CALIFORNIA ASSOCIATION OF REALTORS®

E.M.B. R.A. C.E.

2018 State of the Industry

An Exciting Missive on the Business of Real Estate and the California Experience

E.M.B.R.A.C.E. 2018 State of the Industry

California Real Estate Industry & The REALTOR® Business

Introduction

It's difficult to imagine a time of more significant change, both real and imagined, in the real estate industry. Wherever you look there is talk of fissures in the environment as we currently know it. Ten years after the start of the recovery from the financial crisis, California's housing market is experiencing relatively flat sales and robust price appreciation as growing demand has met limited supply. Housing affordability is an issue throughout the state but primarily in coastal California, and as first-time buyers are priced out of the market, they consider the possibility of finding greater opportunities out of state. As a result, C.A.R. membership has grown sharply while productivity per agent has declined. Not an encouraging sign.

In the real estate brokerage industry, teams have become more and more common, creating challenges for brokers to maintain profitability as well as the appropriate level of supervision. Firms with a compelling story and access to Wall Street capital are growing through recruiting with offers too good to refuse and outright acquisition. There are also models of true disruptors offering things like instant offers and flat fee pricing. Even tried and true rules, like independent contractor status, that have defined the way the business has been done for years are under attack in the courts.

The purpose of this report is to provide a realistic, data-centric look at current trends in the California brokerage Industry. The goal is to encourage California REALTORS® to E.M.B.R.A.C.E. (Exciting Missive on the Business of Real Estate and the California Experience) the change that is happening all around us and continue to keep the dream of homeownership alive.

Let's do this —

Steve White
2018 C.A.R. President

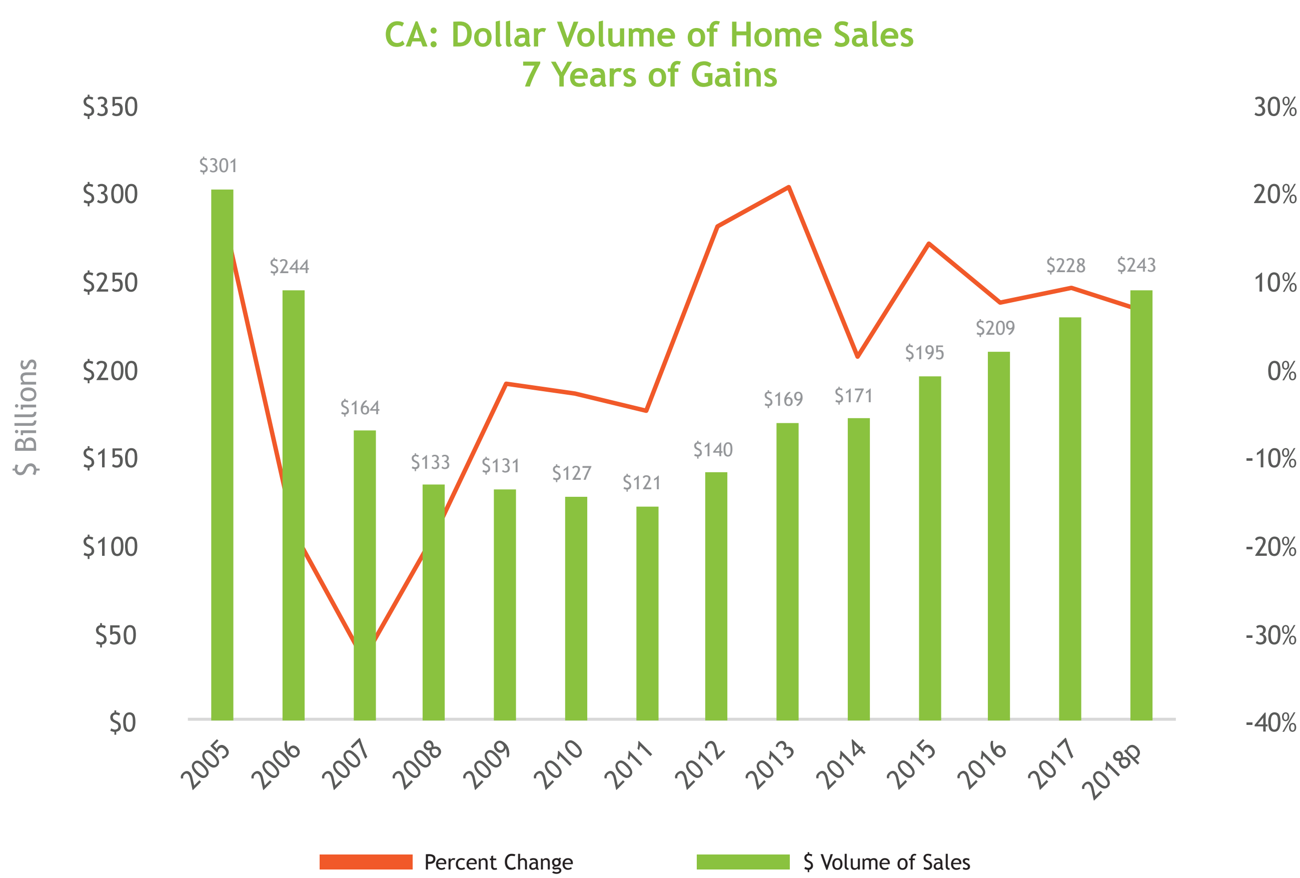
Joel Singer
CEO, C.A.R.

1

The REALTOR® Business

With 12 percent of the nation's population (39.5m out of 325.7m), 10 percent of the nation's housing stock (14m units out of 136.6m) and, if it were an independent country, the 5th largest economy in the world, the California real estate market and the industries that sustain it are a force to be reckoned with. Historically, it has led the U.S. in cycles, both up and down, and statewide trends are often a harbinger of what to expect nationwide. In the most recent cycle, it was the first to show signs of fissures in the housing market in 2005-2006 and the first to take off with investor all-cash sales in 2008-2009. It was also the first to experience the chronic lack of inventory that is now a structural impediment to sales throughout the country. More on that later.

Not surprisingly, given the size of the market and a median price more than double that of the nation, California's real estate brokerage industry is the largest in the country by almost any measure. The dollar volume of sales of existing single-family homes was $228B in 2017, the highest of any state and is projected to reach $243 billion in 2018. With 200,000 CALIFORNIA ASSOCIATION OF REALTOR® members in 2017, California is home to 15% of the nation's real estate professionals, making it the largest state Association in the nation. How are these agents doing? How are the brokerages operating in California faring? How is the health of the industry? The honest answer is - it's complicated.

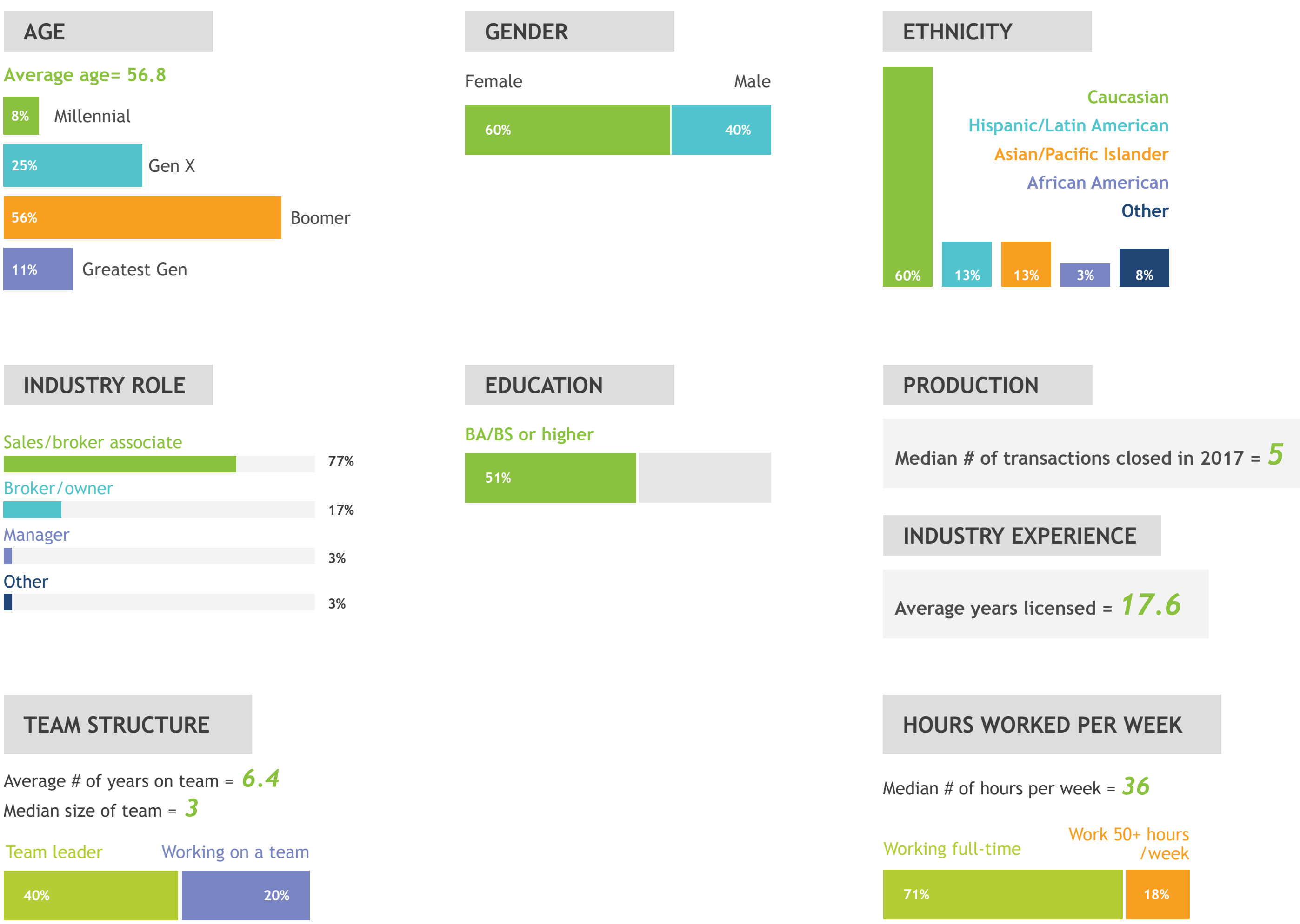


1.1
The Players: Brokers, Agents & Licensees

First, a look at the size of the state's real estate brokerage industry. As of 2018, there were 419,279 licensees in the state, and of that total, 132,817 (32%) held brokers licenses and 286,462 (68%) held salesperson licenses. Also, in 2018, there are projected to be 205,600 members of the CALIFORNIA ASSOCIATION OF REALTORS®, slightly less than half (48%) of the total licensee population. The discrepancy between the number of licensees and the number of REALTORS® is attributed to a variety of factors: no longer being active in the business, real estate attorneys, appraisers, home inspectors, mortgage loan officers etc. It is estimated that the vast majority of the licensees who are active in the business are also members of organized real estate.

What else do we know? Every year C.A.R. conducts a survey of its members asking detailed questions about their business, experience, concerns, engagement and satisfaction with the products and services provided by the Association. In addition to zipForm®, satisfied members cite useful information, legal and other support, and data and resources among their top benefits of membership. According to the 2018 C.A.R. Membership Survey, 77% reported that they were sales/broker associates, 17% broker owners, 3% managers and 3% "other." In other words, three-quarters of the members of the Association are only engaged in the sales side of the business as opposed to ownership or management.

The California REALTOR®: 2018



This information allows us to develop a demographic profile of our membership. The statistically "average" REALTOR® is a Baby Boomer at 56.8 years old and 60% female, has 17.6 years of experience, average production of 5 transactions, and works full-time approximately 36 hours per week. And, like the country, the real estate brokerage industry is undergoing a significant demographic shift as Boomer agents continue to work but eye retirement soon. At 57 years, California REALTORS® are 22 years older than the state's median age of 35 years. But we also know that this age gap will be closing in the years ahead. Twenty percent of the members said that they did not expect to still be in the business in 2021 with retirement by far the most frequently cited reason for leaving. So over the next few years, the old guard will be scaling back, and a new generation of agents and brokers will be taking the lead. One plus is that real estate continues to be an attractive career for newcomers—in 2018 C.A.R. welcomed 25,600 new members.

In the most recent cycle, membership peaked in 2006 with 211,000 California REALTORS®, only to drop to a cyclical low of 160,000 in 2012 as the housing/financial crisis took its toll on the industry. This is a common pattern. As shown on page 6, membership historically lags the market by two years. For example, the market peaked in 1978 with 491,000 sales and membership peaked two years later in 1980 at 148,000 members. A decade later, the market peaked in 1988 with 454,000 sales and membership peaked two years later at 146,000. Both totals are slightly below their decade earlier levels. More recently, this relationship has been tested. The market contracted to a cyclical low of 383,300 in 2013, but membership bottomed in 2012 and gained momentum in subsequent years despite the general plateauing of the market.

