



The Commission Paradox

By Michael Agee
President, Agent Scoreboard

I'm a big fan of facts and proof.

The other night I was watching the Science Channel, about how there is some disagreement in the scientific community about how best to get humans to Mars. It caused me to think about the real estate community's disagreement about commissions.

I think people generally believe that the following statement is true: "Real estate commissions are too high, and real estate services are overpriced"

I began to think where is the proof of that? How do we know it is true? It seems to me that we would need some supporting facts, to be able to confirm that statement applies in all situations. We need to know the following:

1. What are the standard elements to the real estate process
2. Can a baseline cost be applied to each of these elements
3. How does "service level" impact the premium placed on the baseline cost
4. What effect does the market have on the costs
5. What other factors would affect the premium calculation

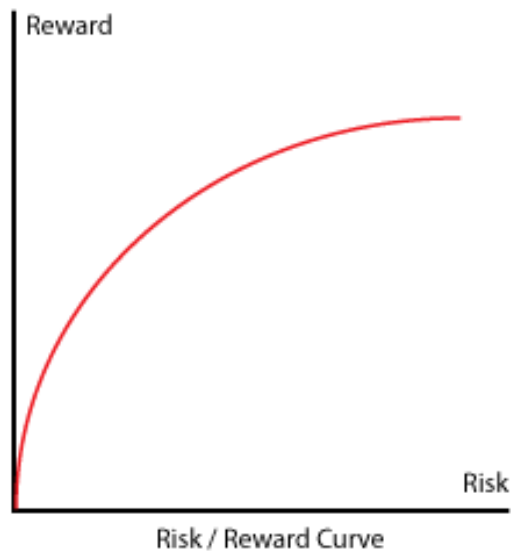
First I believe, have to evaluate the question of whether the current commission structure is equitable for consumer and real estate professionals.



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The *risk versus reward curve* is a fundamental principle in business. The simple explanation is that, as risk in a given transaction increases so does the reward. However, there is doctrine of “*diminishing returns*” where at a certain point in a given transaction, the amount of new risk does not have a corresponding increase in reward.



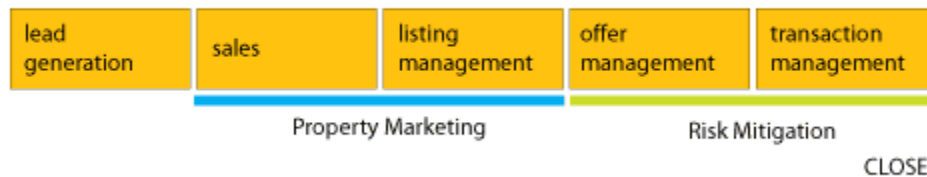
It’s important to understand these concepts as we go thru the next parts of this discussion, because much of what I believe is that the current commission structure was designed to reward real estate professionals for assuming almost 100% of risk in the real estate sales process. One of the questions I asked yesterday was “what are the standard elements of the real estate sales process”.



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In the graphic below, I've outlined the process from both the real estate professional's and consumers perspective, with the consumer having the more simplistic view, thus more likely to have a view that real estate agents do very little, and risk very little.



As we examine the process from the real estate professional's perspective, I'll assign the level of risk and to what party that level is assigned.

THE REAL ESTATE SALES PROCESS

1. Lead Generation (*Risk ~ 100% Real Estate Professional*) The traditional lead generation and distribution model is inherently flawed. In fact I believe that it may be one of the most inefficient systems in American business. This phase of the process is the most likely culprit in the perception that commissions are over priced. Consider the following scenario:

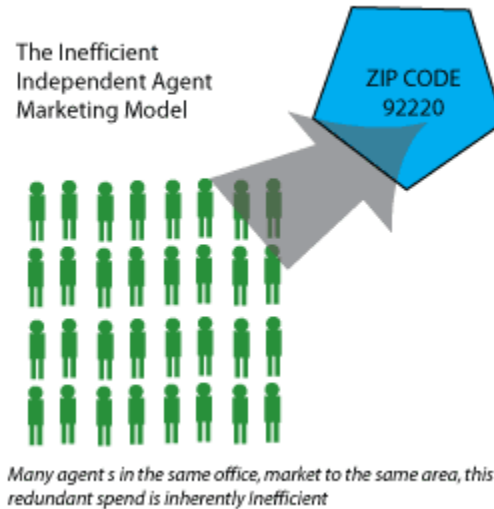


FIG. 1.0

EXAMPLE:

FIG. 1.0 - Broker X has 100 agents in his office, and his office serves approximately 10 zip codes with about 200,000 households. Only about 3 of the 10 zip codes have more than 4% annual turnover and are the target market of more than 30% of the offices agents. Each of the 30 agents that markets to those zip codes spends about \$300 a month on marketing to those zip codes. Total markets spend \$9,000. Lets assume that each agent generates 10 leads from their marketing efforts. That is a cost of about \$30 a lead. If you apply the doctrine of diminishing returns, after a certain point, say mailing #10, any additional spend doesn't have a corresponding increase in return. You could spend only a 1/3 of what was spent by the competing agents and still generated the same amount of leads. Combined per lead cost, \$10. Consider further that agents in that office only convert 1 in 10 leads to a listing, in the current model the cost is about \$300 per listing, vs. \$100 per listing in the combined model.

NOTE: Mary Jane has a better marketing piece and generates more leads than average and has a higher conversion rate from leads to listings. This effect can be incorporated into the model over time by applying best practices to marketing and lead distribution based on conversion rates. We learn from our mistakes.



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This lead generation phase is where the [Zillow's](#) and [Trulia's](#) of the world are going to work on you. They know that there is an economy of scale to lead generation and by having brands generate leads instead of individual agents, the brands can maintain brand integrity, have better control of the customer experience, and mitigate the “top producer” effect.

This phase of the process is one of the most risk intensive parts of the process for the real estate professional. They must extend capital in the hope that they can generate enough leads, that conversion is just a mathematical certainty, without going broke.

2. Sales (*Risk ~ 100% Real Estate Professional*)

The sales phase is the process of which the Real Estate Professional develops property specific proposals and invests mostly time and shared resources in an attempt to convert leads generated in the previous phase. This is “time intensive” in the extreme. The risk here is mostly the value of the agent’s time.

The “risk” involved is almost entirely the agents to mitigate. For example, should an agent not do his due diligence on the property or the sellers, or is “forced” to list the house at a price he knows it won’t sell, the agent is risking, not only his time, but his reputation and possibility a significant amount of money.



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3. Listing Management (*Risk ~ 100% Real Estate Professional*)

There is a common misperception that because the homeowner has entered into a contact with the agent he is somehow sharing the risk with the agent. Not True. The homeowner still has very little to lose if an agent's marketing campaign is unsuccessful. Provided that the house is occupied, or rentable, the sellers risk is almost zero. This phase is typically the entry point for a consumer relationship. From a consumer's perspective this would be the "Property Marketing" phase of the process. They would define it as the period at which they work with their agent to stage and show the house in a manner conducive to a sale.

Much of the "work" that agents do is in this phase. They must conduct an inspection; stage the home, setup marketing for the property, property photos, MLS entries, yard signs, flyers, postcards, mailers, open houses, etc. These activities too, must take place without any guarantee of compensation by the agent.

It is important to understand how and why real estate commissions are constructed, and why consumers and industry outsiders have the perception that real estate professional fees are so high. I'll talk about just when the home seller starts to share the risk and how real estate professionals mitigate that risk.



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It's interesting that once I begin to discuss risk with most people in the context of a real estate professionals' commission, I can see little light bulbs going off over their heads. For consumers who are perplexed by the real estate professionals' commission, they don't see how that commission relates to costs the real estate professional incurred in the sales process, but then, they begin to see how there is a lot of capital tied up in that sale and that the time/value of money equation begins to make sense. Simply put, the real estate professional doesn't make money unless the house sells.

So what's so hard about that?



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4. Offer Management (*Risk ~ 90% Real Estate Professional / 10% Home Seller*)

Here is really where the rubber meets the road. Real estate professionals and home sellers evaluate incoming offers to determine the following:

- Which offer nets the seller the most?
- Which offer meets the seller's closing time frame?
- Which offer is most likely to close?

Basically they are looking for the offer that has the most reward for the lowest risk. This is NOT a straightforward computation of facts. There are several factors that can effect the sale and this is where an real estate professional's experience can play a valuable role. A real estate professional must properly weigh the offer against several given situational facts, such as:

- Market conditions
- Lending environment
- Seller's requirements
- Buyer strength (credit, down payment, source of funds, etc)



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Any one of these factors could have many facets and the balance of those factors can be thrown askew by many external forces.

