we signed a purchase/sale agreement last week, there are about 100,000 home shoppers on Zillow and Trulia every day looking at homes in that ZIP code and the surrounding ZIP codes. **So, 100,000 home shoppers that might be interested in this home that we are going to own in short order.**
>
> There are about **5,000 people that have specifically asked us to notify of them when homes that match this type of criteria**, that square footage, ZIP code, et cetera, those 5,000 people are waiting for an e-mail or a push notification that a home like this has come on the market. And there are about 18 homes that are currently on the market that look like this home that we'll be buying.
>
> So, if you are one of those 5,000 home shoppers who has already looked at those 18 homes that are already in the market or you're one of those 100,00 home shoppers that are looking but aren't receiving notifications from us just yet, you are very interested in this home that Zillow is going to own and then bring back on the market just a couple of weeks later.
>
> So, I think the lowest hanging fruit is to try to bring down that days on market by marketing **and pre-marketing** homes that we own and will own and also using that demand signal to make us a much smarter bidder on the front end, because we know what homes are likely to sell, because we know what buyer demand looks like, because we operate the largest marketplaces on the buy side. So, that **demand signal is very important, a very important input to us on the bidding side**. {Emphasis added}

This is a longwinded way of saying that Zillow has a **massive data advantage** over every other iBuyer in terms of knowing how much to bid on a property.

Redfin, with roughly 15% of Zillow's traffic, might have enough buyer demand data to be statistically significant. The others? Not a chance.

They would have to acquire that buy-side demand data either from Zillow (fat chance), or from the "real estate industry" overall, which means hundreds of MLSs, thousands of brokerages, and millions of REALTORS – none of whom are all that excited about sharing data of any kind with anybody who isn't paying them. In many cases, the MLSs are not sharing data even with people who *are* paying them dues as Participant Brokerages.

Maybe that buy-side demand data is not meaningful. Maybe the sophisticated data analytics and AVM engines of Opendoor and others do not require buy-side demand data.

I find that very hard to believe since no data scientist I have ever met or spoke to ever wants less data. In that world, more data is always better, more granular data is better still, and they live with the constant worry that maybe there's some piece of data out there that they don't have that would wreck their models.

Zillow's Distribution Advantage

That domination of buy-side is not just an advantage in data, but an obvious advantage in *distribution*.

As Rascoff points out, if Zillow knows that 100,000 consumers are interested in exactly the kind of home that it will buy, and that 5,000 of them have asked to be alerted the minute a home like that comes on the market, that house is as good as flipped.

That's obvious. Less obvious is that their distribution channel may be a profit center for Zillow. How?

Zillow has made it clear that they will use Premier Agents to sell their properties. Rascoff said during the Q1/2018 earnings call, "The commissions that we'll be paying are pretty standard for what other investor buyers would pay, those that are at scale in a given city." In other words, the commissions Zillow would pay might be closer to 1% instead of 3%.

But Zillow would only pay agents who are paying them via Premier Agent. We don't know the precise numbers, obviously, but it seems intuitive that Zillow's spending on distribution will be offset by the distributor (i.e., the agent) paying Zillow to be a Premier Agent. It does have the feeling of paying the agent (in part) with her own money.

Zillow also has a distribution advantage in terms of making offers for houses. And I don't mean just the massive traffic advantage.

In the Inman video interview where he announced Homes[7], Zillow's Chief Industry Development Officer Errol Samuelson said:

> We're actually testing a concept… where we're going to work with these brokerages so that when their agents go do their listing presentations with their CMAs, they can also ask us for an Instant Offer, so the agent and the brokerage can come in and offer the consumer the transparency of the two approaches. In either event, the agent can take the listing and earn a commission, or they can have the Instant offer be taken and earn a commission. So really what we're doing here is trying to help the brokerage community compete with the iBuyers in their marketplace.

We know that Opendoor tried this, and we know that Redfin also does this dual-option approach – that is, offering the homeowner the option of listing the property (more money, but more time and more risk) or taking the investor offer (less money, but certainty).

But Redfin has about 1,300 "lead agents" at the end of Q1/2018. Zillow has tens of thousands of Premier Agents, and potentially *hundreds of thousands* of agents if Zillow partners up with some large brokerages or franchisors, who will gladly offer the consumer the option of selling right now to Zillow.

Quantity has a quality all its own.

Once Zillow gets out of its tests and goes wide with Zillow Homes, can we really doubt that it will be able to put its offers in front of many, many, *many* more homeowners than its competitors can?

Advantage, Zillow.

Listing Leads

That Wall Street thinks Zillow is taking a big risk by becoming a direct buyer simply proves that Wall Street doesn't understand real estate.

Fact is, Zillow's Homes segment (which is what they're calling their iBuyer program) is going to make a fortune just from listing leads.

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[7] Video found at: https://www.inman.com/2018/04/12/zillow-will-begin-buying-and-selling-homes-using-agents/

Here's Spencer from the earnings call, once again:

> Eventually this we believe will become a large listing lead generation business, which will benefit IMT on the Premier Agent side. We aren't ready to announce how to actually monetize that. Whether it will be through the seller boost ad products where we are already selling ad product that generate listing leads on not-for-sale homes, whether it will be a brand new products, whether it would be sold at auction, through the agents, through brokerages, et cetera, there are a lot of ways that we can monetize this.
>
> But if you just look at the data that we have on our funnel of how much consumer demand there is for instant offers, we know that we can build a big business that generates listing lead opportunities for agents and brokers from Instant Offers.

That Homes would become a ginormous waterfall of cash from the sale of listing leads should be obvious to anyone who understands the real estate industry.

In the video announcement referenced above, Errol Samuelson says that out of everyone who submits a request for an Instant Offer, 1/3 sell their house within 90 days. That's about as highly qualified as listing lead as one can get.

He then says that 90% of them choose to list with the Premier Agent who sent them a CMA.

If you can think of a more powerful web-based listing lead generation source, I would like to hear about it.

In fact, I would hazard a guess that there's a very good chance that Zillow could lose money on Homes year after year, and more than make that back from monetizing listing leads.

Oh, and Listing Merchandising

One new important disclosure from the Q1/2018 earnings call that every Wall Street analyst appears to have missed is this one, where Rascoff says:

> So, the other question is about merchandising Zillow owned listings is sort of a layup for me, which is why I'm laughing, because it's the other benefit from moving into Instant Offers is that we will get really good at merchandising particular listings and helping to move that product and we

> expect that we will productize that type of merchandising and **it will probably over time become a listing promotion product**, sort of like our Premier Agent direct product today but even more effective.
>
> We've seen companies in other countries of course get really good at merchandising certain types of paid listings and **we will be following that lead with our own inventory and then probably over time productize this and make it available as an ad product for listing agents**.

Say what now? Did I hear that right?

> **Spencer Rascoff**
>
> So, today we are not monetizing homes that we either choose not to buy or homes that we bid on and the home seller chooses to turn down our offer. In the future there will be three forms of monetization from Instant Offers in addition to the Homes segment monetization of buying and selling homes. Those are: listing lead generation, which will directly feed into the Premier Agent business; mortgage revenue, which will directly feed into our IMT business, that's mortgage origination and advertising revenue from homes that we sell; and **number three, and this is more speculative, but I suspect that the merchandising that we'll be doing on Zillow owned homes will become a platform paid ad product for listing agents to promote their own listings as we get better at figuring out how to merchandise a home**.

Yep, I heard that right.

As Spencer said, this is more speculative. But we know – as Spencer himself mentions – that companies in other countries have long monetized listing merchandising. Realestate.co.au, owned by News Corp, comes to mind as a prime example.

There has always been resistance to that in the United States, as listing agents feel that either (a) they would have to pay to promote the listing, or (b) their perceived value in the eyes of the seller would decrease. Those objections disappear when Zillow is the seller, and the agent is not out of pocket.

Of course, once Zillow has figured out how to most effectively promote a listing with minimum disruption to the user experience, that product will make a fortune as well.[8]

Zillow: The Market Maker

Let's get a bit more speculative, but pull the disparate threads together.

In his call, Spencer mentions something rather interesting about the Homes program:

> 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 un-stick 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

That term "liquidity" caught my interest.

I have long maintained that Opendoor is the most interesting company in real estate, because I thought what they were doing was not a real estate play, but a mortgage play. I thought what Opendoor wanted to do was to create a system in which housing can trade much like stocks and bonds and commodities.

Now that Zillow is in the iBuyer game, there's no reason why only Opendoor or Offerpad can pioneer the market maker model of real estate. Zillow can do the exact same thing, but probably at far larger scale, with far more advantages.

In 2017, I wrote a post about Opendoor called "Understanding Opendoor's Mortgage Brokerage Move" in which I outlined my speculations about a "market maker system" of real estate.

[8] My guess at this point is that Zillow is unlikely to go down the path of "Premium Listings" directly on Zillow itself. I think it's more likely that they copy Amazon's "Sponsored products related to this item" or "Compare with similar items" type of approach.

In my sci-fi vision of the market maker system, every property would have a Bid and Ask price, and the seller can sell his house to a market maker (like Opendoor… or Zillow) by accepting the Bid price for his property. Conversely, a buyer simply places an order for a house by agreeing to the Ask price.

As a mortgage broker, Opendoor could legally write an unlimited number of owner-financing deals with whatever underwriting standards it wants for its own properties using its own money.[9]

Well, Zillow has been doing mortgage operations for years now. Spencer talked about how it's been weak during the Q1/2018 call and what they're doing about it.

Now that Zillow is in the iBuyer game, there's no reason why only Opendoor or Offerpad can pioneer the market maker model of real estate. Zillow can do the exact same thing, but probably at far larger scale, with far more advantages.

After all, the function of a market maker in any marketplace is *to provide liquidity*. And here's Spencer talking about injecting liquidity.

Keep in mind that Spencer also just spoke about knowing 5,000 people who want to be alerted when a home that meets their criteria comes on the market.

In a very real way, in inventory-constrained markets, Zillow may be able to do "insta-flips" in which they do absolutely nothing to the house. They just purchase it via Instant Offers, and then *immediately* sell it to an interested buyer (via a Premier Agent, of course).[10]

That is classic market maker behavior: buy at the Bid, sell at the Ask. Make a small spread.

No doubt, this is pure speculation. But with everything that Zillow already has in place, it seems like we have taken a fairly significant step towards making that reality.

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[9] To be fair, there are a number of laws and regulations involved, such as various disclosure rules, and Ability To Repay rules, and such. Please read the whole post in full if you are interested. Contact a competent attorney if you are *really* interested.

[10] In that vein, it is interesting that Spencer specifically talks about what Zillow's willing to do to a purchased home as being "more as touch-up" rather than a remodel – painting, cleaning carpets, etc.

The missing piece today is a seller-financed mortgage product. It would be fun to watch for that innovation in the months and years ahead.

Takeaways from Zillow's iBuyer Strategy

So, there are three major takeaways from Zillow's approach to iBuyer:

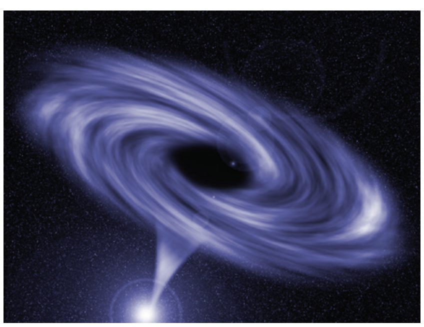
1. They're going to make a fortune on listing leads
2. They're going to make a fortune on buying and selling homes, because of their access to buy-side data
3. They're going to make a fortune on the listing merchandising product.