C.A.R. Membership
(2016-2020)

	2016	2017	2018 Projected	2019 Forecast	2020 Forecast
Total	191.3	200.5	205.6	211.1	205.3
Renewals	165.3	171.5	179.6	184.2	179
New	25.6	28.5	25.6	26.4	25.8
NMSP[1]	0.5	0.5	0.5	0.5	0.5

[1]NMSP: nonmember salesperson

There are two key takeaways from this connection that will be expanded upon later in the report. One is that despite a recovery from the financial crisis that included a rebound in housing prices, historic low mortgage rates, dynamic job growth, the return of household formation and growth in income, sales in the California market have been essentially flat for the past 8 years. This has had negative repercussions for many agents who have had a difficult time establishing or maintaining a foothold in the industry. Second, despite the compression of the market, real estate remains an attractive career choice for a variety of reasons: the requirements for entry are relatively easy to meet, the promise of strong earning potential is enticing, and at least in the early years after the downturn, job opportunities in other industries were scarce. In other words, competition among agents remains fierce despite the market plateau.

California Home Sales vs. C.A.R. Membership

(1971-2017)

Sales Peaks: 1978, 1988, 2004-05

Membership Peaks: 1980, 1990, 2006

1.2
Firms & Teams

The structure of the industry in California reflects that of the nation as a whole—by sheer numbers, most firms are smaller mom and pops. According to C.A.R. membership data, 60% of the firms are run by sole practitioners, and 90.4% of the brokerages have 5 or fewer agents. But while the brokerage community is dominated by small firms, the majority of agents actually work for larger firms. As seen in the following table, 45 percent of the members work in firms with at least 100 agents, while 25 percent work in firms with 5 or fewer agents.

Real Trends provides an annual national list of top firms by volume of sales and agent count. In the report released in March 2018 for 2017, California leads with 43 of the Top 500, the highest of any state with Texas (38) and Florida (32) rounding out the top three. And both nationally and in California, mergers and acquisitions have accelerated in recent years with CEO retirements and/or aggressive growth strategies fueling the trend. Nowhere was this more in evidence than last year's purchase by mega-giant HomeServices ($123B sales volume in 2017) of mid-Atlantic powerhouse Long & Foster.

In California, the most recent big newsmakers were:

Pacific Union International: After continuing its statewide expansion following the 2016 merger with John Aaroe Group (JAG), Pacific Union merged with Partner's Trust, took a majority stake in Gibson International, and merged with Empire Realty in 2017. With 1,700 agents and employees, 54 offices and $14.1 billion in sales volume in 2017, Pacific Union was at that time the largest independent brokerage in the state. Then, in August 2018, it was announced that Compass, with 13 offices in California, was acquiring Pacific Union, again dramatically altering the landscape of California's brokerage industry.

C.A.R Brokerage Analysis

# of Agents in Brokerages	# of CA Brokerages	% of CA Brokerages	# of agents	Cumulative % of agents	Cumulative % of firms
1	17,278	57.00%	17,278	9.70%	57.00%
2	5,279	17.40%	10,558	15.60%	74.40%
3	2,394	7.90%	7,182	19.60%	82.30%
4	1,231	4.10%	4,924	22.30%	86.30%
5	784	2.60%	3,920	24.50%	88.90%
6-10	1,568	5.20%	11,709	31.00%	94.10%
11-20	812	2.70%	11,643	37.50%	96.70%
21-30	272	0.90%	6,806	41.40%	97.60%
31-40	146	0.50%	5,128	44.20%	98.10%
41-50	89	0.30%	4,034	46.50%	98.40%
51-100	220	0.70%	15,580	55.20%	99.10%
101-200	142	0.50%	20,336	66.50%	99.60%
201-300	52	0.20%	12,469	73.50%	99.80%
301-400	21	0.10%	7,141	77.50%	99.90%
401-500	7	0.00%	3,114	79.20%	99.90%
501-1000	28	0.10%	20,327	90.60%	100.00%
1001-2000	6	0.00%	7,120	94.60%	100.00%
2001-3000	1	0.00%	2,434	95.90%	100.00%
3001-More	2	0.00%	7,300	100.00%	100.00%
Total	30,332	100.00%	179,003	100.00%	100.00%

Series: Membership Records through June 2018
Source: CALIFORNIA ASSOCIATION OF REALTORS®

Compass: Another firm making its mark on California is the tech-centric and VC-funded Compass, which now has a total of 13 offices in California and a goal of achieving 20% market share in the 20 largest cities in the U.S. by 2020. At the end of 2017, Compass, marketing itself as a tech company, received $450 million from Japanese firm SoftBank. Combined with the $100 million funding round in November 2017, in addition to recruiting top performing agents with attractive compensation packages, Compass began firm acquisition in the summer of 2018. In August it acquired Pacific Union immediately following the acquisition of Paragon Real Estate Group in July.

Douglas Elliman: Headquartered in New York City, Douglas Elliman, with $27.4B in sales volume in 2016, expanded into the Golden State last year with the purchase of Teles Properties in Los Angeles in 2017, a high-end tech-savvy L.A. brokerage with $3.4 billion sales volume in 2016.

Another trend of critical note is the decades-long drop in company dollar that has put intense pressure on the profitability of the brokerage community. What is company dollar? In its simplest terms, it is the amount of money the brokerage has left after commission splits. Tracing its origins back to the emergence of the 100% concept of RE/MAX and Realty Executives, the decline in company dollar has been relentless and closely tied with the transfer of industry influence and market power from the broker to the agent. The average company dollar today is 15%; many firms are below that number. Twenty years ago, it was twice as high. No wonder ancillary services like title, escrow and mortgage and added agent fees for extra services like tech are commonplace.

Despite the technology, it's still about fundamentals: The single-largest challenge for your business next year? "Acquiring enough clients to make a living and keep myself busy."

We also learned from this year's Membership Survey that 20% of the members who responded to the survey are currently working as part of a team. While teams have always been an attractive model for some, their popularity and structure have evolved significantly. Over the last 5 years the number of teams in California has more than tripled. This has made significant impact on the traditional brokerage model by upending competition in the brokerage community and becoming a more important part of the real estate agent landscape. Years ago, it was common for two agents to form a team and share responsibilities to allow flexibility in their roles at home. Today this is still common, but teams can also be much larger, often operating as a semi-independent business within the brokerage itself. In other words, it's part of the dominance of the agent. The motivation to join a team now also includes growing a larger business and building something that will have value in the future, in addition to sharing job responsibilities. This has created a variety of challenges in terms of establishing a formal team, broker supervision, marketing and how to move forward when a team breaks up.

The rise of teams has led some analysts and commentators to declare that the real estate brokerage industry is on its "death bed." While these claims are likely overblown, a simple thought experiment illustrates the impact of teams on company dollar. Ultimately, successful teams, led by a "super agent" who has deep ties to her community, enables the team leader to control more of the lead generation process, thereby garnering a larger share of the gross commissions before it gets to the broker split.

Essentially, very connected listing agents/team leaders are able to capitalize on all of the foot traffic and other buyer interest generated by their listings through open houses and other means. With a team of buyers agents on standby, the listing agent becomes the rainmaker providing leads to their team members—a role that has historically been filled by a traditional broker for their buy-side agents. By keeping as many sides of as many deals as possible within the team, the team leader is able to maximize her net revenue, thereby reducing the portion left over for the brokerage.

In this context and with all of the other myriad disruptions and challenges laid out in this chapter, successful brokerages will need to be nimble, unique, and tech-savvy to evolve into the next generation of the real estate industry.

And yet, even with the onslaught of technology and Artificial Intelligence entering the space, the human component of the real estate transaction is alive and well. The firms that keep the balance between creating and maintaining brand value, managing agents, maintaining culture, and maximizing fiscal balance sheets – all while providing an impeccable customer experience and a clearly-defined value proposition will determine who will survive and thrive in the industry.

1.3
Productivity: A Conundrum

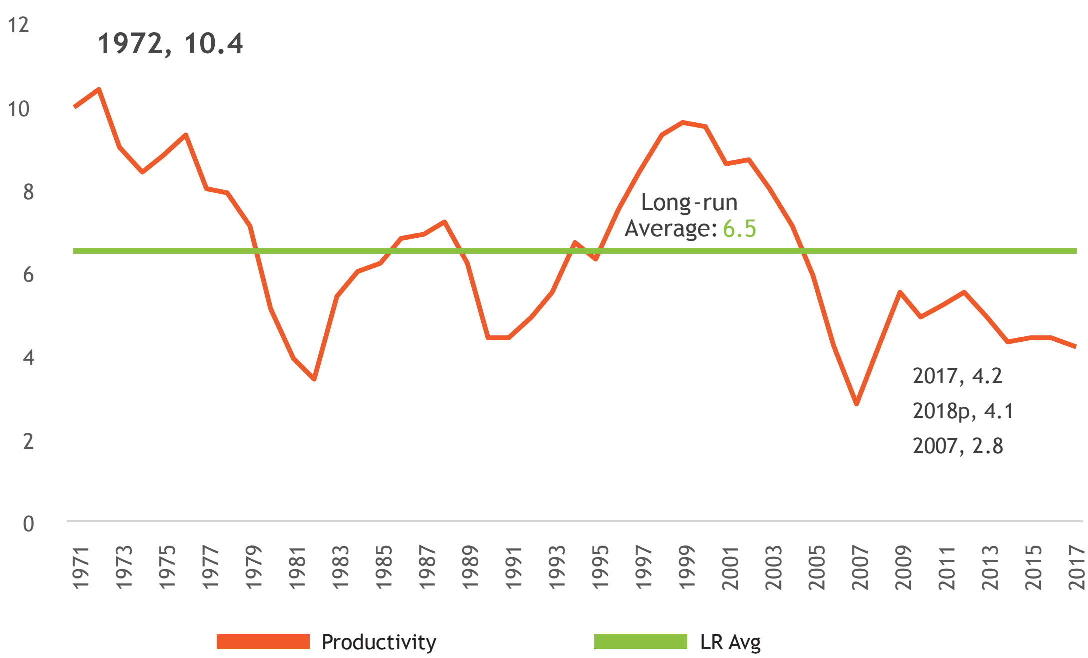
Over the last 20 years, technological advances have revolutionized many industries—smartphones are ubiquitous, over 64% of U.S. households are Amazon Prime members, and the Uber/Airbnb sharing economy is in full bloom. And yet, productivity growth as measured by output per worker has faltered. In the U.S., productivity in the manufacturing sector increased 0.5% from 2011 to 2016, which according to the U.S Bureau of Labor Statistics is “well below the growth rate of 3.2 percent from 1987 to 2016.”

The real estate sector is no exception. The median number of transactions per member as reported in the 2018 Membership Survey was 5, the same as the year before. Compare this to 20 years ago when the median number of transactions per member was twice that. Also, in the 2018 Membership Survey, 24% of the respondents said they had done 0 transactions in the last 12 months, 46% had completed 1-9 transactions and 31% had done 10 or more. Would it be fair to conclude that less than 1/3 of the members of C.A.R. are making a full-time living in real estate? It appears so.

Let’s look at the size of the market itself compared with the number of California REALTORS®. We know that in 2017 there were approximately 420,000 existing single-family homes sold in California, which translates to 840,000 sides or less than 5 transactions for every one of the 200,000 members of the Association. By that measure historically, productivity peaked at 10.2 transactions per member in 1972, reached a low point of 2.8 in 2007, and in 2017 was 4.2 transactions per member. What? Surely with all the technological advances in the last 20 years, shouldn’t productivity be higher? Shouldn’t smartphones, significantly lower marketing costs, the almost complete disappearance of print advertising, electronic forms, and digital signatures have revolutionized the business? Nope. Instead, the industry has increasingly polarized into producers and nonproducers. In many California MLSs, over 50 percent of the participants have not had a single listing in the past 12 months. In fact, the top 10 percent of the agents are often responsible for well over half of the transactions.

Indeed, despite the influx of many new business models, disruptive firms who are challenging the status quo, and the rise of technology, members consistently cite competition from other REALTORS® as their single-largest challenge, with discounting running a close second. New business models and new market entrants run a distant third. What this means is that a relatively small group of California REALTORS® is extremely productive, while the majority are not. When we ask REALTORS® what they anticipate as their greatest challenge in succeeding next year, we find that the answer is still largely back to fundamentals: "Acquiring enough clients to make a living and keep myself busy."