Now, before I go making this sound like a tricky technical skill that can take years to master, you should understand in a good market, good offers are not hard to find; large down payment from a buyer with good credit and pre-qualification letter from a major lender. However, in a slow market, good offers are harder to find, and that makes the real estate professional's skills and abilities all the more important. If there is a single process where great real estate professionals differentiate themselves from the pack it's in "deal mechanics" or understanding the value of the offers, their associated risk and matching that to the seller's needs/wants.

While this is not a practically risky activity for either real estate professional or home seller, the risk a home seller takes when selecting an "inexperienced" real estate professional is great, as they may not have the knowledge to identify the best offer in a handful of offers. Additionally, real estate professional's motivation can play a role, because real estate professionals can "steer" a seller to an offer which may not be the "best" offer because it could mean a "double-sided" or faster payday, this is an ethics violation, but very hard to prove and even harder to enforce.



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5. Transaction Management (*Risk ~ 95% Home Seller / 5% Real Estate Professional*)

This is the phase of the sales process in which the house is, essentially “off the market” the property is under a sales contract and the parties should be working in good faith to complete the transaction. For the real estate professional, if they have done their work in the previous four phases, this phase carries little risk and the task work can be passed to an assistant or transaction coordinator to complete the sales process and close.

However, for the homeowner, the house being “off-market” means they are committed to the deal, and must use best efforts to complete the sale. Should a better offer come, they are precluded from accepting it. An unqualified or lazy and indecisive buyer can tie up a house for months, while they try to find a mortgage or come up with additional funds. Liquidated damages, the practice of keeping the buyer’s deposit, may be hard to enforce, tied up by the escrow company, or little compensation for the period that house is off the market.

If all goes well, the transaction will close, and the home seller will receive the value of his equity, minus any fees due to the respective parties. It’s at this point much consternation is directed at the large sums the real estate professional has earned.



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Many times consumers retroactively apply the outcome from a given transaction to a lower cost method of selling their homes without using the same inputs. Their \$300,000 house sold for \$310,000 in 60 days, it closed on time and with all of their conditions met. It's at this time they say, if I would have used "so & so" to sell my house, I would have saved \$5,000. It's always interesting to say "what if"?

- *What if the house sold for \$320,000?*
- *What if the house closed in 10 days?*
- *What if the could have kept the appliances?*

All of those could have added the extra \$5,000 to the deal and may have been well within their control.

If a real estate professional, meets or exceeds expectations, he/she is met with malaise. It's just hard for the public to get excited over such a long process with so many moving parts. It's easy to lose perspective of the real estate professional's contribution.



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Now we can solve the Commission Paradox and show the holes in this model and how it can be improved for both real estate professional and consumer.

Remember, I started by asking five questions about the real estate sales process and associated costs and premiums.

- 1. What are the standard elements to the real estate process?*
- 2. Can a baseline cost be applied to each of these elements?*
- 3. How does "service level" impact the premium placed on the baseline cost?*
- 4. What effect does the market have on the costs?*
- 5. What other factors would affect the premium calculation?*

Before we put all of this together, I want to make sure we've properly put the concept of "Risk" in the perspective of other types of businesses.

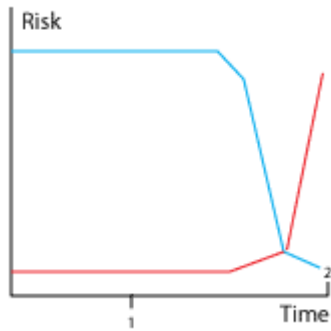
The graph below is an illustration of the "Risk Profile" of a real estate sales transaction from the perspective of the "Vendor and Vendee" or "Real Estate Profession and the Seller." It's at the point where the two lines intersect that risk is passed from the Real Estate Professional to the Home Seller. However, while the risk has decreased substantially, it should also be noted that it's unusual that no money has changed hands at this point. The real estate professional has



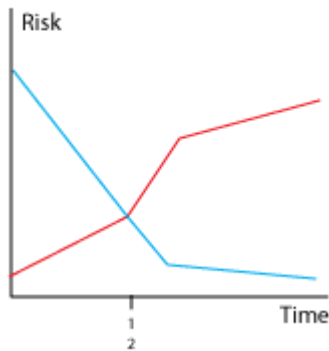
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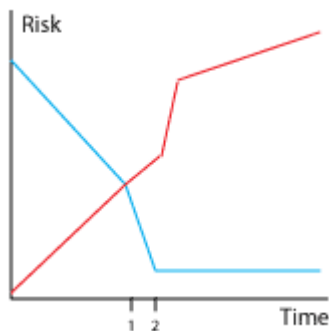
delivered a ready buyer of the seller's home, but has yet to receive any compensation for this work.