Most analysts are completely missing the forest for the trees.

There is also the tantalizing hint that what we may be seeing here is the birth of the transformation of real estate from a labor-intensive, time-consuming, and entirely inefficient "custom" buy-and-sell process into a market maker system with Zillow serving as the provider of liquidity.

But that's just the Zillow Homes initiative. That's actually the less profound initiative of the two that Zillow announced. And as usual, both Wall Street and the real estate industry have focused on the shiny new thing and completely missed the importance of the more important initiative: lead validation.

We turn to that next.



Zillow 5.0: Lead Validation

In the Zillow Group 2018 Shareholder Letter, Spencer Rascoff writes:

> 2018 is on track to be the most exciting year of our existence.
>
> We are about to go further with our model than any of us had previously imagined. The next phase of our evolution is moving beyond advertising and lead generation, toward being what we call a "deeper funnel" partner to the real estate industry – one that helps consumers and professionals in the transaction. We have become an essential resource for consumers during the home shopping process: nearly 4 out of 5 buyers are shopping for their home online today. Many of them expect more seamless services down the funnel from us,

> whether buying, selling, financing or renting a home. Moving from leads into experiences is Zillow Group 5.0.

What does this "deeper funnel" partner deal look like? Well, Spencer explains in the earnings call:

> In the old world, when a consumer wanted to see a home, they would e-mail a real estate agent, e-mail a premier agent, and the e-mail would sit in that agent's inbox.
>
> In the new world, the home shopper e-mails to that real estate agent and Zillow Group contacts that consumer and by text, e-mail now over the phone. Now, frequently that consumer is not actually ready to talk to an agent. They just had a question about the home, they were just kind of up-funnel, if you will. In the old world, that lead dies because the agent typically doesn't do anything to incubate that home shopper. In the new world, we maintain that relationship with that home shopper until she's ready to contact an agent.
>
> So, then when the consumer is ready to talk to an agent, whether it's right away or six weeks later, then at that point we call Premier Agent 1, Premier Agent 2, Premier Agent 3. So, it is a very significant change to how leads become or how consumer inquiries become at the very bottom of the funnel commissions. And so, you got to take these two pieces together, lead validation piece and then the lead disposition piece.

Everyone seems to just glosses over this, shrugs, and moves on to talking about iBuyer.

That would be a mistake.

"We Maintain That Relationship"

The big changes is that sentence: "in the new world, we maintain that relationship with that home shopper until she's ready to contact an agent."

There are some very good reasons for both Zillow and for the Premier Agent to want to migrate to this new world.

Consider how online leads are handled today, whether with Zillow or anybody else. Let's stick with the buyer scenario, as that is more common.

Some buyer goes online, fills out a form or sends an email, expressing some kind of interest in a property. Maybe it's a question. Maybe it's a request for a showing.

The website then sends that inquiry to some agent or broker. As far as the website is concerned, it has fulfilled its duty to the advertising agent or broker.

Throughout this transformation, perhaps nothing transforms more than the relationship between Zillow and the Premier Agent.

That agent or broker then responds to the buyer in some fashion. After whatever conversion strategy is used, the buyer starts working with that agent, perhaps executes a buyer agency agreement, goes through the search and purchase process, and eventually buys a home, and the agent gets paid.

There are two major "break points" in that process. First is the conversion from a lead to a customer. The second is conversion from a customer to a closed transaction.

In real estate, the biggest failure point historically has been at that first break point of conversion from a lead to a customer. And the number one reason?

Lack of response by the agent.

A 2011 NAR study found that 46% of online leads go completely unanswered. An additional 23% of online leads received a response after 8 hours (or more) had passed – an eternity in today's web-based economy.

Why? Why would agents pay for leads from Zillow (for example) and then not respond to them?

There are, roughly speaking, two main reasons:

1. The agent is busy. An agent is not going to respond to a lead if she is showing houses at that moment.
2. The leads are low-quality. Many agents think that internet leads are from unqualified buyers who might be kicking the tire. That problem is compounded by the fact that many consumers simply don't want to deal with a pushy salesperson early in the process, so will not pick up the phone. (And in

> our smartphone age, consumers are especially likely not to answer when the phone number is an unfamiliar one.)

What the real estate industry has learned over time is that the most successful brokers and agents have dedicated systems, processes, and even teams who handle online leads from initial contact through incubation and qualification, then hands off "scrubbed" leads to the actual agents who will handle the transaction.

For major web portals like Zillow, Trulia, and Realtor.com, the problem of agents who don't respond affects them directly. Consumers don't just blame the agent who didn't respond to an inquiry; they blame the website. "Yeah, I used Zillow, but nobody got back to me. It's probably Fake News."

So Zillow moving "down the funnel" to handle everything up until the actual moment that a consumer is ready to talk to an agent benefits both Zillow and the Premier Agent subscriber. The agent is not getting low-quality leads she has to spend the next six months incubating and qualifying. Zillow is not taking a brand hit from the consumer whose inquiry went unanswered. Win-win.

But… there is this….

The Home Depot Effect

Ten years ago, in one of the first posts on my new blog, I wrote a post called "SquidZipper, Trulia, and HomeDepot: Future Tense." In it, I talked about something I called "The Home Depot Effect." Let me quote from the post at length:

> A while back, the wife and I noticed a pretty significant draft coming through our windows. Considering the house had been built in 1940's, and hadn't really had a renovation since then, we thought it wise to invest in some new windows. So we went to HomeDepot like millions of Americans, and looked into getting windows installed.
>
> Everything pretty much went according to plan. We bought the windows, talked to the nice people at HomeDepot, and on the appointed day, a contractor showed up at our house and started work.
>
> I noticed, however, that the contractor's van didn't look like a HomeDepot van; it didn't have any colors. It had some guy's name on the side (like Joe Romano & Sons or

> something like that) with no hint of the ubiquitous HomeDepot orange.
>
> Turns out the HomeDepot installation technician who was in my house wasn't, strictly speaking, a HomeDepot employee. He actually had his own company that installed windows, and did assorted contractor work specializing in decks and patios. He was just one of the numerous independent contractors who had agreed to have HomeDepot send them work, presumably in exchange for some fixed rate, and for agreeing to certain HomeDepot rules and standards.
>
> We had a nice chat, this contractor and I. He installed our windows, and left. I can't remember his name, and I couldn't pick him out of a lineup. I don't remember the name of his company.
>
> What I do remember is that HomeDepot installed my windows.

My point in 2008 was that if the web portals became dominant, consumers would not remember the brokerage or agent who "installed" the house for them. They would remember the website where they shopped for the house, found the house, and found the "installer" who made it happen for them.

Zillow's changes to Premier Agent represents the next step in that evolution.

Going forward, Zillow becomes not just the website where the buyer shopped for a house, found the house, and found the "installer" who helped him buy the house, but also the company that (a) responded quickly to his inquiry, and (b) maintained an ongoing dialogue, qualifying his ability to purchase, interests, necessary criteria, etc. until he was ready to purchase. At that point, Zillow hands him off – in a warm-handoff phone call – to a local real estate agent who can help him tour the homes, and help him through the purchase process.

The relationship of the buyer is not to the agent, or to the broker, but to Zillow.

Assuming that Zillow is not run by stupid people – which it clearly is not – then Zillow will stay in touch with that consumer, and seven years later, when he is ready to upgrade, he is far more likely to reach out to Zillow about selling his house. Especially if Zillow's iBuyer program is in his area.

Just like his experience with buying the house, Zillow will respond to his inquiry quickly, talk him through his options, find out what his criteria are, get him well qualified and validated, and then hand that listing lead off to a Premier Agent.

The Relationship Between Zillow and the Premier Agent

Throughout this transformation, perhaps nothing transforms more than the relationship between Zillow and the Premier Agent.

Today, the Premier Agent is an advertiser on Zillow. For a certain amount of money, Zillow promises a certain number of impressions (CPM-based pricing) of that Premier Agent.

Tomorrow, the Premier Agent becomes something far closer to the windows installer for HomeDepot. Sure, she is still an advertiser. She will still have a customer service rep at Zillow, and a salesperson at Zillow who will be trying to get her to spend more with Zillow.

But when Zillow holds the relationship with the actual buyer or seller, passing them on to her only after they have been "validated", the relationship changes slightly… but in a *profoundly important way*.

Now Zillow becomes more like a *source of revenue* for the Premier Agent, in much the same way that a local windows installer regards HomeDepot as a source of revenue, not as an advertising platform.

What truly underscores the change in relationship is that in the process outlined by Spencer Rascoff, *it is Zillow who makes the determination of who gets the validated lead*.

Read what he says: "**we call** Premier Agent 1, Premier Agent 2, Premier Agent 3."

That is a big change. Because today, it is Premier Agent 1, Premier Agent 2, and Premier Agent 3 who get to decide which Zillow lead gets a response and in what timeframe and what questions to ask to validate and qualify the lead. They might do a great job, or do a terrible job, but they get to decide.

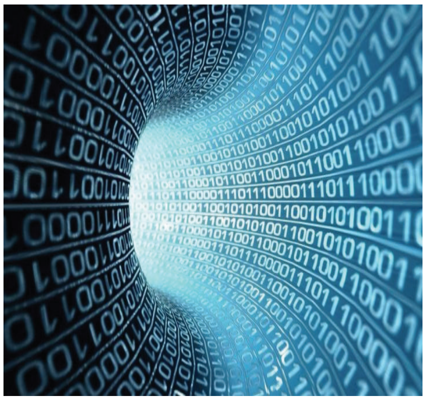
Tomorrow, *Zillow* gets to decide. Then make the appropriate phone calls.

The Safe Speculation

What we don't know today is just *how* Zillow will decide which Premier Agent 1, Premier Agent 2, Premier Agent 3 will get that phone call, and *in what order*.

Will it be a simple round-robin? A simultaneous robo-call and whoever picks up first gets the lead? Will it be based on the amount of money spent on Zillow?

We don't know. And I suspect that Zillow doesn't know either, which is why Spencer talked about testing lead validation and learning what they can.



But we can make some safe speculations, based on what we know about Zillow and its corporate culture, as well as what we see coming on the horizon from Redfin. (Obviously, we'll come back to this when we discuss Redfin.)

Over its history, Zillow's corporate culture has been characterized with obsession with data (from its very start, with the Zestimate product), testing ideas, then rapid deployment at scale of things that test well.

Much of Zillow's testing in the past – whether CPM-based pricing, or consumer product features, or marketing spend – has been marked by the desire to pick up and process and analyze as much data as possible.

In general, we can say that *Zillow makes decisions based on data*.

Why would it be any different for lead validation and lead routing? Especially when one of its primary competitors, Redfin, is able to collect data all the way from the initial website visit to the close of transaction *and beyond*, since Redfin is an actual real estate brokerage with actual real estate agents. (More on this later.)

