VOL 2, ISSUE 1: JANUARY 2019

Year End Review: 2018

The Dawning of the Age of Capital

Brokerage Edition

Observe. Orient. Decide. Act.

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Observe.

INTRODUCTION

Happy New Year!

I began The Red Dot in April of 2018, with the inaugural May issue.

What I thought would be valuable and interesting is to look at the sweep of the entire year, and think about the most important thing that happened in all of 2018.

In a way, this report is a retrospective, and will contain references and excerpts to previous reports. On the other hand, one of the nice things about hindsight is the way that we can see how things fit together. And one of the nice results of that is to identify the most important thing that happened in 2018.

This year, there were a large number of candidates for the most important event of 2018. But after reading through hundreds of pages of past Red Dot reports, dozens of normal posts, and everything else I could get my hands on… I think the signature event of 2018 is not a specific event. It is, rather, a sort of tipping point that has been reached.

2018 is the year when *capital and access to capital* became the most important factor for success in residential real estate.

One could make a strong argument that the tipping point was actually reached in 2017, when some $5 billion was invested into real estate technology, brokerages, and "proptech" companies of all kinds. But the Red Dot did not exist in 2017, and I would note that 2018 is when companies like Zillow and Redfin made major shifts to take advantage of the new rules for competition.

A lot of these themes which have been circling around in my head found a focus recently, in a video released by the venture firm Andreessen Horowitz. Alex Rampell, a General Partner, gave a presentation entitled, "When Software Eats the Real (Estate) World" and it is fantastic. I recommend you watch the whole thing.

In retrospect, what we saw in 2018 was the transition from the old way of competing — recruiting and retention of individual agents — to a new way of competing: institutional delivery of real estate services to consumers who increasingly expect on demand service: Push button, magic happens.

Without further ado, let's get busy saying farewell to the Year of the Dog and welcoming in the Year of the Pig.

Robert Hahn
December 2018

EXECUTIVE SUMMARY: BROKERAGE

There will come a day at some point in the future when we will look back on 2018 as we look back on 1973 today and say, "That's when everything changed."

2018 is when we can say definitively that the old way was replaced with a new basis of competition.

The old basis of competition was based on headcount, which meant that recruiting and retention was the key to success. Everything that brokerages, MLS and Associations, and technology companies in real estate have done for the past 45 years was based on and around creating advantages for recruiting and retention.

The new basis of competition is based on deploying huge amounts of capital, which means that access to capital is the key to success. Everything that the companies that will dominate the future of real estate will do will be based on and around acquiring and deploying large amounts of capital.

Let us start thinking about this by analyzing the best presentation on the state of real estate in 2018. I'm actually a bit envious that it wasn't me that created it, but not all that envious because only an outsider could have cut through the details, cut through the politics, and cut through the crap as succinctly as Alex Rampell of Andreessen Horowitz did in a presentation titled, "When Software Eats the Real (Estate) World".

When Software Eats the Real (Estate) World

Alex Rampell, a general partner at Andreessen Horowitz, one of the preeminent venture capital firms in the world, is one of the very few outsiders who really understands the industry. There are details he misses, and some intricacies beneath the surface that he doesn't address in the presentation, but boy, he sure hit the target squarely with his basic thesis:

> **In the future, you will buy your house from, or sell your house to, a company.**

The arguments he marshals together to support that thesis are virtually ironclad. It's impossible to argue, especially for me since I have made all of those arguments and those points myself over the past several years.

Consumer Experience Sucks

Let us start with the basic observation that cannot be argued: the consumer experience with buying or selling a home in North America today sucks.

Mortgage

He talks about how needing a mortgage means the buyer is just going to lose out on any desirable house with multiple offers, and that getting a mortgage takes an average of 45 days. But of course, getting a mortgage is far, far worse than that.

I addressed the pain of mortgage in the August Red Dot on iBuyers.

Time Consuming

Rampell also says:

> If you're selling a house, and this is for many people their most valuable asset, it might sit on the market for months.

He notes that in some super-hot seller's markets like San Francisco or Los Angeles, you might be able to sell your house quickly if you price it well. But for most of the country, it takes much longer.

He touches on how annoying the process is, mentioning "50 people who go through the open house and all the other things you don't want to do."

Of course, he doesn't go far enough or into great detail about what the experience of selling a house is like today. I did in the August Red Dot.

Why The Experience Sucks

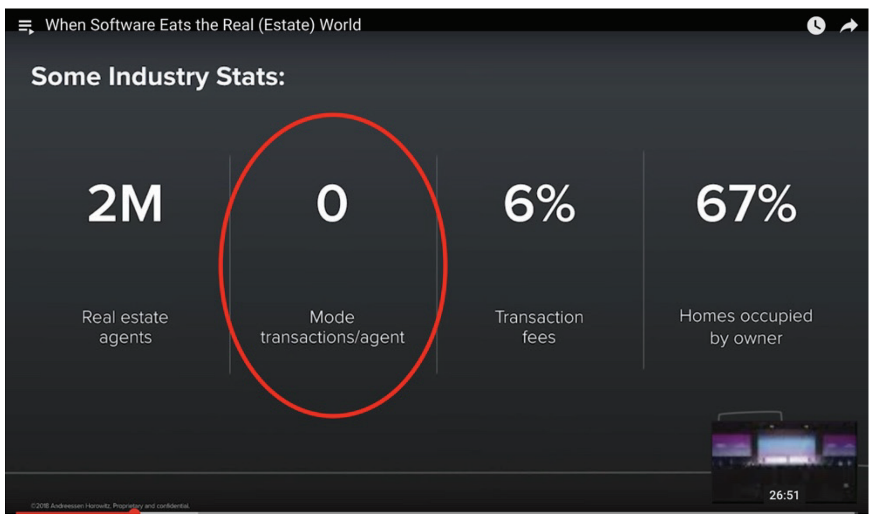
Having succinctly made the case that the experience of buying or selling a house sucks for consumers, Rampell spends the next part explaining *why* it sucks.

The Agency Problem

Rampell points out the problem with agency, which is something of a verboten topic within the industry. Buyer agents make more money if the buyer pays more for a house. Listing agents might make more money if the house sells for more, but there is an incentive to take the deal on the table instead of pushing for more.

The Problem of Incompetence

Rampell also goes directly at the problem of widespread incompetence among real estate agents using statistics that are brutal, yet difficult to argue:



Using stats from Washington State, Rampell says that he tried to find out what the mean, median, and mode of the number of transactions per agent were in 2017. Mode refers to "the most frequently occurring number found in a set of numbers." And the mode for real estate agents in Washington for 2017 was 0. That's right, zero.

Rampell concludes:

> If you find a random real estate agent in Washington State, the highest chance number of transactions they [had] is zero. How is this possible?

He goes on:

> Would you trust a taxi driver that's only driven zero times in the last year. Probably not. Would you trust a surgeon that's done zero [surgeries] in the last year? Hopefully not. But this is how real estate works.

Problem of Organized Real Estate

Rampell then casually throws organized real estate under the bus, something only an outsider can do.

He starts by noting that the U.S. is quite resistant to changes to the high commission rate: 5-6% versus 1-1.5% in Europe and 3% in Canada. He quotes George Bernard Shaw and notes that "All professions and conspiracies against the laity" and then talks about how real estate tries to make it the most anti-competitive industry possible.

It's a remarkable exposé, particularly because it comes across as unemotional. He certainly passes judgment on organized real estate, but there's no real anger or outrage.

From Portals to Actors

As Rampell puts it, the first generation of tech companies in real estate "monetized the traffic by selling into the current industry, as opposed to really trying to change the fundamentals of the industry." That is going to change.

What changed for Real Estate 2.0 tech companies are three things:

- Consumer Expectation of On Demand Experience
- Data Science Technology
- Capital

Rampell thinks that the next generation of real estate companies would leverage all three to create "full-stack" solutions.

He thinks agents won't go away, but they'll operate under the rubric of a company, which can bring data technology and capital to provide the on demand experience that consumers want.

Institutions, Not Individuals

Although the phrase "on demand real estate" instantly brings iBuyers to mind – after all, that was Keith Rabois's vision with Opendoor – it encompasses more than just iBuyer. It speaks to consumer expectations where they push a button and magic happens, as Jeremy Wacksman, President of Zillow, said in the August report.

While iBuyer is at one extreme of the on demand consumer expectation, the principle of on demand expectations exists across the entire consumer spectrum.

That is, consumers will not wait 48 hours to hear back from an agent on an inquiry. That inquiry has to be answered *right now*, as close to real-time as possible.

Not Just Technology

The important thing to remember here, I think, is that meeting the on demand consumer experience is not solely about technology.

The case of agent teams that prioritize responsiveness is another example. Technology alone can't get it done. Teams need people, processes, systems, and technology to respond to consumer inquiries in near real-time.

Rampell thinks that companies will dominate the transaction because of their data science teams and data technology. I think that's only partially correct.

The other reason that companies and institutions have an advantage is that they can execute far better than an individual agent, or a collection of individual agents, can.

It isn't that Companies have data science teams, who can crunch terabytes of data and provide better answers to consumer questions, and individual agents do not. It is that Companies have teams, period, with specialization, systems, processes, and technology to back all of that up – and individual agents do not.

Institutional Advantage Requires Capital

Institutional advantage in providing the on demand consumer experience requires capital.

Staff has to get paid up front, every two weeks. Independent contractors do not.

Staff needs processes and procedures to follow, and somebody has to manage them to make sure things are being done the way they're supposed to be done.

Even for individual agents, if they are doing real estate as a business rather than as a hobby, lead generation is never free.

Technology systems cost money. If companies want a competitive advantage from technology, they're going to have to build it or buy it and keep it from everyone else.

All of this requires capital.

The idea that companies, institutions, need capital to pay salaries and buy/build technology is hardly earthshattering. And every company in every industry faces the same challenges.

In real estate, there is one more capital-intensive requirement.

Lead Generation Requires Capital

To become a Company, the institution needs to generate *leads*.

Without leads, there is nothing for the staff to work on. The data technology is useless unless there is a client who needs the information and insight that technology generates. Advertising is not free. Marketing is expensive and time consuming and filled with uncertainty.

Even for individual agents, if they are doing real estate as a business rather than as a hobby, lead generation is never free. Whether they pay for leads, pay for postcards, pay for marketing campaigns, or simply spend hours staying in touch with their sphere, lead generation requires money or sweat or both.

The Old Way: Recruiting and Retention of Individuals

The old way of doing real estate, at least from the 70s on when Re/Max introduced the agent-centric model to the industry, was to recruit and retain as many individual agents as possible, pushing the capital costs onto the agents, and then taking a small piece of the commission pie.

This is a sensible approach to real estate, pre-Internet. Real estate is not a commodity, local (for obvious reasons), illiquid, and expensive. Even today, referrals and word of mouth remain the mainstay of lead generation for most agents.

Long before the Internet came along, the relationship between brokerages and individual agents was not an employer-employee or even a principal-subcontractor relationship, but that of vendor and customer.

The New Way: Institutional Service Delivery, Using Teams

The new way of institutional real estate is to deliver services to buyers, sellers, renters and landlords using teams of people, rather than individual agents.

Clear roles, standard procedures, common systems, and specialization are the order of the day with institutions. Technology that enables cooperation and collaboration both enables teams and makes them more efficient.

The necessity of delivering a consistent level of service means control over team members, whether by employing them as staff or by controlling the flow of business to "contractors" whose entire livelihood is reliant on the team.

The efficiency of Companies is significantly higher than the efficiency of individual agents, or a collection of individual agents.

Competition under the new way, then, is not about headcount of individual agents. Instead, it is about specialization, teamwork and efficiency. It requires staff, systems, and technology, as well as new services like iBuyer, on demand home tours, close to real time transactions and communications, and whatever else. The goal is to live up to consumer expectation of, "Push button, magic happens."

All of those things require capital and access to capital. Those who have capital or can get capital have a huge advantage; those who do not are left with the old way of doing things.

Redfin Is That Future

Reading over what I wrote about Redfin over the course of 2018, the picture that emerges is of the first true Real Estate Technology 2.0 Company that needed only to learn for itself that it can successfully implement an iBuyer program.

Redfin from the very start has been focused on providing that "on demand" consumer experience at lower cost. Its obsession with efficiency, speed, customer service, and close rate (detailed in the June report) is supported by Redfin's entire technology stack. Redfin has always tried to use data science to support its workforce of employee agents to deliver better, faster, and cheaper service.