California REALTOR® Productivity



1.4
Outlook: The Future of the CA Real Estate Brokerage Industry

Several conclusions emerge from this overview of the California brokerage industry. One is that we are dealing with an industry that has always been intensely competitive, and the stakes are even higher today. The industry attracts vigorous new participants, many extremely well-funded, all paying a premium for established superstar agents. Wall Street and venture capitalists alike view the industry as ripe for innovation and investment. It is an industry characterized by extremes: A few agents are highly productive, and many are struggling for even a tenuous foothold. One thing is clear—in the years ahead we will see unprecedented change and innovation as newcomers redefine the business, millennials and Gen Z become homebuyers, and Boomers exit the stage.

2

Housing Market and Economic Conditions

In addition to the changing landscape represented by tax reform, which provided significant stimulus to the overall economy and whose full impact will remain uncertain until consumers adjust their sails and for those adjustments to be evident, the housing market and overall economic conditions themselves present myriad challenges and opportunities for REALTORS® and brokers.

2.1

The Economy: It's What Drives Housing Demand

The good news is that the economy is on a relatively strong footing. The latest reading on economic growth shows the U.S. posted a 4.1% increase in real gross domestic product (GDP) to close out the first half 2018. This is the fastest pace of growth in almost 4 years and comes as business investment and stronger exports have risen to compliment growth in consumer spending, which had largely been carrying the entire economy up to this point in the cycle. A strong number in the second quarter is not only solid compared to the past few years but represents healthy growth even by historical standards. The manufacturing sector is showing real signs of life, consumers remain confident (as evidenced by a 4% growth rate in spending during the second quarter of 2018), savings have bounced back to healthier levels, and commercial construction has begun to increase in earnest. Taken together with above-3% growth in several quarters last year and the relatively anemic expansion up to the beginning of 2017, the economy might be the greatest source of strength for our industry.

Fortunately, this is translating into continued gains in the labor market—which is what really matters for housing demand. Unemployment is as close to "normal" or "full employment" as we are likely to see given the aging of our population base. In fact, at 4.0 % in June 2018, the U.S. unemployment rate was at its lowest level in nearly 18 years when the dot.com bubble was going strong in 2000. Job growth has slowed to just 1.6% recently, but that is more a reflection of an economy at full employment than it is a cause for concern. Indeed, that we manage to continue to expand payroll employment despite being near full employment suggests that we are attracting folks back or keeping folks in the workforce longer, which is a sign of the underlying demand for workers in our economy.

Perhaps more encouraging is how broad based our current economic expansion is. From a geographic standpoint, virtually every major metropolitan area has recovered from the Great Recession. Indeed, some of our strongest job centers have unemployment rates that could be considered well below the natural level. For example, San Francisco, San Jose, and Orange County all maintain less than 3% unemployment, while the East Bay, San Diego, and Placer County are all in the low-3% range. Even places like Merced, Bakersfield, and Kings County, where unemployment rose to more than 20%, have fallen back into the single-digits. The growth that California has experienced has been across virtually every part of the state. In addition, even though inland areas like the Central Valley and Inland Empire were late to the game from a recovery standpoint, these more affordable and less inventory-constrained markets appear to be gaining momentum as housing costs and availability hinder growth in our major employment centers. Still, it is encouraging that growth is being enjoyed across the state and California is not relying on a single region to carry water for the economy.

Similarly, California is seeing its economy expand across almost every major sector. The biggest winner in 2017 was the construction industry, which grew by 7.1% and added almost 60,000 new jobs. This is a welcome sign, both from a general economy standpoint and from a housing-specific one given that housing supply and a lack of new residential construction underlie our most acute housing challenges. However, growth was not constrained to just "blue collar" jobs. Educational services and information, two relatively high-skilled industries, rounded out the top three in terms of job growth last year. At the other end of the wage spectrum, tourism-related jobs increased as Californians continue to spend money and visitors from the rest of the nation and the world continue to frequent our state. Importantly, job growth raged across all parts of the state and through the full range of skills and wage rates, which should help to keep housing demand strong in 2018.

California's economy was on strong footing heading into the second half of 2018. Not only has economic and job growth continued, but preliminary indications suggest that worker wages are beginning to grow as well. Rising wages have largely been absent from the current economic expansion, so the uptick in wage growth suggests that tighter labor markets are finally translating into rising incomes. This should help to compound demand for housing in California as an increasing share of our residents get back to work and make higher wages for their efforts.

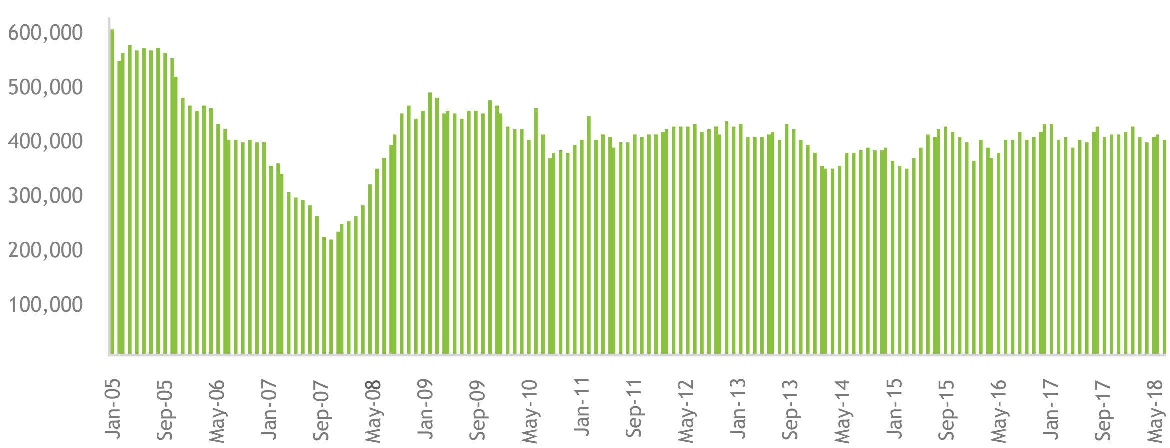
2.2
Failure to Launch: Recent Trends in Home Sales

In some ways, California's greatest strength is also its greatest weakness. Our strength is our powerhouse economy: depending on the measure, California would have been the 5th largest economy in the world last year, were it a stand-alone entity. In addition, it is one of the fastest growing states in the nation. Typically, this would pose no problem at all, and indeed, is exactly what we hope for in the world of economic development. How then could such a strong economy possibly represent a weakness?

The answer stems from the interaction between supply and demand. A growing economy, more jobs, and higher wages are all largely demand-side factors: they tell us how many more people can purchase a home, how much money they must spend, and how optimistic they are about the future. However, demand is only half of the equation, and unfortunately California fails on the supply side. We continue to churn out an increasing number of good jobs, and yet the uptick in new housing construction falls disappointingly short year after year. Because of low inventory, competition for homes in California has grown intense, which in turn has driven prices up, affordability down, and homeownership is bearing the brunt of this imbalance.

In 2017, there were roughly 420,000 detached, single-family homes sold in California, representing a 1.4% increase in the number of closed transactions from 2016 levels. That is roughly the same number of transactions California has averaged since 2009, meaning that ongoing improvements in economic conditions have not translated into a greater number of home sales. Indeed, 420,000 sales is a number that California used to hit back in the 1990s, when the economy was 10 million people smaller than it is today. However, in 2018, the pace of home sales has started to reverse course—most dramatically in June 2018, when existing home sales tumbled 7.3% on a year-over-year basis, their largest decline in early 4 years.

California Existing Single-Family Home Sales
(2005-2018)



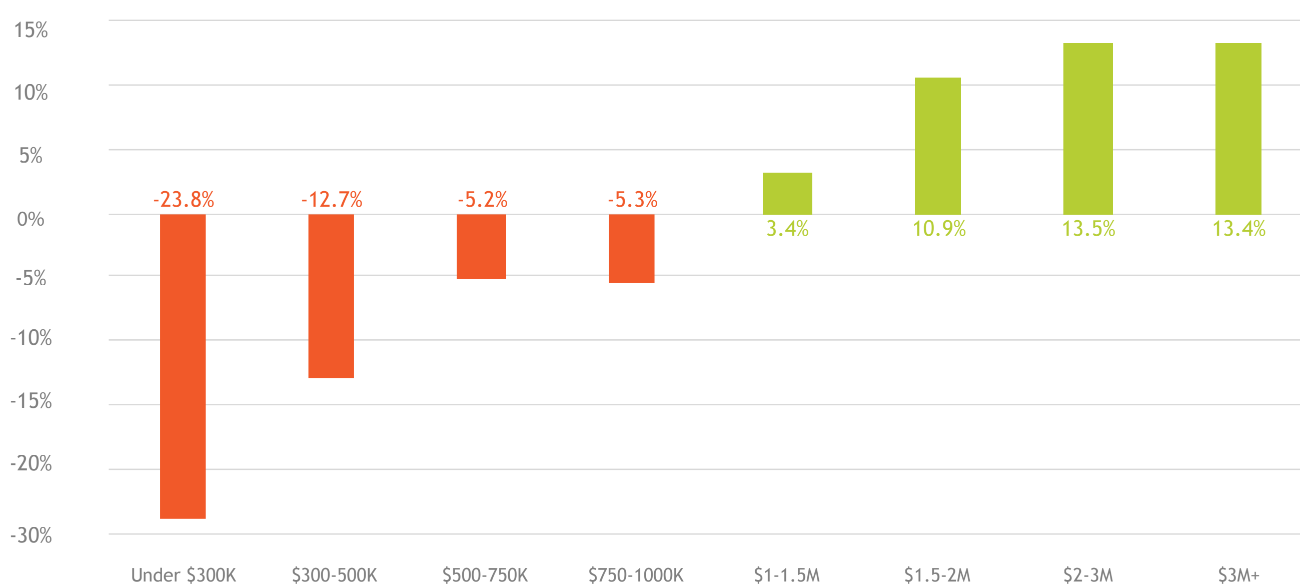
A brief glance at housing turnover shows that we sell roughly half as many homes on a percentage basis than we used to in the past. That presents significant challenges for REALTORS® and brokers, who cannot simply rely on a growing economy to drive an ever-increasing number of transactions or leads through their pipeline given the structural issues that persist in California today. Instead, the successful brokers and agents will be the ones who can carve out the largest share of a relatively flat market by distinguishing themselves, having better networks of potential buyers and sellers, providing superior service, or simply stepping up their "hustle-factor."

The successful brokers and agents will be the ones who can carve out the largest share of a relatively flat market by distinguishing themselves, having better networks of potential buyers and sellers, providing superior service, or simply stepping up their "hustle-factor."

Increasingly, sales have been pushed further and further away from the core employment centers, where inventory is virtually nonexistent, and affordability has eroded to concerning levels. For example, San Bernardino was the only county in Southern California to post a gain to kick off 2018, rising by 5.6% from a year earlier. Every other part of Southern California, where prices are a minimum of $120,000 higher on average, saw a reduction in the number of sales as residents of the region got pushed into more affordable areas in San Bernardino. Ventura County also saw a small increase, but that is likely due to a catch-up effect as the market tries to get back to normal after the wildfires. Similar trends were experienced in the Bay Area at the beginning of 2018: Sonoma and Marin saw a bounce-back after the wildfires, but every other part of the region experienced a decline in home sales. Meanwhile, the North Central Valley is laughing all the way to the bank as counties adjacent to, or near, the Bay Area experienced healthy gains. This includes Placer County (+11.4%), San Joaquin (+9.7%), Sacramento (+3.5%), and Stanislaus (+0.6%).

California Existing Home Sales Growth

(June, Year-to-Year)



The growing economy and historically attractive interest rates have created significant demand among first-time buyers, and retail/owner-occupant buyers, while the rapid growth in prices has decreased demand from investors and foreign buyers. As a result, demand has been disproportionately skewing toward lower-priced homes in recent years—THE segment of the market that is the most inventory constrained. This explains why price growth has been so robust despite large reductions in the number of sub-$500,000 home sales: lack of supply means that entry-level homes end up going to the highest bidder.

