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The Return of the King

Analysis of Q4/2018 Earnings Results

Brokerage Edition

Observe. Orient. Decide. Act.

Table of Contents

Observe.

INTRODUCTION

Over the past year that we have been publishing the Red Dot reports, we have identified the signs that the real estate industry is undergoing fundamental transformation. What was once based almost entirely on local professionals and their relationship with consumers is slowly transforming into something new, something else.

The Q4/2018 earnings results from the public companies in this space make clear what we have been spotting since last year. Longtime readers could not have been surprised at the vision that Rich Barton, the new CEO of Zillow, laid out upon taking back the head job from Spencer Rascoff, even if we were midly surprised at the speed and aggressiveness coming out of Zillow.

At the same time, the dismal results from Realogy for 2018, after a full year of trying to address their deep problems with growth and profitability could not have been particularly surprising to longtime readers either.

Most of what we saw in Q4 confirms most of our major theses throughout the year of transformation, but they are worth digging into in some detail to see what went on yesterday, what's going on today, and what the future will hold.

Robert Hahn
March 2019

EXECUTIVE SUMMARY: BROKERAGE

Q4 featured massive changes at Zillow, and the possibility that the chickens are coming home to roost for Realogy.

Let us begin the examination with the changes at Zillow.

Zillow: The Rich Barton Era Returns

The news out of Zillow in Q4 tells me that Zillow is transforming. I just didn't think it would happen so quickly, and so decisively.

The Numbers

We begin, as always, with the numbers. For the quarter, Zillow posted these results:

	Q4/2017	Q4/2018	% Change
Revenue:			
IMT	282,330	323,988	14.8%
Homes	-	41,347	
Total Revenue	**282,330**	**365,335**	**29.4%**
Cost of revenue (excl. of amort.):			
IMT	22,559	28,498	26.3%
Homes	-	38,974	
Total Cost of revenue	22,559	67,472	199.1%
Gross Profit	*259,771*	*297,863*	*14.7%*
Gross Margins	*92.0%*	*81.5%*	*-11.4%*
Expenses			
Sales and marketing (2)	103,935	138,869	33.6%
Technology and development (2)	85,187	111,195	30.5%

General and administrative (2)	57,778	74,758	29.4%
Impairment and restructuring costs	174,000	69,000	
Acquisition-related costs	97	268	176.3%
Integration costs	-	1,492	
Total costs and expenses	443,556	463,054	4.4%
Income (loss) from operations	**(161,226)**	**(97,719)**	**39.4%**
Other income	1,415	5,962	321.3%
Interest expense	(6,991)	(14,327)	104.9%
Income (loss) before income taxes	(166,802)	(106,084)	-36.4%
Income tax benefit (expense)	89,627	8,402	-90.6%
Net income (loss)	**(77,175)**	**(97,682)**	**26.6%**

The bright spots are that (a) actual top line revenues grew substantially, posting a 14.8% YOY growth from $282.3 million in Q4/2017 to $324.0 million in Q4/2018, and (b) Homes revenue, which didn't exist in 2017, grew to $39.0 million. On a Q/Q basis, Homes nearly quadrupled, going from $11.0 million in Q3 to $41.3 million in Q4.

The cash flow numbers are distressing as well, as Zillow managed just $3.9 million in cash flow from operating activities for all of 2018.

Traffic growth is basically stalled as well, with 157.2 million average monthly unique users at the end of December, 2018.

Going just by the numbers, this was not a good quarter… at all. What about the full year?

	2017	**2018**	**% Change**
Revenue:			
IMT	1,076,794	1,281,189	19.0%
Homes	-	52,365	
Total Revenue	**1,076,794**	**1,333,554**	**23.8%**
Cost of revenue (excl. of amort.):			
IMT	85,203	104,330	22.4%
Homes	-	49,260	
Total Cost of revenue	85,203	153,590	80.3%
Gross Profit	*991,591*	*1,179,964*	*19.0%*
Gross Margins	*92.1%*	*88.5%*	*-3.9%*

Expenses			
Sales and marketing	448,201	552,621	23.3%
Technology and development	319,98	410,818	28.4%
General and administrative	210,81	262,153	24.4%
Impairment and restructuring costs	174,00	79,000	-54.6%
Acquisition-related costs	46	2,332	403.7%
Integration costs	-	2,015	
Loss (gain) on divestiture	-	-	
Total costs and expenses	1,238,668	1,462,529	18.1%
Income (loss) from operations	**(161,874)**	**(128,975)**	**20.3%**
Loss on debt extinguishment	-	-	
Other income	5,385	19,270	257.8%
Interest expense	(27,517)	(41,255)	49.9%
Income (loss) before income taxes	(184,006)	(150,960)	-18.0%
Income tax benefit (expense)	89,586	31,102	-65.3%
Net income (loss)	**(94,420)**	**(119,858)**	**26.9%**

First, sort of overlooked in the major changes is the fact that Zillow did $1.3 billion in revenues in 2018, up 23.8% YOY. The core IMT revenues were also up nearly 20%, which is somewhat amazing given the turmoil around Premier Agent 4.1 (now called Premier Agent Forward).

Second, losses from operations narrowed by 20%, which is interesting since Zillow has obviously made a huge bet on its Homes segment.

Rich Barton Back at the Helm

The headline news was that Spencer Rascoff was stepping down, and Rich Barton, co-founder and former CEO prior to Spencer was coming back.

I think this was a mutually agreed move that all involved likely agreed upon, because Zillow wanted to *accelerate* the transformation I wrote about in December.

Thanks to an amazing interview in Ben Thompson's Stratechery, (Subscription Required) we got a peek into his mindset and some of the origin story behind Zillow.

The Stratechery Interview

Rich Barton says:

> When we finished up with Expedia and both Lloyd and I had left we were casting about for the next thing to do — this is in 2005 — we latched on pretty quickly to the fact that nothing had really changed in the real estate vertical. **Consumers were just as in the dark, just as disempowered, the fees hadn't really come down, people were still stuck, the process usually took three to six months if you wanted to move, so most people didn't move, they just made do with what they had.** [Emphasis added]

The important takeaway here is *motivation*, the *mission*, if you will behind the original Zillow. Rich Barton has lost none of that mission; he was just biding his time.

What Barton says more or less confirms what I've been writing about Zillow from the beginning:

> The really interesting challenge and opportunity that we have in the core Premier Agent business now is to turn our advertisers into partners for two reasons: we get them off of subscription-based advertising so no more of any of this model that we're talking about, and move them towards a success-based compensation scheme that is around what happens when consumers actually close a transaction.

Zillow's Leverage Showing up in Unit Economics

In the Stratechery interview, Barton talks about how Zillow has an advantage, that is growing, over other iBuyers, especially Opendoor. Zillow has both a capital advantage and a traffic advantage (demand advantage, as he calls it) over everyone else.

It's showing up in the unit economics, which Zillow published in its supplemental financials.

I wrote a post about this on Notorious, but let me reprint parts of it here to keep it all in one place.

Bottomline is, if my assumptions are correct, then a homeowner would net more money selling to Zillow than he would by listing with a real estate agent in the traditional model.

Zillow Offers Unit Economics

From the Supplemental Financials:

Zillow's Numbers	Per Home
Homes revenue	293,241
Service Fee (7%) to Seller	18,489
Actual Sale Price of Home	274,752
Operating costs:	
Home acquisition costs	264,134
Renovation costs	9,121
Holding costs	2,589
Selling costs	13,043
Total operating costs	288,887
Interest expense	2,631
Return on homes sold after interest expense	1,723

If that same homeowner chose not to accept Zillow's offer, and listed it with a REALTOR instead, then her expected net looks like this:

Sell with REALTOR		
Sale Price		274,752
Renovation costs		9,121
Holding costs		2,589
Selling costs		
REALTOR Commissions	6%	16,485
Closing Costs	0.75%	2,061
NET		**244,496**

Her expected net selling with a REALTOR is **$244,496** vs. **$245,645** selling to Zillow.

She makes less money, with more effort, more uncertainty, and more work, by listing her home with a REALTOR and going into the open market.

This is a complete game changer, and it means that the iBuyer model (at least Zillow's iBuyer model) will gain traction and market share much faster and much wider than anyone ever thought possible.

Zillow's target of $20 billion in revenues from the Homes business within 3-5 years is *far too conservative*, if these numbers are correct.

Now, layer on mortgage and title and other core services.

On that point, Barton says in the Stratechery interview that Zillow's plans do not include "**lots of starry-eyed ancillary fries with that burger.**"

Well then. It will be all kinds of interesting once the ancillary fries begin to get served with that iBuyer burger.

The Iron Throne

One further note here is that Barton's ultimate vision of what Zillow looks like in the future more or less tracks what I've written over the past year or so. Zillow will contend for the Iron Throne, the Real Estate Platform.

The Return of the King

If you're explicitly going after the Iron Throne, undertaking a massive redeployment of resources and a complete transformation of one's P&L, and making huge bets because you have to get there first… that is a job for Aragorn, not Denethor.

The transformation I have been predicting for over a year is now complete. Zillow is no longer a media company, but a real estate company moving towards becoming the Platform for Real Estate, the marketplace for buyers and sellers.

The relationship between brokers and agents and Zillow was changing slowly under Rascoff; that change will now accelerate under Barton. Things now get confusing for the industry.

Redfin: Biding Their Time

After the fireworks of Q3, when Redfin announced that it was going to bring the darkness, it would have been reasonable to expect more fireworks. Instead, we got retrenchment, we got conservative statements from Glenn Kelman, and we got careful optimism.

REDFIN
Your New Way Home

The Numbers

The full 2018 results for Redfin were:

	2017	*2018*	*Change*
Revenue	370,036	486,920	31.6%
Cost of revenue	258,216	367,496	42.3%
Gross profit	111,820	119,424	6.8%
Gross Margin	**30.2%**	**24.5%**	-18.8%
Operating Expenses			
Technology and development	42,532	53,797	26.5%
Marketing	32,251	44,061	36.6%
General and administrative	53,009	65,500	23.6%
TOTAL	127,792	163,358	27.8%
Income (loss) from operations	(15,972)	(43,934)	(175.1%)
Net Income/(Loss)	**(15,002)**	**(41,978)**	(179.8%)

The erosion in gross margin to below 25% should be extremely concerning.

Redfin's major advantage over other larger brokerages was that its gross margins were double or more due to using W-2 employee agents instead of 1099 independent contractors. But once your gross margins start creeping below 25%, Redfin gets into Realogy territory.

And Chris Nielsen, CFO of Redfin, sounded eerily like Realogy executives when he reported that real estate services gross margin was 27.8%, down 570 basis points YOY, which was "primarily driven by a 440 basis point increase in personnel costs."

Some of the key metrics I track for Redfin were rather healthy for 2018 (except financially, as we discussed above):

Key Metrics	**2017**	**2018**	**Change**

Monthly average visitors (in thousands)	**22,623**	**27,261**	27.8%
Real estate transactions:			
Brokerage	35,038	42,954	22.6%
Partner	10,755	11,608	7.9%
Total	45,793	54,562	19.1%
Real estate revenue per transaction:			
Brokerage	9,429	9,459	0.3%
Partner	1,971	2,229	13.1%
Aggregate	7,677	7,921	3.2%
Sales Volume (millions)	21,280	25,812	21.3%
U.S. market share by value	0.67%	0.81%	20.9%
Average number of lead agents	1,023	1,390	35.9%
Transactions per Lead Agent	34	31	(9.8%)
Brokerage Revenue per Lead Agent	322,944	292,297	(9.5%)
Brokerage Gross Profit per Lead Agent	111,181	88,560	(20.3%)

The Brokerage numbers exclude Partner revenue and profits.

So those metrics look just fine, if a bit uninspiring.

What is a bit more inspiring and a bit more worrisome are its numbers from its iBuyer services, Redfin Now.

Redfin Now: Signs of Trouble

On the one hand, Redfin Now turned in a surprisingly robust result. The Properties segment turned in $46.6 million in revenues for 2018, up 350% from the $10.4 million it posted in 2017.

But on the other hand… Redfin's gross margin was minus 4.3% in Q4, "primarily due to a 490 basis point increase in the cost of properties, a 150 basis point increase in personnel costs, including stock-based compensation due to increased headcount and an 80 basis point increase in transaction bonuses, each as a percentage of revenue." (Chris Nielsen, Redfin CFO, Q4 earnings call.)

This is a problem. And I'm going to make a bigger deal of this than perhaps others might because it goes to the heart of Redfin's claim of superiority: execution.

Redfin simply cannot lose money on Redfin Now (negative 4.3% margins) while Zillow made money on its iBuyer program. That just can't happen.