The missing piece of the puzzle was iBuyer: a way to make the transaction itself far less painful, uncertain, and time-consuming. Redfin jumped on iBuyer early on, launching Redfin Now as a test in Q2 of 2017. Apparently, the test was successful, since Redfin openly committed to Redfin Now as of Q3/2018.

The goal is to live up to consumer expectation of, "Push button, magic happens."

When we take a step back, then, and look at what Redfin has become by the end of 2018, we see a company perfectly situated to be one that consumers buy houses from, and sell houses to.

Critically, Redfin has the "last mile" of actual human beings with boots on the ground covered. Even Rampell conceded that agents aren't going away; they will simply work under the rubric of a company, because only a company can take advantage of the kinds of data technology and capital-intensive services that the real estate transaction of the future will require. Redfin has those agents, and what's more, it has them in a way that no other major brokerage does.

The industry as a whole has tended to ignore Redfin because of its boots on the ground are not numerous. Even today, Redfin only has some 1,400 lead agents which is about what a decent sized midsized regional brokerage might have. eXp by comparison had almost 14,000 by the end of Q3.

That mattered a great deal when the basis of competition was headcount: the ability to recruit and retain individual real estate agents. It matters far less, as Redfin has shown us, when the basis of competition is access to capital and the ability to deploy that capital to deliver on demand services backed up by data technology.

In that case, it turns out that Redfin's last mile is superior to everybody else's last mile.

Is it any wonder that Redfin is now going straight at one of the most sacred pillars of the real estate industry, the *6%* commission rate?

That the real estate game has changed, and that Redfin is well-positioned to take advantage of those changes, explains the strategic thinking behind Zillow's pivot in 2018 from an advertising website to something more like an agent team.[1]

Zillow's Pivot, Reconsidered

The combination of initiatives that Zillow launched, almost simultaneously, including Premier Agent 4.1, Zillow Homes, mortgage, Zillow Flex, and the Consumer Experience Report (CSAT) means that Zillow is taking a huge risk, but with huge potential rewards.

Looking back on 2018 with the changed rules of competition in mind, Zillow had little choice but to gamble because it was falling behind Redfin in one absolutely critical area: the last mile, the real estate agent.

[1] I spent a lot of time in the December report discussing Zillow's transformation into something like a brokerage, but really more of like an agent team, or a team of teams.

The Strategic Problem, Take Two

In the December Red Dot, I thought that the strategic problem for Zillow is *how to increase revenues and profits if the top of the funnel (traffic and leads) is maxed out*. In light of the Rampell presentation, which I believe could be representative of how the smart money thinks about real estate, Zillow may have been facing a different strategic problem.

If the strategic problem isn't to monetize capped traffic, but to create the on demand consumer experience, with agents who are empowered with data technology, just like Redfin can and does, then Zillow has a real problem. As Glenn Kelman said, what can Zillow promise potential customers when each brokerage customer and each Premier Agent at that brokerage set their own service level and pricing?

Zillow could dominate traffic. It could generate far more leads than Redfin ever could. It could become awesome at iBuyer services.

You know what Zillow can't do? Provide assurances to buyers and sellers if they want to go the traditional route. Because Zillow does not control its brokers and agents any more than traditional brokerages control their agents.

That last mile problem is a big one, if the future of real estate is buying from and selling to a company.

This is one of the things that the industry does not talk about in public: the best agents are not always the top producing agents, and the top producers are often the worst agents in terms of customer service and ethics.

Zillow, the Arms Dealer

I now believe that what Zillow has done is to try to tackle the last mile problem in the smartest way possible: go past the Company stage and go straight at becoming the Platform.

Let's assume for the sake of discussion that Redfin has become a Company that can deliver the on demand experience that consumers demand. Zillow cannot compete head-on against Redfin.

What Zillow can do, however, is to help its customers – the brokers and agents who pay them – become Companies. If you will excuse the analogy, Zillow can't go to war against Redfin directly, but it can become the arms dealer to Redfin's rivals and help them go to war against Redfin.

The question of the next few years in real estate is whether an agent team, equipped with all that Zillow has to offer, can compete with Redfin in its local market even in a low-commission environment. Zillow is betting that they can.

This is not and will not be easy for a number of reasons.

Competence vs. Production

Many real estate brokers and agents are every bit as good as Redfin, *if not better*, at delivering great personalized service to buyers and sellers.

The problem for Zillow is that while some top producers are extremely competent, personable, charming, ethical, deeply knowledgeable, with years of on-the-ground experience with all manner of situations and difficult transactions… many are not.

This is one of the things that the industry does not talk about in public: the best agents are not always the top producing agents, and the top producers are often the worst agents in terms of customer service and ethics.

Zillow's problem then is to find top producers who are also excellent at client care, who score highly on the CSAT not just on the front end with quick responsiveness to leads, but who score highly on the CSAT on the back end *after the transaction is done*.

If there aren't enough such people, then a secondary tactic could be to find agents and teams who are excellent at customer service, and make them into top producers with a river of qualified leads. The problem is that these agents and small teams are not top producers and accordingly lack some of the staff, systems, processes and infrastructure that larger teams already have. And building those, you guessed it, requires capital.

Consistency of Service Delivery

There is a second important and related question for Zillow: can they provide consumers a *consistent* on demand experience with hundreds of thousands of different service providers in the last mile?

The answer is a qualified yes. It's qualified in the same way that any other platform experience is qualified: consumers will tolerate a few bad apples on a platform, as long as the platform itself delivers a high quality experience on the whole.

That is why Zillow implemented its CSAT system and why it is so important to its future. It was important enough that Zillow chose to take the risk of pissing off its paying customers and chose to preempt both (a) defections, and (b) forthcoming banishment by talking about not wanting to take money from subpart agents.

Zillow's platform play will work if most of the agents who are left on the system provide a high level of last-mile service to consumers who contact them. It will fail if most of them do not. Consumers will not blame the platform itself for one-off bad experiences, but they will not bother with a platform where the experience is a crapshoot.

The Platform, Revisited

Zillow's weakness as a Company (the last mile problem) turns out to be a strength as a Platform.

To extend the AirBnB analogy even further:

- Redfin = Marriott
- Agent Teams = Individual Hosts
- Zillow = AirBnB

Absent dramatic changes in 2019 and beyond, brokers and agents are far more likely to see Zillow as the platform (even as they chafe under Zillow's new rules) while they see Redfin as a direct competitor.

Opendoor, Realogy, Compass

In the September report, I put Opendoor, Realogy and Compass as contenders for the Platform.

In light of the analysis above, I think it's fair to now classify all three of them as wannabe Companies.

Opendoor

Opendoor is obvious as a Company, and Rampell even mentioned them by name. And until and unless Opendoor makes a major acquisition for consumer traffic (such as Realtor.com) it seems more likely than not that Opendoor would be happy to take 5-10% market share as one of the primary companies that buy and sell houses directly from consumers.

It should be noted that should Opendoor be successful as a major iBuyer, and in the future a major market maker in real estate, it would justify its unicorn status and then some.

Realogy

I had thought in September that Realogy could contend, if it wanted to. The rest of 2018, however, seems to suggest that Realogy's goal is to figure out how to become a Company with hundreds of thousands of independent agents and franchisees instead.

Ryan Schneider's focus appears to be to get Realogy back to its core, getting far better and far faster (his word) at execution, and then figuring out how to deliver the data technology that agents need to compete. Schneider has been talking about how to leverage the data assets that Realogy has since he took over as CEO, and his background in consumer finance will serve him well there.

Compass

At face value, Compass appears to be the one brokerage in real estate that is really shooting for becoming the Platform. The "referral economy" vision of Compass, which we've discussed throughout 2018, further suggests some kind of a Platform play.

Compass appears to be doing what Zillow wants to be doing: equipping its top producing agents and agent teams with the technology tools and capital-intensive services in order to compete against other Companies, such as Redfin and Opendoor. But

Compass lacks the traffic and leads that Zillow has in addition to the technology and capital.

Plus, as a full-blown recruiting-and-retention based brokerage, Compass is not seen by other brokers and non-Compass agents as a potential platform for doing business. It is, rather, a true competitor in the marketplace like Redfin is.

Everybody Else

As of today, it does not appear that anybody else is even seriously thinking about the future of real estate.

eXp is growing explosively, but it appears at least at this time to be following the old playbook of recruiting and retention, and headcount uber alles.

HomeServices of America is interesting solely because of its affiliation with Warren Buffet's Berkshire Hathaway, which means access to capital... but HSA keeps following the old playbook as well.

Re/Max acquired booj, and appeared to make that a centerpiece of its strategy, but as we went into in some depth throughout 2018, technology alone has a very poor track record in real estate.

Keller Williams keeps on doing Keller Williams things, which means growth, success, and the same old agent-first mentality that its competitors have copied and improved upon. (See, e.g., eXp Realty.)

The Next Generation Brokerages I wrote about in October haven't gone anywhere, but none of them have done anything in the new capital-driven world.

The tens of thousands of other brokerages in real estate keep doing what they have been doing for decades, trusting in the old adage that real estate was, is, and will forever be a relationship business and that they merely need to have strong relationships with agents who have strong relationships with buyers and sellers. To be fair, most of these smaller brokerages have little choice: they don't have access to capital to do anything other than what they have been doing.

Don't Forget: Leads

As long as individual agents bear the primary responsibility for lead generation, as well as the cost of doing so, these companies will face an uphill battle in offering institutional real estate service delivery. The best they can hope for is to do a Zillow strategy of trying to become an arms dealer to the agent teams, providing data, technology, insights, information, and tools to help them compete against the Companies out there.

But that effort runs into major problems due to the lack of lead generation capability.

Providing technology and tools to agent teams is just one of the four elements necessary to be a platform. Audience building and matchmaking are lead generation and lead management, respectively. These companies have very little capability in that respect.

Organized Real Estate in the Age of Capital

One of the more interesting things about this shift to capital, not headcount, as the basis for competition is the near-total irrelevance of organized real estate to this new world.

The MLS

In the new capital-centric world, the MLS remains important… but only as a repository of listing data. The capitalists neither care about nor pay attention to the myriad rules and policies of the MLS.

Why might that be?

I speculate that the reason is that the capitalists believe the new breed of companies (and ultimately, the Platform) will rewrite the rules of the road.

The MLS was born out of the pre-Internet broker-centric world, then evolved into the post-Re/Max agent-centric world, but everything about the MLS is rooted in the old way of individual agents delivering services to individual clients.

Institutional real estate, with its focus on fewer team members delivering services efficiently, is something the MLS is not designed for. The MLS would need to reconsider almost everything about itself if it is to remain valuable to the new way of competing.

That can be done; the MLS *can* change. But the highly political, subscriber/member-driven governance, the city council rather than corporate boardroom philosophy of most MLSs, and organic monopoly status enjoyed by most militate against making such a change until it becomes *absolutely* necessary.

The question is whether the MLS will have the time or the capability to make that change when it becomes absolutely necessary.

Redfin v. Zillow; Companies v. Platform

With all that said, 2018 turns out to have set the stage for the next big struggle for power in the real estate industry. The two principal sides will be Redfin (and similar) on one side representing Companies, and Zillow (and similar) on the other side representing the Platform.

It is an interesting battle between two giants because both are very smart and well aware of each other's strengths and weaknesses, and both are extremely savvy about competing for all the marbles.

Let us go through some of the more interesting obvious lines of attack and defense by both sides.

The Darkness Comes

In the December Red Dot, I wrote that Redfin would bring about a lower commission environment for everybody.

Taking revenues away from competing agent teams takes revenue away from brokerages and from Zillow, since Zillow relies on fees from agents and agent teams for 70% of its revenues. It's not a direct attack on Zillow, but it is an effective indirect attack, chopping a leg out from under Zillow's entire business model.

Concentration of Power

Although loss of revenues will hurt Zillow in the short run, I think it ends up helping Zillow in the long run as it makes a play for the Platform

If there is attrition among agent ranks, the best will survive and take market share. They will look a whole lot like Redfin does.

Redfin will still find success. But thousands of entrepreneurial, experienced, and highly motivated local teams, equipped with the latest technology and data tools from Zillow, who can more than match Redfin's advertising spend and online lead generation capabilities *through Zillow*, will be tough competition indeed.

Where Do Brokerages Fall?

One of the interesting fault lines of the future is where brokerages fall once the basis for competition shifts away from headcount and towards capital.