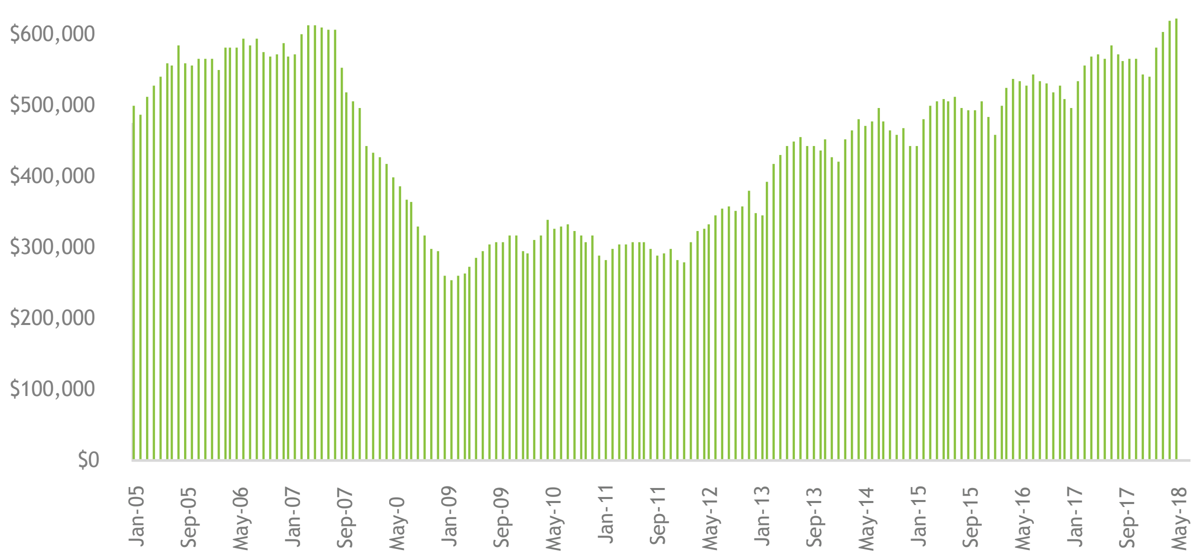
Indeed, we see that sellers are getting virtually full price for their homes at the bottom end of the spectrum, while there is still evidence of discounting happening in the $1 million and up category. In addition, the time on market dropped into the teens last summer and remained less than one month even in the dead of winter.

2.3 Rising Prices: A Double-Edged Sword

Despite, or perhaps because of, the lack of sales growth, prices continue their unabated upward trek—in fact, prices have continued to gain momentum as California closed out 2017 and headed into the second half of 2018. Overall, California ended last year with a median price for a single-family, detached home of $550,000. This marks the 6th consecutive year of rising home prices. And, by June 2018, California had pushed through the pre-recession peak and set a new all-time high for prices at over $600,000.

California Existing Single-Family Median Home Price

(2005-2018)



For those who already have a foot or two on California's property ladder, almost 7 years of uninterrupted price growth has been great for wealth building. In addition, it has helped those who saw their home prices plunge during the downturn to get their heads back above water, financially. In fact, CoreLogic reports that just 3.2% of outstanding mortgages in California are currently underwater (loans larger than the value of the home). That is down from more than 25% at the depths of the recession. From that perspective, rising prices have been an enormous benefit to California.

However, many Californians have yet to dip their toes in the market—because of a lack of financial wherewithal, lack of inventory, desire to own, or some other reason. For this group, rising prices are helping to push the dream of homeownership further out of reach. For example, during the first 6 months of 2018, home prices in California have been growing at more than 8% consistently. That is far above the pace of growth in worker wages, which means that even though incomes are rising, California continues to fall farther behind the eight-ball from an affordability standpoint because buyers simply cannot keep up with prices.

As a result, the CALIFORNIA ASSOCIATION OF REALTORS® Housing Affordability Index has dropped into the teens—meaning that 80%+ of households in these areas cannot afford to purchase the median-priced home. This in turn has driven California's homeownership rate down from a pre-recession high of more than 60% down to something that is dangerously close to being a majority-renter state. In fact, some of our major metropolitan areas have already descended into majority-renter status with the state as a whole not far behind.

Of course, like the lackluster sales response, the rapid price growth is also a function of the rapid up-valuing of homes at the bottom end of the market. This illustrates our familiar Tale of Two Markets, recast from a pricing perspective. If you break the housing market up into 20% increments, ranging from the 20% least expensive to the 20% most expensive, you can see that California is quickly losing any "bottom end" of the market at all. Examining price growth across these "quintiles" of price, the supply-demand imbalance for more affordable properties becomes clear. Exactly as economic theory would predict, those segments of the market with the greatest amount of demand and the least available supply should experience the fastest increase in prices. Indeed, this is exactly what we observed in California during 2017. Homes in the bottom quintile grew by double-digits last year, while growth in each subsequent quintile as you move up the price ladder experienced slower growth in home prices.

Overall, prices in California continue to rise and indeed show signs of actually picking up steam. While this is good for potential sellers, it represents equally daunting prospects for those who do not own their own home yet. In the absence of a big economic shock that undermines the demand side of the equation, prices are expected to continue to rise. As such, the primary, and perhaps only, solution to this housing crisis will have to come from the inventory side, which, as we see in the following chart, underlies the vast majority of our housing woes in California.

2.4
Rising Inventory and Signs of a Shift

Whether the lack of new sales activity, the rapid growth in home prices, the erosion of affordability, or the decline of homeownership, California can trace virtually all its housing crisis back to its inability to produce an adequate supply of housing.

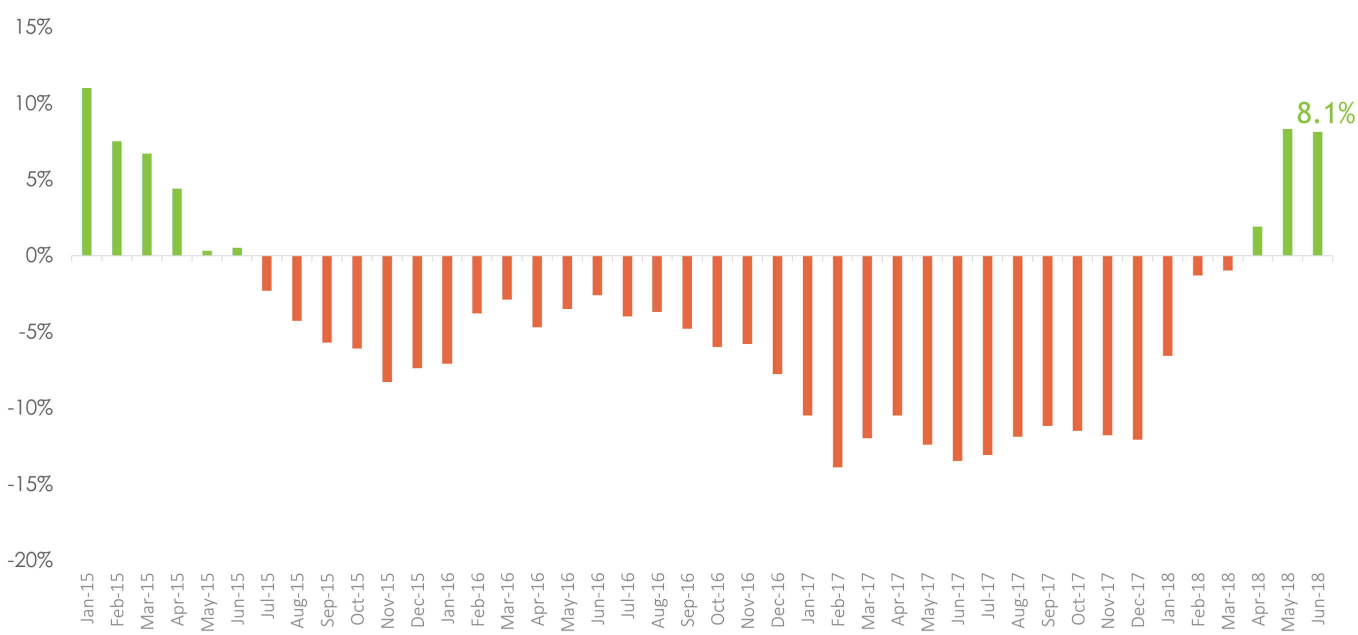
However, as we begin the second half of 2018, California has begun to experience a shift in its housing market. Rewinding to the end of 2017, the CALIFORNIA ASSOCIATION OF REALTORS® Unsold Inventory Index dropped to just 2.5 months of supply—a 14-year low coming off the back of some of the lowest-inventory years that preceded it. Last year, California also saw the number of active listings decline by more than 10% in every single month. This means that despite already-low levels of inventory, California's housing market was getting even tighter at a faster pace.

Fast forward to 2018, and the state is certainly seeing the inventory shift. First, the decline in active listings began to decelerate significantly in the new year. For example, after double-digit declines throughout the entirety of 2017, California saw active listings decline by less than 2% in both January and February 2018. In March, active listings actually began to rise for the first time in nearly 3 years. The growth began slow (at just 1.9%), but quickly ramped up to more than 8% in May and June, respectively. This has helped to boost the Unsold Inventory Index from historic lows and combined with falling sales, the market is less tight than it was a year ago.

In addition, the largest swings in inventory came at the bottom end of the market, which has suffered most from the dearth of available listings. However,

California Single-Family Active Listings Growth

(Year-over-Year % Change)



as California enters the second half of 2018, the biggest swings in active listings has actually come in this crucial market segments. For example, the number of homes available for sale between $300,000 and $750,000 grew by more than 13%, while homes priced $1,500,000 and above posted much more modest gains in the mid-single-digits. What is perhaps even more remarkable is how dramatic this change is from even a year ago. For example, last year, the number of active listings of homes priced between $300,000 and $500,000 were declining by between 10% and 15%. Thus, this growth represents nearly a 30-percentage point swing in the marketplace, from large negatives to fairly large positives. Listings at the top end of the market have been occurring for some time, but now California doesn't have steep declines at the bottom end, which has allowed the aggregate number of listings to finally jump into the positives.

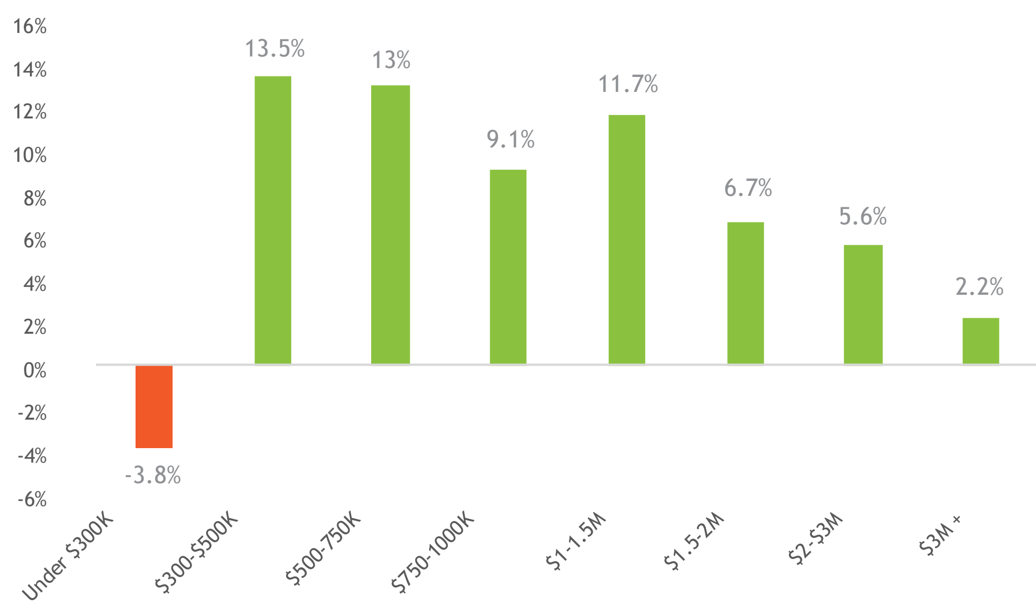
Sales performance by price segment also provides more evidence that the market is shifting. For years, the bottom end of the market (the lowest 20% of homes by price) has been the most inventory-constrained segment. Despite this, price growth was actually slowest for these homes by mid-2018, even as the supply constraint has eased somewhat for homes in this category in recent months. Homes in the 0-20th percentile experienced a 7.0% increase in median prices in June 2018 and homes in the 21st-40th percentile grew by 6.2%. On the other hand, the most expensive homes in the state (80th-100th percentiles) increased by 9.6% over the same period.

If deteriorating affordability were not in play, it would be reasonable to assume that the most inventory-constrained segments would see sales begin to rise as soon as new inventory hit the market. That this has failed to materialize in 2018 despite rising listings suggests that the erosion of affordability has left potential buyers either unwilling or unable to meet the accelerating home prices. Indeed, C.A.R. has been warning for some time that our supply problems could eventually turn into demand problems as larger swaths of the state can no longer afford to become homeowners.

This is further supported by the fact that the median number of days on market actually increased for the bottom 40% of homes (by price) while the top 20% of homes saw the time on market contract last month. Overall, home sales are still above the 400,000 benchmark at 410,800, but this provides further evidence that the market is undergoing a shift. In addition, sellers have started to make concessions in their listing prices. After declining for 17 months in a row through March 2018, the percentage of active listings that have had some sort of price reduction in order to sell has been growing as we enter the second half of the year, which is another precursor to a softening market.