If you have tied your success to your operational expertise, then you have to deliver operational expertise. If you claim that nobody is better at selling homes than you are, then you actually have to show that in the numbers.

Redfin simply cannot lose money on Redfin Now (negative 4.3% margins) while Zillow made money on its iBuyer program. That just can't happen.

Combined with the lackluster gross margin numbers, due to higher personnel costs, I start to wonder about Redfin.

Show Me the Money!

For what it's worth, I have long said that Redfin is the most important brokerage in North America.

We can overlook 2018 because of the huge surge in hiring, followed by the "cultural changes" Kelman mentions in a number of calls to change how Redfin agents are supposed to work with prospects and clients. But as Kelman said during the Q4 call, that's over now, and Redfin will start assigning more prospects to agents in 2019.

Redfin has to show up in a big way in Q2 and Q3, which are the height of the selling season in real estate.

Realogy: The Deathwatch Gets Serious

Since the start of the Red Dot reports covering publicly traded real estate companies, I have worried about Realogy.

My concern was centered on the fact that all of the announced plans from Realogy were still around the old agentcentric model of recruiting and retention:

In response, one Realogy executive said that Realogy under Ryan Schneider's leadership was the "800lb gorilla who is finally waking up, and he's pissed off."

Well, if 2018 is the best which a pissed off 800lb gorilla can manage, one wonders what would have been different if it had never woken up in the first place.

The Numbers

As most of you already know, 2018 results were a bloodbath. And the Street has responded accordingly, driving Realogy's share prices to the lowest level ever.

	2017	*2018*	*Change*
Revenues (in millions)			
Gross commission income	4,576	4,533	-0.9%
Service revenue	938	947	1.0%
Franchise fees	396	393	-0.8%
Other	204	206	1.0%
Net revenues	**6,114**	**6,079**	**-0.6%**
Expenses (in millions)			
Commission & agent costs	**3,230**	**3,282**	**1.6%**
Operating	1,544	1,548	0.3%
Marketing	261	258	-1.1%
General and administrative	364	328	-9.9%
Former parent legacy cost (benefit), net	(10)	4	-140.0%
Restructuring costs, net	12	58	383.3%
Depreciation and amortization	198	195	-1.5%
Interest expense, net	158	190	20.3%
Loss on the early exting. of debt	5	7	40.0%
Other expense (income), net	1	-	-100.0%
Total expenses	**5,763**	**5,870**	**1.9%**
Income (Loss) before income taxes, equity in losses and noncontrolling interests	351	209	-40.5%
Income tax expense (benefit)	(65)	65	-200.0%
Equity in losses of unconsolidated entities	(18)	4	-122.2%
Net income (loss)	**434**	**140**	**-67.7%**

So we have lower revenues, higher expenses, and net profit is cut by more than 2/3.

By far the most troubling is that commission and agent-related costs are up 1.6% from 2017 to 2018. Considering that this was what Ryan Schneider said he was focusing on, as that was where "the violence in the P&L" was, a 160bp increase is... disheartening.

If 2018 is the best that a pissed off 800lb gorilla can manage, one wonders what would have been different if it had never woken up in the first place.

What made the situation worse for 2018 was the fact that the NRT unit actually sold fewer homes.

	2017	2018	Change
Closed Transaction Sides	344,446	336,806	-2.2%
Average Home Price	514,685	523,426	1.7%
Total Sales Volume	177,281,189,510	176,293,017,356	-0.6%
Avg commission rate	2.44%	2.43%	-0.4%
GCI per side	13,309	13,458	1.1%
Total GCI (per-side X sides)	4,584,231,814	4,532,735,148	-1.1%
Commission paid to agents	3,230,000,000	3,282,000,000	1.6%
Company Dollar	1,354,231,814	1,250,735,148	-7.6%
Company$ Margin	29.5%	27.6%	-6.6%
Agent Split	70.5%	72.4%	2.8%
EBITDA	135,000,000	44,000,000	-67.4%
EBITDA Margin to Total GCI	2.94%	0.97%	-67.0%

No wonder that the NRT's EBIDA dropped by more than 2/3 and its EBITDA margin to total GCI was an *abysmal* 0.97%.

It's just really hard to find any bright spots in these numbers. So let's see if we can find any in the announcements and plans from Realogy.

Realogy: 800lb Gorilla Waking Up Pissed Off?

In 2018, Realogy announced a number of technology initiatives, data-driven changes to recruiting and agent compensation, two new brands, a partnership with Home Partners of America to offer an "iBuyer product", and a number of smaller initiatives.

None of those have had a real positive impact in 2018, but let's grant that maybe it'll take time to implement and 2018 was all about planning such initiatives. So 2019 is when things will need to turn around.

I'm afraid the narrative isn't particularly compelling from an industry insider's perspective. Let's look briefly at three initiatives: machine learning for recruiting, marketing and technology tools to enhance productivity, and Realogy's "iBuyer" program.

Magical Recruiting Tool

First, we have the machine learning data-driven recruiting tool that Schneider has mentioned a few times.

Essentially, Realogy's local brokers/managers will be given a list of targets to go recruit. Realogy is also doing the same thing with commissions.

What makes this narrative less than compelling is the unspoken assumption that the missteps and failures of the past are the result of Realogy's local brokers and managers not trying to recruit the right kind of agents.

As far as I know, every single local manager not just of Realogy but of every single traditional brokerage of every brand is **always recruiting everybody**.

Magical Productivity Tool

Another important strategic initiative is the development and launch of a number of marketing and technology tools to enhance an agent's productivity and income. An example is "Listing Concierge" that Schneider talked up in the earnings call.

It turns out that Listing Concierge is a web-based storefront for branded marketing materials that agents pay a subscription fee to access.

I can't think of a major national brand, whether Keller Williams or Re/Max, or smaller brands like Realty One Group or HomeSmart or NextHome, or even brokerages like Compass and HomeServices of America who do not boast the *exact same* functionality.

This strategic initiative isn't just not new, it's not just old, it's actually already-in-place at Realogy brands and companies.

The So-Called iBuyer Program

Finally, we have Realogy's "iBuyer" program in partnership with Home Partners of America ("HPA").

HPA is fundamentally more of a real estate investor who buys a home to rent it out, then sell for a guaranteed gain (under the standard HPA agreement), than it is a real iBuyer.

The most important takeaway here, however, is the same takeaway from across the board from Realogy's strategic initiatives. Not one has anything to do with the consumer experience, with real consumer convenience, and with consumer benefit. They are all about agent experience, agent convenience and with agent benefit.

And cataLIST itself is fundamentally an agent-centric program than it is a consumer-centric program.

As a variation of the old "purchase guarantee" program that brokers and agents have been running for decades, Realogy's iBuyer program is more or less a bait-and-switch on consumers. Those programs have not changed the fortunes of traditional brokerages.

The most important takeaway here, however, is the same takeaway from across the board from Realogy's strategic initiatives. Not one has anything to do with the consumer experience, with real consumer convenience, and with consumer benefit. They are all about agent experience, agent convenience and with agent benefit.

The Deathwatch Gets Serious

I called Realogy a dead man walking after Q1 of 2018. But I have long held out hope for Realogy to turn things around because it still remains the largest real estate company in North America.

Much of my hope, I admit, was based on the new leadership at the top, which also resulted in significant organizational and cultural changes at Realogy. Ryan Schneider is undoubtedly an accomplished leader, who is extremely smart and capable. He has brought on or elevated a number of other leaders to help turn things around.

What 2018 results tell me is that getting Realogy back to the disciplines that made it great in the first place is not working. And none of the strategic initiatives announced thus far have a compelling narrative that justifies the faith in Realogy recapturing its former glory.

I still have a great amount of faith in Ryan Schneider and the team he assembled at Realogy. But the time is running out for them to show results, show a change in trajectory in Realogy's fortunes.

eXp Realty: Hypergrowth

After its 2018 results, there is no question that eXp Realty (trading as eXp World Holdings, EXPI on NASDAQ) is the fastest growing large brokerage in the country.

Unfortunately, eXp still doesn't do analyst earnings calls so our analysis must be content with what we could tease out from their financial reports.

The Numbers

With more information available on eXp, we can do a better job with the numbers. These are their FY 2018 results:

	2017	2018	Change
Revenues	**156,104,544**	**500,147,681**	**220.4%**
Commission and agent-related costs	139,603,970	459,715,836	229.3%
General and administrative	35,685,512	57,618,506	61.5%
Professional Fees	1,274,675	2,236,236	75.4%
Sales & marketing	1,572,041	2,961,618	88.4%
Total expenses	178,136,198	522,532,196	193.3%
Total expenses (excl. agent costs)	38,532,228	62,816,360	63.0%
Operating Income/(Loss)	(22,031,654)	(22,384,515)	1.6%
Income (loss) before income tax	(22,033,731)	(22,352,556)	1.4%
Income tax benefit (expense)	(97,234)	(77,800)	(20.0%)
Net Income/(Loss)	**(22,130,965)**	**(22,430,356)**	**1.4%**

The 220.4% YOY growth in revenues is obviously impressive, but the fact that Commissions and agent-related costs rose by an even

greater 229.3% is of concern. In fact, if you read through the Red Dot reports this year, that has always been my main concern with eXp.

So what of some of the other key metrics of eXp? Here we go:

	2017	2018	Change
Key Metrics, eXp			
Closed homesale sides	25,299	74,678	195.2%
Homesales volume	6,083,479,207	19,844,237,031	226.2%
Average homesale price	240,463	265,731	10.5%
Agent count	**6,511**	**15,570**	**139.1%**
Gross profit/Company Dollar	16,500,574	40,431,845	145.0%
Company$ Margin	10.6%	8.1%	(23.5)%
Agent split	89.4%	91.9%	2.8%
Revenue per Agent	23,976	32,123	34.0%
Cost of Revenue per Agent	21,441	29,526	37.7%
Gross Profit per Agent	2,534	2,597	2.5%
Closed sides per Agent	3.9	4.8	23.4%
Volume per Agent	934,339	1,274,517	36.4%

[The blue are numbers I calculated.]

A few things jump out from looking at the key metrics. The most salient is the fact that Company$ Margin (basically, the gross profit margin as it is revenues less Commissions and agent-related costs) dropped by almost 25%.

But the other interesting figure is the Closed Sides per Agent. eXp improved that metric by 23.4%, so the average eXp agent closes 4.8 transactions a year. Despite the improvement, however, that figure is far below NAR's median for REALTORS, which is 11 closed transactions per year (2017 numbers).

The final interesting note comes from two other numbers reported by eXp:

	2017	2018	Change
Agent equity program	5,857,554	21,253,677	262.8%
Cash From Operating Activities	4,568,353	24,310,719	432.2%

It seems clear that eXp's cash flows depend heavily on its agents taking a part of their commission in eXp stock. Without the Agent equity program, eXp's cash from operations in 2018 would have been just over $3 million.

It's a really clever idea, and a way to boost the actual cashflow of the company, even while reporting paper losses. There is one problem with it, however.

Vulnerability to Market Conditions

eXp more than just about any other brokerage is vulnerable to a change in the housing market.

eXp has a low cap on commissions. If more of the revenues come from top producers, as happens in just about every down market, then eXp's margins get absolutely crushed.

But even more on-point for eXp, in a down market, the agents themselves get into cash crunch situations, which means fewer of them are likely to take any part of their commissions in eXp stock because they need cash.

That then puts pressure on share prices, which then makes stock less attractive for agents to accept as payment, and the vicious cycle continues.

eXp is going to need new lines of businesses (mortgage, title, escrow, etc.) or an infusion of cash before the downturn comes. That clock is ticking.

What The Future Holds

In the December Red Dot, I wrote that the future of real estate is likely to be a lower commission environment from Redfin's big marketing push, and a concentration of power as the top agents get even more market share at the expense of the middle-tier of professional full-time agents who won't be able to make ends meet.

I also wrote that Zillow as a player instead of a vendor is an important shift, and that super teams will find themselves needing to ally with Zillow and become more dependent on Zillow, not less, because only Zillow (and Realtor.com) have the website, the traffic, the lead flow, and a large enough technology and data analytics team to help such super teams compete against Redfin.

The 2018 results make me adjust those views slightly, but not fundamentally. The inflection point is still here, but *who* drives the changes may have changed.

The Driver Changes

When I wrote my December report, Redfin had announced its aggressive plans and Zillow was just starting the pivot. My take then was that Zillow was going to slowly pivot to its new model as a player, since it was so beholden to the industry and to the real estate agents who are its advertising customers, while Redfin wanted to change the basic math behind real estate brokerage.