On the one hand, Redfin is a direct competitor to their agents for buyers, sellers, and other services.

On the other hand, Zillow ends up delivering so much of the value that these brokerages and brands also want to provide: technology tools, data products, etc. If the brokerages think their way forward is to become an arms dealer to agents, then Zillow is a direct competitor in that arena.

Will the MLS Pick Sides?

Those of us in the industry realize that the MLS still remains powerful, isn't going anywhere without a fight, and could sway the outcome between Companies and the Platform.

But there are so many factors to consider for the MLS.

On the one hand, ever since NAR decided to get involved with RPR and Project Upstream, the MLS community has gotten closer to Zillow, who in turn has made substantial efforts to be the best friend of the MLS in exchange for listing feeds.

On the other hand, Redfin is a full brokerage Participant in every MLS it joins. The MLS was built to facilitate transactions between Participants and their agents.

On the third hand, MLSs are deeply embedded in REALTOR Associations. Siding with Companies, who by their very existence drive weaker brokers and agents out of business, would be difficult to say the least. It requires a wholesale change in culture, governance, and possibly corporate structure.

On the fourth hand, the MLS has long been the platform for real estate, at least in its local market. Companies like Redfin and agent teams do threaten that platform status. But the emergence of an actual Platform truly threatens the MLS.

Whatever a particular MLS decides to do, it does not have much access to capital to do much of anything. Many MLSs are not even standalone entities; they are member services of the local nonprofit REALTOR Association. Many others are setup as nonprofit organizations. Who is investing in nonprofits?

Government Intervention

Finally, since real estate is a heavily regulated industry, and the REALTOR Associations remain politically powerful if economically irrelevant to the new age of capital-based competition, we need to be watching for government ~~interference~~ action.

Over the years, I have also written about the problem of employment law and real estate.

I have long said that the problem with misclassification of agents will arise out of agent teams who exercise far too much control over the team members.

Gradually, then Suddenly

In Ernest Hemingway's *The Sun Also Rises*, Mike is asked how he went bankrupt. His answer is, "Gradually and then suddenly." I think most changes come gradually and then suddenly.

We have been looking at these changes throughout 2018 and for a few years prior. It may be that 2019 is another year of gradual change as well: when in doubt, bet on inertia, at least in real estate.

Nonetheless, there are some reasons to think that the "suddenly" part of the equation is not too far off.

The march towards institutional real estate has been long indeed. Redfin has been in business for over a decade. Zillow has grown year after year for over a decade. Brokerages have been struggling with all of the issues we covered throughout 2018 for decades. The emergence of agent teams is nothing new, and capital has been flooding into real estate for a while now.

Uber & Lyft overtook taxis in one year: Q1 of 2014 to Q1 of 2015. They overtook rental cars after one more year. And the growth curve of ridesharing vs. the decline of traditional taxis and rental cars looks to me like the definition of "gradually, and then suddenly."

A Note on Access to Capital

I can't leave this report without at least taking note of something interesting: venture capital isn't the only kind of capital out there.

There are hundreds, if not thousands, of hedge funds, private equity funds, private investors, and others who are not in the venture capital game, but remain keenly interested in the transformation happening in real estate today.

I know, because I get phone calls from them all the time.

If competition going forward is going to be based on capital and access to capital, you need to get capital. It requires taking on some risks, requires changing the way you've been doing things for decades, and some kind of a plan that makes sense in the environment ahead of you. But the good news is that for those willing to change and compete, access to capital can be had. You don't have to be a tech startup with data science teams and a cool Silicon Valley office. You don't have to be a young thirtysomething tech guy. You just have to be willing to change as the nature of competition changes.

Recommendations: Brokerage

Please read the full Recommendations section for more detail.

- **The Platform Play; Run the Brokerage as a Loss Leader The Platform Play; Run the Brokerage as a Loss Leader**
- **Become a Company**
- **Cut Costs Dramatically, and Become a Next Generation Brokerage**
- **The 1099 Conundrum**
- **Get Capital**

Orient.

MAIN SECTION

There will come a day at some point in the future when we will look back on 2018 as we look back on 1973 today and say, "That's when everything changed."

1973 is when Dave Liniger founded Re/Max in Denver and ushered in the age of agent-centric brokerage. Although the real estate industry initially fought Liniger and Re/Max with the fear and loathing that we associate with the anti-Zillow crowd today, eventually, everyone copied Re/Max's agentcentric model. Brokers started to transform into B2B services providers, and recruiting and retention became **the** basis of competition.

Despite the bewildering variety of brokerages with a wide variety of value propositions, for the past 45 years the industry has operated in large part with the same headcount-based business model of recruiting agents as 1099 independent contractors, providing them with some mix of services, and then taking a cut of commissions generated by those agents. Many of the traditionalists tried to hold on to the idea that the brand, the company, the brokerage is what really matters and have tried time and again to keep their margins high, keep control over the agents, and pursue something like a modified apprenticeship model. Each time, they saw losses in market share, losses in revenues, and had to adjust to the competition in order to survive.

Most recently, traditional brokerages attempted to fight the formation of agent teams in a variety of ways, from discouraging them in the first place, creating rules and policies to put up barriers to forming and operating a team, to trying to supply the kinds of products and services that teams would provide. All have failed, and the most diehard brokerages who saw the agent team as an existential threat found that they had to go along, or lose all of their top producing agents to competitors who embraced and encouraged teams. The growth curve of Keller Williams is largely attributable to its embrace of agent teams early on.

The old basis of competition was based on headcount, which meant that recruiting and retention was the key to success. Everything that brokerages, MLS and Associations, and technology companies in real estate have done for the past 45 years was based on and around creating advantages for recruiting and retention.

Today, it is nigh-impossible to find a non-boutique brokerage that does not offer high agent splits, an environment conducive to agent teams, and (effective) caps on commissions. That they do this through fig leaves, such as paying for an agent's marketing expenses or providing them free office space or other perks, to avoid admitting that they do offer these things is of little importance. As the Bard noted, a rose by any other name would smell just as sweet.

2018 is when we can say definitively that the old way was replaced with a new basis of competition. Like most ancient traditions that die, it will take time for the rest of the world to notice. There are, after all, still taxi companies that exist with taxi medallions and taxi and limousine commissions and such.

The old basis of competition was based on headcount, which meant that recruiting and retention was the key to success. Everything that brokerages, MLS and Associations, and technology companies in real estate have done for the past 45 years was based on and around creating advantages for recruiting and retention.

The new basis of competition is based on deploying huge amounts of capital, which means that access to capital is the key to success. Everything that the companies that will dominate the future of real estate will do will be based on and around acquiring and deploying large amounts of capital.

It is the brokercentric model that Re/Max killed off in 1973 come back from the dead in a whole new way. The difference is that the companies that will dominate the future may not be brokerages.

Let us start thinking about this by analyzing the best presentation on the state of real estate in 2018. I'm actually a bit envious that it wasn't me that created it, but not all that envious because only an outsider could have cut through the details, cut through the politics, and cut through the crap as succinctly as Alex Rampell of Andreessen Horowitz did in a presentation titled, "When Software Eats the Real (Estate) World".

Watch the whole thing if you have not already. It's relatively short, and it lays the groundwork for understanding the shift that hit the tipping point in 2018.

When Software Eats the Real (Estate) World

One of the things I do in my consulting practice is work with and talk to a rather large number of people in the investment community. As a general rule, what I have found is that most of them are incredibly smart people who deeply understand finance and the business world, but are befuddled when it comes to residential real estate brokerage. So much of what happens in our industry makes no sense to these men and women who are used to industries where business is just that: business.

So it is that I have found that outsiders rarely get the industry right. They make huge assumptions which turn out to be wrong, or simply do not understand how things actually work in real estate.

Alex Rampell, a general partner at Andreessen Horowitz, one of the preeminent venture capital firms in the world, is one of the very few outsiders who really understands the industry. There are details he misses, and some intricacies beneath the surface that he doesn't address in the presentation, but boy, he sure hit the target squarely with his basic thesis:

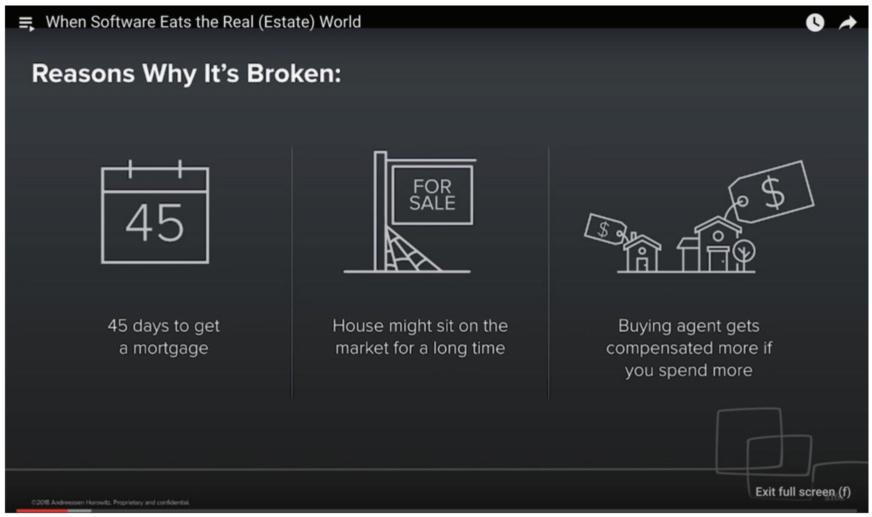
> **In the future, you will buy your house from, or sell your house to, a company.**

The arguments he marshals together to support that thesis are virtually ironclad. It's impossible to argue, especially for me since I have made all of those arguments and those points myself over the past several years.

Consumer Experience Sucks

Let us start with the basic observation that cannot be argued: the consumer experience with buying or selling a home in North America today sucks.

Rampell says there are "many reasons why it sucks to buy or sell a house right now" but focuses on a few of the major ones:



Mortgage

He talks about how needing a mortgage means the buyer is just going to lose out on any desirable house with multiple offers, and that getting a mortgage takes an average of 45 days. But of course, getting a mortgage is far, far worse than that.

In the August Red Dot on iBuyers, I wrote:

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

mortgage required 50% down payment, and offered a 5 year term for an interest-only coupled to a balloon payment at the end, as was common at the turn of the 20th century, relatively few families could afford to buy a home at all.

The reforms of the New Deal in the 1930s—the 30 year mortgage, amortization, lower down payment requirements, government guarantees, etc.—opened up homeownership to vast numbers of middle and lower-income families. Homeownership became the American Dream because of those changes to financing.

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

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

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

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

> 1) **The government is clamping down hard.** Since 2009, the government has created enormous regulation for banks in order to not repeat the housing crisis again. For example, the CPA letterhead and signature requirement was introduced recently in Feb, 2014, and it's causing massive headache for tons of small business owners in America. CPAs are charging usurious fees to audit because they can. Meanwhile, the government makes us send a new 7-10 page Good Faith Estimate every single time we change a single number.

> The rules were created by the Consumer Finance Protection Bureau and were mandated under the Dodd-Frank Act to ban many of the loose practices during the housing bubble e.g. NINJA loans. To be considered a qualified mortgage, a loan amount cannot exceed a total debt-to-income ratio of 43%. In the past, plenty of borrowers were up to 70%+ . Average mortgage refinance or new mortgage lengths have doubled in the past four years as a result.

Rampell is correct that in a competitive situation, the buyer who needs a mortgage will lose out to a cash buyer. But even if the seller accepts your offer, and you do end up going under contract, the pain has simply begun for the buyer who needs a mortgage.

In the August Red Dot, I discussed the three main problems that Keith Rabois of Opendoor wanted to solve: uncertainty, inconvenience, and the length of time the transaction takes.

Time Consuming

Rampell also says:

> If you're selling a house, and this is for many people their most valuable asset, it might sit on the market for months.

He notes that in some super-hot seller's markets like San Francisco or Los Angeles, you might be able to sell your house quickly if you price it well. But for most of the country, it takes much longer.

He touches on how annoying the process is, mentioning "50 people who go through the open house and all the other things you don't want to do."

Of course, he doesn't go far enough or into great detail about what the experience of selling a house is like today. I did.

In the August Red Dot, I discussed the three main problems that Keith Rabois of Opendoor wanted to solve: uncertainty, inconvenience, and the length of time the transaction takes.