Real Estate Professional Risk



Auto Mechanic Risk



Retailer Risk

Note: 1 is where the consumer engages the vendor, and 2 is where the vendor is paid

Contrast the real estate professionals risk profile with the risk profile of a retailer, or a service provider like an auto mechanic. All of them have some upfront risk, associated with attracting clients; however, the retailers risk is slightly lower, because it's mitigated by the salvage cost of the merchandise. As you see their risk transfers to the customer as soon as the customer purchases goods or engages them for services. It is at that point when a "revenue event" occurs and the vendor can record a receivable.



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When the Vendor and a Vendee engage in a “meeting of the minds” regarding the purchase of goods or services, the transaction is complete. Compare that with the real estate industry, when a seller engages a real estate professional’s services, no revenue event occurs, it is not until a third event the “closing” occurs when the real estate professional can record a receivable.

I know you must be say “duh” this is all common sense stuff, true, but I don’t think most of us think of it as a reason for why commissions are constructed the way they are.

Our commissions are based on a “contingency” that the house is sold. This contingency can be influenced by several outside factors, the market, the seller, the availability of capital. Not too many other service professions have such “contingencies” that can be influenced by third parties, except maybe trial lawyers that work on contingencies, and their fees are steep, up to one-half of your award.



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We can now begin to answer my original questions:

1. What are the standard elements to the real estate process?
 - a. Lead Generation
 - b. Sales
 - c. Listing Management
 - d. Offer Management
 - e. Transaction Management
 - f. Closing

2. Can a baseline cost be applied to each of these elements?
 - a. No, there is no guarantee of success in a given transaction; a real estate professional cannot make a forecast regarding costs.

3. How does “service level” impact the premium placed on the baseline cost?
 - a. Since you can’t standardize costs, the addition of “premium service” can only drive up costs, in a given transaction. However, over a series of transactions it may actually drive down the cost of lead generation, further lower a real estate professional “risked capital” and creating higher profit margins.

4. What effect does the market have on the costs?
 - a. If there is a “hot” real estate market, meaning short “on-market” times for a given property, then costs associated with a transaction are lowered, and vice versa.

5. What other factors would affect the premium calculation?
 - a. Risk is the primary factor which effects any premium above the costs of doing business, in this profession.



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While many complain that real estate commissions are high, an opinion I share, but not because of the “greedy” real estate professional, but rather the consumer’s aversion to risk.

It’s the home seller that must assume some of the risk if they want to change the industry, and the cost of commissions. In the current environment where the home seller wants the real estate professional to tie up his capital, time, and resources selling their house, for an unspecified time, with an undetermined outcome, the real estate professional needs to have some sort of reward that is inline with that risk.

Yes, the real estate model is broken, it is inefficient, and the barrier to entry of new participants is low. However, it is only when we present a model to the consumer where some of the risk in the transaction is shifted to the home seller, that we can offer a “low fee” for our services.

I believe it is for this reason, that history has seen the loss of market share by the “flat fee” providers during down markets, as they just haven’t built up adequate reserves and their revenues are not high enough to sustain their model when the entire market shrinks.



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There are some popular companies out there charging lower fees and giving rebates, but at a time when cash is needed to drive the marketing engines of what is essentially a marketing business, they will only last so long before they fold, unless they can achieve enough market share that they can basically bring their lead generation costs close to zero.

If you know me, you know I'm a 9 year veteran of the discount wars, I've founded and run my own "flat fee" company that had offices in several states, and have been the Chief Technology Officer of one of the nations' major discount brands. I do truly believe commissions are not inline with costs incurred. However, as I've come to see now, when many of the "non-venture" funded discount brands struggle to grow and their offices are closing their doors, it is because our margins were too low. In a robust market, you can lower your margins because your risk/reward profile is shorter and your carry costs are lower, but when the market turns, as it has now, those companies, and real estate professionals, can't simply survive on thin margins.

I hope traditional real estate doesn't read this a "defense" of the 6% commission, it's NOT. It's an explanation of why it is what it is. The system is broken, but consumer education on shared risk is the only way to create change. If I were at the helm of a "big brand" I would start charging up front fees! The reward for both the consumer and the company are huge.