California Active Listings Growth by Price Segment

(June 2018)

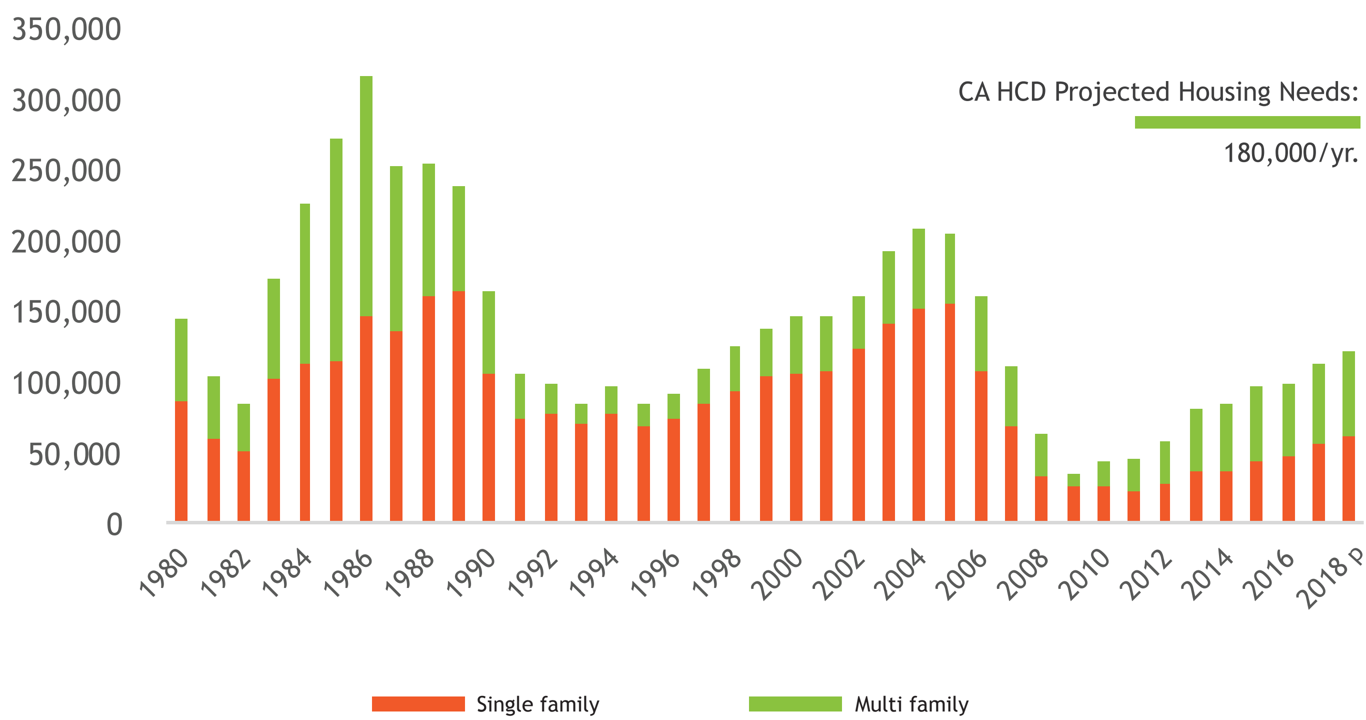


That is not to say that deep declines in home prices are on the horizon. In fact, after reducing prices from their initial optimistic level, sellers are still largely able to garner that final listing price. And, it will take time for the mismatch in expectations between buyers and sellers to materialize into slower price growth. However, with sales declining in precisely the categories where we might expect to see growth, under the assumption that inventory is the most important constraint despite more homes available for sale in these segments, does underscore that the market is undergoing a shift.

There are several reasons to believe that even if a soft patch does present itself, it will not be as devastating as last time around. First and foremost, prices are not as overheated as they were at the height of the last bubble. A simple thought experiment of where prices "should" be given incomes and interest rates in California shows that, although home prices are higher than what one would expect to see in a market with zero constraints, they are less than 1/3 as inflated as they were back in 2006. Secondly, California still has a 30-year accumulated deficit in terms of new construction, where we have habitually failed to build enough homes to keep pace with our growing population. Despite outmigration to other states, Californians continue to have babies, and people from the rest of the world still move here every year. Combined with an unemployment rate at its lowest levels in more than 4 decades and incomes that have finally started to rise again, this will help to offset some of the weakness in prices that will come from reduced affordability.

As a reminder, California's Housing and Community Development Department (HCD) estimates that the state needs to build 180,000 new housing units—and that is how much we need to tread water on affordability, not to begin chipping away at the lack thereof. Unfortunately, we've never even broached 100,000 units in the past 11 years, except in 2017. That means that we are falling behind each and every year.

California Residential Construction Permits



The lack of construction goes a long way towards explaining the lack of affordability and homeownership in our most expensive and tightest markets. For example, between 2010 and 2016, Los Angeles County added roughly 440,000 new jobs, and yet it permitted just 100,000 new housing units during that time. San Francisco added nearly 225,000 jobs during the same window but permitted less than 30,000 new housing units. And this actually overstates how good a job they've been doing as many of these permits represent infill or teardown/rebuilds, so the overall stock of housing increased by less than those figures would suggest on net.

California's housing turnover is also being impacted by state-specific policies—namely Proposition 13, which limits increases in a homeowner's property tax base. This policy was intended to help homeowners maintain a predictable stream of taxes on their property and was adopted in a period of significant inflation, which taxpayers were suffering from as property values saw big swings from year to year. One of the unintended consequences of this policy is that as homeowners live in their homes for significant periods of time, they ended up accumulating significant property tax savings as the market value of their home shot up well beyond the increase in their property tax basis allowed under Prop.13.

In these cases, moving would result in a significant increase in annual property tax bills were these folks to move. As a result, they tend to not move at even greater rates than in the rest of the nation. And, in an interesting corollary, spending on remodeling alterations/additions to existing homes in California continues to breach new all-time highs each year as older homeowners hunker down in their existing homes for the long haul.

The third leg of the inventory stool is the single-family rental market. During the downturn, many former homeowners defaulted or foreclosed on their properties, and many more were forced into bankruptcy. As a result, the number of owner-occupied homes declined as these folks joined the ranks of the renter population. At the same time, prices were falling significantly, and many savvy investors swooped in during 2009 and 2010 to enter the single-family rental business. Information on this segment is difficult to come by, but the CALIFORNIA ASSOCIATION OF REALTORS® estimates that somewhere between 400,000 and 1 million single-family homes were taken out of the ownership stock and converted into rentals. Unfortunately, it is still a tremendous time to be in the rental business with rising rents, rock-bottom vacancy rates, and declining homeownership/affordability. As such, we do not expect these rentals to be converted back into ownership housing under those conditions.

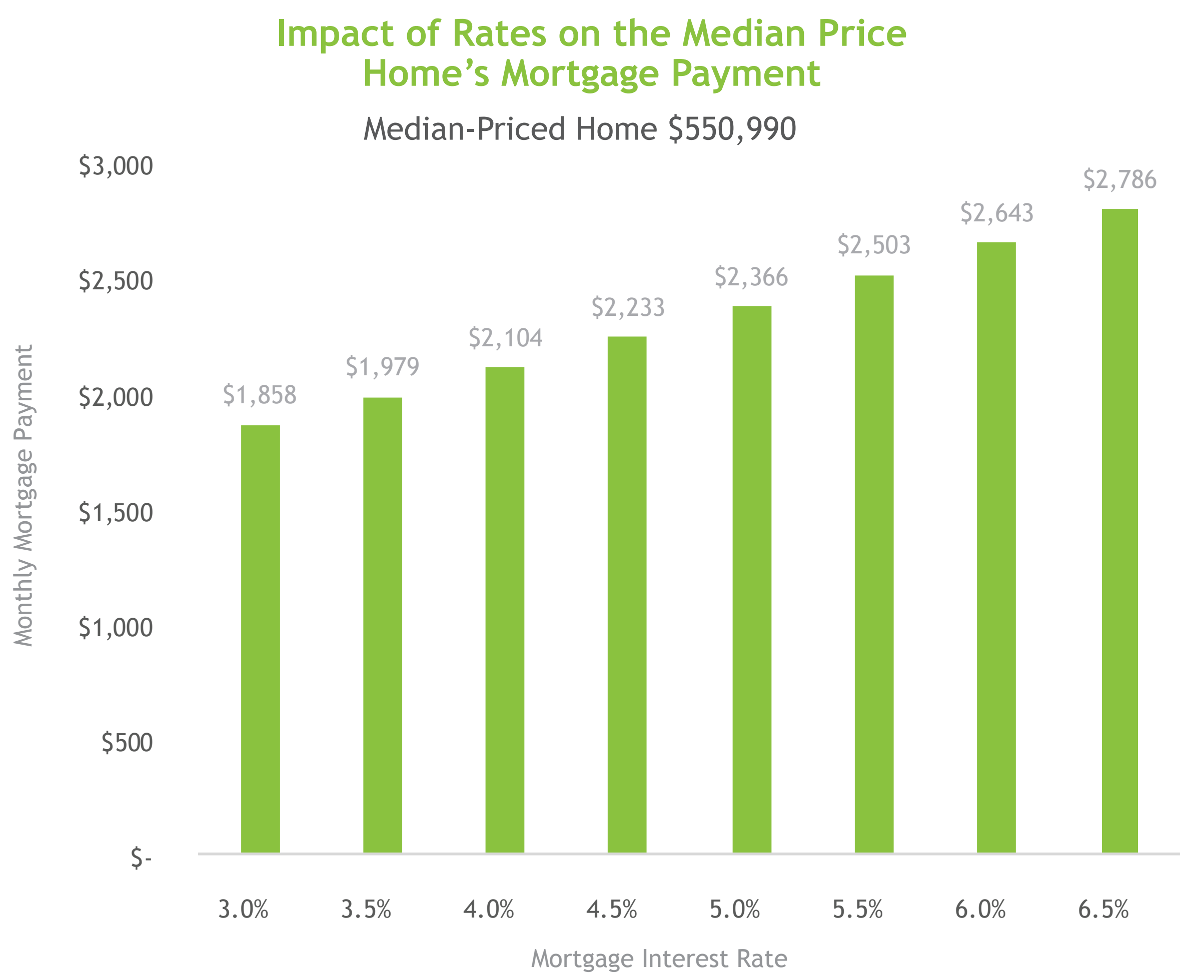
Inventory remains tight for these and other reasons, but it is becoming clearer with each passing month that the housing market here in the Golden State is undergoing a shift. And, while rising inventory might represent a positive for agents and brokers over the short run, as it provides more potential transactions to work on, it may actually be a broader negative for the industry over the longer term. This is because the inventory again may be the result of fewer and fewer Californians being able to purchase and own their own home. Similarly, if these listings come online and don't represent a second deal on the other side because these former homeowners are taking their equity and moving to states like Nevada, Texas, and Arizona—which is a trend that has risen solidly in recent years as well.

2.5 The Finance Environment and Other Challenges

In addition to the supply and demand considerations that dominate California's housing market, financing issues are likely to be more important looking ahead. On the one hand, credit standards and regulatory burden under the new administration are likely to be eased. This will make mortgage credit more available and indeed, we have seen the average FICO credit score for a closed mortgage loan come down over the past 4 years from more than 750 to 726 at the mid-point of 2018. That still represents relatively excellent credit, but FHA loans have trended lower as well with an average of 677 on closed loans.

Although we certainly do not want to go back to the "Wild West" days of 2004-2006 when "NINJA" loans (No Income, No Job or Assets) dominated the market, there is certainly plenty of credit worthy borrowers somewhere in the middle. The good news is that we are trending in the right direction.

The bad news is that the days of 3.5% mortgage rates are firmly in the rear-view mirror for now. Following the January 2018 employment report, which showed a solid increase in wage inflation, bond yields have surged with a 10-year treasury near 3% by mid-2018. Mortgage rates have followed suit and sat at 4.57% at the same time. This is a dramatic increase from the rates that persisted prior to the presidential election, and taken together with rising prices, represents the 1-2 punch for affordability. That could cut the opposite way as more credit availability: it might be easier to get a loan, or at least the banks will want to lend more willingly, but many can no longer afford homes at these higher rates.



To illustrate the impact of rates on affordability, consider the following. At 3.5% interest, which is where rates were prior to the election in 2016, the mortgage payment on a median-priced home in California would cost roughly $2,000 per month. At 5.5% interest, where some forecasters suggest we are heading before long, the mortgage payment increases by almost $500 per month on the exact same home. Thus, as rates continue to rise, California's affordability crisis will only become more acute. This should be a great motivator for buyers who are on the fence about jumping into the market, because their cost of homeownership increases significantly with fluctuations in rates.

2.6 Potential Risks: What to Watch For

Finally, although the housing market hasn't given us much to write home about, the threats to the housing market remain largely external at this point. As demonstrated herein, higher levels of interest rates will have a dramatic effect on affordability.

