The Commercial Real Estate Brokerage Industry Is Broken: For Brokers <u>and</u> Agents

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March, 2010 - I share these observations as a 35+ year veteran having played a role in many facets of the commercial real estate brokerage industry: sales agent, local company owner, multiple management positions in the largest firm in the industry, consultant to numerous national CRE brokerage brands, trainer to tens of thousands in the industry , presidency of two international brokerage firms and my current role as the master licensee of Florida with a large national privately owned brand. With further disclosure, I own stock in a public CRE company as well as stock in one of the largest private networks. Jerry Anderson, CCIM

The fragile financial model of the **Commercial Real Estate (**CRE) **Brokerage** industry was suddenly exposed by late '08 and 2009 market conditions. Even in the best of times a thin profit margin of 5-10% is all company owners can expect and to make matters worse . . . the assets . . . . agents and their production . . . walk in and out the door daily. This is at best, a vulnerable lopsided relationship. Read the annual report of any of the public commercial real estate brokerage firms and weep for the stockholders losing tens of millions quarter after quarter. One brokerage firm for the first six months of 2009 reported a net loss of $76 million. Even the public behemoth and industry leader CB Richard Ellis' CEO midyear said, "we took steps to cut annual costs by $600 million". And public firms typically are more profitable than the local or regional firms due to a diversity of services and reduced commission splits for agents.

Give both CBRE and Jones Lang LaSalle(JLL) kudos for quickly reacting to market conditions with drastic cost cutting over the past 12 months to protect their businesses. For all of 2009 CBRE earned net income of just $33.3 million on revenues of over $4 billion, which is a vast improvement over the <u>$1 billion loss</u> recorded for 2008. (Remember, that is only 3.3 million to the bottom line on 4,000 millions earned). JLL reported a jump in fourth quarter profit of $52 million on $815 million in revenues to save their year. The results compare favorably to JLL's first-quarter 2009 loss of $61 million. JLL lost about $4 million on entire firm revenues of $2.5 billion for all of 2009, down substantially from the $84.8 million profit it made in revenue of $2.8 billion in 2008. Both CBRE and JLL are diversified in their service offerings far beyond just transaction brokerage.

Trust me on this one: The more entrenched and dependant on sales and leasing transactions, the more dismal and unstable the bottom line for the owner of a CRE brokerage company for the foreseeable future.

Consider:

- All the scampering at the brand and local level taking place in the last 6 months; it feels like the "musical chairs of commercial real estate brokerage".

- Local and regional companies will be unable to survive the current downturn unscathed, unless they adjusted quickly or have capability and willingness to tap deep into personal wealth.

- The CRE industry experienced an unprecedented drop off in activity in just eighteen months; $522 billion of commercial real estate transactions in 2007 compared to $51.9 billion in 2009, according to deals tracked by Real Capital Analytics. That calculates to a 90% plunge!
  - Local Leasing volume was off 30-40% in 2009
  - Local Sales were off 60-80% in 2009
  - Most companies finished 2009 with a 50-70% drop from 2008 revenues – and 2008 was a dismal year compared to '05-'07

- One company owner (In top 3 in a metro market) told me his firm's 2009 revenues were down 80%. He cut expenses by 70% and is still funding a significant amount monthly out of his personal account to keep the doors open, "I cannot survive much longer. And I no longer want to support agents that are unable to produce, whether it is the economy or their inability to adjust to a more difficult market."

- Large national or regional firms that have a high % of revenue in recurring income(property or facilities management) will have a better chance of surviving the continued downturn of 2010-2011.

- Firms that have the expertise and fully functioning "Distressed Asset" capability to serve banks and receivers will be very active for the next 24 months. There are only a few brokerage firms that are organized, experienced and active in this space on a national level. Small independents and sole practitioners simply cannot compete in this arena; too many diverse services are required.

