THE RED DOT

MLS & ASSOCIATION EDITION

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Darkness Comes

Q3/2018 Earnings and the Rise of Redfin

MLS & Association Edition

Observe. Orient. Decide. Act.

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Observe.

INTRODUCTION

I am not an investment analyst, so I don't cover each and every quarterly earnings report from the public companies in the residential real estate space. I cover them when the earnings reports and the analyst calls which accompany them reveal something interesting and important about the overall direction of the industry.

Q1/2018 was such a time, when looking at the releases and conversations from Zillow, Redfin, and Realogy showed us the shape of things to come.

Q3/2018 is another such time, because of big moves by Zillow on the one hand, one very smart move by Redfin on the other, and stay-the-course moves by traditional companies as represented by Realogy.

But Q3 will be remembered as Redfin's debutante moment. Redfin's IPO opened our eyes to just how strong Redfin had become. Q3's announcement that Redfin will start spending serious money on consumer advertising means that for the first time in a very long time, someone other than Zillow will dictate to the industry and force it to react.

I called this Red Dot "The Darkness Comes" because Redfin is fond of saying that it was born in the dark, like Bane from Batman, as it was forced to deal with the biggest housing market collapse in history when it was founded. Over its sixteen year history, Redfin has honed its low-cost, employee-based business model, and has realized that it can survive, and even thrive, in the dark: in low-income market conditions.

So Redfin will bring on the darkness, and force everyone to fight in the dark, by pressuring commissions and seeing who can survive if half the commissions disappear. Even Zillow will be forced to react, as its recent changes makes it far more of a part of the industry than an interloper.

The next year or two is an important inflection point. Either the darkness comes, or it does not. Either Zillow successfully transforms into the most important partner for top producing agents, or it does not.

The former would wreak havoc on the industry, and some grand old companies, ancient and respected brands, and institutions deeply ingrained in real estate would perish. The latter would wreak havoc on the industry, and the next wave of real estate will crash upon the immovable rock of the American real estate industry and wash away into so much sea foam.

Either way, there will be chaos. But oh, what interesting times we live in!

Robert Hahn
December 2018

Note on Sources:

I have used mostly publicly available sources for this report, including the Q3 earnings reports, shareholder letters, and earnings call transcripts.

In addition, I have spoken to Glenn Sanford and Jeff Whiteside, CEO and CFO respectively of EXP Realty (EXPI) by telephone. Both were informed ahead of time and knew that the conversation was "on the record" for the purpose of this report and other reports/analysis I might do.

I have also spoken by telephone to Greg Schwartz, President of IMT for Zillow Group, about various Zillow initiatives. Most of the conversation was on the record, with the full knowledge that the information would be used for this report and others. Some parts were "off the record" and will not be used or referenced.

Finally, I have referenced and used reports and analysis from John Campbell at Stephens, Inc. as well as Brad Safalow of PAA Research. Any use or quotation is with permission.

EXECUTIVE SUMMARY: MLS & ASSOCIATION

The most interesting takeaway from Q3 comes from Redfin, but we will start with Zillow, who had the most to announce. In any other time, Zillow's pivot would be *the* story; this time, it is an important story, but not the headline.

Zillow: From Vendor to Player

I view Q3 as the culmination of a number of trends, a number of predictions, over the course of years. It confirms many thoughts from the June Report, when we dived deep into the Q1 announcements, and expands on them in a way I did not see coming this soon.

The Numbers

Table 1: ZILLOW'S Q3/2018 INCOME STATEMENT

	Q3/2018	Q3/2017	%Δ
Revenue:			
IMT	332,076	281.839	21.7%
Homes	11,018	-	NA
Costs and expenses:			
Cost of revenue (excl. amortization)			
IMT	26,386	22,152	19.1%
Homes	10,286	-	NA
Cost of revenue (excl. amortization)	36,672	22,152	65.5%
Sales and marketing	128,734	107,108	20.2%
Technology and development	105,314	83,389	26.3%
General and administrative	70,743	54,226	30.5%
Acquisition-related costs	1,405	218	544.5%
Total costs and expenses	353,391	264,093	32.3%
Income (loss) from operations	(10,297)	14,746	(169.8%)
Other income	7,773	1,407	452.5%
Interest expense	(12,668)	(6,906)	83.4%

Loss before income taxes	(15,192)	9,247	(264.3%)
Income tax expense	14,700	(41)	NA
Net income (loss)	(492)	9,206	(105.3%)
Adjusted EBITDA	66,154	70,957	(6.8%)

From a financial standpoint, Q3/2018 was not a stellar quarter. The wounds were self-inflicted, and quite on purpose.

Premier Agent 4.1 (and 4.0)

The first place to really begin, I suppose, is Premier Agent 4.1 – an evolution of Premier Agent 4.0. We'll call these PA 4.1 and PA 4.0 going forward.

Zillow saw higher advertiser churn. That's really not good, given that some 70% of Zillow's revenues come from Premier Agent.

One of the things that Zillow learned from rolling out PA 4.0 to its Premier Agents, however, was that while real estate agents might (or might not) value higher quality leads over quantity, real estate agent teams valued both quality *and* quantity. PA 4.1 attempts to fix that by sending along unvalidated leads.

Consumer Experience Report (and Best of Zillow)

Tied to, but separate from, PA 4.1 is the announcement by Zillow that it will implement a new Consumer Experience Report, based on Customer Satisfaction Score (CSAT): The Happy Customer KPI form Emolytics.

The most important purpose, of course, is to help Zillow's paying customers figure out what they're doing well and what they could be doing better, and helping them improve in all three phases: initial conversion to client, initial work with client, and the transaction itself.

There are consequences, however, to CSAT which is revolutionary.

Best of Zillow and the Evolution of Premier Agent

Essentially, if a Premier Agent scores above 90 on the CSAT, he or she will be designated as "Best of Zillow" with additional marketing tools, a new and different badge on your agent profile, and potentially other benefits.

If, on the other hand, you fall below 72 on the CSAT, you will be warned, given 90 days to improve the CSAT score, and if no improvement is forthcoming, *booted from Premier Agent program*. As Greg Schwartz put it, "From now on, only the best will be called Premier Agents."

Quality Assurance

This seems a minor tactical adjustment, but it's quite a big deal. In effect, what CSAT/CER and the new Best of Zillow (and the "Worst of Zillow") initiatives do is to provide some assurances on agent quality to the consumer.

For the first time possibly ever in the history of residential real estate, we have a quality assurance standard that is (a) semi-quantitative, (b) objective, and most importantly, (c) **enforceable**. There are real consequences to the real estate agent in failing to live up to Zillow's standards.

From a psychological and cultural standpoint, it is hard to underestimate just how big a move this is for anybody in the industry to pull off. That it is Zillow, widely feared and hated within the industry, is indeed news.

Zillow Flex

And then you have Zillow Flex, first announced in September in a blogpost by Greg Schwartz.

Basically, Zillow Flex is Zillow taking a percentage of the Gross Commission Income (GCI) as a referral payment. Speculation is that Flex pricing will be in line with industry practices, with 25% being accepted in agent-to-agent referrals and as high as 48% being begrudgingly accepted in relocation leads.

First, it is a departure from longstanding promises by Zillow not to "cross the fence" between media company and brokerage.

Second, Flex has the possibility of increasing Zillow's topline revenues from Premier Agent.

But third, and perhaps most importantly, Zillow Flex is *inevitable* once you move to a CSAT-powered Best of Zillow type of a framework. At the same time, Flex is impossible without a CSAT-powered Best of Zillow framework.

If you're getting paid ahead of time for email leads, then as Zillow you don't really care whether the agent gets a transaction out of those leads or not. If, on the other hand, you get paid only when your Premier Agent customer gets paid, then you care a very great deal about whether the Premier Agent is actually going to convert, service, and close the deal.

Zillow Homes and CSAT

In April, I wrote a post that appears prescient with 20/20 hindsight, entitled, "No Hat, Lots of Cattle: In Which Zillow Transforms". One of the things I wrote then seems directly on point here: that Zillow's incentives change once they are taking on the risk of buying and selling homes on their own account.

That still seems correct to me. Just like any other home buyer or home seller, Zillow has enormous incentive to work with the best of the best. The Best of Zillow, even.

The same analysis goes for the listing leads that Zillow Homes are going to generate.

Getting that 90+ CSAT rating has rewards beyond advantages in marketing and a badge. Conversely, losing your Premier Agent status by falling below 72 could be disastrous.

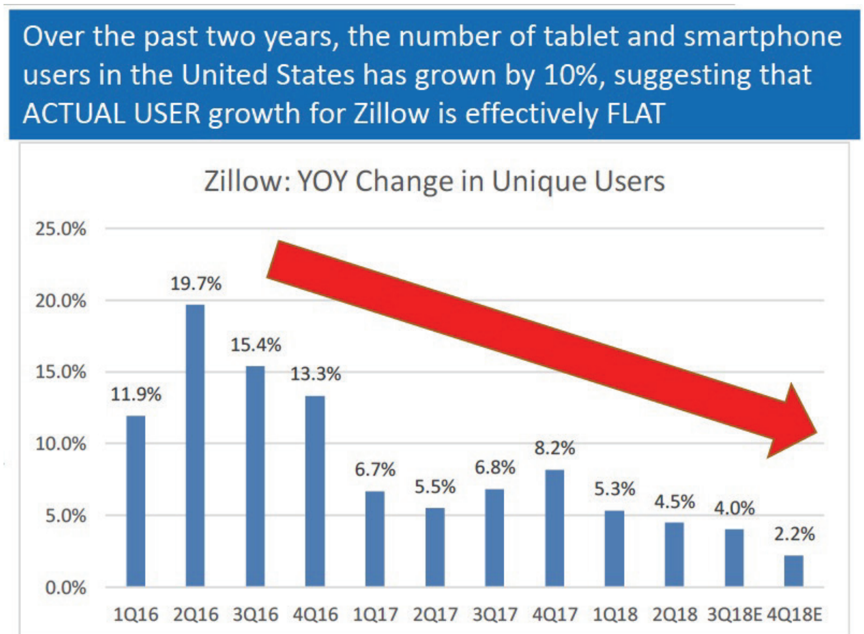
Zillow's Strategic Problem

There are other fascinating details in the Q3 results, but the items above are the real big stories. Taken together, they represent a major pivot and a turning point in Zillow as a company and real estate as an industry.

These things could be thought of as tactics to address Zillow's strategic problem, which became clearer in Q3.

Zillow's traffic growth has slowed, and that Zillow very well may be getting to saturation point. After all, Zillow's Q3 average monthly unique users was 186 million. The population of the United States is 325.7 million.

It's hard to argue with PAA Research when it concludes that actual user growth has been flat:



The strategic problem for Zillow, then, is how to increase revenues and profits *if the top of the funnel (traffic and leads) is maxed out*.

The tactics to solve that strategic problem are many and varied. Just off the top of my head:

- Increase the TAM, for example, by expanding internationally;
- Improve the product enough to warrant a higher price;
- Create more of the same product to sell;
- Create new products to sell;
- Take risks and charge for the risk;

Zillow chose to do all of the above, at the same time.

Zillow is Transforming

Bradley Safalow of PAA Research calls Zillow a broker in all but name in his "Short Thesis" segment:

> "**Zillow is a broker in everything but name; margin expansion should continue to disappoint**. Zillow structurally has evolved into a "broker" with high marketing spend, technology expenses, and call center support – why should the company's margin profile be different?" [Emphasis in original]

He's not far off the mark. But I think with all of the already announced initiatives, Zillow *is* transforming, but not into a brokerage.

The Truth About Contemporary Brokerage

The modern real estate brokerage is not in the real estate business: it's in the B2B business of recruiting, servicing, and retaining real estate agents. That makes them customers, not contractors.

Over the past couple of decades, the most important shift in the industry has been the rise of the agent team, which has taken over much of what a brokerage used to provide.

In short, the contemporary brokerage is a business services provider to agents and agent teams offering leads, technology, training and legal compliance services.

Zillow Excels at Leads and Technology

It is not debatable that Zillow beats the pants off of brokerages in providing leads and technology.

With Zillow now offering Zillow Flex, the economics of being a Premier Agent looks a whole lot like joining a brokerage.

Zillow Has a Living Brand

At the same time, Zillow has a living consumer brand. By "living" I mean that the brand actually matters to consumers, and after Best of Zillow and the CSAT initiatives, that brand can be enforced.

50% of consumers who fill out a form on Zillow thinks that *they are contacting Zillow*.

CSAT and Best of Zillow naturally flow from the need to defend Zillow's consumer brand. And those provide Zillow with the ability to enforce its brand promise.

Interestingly enough, agent teams have living brands, usually in their local markets, as most teams arise out of a superior individual agent's network and efforts. Accordingly, the teams enforce their living consumer brands on their team members.

How? At the end of the day, the agent team controls the flow of leads and access to technology and systems for making money.

So does Zillow.

Zillow Is Transforming into a Team of Teams

Taken together, this means that Zillow is not transforming into a brokerage but into an *agent team*. Perhaps put more precisely, it is transforming into a Team of Teams.

That is an ever-so-slight difference from Bradley Safalow's take, but it makes an enormous difference.

Zillow's New Exposure to the Market

Where Safalow is on the money is that like most brokerages, Zillow is now exposed to market risk in the same way that Redfin, Realogy, and most other brokerages are.

Perhaps more worrisome, and this is something Safalow really emphasizes in his analysis, is the prospect of the real estate industry as a whole shifting to a lower commission environment. Pricing pressure on the industry as a whole now has a direct impact on Zillow; it had an indirect impact before.

Zillow Asserts its Power

What does jump out at us looking at everything at a strategic level is that Q3/2018 is when we can truly say that Zillow has finally taken a stand and asserted its power in (and possibly over) the real estate industry in the United States.

It's a subtle change, and one that is hard to see from outside the industry, but in effect, Zillow's relationship to the industry is forever altered. Zillow is no longer a vendor, but a player and one that cannot be ignored.

Redfin: Bring the Darkness

If Zillow made a huge pivot, then Redfin is doing something come 2019 that could make all of us remember Q3 as **the** moment when we knew.

Redfin, born in the dark, will bring forth the darkness to fight in the dark. That's a fight that Redfin is confident it can win, even against the biggest and baddest of competitors.

But let us begin with the numbers.

The Numbers

The Q3 results for Redfin were a real mixed bag.

Table 2: REDFIN'S Q3/2018 INCOME STATEMENT

	Q3/2018	Q3/2017	%Δ
Revenue	140,255	109,479	28.1%
Cost of revenue	97,950	70,166	39.6%
Gross Profit	42,305	39,313	(16.0)%
Costs and expenses:			
Technology and development	14,310	11,483	24.6%
Marketing	8,236	5,588	47.4%
General and administrative	16,470	11,995	37.3%
Total expenses	39,016	29,066	34.2%
Income (loss) from operations	3,289	10,247	(67.9)%
Net income/loss	3,475	10,558	(67.1)%

16% decline in Gross Profit is a real reason for concern since Redfin has always been a real estate brokerage.

In fact, across the first three quarters of 2018, Redfin's Gross Margins have been consistently below the 2017 numbers:

Q1/2017	10.7%	Q1/2018	7.1%	(33.1)%
Q2/2017	35.2%	Q2/2018	31.7%	(10.0)%
Q3/2017	35.9%	Q3/2018	30.2%	(16.0)%

The other Key Metrics look pretty good:

Table 3: REDFIN KEY METRICS

	Q3/2018	Q3/2017	%∆
Monthly average visitors	29,236	24,518	19.2%
Real estate transactions			
Brokerage	12,876	10,527	22.3%
Partner agents	3,333	3,101	7.5%
Average number of Lead Agents	1,397	1,028	35.9%
Value of transactions (Volume)	7.7 billion	6.3 billion	20.7%
U.S. Market Share (by Value)	0.85%	0.71%	19.7%

A 22.3% YOY growth in the number of transactions, and a 20.7% growth in Sales Volume numbers are also impressive, especially given the slowdown in the housing market.