Why wouldn't Zillow try to get as much data as possible on Premier Agent 1, Premier Agent 2, and Premier Agent 3 to see who has the best conversion rates post-handoff, who has the best close rate (the second break-point) and even who has the best consumer reviews after all is said and done? Once Zillow has that data, is it crazy to think that Zillow might make the "lead disposition" decision based on data?

I don't think so. In fact, I think that's pretty safe speculation given Zillow's corporate culture.

There's a hint that Spencer dropped in the earnings call that argues for this kind of a data-driven decision-making by Zillow. He says, in connection to a question about inventory shortage:

> So, there are some puts and takes and it's really hard to know what impact inventory level has on the Premier Agent

> business. I guess the other benefit would be **agents feel flushed because agents are doing great, and when agents feel flushed they tend to buy more advertising**. [Emphasis added]

What that argues for is to make sure that Premier Agents who are getting the validated leads are more able to take those leads all the way through to close, so they feel flushed, and want to buy more Premier Agent advertising.

How would Zillow get that kind of granular data?

Well, have you heard of Dotloop, Zillow's very popular transaction management platform, being used by hundreds of thousands of agents across the country?

People who have speculated that Zillow would use Dotloop without permission are crackpot conspiracy theorists. But would Premier Agents 1, 2, and 3 want to know what the ROI is from these "validated leads" that Zillow is sending them? You betcha. Would Zillow use Dotloop with the full cooperation of Premier Agents 1, 2, and 3? You betcha. Would Dotloop give Zillow all kinds of granular data about the close rate? You betcha.

Zillow is Way, Way Ahead of the Curve

Zillow 5.0 is a very serious, very real effort to transform Zillow. Along the way, it will transform the real estate industry.

And it's difficult to articulate just far ahead of the curve Zillow is here. But we will see far more clearly when we look at Realogy further on in this paper.

It's not close.

REDFIN™
Your New Way Home

Redfin: The Rabid Squirrel

We next turn to Redfin, whose IPO last year opened the eyes of many (including yours truly) as to what they have really been up to. And in recent earnings calls, Redfin made clear what their strategy is.

The industry tends to ignore Redfin, dismissing it as a discount broker with tiny market share and sub-par agents. In a way, it's reminiscent of how the music industry ignored MP3s because it was a crappy audio format compared to CDs with tiny market share among computer nerds and geeks.

It's a mistake to underestimate Redfin.

The Numbers

Q1 results were, much like Zillow's, mixed. Revenues were up a very healthy 33.4% YOY, but so were net losses by almost 30% YOY. But first quarter is always a bad quarter for profitability for a company in real estate, as the market really doesn't get going until spring and summer.

Table 2: REDFIN'S Q1/2018 INCOME STATEMENT

	Q1/2018	Q1/2017	%Δ
Revenue	79,893	59,868	33.4%
Cost of revenue	74,197	53,492	38.7%
Gross Profit	5,696	6,376	(10.7)%
Costs and expenses:			
Technology and development	12,762	9,672	31.9%
Marketing	13,336	10,459	27.5%
General and administrative	16,772	14,367	16.7%
Total expenses	42,870	34,498	24.3%
Income (loss) from operations	(37,174)	(28,122)	(32.2)%
Net income/loss	(36,439)	(28,066)	(29.8)%

The only thing that concerns me, just mildly, is that the gross margin numbers are down from 10.7% in Q1/2017 to 7.1% in Q1/2018. But then, Redfin ended up posting 30.2% gross margins for all of 2017, so we'll just have to wait and see how they do in Q2 and Q3 when the bulk of the revenue hits.

Some of the other Key Metrics look pretty healthy:

Table 3: REDFIN KEY METRICS

	Q1/2018	Q1/2017	%∆
Monthly average visitors	25,820	20,162	28.1%
Real estate transactions			
Brokerage	7,285	5,692	28.0%
Partner agents	2,137	2,041	9.6%
Average number of Lead Agents	1,327	935	41.9%
Value of transactions (Sales Volume)	4,4 billion	3.5 billion	27.5%
U.S. Market Share (by Value)	0.73%	0.58%	25,9%

One number that should jump out is the number of Lead Agents now at Redfin. It increased by 41.9% (which naturally increases expenses) while transactions grew by 28% and volume grew by 27.5%. This was entirely intentional, as Glenn tells us.

So why do we want to pay attention to Redfin, apart from the fact that it is a public company that has to reveal data and tell Wall Street about its strategies?

Basically, Redfin is the only brokerage in real estate who appears to understand what Zillow understands: that the future is going to look very, very different from today.

In order to understand much of this, we have to go back one quarter, to the full year 2017 earnings call, when Glenn Kelman laid out much of Redfin's thinking.

Everything that Redfin does is related to increasing the close rate.

Method to the Madness, 2017 Earnings Call

In a lengthy post on Notorious R.O.B., I laid out my thinking on the 2017 earnings call and why there is a method to the madness that seems to be Redfin.

Since much of this section will be a summary of that post, do feel free to go read the whole thing.

Basically, my thesis is that because Redfin started life as a brokerage, rather than a web portal, Kelman and company realized the importance of the "deep funnel" long before Zillow did.[11] So while they launched a website and paid a great deal of attention to the top of the funnel – lead generation, traffic, etc. – Redfin has been refining the entire funnel for ten years.

In the 2017 earnings call, what Glenn Kelman says is that "the name of the game is to increase close rate." This is the second break point I mentioned above. Just because you have converted someone from a lead to a customer doesn't mean you got paid. You have to convert the customer into a closed transaction.

Zillow hasn't had to pay much attention to that since its Premier Agent advertisers were paying for leads and impressions; Redfin has always had to pay attention to close rate.

What Kelman revealed in 2017 was that Redfin was going to embrace a radical (for real estate brokerages) strategy of limiting how many customers a Redfin agent would serve at one time. I called it the Jerry Maguire strategy: fewer clients, more money.

Everything that Redfin does is related to increasing the close rate. Its spending on technology development is to (a) save time on repetitive tasks, and (b) increase the close rate. Redfin's agent tools are built around increasing the close rate by "knowing more about what that customer needs at any given moment" to deliver the right service at the right time. Redfin embraced a W-2 employee model when every other brokerage is built around a 1099 independent contractor model because that allows Redfin the control it needs to increase the close rate.

I ended my post by suggesting that what Redfin is doing is the future of real estate brokerage:

> I think what Redfin is doing today, what they're obsessed about today, will lead to the real estate brokerage of tomorrow. The close rate (which means consumer win) will be all-important, because it means you got paid, and it means your customer service rating will be higher, which leads to more referrals (i.e., low-cost high quality lead generation), which leads to more conversion opportunities, which leads to

[11] Alternatively, Zillow always knew about the importance of the deeper funnel, but couldn't do anything about it.

> better brand awareness, which leads to more business, etc. etc.
>
> I think the technology stack will support that obsession and every aspect of technology will be geared towards improving the close rate. Just like Redfin, that starts with lead generation, but tech will move down the funnel to conversion, data analytics to support quick decision-making, and automation to speed up execution.
>
> I believe that's the brokerage of tomorrow, primarily because the agent team has to move in that direction. You can't just keep stuffing the top of the funnel (that is, leads, leads, MOAR LEADS!) while having crappy conversion and client care and fewer client wins down below.

That was in March. Now let's look at what comes out of the Q1/2018 earnings call.

Uncertainty, but Confidence

The overall theme of the call is uncertainty, as Redfin implements new strategies designed to increase the close rate, but confidence that they will work it out.

Kelman said during prepared remarks that on the one hand, they saw improvements in customer engagement with Redfin agents in April, but things regressed to the mean, and they won't really know until Q3 or later whether the "fewer customers, more money" strategy will work.

But at the same time, Redfin is increasing its advertising spend significantly, because "We know more than virtually any other brokerage about which of our customers close. We're willing to wait longer for it to happen, and we're constantly seeking to optimize every step in between."

And why is Redfin so willing to invest in advertising and willing to wait? Because of operational excellence. Here's Glenn Kelman:

> And where we really compare ourselves to is the rest of the industry, if we're just much better at getting someone the land on a webpage to describe that house and then clicking a button to see an agent, and then also have superior close rates. That just translates into more money that we can spend as opposed to anyone else on meeting that customer in the first place. **So I think we're encouraged by the fact that**

> **we're getting more efficient throughout the funnel, and that lets us pour more demand into the top of the funnel**. But it's not a step function. It's a game of inches every quarter, every week, everyday trying to drive conversion. [Emphasis added]

Ever since Redfin went public and had to have these calls with Wall Street analysts, I've been listening to or reading these earnings call comments.

My big takeaway from all of those calls is the level of obsession that Redfin has with process improvement, automating repetitive tasks, and driving what seems like tiny incremental improvements. For example, in one call, Kelman boasted about shaving seconds off of the response time to a lead inquiry online. That is absolutely remarkable if you think about what we discussed above about the lack of responsiveness on the part of real estate brokers and agents.

Kelman talked about the immense effort it took to localize offer forms for each jurisdiction, with hundreds of rules and local customs, but the end result means that Redfin agents can submit an offer on a house faster than any other buyer's agent in the market. That difference in speed adds up, and should (Redfin bets) mean an increase in the close rate: the Redfin client being the one to buy the house.

The Brokerage of Tomorrow

Close rate is particularly critical in today's inventory-constrained housing market, but Redfin thinks it is generally important. So do I. It points the way towards the brokerage of tomorrow.

Kelman says:

> Our goal is to increase the rate at which those customers succeed in buying a home. Because it has gotten so hard to buy a home in almost every major U.S. market, the most powerful lever for increasing the profitability of our field organization, and of Redfin overall, is making more of our home buying customers successful. The most successful real estate brokerage in America will be the one with the customers who are most successful.

That is exactly right: **success as a brokerage will be determined by the success rate of its consumers**. That is why Redfin is obsessed with close rate. It is why Zillow is moving down the funnel.

That formulation, while it seems obvious and trite, is in fact exactly the opposite of brokerage success today. We'll address that in greater detail when we look at Realogy.

The challenge is that tying (correctly) success as a brokerage to the success of its buyers and sellers requires three things:

4. Lead generation capabilities.

5. Operational excellence throughout the funnel.

6. Ability to adapt to changing consumer needs.

Redfin has all three, with varying levels of proven success. No other brokerage in America that I know of as of this writing has all three, or in many cases, even *one* of these things.

And Redfin is not focused on the short-term. It looks where the puck is headed, not where it is today. That ability to adapt to changing consumer needs is shared only by Zillow[12] in the real estate industry today.

Nowhere is this more evident than in Kelman's discussion about Redfin Now, its iBuyer program.

Redfin Now and the Market Maker System

Redfin launched its iBuyer program, Redfin Now, a year ago in January 2017. Since Opendoor didn't launch until 2014, and did not really get traction until sometime in 2016, that means Redfin responded rather quickly. Certainly quicker than any other brokerage.

So in Q1/2018, we get the small news that Redfin is increasing the capital limit for Redfin Now from $10 million to $25 million, $5 million more than what they had announced previously. That in itself

[12] Move and Realtor.com may also have that ability, and have those plans in place. But because they do not report publicly and do not have long discussions with Wall Street analysts about their strategies, I do not know. News Corp certainly has bigger issues to discuss on its earnings calls.

is a big shrug, since we're talking about going from 15 homes purchased to 30 by Q2.

Becoming the "provider of liquidity" is the definition of becoming a market maker.

