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Incumbency advantage

In early trading on July 23, the shares of America's No. 1 residential-real-estate brokerage firm, Realogy Holdings Corp. (RLGY on the Big Board), leapt by 30%. The springboard was related neither to earnings, which indeed have been in a funk, nor to the established position of a profitable company in a basic American industry, about which, nowadays, there seems not to be much excitement. The catalyzing agent was rather news of Realogy's exclusive affiliation with an Amazon.com, Inc. platform to connect its 192,000 salespeople with potential home buyers.

Now in progress is the story of the contest between, on the one hand, the merits of free cash flow and, on the other, the prospective fruits of business disruption. Skipping down to the bottom line, we're bullish on the Realogy unsecured, single-B-rated $9\frac{3}{8}$s of 2027 ($550 million outstanding), which languish at a dollar price of $84\frac{7}{8}$ to yield 12.5% to maturity.

A dozen years ago, fixed-income investors threw money at newfangled mortgage-backed securities to earn supposedly certain returns. Nowadays, venture capitalists throw money at new-age real-estate-brokerage startups to earn admittedly uncertain returns. The newcomers contend that Americans pay way too much to buy or sell a house. They say it's an anachronism at best (look at the collapse of transaction costs on Wall Street), and highway robbery at worst. Let the antitrust division of the Justice Department do what it might (the feds have been nosing around the residential-brokerage business for years), the innovators are pledging to build a new industry on the ashes of the old one.

Squarely in the sights of the would-be disrupters is the time-honored 5% realtor-commission structure. Though the startups lose money, the venture capitalists continue to fund them—$80 billion in commissions paid per year in the U.S. market alone is a prize well worth the wait, they believe.

Pending the technological epiphany, competition for star salespeople pressures the margins of all the brokers, established as well as aspiring. Ultra-low mortgage rates seem no longer to work their usual bullish magic. Weakening house sales in the tax-disadvantaged blue states don't help, either—last year, California and New York contributed more than 26% of Realogy's company-wide adjusted earnings before interest, taxes, depreciation and amortization, according to our estimates.

No surprise, then, that 28.5% of the RLGY free float is sold short, that the share price is lower by 90% since May 2013 or that pessimism infuses the rest of the capital structure, too. Nor are we unqualifiedly optimistic. Bullish on the Realogy $9\frac{3}{8}$s, we take no position on the common stock.

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Realogy is the world's largest franchisor of residential-real-estate brokerage businesses; Century 21, Coldwell Banker and Sotheby's International Realty are three of its leading brands. NRT, formerly National

Realogy Holdings Corp.—in brief
in $ millions*

	2014	2015	2016	2017	2018	TTM
revenue	$5,328	$5,706	$5,810	$6,114	$6,079	$5,964
adjusted Ebitda	779	769	770	732	698	659
operating income	537	558	522	515	406	381
net interest expense	267	231	174	158	190	220
net income	143	184	213	431	137	105
cash from operations	423	588	586	667	394	421
capital expenditures	-71	-84	-87	-99	-105	-104
free cash flow	352	504	499	568	289	317
shares repurchased	0	0	-195	-280	-402	-328
dividends	0	0	-26	-49	-45	-43
total debt (excl. securitizations)	3,910	3,752	3,558	3,386	3,575	3,840
cash and cash equivalents	313	415	274	227	225	243
commission splits	68.4%	68.4%	68.9%	70.6%	72.4%	72.5%

* Except for commission splits.
sources: company reports, the Bloomberg

Realty Trust, the wholly-owned Realogy brokerage sub, is the largest real-estate brokerage business in America, employing some 50,000 agents. Doing business as Cartus, Realogy is likewise the top provider of employee-relocation services in the world ("You've been transferred to Mumbai, Jones—Cartus will see to the details"). Realogy's TRG subsidiary performs title and settlement services.

The essential bear story on Realogy is that the legacy business model is doomed and management can do nothing to save it. However that may be, it's a model that keeps making money—more than enough, we think, to service the 9⅜s. In the trailing 12 months ended March 31, Realogy generated adjusted Ebitda of $659 million, down from $698 million in fiscal 2018, and from $732 million in fiscal 2017. Excluding intercompany transactions, NRT, the company's top money-maker, contributed $350 million, or 57%, of last year's Ebitda grand total. The franchise business chipped in $258 million, Cartus $86 million and TRG $49 million. Corporate overhead subtracted $45 million.