So all in all, the negatives are all things that one should expect given Redfin's dramatic increase in hiring lead agents, while the positives are semi-unexpected given the warning bells that Redfin has been ringing for a couple of quarters now.

Redfin's Growing Confidence

The biggest takeaway from the Q3 earnings call is just how confident Glenn Kelman is in Redfin's competitive advantages and its capabilities to adapt.

One would expect that a brokerage company, especially one with employee agents who have to get paid no matter what, would be in a batten down the hatches mode if the market is truly slowing.

Instead, Redfin announces that it's going to go on a massive spending spree on advertising and marketing: in the range of $40 to $60 million on mass media advertising across 20 markets for 2019, compared to $12 million in 2018.

On the Consumer Awareness Campaign

Redfin's big bet on marketing means that Redfin is becoming more like Zillow: a national **brand**, not just a brokerage.

There are numerous reasons why Zillow grew to be the dominant real estate portal over its two main competitors, Realtor.com and Trulia, but one of those reasons was its spending on advertising.

Redfin will now pursue the same strategy and grow consumer awareness of its brand.

Unless Glenn and his team screw up execution, chances are that the outcome will be similar for Redfin as it was for Zillow.

Pressuring the Commission

The real potential for disruption from Redfin is that it will be able to *permanently alter the commission environment* in the United States.

Redfin will put pressure on commissions once it starts mass advertising of its low-cost offerings.

This is neither surprising nor a way-out-there claim. It's obvious.

To be fair, the real estate industry has always dealt with "discounters". Just about everyone who was around in the 90s and the 00s remembers Foxton's, which roared into the real estate scene in 2000 and filed for bankruptcy in 2007.

But there are a few reasons to think that things might be different this time around.

Blacklists vs. the Internet

The Real Deal has written a fairly comprehensive story back in 2007 about why Foxton's failed. It's worth reading in full.

One of the reasons for Foxton's failure, according to TRD, is that buyer agents steered their clients away from Foxton's listings.

But in 2000-2007, the real estate web was in its infancy.

It's not clear whether blacklisting by competing brokers and agents would have the same impact in 2019 as it did in 2005.

This is especially true when the listing broker is Redfin, with 30 million unique visitors a month, growing at a 20% YOY rate, with the Redfin App in the hands of millions of people.

Low Cost = Low Service?

TRD also quotes Dottie Herman, CEO of then Prudential Douglas Elliman, who says that Foxtons failed because they did not do enough to earn even a rock-bottom commission.

Since Foxtons' model was essentially an assisted FSBO, where the sellers do most of the marketing work themselves, it did not gain traction.

But in 2019, technology has advanced dramatically since 2007. Productivity software works. The web has replaced newspapers and yard signs as the most important way to market homes. It may no longer be the case that lower commissions means less service.

Local vs. Brand

Finally, TRD made a point that Foxtons did not have local offices and did not integrate with local brokerage communities.

The fastest growing brokerage in the U.S. has no offices at all, except whatever is required by law. Even firms that do have offices routinely report that their offices are ghost towns populated mostly by administrative staff and a couple of newer agents.

Consumer behavior has completely changed, thanks to the internet. Small stores used to fear Walmart; now, they fear Amazon. Even Walmart fears Amazon. And even more directly on point, the success of Zillow and Redfin suggests that consumers prefer a living national brand that delivers on its brand promises over local brokers and agents, as long as national brands have some sort of a presence on the ground.

Impact of a Low Commission Environment

This topic is entirely too large to do justice here. But at a high level, we can think about the obvious impact if the U.S. goes from a 6% commission environment to a 4% environment, or lower.

Most of the Industry Suffers

First and most obviously, just about everyone in the real estate industry suffers.

Brokerages suffer, as their agents see their income drop by a third. Even if those agents do not ask for higher splits right away, the brokerage splits would also drop by a third.

It'll be nothing short of a bloodbath, as the total pie has shrunk.

Cooperation and Compensation Problems

A low commission environment will absolutely lead to a period of chaos for the longstanding pillar of the American real estate system: cooperation and compensation.

The relationship between brokerages Participants in the MLS become fraught. I have seen this in one market in the U.S. where the dominant brokerages responded to the threat of Foxtons by dropping their own fees.

The result is a serious weakening of cooperation and compensation, unequal offers of compensation, formation of cliques, and a general lack of unity.

The Middle Gets Hollowed Out

Some people might see a lower commission environment as a net positive, as they imagine that it would drive out some of the less experienced, part-time, and incompetent agents from the business. What actually happens is that the middle tier agents leave, while the top producers gain market share, and the bottom-tier agents stay.

It's simple logic.

A top producing team earning $1 million in GCI each year could see its GCI drop to $660,000. That means cutting some staff, reducing some costs, but the team leader isn't going anywhere. That's still a ton of money.

A part-time agent doing one deal every other year isn't relying on real estate to pay her bills. The so-called "soccer mom REALTOR" isn't going to leave the industry because she goes from making $10,000 every other year to making $6,000 every other year.

It's the vast middle, of professional agents who do rely on real estate to make a living, who suddenly find themselves squeezed.

We saw this play out when the real estate Bubble burst in 2007.

Here's the thing: the last crash saw the entire housing market collapse. The low commission environment we're contemplating doesn't have to mean that the entire housing market collapses, just that the pool of commissions is cut by a third (or more).

As the middle-tier agents quit and leave the business, top producers will pick up more and more of those transactions.

Redfin: Bringing the Darkness

There is a very good chance that Glenn and Redfin recognize that they are uniquely positioned among all brokerages to survive and even thrive in the dark. So they will bring the darkness: *a low commission environment*.

Strong agent teams will survive, of course, and Redfin is the strongest agent team of them all. Tens of thousands of competent middle-tier agents will find themselves struggling to make a living. Brokerages will face major profitability problems.

Realogy: Doubling Down on Today

In the June Report, covering Q1, I wrote:

> 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.

Every word remains true today.

Consider for a moment that while Zillow is making a bet-your-company pivot away from being a vendor to a central player in the real estate experience, and Redfin is going to bring the darkness because it is best prepared for a night fight, Realogy's major announcement is that it will launch two new franchise brands.

The Numbers

And again, there's really nothing much to report here. It's the same old story, repeated again.

Table 4: REALOGY Q3/2018 EARNINGS

(millions)	Q3/2018	Q3/2017	
Revenues			
Gross commission income	1,246	1,250	(0.3)%
Service revenue	268	261	2.7%
Franchise fees	109	111	(1.8)%
Other	53	52	1.9%
Net revenues	1,676	1,674	0.1%
Expenses			
Commission and other agent-related costs	902	887	1.7%
Operating	387	394	(1.8)%
Marketing	63	63	0.0%
General and administrative	80	82	(2.4)%
Restructuring costs, net	9	2	350.0%

Depreciation and amortization	49	50	(2.0)%
Interest expense, net	41	41	0.0%
Loss on the early extinguishment of debt	-	1	
Total expenses	1,531	1,521	0.7%
Income/Loss before income taxes, equity in losses and noncontrolling interests	145	153	(5.2)%
Income tax expense/benefit	40	67	(40.3)%
Equity in losses of unconsolidated entities	1	(10)	
Net Income/loss	104	96	8.3%

Revenues are flattish, the unrelenting pressure on commission splits continues, and things look more or less the same YOY.

And just like in Q1, the 1.7% increase in commissions is troubling when Commission Income went *down* 0.3%.

The NRT's numbers are also flattish, but more troubling.

Table 5: NRT Key Metrics and P&L

	Q3/2018	Q3/2017	
Closed Transaction Sides	94,241	95,236	(1.0)%
Avg. Home Price	513,403	506,418	1.4%
Avg. commission rate	2.44%	2.45%	(0.4)%
GCI per side	13,227	13,142	0.6%
(in millions)			
Revenue	1,268	1,267	0.1%
Commission Paid to Agents	902	887	1.7%
Company Dollar	366	380	(3.7)%
Company$ Margin	29.4%	30.4%	(3.4)%
EBITDA	43	64	(32.8)%

Just as in Q1, over the course of a year, the NRT did *fewer* transactions. In contrast, Redfin increased its transactions by 22.3%. True, that's from a smaller base than the NRT, but in raw numbers, Redfin's agents did 2,349 *more* transactions in Q3/2018 vs Q3/2017. The NRT, the largest brokerage by far, did 995 *fewer*.

Realogy: Calm Patience? Or Inability to Adapt?

To make a short story shorter still, Realogy faces the exact same set of fundamental problems that it did in Q1. Its biggest innovation thus far is to launch two new brands.

This might not be a bad thing.

In *How the Mighty Fall*, Jim Collins lays out some dangers for companies that are facing decline. In talking about *Stage 4: Grasping for Salvation*, Collins warns against the danger of dramatic moves out of panic. He prescribes, instead, a disciplined return to the core competencies that made the company great in the first place.

It may be that Schneider is trying to refocus Realogy on its core competencies. He may be concerned about grasping at straws, like buying a technology company, or undertaking a bold but untested strategy. That would be smart.

What we don't know is whether Realogy is staying the course and doubling down on today's strategy for today's problems out of calm patience, or because it is unable to adapt to the changing environment. If the former, then we should see a renewed focus on core competencies restart growth, strengthen agent loyalty, and reverse the trend towards higher and higher splits. If the latter... well... I guess we'll find out how well Realogy fights in the dark.

Other Companies of Note

What could we learn from them, from a strategic standpoint?

eXp Realty

eXp Realty is a brokerage, not a franchise. I don't cover them in greater detail because they don't do earnings conference calls with analysts.

Having said that... I interviewed Glenn Sanford and Jeff Whiteside, CEO and CFO of eXp respectively, for this paper. And there were some interesting takeaways.

A Brief Look at the Numbers

Let's do a mini-review of the numbers, as we did for Zillow, Redfin and Realogy above.

	(thousands)	Q3/2018	Q3/2017	
Net revenues		157,236	47,372	231.9%

Cost of revenues	145,740	42,904	239.7%
Gross Profit/Company Dollar	11,496	4,468	157.3%
Gross Margins	7.3%	9.4%	(22.5)%
Total expenses, (excl. Cost of Revenue)	16,126	9,780	64.9%
Operating Income/(Loss)	(4,630)	(5,311)	
Net Income/(Loss)	(4,628)	(5,315)	

Agent count grew by 182.8% from 4,900 at the end of Q3/2017 to 13,859 at the end of Q3/2018, which is impressive as all get out in real estate.

John Campbell, a research analyst at Stephens Inc., is one of a few who covers eXp and he thinks that its incredible success with recruiting agents is reason for optimism: agent count drives revenue growth.

That much is true.

Agents Drive Revenue, But Not Profit

The first and most important takeaway is that while agent count drives revenues, it most certainly does not drive profits.

The better an agent, the less money the brokerage makes. As counterintuitive as that might be, that is as true for eXp as it is for Realogy.

Brokerage is a Loss Leader?

One of the more interesting insights to come out of my interview with eXp management is that their long term strategy might have very little to do with agent count or with brokerage revenues or profitability.

Glenn Sanford said that eXp looks at real estate "more like Jeff Bezos at Amazon does—your margin is our opportunity" and said, "We'll figure out how to monetize market share over time."[1]

You know who else says very similar things about the "real estate platform"? Compass.

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[1] Please note that I did not record the phone conversation, and am working off of my notes. The quotes may not be exact word for word.

This is a rather different view of the future of brokerage, and one that is far more in line with Zillow than with Realogy.

If you will, think of Compass as trying to get to a "referral economy platform" from the top-down, while eXp is trying to get there from the bottom-up.

Either way, they're not actually in the brokerage business, but in the landgrab business, reminiscent of dotcoms in the first dotcom era: get the traffic and grow, grow, grow… and we'll figure out how to monetize it later.

HomeServices of America

HomeServices of America, as a division of Berkshire Hathaway Energy, does not report publicly. But some of its information is included in BKE's filings.

The big takeaway is that the numbers confirm that Realogy is not alone in its troubles.

According to the Q3/2018 10Q from BKE, HomeServices had $1.2 billion in operating revenue in Q3, $85 million in operating income and $60 million in net income – margins of 7.0% and 4.9% respectively.

HomeServices acquired $769 million in revenue, but increased total revenue by $750 million, implying organic decline of $19 million.

And earning $6 million *less*, after acquiring $769 million in revenue, suggests that maybe Realogy is in far better shape than one might have thought for traditional brokerages.

What The Future Holds

I'd like to lay out a couple of possible scenarios for the implications of these changes from Q3 of 2018 as they will and should inform my Recommendations as well as your thinking about your own strategies.

The Darkness Comes

The most important development out of Q3 is Redfin's announcement that they will go on a national mass media advertising and marketing campaign.

It is a brilliant strategy. Redfin is built from the ground up to operate at low cost, and have refined their processes and systems over ten plus years. The rest of the industry is not.

It should be obvious that Redfin doesn't actually have to gain much market share or get a ton more business from its marketing. It just has to drive the real estate commission lower for everybody.

We could actually look at what Redfin is doing as similar to dumping: *using price to drive competitors out of the market*.

Redfin has gotten to where it is with 0.85% market share. What does Redfin look like with a mere 5% market?

Survival of the Fittest: Concentration of Power

One of the direct results of Redfin bringing the darkness is, as I have laid out above, that the professional full-time agents in the middle get pushed out.

The industry has already been moving towards a kind of a super-pareto state in which 90% of the agents do 10% of the business, and the top 10% do 90% of the business through their teams. Commission pressure accelerates that process, perhaps inevitably and perhaps inexorably.

This is one reason why I don't think commission compression would actually affect Zillow in the long run. Zillow's business model is already tilted towards the top producers.

Redfin will pick up a lot of that market share, but not all of it; great agents and their teams will pick up the rest.

Zillow As a Player, Not a Vendor

Redfin's strategy will hurt Zillow in the short-term, if it comes to fruition. In the long run, I don't think it does since concentration of power benefits Zillow and its basic business philosophy.

And in that context, Zillow's transformation from a vendor to a player is strategically important.

At the end of the day, only Zillow and Realtor.com have the website, the traffic, the lead flow, and a large enough technology and data analytics team to compete against Redfin.

Ultimately, these super teams that end up taking even more market share become *more* dependent on Zillow, not less.

Whither Brokerage?

Concentration of power is really, really not good news for brokerages.

There are not many choices:

1. Get the technology and the traffic and leads to help agents compete with Redfin;
2. Cut costs dramatically and transform into a Next Generation Brokerage;
3. Make a play for the Platform, as eXp and Compass appear to be doing, and be resigned to running the brokerage at breakeven at best;
4. Sell (or close your doors).

In the end, then, brokerages might divide into those who charge a premium to these top agents in exchange for feelz and those who do not. Target vs. Walmart. Starbucks vs. Dunkin Donuts. Lexus vs. Toyota.

Inflection Point

The combination of all these changes, taken together with Redfin's play, means that the next year or two is an important inflection point for American real estate.

If Redfin and Zillow succeed, the industry is permanently altered. It sets up a rivalry between Zillow and Redfin that will come to dominate the industry going forward.

If they fail, then it becomes further evidence that there is something about real estate that prevents any major changes short of a Black Swan type of an earthquake.

Short of that, real estate does not change, like the land underneath us all.

Recommendations: MLS & Associations

Please read the full Recommendations section for more detail.