What's *not* a big shrug is the strategic thinking that Kelman reveals in the earnings call. In an exchange with an analyst, he says:

> 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]

There's that magic word "liquidity" again. What Glenn is pointing out is what Opendoor likely noticed, and what Zillow definitely noticed: it is easier for large well-funded institutions to get financing than the average American family to get financing.

Becoming the "provider of liquidity" is the definition of becoming a market maker. We talked at some length about that above when discussing Zillow. The same analysis applies here, so I won't repeat it.

One thing to note is that Zillow's buyer traffic – and therefore the volume of buy-side signals – is many times larger than Redfin's. On the other hand, Redfin has agents on the ground who are working with buyers and sellers every day, who are W-2 employees who use Redfin's systems and processes and enter data into Redfin's systems. As Kelman put it, "[Having agents] gives us a better eye for the properties that are going to be marketed quickly and sold reliably."

At this time, we don't know who has the advantage between Redfin and Zillow in terms of buy-side signal and buyer/seller data aggregation. We do know that Redfin is so far ahead of the pack when it comes to brokerages or even national franchise brands like

Re/Max and Keller Williams that it really isn't a contest there. And I suspect that Redfin has a significant edge over Opendoor or Offerpad or others who do not have websites with 25 million monthly visitors.

There is little doubt in my mind (although I could be dead-wrong, since I haven't spoken to Glenn or to any Redfin executive in preparing this report) that Redfin sees the *possibility* of the real estate industry transforming into a market maker system. The economics of lending on the one hand, and consumer frustration with the process on the other hand, are driving things towards that system. They're preparing for it, however modestly, since achieving operational excellence there means Redfin alone out of all of the brokerages in North America will be positioned to be a market maker… along with Zillow, Opendoor, Offerpad, or whoever else survives the coming war for domination as market maker.

Redfin Now and Listing Lead Generation

Furthermore, just like Zillow's Homes program has three monetization strategies tied to it, Redfin Now isn't just about buying and flipping homes.

It's also about listing lead generation. Here's Kelman:

> Most of that 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.

Then after a back-and-forth with an analyst:

> 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.

Redfin Now has always worked in this manner: offer the homeowner the choice between listing the home, or taking the “cash on the barrel”.

Zillow more or less copied Redfin Now when it offered Instant Offers initially – get offers from investors, along with a CMA from a Premier Agent. As Zillow moves into becoming a direct buyer, it retains this feature of offering a choice. What’s more, as Errol made clear, Zillow is enabling Premier Agents to solicit an Instant Offer prior to the listing appointment so they can offer the home seller the same thing that Redfin agents can offer them: a choice between immediate certainty and maximum price.

It’s not easy to out-innovate Zillow. But Redfin did it with Redfin Now, a year earlier. Therefore, Redfin has a year’s head start on everybody else, Premier Agent or not, on how that “offer the consumer a choice” thing works in practice.

What’s more, Redfin has a major advantage even over Zillow. We turn to that next.

Redfin Has End-to-End Control

Redfin is a complete vertically integrated operation from start to finish, and beyond. Redfin can actually execute on its obsession with close rate, operational excellence, and consistent service delivery because it controls every aspect of the real estate experience from search to home tours to the transaction process to the closing to post-closing follow-up.

Zillow, with its changes to Premier Agent, hopes to go further down the funnel – to the first breakpoint of converting a lead to a customer. But Zillow *does not control what happens after that*. Zillow does not and cannot control the transaction itself, the service delivery, the closing, or the post-closing follow-up.

At some point, Zillow has to hand off the consumer to a broker, who then hands off the consumer to a 1099 independent contractor agent (who often runs an agent team, which is effectively a brokerage-within-a-brokerage), who in turn might hand the consumer off to an independent contractor team member agent. There are so many points of failure as we go down the funnel.

Redfin controls the entire funnel, end-to-end. I don't think Redfin has perfected the process. They make mistakes. Some agents just aren't that good. They're human beings, all of them, from Glenn Kelman on down. So there will be mistakes, gaps, need for improvement, etc.

But Redfin does control the entire funnel from start to finish, and beyond. There's simply no arguing that fact. If Redfin makes mistakes, it can correct them quickly. Other brokerages cannot. We'll come back to this later as well when we look at Realogy.

The 1% Listing Fee, Redfin Concierge, and Operational Excellence

We can't leave the Redfin discussion without touching on its 1% Listing Fee, and the new program called Redfin Concierge that they launched.

That theme of operational excellence and control over the entire funnel end to end comes up again in this context as well.

The notion that consumers believe "you get what you pay for" when it comes to real estate brokerage services is something that needs to be questioned. Redfin is doing that questioning today.

The 1% Listing Fee is Working

The first thing to note is that Redfin's 1% Listing Fee strategy is working. Brokers and agents who are fretting about Redfin being a dirty discounter need to take note of what Kelman is telling Wall Street:

> The prospective customers respond at low prices. The markets with ads promoting the 1% price gain listing share two to three times faster than similar markets that didn't run the ad. These gains and listing share reinforce our ads with Redfin signs in front of the homes are hired to sell.

He goes on to say that they don't know yet whether advertising will prove profitable. But for our purposes, as industry people, we don't much care whether Redfin's TV ads generate a ROI or not. We care that Redfin's growth – especially in the all-important listings business

– is two to three times faster when consumers find out about the 1% listing fee.

And then, further on, in a discussion with an analyst, Kelman says:

> The listing business has outperformed our expectations in markets where we advertise and in markets where we don't. **This is a product that sells itself, and advertising has only accelerated that**. The staffing is really driven by the demand. **So it's not as if we drive demand by hiring real estate agents**. We drive demand by offering a better product and getting more traffic on our site to connect with our agents. So we will shift agents from one product to the other based on demand. But overall, we've been very encouraged by listing share gain.
>
> Going into the second quarter, we just expect more of the same. We are not segmenting revenues in our guidance or in our reporting, but this product is doing well, and we're happy at it. [Emphasis added]

The sentence that we should pay attention to is "This is a product that sells itself, and advertising has only accelerated that."

The other thing to think about is Redfin saying they don't drive demand by hiring real estate agents. Well, what is it that every other real estate brokerage does to drive demand?

With the small market share that Redfin commands today, perhaps people feel comfortable dismissing Redfin as "yet another discounter" who have historically come and gone in real estate. I think that would be a mistake, but… historically, the skeptics have always been proven correct.

However, I note that in the call that Kelman specifically called out selling a $7 million listing in Seattle, and said, "I think it gives permission to all sorts of people who are risk averse to sell their home, because if somebody did a $7 million, a $10 million house with a Redfin sign, well why not sell my $2 million house [with Redfin]."

The notion that consumers believe the "you get what you pay for" when it comes to real estate brokerage services is something that needs to be questioned. Redfin is doing that questioning today.

In any event, if the 1% Listing Fee is truly a product that sells itself, there are some possible consequences to that becoming widespread.

A Brief Note on Consequences of 1% Listing Fee

I'll keep this as brief as possible, as it is ***highly*** speculative.

If Redfin continues to grow, and the 1% Listing Fee product truly is something that "sells itself", then incumbent brokers and agents will start to feel immense pressure to lower their rates as well.

We have seen this in the past, in at least one market that I know of, where the entrance of discounters (Foxton's) led to incumbent dominant market share brokerages to also discount their fees.

The entirely expectable consequence of that is that once consumers get used to a discount, *they do not go back* to paying a higher "normal" price. This is a lesson that retailers like Macy's have had to learn.[13]

The unexpected consequence for real estate is that discounting led to an *erosion of cooperation and compensation*. How?

Listing agents and brokers knew and know that they have the upper hand, since they control the property. They resented paying out 3% (for example, using the far-from-standard figure of 6% total commissions) to buyer agents, while pocketing only 1%. So they began changing the cooperating compensation amount to buyer agents, so that they were keeping more of the commission.

The seller doesn't care, since the whole commission amount is the same whether the Listing Agent takes 3% and offers out 1%, or the Listing Agent takes 1% and offers out 3%. But the buyer agents and buyer brokers care a very great deal.

Furthermore, at lower commission rates, pressure to double-end the deal grows. Depending on local laws, a single agent might seek to do dual-agency. Or the brokerage might seek to keep all of the commission in-house using designated agency. Or in modern times, the agent team will seek to keep both sides of the transaction within the team by sending the buyer to one of the buyer agents on the team.

Either way, low listing fees erode cooperation and compensation, and impacts the MLS.

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[13] See, for example, this article from New York Times: https://www.nytimes.com/2016/08/12/business/macys-q2-earnings-store-closings.html

Highly speculative, and dystopian futurism, so we'll leave it there. But it is something for forward-thinking leaders to consider.

I found that when you can do something really nasty and weird and complicated at scale, you have a deep competitive advantage.

-Glenn Kelman

Redfin Concierge and Fruits of Operational Excellence

Finally, let me touch on Redfin Concierge. This is a program launched late last year in which Redfin pays for much of the typical work that a homeowner has to do in order to get the house ready for sale such as cleaning, painting, staging, landscaping, etc. in exchange for a 2% listing fee.

It is limited to homes priced at $500,000 or more, and only in Los Angeles and Washington DC so far. And results are as yet unknown, although Kelman did say Redfin was "pleased with the progress" of Redfin Concierge.

The more interesting insight comes from this statement, made in connection to Redfin Now:

> I found that when you can do something really nasty and weird and complicated at scale, you have a deep competitive advantage. So as I said, we're not taking the homes down to the studs. But we are good at doing things like getting the lawn cut, paint a yard sign, paint carpet for a large number of homes in a large number of geographies. That's also the underpinning of this Redfin Concierge service where we use the economic advantage we have around being able to meet customers at a lower cost and sell homes faster to offer service that no one else can. As part of just our standard service, I think we're one of the only brokerages that says for 2% we'll paint it and fix it up. And taking that on isn't for the faint of heart, but we feel like we've taken on other nasty things like that before, so let's dive in.

Operational excellence, consistency of service, the ability control the entire funnel end-to-end results in more than just happier customers. It means that Redfin can try innovations like Redfin Now, Redfin Concierge, and take on tasks that are "really nasty and weird and complicated at scale."

The same skill set that lets Redfin do Redfin Now is letting them to Redfin Concierge. If that doesn't work out, then Redfin will figure out a way to use those skills, that expertise, on something else.

Wrap-up of Redfin

So, what are the major takeaways from Redfin's Q1/2018 earnings results and call?

The biggest one is what Glenn Kelman said repeatedly: wait and see. Redfin is optimistic and confident, but it's too early to tell whether their initiatives will in fact improve the close rate. So we'll see when Redfin reports its progress (or lack thereof) in future earnings calls.

For the industry strategist, however, the real takeaway is that **Redfin is painting the future of brokerage**. It is uniquely positioned with unique capabilities that allow Redfin to navigate the changing environment, innovate and experiment (with some of those experiments not working out) and perhaps to steer the industry into directions where it has an undeniable advantage over all other brokerages. Redfin's end to end control over the consumer experience is unmatched. Its operational excellence is unmatched, at least by brokerages, although individual agents and agent teams might still be better.[14]

Redfin has always known about "the deep funnel" and now they're experimenting with the potential market maker system of real estate. They're learning hard lessons today that they can leverage tomorrow.