The other thing to be on the lookout for is an external shock that impacts the demand side of the housing market equation. California home prices continue to grow because demand for housing outstrips the chronically under-supplied market. However, an economic shock that takes away demand by ramping up job losses or impacting wealth or incomes, will much reduce the upward pressure on home prices in California.

We have already observed one correction in the stock market in early 2018. If the losses there persist or the global economy stumbles, then the market could be in for a bumpy ride. Fundamentals suggest that equities could still be slightly overvalued. For example, the national price-to-earnings ratio is above its normal range, suggesting that the value of companies is currently higher than their profitability would suggest they should be. If the correction eventually causes firms to lay off workers and unemployment begins to rise, it could impact housing demand and, therefore, home prices in California.

The other factor to be on the lookout for is statewide rent control. A ballot measure has qualified for the November ballot in California that would effectively repeal Costa-Hawkins, which provides for vacancy de-control of rent-controlled units as they turnover. Costa-Hawkins also exempts single-family units from rent control as well as newer multi-family buildings. Should this repeal be passed at the ballot box, it could impact the market by suppressing investor demand and by reducing the incentive to construct new housing in California, which would exacerbate our existing supply challenges.

Other likely suspects include consumer spending and consumer debt, both of which have risen much faster and longer than the housing market. Credit card and auto loans are up dramatically while savings rates have been falling as spending consistently outpaces income growth.

Still, despite all these challenges, unemployment remains low, incomes are growing, and even in the face of all these internal and external headwinds, California's housing market put out more sales in 2017 than it did the year before, and overall volume and income in the industry rose. Understanding how to navigate these changes in the coming years will be critical, and the forecast remains fairly positive for sales and prices. However, the growth will not be enough to enable you to sit back and rest on your laurels—capturing market share and stepping up your hustle will remain the name of the game.

3

Disruptors and Shifting Dynamics

At a time when the brokerage industry faces a multitude of risks that are impeding profitability such as commission compression, rising regulatory pressures, increased competition, lower inventory and sales volume, unrelenting consumer expectations and the aesthetic demands for "Instagrammable moments," there has also been a steady flow of capital into the industry, further putting pressure on the status quo.

The unprecedented influx of capital has given rise to a variety of new business models including instant/convenience platforms, discount platforms, agent-centric platforms, all challenging the traditional home sale transaction and the way traditional real estate companies operate. Many of the new entrants are focused on resolving perceived pain points or reducing friction in the real estate transaction. One thing is clear about the companies entering the field: they are laser focused on the consumer and their experience. They want to make the transaction faster, better, cheaper and they have the financial means to fund strong efforts to make that happen.

These new business models are detailed below, profiling several key representatives of each approach to the real estate business. It is important to note that this is by no means an exhaustive list of market participants. Nor does the CALIFORNIA ASSOCIATION OF REALTORS® endorse any specific business model within the industry. The objective is to highlight some of the most innovative business models and see what traditional real estate can learn from them, and vice-versa.

3.1 Convenience-Based Platforms/Direct Buyers

One new model has been the rise of convenience platforms. Some of these firms are direct buyers of real estate, while others are focused on minimizing the sale time for consumers. Convenience-based platforms have been around the industry since the time of the "We buy ugly homes" and "I'll buy your house" signs popped up on telephone poles decades ago.

Today, the concept of a hassle-free transaction is the focus of a slew of new companies in the real estate space. Uncertain timelines, potential fallouts from low appraisals, securing loans, the desire for privacy, among other reasons, all create friction in the transaction—especially in the eyes of the person selling their home. These companies saw an opportunity to reduce this friction by purchasing direct and then reselling the home—hassle-free. All of this comes at a cost, however. The cost of convenience—charging sellers a convenience fee ranging from 6% to 12%. Note that this fee has fallen as one firm has expanded and responded to competition in the marketplace.

Opendoor is a prime example. This platform is simplifying the transaction by purchasing direct from the consumer and then reselling the property. This convenience factor has taken hold in the markets in which Opendoor operates, which now include Phoenix, Dallas, Fort Worth, San Antonio, Las Vegas, Atlanta, Orlando, Tampa, Raleigh-Durham, Charlotte, Nashville, and Minneapolis-Saint Paul. They claim to remove the uncertainty, time, and hassle. And some could argue that the convenience factor increases the velocity of home sale transactions.

The company was founded in 2014 by Eric Wu, a Trulia and real estate tech veteran. According to their website, "We set out to reinvent life's most important transaction with home sellers and buyers in mind." They initially raised $10M in a Series A, early-stage, venture capital round of funding, and most recently secured later staged venture capital funds totaling $135m in January 2018. Although they do not report their sales, clearly their growth in market penetration has been impressive enough to attract interest of the venture capitalists. And, although truncated timelines may very well appeal to sellers, it is important to note that they are paying for that convenience in the form of a premium for a guaranteed sale date.

Offerpad, which was launched in 2015 by co-founders and co-CEOs Brian Bair and Jerry Coleman, operates a similar model: buying homes direct from sellers, at the click of a button. According to their website, they operate in seven markets nationwide and claim to eliminate the traditional sales hassles. Bair states, "We buy quality homes at competitive prices and deliver homeowners the ultimate home selling experience." They, too, are backed by venture capital. According to Forbes, they have $260M in equity and debt financing from LL Funds, a U.S.-based private equity firm. Here's what we know:

- Currently operating in: Phoenix, Tampa, Orlando, Las Vegas, Salt Lake City, Atlanta, and Charlotte.
- Founders have deep roots in real estate and close ties to Blackstone Group on the residential rental markets.
- Currently partnering with Zillow Instant Offers to make offers on properties direct to interested sellers.

Zillow first launched its Zillow Instant Offers (ZIO) program in 2017. The ZIO platform allows prospective home sellers to list their home on the platform, with or without an agent, to solicit "all cash" offers from a group of institutional investors. Along with listing on Instant Offers, sellers receive a comparative market analysis (CMA) from a Zillow Premier Agent. Investor offers and CMA include an explanation of the fees associated with each option, so the homeowner gets a clear picture of how much they will net. Should the seller accept the offer, which expires after 5 days, they are encouraged but NOT required to use an agent and can choose one of the three options:

- Accept an offer and sell directly to an investor
- Accept an offer and use an agent to manage and close the transaction
- Reject the offers and list the property with an agent

The entire process takes place online with the transaction platform dotloop (owned by Zillow). The strategic priority is to, "Create better experiences for consumers and more efficiency for our real estate industry partners. This happens as we accompany home shoppers further down the funnel and closer to the transaction."[2] According to Zillow's CEO, "The early adoption of this product identified a subset of motivated sellers who value speed and certainty of a sale over price, and also connected agents with many consumers who were testing the waters but want to sell a home in the traditional way."[3]

Zillow has now expanded its ZIO program to directly purchase, and then flip homes from sellers. Sellers will still receive the option for an all-cash offer to consider from investors, but Zillow will also throw its own hat in the ring with a purchase offer, where they will then turn around and resell it after some minor improvements.

Knock, founded in 2015 as an online home trade-in company, is another example of a convenience/direct buyer model. The company has raised $34.5 million in seed, Series A and nonequity assistance funding. CEO Sean Black says in the video on their website, "Let's face it, selling a house sucks!" They claim to be a transformative company where their differentiation is that they have a true "trade-

[2] Zillow 2017 Earnings Report.
[3] Zillow Earnings Call, February 8, 2018.

in" model where they buy the seller's home and get them in a new home before their old home is put on the market. According to their website, sellers can use their trade-in program using a 9-step process or they'll buy the seller's home in 6 weeks or less. Although they were only operating in Atlanta last year, they have plans to expand into 10 new markets by 2019 including Charlotte, Raleigh, Los Angeles, San Diego, Phoenix, Chicago, Miami, Orlando, Tampa, and Denver.

Overall, these new business models are aimed at pain relief—making the process for buyers and sellers quicker, easier, and less stressful. However, while these business models make a lot of sense in an up market—such as the one characterizing the current business cycle—it remains to be seen how robust such approaches will be in the inevitable downturn. Buying and sitting on a portfolio of homes is not terribly risky in an environment where prices are rising. But with falling prices, these companies would face significant exposure as the value of their owner-portfolio could decline at precisely the same time that buyer demand softens. A down market is always a concern to anyone working in the real estate business, but falling prices are particularly detrimental to those holding large portfolios of real estate assets.

3.2 The Tech-Enabled Brokerage

The rise of the tech-enabled brokerage is another force disrupting the traditional brokerage business model, and hosts some of the most recognizable entrants into the space. Although they all take slightly different approaches, all of these firms are heavily tech-enabled in terms of tools for agents and consumers. They claim to do everything your traditional brokerage offers, but smarter, more efficiently, and at a lower cost.

Perhaps the most famous of the tech-enabled brokerages is **Redfin**. Redfin is by no means a new player to the industry—they are a technology-powered residential real estate brokerage. Founded in 2004, its website is considered to be in the top 10 of real estate search sites in the U.S. They have staked out the consumer end of the market with a powerful search tool, and its growth in the marketplace has firmly established Redfin as a force in the industry. Prior to going public in July 2017, Redfin had raised $167M in equity funding, and with their initial public offering (IPO), they raised another $138M.[4] This capital has helped the firm expand into new markets, grow their agent and customer base, and grow their slice of the real estate pie.

Their growth has put them on the radar of the traditional brokerages in a major way: by the end of 2017, Redfin had a market share of 0.71% of all existing home sales by value. Although this is still a relatively modest fraction of the market, the traffic on both the Redfin website and its mobile app has increased by 40 percent. In addition, they have expanded their mortgage arm ("Redfin Mortgage"), offering both conforming and jumbo loans with a promise to close in 30 days.

In addition to their growth in the marketplace, Redfin is also disrupting traditional business models of how a brokerage operates. For example, their "Redfin 1%" is expanding to serve more and more of their market areas. The approach to this model is to work with sellers for a 1% listing fee, which does not include commission paid to the buyer's agent. They offset this lower listing fee both by maximizing the efficiency/reducing costs associated with the transaction, and by reducing the Redfin buyer's rebate that is typically offered.

[4] According to TechCrunch.com.

So, not only are they advancing into the search space, they are also providing stiff cost competition to listing agents from traditional brokerages.

In 2017, they also launched a "Redfin Fast Offers" platform, an offer-writing software provided initially to Redfin agents in Washington, D.C. and Virginia, which boasts that it will help "Redfin customers get offers in faster...." Finally, they unveiled a "concierge-style" home selling service in markets like Los Angeles and Washington, D.C., and expanded to other services that will help them compete and gain market share.

It is important to note that although their earnings report showed that revenue increased 38% year-over-year to $370M in 2017, they also reported a net loss of $15M (or $4.47 net loss per share), compared to a net loss of $22.5M in 2016. They are growing and capturing market share, but they have yet to make money—they're playing a long game.

Redfin's search tool is heavily utilized by consumers and had 32.4 million total visits, via desktop & mobile web, in the last 6 months as of January 2018,[5] and their customer-centric focus is undeniable. Looking forward, expect Redfin to expand its Redfin Fast Offers technology, mortgage-related business, and eventually move into digital closings.

eXp Realty is the latest tech-enabled brokerage to go public, with their May 2018 initial public offering (IPO) valuing the firm at $1 billion on its opening day of trading. Prior to going public, eXp Realty, LLC. was an agent-owned cloud-based brokerage. Instead of physical office locations scattered throughout their territories, agents interact in a virtual office environment complete with everything from meeting and event spaces to companywide announcement monitors, and the full compliment of the eXp team interacting in real time within this virtual office space.

eXp Realty is the latest tech-enabled brokerage to go public, with their May 2018 initial public offering (IPO) valuing the firm at $1 billion on its opening day of trading.

In interviewing their President Vikki Bartholomae for this report, eXp's vision is a global community designed, powered, and owned by their agents and partners, and transforming the real estate experience. According to Bartholomae, eXp ended 2017 with more than 6,500 agents—171% annual increase from the prior year. They also generated a revenue increase of 203% year-over-year to $48.1M. eXp Realty now covers 47 U.S. states and 2 Canadian provinces. When measured by territory covered, eXp Realty is one of the largest residential real estate brokerages.

Compass, another player in the tech-enabled brokerage space, was founded in 2012 in New York under the name Urban Compass. Since then, they have raised $808M in 10 rounds of fundraising with the largest being a $450M investment from SoftBank (a Japanese holding company based in Tokyo) in December 2017, which notably also has invested in companies such as WeWork, Uber, Wag, Slack and others.

Compass currently has a valuation of $2.2B according to Crunchbase. They offer a tech-driven luxury real estate platform, and their mission is to "help everyone find their place in the world." They claim to be "building the first modern real estate platform, pairing the industry's top talent with technology to make the search and sell experience intelligent and seamless."