On Uncertainty:

> The listing price is only the starting point; every real estate agent tells you that. The final sales price might be far lower, or far higher, depending on all kinds of factors—many of which you, the home seller, do not control.
>
> When will it sell? Who will buy my house? What concessions will they want from me? Is this going to be easy, or filled with problems?
>
> A good real estate agent will do what she can to help with the uncertainty—expert pricing backed up with good solid comparables, effective marketing, solid negotiations, etc.—but even with all that assistance, uncertainty is part and parcel of every traditional home sale transaction.

Buyer agents make more money if the buyer pays more for a house. Listing agents might make more money if the house sells for more, but there is an incentive to take the deal on the table instead of pushing for more.

On Inconvenience:

> Selling a home is annoying. I wrote about having to stage my house, then tiptoe around my own living room, and then having to leave the house for an hour when buyers wanted to come by and see the place. But that really minimizes the actual experience of living through that process.
>
> ....
>
> It is so bad, in fact, that some people go through the hassle and expense of moving out of their home for the first several days of the home being on the market.
>
> ....
>
> Additionally, most buyers do not want the homeowner present at the house. Listing agents therefore always advise the seller to leave the house while buyers are touring it. Constantly having to secure one's valuables, make sure the house is clean and in ready-to-show condition, then find somewhere to go for an hour or so is not a small thing. If you have children, the annoyance factor and the difficulty goes up, way up.

On How Time-Consuming the Process Is:

> First you have to prepare the home for marketing. That means cleaning, repairs, staging and maybe upgrades from something cheap and easy like new paint to something more involved like new carpets to something major, like a new roof. All of that prep takes money, but it also takes time.
>
> Then you have to market the home, typically through your agent. The full panoply of MLS, online marketing, flyers, open houses, network marketing, etc. etc. go into play, each with its own set of questions and stress: How much traffic is my listing getting on Zillow? How many calls? How many showings?
>
> You go through the whole showings process, which is annoying (see above). Then you sit and wait for offers, then the back-and-forth with the buyers. That could be quick in a hot seller's market, or it could be drawn out in a buyer's market.
>
> At last, you execute a contract with a buyer. Hooray! Except now you enter the contract-to-close process which could be extremely time consuming depending on inspections, financing, any contingencies of the buyer (e.g., they have to sell their house first before they can buy yours), and a hundred other things that could go wrong.
>
> It is not at all uncommon to see 90-day close terms in sales contracts, which means that in addition to the time it takes to prepare and market the home, the homeowner is looking at an additional 3 months of simply waiting to close.

There are other issues, of course, such as burdensome regulations, lack of transparency about the process, and a hundred other details, but broadly speaking, those three are the main problems of the transaction.

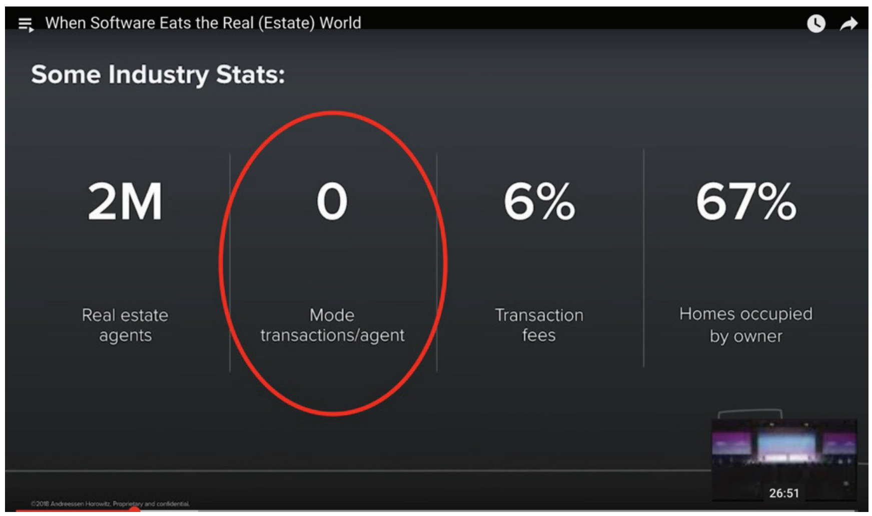
Why The Experience Sucks

Having succinctly made the case that the experience of buying or selling a house sucks for consumers, Rampell spends the next part explaining *why* it sucks. This is the part of the presentation where it becomes obvious that he has done his homework, and really does understand how real estate actually works.

The Agency Problem

Rampell points out the problem with agency, which is something of a verboten topic within the industry. Buyer agents make more money if the buyer pays more for a house. Listing agents might make more money if the house sells for more, but there is an incentive to take the deal on the table instead of pushing for more. As Rampell points out, an extra $1,000 is meaningful to the seller, but the $30 the listing agent would get is not meaningful to the agent, so the agent would rather have the deal close than to risk it blowing up over $1,000.

The agency problem is *hotly* contested by brokers and agents who



insist that they would never place a commission check ahead of the client's best interests. I happen to know that some agents do indeed behave that way, but it's a difficult argument to swallow for most people. It amounts to claiming that real estate agents are angels infused with nobility. Maybe a few are, but most are mere human beings.

The Problem of Incompetence

Rampell also goes directly at the problem of widespread incompetence among real estate agents using statistics that are brutal, yet difficult to argue:

He talks about there being 2 millions licensed real estate agents in the United States. Using stats from Washington State, Rampell says that he tried to find out what the mean, median, and mode of the number of transactions per agent were in 2017.

Most people know mean (average) and median, but mode refers to "the most frequently occurring number found in a set of numbers." And the mode for real estate agents in Washington for 2017 was 0. That's right, zero.

Rampell concludes:

> If you find a random real estate agent in Washington State, the highest chance number of transactions they [had] is zero. How is this possible?

He goes on:

> Would you trust a taxi driver that's only driven zero times in the last year. Probably not. Would you trust a surgeon that's done zero [surgeries] in the last year? Hopefully not. But this is how real estate works.

Those of us in real estate know for a fact that Rampell is right. It's just embarrassing. So we don't often talk about it, at least outside of specific restricted venues.

As I have been writing and talking about this issue for years, I would like to invite you to go search my blog, Notorious ROB, for posts related to "professionalism" and "raise the bar" or "#RTB". There's no reason to rehash issues and topics that have been beat to death within the industry already.

Brutal as the statistic and the conclusion may be, it's hard to argue against them.

Problem of Organized Real Estate

Rampell then casually throws organized real estate under the bus, something only an outsider can do.

He starts by noting that the U.S. is quite resistant to changes to the high commission rate: 5-6% versus 1-1.5% in Europe and 3% in Canada. He quotes George Bernard Shaw and notes that "All professions and conspiracies against the laity" and then talks about how real estate tries to make it the most anti-competitive industry possible.

He points to Department of Justice actions against real estate, anti-rebate laws, minimum service laws, and then even explains the history behind the 6% commission rate.

Finally, he casually notes, “some regulatory capture, lots of lobbying and lots of other laws that are bad for consumers but good for 2 million real estate agents, that’s kind of what’s kept [the 6% commission] going.”

It’s a remarkable exposé, particularly because it comes across as unemotional. He certainly passes judgment on organized real estate, but there’s no real anger or outrage.

From Portals to Actors

Rampell then talks about the impact of technology on real estate, starting with Zillow and Trulia, which he says simply aggregated demand.

Zillow, Trulia and other Real Estate 1.0 tech companies made money by selling leads to real estate agents. As Rampell puts it, the first generation of tech companies in real estate “monetized the traffic by selling into the current industry, as opposed to really trying to change the fundamentals of the industry.” That is going to change.

What changed for Real Estate 2.0 tech companies are three things:

- Consumer Expectation of On Demand Experience
- Data Science Technology
- Capital

Rampell thinks that the next generation of real estate companies would leverage all three to create “full-stack” solutions.

He thinks agents won’t go away, but they’ll operate under the rubric of a company, which can bring data technology and capital to provide the on demand experience that consumers want.

He then goes on to talk about a number of companies, such as Flyhomes, Opendoor, Divvy, Point, Bungalow, etc. Some are iBuyers, others are involved in things like partial ownership, and others are into finding roommates and alternative living arrangements.

Institutions, Not Individuals

Although the phrase “on demand real estate” instantly brings iBuyers to mind – after all, that was Keith Rabois’s vision with Opendoor – it encompasses more than just iBuyer. It speaks to consumer expectations.

I spoke with Jeremy Wacksman, President of Zillow, for the August report on iBuyers and wrote:

> First, Wacksman pointed out something fundamental. He talked about the big picture that most people in the industry are missing, which is that consumers have gotten so used to “pushing a button, and magic happens” that they now expect it. He used Uber as an example. At Uber’s launch, it was magic to push a button and have a car show up a few minutes later with a map showing exactly where the car was. Just a few years later, consumers complain about slow arrival times because they take the magic for granted.
>
> He said that Zillow got into the iBuyer game, first with Instant Offers and now with Zillow Offers, because of that consumer experience of pushing a button and having magic happen will quickly turn into a default expectation. “It’s not about flipping houses; it’s about pushing a button,” he said.

But in retrospect, it isn’t just Zillow Offers that is about pushing a button and expecting magic.

Rampell uses the example of driving around with a real estate agent who has access to the lockbox, and contrasted that with new technology like August Locks. We already know that Opendoor uses smart locks to allow potential buyers access into their homes to speed up the whole process.

That’s just one example.

Within the industry, we know that one of the most important and fundamental technologies that changed things was digital signatures. Simply by allowing clients to sign reams of paperwork on the computer, on a tablet, or even on their phones, and avoiding FedEx envelopes, fax machines, messengers, or needing to meet in person to sign papers changed the experience for the better.

One of my important takeaways from 2018, especially with Zillow's Premier Agent 4.0 change, is that consumers expect as close to instant results as possible. After all, they get that in other areas of their lives; we all do. We don't pull up an Uber app and wait for someone to call us back to schedule the ride. We don't place an order on Amazon and wait for the actual retailer to contact us. Hell, most of us don't even bother buying CDs; just buy a song on iTunes or Amazon Music and voila, it's instantly on our computer, phones, or music players.

...meeting the on demand consumer experience is not solely about technology

So while iBuyer is at one extreme of the on demand consumer expectation, the principle of on demand expectations exists across the entire consumer spectrum.

That is, consumers will not wait 48 hours to hear back from an agent on an inquiry. That inquiry has to be answered *right now*, as close to real-time as possible. Studies by NAR and others in real estate have shown that an overwhelming percentage of consumers work with the first real estate agent to call them back. Quite a few top producing agent teams put in systems, hire staff, and implement technology to make sure that they are responding to leads as quickly as possible.

Not Just Technology

The important thing to remember here, I think, is that meeting the on demand consumer experience is not solely about technology. The iBuyer case is obvious: you also need enormous amounts of capital to deliver *that* on demand experience.

But the case of agent teams that prioritize responsiveness is another example. Technology alone can't get it done. Teams need people, processes, systems, and technology to respond to consumer inquiries in near real-time. They have ISAs (Inside Sales Agents) who staff telephones, respond to emails and text messages, and ensure that consumers have as close to an on demand experience as possible.

Rampell thinks that companies will dominate the transaction because of their data science teams and data technology. I think that's only partially correct.

The other reason that companies and institutions have an advantage is that they can execute far better than an individual agent, or a collection of individual agents, can.

Take something as basic as a home tour, as an example. A buyer who wants to see a particular home and is working with an individual agent (and even most agent teams) has to contact his agent, schedule a showing, show up at the appointed time and place, and go tour the home with the agent. The agent often has to coordinate with the listing agent to make sure that the home can be shown at that time: current residents, if any, are out, no one else is touring the home at that time, etc. etc. Yes, smart locks placed on empty institutionally-owned homes would be one way around the problem.

But in some of its markets, Redfin uses showing agents who are on call and are placed in strategic locations. Redfin's technology automates the showing request as much as possible, and sets up the tour as quickly as possible – sometimes, within minutes of the request. The showing agent then drives over, opens the door, and the buyer can tour the home.

The criticism of this system is that the showing agent has very little knowledge of the home and is merely a door opener. It is inferior to walk through a house with a local expert who is advising you on the possible purchase.

What that criticism misses, however, is that if the consumer wants an on demand experience, he can get it from Redfin by using a door opener who knows nothing... and then speak to the more experienced advisor after the tour. Is it disjointed? Yes. But is it more on demand? Of course it is.