Like Zillow, Redfin is also far ahead of the curve.

And it's not close.

[14] I must note in passing that if agent teams are better than Redfin at operational excellence, they are likely in violation of labor law by misclassifying their employees as independent contractors. This may be a future Red Dot topic, but it is a problem that the industry is well aware of (or should be).

Realogy: The Walking Dead

If Zillow and Redfin paint the picture of what the future of real estate might look like, Realogy paints a picture of what the present reality of brokerage is in North America.

Let us by all means start with a caveat: Realogy is but one company. It is entirely possible that other brokerage companies are absolutely killing it with the traditional model (although we will reference a couple of other companies to show why that is highly unlikely). It is absolutely possible that I am completely misreading what Realogy's earnings results and earnings calls mean, and somehow, Realogy is especially poorly managed and poorly run.

We would be remiss to deny that *is* a possibility. It is a highly unlikely possibility, however.

NRT, Realogy's company-owned brokerage, remains the largest brokerage by far in both volume and transactions. With over 50,000 agents, the NRT is the largest brokerage by headcount as well. Their franchise brands are among the oldest, largest, and most respected in real estate. Their corporate management is absolutely top notch, starting with the new CEO, Ryan Schneider, who came over from Capital One. NRT's management at all levels is filled with experienced operators with a track record of success – you simply do not climb the ladder at a major company like the NRT if you can't produce consistent results.

Realogy also has been concerned about the issues and pressures we will talk about for *years*. I've been tracking Realogy since 2012, when they went public again after being taken private by the Apollo Group. And for as long as I've been following them, under Richard Smith's leadership and now under Ryan Schneider's leadership, Realogy has been concerned about the same things. They've been working hard at solving those problems, and have made major investments to try and solve them.

In a real way, we can say that Realogy is the poster child, the archetype, the flag bearer of traditional brokerage in North America. It is what every brokerage not named Redfin aspires to be one day.

And it is a dead man walking.

The Numbers

Let's start with the quarterly results numbers, as we did for Zillow and Redfin. We'll start with Realogy overall, but focus on the brokerage operations, since that is what we're really interested in.

Table 4: REALOGY Q1/2018 EARNINGS

(millions)	Q1/2017	Q1/2018	
Revenues			
Gross commission income	881	902	2.4%
Service revenue	194	197	1.5%
Franchise fees	75	79	5.3%
Other	53	51	-3.8%
Net revenues	1,203	1,229	2.2%
Expenses			
Commission and other agent-related costs	605	645	6.6%
Operating	383	392	2.3%
Marketing	62	67	8.1%
General and administrative	89	89	0.0%
Restructuring costs, net	5	30	500.0%
Depreciation and amortization	50	48	-4.0%
Interest expense, net	39	33	-15.4%
Loss on the early extinguishment of debt	4	7	75.0%
Total expenses	1,237	1,311	6.0%
Loss before income taxes, equity in losses and noncontrolling interests	(34)	(82)	141.2%
Income tax benefit	(9)	(19)	111.1%
Equity in losses of unconsolidated entities	3	4	33.3%
Net loss	(28)	(67)	-139.3%

That's not a stellar quarter. True, Zillow and Redfin also posted much larger losses on a YOY basis. But those guys grew revenues by 22.0% and 33.4% respectively. Realogy grew revenues by 2.2%.

To be fair, we have to note the additional $25 million in restructuring expenses over Q1 of 2017. Take that out, and Realogy loses only $42 million. Still not great, but less bad.

The real problem is that "Commission and other agent related costs" line. That went up a whopping $40 million YOY, or 6.6%. Which would be great if Commission Income also went up 6.6%, but alas, Commission Income only went up 2.4%, roughly a third of the increase in expenses.

That, in a nutshell, is the whole story. But let's dive in further into NRT's key numbers. Some of these are computed, and are colored blue.

*This erosion of profitability is **The Problem** of the traditional brokerage since emerging from the Housing Collapse.*

Table 5: NRT Key Metrics and P&L

	Q1/2017	Q1/2018	
Closed Transaction Sides	66,570	66,097	-0.7%
Avg. Home Price	509,197	525,020	3.1%
Avg. commission rate	2.45%	2.45%	0.0%
GCI per side	13,261	13,666	3.1%
(in millions)			
Revenue	897	917	2.2%
Commission Paid to Agents	605	645	6.6%
Company Dollar	292	272	-6.8%
Company$ Margin[15]	32.6%	29.7%	-8.9%
EBITDA	(21)	(45)	-114.3%

In the course of a year, the NRT did *fewer* transactions. In contrast, Redfin increased its transactions by 28%. True, that's from a smaller base than the NRT, but in raw numbers, Redfin's agents did 1,593 *more* transactions in Q1/2018 vs Q1/2017. The NRT, the largest brokerage by far, did 473 *fewer*. That has nothing to do with percentages or a smaller base.

They both lost money, but one did it while closing more transactions and gaining market share, while the other did it while doing fewer transactions and losing market share. If it weren't for home values increasing by 3.1%, the losses would have been more severe.

[15] Please note that in the overall Realogy P&L, there's a line for "Gross Commission Income" of $902 million, which is less than the $917 million for NRT's Revenues. I've computed "Company$ Margin" using NRT's Revenues.

But the real problem is that even as the NRT's agents did fewer transactions, they took home more money: 6.6% more, against revenue growth of 2.2%.

That continuous loss of profit margin to the agents has been Realogy's problem since 2012. The computed "Company$ Margin" number is incredibly important, and it tells a story. In 2016, Realogy had Company Dollar margins of 32.2% for the year. In 2017, it was 30.4%. And as we see above, Q1 of 2017 began with Company Dollar margins of 32.6%.

So if Realogy is starting 2018 with Company Dollar margins of 29.7%, if its numbers follow the pattern of the past, where does the full-year margins end up? 27%? 26%?[16]

This erosion of profitability is **The Problem** of the traditional brokerage since emerging from the Housing Collapse. It certainly is Realogy's main headache, and Ryan Schneider, the new CEO at the helm, was not shy about admitting it.

We turn to the earnings call next, so we can "get some color" as the Wall Street folks like to say.

Unrelenting Agent Split Pressure

All prepared remarks in any corporate earnings call are written by specialists who know how to suck all of the drama out of the English language, and to obfuscate things as much as possible. They must be.

Schneider addressed the commission split problem like this:

> This upward commission rate explains the lion's share of the change in operating EBITDA in Q1 of 2018 versus Q1 2017. Consistent with what we said last quarter, while we expect continued upward pressure on agent commission rates, we expect that quarterly year-over-year increases will substantially moderate over the rest of 2018.

Very dry. Very professional.

But later in the call, Schneider says (and I have to admit I love the language here), "Well, commission split is the dominant thing at the

[16] Also note that NRT's ~30% Company Dollar Margins are almost *double* the industry's average company dollar margins of between 14 and 16%, according to research by 7DS Associates as well as by Real Trends.

moment just because that's where kind of the **violence in the P&L has been**."

Violence in the P&L. Love it! In fact, he uses that word "violence" three times during the call, and all three times, it's in reference to the effect of agent commission splits on profitability.

Fact is, there is relentless pressure on commission splits, and has been for years now. This is hardly a new problem.

Back in 2013, I wrote a Black Paper on the then-newly public (once again) Realogy's 2012 earnings call.[17] Richard Smith, then CEO, and Tony Hull, CFO, talked about pressures on commission splits back then as well.

Here's an exchange that I quoted at length in that paper:

> **Dave Katz** - JPMorgan - Analyst
>
> Okay. And coming back to the business itself, it seemed like the commissions were running about 73.5% of NRT sides related gross commission income. I know you've talked a little bit about the dynamics there, but I was just curious where you expect that to run over 2013.
>
> **Tony Hull** - Realogy Holdings Corp. - EVP, CFO, Treasurer
>
> I'm not sure how you are doing your math, but for the year, it was about 67.5%, which was up about 150 basis points from 2011. So again, based on the question earlier, we expect that level to sort of be maintained from actions that NRT is going to take proactively, as well as the lower split agents doing more of the business going forward.
>
> **Richard Smith** - Realogy Holdings Corp. - Chairman, President, CEO
>
> Just think of it this way. This is very true to form, based on past recoveries. As the housing market recovers, the top producers produce the business as the low -- so that's not low-hanging fruit. That's a tough business, the top producers are the most efficient, the most effective, they have the best relationships. And that is also true of the brokers, our

[17] I do not believe that paper is available for download anymore. But since you're a premium Red Dot subscriber, please contact me if you would like a copy sent to you.

> franchisees. They capture a lion's share of the business. As the market improves, the lower-tier producers start participating. And that creates that balance in the average broker commission rate and also the net effective rate. So this is how markets recover, and there is nothing unusual about this.

I wrote back then that as the housing market improves, the lower-tier producers should start producing more. But I was curious about these "proactive actions" to be taken by NRT management.

We now know five years later that the improving housing market has done diddly squat for profitability, and that most of those "proactive actions" by NRT management were to loosen up the purse strings and pay agents more and more. Examples?

2017 Earnings Call: "From 2014 to late 2016, Realogy held agent commission rates mostly constant while losing 1 percentage point of market share from 16.7% to 15.7%. Starting in Q4 of '16, Realogy shifted growing market share at 15.9% last year but with *substantially increased agent commission rates that you've seen in our numbers*."

2016 Earnings Call: "Despite higher revenue in the period relative to last year, first-quarter operating EBITDA is likely to be down year-over-year due to our actions at NRT *resulting in higher agent commission splits*."

2013, 2014, 2015 all more or less repeat the same theme.

Suffice to say that over all of these years, Realogy and NRT executives have been focused on trying to "moderate" commission splits. In late 2016, Realogy made three C-level appointments at the NRT to try to do something about maintaining profitability while recruiting and retaining top producers.

None of these proactive measures, none of the things Realogy and NRT have tried in the past, have worked to stop the unrelenting pressure on margins from agent commission splits.

In his first earnings call as Realogy's CEO, for Q4 and full-year 2017 results, Ryan Schneider addressed the agent commission issue head-on:

> Fourth is our strategy around agent commission rate economics. You have seen our agent commission rates rise substantially over the past 15 months. While we are subject to competitive market forces, we will use a different approach to

> this issue in 2018 including providing new, great strategic clarity and the implications of ours choices.
>
> Let me talk more about 2018 with more detail on the agent commission point I just mentioned. From 2014 to late 2016, Realogy held agent commission rates mostly constant while losing 1 percentage point of market share from 16.7% to 15.7%. Starting in Q4 of '16, Realogy shifted growing market share at 15.9% last year but with substantially increased agent commission rates that you've seen in our numbers. 2017 rates are up 173 basis points year-over-year and Q4 2017 rates are up 204 basis points year-over-year. While we continue to face upward pressure on commission rates in 2018, we expect year-over-year rate increases will substantially moderate after Q1 of '18.

We got a bit more clarity on what this "different approach to this issue" looks like in the Q1 call.

Productivity Technology, Corporate Control, and Data-Based Recruiting

Søren Kierkegaard
Danish philosopher, 1813-1855
Famous for opaqueness

In the Q1 call, Schneider gets into a good bit more detail on what the new strategy around commission splits might be. Now, I've read the long passage quoted below at least a half dozen times, and I *think* I understand what he's saying here, but I'm not 100% sure. Keep in mind that I'm a philosophy major, and have read guys like Heidegger and Kierkegaard, who are famous for the opaqueness of their prose.