With the conservatism coming out of Redfin in Q4, and its lackluster results in 2018, combined with the change in leadership at Zillow, I think those two are flipped. Now, it feels like it will be Zillow that drives the changes in the industry while Redfin regroups to get back the competitive advantages that allow it to be bold.

The New Process

At a recent real estate conference, the former CEO of Century 21, Nick Bailey, said that the process of buying a home had changed from Consumer → Agent → Home to Consumer → Home → Agent.

But the old process remained and remains very much in place when it comes to selling a home: Consumer → Agent → Sale of Home. This is the process that institutional real estate is trying to change.

If Zillow, Redfin, Opendoor, and other real iBuyers are successful, the new process will be Consumer → Institution → Sale of Home, or if there is no offer or the offer is rejected, then Consumer → Institution → Agent → Sale of Home.

As Alex Rampell said during his a16z presentation, this doesn't mean that agents go away, but that agents will all be working for a company of some sort, either as W-2 employees (Redfin) or as 1099 subcontractors (Zillow).

Zillow's New Vulnerability

It is possible to imagine some of the largest companies and organizations in real estate deciding to team up in order to make sure that Zillow never becomes The Platform for real estate.

This has always been a latent threat against Zillow, but Zillow always held it off with a combination of smart industry relations activity and the self-interest of individual agents, agent teams, and brokerages working against any such coordinated action.

Plus, the buy-side business has always been a bit of a bete-noire in the industry.

In other words, the Consumer → Homes → Agent revolution was a revolution, and brokers and agents were and remain upset about it, but it is a different animal psychologically and culturally from the Consumer → Institutions → Sales change that is coming.

The new generation of leadership at companies like Compass, Redfin, Realogy, eXp, and others are younger, newer to the industry, and slightly more savvy. Throw in companies like Opendoor and Offerpad who ought to see Zillow's announcements as a declaration of war, and we have an interesting possibility of alliances, networks, partnerships, and cooperation on the horizon.

The new vulnerability is simply that the new Zillow with its new wartime CEO may provide enough of an impetus for the normally fractious real estate industry to unite for once and do so intelligently.

Recommendations: Brokerage

Please read the full Recommendations section for more detail.

- **The Old Way vs. The New**
- **Become a Next Generation Brokerage**
- **Go W-2 and Become a Firm of Super Teams**
- **What Is the Business in an Institutional World?**

Orient.

MAIN SECTION

The Q4 and full year 2018 reports are now out for all of the public companies in residential real estate. Because of the timing of the earnings reports, and the Red Dot, by the time you read this, most of the shock and amazement will have faded. Wall Street would have reacted to good news and bad, and we should be well into the Spring selling season for residential real estate.

In past reports delving into the public companies in real estate – Zillow, Redfin, Realogy, eXp, and to some extent, Re/Max and HomeServices of America – I have reacted to the revelation of something truly significant.

In 2018, the Q1 earnings report and the Q3 earnings report were those times, which suggests how fast everything in moving in American real estate.

In the Q3 report, I wrote:

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

It turns out, that the inflection point has inflected in Q4 with massive changes at Zillow, and the possibility that the chickens are coming home to roost for Realogy. So much of what Q4 and the full year of 2018 reveal are things we have already discussed, with one major exception.

Let us begin the examination with the changes at Zillow.

Zillow: The Rich Barton Era Returns

In the Q3 report, I wrote:

> In short, what Zillow has done is to bet the company on an important strategy, which it has hinted at in recent earnings calls but has contemplated for years. We could call it Premier Agent 4.1, but it encompasses so much more. In includes the new Best of Zillow, which has underlying it the all-important Consumer Experience Report. It includes the Zillow Homes strategy, which includes Zillow's foray into mortgage lending via Mortgage Lenders of America. It includes Zillow Flex, which goes back on years of policy and public promises not to take referral payments.
>
> This is a big risk. And investors are likely smart to take the risks into account. But taken together, these moves represent nothing short of standing up and asserting that it controls the American real estate industry.

The news out of Zillow in Q4 tells me that I was on the right path: Zillow is transforming. I just didn't think it would happen so quickly, and so decisively.

The Numbers

We begin, as always, with the numbers. For the quarter, Zillow posted these results:

	Q4/2017	Q4/2018	% Change
Revenue:			
IMT	282,330	323,988	14.8%
Homes	-	41,347	
Total Revenue	**282,330**	**365,335**	**29.4%**
Cost of revenue (excl. of amort.):			
IMT	22,559	28,498	26.3%
Homes	-	38,974	

Total Cost of revenue	22,559	67,472	199.1%
Gross Profit	*259,771*	*297,863*	*14.7%*
Gross Margins	*92.0%*	*81.5%*	*-11.4%*
Expenses			
Sales and marketing (2)	103,935	138,869	33.6%
Technology and development (2)	85,187	111,195	30.5%
General and administrative (2)	57,778	74,758	29.4%
Impairment and restructuring costs	174,000	69,000	
Acquisition-related costs	97	268	176.3%
Integration costs	-	1,492	
Total costs and expenses	443,556	463,054	4.4%
Income (loss) from operations	**(161,226)**	**(97,719)**	**39.4%**
Other income	1,415	5,962	321.3%
Interest expense	(6,991)	(14,327)	104.9%
Income (loss) before income taxes	(166,802)	(106,084)	-36.4%
Income tax benefit (expense)	89,627	8,402	-90.6%
Net income (loss)	**(77,175)**	**(97,682)**	**26.6%**

The adjusted EBITDA for Q4/2018 was $32.4 million, a decline of 54.3% from Q4/2017's $70.9 million. The Net Income declined by 26.6% to $(97.7 million) from a loss of $(77.2 million). Gross Profit was up to $297.9 million from $259.8 million, a gain of 14.7%, but the Gross Margin was down 11.4% from 92.0% in Q4/2017 to 81.5% in Q4/2018.

The bright spots are that (a) actual top line revenues grew substantially, posting a 14.8% YOY growth from $282.3 million in Q4/2017 to $324.0 million in Q4/2018, and (b) Homes revenue, which didn't exist in 2017, grew to $39.0 million. On a Q/Q basis, Homes nearly quadrupled, going from $11.0 million in Q3 to $41.3 million in Q4.

The cash flow numbers are distressing as well, as Zillow managed just $3.9 million in cash flow from operating activities for all of 2018. Even if 2017 is an anomaly because of the Trump tax cuts, $3.9 million is less than half the cash flow Zillow generated in 2016: $8.6 million.

Traffic growth is basically stalled as well, with 157.2 million average monthly unique users at the end of December, 2018. That's a 3.7% increase over the December, 2017 numbers of 151.6 million. As I wrote in a previous report, it appears that Zillow has more or less hit the saturation point as it comes to website traffic. It may be that Zillow has all of the home buyer and home seller eyeballs in the United States, with its population of roughly 330 million, many of whom are children who aren't buying houses anytime soon.

Going just by the numbers, this was not a good quarter… at all. What about the full year?

	2017	2018	% Change
Revenue:			
IMT	1,076,794	1,281,189	19.0%
Homes	-	52,365	
Total Revenue	**1,076,794**	**1,333,554**	**23.8%**
Cost of revenue (excl. of amort.):			
IMT	85,203	104,330	22.4%
Homes	-	49,260	
Total Cost of revenue	85,203	153,590	80.3%
Gross Profit	*991,591*	*1,179,964*	*19.0%*
Gross Margins	*92.1%*	*88.5%*	*-3.9%*
Expenses			
Sales and marketing	448,201	552,621	23.3%
Technology and development	319,98	410,818	28.4%
General and administrative	210,81	262,153	24.4%
Impairment and restructuring costs	174,00	79,000	-54.6%
Acquisition-related costs	46	2,332	403.7%
Integration costs	-	2,015	
Loss (gain) on divestiture	-	-	
Total costs and expenses	1,238,668	1,462,529	18.1%
Income (loss) from operations	**(161,874)**	**(128,975)**	**20.3%**
Loss on debt extinguishment	-	-	
Other income	5,385	19,270	257.8%
Interest expense	(27,517)	(41,255)	49.9%
Income (loss) before income taxes	(184,006)	(150,960)	-18.0%
Income tax benefit (expense)	89,586	31,102	-65.3%
Net income (loss)	**(94,420)**	**(119,858)**	**26.9%**

There are a couple of interesting things here from the full 2018 results.

First, sort of overlooked in the major changes is the fact that Zillow did $1.3 billion in revenues in 2018, up 23.8% YOY. The core IMT revenues were also up nearly 20%, which is somewhat amazing given the turmoil around Premier Agent 4.1 (now called Premier Agent Forward).

Second, losses from operations narrowed by 20%, which is interesting since Zillow has obviously made a huge bet on its Homes segment.

So all in all, a decent year overall, but… let's be honest. With Zillow, the action is not in the numbers. It's in the bombshell announcements they made during the Q4 earnings call.

Rich Barton Back at the Helm

The headline news was that Spencer Rascoff, the longtime CEO of Zillow and the man who grew the company massively, acquired onetime rival Trulia, took the company public, and was often in the Top Three of the SP200 Most Powerful People in Real Estate, was stepping down. And Rich Barton, co-founder and former CEO prior to Spencer being elevated, was coming back.[1]

I think what happened was that they came to the realization that Zillow needed to pivot much faster and much more aggressively.

Some in the industry saw this as some kind of a punishment for Zillow's recent struggles with its share price, for the hullabaloo over the new Premier Agent programs, and the flirting with iBuyer, which many Wall Street analysts lambasted.

[1] I spoke with some friends at Zillow about the CEO change, but not to Spencer Rascoff or Rich Barton directly. My conversations helped understand a few things, but for the purposes of this paper, I am using public information and widely held impressions.

I don't see things that way at all. I think this was a mutually agreed move that all involved likely agreed upon, because Zillow wanted to *accelerate* the transformation I wrote about in December.

Here is my basic thesis about Zillow before the Q4 earnings call:

- Zillow was pivoting away from its old business of selling advertising to real estate agents to a new one where it was much more of a player in the marketplace.
- We're not certain, but we think that it was because Zillow had capped out on its core advertising business; and
- Opendoor opened eyes to what is possible once you apply a great deal of capital and technology to an insoluble problem.
- Zillow realized that it had to get on the "Push Button, Magic Happens" bandwagon before it was too late.
- All of the initiatives launched throughout 2018, from the new Premier Agent to Zillow Flex to Best of Zillow, were all attempts to slowly turn the ship that is Zillow.
- Zillow Homes was a central piece of that pivot, because the goal is the Iron Throne: the Platform for Real Estate. Homes would be the "Push Button, Magic Happens" piece that Zillow would surround with all kinds of partnerships, relationships, and opportunities.

Then Q4 happens and Spencer steps down and Rich Barton steps in.

I imagine that prior to that happening, there must have been a series of conversations between the senior executives about how much to pivot, how fast to pivot, how to preserve the existing businesses at Zillow while they pivot, and so on and so forth.

I think what happened was that they came to the realization that Zillow needed to pivot much faster and much more aggressively. And I think Spencer looked at the work that it would involve, looked at the fact that he had nothing left to prove in the world of business, looked at the fact that he has a beautiful home in Los Angeles (where he's from) and a young family, and decided, "No thanks!"

Rich Barton, in contrast, was the original visionary behind Zillow. He had started Zillow to change the world, or at least the real estate industry. I think he might have put Spencer in charge and left to do other things because it became clear that Zillow could not truly disrupt real estate. Now he's back, because he thinks it can.

Thanks to an amazing interview in Ben Thompson's Stratechery, (Subscription Required) we got a peek into his mindset and some of the origin story behind Zillow. Let's spend some time on the interview as I think it points to what we can expect from Zillow going forward.

The Stratechery Interview

The interview starts with Rich Barton giving credit to Ben Thompson of Stratechery for being an inspiration (or a kick in the ass) to make the change.

Rich Barton says early on in the interview:

> I do want to thank you. Your strategic tear-down of Zillow [in that Article] as a kind of weak Aggregator, non-disrupter, kind of a leech on an existing business model versus the upstart who was *really* changing things really got to my core, because it was exactly for the real disruption and consumer empowerment reasons that we got into Zillow in the first place.
>
> Of course we needed to make a business out of it, so for a long time we figured how to make a business while we bided our time and waited for the right time to really attack the fundamental problem, and now we're after it, so that's great.

He then relates some of the background story behind how Zillow was founded, starting with when he and co-founder Lloyd Frink were at Microsoft. The first iteration was an auction model, because he (and many others in tech) were enamored with auctions as a way to do perfect price discovery. The goal originally was to create a marketplace with a bid and an ask on every house, so the Zestimate was born to serve as one half of that puzzle.