For what it's worth, on an initial home tour, the buyers may not be interested in an in-depth explanation of the history of the house and the developer who built the neighborhood. They might just want to get a quick feel for the house, walk through it, look at the kitchen, and get a general sense of the place. They may not need an expert advisor for an initial tour. They will need her later, if they decide to move forward.

Across the board, institutions have an advantage over individuals when it comes to delivering this kind of an on demand experience.

They have more staff, more money, more technology, more systems, and more efficiency from division of labor.

It isn't that Companies have data science teams, who can crunch terabytes of data and provide better answers to consumer questions, and individual agents do not. It is that Companies have teams, period, with specialization, systems, processes, and technology to back all of that up – and individual agents do not.

Institutional Advantage Requires Capital

The reason why I wrote in the introduction that we are moving into a new era in which capital becomes the basis of competition, rather than headcount, is that this institutional advantage in providing the on demand consumer experience requires capital.

Staff has to get paid up front, every two weeks. Independent contractors do not. But staff has to follow your procedures and use your systems; independent contractors do not.

Staff needs processes and procedures to follow, and somebody has to manage them to make sure things are being done the way they're supposed to be done. If there are problems with the process, then someone needs to tweak it, change it, or abandon it and put something else into place.

Technology systems cost money. While vendors abound who promise to deliver all kinds of advantages, buying technology yields no advantage whatsoever since everyone else can buy the same technology. If companies want a competitive advantage from technology, they're going to have to build it or buy it and keep it from everyone else.

All of this requires capital.

The idea that companies, institutions, need capital to pay salaries and buy/build technology is hardly earthshattering. And every company in every industry faces the same challenges.

In real estate, there is one more capital-intensive requirement.

Lead Generation Requires Capital

Even if an institution has a great deal of capital, has built technology, and has a data science team, in real estate, that institution will not become a Company from whom people will buy houses and to whom people will sell houses. To become a Company, the institution needs to generate *leads*.

Without leads, there is nothing for the staff to work on. The data technology is useless unless there is a client who needs the information and insight that technology generates. Advertising is not free. Marketing is expensive and time consuming and filled with uncertainty.

Even for individual agents, if they are doing real estate as a business rather than as a hobby, lead generation is never free. Whether they pay for leads, pay for postcards, pay for marketing campaigns, or simply spend hours staying in touch with their sphere, lead generation requires money or sweat or both.

The Old Way: Recruiting and Retention of Individuals

The old way of doing real estate, at least from the 70s on when Re/Max introduced the agent-centric model to the industry, was to recruit and retain as many individual agents as possible, pushing the capital costs onto the agents, and then taking a small piece of the commission pie.

Long before the Internet came along, the relationship between brokerages and individual agents was not an employer-employee or even a principal-subcontractor relationship, but that of vendor and customer.

This is a sensible approach to real estate, pre-Internet. Real estate is not a commodity, local (for obvious reasons), illiquid, and expensive. Word of mouth marketing and referrals have proven to be the most effective way to get leads and inquiries over the years. Even today, referrals and word of mouth remain the mainstay of lead generation for most agents.

It made economic sense for brokerages to offload the cost to agents in exchange for very high splits. Since the cost to the brokerage of having 1099 independent contractor agents who paid their own expenses including lead generation was negligible, it made sense to recruit and retain as many individual agents as possible.

Long before the Internet came along, the relationship between brokerages and individual agents was not an employer-employee or even a principal-subcontractor relationship, but that of vendor and customer.

Re/Max started the revolution, Keller Williams improved upon it, and the Next Generation Brokerages (profiled in the October report) took it all to the logical conclusion:

> Our thesis is that the NGB is best thought of not as a real estate brokerage but as a **niche coworking space company**.
>
> The NGB is, in effect, the adoption of the coworking space movement and philosophy into the real estate industry. The NGB is a broker, legally speaking, who does do all of the things a broker is required to do.
>
> Outside of that limited role, however, the NGB is actually operating a coworking space for real estate agents.

I still believe that the NGB model is best suited for competition under the old way of recruiting and retention for all of the reasons I went into in the October Red Dot. But even the NGB faces problems once competition shifts away from one based on having thousands of individual agent customers to one based on becoming an institution, a Company, with access to capital.

The New Way: Institutional Service Delivery, Using Teams

The new way of institutional real estate is to deliver services to buyers, sellers, renters and landlords using teams of people, rather than individual agents. Note that the agent team is exactly that: a team of people.

Clear roles, standard procedures, common systems, and specialization are the order of the day with institutions. Technology that enables cooperation and collaboration both enables teams and makes them more efficient.

The necessity of delivering a consistent level of service means control over team members, whether by employing them as staff or by controlling the flow of business to "contractors" whose entire livelihood is reliant on the team.

For the consumer working with an institution, he works with and interfaces with a number of different team members who specialize in certain roles. There may be a lead relationship manager (the lead agent or a senior buyer's agent) who is responsible for the overall transaction, advice, and strategy. The paperwork is likely handled by a transaction coordinator. If listing a home for sale, marketing specialists get involved. Professional photography, staging, repairs and updates, even lawyers in states that require their involvement, as well as mortgage, title and escrow people all get involved under the direction, guidance and management of the lead relationship manager/agent and the team itself.

When the mode of transactions for Washington State real estate agents is zero, the gap in efficiency between institutional real estate and individual real estate comes into focus.

So even for the traditional real estate transaction, institutions have advantages over individual agents. Now add iBuyer services and data science – differentiating technology that cannot be bought off the shelf.

When Rampell talked about buying homes from and selling homes to Companies, I believe he was referring to this overall mechanic: having agents under the rubric of a company, armed with institutional-grade technology, data analysis, information, with a team of support staff to help even the painful traditional experience go as smoothly as possible.

And should you want to cut out all of the delays and uncertainty and annoyance and either buy a house out of inventory or sell your house to the Company? Why, the Company can perform that service for you for a fee.

The efficiency of Companies is significantly higher than the efficiency of individual agents, or a collection of individual agents. The average Redfin lead agent closed 9.2 transactions in Q3, an annual rate of almost 37 transactions. There are agent teams (and small boutique brokerages, which are essentially teams) where the team average is north of 40 transactions a year, with a minimum of 24 in order to remain on the team.

When the mode of transactions for Washington State real estate agents is *zero*, the gap in efficiency between institutional real estate and individual real estate comes into focus.

Competition under the new way, then, is not about headcount of individual agents. Instead, it is about specialization, teamwork and efficiency. It requires staff, systems, and technology, as well as new services like iBuyer, on demand home tours, close to real time transactions and communications, and whatever else. The goal is to live up to consumer expectation of, "Push button, magic happens."

All of those things require capital and access to capital. Those who have capital or can get capital have a huge advantage; those who do not are left with the old way of doing things.

So it is a bit strange that Rampell left out the one company in real estate that perfectly fits his description of a company that can leverage data scientists and data technology as well as capital to provide a full-stack on demand consumer experience: Redfin.

Redfin Is That Future

Reading over what I wrote about Redfin over the course of 2018, the picture that emerges is of the first true Real Estate Technology 2.0 Company that needed only to learn for itself that it can successfully implement an iBuyer program.

In the June Red Dot, I wrote:

> Basically, my thesis is that because Redfin started life as a brokerage, rather than a web portal, Kelman and company realized the importance of the "deep funnel" long before

> Zillow did. So while they launched a website and paid a great deal of attention to the top of the funnel – lead generation, traffic, etc. – Redfin has been refining the entire funnel for ten years.

Think of "deep funnel" as a way of saying what Rampell said about the on demand consumer experience, and the whole paragraph still works and moreover, fits the Redfin strategy better.

Redfin from the very start has been focused on providing that "on demand" consumer experience at lower cost. Its obsession with efficiency, speed, customer service, and close rate (detailed in the June report) is supported by Redfin's entire technology stack. Redfin has always tried to use data science to support its workforce of employee agents to deliver better, faster, and cheaper service.

The missing piece of the puzzle was iBuyer: a way to make the transaction itself far less painful, uncertain, and time-consuming. Redfin jumped on iBuyer early on, launching Redfin Now as a test in Q2 of 2017. Apparently, the test was successful, since Redfin openly committed to Redfin Now as of Q3/2018.

Critically, Redfin has the "last mile" of actual human beings with boots on the ground covered.

But iBuyer was just one piece of the puzzle for Redfin, rather than the whole solution, as it was for Opendoor. As I wrote in June:

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

When we take a step back, then, and look at what Redfin has become by the end of 2018, we see a company perfectly situated to be one that consumers buy houses from, and sell houses to.

Redfin has not forsaken the traditional agency business of helping buyers find and buy homes and sellers list and sell their homes. That remains its bread and butter. Redfin has mortgage operations, as well as title through its subsidiary, Title Forward. It now has an iBuyer business to which it committed, a necessary condition to contend to be the Platform for real estate, so it can buy your house from you directly, or sell you one of their own directly.

Redfin has always had strong data technology and data science capabilities, and it has access to capital to provide the on demand experience that consumers want.

Critically, Redfin has the "last mile" of actual human beings with boots on the ground covered. Even Rampell conceded that agents aren't going away; they will simply work under the rubric of a company, because only a company can take advantage of the kinds of data technology and capital-intensive services that the real estate transaction of the future will require. Redfin has those agents, and what's more, it has them in a way that no other major brokerage does.

From the December report, quoting Glenn Kelman from the Q3 earnings call:

> 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**.
>
> …
>
> **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

The industry as a whole has tended to ignore Redfin because of its boots on the ground are not numerous. Even today, Redfin only has some 1,400 lead agents which is about what a decent sized midsized regional brokerage might have. eXp by comparison had almost 14,000 by the end of Q3.

That mattered a great deal when the basis of competition was headcount: the ability to recruit and retain individual real estate agents. It matters far less, as Redfin has shown us, when the basis of competition is access to capital and the ability to deploy that capital to deliver on demand services backed up by data technology.

In that case, it turns out that Redfin's last mile is superior to everybody else's last mile.

If consumer demand for other services – such as the trade-up situation of Knock and Flyhomes, or the partial-ownership of Divvy, or finding roommates of Bungalow – Redfin has the technology, the boots on the ground, the processes, the know-how and the access to capital to deploy those services.

Is it any wonder that Redfin is now going straight at one of the most sacred pillars of the real estate industry, the 6% commission rate?

That the real estate game has changed, and that Redfin was well-positioned to take advantage of those changes, explains the strategic thinking behind Zillow's pivot in 2018 from an advertising website to something more like an agent team.[2]

Zillow's Pivot, Reconsidered

We dealt at length with this topic in the December Red Dot, when I wrote that 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. Please go back and re-read the December report if you'd like to re-engage the topic in greater detail.

The combination of initiatives that Zillow launched, almost simultaneously, including Premier Agent 4.1, Zillow Homes, mortgage, Zillow Flex, and the Consumer Experience Report (CSAT) means that Zillow is taking a huge risk, but with huge potential rewards.

[2] I spent a lot of time in the December report discussing Zillow's transformation into something like a brokerage, but really more of like an agent team, or a team of teams.

Wall Street reacted negatively, and that makes sense for investors who might be looking at things on a quarterly basis. For the long term buy-and-hold investors, they need to try to figure out if the rewards are worth the risks, and if Zillow is going to win its gamble.

Looking back on 2018 with the changed rules of competition in mind, Zillow had little choice but to gamble because it was falling behind Redfin in one absolutely critical area: the last mile, the real estate agent.

What can Zillow promise potential customers when each brokerage customer and each Premier Agent at that brokerage set their own service level and pricing?

The Strategic Problem, Take Two

In the December Red Dot, I wrote that Zillow's strategic problem was that its traffic had stopped growing because it was pretty close to the cap. I was convinced by the data that Bradley Safalow of PAA Research had produced showing slowing traffic growth, and the fact that Zillow was pushing 190 million monthly unique visitors. I wrote:

> 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.

I thought then that the strategic problem for Zillow is *how to increase revenues and profits if the top of the funnel (traffic and leads) is maxed out*. In light of the Rampell presentation, which I believe could be representative of how the smart money thinks about real estate, Zillow may have been facing a different strategic problem.

After all, Zillow could have simply invested in creating more seller leads, implementing Zillow Flex (payments on close), and other tactics to monetize the now-capped traffic. Because capped traffic does mean a problem on the one hand, but on the other hand, it means absolute dominance of the space.

It may not have been necessary to (a) be the first point of contact for the consumer, and (b) implement the CSAT consumer satisfaction system just to sell more leads, take success fees at closing, or just go forward with its iBuyer program, Zillow Homes.