- **Wargame the Darkness**
- **The Subscription Fee Model**
- **The Issue of Agent Teams**
- **For the REALTOR Association: Assurance of Quality**
- **Dual Agency and Designated Agency**

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 the earnings calls that these companies conduct with Wall Street analysts are filled with interesting insights.

From time to time, the public information and the public earnings calls by the CEOs reveal something truly significant. Q1 was one of those times. Well, Q3/2018 is another one of those times.

In the June Report, I wrote "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." Well, in looking at Q3, I can confirm that my instincts were mostly correct from June.

But Q3 tells us far more than that. What Q3 tells us is that we are at an inflection point in the industry, and the next year or two will determine whether the new will emerge victorious over the old, or the stalwarts of the industry will prove that real estate, like the land underneath it all, changes ever so slowly and only through earthquakes.

The most interesting takeaway from Q3 comes from Redfin, but we will start with Zillow, who had the most to announce. In any other time, its pivot would be *the* story; this time, it is an important story, but not the headline.

Zillow: From Vendor to Player

It is difficult to avoid hyperbole when talking about Zillow's moves in Q3. Sober Wall Street analysts couldn't do it, as Jim Cramer called Zillow a "land mine" and Marc Chaikin of Chaikin Analytics called the company's business model "ridiculous." Zillow's stock took a nose dive immediately afterwards, of roughly 20%.

Yet, even from my perspective as an industry analyst unconcerned with the ups and downs of the stock market, it is proving impossible to avoid hyperbole.

In short, what Zillow has done is to bet the company on an important strategy, which it has hinted at in recent earnings calls but has contemplated for years. We could call it Premier Agent 4.1, but it encompasses so much more. In includes the new Best of Zillow, which has underlying it the all-important Consumer Experience Report. It includes the Zillow Homes strategy, which includes Zillow's foray into mortgage lending via Mortgage Lenders of America. It includes Zillow Flex, which goes back on years of policy and public promises not to take referral payments.

This is a big risk. And investors are likely smart to take the risks into account. But taken together, these moves represent nothing short of standing up and asserting that it controls the American real estate industry.

I view Q3 as the culmination of a number of trends, a number of predictions, over the course of years. It confirms a number of thoughts from the June Report, when we dived deep into the Q1 announcements, and expands on them in a way I did not see coming this soon. The shape of things to come from Q1 are beginning to become clearer, as if the mist is starting to lift.

Given how careful Zillow's management is about making sure that the data from surveys, beta tests and trial balloons supports major decisions, I can only surmise that their confidence in making these moves is indeed confidence, rather than hubris.

The Numbers

We begin, as always, with the actual numbers themselves.

Table 6: ZILLOW'S Q3/2018 INCOME STATEMENT

	Q3/2018	Q3/2017	%∆
Revenue:			
IMT	332,076	281.839	21.7%
Homes	11,018	-	NA
Costs and expenses:			
Cost of revenue (excl. amortization)			
IMT	26,386	22,152	19.1%
Homes	10,286	-	NA
Cost of revenue (excl. amortization)	36,672	22,152	65.5%
Sales and marketing	128,734	107,108	20.2%
Technology and development	105,314	83,389	26.3%
General and administrative	70,743	54,226	30.5%
Acquisition-related costs	1,405	218	544.5%
Total costs and expenses	353,391	264,093	32.3%
Income (loss) from operations	(10,297)	14,746	(169.8%)
Other income	7,773	1,407	452.5%
Interest expense	(12,668)	(6,906)	83.4%
Loss before income taxes	(15,192)	9,247	(264.3%)
Income tax expense	14,700	(41)	NA
Net income (loss)	(492)	9,206	(105.3%)
Adjusted EBITDA	66,154	70,957	(6.8%)

Because Zillow started breaking out the Homes segment, it's a little bit harder to compare YOY, but still… this isn't a great quarter. To go from a profit of $14.7 million to a loss of $10.3 million likely doesn't make Spencer Rascoff and Greg Schwartz all that happy.

Then again, like usual, much of their expenses (especially in the overhead departments of Sales & Marketing, Technology, and G&A) are stock-based compensation, which totals $111.4 million. So after all the accounting adjustments and whatnot, Zillow posted $102.5 million in net cash from operations… although even that isn't great news since that's a drop of 42%. Ouch.

Still, with almost $343 million in revenues with $36.7 million in cost of revenue, Zillow has gross margins of 89.3% which is astonishing even for a tech company. Most other technology companies have gross margins in the 70% range.

Nonetheless, from a financial standpoint, Q3/2018 was not a stellar quarter. Some of it likely has to do with the slowdown of the real estate markets, particularly in the West, but since Zillow is not a brokerage, the impact of the market should be at least one step removed.

Fact is, the financial wounds were self-inflicted, and quite on purpose.

Premier Agent 4.1 (and 4.0)

The first place to begin is Premier Agent 4.1 – an evolution of Premier Agent 4.0. We'll call these PA 4.1 and PA 4.0 going forward.

Let me quote from Spencer Rascoff's Q3 Shareholder Letter:

> Our third quarter Premier Agent revenue was lower than our guidance because of higher-than-expected advertiser churn. We made big changes to the Premier Agent program, and they were not all well-received by our advertisers.
>
> First, we introduced new changes to our model just as agents began feeling a high amount of strain from three factors: 1) cost-per-lead increases resulting from growing demand in the auction-based pricing model; 2) pressure on home sales from a slowing market; and 3) seasonality in the back half of the year when real estate typically slows.
>
> Second, we prioritized quality of leads over quantity. Regardless of lead quality, many agents tell us that they also value a higher quantity of leads. Both the timing and effects of our changes drove higher advertiser churn, despite continued strong sales. [Line breaks added for legibility]

That's really not good, given that some 70% of Zillow's revenues come from Premier Agent. "Advertiser churn" really means that a whole bunch of agents canceled their Premier Agent programs, forcing Zillow to have to go find someone else to buy impressions in affected zip codes.

So what happened?

The short answer is that PA 4.0, announced in the Q2 Shareholder Letter, changed the way that Zillow delivered leads to its Premier Agents. Instead of sending along an email with the lead's information, with PA 4.0, Zillow would contact the consumer, qualify them, nurture them, and then contact the Premier Agent by telephone to do a warm handoff only when the consumer is ready to meet with a real estate agent.

The idea was that it would significantly raise lead quality at the expense of lead quantity, but that the tradeoff would be worth it for both the consumer and the paying Premier Agent customers. From the Q2 Shareholder Letter:

> In April, we launched a test of our new consumer lead validation and distribution process for Premier Agents and Brokers. **Real estate agents value higher quality leads over quantity**.
>
> Our new process improves lead quality by validating each consumer before connecting them with a Premier Agent, and improves the connection rate by contacting the next Premier Agent in the queue if the first does not answer the phone. This allows Premier Agents and Brokers to **focus their time and energy on delivering superior client service and closing more deals**. [Line breaks and emphasis added]

One of the things that Zillow learned from rolling out PA 4.0 to its Premier Agents, however, was that while real estate agents might (or might not) value higher quality leads over quantity, real estate agent teams valued both quality *and* quantity.

As Greg Schwartz explained in our phone conversation, many of the agent team owners/leaders wanted all of the leads, validated or not, nurtured or not, so that they can keep the agents and ISAs (Inside Sales Agents) on their teams busy. Plus, the people doing the "lead validation" work for Zillow are not licensed as real estate agents, which severely limits the kinds of questions they can ask and the kinds of assistance they can provide to a consumer.[2]

[2] The specific restrictions are based on state real estate law, but generally speaking, unlicensed assistants can gather information, distribute prepared

The major change between 4.0 and 4.1, therefore, is to deliver not-yet-ready leads to Premier Agents who ask for them. The vast majority of those, according to Schwartz, were the top tier agent teams who are some of Zillow's best customers.

Consumer Experience Report (and Best of Zillow)

Tied to, but separate from, PA 4.1 is the announcement by Zillow that it will implement a new Consumer Experience Report. Some media reports out there have called the Consumer Experience Report "CSAT", presumably after the Customer Satisfaction Score (CSAT): The Happy Customer KPI from Emolytics.

Zillow will survey each and every consumer who sends an inquiry and is connected to a Premier Agent. According to Schwartz, this will happen the day after making the connection, two weeks afterwards, and then two months afterwards. The timing corresponds roughly to critical steps in the real estate funnel:

- Next day deals with the actual conversion of the inquiry/lead into a customer, and likely can measure the Premier Agent's personal skills, responsiveness, market knowledge, personality fit, etc.
- Two weeks afterwards likely measures customer satisfaction after the initial bit of working with an agent. An initial meeting, a tour of properties, deciding on an offer, etc. would usually happen within two weeks.
- Two months afterwards likely captures the post-transaction customer satisfaction.

According to Schwartz, this CSAT data will be absolutely confidential between Zillow, the agent, and the consumer. It will be shared only in aggregate form with the agent (or the agent team leader or broker) for specific purposes.

The most important purpose, of course, is to help Zillow's paying customers figure out what they're doing well and what they could be

information, deliver documents, write ad copy, place and remove signs, order repairs, etc. The important thing an unlicensed assistant usually cannot do is answer questions about a property.

doing better, and helping them improve in all three phases: initial conversion to client, initial work with client, and the transaction itself.

There are consequences, however, to CSAT which are revolutionary.

Best of Zillow and the Evolution of Premier Agent

Two aspects of Zillow's announcement are eye-opening. I wrote at length about them in a long blogpost titled, "Things Become Clearer: NAR vs. Zillow; C2EX vs. Best of Zillow." It might save you some time to read that post.

Essentially, if a Premier Agent scores above 90 on the CSAT, he or she will be designated as "Best of Zillow" with additional marketing tools, a new and different badge on your agent profile, and potentially other benefits.

If, on the other hand, the Premier Agent falls below 72 on the CSAT, he or she will be warned, offered coaching and help, given 90 days to improve the CSAT score, and if no improvement is forthcoming, *booted from Premier Agent program*. As Greg Schwartz put it, "From now on, only the best will be called Premier Agents."

This is a big step for Zillow, and a fulfillment of their vision from 2015 (or earlier) about focusing only on the best agents in the industry.

Quality Assurance

This seems a minor tactical adjustment, but it's quite a big deal. In effect, what CSAT and the new Best of Zillow (and the "hit the road, Jack") initiatives do is provide some assurances on agent quality to the consumer.

One of the most difficult problems for the average homebuyer or home seller is trying to figure out the answer to an important question: "How do I know if my agent is any good?"

I asked this question on my blog back in 2009: "What Makes a REALTOR Good?" I have since written about this issue a few times. Ten years later, I still don't have a good answer.

It's a problem that people face with any professional service: How do I know if my lawyer is any good? How do I know if my doctor is competent? How do I know if my accountant is good or bad?

But it's even worse in real estate since the price signal is missing. A bad lawyer with few clients can't charge the same hourly rate as an excellent one who is turning clients away. A world-class heart surgeon costs quite a bit more than your local family doctor.

But the best REALTOR in the country costs the same commission at the close of the transaction as using an incompetent one.

Real estate brokerages and brands can't provide any real assurance of quality, since real estate agents are not employees (with the significant exception of Redfin) and cannot be controlled.

NAR with its REALTOR brand cannot assure quality, since just about every single licensed broker and agent is a REALTOR. When everyone has the brand, no one has that brand.

There have been numerous attempts by third party companies to provides some kind of quality assurance about real estate agents, from RealSatisfied, Quality Service Certification (QSC), and others. None have worked all that well, because they were bought by the agents being certified/measured and used as marketing tools.

With Zillow's CSAT, for the first time in the history of residential real estate, there is a quality assurance standard that is (a) objective, (b) measurable, and most importantly, (c) **enforceable**. There are real consequences to the real estate agent in failing to live up to Zillow's standards.

From a psychological and cultural standpoint, it is hard to underestimate just how big a move this is for anybody in the industry to pull off. That it is Zillow who pulls it off is indeed news.

Zillow Flex

And then you have Zillow Flex, first announced in September in a blogpost by Greg Schwartz:

> Which is why we've decided to test a new payment model for our Premier Broker program called Flex Pricing.

> The test, which is launching in Florida in October, will meet the need for more flexible payment options for our broker partners and introduce a "performance advertising expense" payment model.
>
> As part of this model, participating brokers and their agents will receive a limited number of connections to home shoppers at no upfront cost. If you make a sale from a connection we deliver, a percentage of that – the performance advertising expense – is due *only* when the transaction closes.

Basically, Zillow Flex is Zillow taking a percentage of the Gross Commission Income (GCI) as a referral payment. Speculation is that Flex pricing will be in line with industry practices, with 25% being common in agent-to-agent referrals. According to customers, OpCity, recently acquired by Move, Inc., charges 30%, as does Redfin, according to Partner Agents. Relocation companies charge as much as 48%.

At the risk of sounding repetitive, this is a very big deal.

First, it is a departure from longstanding promises by Zillow not to "cross the fence" between media company and brokerage. Certain past executives of major real estate companies, such as Richard Smith of Realogy and Dave Liniger of Re/Max, had stated in no uncertain terms that if Zillow starts taking referral payments, "We are at war."

With changes in leadership, Realogy and Re/Max appear to have accepted Zillow taking referral payments. It is not so clear whether companies who have not had a leadership change, such as HomeServices of America, Keller Williams, Howard Hanna, and others feel the same way.

Second, Flex has the possibility of significantly increasing Zillow's revenues from Premier Agent.

In his Q3 earnings call, Spencer Rascoff mentioned that Zillow estimated generating $6.5 billion in commissions for Premier Agents in 2017. Zillow's full year 2017 revenues were $1.1 billion. For the sake of discussion, let's assume all of that was from Premier Agent and ignore all of Zillow's activities in rentals, mortgage, etc.

That means Zillow captured 15.5% of the GCI of its Premier Agents. If Zillow had all of its Premier Agents under Flex in 2017, at the agent-to-agent industry standard rate of 25%, Zillow's revenues would have been $1.625 billion. At a 30% referral fee (in line with OpCity and Redfin), Zillow's revenues would have been $1.95 billion for 2017. That's almost double what Zillow actually posted for 2017.

But third, and perhaps most importantly, Zillow Flex is *inevitable* once you move to a CSAT-powered Best of Zillow type of a framework. At the same time, Flex is impossible without a CSAT-powered Best of Zillow framework.

Say you're Zillow with PA 3.0. You get paid ahead of time for email leads. Sure, you want your advertisers to get a ROI so they would renew and perhaps not mind so much if you raise the cost of advertising. But as long as you sent them leads, whether they convert or close on those is on them.

On the other hand, if you're Zillow with PA 4.1 and Flex, you get paid only when your Premier Agent gets paid. Now you care a very great deal, a very great deal indeed, about whether the Premier Agent is actually going to convert that lead, service the client, and close the deal. CSAT lets you know who is more likely to do that.

At the same time, if you know which Premier Agents are likely to convert and close on a lead, you're leaving money on the table by charging them a lower up-front advertising fee instead of taking 25-30% of the commission income.

Zillow Homes (and Mortgage)

The final piece of the jigsaw puzzle is Zillow Homes, and the closely related initiative of Zillow's move into mortgages.

We have already spent many thousands of words on Zillow's move into iBuyer in the June, August, and September Red Dot reports. But it is worth highlighting (and repeating) a couple of ways in which Zillow Homes intersects with the rest of Zillow's pivot.

Zillow Homes and CSAT

In April, I wrote a post that appears prescient with 20/20 hindsight, entitled, "No Hat, Lots of Cattle: In Which Zillow Transforms". One of the things I wrote then seems directly on point here: that

Zillow's incentives change once they are taking on the risk of buying and selling homes on their own account.