- Smaller regional and local firms that refuse to change their business model and depend only on sale or lease transactions with a "2006 high overhead model" will not survive – the sudden closing of GVA Advantis offices in the Southeast and Florida, perceived as a strong regional player, is a prime example. I am aware of a number of local and regional companies over their head in debt and unable to pay the agent the % of commission owed from current closings – owners are basically in survival mode. And if agents file litigation for payment, which I suspect they will, well, let's just say what a mess!

- Agents that live from deal to deal, closing to closing are rapidly dropping from the ranks

- I estimate that 80% of agents that were highly productive the previous 3 years earned less than $50,000 gross in 2009 – if the "house" split is 50/50 or even 60/40 both the agent and the house are is serious trouble in terms of sustainability. Agents could make more working at a $15 per hour job PLUS not have to pay any CRE association dues.

- I am acquainted with a number of very talented agents that generated over $1 million in commissions 3 years in a row from multi-family sales activity that have not closed one single transaction in the last 15 months – that is hardly a sustainable career. Especially since the spending habits when earning over $1 million annually tend to creep toward the high side.

The opportunity for revenue in 2009 was not . . . and the next few years is clearly not what many agents had become accustomed to 2004-2008.

The current model of a local or even moderate size regional company being supported by independent contractors with high commission splits(to retain them at the firm) is broken. It is quite the dilemma . . .

- Agents want a higher split(60%-90%) to stay (it is after all their client base - at least in their minds) The longer an agent is with a company the less valuable the agent thinks the brand is to them. The company, of course, thinks it brings all the value to the agent. News bulletin for company owners and agents! It is truly a partnership and BOTH are critical to the success of the other. Treat it that way.

- Companies(the house) need aggregate average of 32-36% of gross commissions to pay the high overhead of providing brand, marketing services, staff, subscriptions and physical facilities let alone squeeze out a profit.
    - The producers carry the load of not only the company overhead, but also other agents that are not producing. If the company exceeds 64% split to an agent, it needs to make it up on another to extract the 36% average.

    - Ask any company owner how they feel every time they see empty unproductive desks or offices in their very expensive space. Then ask them how much they carry in "desk costs" that need to be covered by the agents' commissions paid to the broker. (desk cost = total fixed overhead/number of agents on the roster).

- Ask any brokerage owner about the high cost of a market data subscription service that is based on "the number of agents and staff on your roster" – watch them cringe.

- And as an independent company without a national brand, referrals and resources; the firm is really behind the power curve destined to serve a small circle of loyal and local clients.

- I am aware of two companies that have sales managers that receive a small base salary and 20% of the annual net income from operations: a reasonable compensation approach to motivate the manager to focus on recruiting, training, managing the agents, revenue and expenses. For the last 24 months neither manager has received any contingent compensation. This is not sustainable. In fact one of the managers left the business and now all the agents are scattering as well.

- When and if a brokerage company is sold, the anticipated future production of agents is capitalized and sold with no remuneration whatsoever to the agents producing the revenue. Again, a lopsided relationship.

- You need look no further than the "insider transactions" of any of the public companies to see the wealth created on the backs of the local agents. Agents: be prepared to be discouraged with the "disposition activity" details. Nothing illegal or unethical about the activity, just recognize whose efforts create the value.

Most companies with 2-10± agents are "tweeners". They are too small to be big and too big to be small.

- **They are too small to be big** and compete with the safe choice brands in town
  - Their clients, no matter how personally loyal and local in nature; in difficult market conditions demand industry leading tools, resources, technology and a safe choice brand – a vibrant market made it much easier for smaller operators to compete and be profitable
- **They are too big to be small**
  - Even though they are agile, the smaller company still amasses overhead that is too heavy. They struggle to offer tools, resources, technology, training, agent management or national brand and connectivity that enable them to compete. They need a manager to lead the charge, but the owner/manager needs to be a producer or rainmaker to pay the bills. The owner is typically the top producer.
- Even operating as a sole practitioner is a struggle. The sole practitioner needs a foundation of marketing tools, systems and technology. The lone ranger format keeps overhead low, but they fall short beyond the personal relationship and very local knowledge, so expanded services, scope and income are limited.