Compass is focused on agents: providing them with tech tools so that they can spend more time with clients. They have 51 engineers tasked with accomplishing this feat. They are already in 18 markets nationwide and moved into the California market in 2015, landing first in Beverly Hills, then in the San Francisco Bay Area, Santa Barbara, Montecito, Orange County and San Diego. In the summer of 2018 they made two acquisitions in the state, Paragon Real Estate Group in July and Pacific

[5] According to Similarweb.com: https://www.similarweb.com/website/redfin.com?competitors=zillow.com

Union International in August. Their co-founder and chairman Ori Allon is a Twitter and Google veteran, and their CEO, Robert Reffkin, is a former Goldman Sachs executive. In Reffkin's company-wide address on October 24, 2017, he unveiled the vision for Compass: 2020 by 2020 where they want to be, "In the top 20 cities, 20 percent market share by 2020," with continued investment in their agents, according to reporting by Inman News. Clearly, they expect to be around for the long run.

What about computers? Will the real estate agent be replaced by a robot? Perhaps not yet, but **REX**, a Woodland Hills-based company founded in September 2014, is hoping to change that. They've received $25.5M in three rounds of venture capital funding. They list and market homes outside of the Multiple Listing Service (MLS). According to CrunchBase, "Using data and technology never before seen in real estate, REX goes around the existing infrastructure to deliver a more efficient process, faster sales, and tremendous savings, while capturing data and getting smarter with every home sale. As the only full-service real estate company not using the MLS, REX is saving sellers $25,000 in fees on average by charging just 2% in sales commission, versus the 5-6% of traditional agents." According to *The Wall Street Journal* (McLaughlin, 2018): "REX said it listed a house per day in 2017 in Southern California and the New York area, and plans to operate in San Francisco, Austin, Denver and Dallas by the end of the year." [6]

Thus, not only are the convenience-based platforms changing the relationship between players in the space and buyers and sellers of real estate, but the traditional brokerage model is also being disrupted by venture-capital-backed firms driving rapid improvements in efficiency and technology, which are impacting the bottom line of traditional firms.

[6] Wall Street Journal: Why Your Next Real-Estate Deal Might Involve a Robot, https://www.wsj.com/articles/why-your-next-real-estate-deal-might-involve-a-robot-1519908587?shareToken=st11c3875e08a34171b4fb1f1d9b8f0538&reflink=article_email_

3.3
Low-Cost/Flat Fee

Purple Bricks is a UK-based public company founded in 2012, and in 2017 raised 50M pounds or approximately $62M in a special stock offering to enter the U.S. They launched in Los Angeles as a cloud-based model where agents list homes for a flat fee of $3,200 (regardless whether they ultimately sell the home) and offer a $1,000 buy-side rebate towards closing costs—according to their website. They currently have fewer than 30 agents in the area, but that number is expected to grow.

Purple Bricks' motto, "an agent you can love," is based on the notion that their agents will provide lower upfront fees and better service than traditional real estate firms. Purple Bricks is completely cloud-based, meaning they do not have traditional brick and mortar real estate branch offices.

According to their June 2017 press release, U.S. CEO Eric Eckardt said, "Purplebricks is launching in the U.S., with a distinct offering, which aims to offer a better deal for customers and a compelling opportunity for highly skilled, experienced local real estate experts. Our plans are progressing well and we remain on-course to launch in the second half of 2017." Eckardt also spoke to C.A.R.'s Strategic Planning and Finance Committee in November 2017, where he said Purple Bricks is focused on the consumer and they're just trying to make the process "easier, efficient, and more transparent."

According to *The Wall Street Journal*, Purple Bricks grew rapidly in 2017 (a roughly 150% increase from 2016). Other indications of the company's aggressive growth include an approximately 42% increase in operating income growth as well as 75% increase in net income growth.

Some industry analysts expect that, in the end, there will only be room for a few large low-cost options in the marketplace, with the remaining firms competed out of business by the ones with the most economies of scale who will be able to drive the efficiencies needed to survive in a low-fee-based environment. Ultimately, it remains to be seen which of these newer business models will rise to the top of that heap, but we can be sure that they will continue to disrupt the traditional brokerage industry and adapt to these external forces—both in terms of attracting the talented agents that they need to survive, and by staying top of mind with consumers/offering a compelling value proposition.

C.A.R. Members commonly cite "discounters, disruptors, and 'free' brokerages" as the largest threat to the traditional brokerage business.

4

Legal and Regulatory Issues

4.1

Independent Contractors in the Real Estate Industry

For at least half a century, real estate agents have enjoyed being independent business persons under the license of their brokers and brokerage companies. The sales licensee's entrepreneurial spirit makes this the arrangement of choice due to its flexibility, rewards for productivity, the ability to be creative in marketing, tax benefits, and many other reasons. In many ways, the agent competes not only with other companies, but with the other licensees within the company itself to get listings from sellers, helping buyers with their purchases, and market properties.

The advent of the sharing economy and the nationwide evolution of on-demand businesses, such as Uber, has been a gamechanger in this regard. Along with the desire for some companies to be flexible with their workforce, there has been a crackdown on misclassification of employees as independent contractors across the country. Notwithstanding the historic practice in the real estate industry, in the residential real estate market, it is highly unusual for agents to choose, even if offered, the position of an employee salesperson. The exceptions are functions such as transaction coordinators, marketing coordinators and some supervising office managers, which are more likely to adopt the employee-employer structure. However, the overwhelming numbers indicate that most traditional, and even some nontraditional, salespersons and brokers have selected an independent contractor arrangement.

One reason productive agents prefer to be independent contractors is control. An independent contractor can choose to work when they want, spend their own money to advertise, put pumpkins around neighborhoods at Halloween (or flags on the Fourth of July), send out newsletters, door knock, and any number of activities. They are free from the early morning office meeting and stay-until-five routine unless self-imposed. Truth be told, much activity is done when potential customers are available and that could be any time at all. This is why, even though the majority of C.A.R. members are salespersons, not brokers, there has never been a push to change the association's policy on freedom of choice on this issue.

In the 1970s, there were factors tests that attempted to guide salespersons and brokers through the maze of too much or too little control so that licensees could comply with existing law. In 1982, the U.S. Tax Code was amended to include a simple three factor test, U.S.C. 3508 states: a) the person must be a licensed real estate agent, b) substantially all remuneration for services is directly related to sales or other output, c) the services are pursuant to a contract that states the individual will not be treated as an employee for federal tax purposes. In California, the Real Estate Law as reflected in the Business & Professions Code 10032(b), the Unemployment Insurance Code (650, 1300-133504), followed suit to codify this historical practice. Real estate licensing law specifically indicates that salespersons may be either independent contractors or employees as mutually elected. But it goes beyond, indicating that it is not limited to those code sections and taxes but is for "statutory purposes." The real estate licensing law was designed to impose supervision of salespersons by the brokers so that those with the more rigorous license, the broker, can oversee licensed activities of the salespersons, for which the qualifications, experience and test thresholds were less. This consumer-friendly construct served all parties well for decades and was never intended to dictate that there must be an employment relationship between broker and salesperson.

Many agents are quite mobile between the highly varied business structures of brokers as they seek different styles and compensation. Inevitably, some partings are less than agreeable and lawsuits result. In California, these were typically commission disputes that were handled very cost-effectively by panels of local REALTORS® through mediation or binding arbitration. The National Association of REALTORS® only mandated arbitration between firms, but the norm in California was that salesperson-broker disputes could also be arbitrated with the consent of both parties. However, as employment law developed, so did the creative approach of resolving these disputes: salespersons lawyered up and sought a court resolution. At the same time, some traditional employers outside the real estate industry had been mandating forms of arbitration between employers and employees. The simple peer review approach was challenged in a case involving noncommission issues. As a result, the simple arbitration clause with simple peer review was removed from the C.A.R. Independent Contractor agreement. Nevertheless, some post-dispute arbitration agreements still were used to resolve the overwhelming majority of the conflicts of a broker-salesperson breakup: how to treat commissions when the salesperson left and some transactions were pending, which were the type of conflicts typically faced by agents.

Bararsani vs. Coldwell Banker

In 2012, one of the lawsuits was brought by an unproductive (as in never able to complete even one sale) salesperson in the Bararsani v. Coldwell Banker case. Taking a page from the class action playbook in the plaintiffs' employment bar, the salesperson filed a putative class action alleging all of these arrangements were really employment relationships. This struck at the very heart of why salespersons love their independence: freedom to reap the fruits of their labor in proportion to the time, effort and costs they wish to expend—all with tax-deductibility and flexibility. In that case, after the lawsuit was filed, the broker asked its salespersons if they wished to be a part of the class action or opt for individualized arbitration. The response was overwhelming. The putative class size shrunk from about 6,000 to a few hundred. It was never certified. And since that time, all other attempts at certifying a class action of salespersons have failed. The reason is they like the independence and their work habits are highly variable. Even some nontraditional brokerages such as Redfin have been sued on the independent contractor issue. The one court where it got far enough to address class action status did not certify the class and most ended up in single-person arbitrations. Due to the close proximity in timing of Redfin going public, a few of the cases settled. Since that time, a few salespersons, presumably who wished to leave the real estate profession, have tried an independent contractor challenge. To date, none have been resolved on the merits and none have become a certified class.[7]

Some in the brokerage community would not mind an employee construct—but only if the entire industry converts simultaneously. Some brokers indicate that if such a structure was imposed, they would terminate over 50 percent of their salespersons, maybe more. In a recent survey of California brokers, we asked how they would change their business model if independent contractor status was eliminated. Some were sure this would end their career in real estate:

> *"I'd cease to exist without the agent/ independent contractor status."*

> *" I wouldn't change, I'd just stop being a REALTOR®. Retire earlier. I think the transition period would break most existing brokerages because of all the changes required."*

[7] Certified class: The process of certification ensures that the plaintiffs have enough similarities to proceed with litigation against the named defendant as part of one larger case.

" I would fight tooth and nail not to have that happen."

Others indicated the types of changes that would have to be made:

"We would set sales quotas, pay a minimum wage plus bonus. Have set hours and the ability to control, educate, and supervise."

"As a broker, my profitability would increase, number of agents would decrease, and I could control my P&L more."

"We would reduce staffing to only those agents that were producing over to 6 to 8 sales a year."

"The agent count would likely change dramatically with productivity standards and added layers of daily oversight to maintain a productive and financially viable model."

In short, only the highly productive salespersons would survive. It would also likely put pressure downward on commission the salespersons get paid as the consistent costs would be predictable while the sales income is highly variable. The brokers indicate most would dismiss part-timers and nonproductive salespersons. Some believe such a change would possibly increase professionalism but would also reduce competition. One would think the FTC, which likes low barriers to entry and free-wheeling competition even in regulated industries, would decry such an anticompetitive result.

So why do brokers keep unproductive salespersons? We are told some do so because it is difficult to predict how successful someone is at the outset. There is tremendous turnover in the real estate licensee space. Some indicate selling anything is hard and is a special skill set and it is difficult to screen for that skill. This is even more so when the transaction is complicated with regulations, disclosures, inspections and heavy competition to list properties for sale and obtaining clients is difficult. Additionally, brokers' business models vary widely with some benefiting from desk fees and actually consider their salespersons as profit centers whether or not they produce sales, and others benefiting from ancillary services to the extent the law allows. In the end, an agent's creative approach is the consummate competitive situation in which the buyers and sellers benefit by being exposed to massive experimentation and service choices.

California law is clear: the three-factor test should apply for all statutory purposes. Workers' compensation is unusual and still applies in California, though the rest of the country typically does not require brokers to provide workers' compensation insurance for its independent contractor salespersons. There is some authority that license law requirements should not count as "control" under classic employment law analysis. Beyond the business itself, if the real estate industry has to deal with the common law factors tests of control, there will be a clash of consumer protection, real estate law, regulation, and employment law tests. Clearly this would hurt the consumer if good risk management and regulatory control means that transactions, are less regulated and less supervised: it is a Hobson's choice for brokers. Choose your poison: a nonproductive salesperson looking for a quick dollar as they leave the industry or an injured buyer or seller due to diminished supervision and training. Good public policy should reinforce what the California Legislature declared long ago: the regulation of real estate licensees, including good broker supervision and policies, exists independently and is not connected with an employer-employee relationship. The brokers and salespersons are free to choose, and they have overwhelmingly voted with their contracts…which are independent.

So why now? Why the challenges in this free-flowing structure when it has been around for so long? It appears the lucrative class action employment movement has moved into a nontraditional business structure and the cost of defending the cases resulted in some settlements. While individualized arbitration will allow for a cost-effective resolution of typical commission disputes on parting, the risk of having an agent try to cash in with a lawsuit is a continuing possibility. Brokers taking care to loosen controls as much as they can without tripping the regulatory oversight protocols and good practices will have difficult choices to make.