> That incentive *changes completely* once Zillow is an actual participant in the deal.
>
> Zillow thinks that it will have purchased 300-1,000 homes in the Instant Offers markets of Orlando, Phoenix and Las Vegas by the end of 2018. The median price of listed homes across all three markets is $275K. That means Zillow has as much as $275 million in inventory risk, as well as enormous upside if they can buy at $260K and sell at $290K.
>
> Now, *Zillow cares very much whether the Premier Agent they are using to buy and sell those properties actually gets shit done or not*. The risk isn't only on the Premier Agent as the advertiser; in fact, Zillow has most of the risk now as the homebuyer and as the homeseller.

That still seems correct to me. Just like any other home buyer or home seller, Zillow has enormous incentive to work with the best of the best. The Best of Zillow, even.

The same analysis goes for the listing leads that Zillow Homes are going to generate. In the June Report, I noted that Zillow's foray into iBuyer will create a waterfall of cash in the form of seller leads.

Spencer in his Q3 earnings call said:

> To answer your second question about seller leads from Zillow Offers, we have just started in the last two or three weeks, testing monetizing seller leads through Zillow Offers. **We're now passing those leads to agents and brokerages on a success fee**. It's too early to share results because we just started. We think there's a lot of potential in this business. And to give you a data point or two to understand my interest in this, about 45% of consumers that go through the Zillow Offers funnel end up listing their home overall. So about 20% of them end up listing in the first two months after asking for us to make an offer. And another 25% end up listing a couple months later. **So these are serious home sellers, and if we can succeed in connecting those whose homes we don't buy with real estate agents, then this should over time become a really nice revenue stream for Premier Agent that hangs off**

> **Zillow Offers**. But we're only two or three weeks into it. [Emphasis added]

The seller leads from Zillow Homes is already being sold on a "success fee" basis, i.e., Zillow Flex. That means ensuring that such leads flow to Premier Agents who are going to convert, service and close those deals.

Getting that 90+ CSAT rating has rewards beyond advantages in marketing and a badge. Conversely, losing one's Premier Agent status by falling below 72 could be disastrous. Just getting close to the bottom could be problematic, as there will be less and less incentive in a Flex-based Zillow to send such leads to not-great agents.

Zillow's Strategic Problem

There are other fascinating details in the Q3 results, but the items above are the real big stories. Taken together, they represent a major pivot by Zillow as a company and an inflection point for real estate as an industry.

These big initiatives as tactics to address Zillow's strategic problem, which became clearer in Q3.

Bradley Safalow at PAA Research has long been a Zillow bear, but a perceptive and fair analyst. I've known about and read his work for years, and find his research to be provocative and interesting, even if I disagree with some of his conclusions.

In his latest report, based on the 9th annual survey of 380 real estate agents, Safalow lays out his case against Zillow:

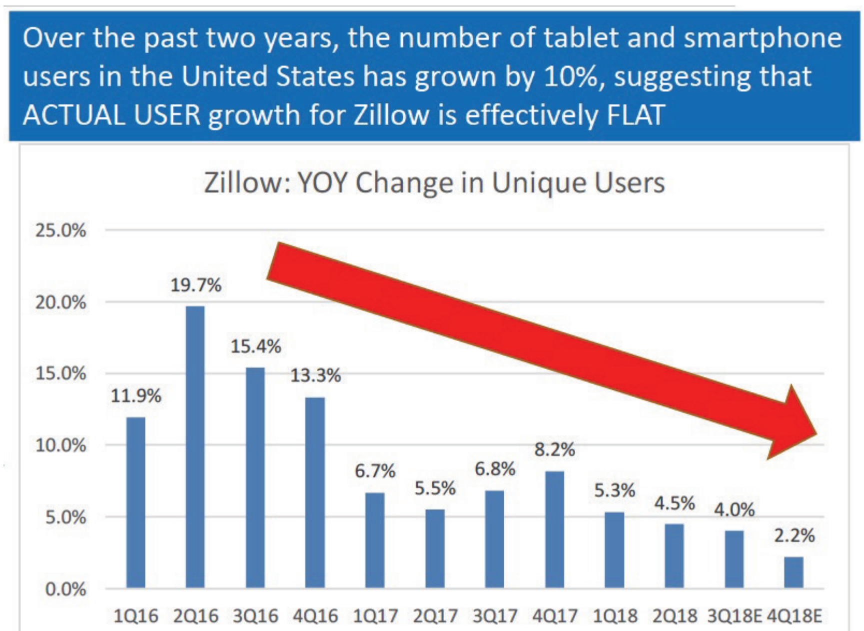
1. A smaller total addressable market (TAM); $2-3B rather than $12B estimated by Zillow management;
2. Slowing traffic growth, and competition from Redfin, Facebook, Realtor.com, and others; without traffic growth, Zillow's growth collapses;
3. Zillow is a broker in all but name, with high marketing, technology, and call center expenses; margins should be similarly low;
4. Lead quality has not improved and remains a persistent issue;

5. ARPA growth is not sustainable without traffic gains. Zillow is in a desperate rush to improve lead quality and conversion rates before slowing traffic impairs growth for the Premier Agent biz.

It should also be noted that Safalow doesn't think much of Zillow's foray into iBuyer, calling it a "disastrous initiative." Obviously, I disagree on that point.

Where I agree with Safalow is that Zillow traffic growth has slowed, and that Zillow very well may be getting to saturation point. After all, Zillow's Q3 average monthly unique users was 186 million. The population of the United States is 325.7 million. Even allowing for multiple devices per person, different browsers, etc., given that there are only about 5 million homes sold in a given year, it is difficult to imagine that there remain millions of people left for Zillow to reach.

True, Zillow still posted a 7% YOY gain in average monthly visitors, but it's hard to argue with PAA Research when it concludes that actual user growth has been flat:



And as we learned in the Q3 Shareholder's Letter and the earnings call, there are real limits to Zillow's pricing power as it comes to online leads even to their most loyal Premier Agent customers. Why else would Zillow have implemented "auction pricing caps in certain zip codes to help improve agent ROI"?

The strategic problem for Zillow, then, is *how to increase revenues and profits if the top of the funnel (traffic and leads) is maxed out*. There are only so many people looking to buy or sell a house; if you've maxed out, how do you keep growing revenues?

The tactics to solve that strategic problem are many and varied. Just off the top of my head:

- Increase the TAM, for example, by expanding internationally;
- Improve the product enough to warrant a higher price;
- Create more of the same product to sell;
- Create new products to sell;
- Take risks and charge for the risk;

Zillow chose to do all of the above, at the same time.[3] That, in essence, is the pivot that Zillow made starting in Q2 and really implemented in Q3.

Or, as Spencer Rascoff put it in the Q3 earnings call:

> In 2018, we pledged to create better experiences for consumers as we accompanied them further down the funnel and closer to the transaction. We also said that we would evolve our business models to better align our results with our industry partners. These were big promises and we kept them. Consumers using our platforms deserve a better experience. Now we're ensuring that from searching listings all the way through closing on their dream home. Our industry partners deserve high-quality validated leads. The changes we're making to our Premier Agent program are already dramatically improving connection rates and we're now shifting our focus to helping agents increase conversion of those connections into transactions.

PA 4.0 is intended to improve the product to warrant a higher price; many Zillow Premier Agents are happy to pay a higher per-lead price, because they are far more transaction-ready.

[3] We're not going to cover Zillow's international expansion into Canada, as it is far too early, a bit too small a market, and as yet unclear whether that expands the TAM or simply creates a whole new TAM.

PA 4.0 is also aimed at creating more of the same product to sell, by addressing one of the most difficult problems for real estate portals: responsiveness. Spencer addressed it in his comments:

> Sure. Thanks, Ron. So the changes that we made to Premier Agent with 4.0 and 4.1, although painful this quarter and you see it in our guidance, position us very, very well for 2019 and the buying season because **we have just solved the leaky bucket of our lead connection rate from a 49%, I think, it was response rate, to nearly a 100% response rate**. And that – and we've improved the consumer satisfaction of the experience dramatically.
>
> So that to me is the big story here, which I know in the hand-wringing around Premier Agent revenue in Q3 and Q4 might get lost, but for me it's hard to lose sight of the importance of that. [Emphasis added]

On the one hand, if an inquiry on Zillow leads to contact with an agent only half the time, that is a horrible consumer experience. Zillow had to address that issue if for no other reason than to protect its brand with consumers.

But on the other hand, if Zillow has maxed out its traffic, which means it has maxed out its lead generation capabilities, then recovering half of the unanswered leads has a giant impact on the topline.

In September, after Move acquired OpCity, Mike DelPrete of Adventures in Real Estate Tech wrote an article for Inman News breaking down Zillow's Lead Qualification Opportunity using FY16 lead numbers, OpCity's 4% conversion rate, and a 30% referral fee, and concluded that those 17 million leads are worth $1.4 billion in revenue to Zillow.

Let's use that same template, but assume that 17 million leads in FY16 with 140 million monthly uniques would translate to 22.6 million leads in FY18 with 186 million monthly uniques.

	Pre PA 4.0	Post PA 4.0
Monthly Traffic	186 million	186 million
Leads Generated	22.6 million	22.6 million
Leads Responded To (50% vs. 95%)	11.3 million	20.3 million

Conversion Rate	4%	4%
Average Home Price	$250,000	$250,000
Agent Commission	2.75%	2.75%
Referral Fee	30%	30%
Value Per Lead	$2,063	$2,063
Total Value	$931.7 million	$1,770.2 million

Just by responding to consumer inquiries, Zillow could see dramatic growth in its revenues from Premier Agent, especially using Zillow Flex as the pricing model.

That's creating new products from the same (and maxed out) traffic.

Zillow Homes and the seller leads it provides is creating new products to sell. The Mortgage product is creating new products to sell.

Zillow Flex is classic risk-shifting from the advertiser to Zillow. And of course, buying and selling homes directly is taking on huge risks for potentially huge rewards.

But all of these things are intended to address Zillow's strategic problem: the traffic is maxed out. Now what?

Zillow is Transforming

The answer is to become something other than an ad-supported media company, which is essentially a vendor of leads. Zillow is transforming into something else.

Bradley Safalow of PAA Research calls Zillow a broker in all but name in his "Short Thesis" segment:

> "**Zillow is a broker in everything but name; margin expansion should continue to disappoint**. Zillow structurally has evolved into a "broker" with high marketing spend, technology expenses, and call center support – why should the company's margin profile be different?" [Emphasis in original]

He's not far off the mark. With all of the already announced initiatives, Zillow *is* transforming, but not into a brokerage.

In order to make sense of what Zillow is becoming, it is necessary to make a short digression into contemporary brokerage.

The Truth About Contemporary Brokerage

Most people outside the real estate industry do not know, and most people within the industry do not want to admit, that the modern real estate brokerage is not in the real estate business: it's in the B2B business of recruiting, servicing, and retaining real estate agents.[4]

The prevailing mindset has long been that the real estate agent works for the brokerage as an independent contractor. The truth is that the relationship is closer to that between a vendor and its customer, with many brokerage CEOs admitting it in recent years. Robert Reffkin, CEO of Compass, is one such person who was asked about his company's aggressive recruiting tactics and dismissed it saying that you can't recruit customers, and agents are customers.

So if "recruiting" is actually "sales", then one might ask, what is it that the brokerage is selling the agent? There are, of course, a limitless list of value propositions, but at a high level, they boil down to four broad buckets:

- Leads
- Technology
- Training
- Legal & Compliance

Legal and compliance services are required by state real estate license laws, and every brokerage must offer them. It matters not that the brokerage might think of itself as "supervising" its agents; the reality is that the agents can get such "supervisory" services from any licensed broker.

Furthermore, every brokerage has to offer leads, technology and training in some form or fashion. They are table stakes to play the brokerage game, much like "clean beds" are table stakes to be in the hotel game.

[4] I have gone into some depth about this topic in the October Red Dot: Next Generation Brokerage if you are interested in more.

Training is a funny value proposition: its value decreases as the agent becomes more productive. No experienced agent is going to pick a brokerage because it offers great training, with an exception for teams, which we'll discuss below. And the training offered is very rarely product training, process training, or real estate training. It is overwhelmingly focused on lead generation and sales techniques.

Over the past couple of decades, the most important shift in the industry has been the rise of the agent team, which has taken over much of what a brokerage used to provide. Agent teams conduct their own training, for example, unless the brokerage (or someone else, like the REALTOR Association) offers similar basic training to new agents.[5]

In short, the contemporary brokerage is a business services provider to agents and agent teams offering leads, technology, training and legal compliance services.

Zillow Excels at Leads and Technology

It is not debatable that Zillow beats the pants off of brokerages in providing leads and technology.

Training is of little value to the type of agents that Zillow has targeted as its market: the top producing agents, and especially agent teams.

And legal compliance is both required by law and a commodity good. Zillow doesn't need to provide it, and it has zero incentive to do so.

With Zillow now offering Zillow Flex, the economics of being a Premier Agent looks a whole lot like joining a brokerage: either pay a (lower) fee up front, or pay a percentage of commissions on the back end.

[5] This is the context in which an agent might look for great training by the brokerage, but even so, the good teams would supplement the basic training with its own far more practical training centered around their own processes and systems

Zillow Has a Living Brand

At the same time, Zillow has a living consumer brand. By "living" I mean that the brand actually matters to consumers, and the brand can be enforced.

In a lengthy blogpost after Zillow's PA4 announcement, I noted something interesting from a podcast from Ryan Lazine, a Premier Agent who attended an information session in which top producers were briefed on PA4 by Greg Schwartz.

It turns out that 50% of consumers who fill out a lead form on Zillow thinks that *they are contacting Zillow*.

Zillow's decision to undertake PA4 can actually be justified solely on the ground of defending Zillow's consumer brand. 51% non-response rate from Premier Agents (as cited by Spencer Rascoff above) means that almost *25% of consumers think that they are contacting Zillow and not getting a response*. That is unacceptable to any company that gives a damn about its brand.

CSAT and Best of Zillow naturally flow from the need to defend Zillow's consumer brand. And those provide Zillow with the ability to enforce its brand promise.

In contrast, brokerages not named Redfin have a dead brand, in that their brands do not matter to consumers and the brand promises cannot be enforced due to the fact that their agents are not partners or coworkers, but *customers*. Indeed, brokerages have industry-focused brands that might or might not be meaningful to real estate agents, but are certainly irrelevant to consumers.

Interestingly enough, agent teams often have living brands, as most teams arise out of a superior individual agent's network and efforts. Quite literally in many cases, that agent's name is at stake when the team works with a client. Accordingly, the teams enforce their living consumer brands on their team members.

How? At the end of the day, the agent team controls the flow of leads and access to technology and systems for making money.

So does Zillow.

Zillow Is Transforming into a Team of Teams

Taken together, this means that Zillow is not transforming into a brokerage but into an *agent team*. Perhaps put more precisely, it is transforming into a Team of Teams.

That is an ever-so-slight difference from Bradley Safalow's take, but it is an important distinction.

For one thing, the expected margin erosion that Safalow predicts may not necessarily come to pass because Zillow is not a brokerage in all but name, but a super Team of Teams in all but name.

Agent teams normally command 50/50 splits (or better!) with the agents on the team because the team provides Leads and Technology. That's not quite Zillow's astonishing 89% gross margin numbers, but it isn't in the same league as margin problems of brokerages.

What it means in the short to medium term, strategically, is that Zillow and Redfin are converging. In the long run, it merely means that both are continuing their march towards the Iron Throne: becoming **the** Real Estate Platform.[6]

Zillow's New Exposure to the Market

Where Safalow is on the money is that like agents, agent teams and brokerages, Zillow is now exposed to housing market risk.

Whether it's called a commission split or a referral fee, Zillow's revenues are now tied directly to the housing market. One can argue that they were always tied to the housing market, but when Premier Agents were paying an up-front fee, the tie was at least one step removed. If the market dropped, the issue was going to be whether Zillow's customers – top producing agents and teams – would continue to pay for advertising and leads.