The interesting passage, however, is this:

> When we finished up with Expedia and both Lloyd and I had left we were casting about for the next thing to do — this is in 2005 — we latched on pretty quickly to the fact that

> nothing had really changed in the real estate vertical. **Consumers were just as in the dark, just as disempowered, the fees hadn't really come down, people were still stuck, the process usually took three to six months if you wanted to move, so most people didn't move, they just made do with what they had.** [Emphasis added]

If that sounds eerily like something Keith Rabois and Eric Wu of Opendoor might say, it's because it is exactly like what they might say. The important takeaway here is *motivation*, the *mission*, if you will behind the original Zillow. Rich Barton has lost none of that mission; he was just biding his time.

As Rich Barton makes clear elsewhere:

> So this "turn on the lights" thing was a lookback strategy attribution, ok? That was a symptom of **what we were really trying to accomplish which was fundamentally changing the way homes are rented, bought, and sold, and make it radically easier for us, our family and friends, everybody we knew**. [Emphasis added]

Then as he admits, Opendoor comes along and opens his eyes. With Opendoor and other iBuyers raising hundreds of millions of dollars to attack the problem of the inconvenient, uncertain and time-consuming transaction, Rich says Zillow felt they could get into the game, even as a public company, even as the largest portal in real estate, because "they actually gave us the air cover the attack the transaction directly." He then says, "It became an existential threat."

Longtime readers of these Red Dot reports should not be surprised.

The next passage from the interview has gotten a great deal of play in the industry, and I can't help but feel that Barton would like to have another chance to rephrase what he said.

Here's the exchange in its entirety:

> Thompson: *So to modify that then: you wanted to do this, but you were a public company, and for those reasons and lots of reasons that we are all familiar with companies that are established and have successful businesses, it's harder to pivot particularly in such a capitally-intensive direction, but by Opendoor existing, by raising so much money, you could justifiably do what you wanted to do all along.*

> Barton: That's right. **It was always our strategy to bide our time**, I can't remember if you named the process, you've been talking a lot about Netflix recently and you've always had this strategic intuition that one entry strategy for the disruptor is to come into the industry, bring the casserole to the dinner, come into the house, sit down at the table, be polite, eat, and grow like you're a baby elephant when you brought the casserole, now you're eating, you're growing bigger and bigger and bigger and before you know it you can't be kicked out of the house. That was my paraphrasing of how you describe the Netflix strategy.
>
> Thompson: *Right. And that's Zillow for real estate agents*.
>
> Barton: Yes. And by the way, I did the same thing with Expedia. It's the exact same. This is a very interesting would-be digital aggregator entry strategy when you basically take advantage of a highly fragmented, individually rationally-behaving industry, and provide incentives to some subset of them and those incentives end up securing your supply and helping you get big. [Emphasis added]

JD Ross, one of the cofounders of Opendoor, immediately quoted that passage on Twitter and noted:

> In @zillow CEO Rich Barton's Stratechery interview is the frank confession that they're going to displace real estate agents because there's nothing they can do about it anymore

It is not an unfair characterization of that passage. It is possible to view Barton's statements as confirmation of all of the conspiracy theories and anti-Zillow sentiments within the real estate industry. The mention of Expedia is particularly insensitive, given how long the real estate industry has been worried about whether agents will meet the fate of travel agents.

It is not unfair, and I suspect there will be some fallout from those comments. But I think that interpretation is inaccurate because of what comes next, so ultimately, it's irrelevant.

What Barton says more or less confirms what I've been writing about Zillow from the beginning.

Here's what I wrote in the June Report:

> Throughout this transformation, perhaps nothing transforms more than the relationship between Zillow and the Premier Agent.
>
> Today, the Premier Agent is an advertiser on Zillow. For a certain amount of money, Zillow promises a certain number of impressions (CPM-based pricing) of that Premier Agent.
>
> Tomorrow, the Premier Agent becomes something far closer to the windows installer for HomeDepot. Sure, she is still an advertiser. She will still have a customer service rep at Zillow, and a salesperson at Zillow who will be trying to get her to spend more with Zillow.
>
> But when Zillow holds the relationship with the actual buyer or seller, passing them on to her only after they have been "validated", the relationship changes slightly… but in a *profoundly important way*.

And then in the December Red Dot, I wrote:

> Taken together, this means that Zillow is not transforming into a brokerage but into an *agent team*. Perhaps put more precisely, it is transforming into a Team of Teams.
>
> That is an ever-so-slight difference from Bradley Safalow's take, but it is an important distinction.
>
> For one thing, the expected margin erosion that Safalow predicts may not necessarily come to pass because Zillow is not a brokerage in all but name, but a super Team of Teams in all but name.
>
> Agent teams normally command 50/50 splits (or better!) with the agents on the team because the team provides Leads and Technology. That's not quite Zillow's astonishing 89% gross margin numbers, but it isn't in the same league as margin problems of brokerages.
>
> What it means in the short to medium term, strategically, is that Zillow and Redfin are converging. In the long run, it merely means that both are continuing their march towards the Iron Throne: becoming **the** Real Estate Platform.

Well, here's Barton in the Stratechery interview:

> The really interesting challenge and opportunity that we have in the core Premier Agent business now is to turn our advertisers into partners for two reasons: we get them off of

> subscription-based advertising so no more of any of this model that we're talking about, and move them towards a success-based compensation scheme that is around what happens when consumers actually close a transaction.

He goes on to talk about how Zillow is making a huge change in mindset, which includes moving away from salespeople dialing for dollars to advertisers to interviewing and selecting partners who can do the best job for "our collective customers."

Barton talks about a bridge over a "yawning chasm of despair" with a fast lane, which is Zillow Offers, and a slow lane, which is the traditional Premier Agent-based real estate agent model.

But the way he describes these agent partners is exactly in line with what I wrote about Zillow's transformation. Barton accepts that what he's describing is basically Redfin's vision but without the overhead of employees. Thing is, he isn't even ruling out that possibility in the future. He says:

> The challenge will be externalizing it to third-party partners rather than having these employee agents that Redfin has, but we'll keep our eye on that too. That's a possibility but they don't have any leverage in that model. They have a really hard time growing because they just don't have very much gross profit at that company so they just can't invest that much. They'll be at a disadvantage there.

We'll discuss this below when we talk more about Redfin, but the important takeaway here is the *mindset*. The only reason why Zillow does not simply hire employee agents is gross profit margins: Zillow's is north of 80% of revenue, while Redfin is hovering around 30%.

But Barton and Zillow may find in the years ahead that the iBuyer business does not offer 80%+ margins and decide that having employee agents gives them what Redfin has: more control over the consumer experience. If so, then Zillow will have agents. Zillow under Barton will not say, "We can't go down that road, because of our agent business." Instead, it will just hire agents, forsake the Premier Agent business and continue down that road.

As Barton says towards the end of the interview:

> This is a massive redeployment of resources, a complete transformation of our P&L, and a dramatic expansion of the opportunity that we face.

Zillow's Leverage Showing up in Unit Economics

In the Stratechery interview, Barton talks about how Zillow has an advantage, that is growing, over other iBuyers, especially Opendoor. Zillow has both a capital advantage and a traffic advantage (demand advantage, as he calls it) over everyone else.

It's showing up in the unit economics, which Zillow published in its supplemental financials. I have to admit I was amazed to see these numbers, so I played with them. And discovered something amazing.

I wrote a post about this on Notorious, but let me reprint parts of it here to keep it all in one place.

Bottomline is, if my assumptions are correct, then a homeowner would net more money selling to Zillow than he would by listing with a real estate agent in the traditional model.

Zillow Offers Unit Economics

From the Supplemental Financials:

Zillow's Numbers	Per Home
Homes revenue	293,241
Service Fee (7%) to Seller	18,489
Actual Sale Price of Home	274,752
Operating costs:	
Home acquisition costs	264,134
Renovation costs	9,121
Holding costs	2,589
Selling costs	13,043
Total operating costs	288,887
Interest expense	2,631
Return on homes sold after interest expense	1,723

A few things to note here.

First, that 7% service fee to the seller comes from Zillow's press release. I didn't make it up.

Second, I'm assuming that the Selling costs line consists of REALTOR commissions. It equals 4.75% of the Actual Sale Price so I estimate that we're looking at 1% to the listing agent and 3% to the buyer agent (which would be completely normal for institutional clients) and 0.75% in closing costs like title and escrow.

Third, holding costs according to Zillow includes "utilities, taxes and maintenance."

She makes less money, with more effort, more uncertainty, and more work, by listing her home with a REALTOR and going into the open market.

Given the above, Zillow paid $264,134 to buy a home that it sold in Q4. That homeowner who accepted Zillow's offer paid Zillow a 7% Service Fee, which comes to $18,489. Zillow then sold the home for the Actual Sale Price of $274,752 in Q4 of 2018, which gets us the total Homes revenue line of $293,241.

The homeowner who took Zillow's offer received $264,134 less the $18,489 in Service Fee, which means that her net from the sale was **$245,645**.

If that same homeowner chose not to accept Zillow's offer, and listed it with a REALTOR instead, then her expected net looks like this:

Sell with REALTOR		
Sale Price		274,752
Renovation costs		9,121
Holding costs		2,589
Selling costs		
REALTOR Commissions	6%	16,485
Closing Costs	0.75%	2,061
NET		**244,496**

Some reasoning here is necessary.

1. **Sale price.** There is absolutely no logical reason to think that she would get more in the open market than Zillow would, since both are represented by a REALTOR. Zillow has said from the very inception of Zillow Homes (then Instant Offers) that they, unlike competitors, will use a REALTOR to list and sell the homes in their inventory.

2. **Renovation and holding costs.** Similarly, I see no logical reason to think that an individual would somehow spend less on renovation and holding costs than Zillow would. In fact, an individual's cost might be higher than Zillow's, due to scale and advantages of a multibillion dollar public company over a family.

3. **REALTOR commissions at 6%**: I know some would argue that prevailing commissions are lower, but I've actually looked for information on what the average commission in Phoenix (the ground zero of iBuyer activity) is… and I'm finding 6%.

Her expected net selling with a REALTOR is **$244,496** vs. **$245,645** selling to Zillow.

She makes less money, with more effort, more uncertainty, and more work, by listing her home with a REALTOR and going into the open market.

(Note that even if we change the REALTOR commission to 5%, her net only goes to $247,243. So she waded across the chasm of despair that Barton described of the home selling experience for an additional $1,598?)

This is a complete game changer, and it means that the iBuyer model (at least Zillow's iBuyer model) will gain traction and market share much faster and much wider than anyone ever thought possible. That includes me, and I have been a bull for iBuyer from the beginning.

Zillow's target of $20 billion in revenues from the Homes business within 3-5 years is *far too conservative*, if these numbers are correct.

Now, layer on mortgage and title and other core services. In a previous post, where I made the case for iBuyer becoming the default, I wrote:

> But if the seller uses Zillow Mortgage to buy their next home (which could be a Zillow-owned home, or could be some other home), Zillow stands to make $9K from the mortgage business. Knowing this, Zillow offers to charge only 4% as a fee to sell the home to Zillow, if the homeowner would use Zillow Mortgage for his next house.

The thinking was that consumers would flock to Zillow Offers if it offered the Uberized convenience of the "Fast Lane" over the chasm of despair and at lower cost than using a real estate agent.

Well, that might already be the case. Layering on other ancillary services, such as mortgage and title, means a significant increase for Zillow's revenues and consolidated margins.

On that point, here's Barton from the Stratechery interview:

> The hundred to two hundred basis points really is contemplating what we think of as Zillow Offers right now. **It doesn't include lots of starry-eyed ancillary fries with that burger**, but there are lots of those opportunities, some of them we have a separate segment of mortgages, we're reporting our mortgages at least for now separately, and we see big growth opportunity in mortgages, that is a different margin profile, kind of in-between the two, and we see a growth in the kind of PA [Premier Agent] business that we're pretty encouraged by the opportunity with all of these partner leads that are thrown off from the homes business. [Emphasis added]

Well then. It will be all kinds of interesting once the ancillary fries begin to get served with that iBuyer burger.

The Iron Throne

One further note here is that Barton's ultimate vision of what Zillow looks like in the future more or less tracks what I've written over the past year or so. Zillow will contend for the Iron Throne, the Real Estate Platform.

Here's what he says:

> The organization had become really focused on looking down at the existing business and trying to solve for all the micro-problems and opportunities they saw in the existing business.

> [T]he big picture is there is a giant hill that is empty across the way here, and we need to get the high ground, take that hill, get there first, and if we don't get their first then we are really in trouble.