But if the strategic problem isn't to monetize capped traffic, but to create the on demand consumer experience, with agents who are empowered with data technology, just like Redfin can and does, then Zillow has a real problem. As Glenn Kelman said, what can Zillow promise potential customers when each brokerage customer and each Premier Agent at that brokerage set their own service level and pricing?

Keep in mind that one of the reasons for Premier Agent 4.0 that Zillow kept invoking was the fact that a consumer's inquiry on Zillow leads to contact with an agent only *half the time*. That is pretty far from an on demand experience; in fact, it's not even close to a satisfactory experience, never mind an on demand one.

Zillow could dominate traffic. It could generate far more leads than Redfin ever could. It could become awesome at iBuyer services, which appears to be a strategic focus given the actions that Zillow has taken, such as hiring Arik Prawer of Invitation Homes to run Zillow Homes.

You know what Zillow can't do? Provide assurances to buyers and sellers if they want to go the traditional route. Because Zillow does not control its brokers and agents any more than traditional brokerages control their agents.

That last mile problem is a big one, if the future of real estate is buying from and selling to a company.

Zillow, the Arms Dealer

I now believe that what Zillow has done is to try to tackle the last mile problem in the smartest way possible: go past the company stage and go straight at becoming the Platform.

Let's assume for the sake of discussion that Redfin has become The Company that can deliver the on demand experience that consumers demand. Zillow cannot compete head-on against Redfin. For one thing, it would need to become a brokerage with employee agents, and Redfin has a 10-plus year head start on that. More importantly, becoming a real brokerage would mean the immediate crash of its Premier Agent business as well as the termination of all MLS, franchise and brokerage data feeds.

What Zillow can do, however, is to help its customers – the brokers and agents who pay them – become Companies. If you will excuse the analogy, Zillow can't go to war against Redfin directly, but it can become the arms dealer to Redfin's enemies and help them go to war against Redfin.

What local experts with solid spheres, a good reputation, and a knack for great customer service lack is the online lead generation, data technology, and capital-intensive iBuyer (and similar) services that Redfin has. As it turns out, Zillow has exactly those things.

The question of the next few years in real estate is whether an agent team, equipped with all that Zillow has to offer, can compete with Redfin in its local market even in a low-commission environment. Zillow is betting that they can.

This is not and will not be easy for a number of reasons.

That last mile problem is a big one, if the future of real estate is buying from and selling to a company.

Competence vs. Production

While the real estate industry is filled with incompetence and unproductive agents (Rampell pointed this out with devastating simplicity), fact is that many real estate brokers and agents are every bit as good as Redfin, *if not better*, at delivering great personalized service to buyers and sellers.

There is a lot of truth to the talk within the industry that while Redfin as a company is impressive, many of its lead agents are not necessarily the best of the best. Other brokerages have had success recruiting agents away from Redfin with promises of unlimited earning potential, for example.

The problem for Zillow is that while top producers are often extremely competent, personable, charming, ethical, deeply knowledgeable, with years of on-the-ground experience with all manner of situations and difficult transactions… many are not.

For every top producing agent team leader who takes her fiduciary responsibility to protect her clients' interests very seriously, you can find another who is just focused on numbers and commission dollars and would not hesitate to manipulate their clients to get to a closing.

Indeed, one of the highest profile agent teams in the country admitted to data manipulation and fraud in the MLS. I wrote about that scandal in 2018.

This is one of the things that the industry does not talk about in public, although it is widely whispered, and often commented on in online forums: the best agents are not always the top producing agents, and the top producers are often the worst agents in terms of customer service and ethics.

Zillow's problem then is to find top producers who are also excellent at client care, who score highly on the CSAT not just on the front end with quick responsiveness to leads, but who score highly on the CSAT on the back end *after the transaction is done*.

If there aren't enough such people, then a secondary tactic could be to find agents and teams who are excellent at customer service, and make them into top producers with a river of qualified leads. The problem is that these agents and small teams are not top producers and accordingly lack some of the staff, systems, processes and infrastructure that larger teams already have. And building those, you guessed it, requires capital.

Consistency of Service Delivery

There is a second important and related question for Zillow: can they provide consumers a *consistent* on demand experience with hundreds of thousands of different service providers in the last mile?

The answer is a qualified yes. It's qualified in the same way that any other platform experience is qualified: consumers will tolerate a few bad apples on a platform, as long as the platform itself delivers a high quality experience on the whole.

Take AirBnB as an example. Not every AirBnB house is delightful, or even clean; ask me how I know. Not every AirBnB host is well-organized, considerate, or responsive. But on the whole, the AirBnB platform delivers what it promises: clean, comfortable lodging, often at lower cost compared to hotels.

And try as I might, I can't seem to find a property on AirBnB that is less than four stars. One assumes that lower rated properties (3 and below) are simply removed from the platform altogether.

And AirBnB has a number of methods for quality assurance. There are star rating, with consumer reviews (which AirBnB actively solicits). There are "Superhost" designations. There are ways to "Report a listing" (and presumably, once reported, AirBnB can take corrective action).

An example of that corrective action by AirBnB comes from here, a community for AirBnB hosts:

> As a superhost, I have found that two 4 stars in a row in any category prompt the warning. So, a 4 star for location followed by a 4 star for value prompted it! It gives me the s**ts.

And try as I might, I can't seem to find a property on AirBnB that is less than four stars. One assumes that lower rated properties (3 and below) are simply removed from the platform altogether.

That, in a nutshell, is why Zillow implemented its CSAT system and why it is so important to its future. It was important enough that Zillow chose to take the risk of pissing off its paying customers and chose to preempt both (a) defections, and (b) forthcoming banishment by talking about not wanting to take money from subpart agents.

Note that Redfin has been monitoring and measuring customer satisfaction from the very start. It has long talked about its use of NPS, of tying bonuses to customer satisfaction scores, and firing agents who score too low on customer satisfaction. Zillow is getting into the game a bit late, and though they might be fast learners, they're having to do it on the fly and enforce customer satisfaction standards not on paid employees but on paying customers. It's a tricky tightrope to walk.

Nonetheless, the strategy remains the same. Zillow's platform play will work if most of the agents who are left on the system provide a high level of last-mile service to consumers who contact them. It will fail if most of them do not. Consumers will not blame the platform itself for one-off bad experiences, but they will not bother with a platform where the experience is a crapshoot.[3]

The Platform, Revisited

In the September Red Dot on the Real Estate Platform, I wrote that the real estate platform must be a hybrid:

> Because the real estate transaction is mediated, and there are deep fundamental reasons for the mediation that are not subject to transformation through technology alone, the Real Estate Platform must be a hybrid of a platform play with a linear business model that solves some key strategic problems for the network, which includes consumers.
>
> Just like Amazon "seeds" the value exchange by selling directly to consumers at lower margins, then leverages that investment as well as the investment into infrastructure to power the platform, the Real Estate Platform must find a way to "seed" value exchange for the consumer even at lower margins, then leverage that to power the platform.

Zillow has its iBuyer program as that seed value exchange, just like Redfin does with Redfin Now. Both can use that iBuyer service as the guaranteed value for consumers to draw them in, and both control the last mile of the iBuyer program as it does not require the participation of a real estate agent.[4]

But Zillow is a far more attractive platform for brokerages, agent teams, and agents should the consumer decide to reject the iBuyer

[3] The sole exception to this rule may be online dating platforms, where the experience is by definition a crapshoot.

[4] That Zillow has structured its iBuyer program to use a real estate agent on both sides of the buying then selling transactions does not mean that Zillow needs those agents. That decision was largely political.

offer. Zillow's weakness as a Company (the last mile problem) turns out to be a strength as a Platform.

To extend the AirBnB analogy even further:

- Redfin = Marriott
- Agent Teams = Individual Hosts
- Zillow = AirBnB

To be fair, Redfin has long had platform characteristics with its Partner Agents program. And with the changes that Zillow has made in 2018, being a Zillow Premier Agent looks and feels a lot like being a Redfin Partner Agent.

Nonetheless, absent dramatic changes in 2019 and beyond, brokers and agents are far more likely to see Zillow as the platform (even as they chafe under Zillow's new rules) while they see Redfin as a direct competitor.

Opendoor, Realogy, Compass

In the September report, I put Opendoor, Realogy and Compass as contenders for the Platform.

In light of the analysis above, I think it's fair to now classify all three of them as wannabe Companies.

Opendoor

Opendoor is obvious as a Company, and Rampell even mentioned them by name. And until and unless Opendoor makes a major acquisition for consumer traffic (such as Realtor.com) it seems more likely than not that Opendoor would be happy to take 5-10% market share as one of the primary companies that buy and sell houses directly from consumers. As I wrote in September:

> As a final consideration, Opendoor may not have any ambitions of trying to become the Real Estate Platform even if they could contend for that position. Opendoor may be perfectly happy to be a major market maker in housing, and perhaps even operate on whatever Platform comes into existence in the future.

> Not everybody wants to be NASDAQ or the NYSE. Some are perfectly happy being Citadel Securities.

It should be noted that should Opendoor be successful as a major iBuyer, and in the future a major market maker in real estate, it would justify its unicorn status and then some.

An alliance, formal or informal, between Opendoor and Zillow would be all sorts of interesting for the future of the industry.

Realogy

I had thought in September that Realogy could contend, if it wanted to. The rest of 2018, however, seems to suggest that Realogy's goal is to figure out how to become a Company with hundreds of thousands of independent agents and franchisees instead.

Ryan Schneider's focus appears to be to get Realogy back to its core, getting far better and far faster (his word) at execution, and then figuring out how to deliver the data technology that agents need to compete. Schneider has been talking about how to leverage the data assets that Realogy has since he took over as CEO, and his background in consumer finance will serve him well there.

The experimentation with iBuyer in partnership with Home Partners of America seems like just that: experimentation. It may be an effort to help Realogy agents generate listings, or at least defend against others (particularly Redfin agents) who can tell consumers, "List with me, or I can buy your home if you're in a hurry." It does not appear, yet, to be a seed value exchange in preparation for a Platform play.

Compass appears to be doing what Zillow wants to be doing.... But Compass lacks the traffic and leads that Zillow has in addition to the technology and capital.

Compass

At face value, Compass appears to be the one brokerage in real estate that is really shooting for becoming the Platform. In the September report, I quoted Robert Reffkin, CEO of Compass, from an Inman News story:

> "What the world deserves is everything that an MLS has, everything that a consumer site has, merged with the agent services, merged with the CRM that the agent has, all of their marketing and brochures, digital newsletters, social media, everything in one place and all on mobile," Reffkin said.
>
> "There will be a single platform in real estate," he added. "There will be one. There's not going to be 10 Googles. There's not going to be 10 Amazons. There's going to be one real estate platform."

The "referral economy" vision of Compass, which we've discussed throughout 2018, further suggests some kind of a Platform play.

Nonetheless, Compass did not really acquire the necessary components to make a real bid to be the Platform, such as a true iBuyer program or consumer web traffic. It did announce an iBuyer program of sorts at its 2018 conference, but it was patterned after Redfin, Realogy and other brokerages' versions: a listing tool, rather than a real standalone business.

In a way, Compass appears to be doing what Zillow wants to be doing: equipping its top producing agents and agent teams with the technology tools and capital-intensive services in order to compete against other Companies, such as Redfin and Opendoor. But Compass lacks the traffic and leads that Zillow has in addition to the technology and capital.

Plus, as a full-blown recruiting-and-retention based brokerage, Compass is not seen by other brokers and non-Compass agents as a potential platform for doing business. It is, rather, a true competitor in the marketplace like Redfin is.

Compass's challenge going forward will be to answer the question that Glenn Kelman raised: What can Compass promise potential customers when agents at Compass set their own service level and pricing?

Perhaps Compass's answer, like Zillow's, is to only have top producing agents who provide a high level of service. If so, we should expect to see Compass implement something similar to CSAT for its agents.

Everybody Else

As of today, it does not appear that anybody else is even seriously thinking about the future of real estate.

eXp is growing explosively, but it appears at least at this time to be following the old playbook of recruiting and retention, and headcount uber alles.

HomeServices of America is interesting solely because of its affiliation with Warren Buffet's Berkshire Hathaway, which means access to capital… but HSA keeps following the old playbook as well, making noise only by acquiring large brokerages (and losing money to do it, at least by what's reported).