Going forward, between PA4, Flex, and iBuyer initiatives, if the housing market drops, then Zillow's revenues will drop in step.

Suppose a team spent $10K a month on Zillow in 2018, generating a 6X return, or $60K in commissions each month.

[6] I wrote an entire Red Dot on this, so please review the September issue.

In 2019, the market softens, and though the team does the same number of transactions, housing prices have dropped 20%. That team is now generating $48K in commissions from the same work.

Under PA3, that team could decide to reduce its Zillow spend, but why would it? Zillow is doing its job delivering the same number of leads for the same number of transactions. The ROI might be reduced, but it's still a 4.8x return.

Under PA4 and Zillow Flex, that team could be on a 30% referral payment to Zillow. Zillow's revenues go from 30% of $60K (or $18K) to 30% of 48K ($14,400) because prices have dropped 20%. The team doesn't change its level of business, but Zillow's revenues have dropped in lockstep with the drop in housing prices.

Granted, the new amount is still more than the $10K per month under the old fixed up-front system, but the point is that Zillow is now exposed to market risk in a far more fundamental way than before.

Perhaps more worrisome, and this is something Safalow really emphasizes in his analysis, is the prospect of the real estate industry as a whole shifting to a lower commission environment. Pricing pressure on the industry as a whole now has a direct impact on Zillow; it had an indirect impact before.

We will revisit this issue further below.

Zillow Asserts its Power

For investors, all of this uncertainty is worrisome. And Zillow's share prices have taken a nosedive since the Q3 earnings release. Tons of people are talking about it, thinking about it, and making ginormous bets based on where they think Zillow is going from a financial/investment perspective.

As you know by now, we're going to take a different slant. If it ends up informing investment decisions, well, so be it, but that isn't what we do here, so it isn't what jumps out at us.

What does jump out at us looking at everything at a strategic level is that Q3/2018 is when we can truly say that Zillow has finally taken a stand and asserted its power in (and possibly over) the real estate industry in the United States.

Take the PA4 initiative. Yes, Zillow had to change its mind and go to 4.1, in which it would send the non-validated leads to agent teams who ask for them. But the fact remains that Zillow has decided, for a number of good reasons, to be the *initial point of contact* for the millions of consumers who inquire about a house.

In the June Red Dot, I talked about "The Home Depot Effect" and wrote:

> 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.

Well, that tomorrow was only two quarters away.

The true significance of this pivot is that Zillow felt confident enough to make it in the first place.[7] The pivot was not without significant risks.

[7] On the other hand, if half of the consumers filling out the lead form thought they were contacting Zillow, perhaps it wasn't that big a risk.

There was a nontrivial chance that Premier Agents would have balked at going from an advertiser on Zillow to something more like a local service provider to Zillow's clients.

There was a decent chance that brokers and agents would have responded to Zillow Flex with rebellion. Brokerages could have responded by cutting off listings to Zillow en masse. Agents could have rebelled by terminating their Premier Agent contracts. Neither has happened. Zillow looked at the data, talked to whomever they needed to talk to, and decided that the revolt would be small and manageable.

Similarly, the new CSAT and Best of Zillow programs carried a huge element of risk. It was not a given that Premier Agents would accept being "graded" by Zillow and being told whether they were good enough or not.[8]

Once again, Zillow decided to take the risk.

The entire pivot is an assertion of power, of Zillow standing up and declaring that they have arrived, and the industry had better deal with it. Sure, Zillow takes on some additional market risks, but its management obviously feels that they can do just that.

It's a subtle change, and one that is hard to see from outside the industry, but in effect, Zillow's relationship to the industry is forever altered. Zillow is no longer a vendor, but a central player in the transaction cycle.

[8] It seems to me a distinction without a difference that Zillow would grade the Premier Agent based on consumer feedback, since Zillow would be the entity sending out the surveys and asking the questions.

Redfin: Bring the Darkness

In the June Red Dot, I wrote that it's a mistake to underestimate Redfin. It is safe to say that Redfin has not let me down for making that warning.

If Zillow made a huge pivot, then Redfin is doing something come 2019 that could make all of us remember Q3 as **the** moment when we knew.

Redfin, born in the dark, will bring forth the darkness to fight in the dark. That's a fight that it is confident it can win, even against the biggest and baddest of competitors.

But let us begin with the numbers.

The Numbers

The Q3 results for Redfin were a mixed bag. On the one hand, Redfin's margins took a beating. But on the other hand, Redfin kept growing traffic, revenues, and market share in a weakening market environment.

Table 7: REDFIN'S Q3/2018 INCOME STATEMENT

	Q3/2018	Q3/2017	%Δ
Revenue	140,255	109,479	28.1%
Cost of revenue	97,950	70,166	39.6%
Gross Profit	42,305	39,313	(16.0)%
Costs and expenses:			
Technology and development	14,310	11,483	24.6%
Marketing	8,236	5,588	47.4%
General and administrative	16,470	11,995	37.3%
Total expenses	39,016	29,066	34.2%
Income (loss) from operations	3,289	10,247	(67.9)%
Net income/loss	3,475	10,558	(67.1)%

Revenue growth of 28.1% YOY is nothing to sneeze at, but a 16% decline in Gross Profit is a real reason for concern since Redfin has always been a real estate brokerage.

In fact, across the first three quarters of 2018, Redfin's Gross Margins have been consistently below the 2017 numbers:

Q1/2017	10.7%	Q1/2018	7.1%	(33.1)%
Q2/2017	35.2%	Q2/2018	31.7%	(10.0)%
Q3/2017	35.9%	Q3/2018	30.2%	(16.0)%

No doubt these margins are the result of Redfin's massive hiring in Q3 of 2017 coupled to the "fewer clients, more success" strategy from Q1, since the average number of transactions per lead agent fell from 10.2 in Q3/2017 to 9.2 in Q3/2018. Nonetheless, it is a number that we need to pay attention to.

That is especially true since Kelman said during the Q3 call that Redfin plans to increase the cap on clients as he felt that the agents are now ready to take on more work:

> So we think there is some upside in agent productivity, because our agents really have learned new habits around meeting customers and we've built really good systems to drive performance and close rate.

The other Key Metrics look pretty good:

Table 8: REDFIN KEY METRICS

	Q3/2018	Q3/2017	%Δ
Monthly average visitors	29,236	24,518	19.2%
Real estate transactions			
Brokerage	12,876	10,527	22.3%
Partner agents	3,333	3,101	7.5%
Average number of Lead Agents	1,397	1,028	35.9%
Value of transactions (Volume)	7.7 billion	6.3 billion	20.7%
U.S. Market Share (by Value)	0.85%	0.71%	19.7%

Nearly 30 million monthly uniques is nothing to sneeze at. Redfin still has a long way to go before it caps out its funnel as Zillow has, especially since it is not in every market in the U.S.

A 22.3% YOY growth in the number of transactions, and a 20.7% growth in Sales Volume numbers are also impressive, given the slowdown in the housing market.

So all in all, the negatives are all things that one should expect given Redfin's dramatic increase in hiring lead agents, while the positives are semi-unexpected given the warning bells that Redfin has been ringing for a couple of quarters now.

In June, I wrote that 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. In Q3, Redfin shows us that they not only understand the future, they plan to create it.

Redfin's Growing Confidence

Consider that Redfin was one of the earliest companies to sound the alarm about the slowing housing market, back in Q2. In Q3, that appeared obvious to everybody.

Here's Glenn Kelman talking about the market during the conference call:

> In our last call we said that the market was weaker than most analysts realize, especially in high-priced coastal cities. Since then, rising rates and high home prices have caused buyers to become cautious industry wide, a trend that we believe will continue if not strengthen at least through November.
>
> Our agents report that more customers are comparing their likely mortgage payments with rents, especially in markets like Seattle, Chicago, and Denver, where many of the newly built properties have until recently been for rent, not for sale. September sales in Seattle, San Jose, Sacramento, Los Angeles, and Orange County fell industry wide 20% or more. Across the 88 markets that Redfin serves, the percentage of all listings that accepted an offer within two weeks of reaching the market was higher at this point last year than now. And the percentage of listings that drop their price was lower last year indicating that sales and prices are unlikely to strengthen.

One would expect that a brokerage company, especially one with employee agents who have to get paid no matter what, would be in a batten down the hatches mode if the market is truly slowing that much.

Instead, Redfin announces that it's going to go on a massive spending spree on consumer advertising:

> After four years of spending between $4 million and $13 million on mass media ads in 5 markets to 13 markets, we plan to spend $40 million to $60 million on mass media in 2019 across 20 plus markets. This will increase both the breadth and depth of our advertising. 8 to 10 of those markets will get mass media ads for the first time in the media and our 10 largest markets will have at least 25% more reach and frequency than in 2018.

Kelman does the signature "we've looked at data from years of experimentation" thing, talks about how Redfin is going to take an engineering-style approach to advertising rather than "branding voodoo and a Taco Bell sized budget." As a former marketer, I was laughing out loud at that phrase.

Redfin can bet $60 million on mass-media advertising because its business model, its systems, its technology, and its processes all add up to a massive competitive advantage over other brokerages:

> Just as important, we believe that telling the world there is a modern way to buy or sell a home can increase customers affinity for Redfin, for years to come. **The basis for our plans to get the industry's highest return on advertising is the decade we've invested in differentiating our service. Other brokerages can advertise, but what can they promise potential customers when each agent at that brokerage sets their own service level and pricing.**
>
> At Redfin our listing agent's charge about half the typical fee to sell a home. We set up a digital marketing campaign for each listing and let each customer see the results online. We sell homes faster for more money, we use technology to get buyers into homes first and to make an offer first.
>
> We are the only major brokerage to employ our agents rather than relying on franchises and contractors. So we can organize the whole Company around what's best for the customer. Our customer satisfaction scores are 50% higher

> than traditional brokerages. Our repeat rates are 69% higher. [Emphasis added]

As a result, even with the market slowing down, which would mean serious pressure on revenues and profitability, Redfin is going to spend money on advertising. Serious money on advertising at that.

This final paragraph of the prepared statement is one brimming over with either confidence or hubris:

> Regardless Redfin will be ready. This earnings call has told two stories of a market at least in temporary retreat and have **a company with the widening competitive advantage**. The discipline that lets us sell homes for more money at lower fee is even more important now. And the true measure of that is our continued share gains. [Emphasis added]

We've gone over in depth what those competitive advantages are in the June Red Dot. None of those have changed. If anything, they're proving themselves in a tougher market environment.

On the Consumer Awareness Campaign

In the Zillow section above, I wrote that Zillow is becoming something more like an agent team, or a Team of Teams. Since many of you already know that I have written that Redfin is not really a brokerage but a giant agent team, the implication is that Zillow is becoming more like Redfin.

Well, Redfin's big bet on advertising means that Redfin is becoming more like Zillow: a national **brand**, not just a brokerage.

Of course Redfin already has a brand, a living brand, that means something to consumers and can be enforced and protected – just like Zillow has. When Glenn Kelman talks about "organizing the company around what is best for the consumer" he means that Redfin can make a brand promise and deliver on it.

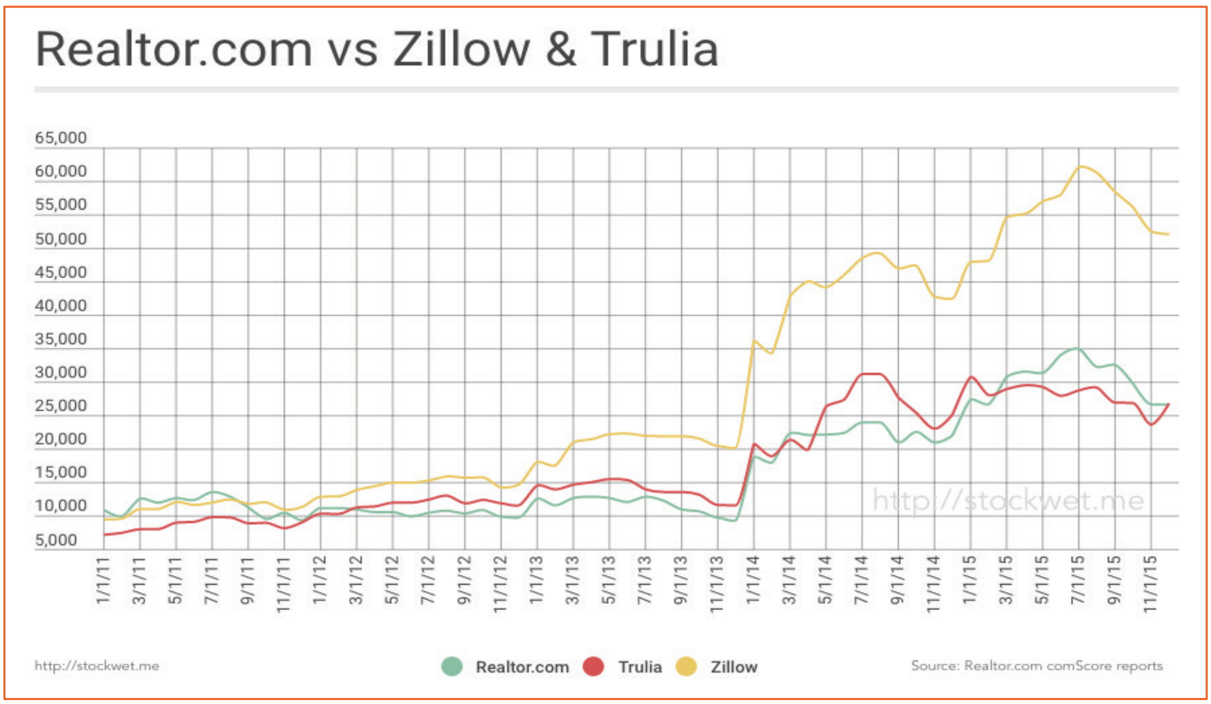
But by his own admission, Redfin has never been a major real estate brand, not even in their own backyard:

> In May 2018 survey, thousands of home buyers and sellers in the markets we serve, only 8% named Redfin as one of the

> first three brokerages that come to mind, up from 4% in December 2016. The highest awareness was where we've advertised the longest and had the highest listing share, in our hometown market of Seattle at 19% and in the Washington DC area at 13%.

I'd bet that those awareness numbers are just about where Zillow's were in 2013 when it started its massive investments into consumer advertising and branding campaigns.

There are numerous reasons why Zillow grew to be the dominant real estate portal over its two main competitors, Realtor.com and Trulia, but one of those reasons was its spending on advertising. Take a look at this chart from Stockwet:



Of course, Zillow acquired Trulia in 2014, and there are reasons other than TV commercials for Zillow's success and growth, but Zillow itself saw the advertising as important for its growth. From the 2013 Annual Report:

> Next, after years of vigorous field testing, we began large-scale national advertising in early 2013 on television and across other complementary channels. As a result of these advertising efforts, our traffic has grown to 54.4 million average monthly unique users for the three months ended

> December 31, 2013, an increase of 57% compared to the three months ended December 31, 2012. The majority of our traffic and brand awareness comes direct, not dependent on search engines, with demonstrated consumer intent to visit the Zillow brand.

Redfin will now pursue the same strategy and grow consumer awareness of its brand.

Unless Glenn and his team screw up execution, chances are that the outcome will be similar for Redfin as it was for Zillow. It's not a short-term play, as Glenn makes clear, but it is a huge ongoing investment for the long haul:

> If we were only advertising for a result in 2019, I think we would be more careful about the timing. We certainly do want to see a result in 2019 and I think we'll be sensitive to which markets we advertise in, because there has been such a shift away from some of the coastal market. But we're advertising for long-term awareness gains.
>
> When I look back at how differentiated the product is, how much customer preference there is once customers have awareness, my main reaction is that, we should have done this a long time ago. And I'm really glad that we're doing it now. So, I think we will see modest improvements in 2019 growth rate over 2018 and longer-term significant benefits. So it's a good investment to make.