And what does this "giant hill" actually look like? Why is it so critical that they get there first?

> It's an integration of all of these giant hands that surround the transaction which are all fraught with their own kind of hairy process and regulatory messes and recognizing we ought to be able to radically streamline and integrate all of those processes and make it way more seamless for a seller, whether or not they are selling with us or selling with a partner, and a buyer, whether or not they are buying with us or buying with a partner.

From my September Red Dot on The Platform:

> Let us suppose that one of the Contenders wins the race and establishes the Real Estate Platform as a hybrid with a strong market maker linear business at least in a dozen markets or so. Let us further suppose that the frontrunner, Zillow, wins that race for the sake of this hypothesis.
>
> As per the discussion above, the Zillow Platform would provide:
>
> - A large audience/network
> - Matchmaking
> - Core tools and services
> - Rules and standards
>
> Because real estate is a mediated transaction, the Platform's network would include consumers and professionals.
>
> Zillow Offers would form one of the core services, which keeps consumers coming back. Because of the size of the real estate market, other companies would function as market makers on the Zillow Platform, whether by geography or by property type or some other category. Major financial players would get involved as market makers or as funding sources for market makers, once that business model is proven out by startups like Opendoor.
>
> The other core services would need to include various technology tools and services to enable the transaction on both the direct retail and third-party operations. In real

> estate, we're talking about things like access to the property (showings, lockboxes), legal forms, payment processing, financing, getting the property ready for sale, and so on.
>
> The rules and standards would need to include items that most Platforms provide today, such as reputation management (think ratings of Uber drivers *and* passengers), enforcement, and dispute resolution. Importantly, just like Amazon and Ebay handle payments to sellers on their payment processing platforms, the Real Estate Platform would need to ensure that professionals get paid.

That is the giant hill. It doesn't mean becoming the only iBuyer in real estate, or the only source of leads for real estate agents. It means being the platform with a large audience, a large network, with core services that "radically streamline and integrate" all manner of complicated processes and regulatory issues, with rules and standards such that all of the market participants can buy, sell, lease, and make money.

That being the case, the giant hill is actually the Iron Throne. And it is critical to get there first, because when you play the game of thrones, you win or you die.

The relationship between brokers and agents and Zillow was changing slowly under Rascoff; that change will now accelerate under Barton. Things now get confusing for the industry.

The Return of the King

If you're explicitly going after the Iron Throne, undertaking a massive redeployment of resources and a complete transformation of one's P&L, and making huge bets because you have to get there first… that is a job for Aragorn, not Denethor.

As Barton says:

> And the challenge is only one of strategic clarity and leadership execution, and that is why I am sitting here now. There are some things that only founders have the authority to do to get people to realize that this isn't just a small, minor tweak and change that's happening at the company here.

The transformation I have been predicting for over a year is now complete. Zillow is no longer a media company, but a real estate company moving towards becoming the Platform for Real Estate, the marketplace for buyers and sellers. Brokers, agents, mortgage, title, escrow, home maintenance, moving – all of these become the “giant hands” that Zillow will try to integrate and streamline for the benefit of the only network that matters at the end of the day: buyers and sellers.

The relationship between brokers and agents and Zillow was changing slowly under Rascoff; that change will now accelerate under Barton. Things now get confusing for the industry.

I wrote in the December Red Dot that Zillow’s moves was an assertion of power. Barton made clear that he believes that Zillow is now too big to get kicked out of the house of real estate. But you know who else believed that? Realtor.com. And Realtor had the advantage of being considered one of the family, even if a faintly disliked distant cousin. Then came Trulia and Zillow.

Nothing says that Zillow can’t suffer the same fate. As yet, Zillow hasn’t taken the Iron Throne. By going after it so plainly, so openly, Zillow has revealed some vulnerabilities.

If some of the other players in real estate decide to really play the Game of Thrones, and can set aside their rivalries, the outcome is not yet written.

We will get into the implications for the future down below, because it requires looking at one of the other contenders: Redfin.

Redfin: Biding Their Time

After the fireworks of Q3, when Redfin announced that it was going to bring the darkness, it would have been reasonable to expect more fireworks. Instead, we got retrenchment, we got conservative statements from Glenn Kelman, and we got careful optimism.

It’s hard to make sense of Redfin’s Q4 earnings call and its full year results. But let’s give it a shot.

The Numbers

The full 2018 results for Redfin were:

	2017	2018	Change
Revenue	370,036	486,920	31.6%
Cost of revenue	258,216	367,496	42.3%
Gross profit	111,820	119,424	6.8%
Gross Margin	**30.2%**	**24.5%**	-18.8%
Operating Expenses			
Technology and development	42,532	53,797	26.5%
Marketing	32,251	44,061	36.6%
General and administrative	53,009	65,500	23.6%
TOTAL	127,792	163,358	27.8%
Income (loss) from operations	(15,972)	(43,934)	(175.1%)
Net Income/(Loss)	**(15,002)**	**(41,978)**	(179.8%)

It was a mixed bag of a year, overall. Revenue growth remained strong, but the erosion in gross margin to below 25% should be extremely concerning.

Redfin, after all, is not a portal selling advertising but a real estate brokerage. Its major advantage over other larger brokerages was that its gross margins were double or more due to using W-2 employee agents instead of 1099 independent contractors. But once your gross margins start creeping below 25%, Redfin gets into Realogy territory. Indeed, for FY 2018, Realogy's NRT unit posted higher gross margin numbers than did Redfin, which is a real problem.

And Chris Nielsen, CFO of Redfin, sounded eerily like Realogy executives when he reported that real estate services gross margin was 27.8%, down 570 basis points YOY, which was "primarily driven by a 440 basis point increase in personnel costs."

The consolation for Redfin is that unlike Realogy, it can do something about the margin problem: give more customers to its agents. That is more or less what Glenn Kelman said they would do, now that Redfin was done easing back on the throttle to incorporate "culture changes" throughout its salesforce.

Some of the key metrics I track for Redfin were rather healthy for 2018 (except financially, as we discussed above):

Key Metrics	2017	2018	Change
Monthly average visitors (in thousands)	**22,623**	**27,261**	27.8%
Real estate transactions:			
Brokerage	35,038	42,954	22.6%
Partner	10,755	11,608	7.9%
Total	45,793	54,562	19.1%
Real estate revenue per transaction:			
Brokerage	9,429	9,459	0.3%
Partner	1,971	2,229	13.1%
Aggregate	7,677	7,921	3.2%
Sales Volume (millions)	21,280	25,812	21.3%
U.S. market share by value	0.67%	0.81%	20.9%
Average number of lead agents	1,023	1,390	35.9%
Transactions per Lead Agent	34	31	(9.8%)
Brokerage Revenue per Lead Agent	322,944	292,297	(9.5%)
Brokerage Gross Profit per Lead Agent	111,181	88,560	(20.3%)

The Brokerage numbers exclude Partner revenue and profits.

Since Redfin made no major acquisitions in 2018, all of the transaction and volume growth are organic. Redfin does not report to Real Trends, but using these numbers and the 2018 Real Trends 500 report, Redfin would be the #5 brokerage in the United States by both transactions and by volume.

So those metrics look just fine, if a bit uninspiring.

What is a bit more inspiring and a bit more worrisome are its numbers from its iBuyer services, Redfin Now.

Redfin Now: Signs of Trouble

On the one hand, Redfin Now turned in a surprisingly robust result. The Properties segment turned in $46.6 million in revenues for 2018, up 350% from the $10.4 million it posted in 2017. Seeing as how Zillow Homes only posted $52.4 million in revenues for 2018, what it says is that Redfin quietly and quite beneath the radar has built an iBuyer business that is as large as Zillow's.

So that part's great. But on the other hand… here's Chris Nielsen from the earnings call:

> For our properties segment, cost of revenue includes the purchase price, capitalized improvements, selling costs and home maintenance expenses. In the fourth quarter, properties gross margin of minus 4.3% was down from 2.4% in the fourth quarter of 2017, primarily due to a 490 basis point increase in the cost of properties, a 150 basis point increase in personnel costs, including stock-based compensation due to increased headcount and an 80 basis point increase in transaction bonuses, each as a percentage of revenue.

This is a problem. And I'm going to make a bigger deal of this than perhaps others might because it goes to the heart of Redfin's claim of superiority: execution.

Redfin simply cannot lose money on Redfin Now (negative 4.3% margins) while Zillow made money on its iBuyer program. That just can't happen.

In the Q2/2018 earnings call, Glenn Kelman said:

> In committing to Redfin now long-term, we eyed our competitors wearily as many are well run, some are willing to take risks we aren't and seeming all of them are well funded. **But we decided we can win, because we believe nobody is better at selling homes than we are. We believe that nobody in real estate is better at combining local service and technology.**
>
> Newer entrants don't have the online audience we do, **and pure websites don't have as much operational expertise. We believe few companies have our spending discipline**. This audience field experience and penny-pinching should let us acquire and sell homes at a lower cost, which will let us offer homeowners more money. For the person selling her home to Redfin Now that money is almost all that matters, and a war on price is the one we feel best prepared to win.

If you have tied your success to your operational expertise, then you have to deliver operational expertise. If you claim that nobody is better at selling homes than you are, then you actually have to show that in the numbers.

In other calls, Kelman has said repeatedly that Redfin has a decade-plus experience of helping homeowners renovate homes, stage them, maintain them, and sell them for top dollar. He claimed that same experience, that same expertise, would let Redfin Now compete against the likes of Zillow who lacks such on-the-ground experience.

After all that, Redfin simply cannot lose money on Redfin Now (negative 4.3% margins) while Zillow made money on its iBuyer program. That just can't happen. And Redfin lost money due to paying more for houses, and paying more to Redfin's staff for buying and selling those houses. That can't happen either. If Redfin is going to compete because of its operational expertise and local agents on the ground, then it can't overpay for houses and then sell them for less, not while Zillow without that local experience apparently did just fine.

So yeah, I'm making a bigger deal of this failure than perhaps others will, and perhaps more than I should. But it's a big flashing red light.

Combined with the lackluster gross margin numbers, due to higher personnel costs, I start to wonder about Redfin.

Show Me the Money!

Glenn Kelman in his Q3 earnings call made a series of extremely confident statements about Redfin:

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

For what it's worth, I have long said that Redfin is the most important brokerage in North America for many of the reasons that Kelman cited.

Well, the 2018 results undermine quite a lot of that confidence. Q2 and Q3 become even more important as a result for Redfin to show up and show out. 24.5% gross margin is not "significant cost advantage" over traditional brokerage competitors, and certainly not over actual tech companies like Zillow. Selling houses faster for more money had better show up in the Redfin Now results, where Redfin agents are selling Redfin's own houses.

We can overlook 2018 because of the huge surge in hiring, followed by the "cultural changes" Kelman mentions in a number of calls to change how Redfin agents are supposed to work with prospects and clients. But as Kelman said during the Q4 call, that's over now, and Redfin will start assigning more prospects to agents in 2019.

We can be understanding of the seasonality of revenues, where Q4 and Q1 tend to be slow. Redfin with its W2 model has cost structures that are not as variable as competing brokerages.

Those are all fine. But then Redfin has to show up in a big way in Q2 and Q3, which are the height of the selling season in real estate. At a minimum, Redfin has to return to the 30% gross margin range which it enjoyed in 2016 and 2017; I would prefer to see Redfin break 35% gross margins reflecting the improvements to their processes that took all of 2018 to put into place.

So it worries me a bit when Chris Nielsen tries to moderate expectations on margins during the Q4 earnings call:

> Sure. So we're not breaking out gross margin guidance for Q1. Just as you think about the whole year though, we do think there's an opportunity for agent productivity to improve. We talked on the call about increasing the number of customers our agents meet and as long as we can hold close rate the same or improve it through the programs we have in place, that will lead to improving agent productivity and improving gross margins. It is the case though as you look at Q1, really, of every year that that's not necessarily indicative of the way the whole year plays out for gross margins because we're hiring agents for the peak of that year, and so the excess capacity that we have or don't have doesn't really come into play until we get into the middle part of the year itself.

And Redfin Now *cannot* be less profitable than Zillow Homes. It just can't, because failure there means that the entire premise of Redfin's competitive advantage – operational excellence, boots-on-the-ground experience, with W2 employee agents – is wrong. Zillow's audience advantage could give it an advantage in volume and number of actual transactions; it can't give Zillow an advantage in per-unit economics.

Finally, Q2 and Q3 are when Redfin has told us to expect to see some lift from the consumer advertising they'll start running in Q1. They have long said that the impact of brand advertising will take a while and have longer positive impact, but they have consistently said that Q2 and Q3 of 2019 is when we should see some results. So yes, as Redfin brings the darkness (as I wrote in December), we need to see market share gains in some key markets along with better productivity and better gross margins.