I now know what Fed Watchers might have felt like while Alan Greenspan was the Fed Chairman. Read the passage for yourself first:

> So one is, I talked before a little bit in the answer to Matthew's question, the more we can enhance our value proposition, especially with technology and data products to support agents, the more we can continue to build on our strong lead generation engine that we already have today and deliver more value to agents. That's going to help us vis-à-vis agent commissions just by delivering more value and making them more productive.
>
> Second, we have a big opportunity to take a more data-driven approach around agent commissions, and frankly, start to make some of the decisioning around individual agent commission decisions more driven by analytic insights and frameworks in, kind of, call it the home office as opposed to

> kind of the individual negotiation in the field, which is a little more how the business kind of works today. We -- I talked last time, we started to do some analytics around commissions. I won't share the insights yet, but we're starting to build our muscles using a more data -- much more data-driven approach to that to take more of that ownership into kind of the analytics decision-making being done in the home office.
>
> And then third, and I mentioned this last time a bit, is changing our target recruiting profile, again, through a different use of analytics. Over the first quarter, we actually did some pretty good analytic work, I think, as a company using some different AI tools and things like that, that really said, "Hey, there is a different profile of recruiting that we can target." The recruiting we did in 2016 and '17 was quite powerful. We're net up by about 2,000 agents in our team. We like those agents. Their productivity has been good. And so that was all good things to do.
>
> But you'll notice we took a little bit of a pause in that right now, and our next generation that's probably going to be more of -- a little more analytically driven, likely targeting a slightly different mix that has some impact on the commission dynamics.
>
> So we need to make some changes in all 3 of those kind of areas, I believe, over time, both to make our agents more productive, which helps on this topic, but also to recalibrate the approach that we've been using a bit.

As far as I can tell, I think what Schneider means is that:

(4) Realogy will use technology to deliver more value, which means the agents will be willing to pay more (in the form of lower splits);

(5) Corporate will take control over commissions negotiation; and

(6) Realogy will recruit fewer top producers who demand high splits, but make it up in volume.

If those are not the conclusions you draw from what he said, I'd love to hear from you.

Let's discuss these in reverse order.

A Different Mix of Agents

I discussed #3 in my blogpost about Realogy's 2017 earnings results, and said that if Realogy can successfully implement some kind of a pareto efficiency approach to agent recruiting, it will reverberate throughout the industry. I wrote:

> Schneider doesn't care as much (if at all) about Headcount, Volume, or Transaction Sides as he does about Company Dollar and Profit Margin. That's a philosophical sea change. If what I'm reading is correct, he's saying that the NRT would rather have three agents who do 60 deals between the three of them, at a lower split so the company has better margins, than a single super-agent team that does 60 deals and demands 95/5 splits.

The problem is… it isn't at all clear that split-based competition (or "cost-based competition" if you will) is somehow less intense for these mid-level agents than they are for the top producers.

What I mean is, the single super-agent team is obviously getting courted by everybody. They can demand 90/10 splits or better and get them from traditional brokerages, like the NRT or HomeServices or whomever else.

But the trend in real estate in recent years is the emergence of truly low-cost brokerages who are happy to offer even marginal agents, never mind the mid-level producers, extremely high splits.

In fact, the fastest growing brokerage in the U.S. over the past 12 months or so is eXp Realty, a "virtual" brokerage based in Bellingham, WA. eXp offers a complex compensation scheme, complete with revenue share, stock-based compensation, and so on, but a high-level look at their numbers (eXp is actually a public company, trading on NASDAQ as of May 21, 2018 under EXPI) shows that they appear to be effectively a 90/10 split company. We'll look closer at eXp later in this paper.

Close behind are companies like HomeSmart and Realty One Group, the so-called "100% shops" who offer every agent of whatever level of production 100% of the commissions and charge a flat fee per transaction.

So, yes, Realogy can use data analytics and "different AI tools and things like that" to target agents who are not at the top of other brokerages' lists… but even those mid-level and entry-level and marginal agents are being targeted by the low-cost operators today.

The midlevel agent who does 8 transactions a year, $2 million in volume, $50K in GCI… she's being offered 80/20 splits with a cap and revenue share and stock options, or 100/0 splits with a $300 per transaction fee.

How does AI change *that* dynamic? I can't see that it does.

Corporate Control?

#2 suggests that the managing brokers at local NRT offices will no longer be allowed to negotiate commissions with agents they are trying to recruit. I can't interpret "home office as opposed to kind of the individual negotiation in the field" any other way.

I suppose we will see how this works in action, but as of this writing, I can't imagine the local office managers and local brokers, many of whom have recruiting quotas to meet, are going to love the idea that they can no longer negotiate commission splits or commission packages. Corporate "home office" will do its data analytics thing, and tell them what the offer to Agent Jones will be, and what the offer to Agent Smith will be.

Maybe the actual execution will be more like a "Here's a list of agents you need to contact, with the compensation guidelines you cannot exceed" type of a thing. Even so, taking decisions and initiative out of the hands of local management strikes me as a wonderful way to alienate your local management, who are often the only thing standing between agents and the exit door.

The importance of personal loyalty and personal relationships between a local managing broker and his or her agents simply cannot be underestimated. It isn't everything, since agents walk into their manager's office every day to cry and lament about why they have to leave to join a lower-cost brokerage across town. "I love you so much, and we'll always be friends, but I have to do what's best for my family," is not exactly a rare occurrence in real estate brokerage.

But losing a popular local managing broker can open the floodgates, and if the brokerage is not price competitive, the trickle of agents leaving can quickly become a Noah's Ark level flood and decimate an office.

How that is a winning strategy to keep commission splits in check is as yet beyond me.

Value Through Technology

So finally, we come to #1: deliver more value, "especially with technology and data products," and agents will accept a lower split.

There is truth to that statement, of course. Higher value does mean higher revenue from higher cost. Why, this Red Dot Report itself is based on the idea that people are willing to pay for high value products and services.

And over the past ten years, the emergence of true technology companies in real estate – exemplified by Zillow and Redfin – has completely altered the economics of technology development.

However, that "more value for more money" strategy is not exactly new and different. In fact, it can't get more conventional wisdom than "more value for better splits." That is quite literally *the* strategy of every single split-based brokerage in North America today, from the largest like the NRT and HomeServices to the smallest boutiques.

But there are two nearly insurmountable problems for Realogy, and by extension, every single traditional brokerage in this "value through technology and data" strategy.

These twin problems are the heart of the matter, and why this strategy will ultimately fail. They are the reasons why I call Realogy a dead man walking. They reveal the central weakness of the NRT, and by extension, every single traditional brokerage.

Technology? Data? Day Late, Dollar Short

So begin with the premise that technology and data products are the focus of Realogy's strategy. Schneider says:

> Second, we are incredibly focused on enhancing our agent value proposition by producing new technology and data products. To that end, I'm excited to share that in the past 75 days, our new technology and business leaders developed 4 new beta products meant to increase agent productivity and efficiency. We've also established an enterprise data platform that will accelerate our ability to generate and implement better data insights. Success with good technology and data

> product development will be increasingly important in how we drive value for agents and for Realogy

Time will tell what these four new beta products are, exactly how they increase productivity and efficiency, and what this enterprise data platform is and what it does.

If this were 2008, this "value through technology and data" strategy might be all kinds of interesting. We would all be curious what the beta technology products from the giant Realogy are, and what this enterprise data platform looks like.

Alas, it is not 2008 but 2018 and the "technology and data" game has been going on for the past ten years with Realogy mostly sitting on the sidelines. Realogy's one big move in the technology space – the acquisition of ZipRealty and the Zap platform in 2014 – has yet to pay real dividends. As of this writing, Realogy is *still* working on a Zap rollout, after all.

And over the past ten years, the emergence of true technology companies in real estate – exemplified by Zillow and Redfin – has completely altered the economics of technology development.

Consider this: Zillow spent $93.9 million in just Q1 on Technology. Redfin spent $12.8 million on the same.

Since Realogy doesn't break out "Technology and development" as a separate line item, we don't know how much it spent on technology. We do know that its "Operating" expense was $392 million in Q1/2018. How much of that was spent on technology development?

Whatever the amount, there is one thing we do know. Realogy did not consider investing in technology to be more valuable than buying back its own shares:

> We returned $99 million to shareholders through share buybacks and another $12 million in dividends during the first quarter, and we expect to repurchase approximately $100 million in shares in the second quarter subject to market conditions.

While it's never a bad thing to give your shareholders more money, it does seem a bit odd that Realogy would spend so much on buying back shares while talking about the importance of technology.

There are many reasons why a company chooses to buy back its own shares. But not one of them could rightly be classified either as a strategic growth initiative, or as a profitability improvement initiative.

My take is simple: if you're late to the party, you need to spend way more than the incumbents to compete.[18] If Realogy were truly serious about technology being at the center of its strategy, it should probably spend that $100 million a quarter on either developing technology or on buying technology companies.

So why isn't Realogy doing that? Why aren't they opening a second Realogy Technology HQ in Silicon Valley or Seattle (the two tech hubs today) and competing with Google and Facebook and Zillow for engineering talent?

I have a thought.

The 1099 Conundrum

The issue is that Realogy's agents are 1099 independent contractors, whereas Redfin's agents are W-2 employees, and Zillow's Premier Agents are paying customers.

That difference makes all the difference in the world when it comes to technology investment.

This is a point that I have raised repeatedly in the past, especially in the Future of Brokerage Black Paper (available for free on Notorious R.O.B.). But it bears repeating, especially with Zillow's new approach thrown into the mix.

Redfin can afford to spend $40-50 million annually on technology, even with a fraction of Realogy's revenues or market share or agent count, because it doesn't have agent adoption problems.

Zillow can afford to spend ~$400 million annually on technology since Premier Agents are *paying customers*.

Realogy, on the other hand, has to take agent adoption and agent acceptance of any of its technology initiatives into account. And the numbers are not encouraging. The numbers are not encouraging because the logic of technology adoption is not in Realogy's favor.

Take for example this paragraph from the earnings call:

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[18] And the usual way that a big company does that is by acquiring the technology. See, e.g., Facebook's acquisition of Whatsapp.

> I do think, going forward, kind of using the technology data, kind of innovations and delivery to agents in all the different brands that we have, it can be a powerful part of the future of making people more sticky with the brands, both in terms of giving them things that's going to make them more productive, that's going to make them want -- make it harder for them to leave. But also, if we can create an easy operating environment for them with technology, it raises the bar kind of in terms of switching costs a bit.

It makes sense for Realogy to create technology and data products that makes it harder for agents to leave Realogy, but why does it make sense for the agents to embrace the same? Why would an agent want to limit how much freedom she has to move around?

As an example, almost every brokerage and every Realogy brand (e.g., Coldwell Banker, Century 21) offer the agent a free personal profile on the corporate website. And yet, just about every agent who is doing any kind of production pays for her own individual website, often at significant cost. She does not want to rely on the brokerage/brand too much, *in case she has to move her practice to a competitor*.

Furthermore, Schneider assumes that given Realogy's geographic reach and scale, they have a major advantage in creating data products to improve agent productivity.