For most of its history, apart from a couple of turbulent years right at its birth, Redfin has been content to fly beneath the radar. Despite being a Top 5 brokerage by transactions and by volume, Redfin didn't report to industry reports like Real Trends 500. Redfin was happy to let the industry think that it was just a weird little venture-backed money-losing brokerage with a nice website for over a decade.

No more. That all stops when Redfin starts dropping $60 million in advertising in 20 major metro markets, especially with its low-cost appeal. The "1% Listing Fee" will be prominent, unless the market changes enough to be a buyer's market, in which case the messaging will likely focus on how much money buyers will save by using Redfin agents.

Just like Zillow's moves in Q3 represent Zillow taking a stand and asserting power, with full confidence in its abilities, I regard Redfin's coming out of the shadows as a sign that it is now utterly confident that the industry can do very little to truly harm them.

Indeed, it's quite the other way around. Redfin may be powerful enough now to start inflicting real pain on the industry.

Pressuring the Commission

The real potential for disruption from Redfin is that it will be able to *permanently alter the commission environment* in the United States. Once changed, that environment will prove extraordinarily difficult to change back.

One of the more interesting takeaways from Bradley Safalow's work at PAA Research is the conclusion he reaches that no company in real estate has gained more consumer mindshare in the last few years than has Redfin. And he observes, "Redfin has achieved these mindshare gains with limited marketing spend. What happens when the company advertises its 1% listing fee on a national basis?"

Safalow is careful not to be dramatic:

> **Redfin could present a deflationary force on agent commissions**. Zillow's Premier Agent revenues are inextricably linked to the current commission structure in the industry. [Emphasis in original]

Since I don't have to be as careful, not being an investment analyst, let me be more clear: **Redfin will put pressure on commissions once it starts mass advertising its low-cost offerings**.

This is neither surprising nor a way-out-there claim. It's obvious.

Bloomberg recently reported on massive discounts and incentives that homebuilders were offering to try and move higher end homes. Contained in that story was this paragraph:

> His own sales are half what they were in 2016. In many cases, he's rebating to customers all but $1,000 of his commission on each home sale. He walks into an Indian restaurant for lunch and looks up at the television screen. **A competitor, the "Maximum Cash Back Realtor," says he'll take only $750. "You know what that means," Konara says. "I'll have to do the same."** [Emphasis mine]

It's hard to imagine anything less surprising than having to match the price of a competitor offering more or less the same service.

In markets where Redfin has been around the longest, and have been advertising its "1% Listing Fee", brokers and agents have already been feeling the pressure. There is no reason to think that pressure gets less if Redfin spends *more money* on billboards, TV commercials, radio, and online advertising.

Accordingly, the industry's expectation should be that Redfin will put tremendous pressure on commissions, at least on the listing side and likely on both the listing and the buy side. Don't forget that Redfin still offers rebates to buyers; just not as much as before in the current market environment.

And yet… the response from brokers and agents will be to dismiss the advertising campaign and Redfin out of hand.

The real estate industry has always dealt with "discounters". And none of them ever have changed the commission environment all that much.

For example, just about everyone who was in the industry during the 00s remembers Foxton's, which roared onto the real estate scene in 2000 and filed for bankruptcy in 2007.

So there is some justification for handwaving away the threat of commission compression from Redfin. Foxton's couldn't do it. Thousands of discount brokerages couldn't do it. Purplebricks is here, but not taking 20% market share, and Redfin itself has been discounting for over a decade… and has less than 1% market share.

The doubters may very well be right. But there are a few reasons to think that things might be different this time around.

Blacklists vs. the Internet

The Real Deal has written a fairly comprehensive story back in 2007 about why Foxton's failed. It's worth reading in full.

One of the reasons for Foxton's failure, according to TRD, is that buyer agents steered their clients away from Foxton's listings:

> Still, the low "co-brokes" paid to cooperating brokers — either buyer brokers who showed their clients Foxtons' listings, or seller brokers, who showed their properties to Foxtons' clients — may have been the crucial factor that worked against the Foxtons' discount model.
>
> "In New York City, the seller pays, and if there is only 2 percent, there is not enough money to split the deal," said Janice Silver, executive vice president and sales manager of Bellmarc Realty, East Side.

Of course this practice is illegal and unethical, but it is oh so common, and so incredibly difficult to stop. So it continues today and will likely continue tomorrow.

But in 2000-2007, the real estate web was in its infancy. Trulia and Zillow weren't even founded until 2006-2007 timeframe. Consumer behavior was changing, but it had not completely changed during that timeframe. Today, buyers are doing all of the searching themselves and then emailing the listings to their agents to tour in person.

The iPhone wasn't introduced until January of 2007. Today, more consumers search for properties using mobile apps than they do desktop websites, and mobile apps are not merely passive search interfaces, but will push alerts to the phone and email when a matching property comes on the market.

It's not clear whether blacklisting by competing brokers and agents would have the same impact in 2019 as it did in 2005.

This is especially true when the listing broker is Redfin, with 30 million unique visitors a month, growing at a 20% YOY rate, with the Redfin App in the hands of millions of people.

Low Cost = Low Service?

TRD also quotes Dottie Herman, CEO of then Prudential Douglas Elliman, who says that Foxtons failed because they did not do enough to earn even a rock-bottom commission:

> Despite very good advertising and marketing, Herman said it appeared as if the salespeople did not know the market well and just put a listing on the Internet.
>
> Because the firm only offered minimal marketing and very little support, Herman said, "I used to tell clients, if you're going to pay them just 2 percent, you're better off just doing it on your own instead."

Since Foxtons' model was essentially an assisted FSBO, where the sellers do most of the marketing work themselves, it did not gain traction.

But in 2018, Redfin offers a service that is a far cry from an assisted FSBO. It is not at all clear that low cost means low service.

Redfin's Q3 transaction sides of 12,876 suggests that whatever else may be going on, its clients are finding the service adequate to earn the fee. Read up on what Redfin offers to its sellers, and see if you can find some element that traditional brokers and agents always offer that Redfin does not.

In short, technology has advanced dramatically since 2007. Productivity software works. The web has replaced newspapers and yard signs as the most important way to market homes. It may no longer be the case that lower commissions means less service.

Discounter Means Incompetent Agents?

TRD wrote in 2007:

> A lot of work needs to be done by the broker for co-op sales, [Janice Silver of Bellmarc Realty] explained. "They recommend a mortgage broker, or a banker, an attorney, they know the managing agents of the buildings, and we also

> instruct people how to present themselves to the board for approval," Silver noted. "Can you imagine a virtual agent filling out a board package that often goes 200 pages?" she asked.

The conventional wisdom is that discounters cannot attract competent agents who would not want to make less money doing the same work. Why settle for 1% if you can make 3% doing roughly the same thing?

The trouble with this line of reasoning is that incompetence is not limited to discounters, at least not in 2018, if ever. NAR itself in its D.A.N.G.E.R. Report highlighted the problem of a "large number of part-time, untrained, unethical, and/or incompetent agents." Those agents do not work only at discounters, but at every brokerage and at every brand, including some of the top luxury brands.

In contrast, every Redfin agent is a full-time employee closing an average of 9.2 transactions in Q3 alone. They are trained, and that training is mandatory. They must follow procedures, work within a system, and use technology tools as mandated by Redfin.

In fact, Redfin's press release about Q3 earnings contains this:

- Expanded offer-writing software to Redfin agents in Portland, Oregon, North Carolina and Wisconsin. The software is now available in nine states and in Washington D.C. Each new Fast-Offers market requires extensive customization based on dozens of different forms, local customs around earnest-money amounts, and other deal terms.

There is a very good chance that with these kinds of sophisticated tools, whose usage is mandatory, the average Redfin agent is *more* competent rather than less competent than the average traditional agent at writing offers, negotiating terms, and handling the transaction.

Local vs. Brand

Finally, TRD made a point that Foxtons did not have local offices and did not integrate with local brokerage communities:

> Devlin-McNiff's Epstein said what hurt Foxtons the most was that they never had local offices, "just signs and a phone number." In a market like the Hamptons, "where 80 percent of the business is done by 20 percent of the brokers," she said, "you can't drop in from outer space and do well."

Just reading that paragraph brings forth a pang of nostalgia for an era gone by. British aristocrats must feel the same way watching *Downton Abbey* on TV.

The fastest growing brokerage in the U.S. has no offices at all, except whatever is required by law: eXp Realty. Even firms that do have offices routinely report that their offices are ghost towns populated mostly by administrative staff and a couple of newer agents working "floor time" because they have nothing else going on.

The business is now almost entirely mobile, done on laptops in coffee shops, or on smartphones while sitting in a car. Some producing agents make a point of never going into the office.

The next generation brokerage is designed around this shift, as we discussed in the October Red Dot.

Consumer behavior has completely changed, thanks to the internet. Small stores used to fear Walmart; now, they fear Amazon. Even Walmart fears Amazon. And even more directly on point, the success of Zillow and Redfin suggests that consumers prefer a living national brand that delivers on its brand promises over local brokers and agents, as long as national brands have some sort of a presence on the ground.

Impact of a Low Commission Environment

This topic is entirely too large to do justice here. It may need to be its own separate Red Dot, or a series of them in the future. But at a high level, we can think about the obvious impact if the U.S. goes from a 6% commission environment to a 4% environment, or lower.

Most of the Industry Suffers

First and most obviously, just about everyone in the real estate industry suffers if we're in a 4% environment.

Safalow has already predicted that Zillow would suffer. Since the new initiatives now make Zillow far more subject to market risk, that seems obvious.

Every single split-based brokerage suffers, as their agents have seen their income drop by a third – and that's assuming that the buy-side commission is unaffected, and assuming that transaction counts remain the same. Even if those agents do not ask for higher splits right away, the brokerage splits would also drop by a third.

Redfin has already been operating in that 4% (or lower) environment anyway, so it won't be affected. The Next Generation Brokerages from the October Red Dot won't be affected as much, as they're not reliant on commission splits at all, though they might need to drop the price of some of their fees as the customers have seen a minimum of a 1/3 drop in income.

It'll be nothing short of a bloodbath, as the total pie has shrunk.

Cooperation and Compensation Problems

As the article about Foxtons illustrates, a low commission environment will absolutely lead to a period of chaos for the longstanding pillar of the American real estate system: cooperation and compensation.

Listing agents are quite unlikely to keep 1% while giving out 3% to the buyer agent, when their control over the listing means they have the upper hand. More and more of them will attempt to get both sides of the deal, whether individually if allowed by law, or at least within the team if not, with intra-team splits being adjusted to reflect the new commission reality. [9]

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[9] Many states prohibit dual agency, in which a single agent represents both the buyer and the seller. But I'm not aware of any that prohibits designated agency, in which the listing agent and the buyer's agent both work for the same brokerage firm. In practice, that means the buyer's agent can be on the listing agent's team,

The relationship between brokerage Participants in the MLS becomes strained. I have seen this in one market in the U.S. where the dominant brokerages responded to the threat of Foxtons by dropping their own fees. Those fees have never come back up, as consumers have gotten used to paying lower fees.

The result is a serious weakening of cooperation, unequal offers of compensation, formation of cliques, and a general lack of unity.

MLS executives fully understand in their bones what a weakening of cooperation and compensation means for them and for the REALTOR Associations that own them.

The Middle Gets Hollowed Out

Some people might see a lower commission environment as a net positive, as they imagine that it would drive out some of the less experienced, part-time, and incompetent agents from the business. Unfortunately, that isn't what happens in a game of economic musical chairs. What actually happens is that the middle tier agents leave, the bottom-tier agents stay, while the top producers gain market share.

It's simple logic.

A top producing team earning $1 million in GCI each year could see its GCI drop to $660,000. That's a big hit, but it's still a ton of money for the team leader. The consequences are cutting costs, laying off staff, hustling harder, and fewer first class flights for the team leader. But the team itself isn't going anywhere.

A part-time agent doing one deal every other year isn't relying on real estate to pay her bills. She's doing real estate for non-monetary reasons: networking, socializing, keeping busy. The so-called "soccer mom REALTOR" isn't going to leave the industry because she goes from making $10,000 every other year to making $6,000 every other year.

It's the middle tier that gets hammered. These are full-time professional agents who do rely on real estate to make a living, who

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and have splits within the team that could shift the economics to a 3% to listing agent and 1% to buyer agent on the team.

suddenly find themselves squeezed. Going from $100,000 a year in GCI to $66,000 a year while doing the same amount of work for the same number of deals is a devastating hit. She either has to figure out how to become a top producer, which is what she's been trying to do all along in any event, or has to consider getting a regular job with a steady paycheck.

We saw this play out when the real estate Bubble burst in 2007. The enormous drop in the number of active agents, in the number of REALTORS, in the number of MLS subscribers, did not come from the bottom quartile or the top quartile. They came from the middle two quartiles.

Here's the thing: the last crash saw the entire housing market collapse, and the number of transactions plummeted along with home prices. There were 900,000 fewer existing home sale transactions in 2008 vs 2007: from 5.02 million to 4.12 million.

The low commission environment we're contemplating doesn't have to mean that the housing market collapses. Indeed, the housing market could remain flat, but the pool of commissions is cut by a third (or more). Those who remain standing, the top producers who can withstand the loss of income, can make it up in volume.

As the middle-tier agents quit and leave the business, these top producers will pick up more and more of those transactions. Who else could? It isn't as if the bottom tier part-timers will grow their businesses at the expense of the professionals leaving the industry.

Redfin: Bringing the Darkness

Glenn Kelman is fond of saying that Redfin was born in the dark, like Bane from Batman, because of its early years during the bursting of the Bubble. His confidence in Q3 is based on that experience:

> We feel that our business model is built like a brick outhouse. It is solid. We have a significant cost advantage over our competitors. We can sell houses faster for more money at a lower fee. And that is going to become even more important over the next few years.

There is a very good chance that Kelman recognizes that Redfin is uniquely positioned among all brokerages to survive and even thrive in the dark. So they will bring the darkness, by spending $60 million to *bring about the low commission environment*.

Strong agent teams will survive, of course, and having survived, they will actually grow their market share. And Redfin is the strongest agent team of them all. But tens of thousands of competent middle-tier agents will find themselves struggling to stay in business.

Brokerages will struggle mightily. Even the strongest brokerages with dominant market share face enormous problems in a low commission environment.

Take Redfin's home market of Seattle. According to one magazine article, Windermere has 32% market share in Seattle, while Redfin has 5%. Now say Seattle goes to a 4% commission environment.

The GCI from that 32% market share will be *cut by a third*, thereby cutting Windermere's Company Dollar by a third. And that's before its agents start (a) demanding better splits, or (b) getting a "real job" somewhere else. What does Windermere look like afterwards?

What we know at 7DS through our brokerage practice is that many traditional brokerages actually make very little money from their top producers. In some cases, they *lose money* on every deal that a top producer does, because of various financial incentives they provide to keep superstars happy. Top producers are a loss leader for traditional brokerages.

What they get from the top producer, however, are advantages for recruiting and retention: (a) market share, (b) yard signs, which can help consumer awareness, and (c) star power. Don't forget that modern brokerages are not in the real estate business, but in the B2B services business. Agents and agent teams are in the real estate business.

Where Windermere and other brokerages make their money is in that professional middle-tier of agents who are productive, but not quite productive enough to warrant the money-losing splits of top producers.