Realogy: The Deathwatch Gets Serious

Since the start of the Red Dot reports covering publicly traded real estate companies, I have worried about Realogy. In the June Report, where I covered Zillow, Redfin and Realogy, I called Realogy "the walking dead."

My concern was centered on the fact that all of the announced plans from Realogy were still around the old agentcentric model of recruiting and retention:

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

In response, one Realogy executive said that Realogy under Ryan Schneider's leadership was the "800lb gorilla who is finally waking up, and he's pissed off."

Well, if 2018 is the best which a pissed off 800lb gorilla can manage, one wonders what would have been different if it had never woken up in the first place.

The Numbers

Let's start with the quarterly results numbers. As usual, we'll start with Realogy overall, but focus on the brokerage operations of the NRT.

As most of you already know, 2018 results were a bloodbath. It is difficult to find a bright spot in Realogy's numbers. And the Street has responded accordingly, driving Realogy's share prices to the lowest level ever.

As of this writing, Realogy is trading near its historical lows at about 11.40, far below the book value of the stock. Its market cap has plummeted to 1.3 billion, which is lower than Redfin's market cap, and far below the valuation of smaller competitors like Compass.[2]

Let's take a look at the disaster that was 2018.

	2017	***2018***	***Change***
Revenues (in millions)			
Gross commission income	4,576	4,533	-0.9%
Service revenue	938	947	1.0%
Franchise fees	396	393	-0.8%
Other	204	206	1.0%
Net revenues	**6,114**	**6,079**	**-0.6%**
Expenses (in millions)			
Commission & agent costs	**3,230**	**3,282**	**1.6%**
Operating	1,544	1,548	0.3%
Marketing	261	258	-1.1%
General and administrative	364	328	-9.9%
Former parent legacy cost (benefit), net	(10)	4	-140.0%
Restructuring costs, net	12	58	383.3%
Depreciation and amortization	198	195	-1.5%
Interest expense, net	158	190	20.3%
Loss on the early exting. of debt	5	7	40.0%
Other expense (income), net	1	-	-100.0%

[2] Source: Yahoo! Finance, 3/30/19.

Total expenses	**5,763**	**5,870**	**1.9%**
Income (Loss) before income taxes, equity in losses and noncontrolling interests	351	209	-40.5%
Income tax expense (benefit)	(65)	65	-200.0%
Equity in losses of unconsolidated entities	(18)	4	-122.2%
Net income (loss)	**434**	**140**	**-67.7%**

So we have lower revenues, higher expenses, and net profit is cut by more than 2/3. The cuts to G&A and Marketing suggest that Realogy is tightening its belts and trying to be more efficient, but that also leads to issues as we'll discuss below.

By far the most troubling is that commission and agent-related costs are up 1.6% from 2017 to 2018. Considering that this was what Ryan Schneider said he was focusing on, as that was where "the violence in the P&L" was, a 160bp increase is… disheartening.

If 2018 is the best that a pissed off 800lb gorilla can manage, one wonders what would have been different if it had never woken up in the first place.

What made the situation worse for 2018 was the fact that the NRT unit actually sold fewer homes. Even with the average home price rising a healthy 1.7%, the combination of fewer transactions and higher agent costs doomed the NRT.

	2017	2018	Change
Closed Transaction Sides	344,446	336,806	-2.2%
Average Home Price	514,685	523,426	1.7%
Total Sales Volume	177,281,189,510	176,293,017,356	-0.6%
Avg commission rate	2.44%	2.43%	-0.4%
GCI per side	13,309	13,458	1.1%
Total GCI (per-side X sides)	4,584,231,814	4,532,735,148	-1.1%
Commission paid to agents	3,230,000,000	3,282,000,000	1.6%
Company Dollar	1,354,231,814	1,250,735,148	-7.6%
Company$ Margin	29.5%	27.6%	-6.6%
Agent Split	70.5%	72.4%	2.8%
EBITDA	135,000,000	44,000,000	-67.4%
EBITDA Margin to Total GCI	2.94%	0.97%	-67.0%

The NRT did *fewer* transactions year over year. In contrast, Redfin increased its transactions by 22.6% or 7,916 more brokerage transactions in 2018 over 2017. And Redfin didn't have a great year for the reasons discussed above. And its total sales volume was down, resulting in lower total GCI, out of which the agents took a larger share.

No wonder that the NRT's EBIDA dropped by more than 2/3 and its EBITDA margin to total GCI was an *abysmal* 0.97%.

Finally, 2018 was the first time ever that the NRT was not the #1 brokerage by both transaction sides and sales volume in the Real Trends 500 report. HomeServices of America took the top spot for the first time ever. While not all that meaningful ultimately, the psychological impact on the industry and on NRT cannot be underestimated. NRT is no longer the biggest gorilla in the jungle, and its air of dominance has taken a real hit.

It's just really hard to find any bright spots in these numbers. So let's see if we can find any in the announcements and plans from Realogy.

Realogy: 800lb Gorilla Waking Up Pissed Off?

As I have noted continuously since I began the Red Dot series, erosion of profitability is **The Problem** of the traditional brokerage since emerging from the Housing Collapse. It certainly is Realogy's main headache, and Ryan Schneider admitted it when he took over and said it would be Realogy's focus going forward.

Realogy announced a number of technology initiatives, data-driven changes to recruiting and agent compensation, two new brands, a partnership with Home Partners of America to offer an "iBuyer product", and a number of smaller initiatives.

Obviously, none of those have had a real positive impact in 2018, but let's grant that maybe it'll take time to implement and 2018 was all about planning such initiatives. So 2019 is when things will need to turn around, as Ryan Schneider said during the Q4 earnings call:

> First, we expect to drive incremental revenue in 2019 as our strategic initiatives begin to show results. We've changed many aspects of our business to improve our value

> proposition and drive growth, via both greater agent recruiting and greater productivity.

Schneider then cites some examples of these strategic initiatives, such as new commission plans, machine learning analytics for recruiting, and technology products to "enhance our agent value proposition." So the idea appears to be that Realogy will have products and services that will make agents more productive, which means they can charge more (in the way of splits) than competitors can, and that Realogy can identify the potentially productive agents to recruit them.

It's a narrative, but I'm afraid it isn't particularly compelling from an industry insider's perspective. I'm not going to cover all of the initiatives, but let's look briefly at three of them: machine learning for recruiting, marketing and technology tools to enhance productivity, and Realogy's "iBuyer" program.

Magical Recruiting Tool

First, we have the machine learning data-driven recruiting tool that Schneider has mentioned a few times, most recently in the Evercore ISI Industrials, Housing & Building Products, Airlines Conference.

During the Q&A, Schneider talks about the machine learning recruiting tool. He starts by noting that Realogy sucks in performance data on 2 million agents from the MLS, then says:

> We've built kind of a – we've built a machine learning model that's looks at not just their characteristics, but our characteristics and is all about trying to predict who's going to be able to drive the most incremental productivity down the future. It's not who's the whales because everyone's knows that, it's who are the up-and-coming people, where are people potentially of, effectively the efficient frontier. And when we do that, and we keep improving it over the course of 2018 and 2019, we find two things.
>
> One is, of the 10 most important variables that explain someone's future potential, five are actually Realogy-specific. It's the match between us and them, but five are them. And there's some unique data about Realogy, the Realogy-specific data that actually creates something there that could be a bit

> of a competitive advantage because others don't have that data or have it in depth.
>
> The other thing then is we take about 75,000 of those – of the top people out of that and put that out to our local managers every quarter to really let them use that to prioritize their agent recruiting, to effectively help them spend their resources both dollars and time on people we think have the highest productivity.

What that means essentially is that Realogy's local brokers/managers are given a list of targets to go recruit, because those agents have the ideal characteristics for a Realogy agent. As Schneider puts it, Realogy will tell them "Hey, keep your eye on this one, he's over with somebody else."

Realogy is also doing the same thing with commissions, so that local brokers and managers can recruit agents who represent the efficient frontier between production and profitability, since the top producers command a premium in commission splits. As Schneider puts it:

> And we're doing some of the same things on commissions, and there's three or four more we need to do, but it's using those kind of approaches a bit differently, we hope, can unlock some incremental value because we have unique data that others don't, because we have more data than others, and we have the scale, nationally, to really make these investments.

What makes this narrative less than compelling is the unspoken assumption that the missteps and failures of the past are the result of Realogy's local brokers and managers not trying to recruit the right kind of agents.

As far as I know, every single local manager not just of Realogy but of every single traditional brokerage of every brand is **always recruiting everybody**. It isn't as if the NRT has some minimum production standards before they'll talk to an agent; they'll take every agent, even brand new ones fresh out of real estate school, as long as they could pass licensing background checks and do not appear likely to create liability for the brokerage by doing something stupid and illegal.

There may have been a time in the past when Realogy brands were considered "premium" brands within the industry, and so agents were more susceptible to the idea that "Hey, Realogy is paying attention to me! I must be special!" Those days are long past, and Compass has taken that position... backed up by the millions it spends on "buying" top producing agents.

The continuing confusion arises from the fact that brokerages keep using the word "recruiting" to refer to bringing agents into the company, when the proper term is "sales" since it is the agent who pays the brokerage, not the other way around. That being the case, the idea that a machine-learning tool will tell salespeople (local managers) who to go after is valuable only if those salespeople were not already calling on those prospects... which they have been, incessantly and diligently for years and years.

Magical Productivity Tool

Another important strategic initiative is the development and launch of a number of marketing and technology tools to enhance an agent's productivity and income. An example is "Listing Concierge" that Schneider talked up in the earnings call:

> One, the Listing Concierge product I mentioned on our last call, where agents purchased an enhanced listing marketing package, continues to expand across our own brokerage footprint. Agents are using this product to win more listings. More interestingly, agents using Listing Concierge are getting higher commission rates from home sellers compared to agents who don't use the product in the same market across every price band. We like the impact of this new product for the agent's economics, for recruiting and is a real example of enhancing our value proposition.

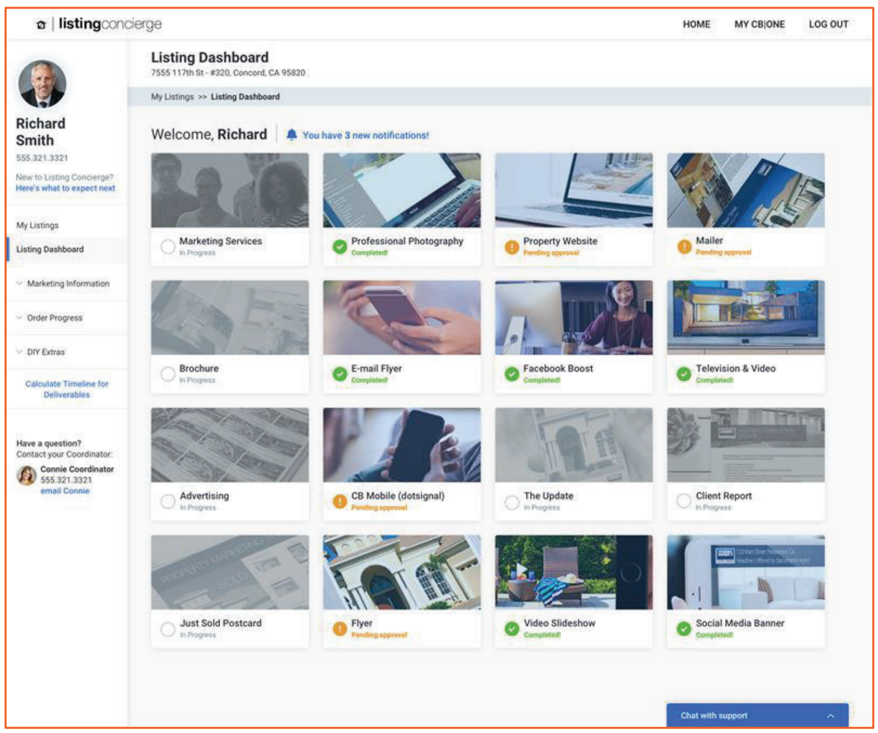
What is this magical product for agents? From the Evercore ISI Conference:

> And Listing Concierge is just one example, we have tech examples, we have data examples. That is a marketing example, where instead of asking an agent to do the marketing for their listing, we have used our scale to put together a set of resources, where if they pay us a small fee, we will effectively push button, build an integrated marketing

campaign for them with photos, social, et cetera, for every one of their listings.

It turns out that Listing Concierge is a web-based storefront for branded marketing materials that agents pay a subscription fee to access. The materials are not free; agents still pay for those, but they can order them from one place.