- All 3 groups have serious cash flow issues in a market of few transactions and basically survive closing to closing.

- Consequently, the majority of CRE brokerage firms have very little value. Ask any company owner and they will agree. They will tell you that the company is a “vehicle” and most of their wealth(if any remains after ’08-‘09) has been created by real estate opportunities found via the vehicle of their brokerage company, not the company’s cash flow.

- Trade associations like CCIM, Commercial Associations and local Boards, although trying to assist members with connectivity and some technology, are a thin substitute for the tools, expertise, resources, capability and brand that agents need to compete.

A few of the networks and franchisors do a decent job of providing a platform of systems, tools, resources and brand visibility. The local offices still have the issue and delicate balance of commission splits with agents plus the high cost of operation, especially if part of a loosely coupled network. Some of the networks do not have a sustainable business model without raising a significant amount of cash from investors in hopes of riding out the slow market. Networks that depend on delivering deals to and from members more so than tools and resources are particularly vulnerable when deal velocity drops. The tighter the brand on a state or regional level, the more valuable to local producers and most importantly - the clients of the local producer.

CRE brokerage as an industry has not yet fully realized that the market velocity over the past 5 years shielded it from its own mediocrity. Some firms and agents blindly keep doing what they did the last few years when market velocity carried them. The following were all gradual changes over the last 18 months that many agents and company owners didn’t see until the market literally fell off the table. Some still “don’t get it”. Not to worry, they will be gone soon.

1. The CRE business is an outside business not a “in front of my computer” business
    a. *Agents need to see people that own and use real estate*
    b. *Some call it “belly to belly” or “press the flesh” versus “click the mouse”*
2. Mobility, computers and iPhone/Smartphone technology negate the need for a company’s high overhead of expensive physical space with private offices and fine mahogany furniture for agents. A high tech multi-media conference room environment for face to face and video conference client meetings is more important.
3. The internet is the first place clients look for expertise - most CRE brokers have no digital footprint and thus are invisible.
4. Consumers and prospects do not look past the first page of search engine results to find a CRE service provider - *Be there or be gone*

5. Digital social media, blogging and digital presence with dynamic SEO is critical to the CRE brokerage professional
6. Information is everywhere and no one controls deals anymore by controlling information
7. Subscriptions to information and the ability to interpret it for clients is more important than collecting data and publishing a report
8. Web 2.0 (some say now 3.0) is about providing dynamic information of value linked to social media interaction versus a static website
9. Who knows you is far more important than who you know
10. Be an advisor and provide value, not just a "deal slammer" connecting and matchmaking sellers & buyers or landlords & tenants.
11. Recruiting top agents comes down to the quality, integrity and leadership of the people involved. And then tools, resources, collaboration and the value proposition your platform or brand offers - INCLUDING high commission splits in the agent's favor.

Bottom Line: the current commercial real estate brokerage industry model does not work for agents or company owners. Agents need to find a strong "door opening" brand that offers them collaboration, resources, leading edge technology tools and a generous commission structure. Agents need to provide service to their clients far beyond the "matchmaking" that carried the industry for the first 8 years of this 21^{st} century. Company owners need to alter their strategy, tactics and business model to get out from under the heavy burden of overhead being carried in hopes of their agents "closing a deal". Look at the % returns to brokerage company owners – other than ego why would you want to own a brokerage company? Clients don't want ego; they want, need and will pay for commercial real estate services that either save them or make them money.

Short Term Prediction: the CRE brokerage model is being reinvented by a few progressive brands offering a strong platform that focuses on the needs of the client first, while still meeting the needs of the individual agent including a high commission split to them. After all, the individual agent is the variable that brings the value to the table for the client in the first place, not the logo on the business card or in the email signature line.

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