If that middle tier gets hollowed out because they can't afford to make a living doing real estate full-time, then Windermere is stuck between a rock and a hard place. They won't make any money from the top producers, who are getting stronger and gaining more market share, and quite disinclined to share more of their now-reduced income with the broker. And they won't make any money from the bottom tier newbies and part-timers who fall into a transaction now and then.

That's fighting in the dark. And Redfin, like Bane, was born in the dark.

Realogy: Doubling Down on Today

I have very little new to say about Realogy. And that's the problem.

In the June Report, covering Q1, I wrote:

> 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.

Every word remains true today. I also wrote that even if Realogy is successful on all of its Q1 initiatives, it was skating to where the puck is, rather than where it will be:

> 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.
>
> …
>
> 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.

I don't need to alter a single word there.

Consider for a moment that while Zillow is making a bet-your-company pivot away from being a vendor to a central player in the real estate experience, and Redfin is going to bring the darkness because it is best prepared for a night fight, Realogy's major announcement is that it will launch two new franchise brands.

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.

And again, there's really nothing much to report here. It's the same old story, repeated again.

Table 9: REALOGY Q3/2018 EARNINGS

(millions)	Q3/2018	Q3/2017	
Revenues			
Gross commission income	1,246	1,250	(0.3)%
Service revenue	268	261	2.7%
Franchise fees	109	111	(1.8)%
Other	53	52	1.9%
Net revenues	1,676	1,674	0.1%
Expenses			
Commission and other agent-related costs	902	887	1.7%
Operating	387	394	(1.8)%
Marketing	63	63	0.0%
General and administrative	80	82	(2.4)%
Restructuring costs, net	9	2	350.0%
Depreciation and amortization	49	50	(2.0)%
Interest expense, net	41	41	0.0%
Loss on the early extinguishment of debt	-	1	
Total expenses	1,531	1,521	0.7%
Income/Loss before income taxes, equity in losses and noncontrolling interests	145	153	(5.2)%
Income tax expense/benefit	40	67	(40.3)%
Equity in losses of unconsolidated entities	1	(10)	
Net Income/loss	104	96	8.3%

Revenues are flattish, the unrelenting pressure on commission splits continues, and things look more or less the same YOY. The 8.3% increase in net income is very nice, but most of that appears to be attributable to eliminating $10 million in losses of unconsolidated entities.

In Q1, the "Commission and other agent related costs" line went up a whopping $40 million YOY, or 6.6%. In Q3, it went up 1.7%. I suppose that is why Ryan Schneider, CEO of Realogy, suggested during the earnings call that commission split pressure has moderated and will continue to moderate. But then again, Realogy has been saying that in just about every quarterly call since it went public (again).

And just like in Q1, the 1.7% increase in commissions is troubling when Commission Income went *down* 0.3%.

The NRT's numbers, which are of greater interest to us because that gets to what's happening to traditional brokerage, are also flattish, but more troubling.

Table 10: NRT Key Metrics and P&L

	Q3/2018	Q3/2017	
Closed Transaction Sides	94,241	95,236	(1.0)%
Avg. Home Price	513,403	506,418	1.4%
Avg. commission rate	2.44%	2.45%	(0.4)%
GCI per side	13,227	13,142	0.6%
(in millions)			
Revenue	1,268	1,267	0.1%
Commission Paid to Agents	902	887	1.7%
Company Dollar	366	380	(3.7)%
Company$ Margin	29.4%	30.4%	(3.4)%
EBITDA	43	64	(32.8)%

Just as in Q1, over the course of a year, the NRT did *fewer* transactions. In contrast, Redfin increased its transactions by 22.3%. True, that's from a smaller base than the NRT, but in raw numbers, Redfin's agents did 2,349 *more* transactions in Q3/2018 vs Q3/2017. The NRT, the largest brokerage by far, did 995 *fewer*. That has nothing to do with percentages or a smaller base.

It also has nothing to do with the slowing housing market, since the housing market slowed for both of them. It has little to do with the fact that the NRT is concentrated in expensive coastal markets because that's also precisely where Redfin is concentrated.

So all of the problems that I outlined in the June Report, namely the pressure on commission splits and the inability to control the consumer experience due to the peculiarities of the 1099 independent contractor status, all remain as they were in Q1, as they have been for years and years.

And Realogy's response to date is to launch two new franchise brands, neither of which is particularly differentiated in any way that matters.

Recall the discussion above about living brands vs. dead brands. Zillow and Redfin have living brands, because they are consumer-oriented brands that can be *enforced and protected*. None of the Realogy brands today are, because they cannot be enforced and protected when the sales associates are independent contractors who cannot be told how they should conduct themselves.

Neither Climb nor Corcoran have, at least at this stage of what has been announced, differ from the rest of the RFG brands from a control standpoint. Which means that they will not impact consumer experience, which means that they are dead brands that matter only to real estate professionals who find something meaningful about the design and the color scheme of the office.

Realogy: Calm Patience? Or Inability to Adapt?

This might not be a bad thing.

In *How the Mighty Fall*, Jim Collins lays out some dangers for companies that are facing decline. In talking about *Stage 4: Grasping for Salvation*, Collins warns against the danger of dramatic moves out of panic:

> The cumulative peril and/or risks gone bad of Stage 3 assert themselves, throwing the enterprise into a sharp decline visible to all. The critical question is: How does its leadership respond? By lurching for a quick salvation or by getting back to the disciplines that brought about greatness in the first place? Those who grasp for salvation have fallen into Stage 4. Common "saviors" include a charismatic visionary leader, a bold but untested strategy, a radical transformation, a

> dramatic cultural revolution, a hoped-for blockbuster product, a "game-changing" acquisition, or any number of other silver-bullet solutions. Initial results from taking dramatic action may appear positive, but they do not last.

One could look at the “we are a technology company” pivot of Keller Williams, or the “game changing acquisition of booj” by Re/Max and think about this passage.

It may be that Schneider is trying to get Realogy back to the disciplines that brought about greatness in the first place: selling franchise brands, operating brokerages, selling relocation services, doing title work, etc. He may be concerned about grasping at straws, like buying a technology company, or undertaking a bold but untested strategy. That would be smart.

What we don’t know is whether Realogy is staying the course and doubling down on today’s strategy for today’s problems out of calm patience, or because it is unable to adapt to the changing environment.

If the former, then we should see the renewed focus on core competencies restart growth, strengthen agent loyalty, and reverse the trend towards higher and higher splits.

If the latter… well… I guess we’ll find out how well Realogy fights in the dark. Just imagine NRT’s revenues cut by a third, while its margins shrink by 10%.

Other Companies of Note

While I have always focused on those three public companies in real estate for a variety of reasons, eXp Realty is a publicly traded brokerage. HomeServices of America is a subsidiary of a public energy company and releases some limited information.

What could we learn from them, from a strategic standpoint?

eXp Realty

eXp Realty is a brokerage, not a franchise, which is a public company and Wall Street analysts cover them. So why aren't they one of the companies covered in detail above?

The main reason is that they don't do conference calls with analysts, where they take questions and provide answers that give the rest of us some kind of insight into how management is looking at their operations, the business environment, and overall strategy.

Having said that... I interviewed Glenn Sanford and Jeff Whiteside, CEO and CFO of eXp respectively, for this paper. And there were some interesting takeaways.

A Brief Look at the Numbers

Let's do a mini-review of the numbers, as we did for Zillow, Redfin and Realogy above.

(thousands)	Q3/2018	Q3/2017	
Net revenues	157,236	47,372	231.9%
Cost of revenues	145,740	42,904	239.7%
Gross Profit/Company Dollar	11,496	4,468	157.3%
Gross Margins	7.3%	9.4%	(22.5)%
Total expenses, (excl. Cost of Revenue)	16,126	9,780	64.9%
Operating Income/(Loss)	(4,630)	(5,311)	
Net Income/(Loss)	(4,628)	(5,315)	

Blue text is for categories/numbers calculated by yours truly.

Agent count grew by 182.8% from 4,900 at the end of Q3/2017 to 13,859 at the end of Q3/2018, which is impressive as all get out.

John Campbell, a research analyst at Stephens Inc., is one of the few who covers eXp and he thinks that its incredible success with recruiting agents is reason for optimism. He has them as Overweight (but volatile, so be careful). And he thinks that agent count drives revenue growth.

That much is true. I mean, just look at the explosive growth in revenue: 231.9% YOY? And it isn't like eXp started with twenty bucks in revenues; it posted $47.4 million in revenues last year, then more than tripled it.

There is little question that eXp has mounted a stiff challenge against existing brokerages and brands, particularly Keller Williams, whose basic model was the inspiration, nay, blueprint, for eXp. Glenn Sanford, eXp's CEO, was a former KW agent and has been very forthright in admitting to copying KW's basic model and improving on it.

So, what can we learn from eXp Realty?

Agents Drive Revenue, But Not Profit

The first and most important takeaway is that while agent count drives revenues, it most certainly does not drive profits.

We already know the reason from Realogy, but Realogy is the flagbearer of the old school traditional split-based brokerage with relatively low splits. eXp took KW's lower-cost, cap on commissions model, and made it even less expensive: 80/20 split up to a cap of $20K.

And yet... from the 10Q:

> Cost of revenues includes costs related to sales agent commissions and revenue sharing. These costs are highly correlated with recognized revenues. As such, the increase in cost of revenues, compared to the comparable prior year period, was primarily attributable to a higher amount of revenues and increase in agent commissions paid. **As we continue to attract agents who produce at higher than average levels, these agents typically earn high commission payout rates resulting in a lower margin on their specific production.** [Emphasis added]

Agents who produce at higher than average, i.e., drive up revenues, earn high commission rates, i.e., drive down profits. The situation is even worse for eXp (and by extension for Keller Williams and any other brokerage model that features a cap on commissions) because once a high producing agent caps, the split goes to 100%.

The gross margins for eXp over the last eight quarters looks like this:

- Q4/2016: 11.4%

- Q1/2017: 11.9%
- Q2/2017: 10.9%
- Q3/2017: 9.4%
- Q4/2017: 10.8%
- Q1/2018: 10.1%
- Q2/2018: 9.5%
- Q3/2018: 7.3%

During that period, revenues went from $17.6 million to $157.2 million and agent count went from less than 3,000 to almost 14,000.

The better an agent, the less money the brokerage makes. As counterintuitive as that might be, that is as true for eXp as it is for Realogy.

Brokerage Is a Loss Leader

One of the more interesting insights to come out of my interview with eXp management is that their long term strategy might have very little to do with agent count or with brokerage revenues or profitability.

When asked about the gross margin issue, Jeff Whiteside said:

> As I look at what we do, we're an end to end real estate platform. As volume comes through, it's going to facilitate a large group of businesses to operate on this platform. As we add more services, more stuff, more money comes from outside of brokerage.

Glenn Sanford agreed, saying that eXp looks at real estate "more like Jeff Bezos at Amazon does—your margin is our opportunity" and said, "We'll figure out how to monetize market share over time."[10]

You know who else says very similar things about the "real estate platform"? Compass. From The Real Deal in September:

> According to [Maelle Gavet, COO] the goal of automation is to give agents more time with clients — and **ultimately create a vast "referral economy" that agents can make money off of**. That means giving agents referral fees for

[10] Please note that I did not record the phone conversation, and am working off of my notes. The quotes may not be exact word for word.

> everything from title insurance business (which its rivals already offer) to design services (which they do not) to contractors to painters.
>
> In July, Reffkin said he envisions a day when agents only rely on commissions for 20 to 30 percent of their earnings.
>
> He said Compass is spending "billions" to **create a single platform that will formalize the slew of referrals agents are already making**. "You're answering them today, you're just not getting paid for it." [Emphasis added]

This is a rather different view of the future of brokerage, and one that is far more in line with Zillow than with Realogy. If Compass can try to monetize the "volume" then there's no reason why eXp couldn't try to do the same, but from a different approach.

If you will, think of Compass as trying to get to a "referral economy platform" from the top-down, while eXp is trying to get there from the bottom-up.

In a way, eXp and Compass do represent one future of brokerage. Once you accept that brokerages are not in the real estate business, but in the recruiting and retention business, then a land grab strategy with no consideration of profitability is fairly rational as long as there is enough cash to keep grabbing market share.

Zillow did much the same thing: get a critical mass of traffic, and then figure out how to monetize it. eXp and Compass can get a critical mass of agents, and then figure out how to monetize it. It's a Platform play.

From that perspective, eXp and Compass both should be fine with a low commission environment. They were running brokerage as a loss leader anyhow. What do they care if brokerage runs at a steeper loss, as long as they have the cash to keep doing that and grab more and more market share?

HomeServices of America

HomeServices of America, as a division of Berkshire Hathaway Energy, does not report publicly. But some of its information is included in BKE's filings.

The big takeaway is that the numbers confirm what we've been saying about brokerages.

According to the Q3/2018 10Q from BKE, HomeServices had $1.2 billion in operating revenue in Q3, $85 million in operating income and $60 million in net income – margins of 7.0% and 4.9% respectively.

Then the 10Q drily notes, speaking of the first nine months of 2018:

> Operating revenue increased **$750 million** for the first nine months of 2018 compared to 2017 due to an increase from **acquired businesses of $769 million**. Operating income **decreased $6 million** for the first nine months of 2018 compared to 2017 primarily due to **lower brokerage segment earnings at existing businesses of $30 million**, mainly due to lower margin and higher operating expenses, and a gain on the collection of receivables in 2017 in the franchise segment, partially offset by higher earnings from acquired businesses of $47 million. [Emphasis added]

If I'm reading that right, and I don't see any other way to read it, HomeServices acquired $769 million in revenue, but total operating revenue only went up by $750 million. What happened to the other $19 million? It must be that organic revenue from existing operations dropped by $19 million. Is there some other way that math works?

And earning $6 million *less*, after acquiring $769 million in revenue, suggests that maybe Realogy is in far better shape than one might have thought for traditional brokerages.

So if Redfin brings the darkness, what exactly does HomeServices do in a low commission environment? Acquire more revenue to see earnings drop even further? Is that even a rational strategy? Granted, Warren Buffett and Berkshire Hathaway can keep funding losses until the cows come home, so HomeServices might also be on a Platform play like eXp and Compass.

Unfortunately, since none of Berkshire Hathaway companies do earnings calls, we'll wait to see if Buffett mentions something in his annual shareholder letter. Until then, draw your own conclusions.

What The Future Holds

It is always dicey business to predict the future. So let me avoid that problem by not predicting the future.

Instead, I'd like to lay out a couple of possible scenarios for the implications of these changes from Q3 of 2018 as they will and should inform my Recommendations as well as your thinking about your own strategies.

The Darkness Comes

The most important development out of Q3 is Redfin's announcement that they will go on a national mass media advertising and marketing campaign. That campaign is no longer a test, or a trial, but a sustained long-term branding play.

It is a brilliant strategy. Redfin is built from the ground up to operate at low cost, and have refined their processes and systems over ten plus years. The rest of the industry is not.

Redfin's competitive advantage in today's environment is demonstrated by its steady growth with very little marketing, a comparatively tiny roster of agents, and general antipathy from the rest of the industry. I realize that 0.85% market share isn't much, but consider that in Q1/2017, Redfin only had 0.58% market share. That's a 46.6% growth in market share, *all of it organic*, because Redfin can't acquire other brokerages and agents the way Compass or HomeServices can.

With the housing market slowing down, particularly in some of the major urban and suburban areas, the rest of the industry will be feeling the pinch as it is. Various economists and real estate executives are thinking the housing market will drop 5-10% next year.

Redfin is going to drop the 1% bomb on top of *that*.

It should be obvious that Redfin doesn't actually have to gain much market share or get a ton more business from its marketing. I'm sure they'd love to see that, but as Glenn Kelman said in the earnings call, this mass media marketing play is not for 2019, but for long-term awareness gains.