To say this is underwhelming is… quite an understatement. The Inman News article on Listing Concierge literally says, "The idea of a web portal to craft and order branded creative is by no means new." In fact, it is so not-new that Realogy's own Coldwell Banker has had the exact same web-based storefront for years, which allowed agents to go on and order branded marketing materials from a single website.



Could there be differences in ease of use and design? Of course. Perhaps Listing Concierge is a dramatic leap in quality of design that helps Realogy agents impress a client such that they can charge a premium, as Schneider says. But I can't think of a major national brand, whether Keller Williams or Re/Max, or smaller brands like Realty One Group or HomeSmart or NextHome, or even brokerages like Compass and HomeServices of America who do not boast the *exact same* functionality.

In fact, this kind of branded marketing has been Compass's calling card from day one, except that Compass actually assigns a graphic designer to an agent to help create customized yet on-brand marketing materials. So....

Improving design is a matter of hiring better designers. Ease of use is a matter of spending some money on UI/UX design firms. There is no barrier to entry, no moat of protecting whatever competitive advantage a webstore might provide.

This strategic initiative isn't just not new, it's not just old, it's actually already-in-place at Realogy brands and companies. And Realogy's numbers are what they are with this magical productivity tool in place already. Why that would change with a design refresh is difficult to see.

The So-Called iBuyer Program

Finally, we have something that is in fact new: Realogy's "iBuyer" program in partnership with Home Partners of America.

Since Realogy has not published unit economics of its special iBuyer program, it is difficult to analyze whether it is a true iBuyer program (which is about convenience to the seller) or a lowball investor program in disguise.

But we can look at Realogy's partner on this program, Home Partners of America ("HPA"), and make some educated guesses.

The most important takeaway here, however, is the same takeaway from across the board from Realogy's strategic initiatives. Not one has anything to do with the consumer experience, with real consumer convenience, and with consumer benefit. They are all about agent experience, agent convenience and with agent benefit.

The standard way that HPA works is that a renter applies to the program, gets accepted, then finds a "qualified home" which HPA would then purchase for cash. The renter is obligated to lease the home from HPA at a set rate, which increases each year by 3.75% (or less). The renter would also get a right to purchase that home at a preset price, which also goes up each year by 3.5% - 5% (depending on the area).

The list of criteria for a property to qualify for purchase then lease by HPA is rather extensive and can be found here. The criteria include:

- Home Partners will not purchase homes near structures that could impair value (e.g. high tension power lines, cell/water towers).
- Homes within a 100-year flood zone do not qualify except in Florida where a base flood elevation difference of -1.5 or higher is allowed.
- Home Partners will not purchase homes over 30 years old that are in original condition or with obsolete floorplans.
- Homes must have updated plumbing and electrical (e.g. no polybutylene or galvanized plumbing, aluminum branch wiring, cloth wiring).
- Home Partners will not purchase homes with incomplete rehab projects or structures on the premises that are in disrepair.
- Homes must have central air conditioning (exceptions may apply in CO, OR, MN, PA and WA). All new construction homes must have central AC regardless of location.

It is unclear what the "buy box" is for HPA compared to the buy box for true iBuyers such as Opendoor and Zillow. And perhaps HPA has a different buy box with different criteria for the cataLIST program it has with Realogy.

But with no renter on the hook in a straight iBuyer situation, and the existing iBuyer programs either losing money (Redfin Now) or with razor thin margins (Zillow Offers), it seems rather unreasonable to expect that HPA would take huge risks with its capital.

HPA is fundamentally more of a real estate investor who buys a home to rent it out, then sell for a guaranteed gain (under the standard HPA agreement), than it is a real iBuyer.

And cataLIST itself is fundamentally an agent-centric program rather than a consumer-centric program. The name alone should betray the true intent behind Realogy's so-called iBuyer program: it is really meant to be a listing tool, not a consumer-convenience tool. And as

Schneider makes clear, Realogy's iBuyer program is about making the agents more money, not making the consumer's life easier:

> As one more example, we like the early results of cataLIST, our iBuying product with Home Partners of America. We are live in 3 cities, and we plan to expand. Unlike most other iBuying products, with cataLIST, our agents are kept with a similar transaction, participating in both the purchase and the sale of the property. **Data from agents are showing that cataLIST is helping agents get listing appointments and win listings they otherwise would likely not have gotten**. [Emphasis added]

As a variation of the old "purchase guarantee" program that brokers and agents have been running for decades, Realogy's iBuyer program is more or less a bait-and-switch on consumers. Those programs have not changed the fortunes of traditional brokerages. There is no reason to believe that Realogy's cataLIST would have different results.

The most important takeaway here, however, is the same takeaway from across the board from Realogy's strategic initiatives. Not one has anything to do with the consumer experience, with real consumer convenience, and with consumer benefit. They are all about agent experience, agent convenience and with agent benefit.

That may be what Realogy must do today in order to stop the bleeding, but those strategic initiatives are very much rooted in the old recruit & retain mindset at a time when the entire industry is being turned upside down with the rise of institutional real estate.

The Deathwatch Gets Serious

I called Realogy a dead man walking after Q1 of 2018. But I have long held out hope for Realogy to turn things around because it still remains the largest real estate company in North America (well, at least in Sale Volume, after 2018). Realogy owns some of the oldest and largest brands in real estate. It owns the largest relocation network, a very large title company, and has a significant mortgage business.

Much of my hope, I admit, was based on the new leadership at the top, which also resulted in significant organizational and cultural changes at Realogy. Ryan Schneider is undoubtedly an accomplished leader, who is extremely smart and capable. He has brought on or elevated a number of other leaders to help turn things around.

And I was willing to grant that Realogy moving slowly is both a function of its dominant size as well as being intelligent about too much change too fast.

In the December Report, I wrote:

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

But what 2018 results tell me is that getting Realogy back to the disciplines that made it great in the first place is not working. Whatever renewed focus on core competencies and changes in culture at Realogy has not resulted in rebooted growth, greater agent loyalty, and better margins as agents see the value of remaining with the NRT.

And none of the strategic initiatives announced thus far have a compelling narrative that justifies the faith in Realogy recapturing its former glory. It's as if the 800lb gorilla woke up pissed off… and decided to keep doing what it's always been doing, with some minor tweaks along the edges.

I still have a great amount of faith in Ryan Schneider and the team he assembled at Realogy. They're extremely smart and extremely competent executives who know they have some major mountains ahead of them. But the time is running out for them to show results, show a change in trajectory in Realogy's fortunes.

Realogy's shareholders cannot be happy with the loss of value over the past five years, and especially over the last year. 2019 becomes a decisive year, and all eyes will be on Realogy to see if they can turn things around.

It's always possible that they will, of course. But I'm not sure I see how as long as Realogy remains stuck in the mindset of the past, where the agent comes first. Unfortunately for Realogy, it appears that the Street is now turning against it… which means the death watch is begun in earnest.

eXp Realty: Hypergrowth

After its 2018 results, there is no question that eXp Realty (trading as eXp World Holdings, EXPI on NASDAQ) is the fastest growing brokerage in the country.

On the latest Real Trends 500 report, eXp jumped from #7 to #4 largest brokerage in the U.S. by transaction sides by going from 24,655 in 2017 to an eye-popping 73,458 – almost a 200% increase year over year.

Unfortunately, eXp still doesn't do analyst earnings calls despite having three analysts who cover them so our analysis must be content with what we already know about them, plus what we could tease out from their financial reports.

The Numbers

With more information available on eXp, we can do a better job with the numbers. These are their FY 2018 results:

	2017	2018	Change
Revenues	**156,104,544**	**500,147,681**	**220.4%**
Commission and agent-related costs	139,603,970	459,715,836	229.3%
General and administrative	35,685,512	57,618,506	61.5%
Professional Fees	1,274,675	2,236,236	75.4%
Sales & marketing	1,572,041	2,961,618	88.4%
Total expenses	178,136,198	522,532,196	193.3%
Total expenses (excl. agent costs)	38,532,228	62,816,360	63.0%
Operating Income/(Loss)	(22,031,654)	(22,384,515)	1.6%
Income (loss) before income tax	(22,033,731)	(22,352,556)	1.4%
Income tax benefit (expense)	(97,234)	(77,800)	(20.0%)
Net Income/(Loss)	**(22,130,965)**	**(22,430,356)**	**1.4%**

The 220.4% YOY growth in revenues is obviously impressive, but the fact that Commissions and agent-related costs rose by an even greater 229.3% is of concern. In fact, if you read through the Red Dot reports this year, that has always been my main concern with eXp.

I wrote in the December Red Dot, for example, that while agent count drives revenues, it most certainly does not drive profits. And eXp, as a cheaper version of Keller Williams (80/20 split to an annual cap of $20,000), is still very much a traditional brokerage.

So what of some of the other key metrics of eXp? Here we go:

	2017	2018	Change
Key Metrics, eXp			
Closed homesale sides	25,299	74,678	195.2%
Homesales volume	6,083,479,207	19,844,237,031	226.2%
Average homesale price	240,463	265,731	10.5%
Agent count	**6,511**	**15,570**	**139.1%**
Gross profit/Company Dollar	16,500,574	40,431,845	145.0%
Company$ Margin	10.6%	8.1%	(23.5)%
Agent split	89.4%	91.9%	2.8%
Revenue per Agent	23,976	32,123	34.0%
Cost of Revenue per Agent	21,441	29,526	37.7%
Gross Profit per Agent	2,534	2,597	2.5%
Closed sides per Agent	3.9	4.8	23.4%
Volume per Agent	934,339	1,274,517	36.4%

[The blue are numbers I calculated.]

A few things jump out from looking at the key metrics. The most salient is the fact that Company$ Margin (basically, the gross profit margin as it is revenues less Commissions and agent-related costs) dropped by almost 25%.

Since eXp's full year margin is 8.1%, and the first three quarters were 10.1%, 9.5%, and 7.3%, Q4's margins must be 5.5%. That pattern fits with eXp's historical data, as well as what we should expect from its cap on commission model: agents do not cap early in the year, but do as the year goes on, which then drops the margins for eXp as more and more agents cap.

But the other interesting figure is the Closed Sides per Agent. eXp improved that metric by 23.4%, so the average eXp agent closes 4.8 transactions a year. Despite the improvement, however, that figure is far below NAR's median for REALTORS, which is 11 closed transactions per year (2017 numbers).

Taken together with the fact that agent count grew by 140%, while closed transactions grew by 195%, the implication is that eXp has been more successful in recruiting better agents who do far more than 4.3 transactions a year. That's good news in a way, and good news for revenues… but it's bad news for profitability as those better agents cap earlier in the year, and sit at 100% commission splits for far longer.

The final interesting note comes from two other numbers reported by eXp:

	2017	2018	Change
Agent equity program	5,857,554	21,253,677	262.8%
Cash From Operating Activities	4,568,353	24,310,719	432.2%

It seems clear that eXp's cash flows depend heavily on its agents taking a part of their commission in eXp stock. Without the Agent equity program, eXp's cash from operations in 2018 would have been just over $3 million.

It's a really clever idea, and a way to boost the actual cashflow of the company, even while reporting paper losses. There is one problem with it, however.

Vulnerability to Market Conditions

eXp more than just about any other brokerage, even the traditional brokerages like NRT which are on death watch, is vulnerable to a change in the housing market.

Suppose the housing market softens and it becomes more difficult to close a transaction. The top producing agents will continue to be top producing agents, albeit at a slower pace. Everyone else will do fewer deals and have fewer clients.

All traditional brokerages get hurt when the market goes south, since the commission split is affected by home prices. But eXp has a low cap on commissions. If more of the revenues come from top producers, as happens in just about every down market, then eXp's margins get absolutely crushed.

eXp is going to need new lines of businesses (mortgage, title, escrow, etc.) or an infusion of cash before the downturn comes. That clock is ticking.

But even more on-point for eXp, in a down market, the agents themselves get into cash crunch situations. Deals take longer to close, and for less money, which means fewer of them are likely to take any part of their commissions in eXp stock because they need to pay their bills and they're not likely to be able to pay their mortgages, car loans, and website vendors with eXp stock.

That then puts pressure on share prices, which then makes stock less attractive for agents to accept as payment, and the vicious cycle continues. Since the Agent equity program is so important for eXp's cash flows, we could see a real problem for the company should the market turn south and agents stop taking shares in lieu of cash for their commission splits.

eXp is going to need new lines of businesses (mortgage, title, escrow, etc.) or an infusion of cash before the downturn comes. That clock is ticking.