What he seems not to realize is that as independent contractors, *agents compete against each other* – even out of the same office. The idea that agents trust their brokerage enough to share their client data with it is... shall we call it naïve? The company could (and often does) provide a free CRM platform, but agents would rather pay hundreds of dollars a month for their own CRM system from vendors who promise them that they will not share that data with their brokers.

So one must ask why a top producing agent with hundreds of transactions wants her brokerage using her transaction data, client data, or listing data to create products to help her direct competitors who do far fewer deals.[19]

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[19] It must be pointed out that no matter what the law says, no matter what brokerages believe, if a top producing agent does not want to provide the brokerage with any data, she does not have to provide the brokerage with any data… at least if the brokerage wants to retain her.

Finally, just because Realogy has released a product does not mean that any of its agents must use that product, beta or not. There are far too many vendors with far too many products in the open marketplace who are happy to sell them to Realogy agents.

The 1099 conundrum does not affect Zillow as much (and Redfin not at all) because Zillow is seen by agents from the start as a vendor. They see themselves as customers, who pay for leads, who pay for software (e.g., Dotloop), who own and control their own data in Zillow's system.

Of course, Zillow controls a far higher volume of leads than does Realogy. So while agents can choose not to use Zillow's products or services (such as lead validation), that choice could mean foregoing all of the leads from Zillow. They pay for Zillow leads and products because they see value in paying for them.

It is not at all clear that they see value in paying for Realogy's leads and products, albeit on the back end, in the form of commission splits. That difference in timing of the payment – up front, or on the back end – provides real incentive to the agent to use Zillow's products and services *because she already paid for them*. Realogy cannot say the same thing.

Realogy: Skating to Where the Puck Is

Taking these factors into account, we might consider what the "best case scenario" looks like for Realogy. That is, let's assume that Realogy successfully creates wonderful beta products that increase agent productivity, and that somehow, Realogy is able to overcome the agent adoption issue. Let's further assume that all of these initiatives help Realogy achieve its goals on keeping commission margins healthy (for Realogy, not for the agents), and create stickiness so retention is not as difficult.

Even if we assume all of that in Realogy's favor, fact remains that Realogy is working on today's problems using today's solutions. Zillow and Redfin are working on tomorrow's problems using tomorrow's solutions.

Realogy is trying to solve the margin problem, through technology and data. Its metrics are around recruiting and retention statistics, and around commission split statistics.

Zillow and Redfin, meanwhile, are *moving down the funnel* closer and closer to the all-important "close rate" issue.

So even if Realogy wins on all of its initiatives, the end result is that Realogy would have above average commission splits compared to other brokerages, with above average recruitment and retention results. None of those affect the close rate one iota. None of those affect the consumer experience with searching for, finding, and buying a home. None of those affect the consumer experience with buying or selling a home in an inventory-constrained market.

That control over the consumer experience is where the future of real estate is. It's where the puck is headed. Zillow and Redfin are racing towards that spot with iBuyer initiatives, and deeper funnel products. Realogy, like the rest of the brokerage industry, is skating towards where the puck is today: recruiting and retention, and commission splits.

Addendum: Is Realogy Unique?

In the opening paragraphs, I mentioned the possibility that Realogy is somehow unique in the brokerage landscape.

I also said that we would touch on a couple of other companies to show that Realogy's problems are hardly unique.

Since just about every brokerage in North America is privately held, there are only two other companies we can look at today.

One is HomeServices of America, a subsidiary of Berkshire Hathaway Energy. The other is eXp Realty, whose parent company was trading OTC on NASDAQ, but just upgraded to a full NASDAQ listing as of May 21, 2018.

Those two are the only other brokerages who provide any numbers.[20] So we must turn to them for any insight.

HomeServices of America[21]

The #2 brokerage in America by volume and transaction sides has long been, and remains, HomeServices of America. Its 2017 Sales

[20] Please note that Re/Max is a franchisor without company owned brokerage operations, and therefore does not provide numbers useful to us.

[21] I wrote about HomeServices of America in a lengthy blogpost, from which much of this material is taken. You can find that post here: http://www.notorious-rob.com/2018/04/can-we-talk-about-homeservices-for-a-minute/

Volume of $125.4 billion according to Real Trends, is nearly five times the third place finisher, Douglas Elliman. Its 2017 Transaction Sides of 328,355 is more than triple the third place company, Hanna Holdings.

HomeServices is a wholly owned subsidiary of Berkshire Hathaway Energy, and its numbers are combined with (and dwarfed by) the parent's numbers. Obviously, HomeServices does not answer questions from Wall Street analysts.

Nonetheless, there are some numbers that are revealing in their own right.

Berkshire Hathaway Energy's 2017 10-K tells us that HomeServices had revenues of $3.4 billion, operating income of $214 million (6.2% operating margin), and net income of $149 million (4.3% profit margin). Those numbers are not dramatically different from what Realogy posted for 2017. But the issues driving lack of profitability are similar as well.

In the notes to the 10-K, we find this paragraph:

> Operating revenue increased $642 million for 2017 compared to 2016 due to an increase from acquired businesses totaling $542 million and a 4% increase in average home sales prices for existing brokerage businesses. Operating income increased $2 million for 2017 compared to 2016 primarily due to higher earnings from franchise businesses, partially offset by **lower earnings from brokerage businesses mainly due to higher operating expenses at existing businesses**. [Emphasis added]

Further on, we find this paragraph about net income:

> HomeServices' net income increased $22 million, including $31 million of income from 2017 Tax Reform. Excluding the impact of 2017 Tax Reform, adjusted net income was $118 million, a **decrease of $9 million** compared to 2016, **primarily due to lower earnings at acquired and existing brokerage businesses**, partially offset by higher earnings at existing franchise businesses. [Emphasis added]

In other words, without the Trump Tax Cut of 2017, profits at HomeServices would have *shrunk by $9 million*.

What makes both of those so unbelievable is that in 2017, HomeServices acquired the third largest brokerage by transactions and volume, Long & Foster, as well as other very significant brokerage companies, including Houlihan Lawrence, the #12 brokerage in the country.

Even with adding those, HomeServices managed a paltry 0.66% YOY grown in transaction sides and 9.12% growth in sales volume. (And home price increases of 4% contributed mightily to the volume increase).

All of these hints strongly suggest that Realogy is not alone in its troubles with profitability and growth.

eXp Realty

The other brokerage who reports publicly in any way is eXp Realty, whose parent company eXp World Holdings trades on NASDAQ under EXPI.

eXp has garnered a great deal of industry attention in recent years because (a) it positions itself as a low-cost "virtual brokerage" that uses a 3-D virtual environment, similar to the MMORPG Second Life, and (b) it has had great success in recruiting agents away from existing brick-and-mortar brokerages.

We may cover eXp in greater detail in future reports, but for now, for our purposes, just a few numbers stand out.

Table 6: Q1/2018 eXp Income Statement

(thousands)	Q1/2017	Q1/2018	
Revenues	21,528	61,962	187.8%
Cost of Revenues	18,960	55,701	193.8%
Company Dollar	2,568	6,261	143.8%
Company Dollar Margins	11.9%	10.1%	(15.3)%
Expenses			
General and administrative	2,109	15,689	643.8%
Professional Fees	364	592	62.5%
Sales & Marketing	301	646	114.4%
Total expenses	24,402	72,628	197.6%
Net loss from operations	(2,874)	(10,666)	(271.2)%
Net loss	(2,875)	(10,666)	(271.0)%

The first thing to note is that eXp appears to be what is effectively a 90/10 split brokerage. True, much of that is in non-cash stock-related expense due to the Agent Equity program eXp runs, but cost of revenues remains tightly correlated to revenues. For the past year, they hovered around 10-11% of revenues each quarter, which suggests a 90/10 split, with some of the compensation happening with shares of eXp stock.

Nonetheless, it is striking how the enormous percentage increase in revenues is outstripped by an even more enormous percentage increase in cost of revenues and total expenses, leading to even larger operating losses.

Since eXp does not (yet) do analyst calls, we'll see what the company's strategy is moving forward. But eXp represents one of the newest brokerages, that uses its stock to compensate and incentivize agents.

Perhaps eXp is in growth mode, rather than profitability mode, so it is different from Realogy in that sense. But 10% gross profit (or company dollar) margin is 10% margins however it's computed. If eXp were to transition, as Realogy long since has, to trying to maximize profitability, it seems likely that it will run into the same problems that Realogy has.

Taken together with what we at 7DS Associates know about private company financials, we can say with certainty that Realogy is hardly unique in the world of real estate brokerages in its profitability problems as a direct result of relentless pressure on agent splits.

The Takeaway from Realogy

The contrast between Realogy's results and earnings call and those of Zillow and Redfin could not be more stark.

Where Zillow and Redfin talk about the problems of the future, Realogy is talking about the problems of the past and present.

Zillow and Redfin are hinting at a market maker system of real estate, premised on consumer experience and consumer needs, while Realogy is talking about moderating P&L violence from commission splits and doing better with recruiting and retention.

Sure, Schneider sounds awfully confident when he talks about scale and financial resources and tens of thousands of agents on the ground. But all of the strategies he laid out have either been tried before, or lack the foundation for optimism.

"Better tech" has been the mantra in brokerage for at least as long as I have been in the real estate industry, but brokerages have never backed up those words with real action and real investment. Realogy as well would rather spend $100 million a quarter in stock repurchases than invest that into technology.

Taking power away from local managers might not be the worst idea in the world, since local managers have recruiting incentives that might lead them to lower splits more than they need to, but given the realities of recruiting and retention, it isn't clear how that's going to work out in practice. Time will tell.

And given the realities of the market today, where low-cost operators are offering incredibly high splits, caps on commissions, and a variety of profit or revenue sharing arrangements even to marginal agents, it isn't clear that Realogy's AI and big data driven changes to recruiting will ultimately pay off.

More than all of those, however, is the general theme. Realogy and traditional brokerages are still focused on an agent-centric recruiting-and-retention model of business. The world may be moving on. Consumer experience, buyer success, close rate – these are the things that Zillow and Redfin are obsessed with, while Realogy (and by extension, traditional brokerages) are obsessed with recruiting and retention.

On this current path, there is no out for Realogy. There is no reasonable scenario in which profitability improves, and no reasonable scenario under which traditional brokerages can adapt to changes in consumer behavior. They can slow the decline, but that's about it.

Nonetheless, that doesn't mean that Realogy and traditional brokerages are helpless. There are things they can do today, whether to improve the situation, or to buy time to figure out a strategy for the future.

For MLS and Associations, there are clear things that they must consider given what these three public companies have told us about the future of real estate. The troubles of traditional brokerage is at the root of all of the problems of MLS and Associations, and they are mutually intertwined.

For technology companies not named Zillow or Redfin (or Move), they must seriously consider what these changes portend as well.

We turn to those recommendations next.

A Brief Aside: Real Estate's Game of Thrones—The Platform

Before we continue to the Recommendations, I have to take a moment and point out what's actually at stake here.

What is actually at stake here is nothing short of the real estate industry's version of the Iron Throne: **who will be the platform for real estate?**

What do we mean by "platform"? Let me quote from this 2017 New York Times Magazine article:

> Uber, like so many other successful tech companies in 2017, is a "platform business," one built around matchmaking between vendors and customers. If successful, a platform creates its own marketplace; if extremely successful, it ends up controlling something closer to an entire economy.