We might ask, long-term awareness of what? Sure, Redfin is one answer. But surely the other answer is, "1% listing fees."

If consumers become aware that there is a full-service brokerage, that is far from a fly-by-night operation, that is publicly traded, with sleek technology and a top-notch website and awesome mobile apps, with a long track record, that can help them buy or sell a home at roughly half the price (Kelman said this)… wouldn't every conversation with a real estate agent be, "Can you match that price?"

Keep in mind that the extra 2% is not $20. It's more like $15,000 on a $300,000 house. People are going to care.

Plus, brokers and agents keep pointing out that strong relationships with consumers helps fend off the discounters. That's true, but… don't relationships go both ways? If a longtime client, who has bought three houses and sold two with you and referred you a ton of business over the years, calls you up and asks that you match Redfin's 1% listing fee… what then?

I went over all the reasons why Redfin in 2019 is different from Foxtons in 2000. But discounters have existed forever, so the industry is likely to ignore the issue until it is right on the doorstep.

We could actually look at what Redfin is doing as similar to dumping: *using price to drive competitors out of the market*. Obviously, it isn't dumping, since Redfin is built to make a profit at lower cost, but the secondary impact is the same: other agent teams and agents cannot compete with Redfin at such lower fees.

Redfin has gotten to where it is with 0.85% market share. If they drive (conservatively speaking) 30% of their competitors in the middle-tier of agents out of business, what could their market share be then? What does Redfin look like with a mere 5% market share nationally? $800-900 million in quarterly revenue, with 30% gross profit margins, plus whatever Redfin Now and mortgage and title bring in.

Maybe Kelman & Co. aren't thinking as I do, but if they're not, they ought to be.

At least you, the reader, have been forewarned of the possibility.

Survival of the Fittest: Concentration of Power

One of the direct results of Redfin bringing the darkness is, as I have laid out above, that the professional full-time agents in the middle get pushed out. But it isn't just them. Even top producers will get wrecked if they don't have the systems, the processes, the efficiency nailed down in order to compete against Redfin in a low commission environment.

The industry has already been moving towards a kind of a super-pareto state in which 90% of the agents do 10% of the business, and the top 10% do 90% of the business through their teams. Commission pressure accelerates that process, perhaps inevitably and perhaps inexorably.

This is one reason why I don't think commission compression would actually affect Zillow in the long run. Zillow's business model is already tilted towards the top producers. The new initiatives, from PA 4.1 to Flex to Best of Zillow all aim to make the strong stronger still. Sure, they'll be hurt initially, but the best agents and the best teams will actually pickup market share as the middle tier gets hollowed out. Redfin will pick up a lot of that market share, but not all of it; great agents and their teams will pick up the rest.

Similarly, I don't think commission compression would affect the Next Generation Brokerages from the October Red Dot all that much. These 100% brokerages are already built to operate at very low cost, already do not care about GCI, about Volume, about price of homes, because their model is based on low flat monthly fees or transaction fees. Those fees could feel some pressure, but they're already low and getting lower.

Traditional brokerages? Well, we covered those already in depth.

Zillow As a Player, Not a Vendor

Redfin's strategy will hurt Zillow in the short-term, if it comes to fruition. In the long run, I don't think it does since concentration of power benefits Zillow and its basic business philosophy.

And in that context, Zillow's transformation from a vendor to a player is strategically important.

Consider this: suppose Redfin brings the darkness, we're in a 4% commission environment, and the best agent teams not only survive but thrive, just as Redfin does. What do these surviving super-efficient agent teams look like?

They look a whole lot like Redfin, but with a stronger local sphere of influence marketing practice.[11]

What are such super teams missing compared to Redfin?

They don't have the website or the traffic that Redfin has. They don't have the technology stack that Redfin has. They don't have the data analytics capabilities that Redfin has.

Who does? Very few, if any, brokerages or brands have those things. Maybe Compass has the technology stack, but Compass doesn't have the traffic or leads.

At the end of the day, only Zillow and Realtor.com have the website, the traffic, the lead flow, and a large enough technology and data analytics team to compete against Redfin.

Ultimately, then, these super teams that end up taking even more market share become *more* dependent on Zillow, not less. With Flex, they can defer paying for Zillow's traffic, technology, and services until after earning an income.

Whither Brokerage?

Concentration of power is really, really not good news for brokerages like Realogy's NRT, eXp, and HomeServices. We have already covered that these companies increase revenue, but not profit. We have already seen time and again that the reason is that better agents demand higher splits and get them. The truth, if you will, is in the footnotes to earnings reports.

[11] Incidentally, that will make the whole 1099 vs. W2 issue really come to the forefront for these top agent teams. That is a whole other major topic for future consideration.

At the same time, we now see that companies like eXp and Compass are potentially just looking to operate the brokerage at a not-too-big-a-loss so they can figure out a monetization strategy after they've done the landgrab. In the case of Compass, that strategy may be this "referral economy". In the case of eXp, we'll see.

In the case of Realogy, HomeServices and by extension, all traditional brokerage companies… the future looks rather dark.

There are not many choices:

1. Get the technology and the traffic and leads to help agents compete with Redfin;
2. Cut costs dramatically and transform into a Next Generation Brokerage;
3. Make a play for the Platform, as eXp and Compass appear to be doing, and be resigned to running the brokerage as a loss leader;
4. Sell the company (or close your doors).

In the course of writing this paper, I spoke with Phillip Cantrell, CEO and owner of Benchmark Realty in Nashville, and a subscriber. His thought to the possibility of commission compression is that it can only help him, which is what I suspected.

What he did say that is worth relating is that if there is a concentration of power into some kind of a super pareto situation, the Next Generation Brokerages become the obvious choice for those top agent super teams.

The issue, as he sees it, is the supersized egos that go along with super teams and their owners/leaders. He felt that the Next Generation Brokerages have neither the culture nor the incentive to cater to agents who need ego-stroking. "We love all our agents, but we love them equally, because they're all worth the same to us in the end," was the way Cantrell put it.

In the end, then, brokerages might divide into those who charge a premium to these top agents in exchange for feelz and those who do not. Target vs. Walmart. Starbucks vs. Dunkin Donuts. Lexus vs. Toyota.

Inflection Point

The combination of all these changes, taken together with Redfin's play, means that the next year or two is an important inflection point for American real estate.

Either the new way of buying and selling houses, as exemplified by Zillow as a player and by Redfin, will finally prevail over the old, or the conventional wisdom about real estate, that it's all about relationships, will prevail. I'm not sure that there is a middle ground between the two.

Start with Redfin. Either the consumer awareness campaign drives commissions down, or it does not. Either other brokers and agents have to match Redfin's 1% fees in order to compete, or consumers are simply not that price sensitive when it comes to real estate services as long as they feel like they're being taken care of.

If the former, then the business of real estate is permanently altered. If the latter, then Redfin would be irrational to continue pushing discounted pricing when it has become clear that consumers don't mind paying thousands of dollars more.

And if the latter, then the industry will punish Redfin. It isn't clear how, but it will happen. As Ralph Waldo Emerson said, "When you strike at a king, you must kill him."

With Zillow, either the new initiatives win over the top producing agents who don't mind the Home Depot effect as long as they're getting the lion's share of the business, or they do not.

If PA 4.1, CSAT and Best of Zillow, and Flex and iBuyer services are accepted by the top producing agents and by their consumer clients, then Zillow becomes the most important company in real estate, a Team of Teams. It becomes the most important ally of the super teams who can compete against Redfin, but not without what Zillow provides them.

If on the other hand, the new "move down the funnel" Zillow is not embraced by the top producers, then with traffic maxed out, revenue growth stalls and churn increases. Add in a low commission environment, and revenue falls while profitability suffers, and Wall Street will absolutely hammer Zillow down. All of those who are uncomfortable with Zillow (or despise Zillow for whatever reason) can retaliate without fear.

And they will, aided by its many rivals.

Either way, if Redfin and Zillow succeed, the industry is permanently altered. It sets up a rivalry between Zillow and Redfin that will come to dominate the industry going forward.

If they fail, then it becomes further evidence that there is something about real estate, about people buying and selling the biggest asset they own, about the nature of the relationships between consumers and agents, between agents and brokers, between all of the elements of the web that is American real estate, that prevents any major changes short of a Black Swan type of an event. A collapse of the housing market, and the global economy. The advent of the Internet. War. Famine. Something major and unexpected, like an earthquake.

Short of that, real estate does not change, like the land underneath us all.

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Decide. Act.

RECOMMENDATIONS: MLS & ASSOCIATION

For the MLS and Association executives, the issues that arise from Q3 could seem a bit removed. After all, the problems of inter-broker competition are problems of your membership, not necessarily your problem.

Yet, these changes could be so fundamental that they do pose significant challenges to MLS and Associations. Accordingly, there are a few recommendations for action.

Wargame the Darkness

If you do nothing else after reading this Red Dot, I strongly recommend that you immediately think about wargaming the low commission environment.

The two most important possible consequences of the low commission environment to the MLS and Association are:

- Weakening of cooperation and compensation
- Shrinking of the Middle-Tier

There are other possible consequences as well, but those two are real threats. So plan for them.

Wargaming simply means scenario and contingency planning: if X happens, then what do we do? If Y happens instead, what do we do then?

While it is a military maxim that no plan survives contact with the enemy, having a plan that can be adjusted on the fly based on what is actually happening is far better than not having one at all.

Even if you strongly believe that I'm dead wrong about the impact of Redfin's national advertising campaign, and that discounters never succeed, you need to put together an actual plan in the event it happens.

It is simple risk management, really. If I'm wrong, and Redfin fails to shift real estate to a 4% or lower commission environment, and you spent a bunch of time and a bit of money putting together a "How to Fight in the Dark" plan for your company, what have you lost? If I'm right, and that shift does happen, but you don't have a plan to deal with it, you're likely headed for bankruptcy.

Why take the chance? Wargame the low commission environment now and at least have a plan in place.

A few suggestions:

- **Be specific**: overall strategic plans can be general. A wargame plan should be as specific as possible. For example, a strategic plan might be, "Educate the membership about the importance of equal sharing." That's fine, but how do you do that? And when? What do you measure in order to know that you need to implement this education campaign?

- **Logistics, not tactics**: it is often said that amateurs talk tactics, while professionals talk logistics. Your plan should focus far more on the "logistics" of how you'll support what you plan to do rather than on what you plan to do.

- **Build in as much flexibility as possible**: because plans have to change based on events on the ground, your wargamed plan has to be as flexible as possible. Done correctly, one of these plans has a bunch of "If X, then Y but if A, then B into C" type of things in it.

  Some of this flexibility involves questions of authority: who gets to make the decision, when something happens? A really rigid top-down hierarchy might not be the ideal model for flexibility. The traditional "all decisions require Board of Directors approval" is the antithesis of flexibility. So look at your organizational structure, talk to your people, and ask how you could build in the maximum flexibility without descending into chaos.

- **More participants, the better**: depending on your company structure, strategy might be the province of a few top senior people and the Board of Directors. For wargaming, I recommend involving as many people as possible from across the organization.

  For example, your administrative staff might have extremely valuable insights into what problems might arise in a low-commission environment, or if the Home Depot effect really takes root. Why not involve them in the wargaming, post the problems and the scenarios, and ask them for input as to what needs to happen in response?

The Subscription Fee Model

As an MLS, one strategic issue you will need to tackle either prior to or during the wargaming is your pricing model. The typical MLS charges a flat subscription fee, and the cost structure is very often on a per-head basis.

When the Bubble collapsed in 2007-8, quite a few MLSs and Associations went through a crisis period as subscriber numbers plummeted. The low-commission environment has the potential to do the same, but without the housing market collapsing.

The evisceration of the middle-tier poses huge challenges not just for brokerages but also for MLS and Associations.

If the future of the industry is going to be a concentration of power in the hands of the elite few, the MLS and Associations need to think about whether they continue with the headcount-based revenue and cost models, or a usage-based one.

For example, you could adopt FMLS's model of charging a small percentage of GCI upon a transaction closing.

Or, perhaps you could look into a metered data usage or storage-based fee, similar to Amazon Web Services.

The Issue of Agent Teams

We have talked about the challenges that agent teams pose to the MLS and Association structure in the past. We may as well do it again, in light of what we've learned in Q3.

The existing MLS and Association infrastructure, from governance to the rules and policies, were born from an era when real estate brokerages were in the real estate business. Today, the real estate brokerage is in the B2B agent services business, and it is the agent teams that are in the real estate business.

You need to tackle this strategic disjunction, especially if you are the MLS.

There are volumes to be written on this topic alone, so for now, suffice to say that your Board of Directors need to start engaging with this issue today before it becomes a far larger problem as the low-commission environment concentrates power even further in the hands of the elite few top producers and their teams.

Dual Agency and Designated Agency

The MLS and Association world should start some tough conversations about dual agency and designated agency in light of the developments of Q3.

I know this is a complex topic, and not an easy one to tackle for anybody. But again, the entire framework of buyer agency, dual agency and designated agency was built up during an era when brokerages were in the real estate business instead of in the B2B agent services business.

In my recommendation for brokerages, I brought up the point that if the agent teams that survive and thrive in the coming darkness look a whole lot like Redfin, the 1099 vs. W2 issue is going to become urgent for them.

For the Association, that implicates how the Code of Ethics and the state license laws will have to deal with those changes. How does designated agency really work if the listing agent is the employer of the buyer agent on the team? Is that still designated agency as we understand it today? If it is not, what does that mean?

The Code of Ethics places a priority on loyalty to the client; how does that work if you are not paid by that client, but by your employer?

How does something like the duty of confidentiality work for an agent team, or an employee agent in a company like Redfin? After all, in normal labor law, the work product of an employee belongs to the employer, including any proprietary information developed by that employee.

It's a tough topic, but only the REALTOR Association (and by extension, the MLS) can tackle it.

For the REALTOR Association: Assurance of Quality

Finally, the Association of REALTORS should engage with the whole broad topic of assurance of quality. Zillow's new CSAT and Best of Zillow are going to have an impact, and sooner rather than later.

There needs to be some real, difficult, and potentially contentious conversations within the world of organized real estate about whether Zillow should be the arbiter of agent quality.

If the answer is no, then there needs to be some real and difficult conversations about what the alternative is.

NAR's Commitment to Excellence (C2EX) is a step forward, but is it enough of a step? If not, then why not, and what can be done to make it enough of a step?

Every local REALTOR Association hands out awards every year; do those awards have a meaningful impact on consumers? If not, why not, and what can be done to have an impact?

Should there be conversations with Zillow itself on how its CSAT could (or even should) interface with organized real estate?

CONCLUSION

We will look back on Q3 of 2018 as the moment when things changed. It brings on the inflection point that has long been coming. The events of the next year or two will determine what the real estate industry looks like.

Zillow's bet-your-company pivot away from being a vendor/media company to a central player in the real estate experience would have been the story in any other quarter. But Redfin's numbers, it's growing confidence, and announcement about consumer advertising is the story of Q3. It may end up being **the** story of 2018.

For all of the major participants and institutions in American real estate, I think strategy is important, but a concrete wargamed action plan might be even more important right now.

In a way, I think companies in real estate should embrace the Doomsday Prepper mindset just a little bit going forward. We might think the paranoia is quirky and amusing, and folks who are stockpiling food, water and ammunition are entertaining in a slightly scary way. But those odd preppers look incredibly smart if a hurricane hits. In fact, they look smart if a hurricane will hit you three days from now, because they avoid the insane crush at supermarkets and long lines at the gas stations.

Either the darkness comes, or it does not. If it does not, and you're prepared, you have lost very little. If it does come and you are unprepared, the consequences are dire.

I urge you to prepare.

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