What The Future Holds

In the December Red Dot, I wrote that the future of real estate is likely to be a lower commission environment from Redfin's big marketing push, and a concentration of power as the top agents get even more market share at the expense of the middle-tier of professional full-time agents who won't be able to make ends meet.

I also wrote that Zillow as a player instead of a vendor is an important shift, and that super teams will find themselves needing to ally with Zillow and become more dependent on Zillow, not less, because only Zillow (and Realtor.com) have the website, the traffic, the lead flow, and a large enough technology and data analytics team to help such super teams compete against Redfin.

All of those combined to create an important inflection point for real estate over 2019 and 2020:

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

The 2018 results make me adjust those views slightly, but not fundamentally. The inflection point is still here, but *who* drives the changes may have changed.

The Driver Changes

When I wrote my December report, Redfin had announced its aggressive plans and Zillow was just starting the pivot. My take then was that Zillow was going to slowly pivot to its new model as a player, since it was so beholden to the industry and to the real estate agents who are its advertising customers, while Redfin wanted to change the basic math behind real estate brokerage.

With the conservatism coming out of Redfin in Q4, and its lackluster results in 2018, combined with the change in leadership at Zillow, I think those two are flipped. Now, it feels like it will be Zillow that drives the changes in the industry while Redfin regroups to get back the competitive advantages that allow it to be bold.

Zillow's new goal of turning its Homes business into a $20 billion a year business suggests a major shift in emphasis. As we discussed above, it isn't that Barton *wants* to abandon the billion-dollar agent advertising business; it's that he *doesn't mind* abandoning it if necessary. The whole emphasis going forward is not real estate agents as Zillow's *customers*, but as Zillow's *partners*, in serving the consumer. (If one were more conspiratorially minded, one might substitute the term "contractor" for "partner" in the previous sentence.)

The Stratechery interview with Barton more or less confirms all of those thoughts.

And while the entire world, including Redfin, appears to be hedging their bets on the iBuyer model, Zillow is going all-in. The published unit economics numbers suggest that Zillow isn't worrying about down markets or making a healthy profit margin. Zillow just wants to get reps, get experience, and gain expertise and scale to that business. They'll figure out how to make 2% margins on that business as they get better and better at it.

The New Process

The difference between Zillow's approach (and to a lesser extent, Redfin's approach) and that of traditional brokerages like Realogy and eXp is that the process gets fundamentally altered.

At a recent real estate conference, the former CEO of Century 21, Nick Bailey, said that the process of buying a home had changed from Consumer → Agent → Home to Consumer → Home → Agent. That change upset a lot of brokers and agents, as they were no longer the conduit through which consumers found and bought homes, but merely the service provider who helped them buy the home that the consumer had found himself.

But the old process remained and remains very much in place when it comes to selling a home: Consumer → Agent → Sale of Home. This is the process that institutional real estate is trying to change.

If Zillow, Redfin, Opendoor, and other real iBuyers are successful, the new process will be Consumer → Institution → Sale of Home, or if there is no offer or the offer is rejected, then Consumer → Institution → Agent → Sale of Home.

The very best agent super teams will become institutions themselves, so as not to be cut out of the loop, but everyone else will find that new process to be as difficult to navigate as dealing with the shift of buyers to the internet has been for the past 20 years.

This is why the agentcentric and agent-focused initiatives of Realogy are ultimately so problematic. They're all trying to help agents be more productive doing what they have been doing for a century or more, while the underlying process is being challenged.

This is also why the success in recruiting agents that eXp is seeing is ultimately pointless, because margin pressures are not going to get better when the process gets owned by institutions. Like so many other traditional brokerages, eXp will post huge gains in agent count and revenue, but those improvements will be closely correlated to commission cost and agent-related costs, neither of which are improved when institutions get between the agent and the home seller.

As Alex Rampell said during his a16z presentation, this doesn't mean that agents go away, but that agents will all be working for a company of some sort, either as W-2 employees (Redfin) or as 1099 subcontractors (Zillow).

Zillow's New Vulnerability

In the Zillow section above, I mentioned that Zilow has revealed some vulnerabilities by going after the Iron Throne so plainly, so openly. Let me explain my thinking on that.

One of the reasons why Zillow has been so successful on the buyer side is that it was able to take advantage of the highly fragmented and fractious infighting in the industry between brokerages, between MLSs, between real estate agents, between vendors, etc.

But back in 2007, Zillow as an unknown startup with an unproven business model. In 2019, Zillow is the most feared and hated company in real estate.

It is possible to imagine some of the largest companies and organizations in real estate deciding to team up in order to make sure that Zillow never becomes The Platform for real estate. Perhaps the thinking would be that "one of their own" becoming The Platform is preferable to letting Rich Barton do to real estate agents what he did to travel agents.

A hint of such a possibility comes from Redfin's new partnership with Re/Max, under which Redfin will send all leads that its own agents do not handle to Re/Max agents. Competitors cooperating and collaborating is at the heart of the residential real estate industry as that is basically what the MLS is, so it isn't crazy to think that competitors might look to cooperate and collaborate to ensure that an "outsider" does not ascend to the Iron Throne.

This has always been a latent threat against Zillow, but Zillow always held it off with a combination of smart industry relations activity and the self-interest of individual agents, agent teams, and brokerages working against any such coordinated action. (It also would be difficult to take such collective action without running afoul of antitrust laws....)

Plus, the buy-side business has always been a bit of a bete-noire in the industry. As the saying goes, "List to last." Brokers and agents will, of course, gladly work with buyers... but the deeply entrenched cultural norms of the industry are that top agents are listing agents, and newer less-experienced agents are buyer agents.

So, for example, Redfin was around for over a decade and completely ignored by the industry as a nice website with crappy agents... until Redfin started listing more houses assisted in part by its 1% Listing Fee program. Suddenly, more brokers and agents started talking about Redfin.

In other words, the Consumer → Homes → Agent revolution was a revolution, and brokers and agents were and remain upset about it, but it is a different animal psychologically and culturally from the Consumer → Institutions → Sales change that is coming. Just think about what the name of Realogy's iBuyer program says about the mindset of the industry: cataLIST.

The initial reaction from the industry is likely to be ham-fisted and counterproductive and doomed to failure – something like, "Cut off the listings to Zillow!" type of nonsense that has never worked, and cannot work as long as Zillow is the #1 website in the real estate category.

I think, however, that the new generation of leadership at companies like Compass, Redfin, Realogy, eXp, and others are younger, newer to the industry, and slightly more savvy. Throw in companies like Opendoor and Offerpad who ought to see Zillow's announcements as a declaration of war, and we have an interesting possibility of alliances, networks, partnerships, and cooperation on the horizon.

This is not the place to get into what such alliances could do, but just think about what a strategic partnership announcement involving Opendoor, Redfin, Realogy and Compass might read like. The goal of such an alliance is not necessarily for one of them to become The Platform; it will be merely to prevent Zillow from becoming it.

The new vulnerability is simply that the new Zillow with its new wartime CEO may provide enough of an impetus for the normally fractious real estate industry to unite for once and do so intelligently.

Decide. Act.

RECOMMENDATIONS: BROKERAGE

Given the above, what should a brokerage be doing today?

First of all, some of these changes are years in the future. Others are right here, right now. Each brokerage must examine its own situation, its market, its competitive landscape, and decide how quickly to change.

But the one thing that all brokerages must do is to at least plan for change. I have said in presentations that brokerages should embrace the Doomsday Prepper mindset: the idea isn't that nuclear winter will happen, but to be prepared just in case the unlikely should happen.

Most of these recommendations are a bit of a rehash of old recommendations from past Red Dot reports. The trends and facts have not changed, so the recommendations are not going to be dramatically different.

The Old Way vs. The New

The Consumer → Home → Agent transformation has taken place, and it isn't going to change. What comes next (potentially) is the Consumer → Institutions → Home Sale (or Agent). The entire agentcentric playbook of the brokerage industry, that its leaders keep reinforcing, is dependent on the old way in which the Agent is an important gatekeeper and source of business as the holder of the consumer relationship.

The preparation for brokerage leaders possessed of foresight is to deal with an environment in which the Agent is no longer that holder of the consumer relationship, but a subcontractor to one or more institutions who are. Again, following the Doomsday Prepper framework, it isn't that you need to expect that day to come, but that you need to prepare *just in case it does*.

The Realogy model is clearly in deep trouble, and all of its attempts to enhance the value proposition to Agents so that they will pay more are making bets that historically have not proven out. Agents have not paid more (in the way of splits) for a technology tool, or even a suite of technology tools, at least not for long after the warm glow from the initial sales pitch has worn off. And Realogy is hardly alone; it is merely one of two traditional brokerage that has to report publicly.

The eXp model appears to be working, at least in terms of topline growth, but the margin pressures look identical to what Realogy faces: more productive agents cap faster, and pay less.

All of the initiatives, goodies, services, branding and other attempts to shore up the recruit & retain model of traditional brokerage are based on the Old Way.

The New Way is based on an institution offering something of real value to consumers such that the institution becomes the holder of the consumer relationship, and then hires/contracts with service providers to deliver the value to consumers. Zillow, Opendoor, Redfin, Offerpad, etc. are far in the lead in the New Way today. Brokerages wanting to contend should read my reports on iBuyer, on The Platform, and previous reports on the public companies in real estate. The basic insight, however, is this: if you would contend to be an institution, you need **control**, **technology** and **capital**. Today's brokerage has none of these things.

At the same time, simply abandoning what has worked for so long and continues to sort-of work is silly and reckless. So, the Recommendation is to do as Google does: keep the current cash cow business going, make it as efficient/profitable/sustainable as possible, while trying to find the next thing, while trying to prepare for the (unlikely?) scenario in which that cash cow goes away.

However, that can only happen if you as a leader can understand and embrace the New Way as a possibility. It is impossible if you spend all of your time, energy, and intellect denying the New Way, dismissing it as unrealistic, or coming up with a myriad reasons why the Old Way is Forever.

Become a Next Generation Brokerage

As I detailed in the December Red Dot, the easiest transition for brokerages is to slowly morph into 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 it does not require becoming an institution; it "merely" requires financial and process re-engineering. I put "merely" in quotes because obviously, that process is deeply disruptive and painful and difficult and expensive. But again, it's a whole lot easier to do than to get the control, technology, and capital required to be an institution in the New Way.

For more detail, please refer to the October Red Dot in which I discuss the Next Generation Brokerage.

Go W-2 and Become a Firm of Super Teams

I have written extensively on this topic over the years, and have made it a Recommendation in a number of reports. You can read the Future of Brokerage Black Paper on my site, for example, and get most of what our recommendations are for brokerages.

What I can add here is that with the major pivot at Zillow, the timeline for transformation (or utter crash and burn) has been moved up. Individual agents are not and cannot be institutions, as they lack control, technology, and capital. Super teams, however, could be.

The question is what role does the brokerage play for such super teams? And what partnerships and alliances does the brokerage need to form in order to play that role?

What Is the Business in an Institutional World?

Underlying both of the above is the need to figure out what the business actually looks like if the real estate industry becomes institutional.

A number of similar industries exist, the two most prominent in my mind being the insurance industry and the mortgage industry. In both, you have retail brokerages and individual agents who help consumers navigate all of the options in the marketplace.

Independent insurance agencies often do help consumers shop the deal around to find the best policy at the best prices. They get paid by the insurance company for this service, and in effect, they work for the insurance companies.

Mortgage brokers shop the deal around for the best possible rates and terms, and also get paid by the lender. They too in effect get paid by the lenders.

But those are business models for agents, at least in today's brokerage setup. The agent could go form relationships with a bunch of institutions and figure out a business there. What about the brokerage?

This is why embracing the prepper mindset is more important than ever. The answer may be different for each company, but in case the world changes, each company has to have an answer.

CONCLUSION

The big news from the Q4 and full year 2018 earnings results is the change at Zillow. For longtime readers, none of what you read and heard should have been a huge surprise, as the changes simply move up the timetable for the pivot that Zillow has been making for a while.

The continued decline of the traditional brokerage, as exemplified by Realogy's NRT unit, should also be of little surprise.

And while eXp's growth is truly impressive, the flaw at the heart of its business model makes one wonder how the company will do when the market turns and the commission environment gets pressured, as it will.

In a real way, the real surprise of Q4 was Redfin. Its 2018 results were not stellar, and in particular, its performance in the Redfin Now segment was counter to all of is claims about what gives Redfin its competitive advantages. This is not to say that Redfin doesn't have those advantages, or that it cannot emerge as a contender for the Iron Throne. It is merely to note that Redfin had better show up and show out in 2019.

The inflection point is still here. What remains to be seen is who will drive the inflection when it's all said and done.

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