4.2
Teams: Structure, Regulatory, Employment, Disputes

While teams have been around for decades, they are today becoming more and more common. Teams create legal risks for the unwary including employment law issues, commission disputes, structure, and regulatory issues. As discussed in the Independent Contractor section, employment law can create risks for those varying from the classic practice of one salesperson making a commission on a sale. Teams often divide tasks and have accountability and other features that put them at risk for an employment classification. If that wire is tripped, then issues such as payroll stubs, hourly pay, overtime, tracking hours, withholding, reimbursement of expenses, and other issues are mandated by state law. In addition, issues such as mandatory sick time, possible IRA payments, and other landmines appear. Seasoned team leaders will consult with an employment lawyer, use leased employees through an agency, a payroll service, or sometimes make an arrangement with the broker if the broker already has employees and systems. Alternatively, the teams should structure their flow of work and tasks to avoid an employment classification, if possible.

Structure issues through a well-drafted contract can prevent problems downstream. In California, a salesperson may form a corporation and receive assigned commissions but may not do licensed activity under the corporation under the real estate law. One important issue to address is what happens when someone leaves, which is inevitable in the fluid world of real estate. Teams can prevent disputes by having the discussion up front and addressing such issues as who owns the team name, whether and how commissions are paid after the relationship ends, lead sharing, customer lists, etc. If the team is marketing under a name without the name of a lead salesperson, then there may be issues of a DBA at both the county and regulatory level (DRE) as well as whether it should (or even can) be trademarked at the state and national level. Although not in the team context, one real estate firm had to file bankruptcy after a name used was previously registered with someone else. In this case, the litigation continued against the individual salespersons for years after the company's bankruptcy ended the suit for it.

Regulatory issues include understanding the roles played by each member of a team. Team structure does not trump the broker's responsibility to supervise under the licensing laws. Many are familiar with managers and delegated tasks of supervision to the manager. It is important that team leaders and their broker communicate so that the supervision required under the licensing law is done and that the broker and team leader are on the same page as far as the systems for that compliance.

Commission disputes and distribution should also be addressed. Often the team leader has a compensation arrangement with the broker, but the broker has a different compensation agreement with the other members of the team. Commissions are to be disbursed through a broker, so making sure the real estate tasks requiring a license are compensated lawfully through the broker is important and the team understands the protocol. Even tricky issues when one team member leaves the team but is in the same brokerage can cause disputes. Anticipating either mediation or arbitration or other means to resolve such disputes in advance can at least avoid litigation. There are enough issues when a salesperson leaves the firm as well, including how that impacts compensation in a team context.

Team structure does not trump the broker's responsibility to supervise under the licensing laws.

Teams can provide efficiencies and benefits, but compliance and other issues can create great distractions and risks if not handled up front. Seasoned teams typically buy separate insurance including employment law insurance policies and even liability insurance.

4.3
Cyber Security Threats Target Real Estate

Cyber security threats are ubiquitous and have hit the real estate industry hard. The FBI has indicated that in 2017, reported losses in cybercrime in California included about 51,270 victims and crimes valued over $312 million that included Business Email Compromise and real estate. Some of these involve wire fraud diversion of down payments or even the full purchase price, and the incidence of these types of crimes is escalating rapidly. A real estate transaction goes through many hands from listing broker and salesperson to buyer's broker and salesperson, to sellers, buyers, escrow and title companies, banks and many inspectors, appraisers and even repairpersons. Add that to a fast-moving transaction with large amounts of money, to or from the home buyer and seller, escrow, title and lenders. Those using good cyber security practices can often minimize the exposure, but not when individual human error causes the problem. Those involved in a transaction should be particularly wary of cloned emails and have protocols in place to detect and defeat an attempted diversion of funds. These include: verification protocol prior to transferring of funds, two-factor authentication, updated software, to name a few. Some good cyber insurance policies are available, but the insurance policies are evolving and are widely variable. As cyber criminals continue to game any new protocols, this will be an area that will continually need vigilance and attention.

The incidence of these types of crimes are escalating rapidly.

Privacy is also part and parcel of cyber concerns. As efficient electronic commerce and storage become the norm, so is the possibility of storing personal information that, if the system is breached, requires notification, and other actions. As the systems use become more robust and storage is done electronically, data breaches may become more prevalent. This will continue to be an area of concern.

4.4
Interaction with New Business Models

The real estate industry has long had many innovative models in a highly competitive marketplace. This is exacerbated by the models that seek to undercut pricing to professionals while compelling or shifting professional services and risk to less compensated parties in the transaction. Brokers providing rebates or refunds to clients is a decades old practice as is individual licensees cutting fees during escrow to close a gap between principals after some unknown needed repair surfaces. Those representing clients in an agency relationship have a difficult situation when the client wants the transaction to close but the other licensee has a model NOT to do any of the transaction tasks needed for legal compliance. The liability and free-riding under the guise of innovation will continue to be an issue as brokers and salespersons interact with the various new models, including those excluding a player with a license. These issues will be in play as long as innovative business models are out of sync with agency and other duties applicable to real estate licensees, and the actual tasks shuffle with the new models.

4.5
The MLS

The MLS (Multiple Listing Service) remains a hot-button topic that continues to garner attention and discussion across the state and the nation. Entry of many other players in the space including Zillow and Realtor.com, to name two notable examples, has only made the need for the industry to strategize that much greater. However, in many ways, the need to address the MLS is about more than just competitive pressures in the marketplace—it's about consumers: what they need and what they want.

At a high level, the MLS needs to help the REALTORS® do their job by providing the types of information that their clients need to make decisions about listings, pricing, negotiation strategy, staging, repairs, and a whole host of other issues involved in every real estate transaction. The MLS is quite different than the public portals: MLS information is accurate and policed heavily with fines for untimely updates or submittal of inaccurate data. Brokers not complying can be fined up to $15,000 and ultimately expelled from the service. Those portals getting feeds from MLSs free-ride on the complete and cleansed data set from the MLS but charge hefty fees to the salespersons advertising around the good listing data. Those who get direct public input have had instances of fraud and false and old data as they lack the sanctions and discipline of the peer-review/policed MLS. The accurate MLS data has also provided brokers with an antidote to some automated valuations that are done with old information and not-so comparable properties.

With the Department of Justice consent decree expiring, it is not clear whether there will be additional focus on the industry and the MLS given the acceleration of change. Standardizing data fields is clearly pro-competitive but the interaction with the portals and the industry is still evolving.

Conclusion: E.M.B.R.A.C.E. Change

Challenge	Average
Brokerage profitability	4.42
Lack of inventory	4.07
Lack of professionalism	4.00
New business models entering the buiness	3.76
Changes to the independent contractor status	3.68
Unrealistic sellers pricing above market	3.43
Off-MLS/Pocket listings	3.32
Changes to dual agency	3.13
All cash investors crowding out first time buyers	2.60
Tight underwriting	2.48

(Question: Please rate the following critical market challenges in your area on a 5-point scale.)

As we close out this report, it's useful to take stock. Where are we? How challenging is today's brokerage industry environment? Let's start by looking at what California brokers told us. We asked them to rank on a five-point scale 10 realities of today's market to give us an idea of just how challenging they were. The chart presents their responses in rank order, from the most challenging to the least. Broker profitability was rated most challenging by the majority of the respondents. Rounding out the top three were lack of inventory and lack of professionalism. The last three, by a wide margin, were changes to dual agency, all cash investors and tight underwriting. And in between, we have a conglomeration of the usual suspects: new business models, off-market/pocket listings and changes to the independent contractor status of real estate salespersons. Serious stuff.

If you are feeling overwhelmed, you are not alone. Fear is always an option but not recommended — fear can be paralyzing. Stagnation is death. Growth, on the other hand, is life, success and abundance. You might ask: How can I approach this environment from a place of opportunity and E.M.B.R.A.C.E. all it has to offer? How to proceed? In an overwhelming environment the best place to start is with a simple question. What is the next best step? Here are three suggestions:

1. Know Your Why

The first element of E.M.B.R.A.C.E. is to understand your "why." Why are you in this business? What drives you? What are your beliefs about what you do? Why do clients return to your brand? You are likely familiar with Simon Sinek's 2009 Ted Talk entitled, "How great leaders inspire action" that has, to date, garnered close to 40 million views. It's an important message almost 10 years later and one that bears repeating in the context of the real estate industry, ripe for change and full of uncertainty. Sinek's message boils down to this: people don't buy what you do, they buy why you do it. And if you are clear about the why of what you are doing, it becomes the driving force behind how you operate your business, whether it is the brokerage firm itself or the personal business of the agent.

In our recent survey of California brokers one of the questions was a simple one: What drives you to lead in this industry? Some of the responses clearly echoed Sinek's point about the "why:"

"Core belief in value of homeownership in a democracy; a way to provide a measure of stability to families."

"It is my duty in life to help agents build a better life while serving consumers with great experiences"

"Building generational wealth."

"Homeownership in general. Helping people with the biggest investment they make."

"The multiple opportunities and the ability to play a role in one of the most important decisions a person can make."

Note the common themes of homeownership, of building wealth, of community, of quality of life. At its core isn't this what the real estate industry is all about? Helping consumers make the biggest financial purchase and the most important decision of their lives. A choice that will determine where they live, who they interact with, their children's education and so much more. Now what could be more important than that?

2. Focus on Perpetual Engagement

The manner and speed at which people communicate today varies dramatically from person to person. You need to understand what works for that particular person, be flexible and engage in a manner that provides value. And to prepare for the future consumer, look no further than today's 20- and 30-year olds. While the millennial generation has been much maligned, today we know that they are smart, savvy and understand the value of homeownership. They want to invest in their financial future and be part of a vibrant community. They get it. And we know that they are digital natives in a world where speed is everything and information is available at the touch of a button. They are in a perpetual state of engagement. You need to be there too.

They educate themselves before buying and comparison shop; they "google" everything. In Google's famous 2011 The Zero Moment of Truth Macro Study, Shopper Science found that the average number of sources used in making purchasing decisions doubled in one year, from 5.27 in 2010 to 10.4 in 2011. Extrapolate from there and it's pretty clear that we should all be preparing for a world of even greater competitive pressures and radical transparency.

So how do you meet the next wave of homebuyers? Whether they are first-time buyers or long time owners looking to move, the answer is the same. Reach out and connect with them. Get to know them. Outreach. Be visible. Implement strategies that provide a continuous state of engagement and measure the results. Stay connected. Be clear on what you are doing. You are not just selling a house. You are providing a pathway to homeownership and the life and financial security that provides for buyers and an opportunity to move on for sellers. Meet their needs in a way that takes their breath away.

3. Create an Unforgettable Experience

Whatever the market, no matter how many competitors with different business models there are, no matter what the regulatory environment looks like — there will always be consumers who need your help. You have no control over these so-called "exogenous factors." You should strive to have 100% control over the client experience. From the first moment they connect with your brand to everything that follows, you have a role to play by providing an exceptional experience.

This paper has documented many of the challenges and uncertainties facing the dream of homeownership and the industry that actualizes that dream. Despite these obstacles there are many REALTORS® today who are experiencing record-breaking years in the business. Dollar volume in 2017 was at its highest level since before the Great Recession and will be even higher in 2018. Even with flat home sales, the total number of transactions in the state has been above 420,000. Mortgage rates are headed up and yet remain low by historic standards. And, perhaps most importantly, the American Dream is still alive, something that's sought after, and is synonymous with owning your own home.

As we've gleaned from conversations with the best in the business, building the right team, knowing your "why," executing on a vision, providing superior service, being the expert, and staying at the forefront of market and transactional knowledge are all areas where individuals can really move the needle — especially in challenging environments. We hope that you will E.M.B.R.A.C.E. the change that is upon us and use it to expand opportunities for homeownership and business success.
Let's do this.

Contributors:

Leslie Appleton-Young
SVP & Chief Economist, C.A.R.

June Barlow
Senior Vice President and General Counsel, C.A.R.

Sara Sutachan
Vice President of Industry Relations & Strategic Initiatives, C.A.R.

Jordan Levine
Senior Economist, C.A.R.

CALIFORNIA ASSOCIATION OF REALTORS®

The purpose of the CALIFORNIA ASSOCIATION OF REALTORS® is to serve its membership in developing and promoting programs and services that will enhance the members' freedom and ability to conduct their individual businesses successfully with integrity and competency, and through collective action, to promote real property ownership and the preservation of real property rights.

This report is also available online.
Please visit www.car.org to view or download.

E.M.B.
R.A.
C.E.

CALIFORNIA
ASSOCIATION
OF REALTORS®

www.car.org