Harvard Business Review says in a 2017 article called Finding the Platform in Your Product:

> Five of the ten most valuable companies in the world today—Apple, Alphabet, Amazon, Facebook, and Microsoft—derive much of their worth from their multisided platforms (MSPs), which facilitate interactions or transactions between parties. Many MSPs are more valuable than companies in the same industries that provide only products or services: For instance, Airbnb is now worth more than Marriott, the world's largest hotel chain.

As of this writing, there is not one company that can be said to have won the Iron Throne: becoming the real estate platform. Zillow is the closest, but it has not won yet.

As of now, one could say that there are 700-plus "platforms" for real estate in the 700-plus MLSs in the U.S. At the local level, there is no doubt that the MLS still remains central to the "matchmaking between vendors and customers," at least through the customer's own vendors (the buyer agents).

But the MLS platform has always been and remains a platform mostly for active listings. That data is now widely available, as the real estate industry has pointed out time and again to people like the Federal Trade Commission and the Department of Justice.

The rest of the real estate process, from initial dreaming to closed transaction, has been completely decentralized in tens of thousands of brokerages and millions of real estate agents.

What we are looking at, then, are the initial forays into centralizing and consolidating the rest of the real estate experience *outside of seeing what's for sale*. Redfin has been at that game for ten years. Zillow is now entering that game with Zillow 5.0.

And over the horizon, across the narrow sea, there be dragons.[22]

Realogy and the rest of the brokerage industry is still playing the recruit and retain game, while the Game of Thrones is underway.

The big picture subtext of this entire paper is that question: Who will be the dominant platform for real estate transactions? Who will win and keep the Iron Throne?

Our Recommendations, therefore, keep that subtext in mind.

[22] Redfin's partnership with Amazon.com bears close watching. https://www.amazon.com/b?ie=UTF8&node=12636722011

Decide. Act.

Recommendations: Technology

Given what we have studied, what is the technology company of today to do?

The answer, I think, depends on your size, capabilities, and ambitions and relates to the Platform section above.

- If you are one of the Great Houses, or intend to be, then you need to contend with House Zillow.
- If you are one of the minor Houses, then you need to figure out which Great House (or Great Houses) you will ally with.

So what can you do today in this real-life real estate version of Game of Thrones?

Get Obsessed with Close Rate & Consumer Experience

Given that my number one recommendation to brokerages, agent teams, and franchise companies is to get obsessed with close rate and consumer experience, it follows that the number one recommendation for technology companies is to get similarly obsessed with the close rate and consumer experience.

No matter where you stand on the competition to be the Platform, you need to learn from the lessons of Zillow and Redfin. There are reasons why Zillow has gone deeper into the funnel, and reasons why Redfin is expanding Redfin Now. You will face the same challenges, and are likely going to need to make the same kinds of pivots.

Consumer experience is the key. The consumer experience does not end when his contact information is turned over to a real estate broker or agent. That's the lesson Zillow has learned over the years, and that's one major reason for its initiatives.

Any real estate platform that emerges out of the next phase of the industry's evolution will be one that wins the consumer experience battle, which means that tech companies large and small have to obsess about it.

If you are a vendor to real estate, fact is that you need to be obsessed with the experience throughout the entire process of your customer's customer. It is a truism that brokers and agents do not make any money until there is a closing. Your clients and customers might pay you a monthly fee, or buy products from you, but ultimately the pool of money they have to spend on your products and services will be determined by close rate in some form or fashion.

Furthermore, if success as a brokerage will be tied directly to the success of its buyer and seller clients, then brokerages are going to demand more products and services that increase buyer and seller success.

It's going to be a pain in the ass, but I think it's required.

Generally speaking, you as the strategist must understand this paradigm shift:

- Yesterday was about lead generation.
- Today is about lead conversion.
- Tomorrow will be about the close rate.

Get as obsessed with close rate as you do with lead generation and lead conversion, because your customers and clients need to be.

Move Down the Funnel

Closely related to the above is that you need to move down the funnel, whether for yourself or for your brokerage and agent customers.

It is no longer enough just to deliver a lot of leads to some broker or agent. You and they need to move down the funnel and be concerned about the overall consumer experience.

Going deeper into the funnel obviously means getting closer and closer to the actual transaction itself. If your products today are geared entirely around marketing and promotion, you need to think about what happens after the lead is delivered. That might require a far deeper integration with the agent or broker's systems and processes than you have today. It might require more partnerships and data sharing with third party companies, which implies choosing the right Platform, or becoming one. It might require additional customer support, and more customer education.

Going forward, brokerages and agent teams will turn their attention increasingly towards the deep funnel, control over the consumer experience, and the close rate. Because they have to, or become irrelevant. As a technology company, then, you will also want to make sure your products and services help brokers and agents work on those things.

Note that this does *not* mean that you, as a technology company, should expand beyond your core business. That rarely works out for the best. What it means is that you figure out your role in the overall consumer experience value chain, and partner with appropriate companies who supply the other parts.

Get and Promote the Right Metrics

One of the oddities about the real estate industry is that so much of its metrics are irrelevant – or fast becoming irrelevant.

We have seen and worked with far too many brokerage owners and team leaders who pay attention to numbers that don't matter, such as agent headcount, and have no idea what their gross margins are.

For a brokerage, there are two key numbers that matter: Company Dollar and Net Income.[23]

Company Dollar is the rough equivalent of gross profit: revenue, less the cost of revenue. This is the first key number for brokerages because the brokerage controls everything below this line, but very little of everything above it.

The second key number is EBITDA or Net Income or Pre-tax Income, or Operating Income. This is obviously relevant since it represents as close a picture of the profits from the core operations of the brokerage. It is also relevant because this number is one where the brokerage has far more control.

[23] I wrote about this in a blogpost, Cut the Crap with Two Numbers, which you can find here: http://www.notorious-rob.com/2018/03/freb-cut-the-crap-with-two-numbers/

We believe that brokers and agent teams should start measuring Company Dollar, Gross Margin (or, Cost of Revenue Margin), and Operating Income/EBITDA as their KPIs.

That has implications for the technology company, particularly vendors to the industry, but also to the Great Houses who rely on brokers and agents for part of the value chain.

First, your product or service *must show some sort of lift* on one of those three KPIs. If your software generates all kinds of efficiencies, but provides no improvement in EBITDA, then what's the point? Why should an agent or broker spend money on it? If your marketing technology promises more and better qualified leads, then that has to be reflected in the Company Dollar, or Gross Margin KPIs, and ultimately flow down to the Operating Income metric.

Otherwise, what was the point?

Second, in order to show that lift, you have to start collecting that data. A brief glance through the marketing literature from the real estate technology companies show all kinds of claims, but no one I could find in researching for this makes claims about Company Dollar, Gross Margin, or Profit and *backs them up*.

One company's core message is: "Turn your data into leads, listings, **and profit**." Yet there's nothing about how much more profitable their customers became after using their product.

To be fair, there are case studies showing additional leads, listings signed, and closings and closed transaction volume. But the whole point of the Realogy section of this report was that *those numbers do not matter* nearly as much as the new KPIs of the new era.

So get the right KPIs from your customers, then promote your product or service using the right KPIs.

Evaluate Your Platform Strategy

If we take as a given that the Game of Thrones to become the Platform for real estate is now afoot, you need to take a serious, hard, and cold-blooded look at your platform strategy.

If your ambition is to become a contender for the real estate platform, then Zillow is both your role model and your competition. They have so much consumer mindshare that it's daunting, if not insurmountable. And Zillow is set to expand its brand mindshare with both Homes and lead validation.

So the obvious first question is, do you have what it takes to contend with House Zillow? If you do....

Becoming the Platform requires more than just consumer eyeballs and lead generation. It requires *connectivity*, among other things.

The Harvard Business Review article referenced above clearly identifies "Opening the door to third parties" as one of four ways for companies to become a platform:

> In this scenario your product or service has a big customer base that third-party sellers of other offerings are interested in reaching. You become an MSP by making it possible for those third parties to connect with your customers. "Connect with" can mean advertise or sell (or both) to them. The third-party products may be independent of your product or service or may be apps or modules that work in combination with your offerings.

Zillow has shown willingness thus far to have others on its platform. See, e.g., Zillow API, Retsly, Bridge Interactive. How about you?

How open are you to third party companies on your platform? How easy do you make it for other companies to share with you, and share what you have?

If you are a small company not interested in playing the real estate Game of Thrones, then you need to think about your platform strategy as a third party. There are a few questions I would ask:

- What value are you adding to your customers that the Platform cannot or will not add?
- What value does the Platform add to you or to your customers that you cannot or will not add yourself?
- What value could be created in the interaction between you and the Platform? (For example, could you blend Realtor.com's buy-side demand data with something you have that results in benefits for both? Maybe Corelogic's tax records can be analyzed through traffic data?)

The answer depends on the Platform, of course, since to use one example, Redfin and Zillow offer very different things to brokers and agents. But you need a platform strategy and if you already have one, you need to revisit it in light of what we discussed in this Red Dot.

Think About the Market Maker System

Finally, while this remain in the realm of speculative fiction, with the Platform issue at stake, you need to at least think about how things might change with a market maker system of real estate.

You may not be involved with, nor have any desire to get involved with, the iBuyer phenomenon. You might regard the whole thing as a foolish high-risk venture. That's fine.

But you should not ignore the consumer frustration with the process that has led to the rise of the iBuyer phenomenon, nor the macroeconomic factors that contribute to it. Both Zillow and Redfin realize (and one assumes Opendoor does before them) that a major pain point of the consumer experience today is getting a mortgage. Those have not changed, and will not change whatever happens to Zillow Homes or Redfin Now.

Rather than take as given the horrible process we have today, strategize about how your company fits into a system in which well-capitalized big companies inject liquidity into the real estate transaction process.

The real innovation in real estate will not come from virtual reality and blockchain. Not yet. It will come from changing the transaction process and solving for consumer pain with it.

Your staff should focus on the problems of here and now. You, as the person responsible for strategy and vision, need to at least start considering a possible future under a market maker system.

Conclusion

If someone had told me a month ago that I could and would write a 70-plus page report based on nothing other than the quarterly earnings results and calls of three companies, I would have laughed. After some 26,000 words and almost 90 pages… I'm not laughing anymore.

Earnings results from one quarter, particularly the first quarter of the year when the real estate market is very slow, are not definitive guides to much of anything. But these are the three public companies who report, and speak to Wall Street analysts frankly about their plans, their strategies, their challenges.

If one is to spot a trend before it goes viral on Facebook, one has to do some real work teasing out a narrative from the numbers and the hints dropped by public company CEOs. I have tried my best to do just that, and it is fortunate that there was so much to look at, analyze, and discuss in Q1 results.

Q2 results are not too far away; we should all get a clearer idea of how some of these initiatives have impacted things for Zillow, Redfin, and Realogy. What we learn then may force a re-evaluation, or it may confirm what we're seeing today, though darkly as through a mirror.

The shape of things to come is one of deep engagement with the consumer experience. As we go forward and get more facts, more data, and more numbers, that shape can solidify until everyone can plainly see what's going on.

By then, we'll have moved on to trying to discern the shape of things to come in tomorrow's tomorrow.

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