Re/Max acquired booj, and appeared to make that a centerpiece of its strategy, but as we went into in some depth throughout 2018, technology alone has a very poor track record in real estate.

Keller Williams keeps on doing Keller Williams things, which means growth, success, and the same old agent-first mentality that its competitors have copied and improved upon. (See, e.g., eXp Realty.)

The Next Generation Brokerages I wrote about in October haven't gone anywhere, but none of them have done anything in the new capital-driven world. They remain, in large part because of their very structure, very much in the headcount-driven world of real estate. Their short-term success is the result of their strength in the old playbook. But their strength is their weakness as well, as they cannot (and do not wish to) become a Company or a Platform, and it isn't clear that they have the access to capital to do either.

The tens of thousands of other brokerages in real estate keep doing what they have been doing for decades, trusting in the old adage that real estate was, is, and will forever be a relationship business and that they merely need to have strong relationships with agents who have strong relationships with buyers and sellers. To be fair, most of these smaller brokerages have little choice: they don't have access to capital to do anything other than what they have been doing.

Don't Forget: Leads

As a final reminder, even though Realogy, Compass, HomeServices, KW, Re/Max and others are some of the largest, best run and well-capitalized companies in real estate, they all have to deal with the issue of lead generation.

As long as individual agents bear the primary responsibility for lead generation, as well as the cost of doing so, these companies will face an uphill battle in offering institutional real estate service delivery. The best they can hope for is to do a Zillow strategy of trying to become an arms dealer to the agent teams, providing data, technology, insights, information, and tools to help them compete against the Companies out there.

But that effort runs into major problems due to the lack of lead generation capability. Here's what I wrote in the September Red Dot about the Real Estate Platform:

> Platforms, in contrast, own *networks* – the means of connection referenced above and provides four core functions to its network:
>
> - Audience building
> - Matchmaking
> - Providing core tools and services
> - Setting rules and standards
>
> These four are essential characteristics of a platform.

Providing technology and tools to agent teams is just one of the four elements necessary to be a platform. Audience building and matchmaking are lead generation and lead management, respectively. These companies have very little capability in that respect.

And having so little capability, it's difficult for them to set rules and standards for platform participants, whether agents or consumers. Without enforceable rules and standards, it becomes very difficult to deliver consistent high quality service at least at the level where consumers do not reject the platform for the actions or failures of a few bad apples.

At least a straightforward iBuyer like Opendoor does not face that particular problem, since all of its people are employees who work on the overall team of the Company delivering services to consumers.

Organized Real Estate in the Age of Capital

One of the more interesting things about this shift to capital, not headcount, as the basis for competition is the near-total irrelevance of organized real estate to this new world.

Rampell's presentation takes note of organized real estate merely as a negative: a conspiracy against the public by rent seeking real estate brokers and agents. While that seems overly harsh an indictment, it does hint at how the people who control and command capital might look at the industry and how they think about it.

The MLS

In the new capital-centric world, the MLS remains important... but only as a repository of listing data. The capitalists neither care about nor pay attention to the myriad rules and policies of the MLS, the data accuracy, all the work that goes into compliance, and facilitating cooperation and compensation. All of the things that Council of MLS features in its "Making the Market Work" messaging campaign are simply non-issues for the capitalists.

Why might that be?

I speculate that the reason is that the capitalists believe the new breed of companies (and ultimately, the Platform) will rewrite the rules of the road. After all, if the future of real estate is people buying houses from, and selling houses to, *companies* rather than to each other mediated by hundreds of thousands of real estate agents... those companies and the Platform they ultimately choose to use can implement whatever rules and policies that best serve the needs of the companies and their customers.

The MLS was born out of the pre-Internet broker-centric world, then evolved into the post-Re/Max agent-centric world, but everything about the MLS is rooted in the old way of individual agents delivering services to individual clients.

In many cases, the MLS is firmly married to the headcount-driven REALTOR Associations with their mandate to provide services and value to *all* members.

Institutional real estate, with its focus on fewer team members delivering services efficiently, is something the MLS is not designed for. The MLS would need to reconsider almost everything about itself if it is to remain valuable to the new way of competing.

That can be done; the MLS *can* change. But the highly political, subscriber/member-driven governance, the city council rather than corporate boardroom philosophy of most MLSs, and organic monopoly status enjoyed by most militate against making such a change until it becomes *absolutely* necessary.

The question is whether the MLS will have the time or the capability to make that change when it becomes absolutely necessary.

Redfin v. Zillow; Companies v. Platform

With all that said, 2018 turns out to have set the stage for the next big struggle for power in the real estate industry. The two principal sides will be Redfin (and similar) on one side, and Zillow (and similar) on the other side.

Redfin represents the Companies, the institutional real estate service providers who will bring technology, teamwork, and massive amounts of capital to meet consumer demands for an on demand experience (or as close to it as possible). The various iBuyer companies fall into this bucket, as do many top producing agent teams.

Zillow represents the Platform, which hopes to leap over the Companies by creating the marketplace in which (most) of the Companies will do business. Zillow's pivot in 2018 is perhaps best understood as its recognition that institutional real estate has arrived, and that it is 10 years behind Redfin in delivering that.

Both have capital and access to capital, the technology and data science teams, and the linear business of iBuyer to deploy that capital. Both will attempt to meet the consumer's demand for an on demand experience: Redfin directly, like a Marriott Hotel might, and Zillow indirectly, like AirBnB might.

Concentration of power is a direct result of Redfin's attack on the commission rate.

It is an interesting battle between two giants because both are very smart and well aware of each other's strengths and weaknesses, and both are extremely savvy about competing for all the marbles.

Let us go through some of the more interesting obvious lines of attack and defense by both sides.

The Darkness Comes

In the December Red Dot, I wrote that the most significant event in December was Redfin's announcement that they will go on a national mass media advertising and marketing campaign.

That campaign could, and I believe would, bring about a lower commission environment for everybody. But Redfin is built from the ground up to operate at low cost, while few others are, including agent teams. Me, in December:

> 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.

Taking revenues away from competing agent teams takes revenue away from brokerages and from Zillow, since Zillow relies on fees from agents and agent teams for 70% of its revenues. It's not a direct attack on Zillow, since Redfin has little hope of overcoming Zillow's massive advantage in traffic and brand recognition anytime soon. But it is an effective indirect attack, chopping a leg out from under Zillow's entire business model.

Concentration of Power

In the December report, I wrote that concentration of power is a direct result of Redfin's attack on the commission rate. Although loss of revenues will hurt Zillow in the short run, I think it ends up helping Zillow in the long run as it makes a play for the Platform. I wrote then:

> 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.

Thinking it over today, how will those great agents and their teams pick up the rest of the market share if institutional real estate becomes more and more of the norm?

As described above, agent teams can be every bit as good as Redfin, if not better, at delivering great personalized service to consumers. What they lack, however, is online lead generation, data technology and capital-intensive iBuyer services. And Zillow has precisely those things.

I anticipated that in December, when I wrote:

> 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.

> 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.

If Zillow moves towards being something I described as a team of teams, or really, the Platform on which Companies (agent teams and superior boutique brokerages) make money, then it becomes the marketplace on which market makers and Companies do business.

Redfin will still find success. But thousands of entrepreneurial, experienced, and highly motivated local teams, equipped with the latest technology and data tools from Zillow, who can more than match Redfin's advertising spend and online lead generation capabilities *through Zillow*, will be tough competition indeed.

Where Do Brokerages Fall?

One of the interesting fault lines of the future is where brokerages fall once the basis for competition shifts away from headcount and towards capital. Most of them do not have any capital, nor do they have any access to capital.

They have thousands of individual agents, but they're no longer competitive against the Companies that deliver the on demand experience that consumers demand.

A wave of consolidation is likely, especially as the housing market softens. But larger brokerages like Realogy, Compass, and HomeServices of America are caught in an interesting trap.

On the one hand, Redfin is a direct competitor to their agents for buyers, sellers, and other services. The brokerages can't become a Company like Redfin, at least not easily. The difficulty of the task is highlighted by the fact that even Zillow didn't want to go down that path.

On the other hand, Zillow ends up delivering so much of the value that these brokerages and brands also want to provide: technology tools, data products, etc. If the brokerages think their way forward is to become an arms dealer to agents, then Zillow is a direct competitor in that arena.

The Next Generation Brokerages will likely find a way to adapt, since they're really operating coworking spaces with legal oversight and compliance services. Neither of those are things that a Platform like Zillow has any real interest in providing to agent teams. I expect that the NGBs will outsource their technology needs to Zillow if they can, at least for their top producers. Then they can just keep doing what they've been doing since their business is not all that related to the buying and selling of homes.

But where the traditional brokerages line up in the Company vs. Platform conflict could sway the outcome of that battle. They hate and fear both sides, and may end up hoping that they both could lose.

Will the MLS Pick Sides?

Venture capitalists like Rampell pay little attention to the MLS. They see the MLS as a listing data repository, and if push came to shove, well-capitalized Companies could just do their own thing.

Those of us in the industry realize that the MLS still remains powerful, isn't going anywhere without a fight, and could sway the outcome between Companies and the Platform.

But there are so many factors to consider for the MLS.

On the one hand, ever since NAR decided to get involved with RPR and Project Upstream, the MLS community has gotten closer to Zillow, who in turn has made substantial efforts to be the best friend the MLS could have in exchange for listing feeds. Zillow has gone out of its way to reassure the MLS that they value what the MLS does (data compliance, easier syndication, cooperation and compensation, etc.) and have no desire to replace the MLS.

On the other hand, Redfin is a full brokerage Participant in every MLS it joins. The MLS was built to facilitate transactions between Participants and their agents. And Redfin has been very smartly playing off the fear and hatred of Zillow on the part of the MLS, their Boards of Directors, and other brokerages in recent years. That tends to argue for being pro-Redfin.

On the third hand, MLSs are deeply embedded in REALTOR Associations if not outright owned by them. So their culture and governance are built around benefits and services to all members, even those who do zero transactions. Siding with Companies, who by their very existence drive weaker brokers and agents out of business, would be difficult to say the least. It requires a wholesale change in culture, governance, and possibly corporate structure.

On the fourth hand, the MLS has long been the platform for real estate, at least in its local market where it has a de facto monopoly. Companies like Redfin and agent teams do threaten that platform status, especially for smaller MLSs who are seen as barriers to be overcome rather than value-adding platforms by most Companies. But the emergence of an actual Platform for the new world truly threatens the MLS. If the future of real estate is institutional, the larger MLSs might want to make a bid at becoming at least a super-regional Platform, which argues for slowing Zillow's march towards becoming the national Platform.

Finally, whatever a particular MLS decides to do, it does not have much, if any, access to capital to do much of anything. Many MLSs are not even standalone entities; they are member services of the local nonprofit REALTOR Association. Many others are setup as nonprofit organizations. Most MLSs that are setup as for-profit corporations are wholly owned by one or more REALTOR Associations, and are governed and operated like a nonprofit. Who is investing in nonprofits?

In his video, Rampell mentioned that Zillow's first round of funding was for about $15 million and remarked that today, that would be a tiny pre-venture friends and family round in real estate technology. I struggle to think of even one MLS that could raise $15 million in funding.

Government Intervention

Finally, since real estate is a heavily regulated industry, and the REALTOR Associations remain politically powerful if economically irrelevant to the new age of capital-based competition, we need to be watching for government ~~interference~~ action.

Throughout the year, I have written about government regulation and government action, in particular in the November report. At least judging by how Canadian regulators went about things in Toronto, it appears that government will come down on the side of

Companies for whom the industry's control over listing information (by way of control over the MLS) is a barrier to be overcome.

I have long said that the problem with misclassification of agents will arise out of agent teams who exercise far too much control over the team members.

Over the years, I have also written about the problem of employment law and real estate. For example, in May, I wrote about the *Dynamex* ruling out of California:

> The killer is (B) of the ABC Test: that the worker performs work that is **outside the usual course** of the hiring entity's business.
>
> The Court is trying to say that a traditional independent contractor is not an employee, but everyone else is. The actual example the Court uses is a plumber:
>
> > Thus, on the one hand, when a retail store hires an outside plumber to repair a leak in a bathroom on its premises or hires an outside electrician to install a new electrical line, the services of the plumber or electrician are not part of the store's usual course of business and the store would not reasonably be seen as having suffered or permitted the plumber or electrician to provide services to it as an employee. (opinion page 70)
>
> Obviously, if the plumber works for a plumbing company, then he would be an employee, no matter what kind of "independent contractor agreement" he might have signed.
>
> Since every real estate agent works for a real estate brokerage, there is no way to say that their work is outside the usual course of the brokerage's business. Ergo, every salesperson in California is likely an employee.

I have long said that the problem with misclassification of agents will arise out of agent teams who exercise far too much control over the team members. That which is a strength for agent teams, which allows them to contend to become Companies, is a major problem for them under the current confused legal landscape.

With the "gig economy" companies like Uber and Lyft much in the news these days, and politicians eager to strike positions supporting the worker against corporations, and local and state government coffers much in need of taxes, it seems more likely than not that we will see some kind of government action on the issue of who is and is not an employee. That will certainly affect the industry and really sway things in the direction of Companies, and completely kill off the headcount-based model of competition.

Gradually, then Suddenly

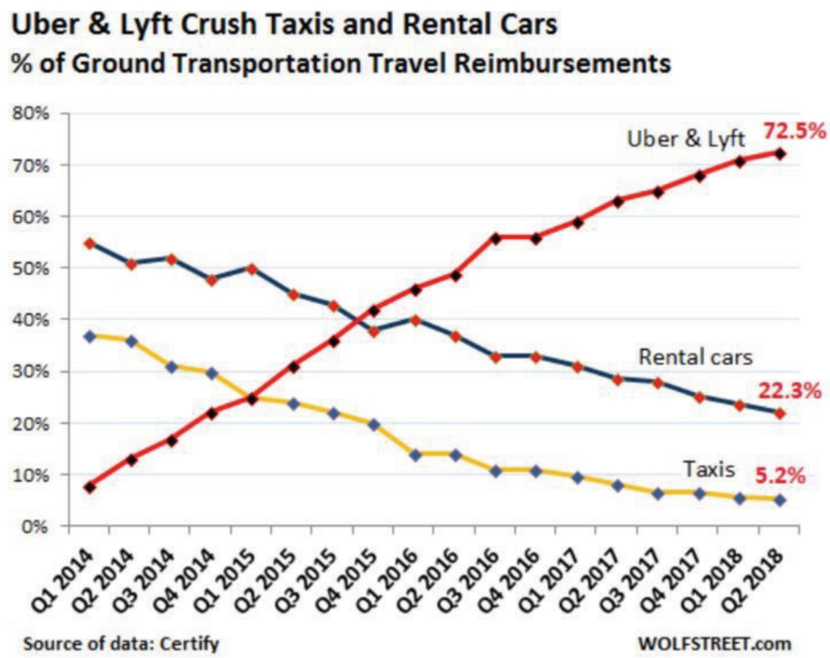
In Ernest Hemingway's *The Sun Also Rises*, Mike is asked how he went bankrupt. His answer is, "Gradually and then suddenly." I think most changes come gradually and then suddenly.

We have been looking at these changes throughout 2018 and for a few years prior. It may be that 2019 is another year of gradual change as well: when in doubt, bet on inertia, at least in real estate.

Nonetheless, there are some reasons to think that the "suddenly" part of the equation is not too far off.

In a blogpost on Notorious ROB in November, I made the case that iBuyer could become the default way that people sell houses. Then I took a stab at how quickly such a thing could come to pass:

> It is very hard to say how fast such a model might take hold, since each company is different, each product is different, each situation is different. Housing isn't the same thing as smartphones or internet access or hotel rooms or taxicab rides. As I've said from the start, this is more of a fun exercise in making the case that iBuyer will become the default way to buy and sell homes in America rather than a prediction that investors should take to their stockbrokers.
>
> Nonetheless, with that spirit of $#!%s and giggles in mind, take a look at this chart:



> That chart comes from this article on Business Insider titled, "Uber and Lyft are gaining even more market share over taxis and rentals."
>
> According to that article, Uber/Lyft went from single-digit market share to 60% market share in three years: Q1/2014 to Q1/2017. It is still trending upward, to 72.5% in Q2/2018.
>
> Yes, again, I realize that ridesharing is not the same thing as housing. But the point is that Uber and Lyft are (a) more convenient, (b) less expensive, and (c) usually a better experience than hailing or riding in a cab. Even if you're skeptical, as I was when I first tried Uber, once you experience just how much better it is than standing on a street corner in the rain with your hand in the air, you won't be going back.
>
> Just think how fast we all went from "Are you nuts?" to "You still take cabs?" when it comes to Uber and Lyft.

The march towards institutional real estate has been long indeed. Redfin has been in business for over a decade. Zillow has grown year after year for over a decade. Brokerages have been struggling with all of the issues we covered throughout 2018 for decades. The emergence of agent teams is nothing new, and capital has been flooding into real estate for a while now.

Uber & Lyft overtook taxis in one year: Q1 of 2014 to Q1 of 2015. They overtook rental cars after one more year. And the growth curve of ridesharing vs. the decline of traditional taxis and rental cars looks to me like the definition of "gradually, and then suddenly."

A Note on Access to Capital

I can't leave this report without at least taking note of something interesting: venture capital isn't the only kind of capital out there.

That is, Rampell's presentation, as great and thought provoking as it was, was being made by a venture capitalist to a venture audience. The focus of such things will always be on new, cutting edge technology companies.

There are hundreds, if not thousands, of hedge funds, private equity funds, private investors, and others who are not in the venture capital game, but remain keenly interested in the transformation happening in real estate today.

I know, because I get phone calls from them all the time.

While headlines in the media are about Compass and Opendoor raising hundreds of millions from venture capital funds, I believe there is capital sitting on the sidelines watching for opportunities in something other than unproven technology-based unicorns.

To the extent that traditional powers in real estate, from agent teams to brokerages to franchises to even MLSs, want to recognize what's coming down the pike and act in advance of needing to react, I believe access to capital may not be as big a problem as some might think.

If competition going forward is going to be based on capital and access to capital, you need to get capital. It requires taking on some risks, requires changing the way you've been doing things for decades, and some kind of a plan that makes sense in the environment ahead of you. But the good news is that for those willing to change and compete, access to capital can be had. You don't have to be a tech startup with data science teams and a cool Silicon Valley office. You don't have to be a young thirtysomething tech guy. You just have to be willing to change as the nature of competition changes.

Obviously, a report is not the place to have that conversation, although who knows what 2019 might bring. But please reach out if you would like to learn more.

Decide. Act.

RECOMMENDATIONS: BROKERAGE

Since this is a Year In Review kind of a report, there are few brand new recommendations. I think most of the recommendations made for brokerages in past reports remain valid here. I will repeat some of them from past reports, but updated with the ideas from this report.

The Platform Play; Run the Brokerage as a Loss Leader

You have the strategic option to do as eXp and Compass are doing and make a play to become a Platform for real estate. That means accepting that your brokerage needs to be operated as a loss leader, and figuring out how to monetize the headcount later.

The main problem with this strategy is that trying to maximize your headcount is precisely what you've been trying to do for the past couple of decades. Not only that, recruiting (sales) is also what all of your competitors have been trying to do for the past couple of decades.

Furthermore, as I have detailed out in the September Red Dot on The Real Estate Platform, just adding headcount does not make you a platform of any kind. A platform requires:

- A large audience/network
- Matchmaking
- Core tools and services
- Rules and standards

None of those four elements are easy to build, nor inexpensive, nor done overnight.

Having said that, one practical recommendation for every brokerage has to be to really pursue non-brokerage revenues. Affiliated businesses are going to be even more important than before. If you've been putting off doing something in mortgage, title, escrow, property management, etc., do not put it off any longer.

With what we discussed above, and Zillow making the play to become the Platform for real estate, any platform play by brokerages and brands have to take that into consideration. Competing against Zillow and Redfin both in the age of capital is not recommended, because you are likely to need at least one of the two to be your ally.

Become a Company

The alternative is to start planning to become a Company, an institution that can offer consistent on demand real estate services to consumers. If you become a Company that people will buy houses from and sell houses to, then you can compete.

As discussed above, that requires staff, systems, processes, leads, and technology. All of these things require capital. You need managers, not recruiters. You need brand promises, a way to measure customer satisfaction, and a way to enforce them both.

For most brokerages and brands, this transformation will require partnering with or allying with someone like Zillow, Realogy, Compass, or someone with access to capital. It will require finding a partner for iBuyer services, and local hard money lenders and house flippers are not actually in the iBuyer business.

There are smart tactics for trying to become a Company, but this may be an instance where you might want to take advantage of the Red Dot discount and call me. It is impossible to make written generalized recommendations without knowing your specific situation.

Cut Costs Dramatically, and Become a Next Generation Brokerage

The first reasonable strategy for brokerage is to become a Next Generation Brokerage. We profiled these in depth in the October Red Dot, but they're basically 100% transaction-fee only shops who operate on razor thin gross margins and require significant scale to make financial sense.

This transformation is far from easy, but at least it doesn't require 8-figure technology budgets or triple-digit percentage growth.

The two main issues here are (a) if you are a traditional brokerage, you have to completely re-engineer your structure and operations, and (b) you have to completely re-engineer your financial model so that you can turn a profit at some scale.

To use but one example, you can't have managing brokers for each office. They need to be centralized in one location, and function as a kind of a customer service call center. The skill set needed to be this kind of a broker is almost completely different from the skillset needed to be a managing broker of an office in a traditional setup. You're going to have wholesale turnover of staff and management, which is painful and could lead to losing so many of your agents who were recruited to your company by their managing brokers.

At the very least, however, the NextGen Brokerage strategy is one that smaller companies without $800 million in funding have successfully proven out over the past several years.

If you are a large enough company, and can do M&A, my recommendation is to look at acquiring a successful Next Generation Brokerage, operate it as a separate entity, solely for the sake of learning what those operators already know and have proven.

For example, I would be far more impressed if Howard Hanna had purchased Fathom Realty, a 100% NextGen Brokerage, than Allen Tate, a traditional powerhouse. I would have been far more impressed with Realogy had it launched a low-cost brand aimed at this 100% NextGen Brokerage model, rather than two luxury lifestyle brands.

If you're not big enough to think about acquiring one of these, try to learn what you can about them and really put together a plan for transformation with varying timelines.

The 1099 Conundrum

I'm not going to spend a ton of time on this, as I have written extensively on the topic over the years. You can read the Future of Brokerage Black Paper on my site, for example, and get most of what our recommendations are for brokerages.

But as I pointed out in December, the low-commission environment brings about concentration of power. So do Zillow's new CSAT and Best of Zillow initiatives. The very best agents and their teams are going to gain market share at the expense of the middle-tier agents.

I wrote that agent teams that survive are going to look at whole lot like Redfin. That means that the whole 1099 vs W-2 issue gets ratcheted up even more.

The emergence of institutional real estate, combined with the attention paid to the gig economy companies like Uber, likely attracts the attention of the government on the one hand, and lawyers on the other hand.

It may be smarter to grab the ox by the horns and engage with the problem proactive, especially if your strategy involves trying to become a Company.

Get Capital

It seems obvious since the entire report detailed why competition in the future will be based around capital and access to capital. So let's just leave it there. Get capital if you can. If you don't need any right this minute, get access to capital for when you will.

CONCLUSION

2018 will be a year that we will look back on and remember. It will be when we mark the turning point in the transition from the old individual agent based way of doing business to the new institution based way of doing business. This may be when the gradually of change started becoming the suddenly, and 2019 will tell us if that's true.

Alex Rampell's statement that in the future, we will buy houses from and sell houses to companies is compelling. Consumer expectations have changed. The maturation of technology, particularly data technology, and the infusion of enormous amounts of capital into the residential real estate industry have created conditions for the gradual change to become sudden.

The biggest event of 2018 in retrospect is Zillow's pivot away from being a web 1.0 advertising portal to something new. It may have done so because it had no choice if it were going to remain relevant in the future. Redfin had already become a Company with a ten year head start. The pivot strongly implies that Zillow will try to jump over the Company stage and go directly to becoming the Platform.

There will be conflict and confusion in real estate in 2019 as brokerages, MLSs, Associations, tech companies and agents who have been operating under the old rulebook of headcount, recruiting and retention, come face to face with the new rulebook of teamwork, technology and capital. Those who survive the change will be more successful than ever, while others will fall prey to evolutionary forces. Nature, after all, is red of tooth and claw.

As capital becomes more and more important to competing, there will be new opportunities and new challenges for everyone in the industry. 2019 promises to be an interesting time in which to live… which is an ancient Chinese curse.

Happy New Year, everybody. I have appreciated your support throughout 2018.

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