In the 12 months ended March 31, Realogy reported $105 million in net income, a slight drop from the $137 million in fiscal 2018 but a much steeper falloff from the $431 million in 2017—much of the difference from 2017 to 2018 is explained by $32 million more in interest costs owing to the rise in rates and $130 million in taxes.

Free cash flow weighed in at $317 million in the 12 months to March 31, better than the $289 million produced in 2018 but down with a thud from the $568 million in 2017.

The March 31 balance sheet showed $3.8 billion of debt and $243 million of cash. The earliest debt maturity is December 2021 (when $550 million in unsecured notes fall due). Another maturity comes up in February 2023 ($1.1 billion in secured claims). Sell-side analysts forecast $243 million in free cash flow this year (coincidentally identical to the March 31 cash level) and $297 million next year.

It can't be said that capital allocation is Realogy's top excellence. In the 36 months ended in February, management bought $877 million of stock at prices as high as $33.8 a share. Through the journalistic retrospectoscope (the handy device for judging the quality of decisions after the event), it was a huge error. Better to have paid down debt given the looming downshift in earnings and free cash flow and the rise of the VC-funded profitless competition.

We're not the only ones who understand that deleveraging now takes precedence over other potential uses of cash. It's a source of comfort to Realogy's creditors that the 9⅜s have a covenant that prohibits share buybacks until net leverage is less than four times adjusted Ebitda. "Our balance sheet continues to provide us with financial flexibility, and we will prioritize investing in the business and reducing leverage until we achieve leverage below four times," Charlotte Simonelli, Realogy's CFO, told dialers-in on the latest earnings call.

Debt minus cash—net leverage—at the end of March stood at 5.2 times adjusted Ebitda. "It might be a high point," colleague Fabiano Santin speculates, "given that cash generation is seasonally weak in the first quarter."

Additional fine print in Realogy's credit facility nudges the front office in the constructive direction of reducing leverage. For instance, a covenant pertaining to the senior secured debt mandates a leverage ratio below 4.75:1; on March 31, that reading was 3.0 times. Forecast Ebitda after capital expenditures this year would cover interest expense by 2.4 times.

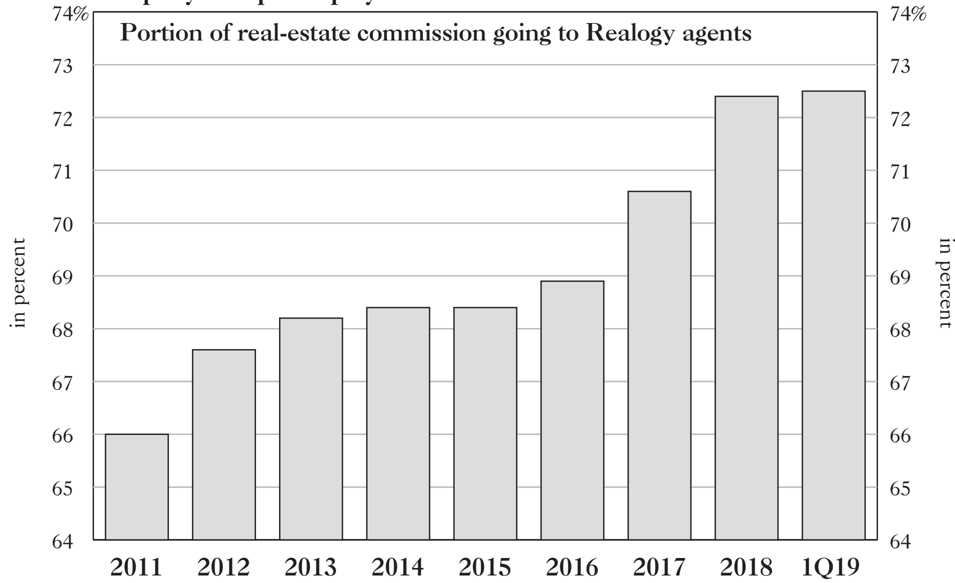
Gross real-estate commissions have long hovered in the neighborhood of 5%. How the funds are apportioned says much about the dynamics of the home-selling business. As a rule, a commission is split down the middle, with the sell-side and buy-side agents each getting 2½%. As to the split between agents and their employers, 70%/30% is customary, but the better agents now command much more. Naturally, the extra increment comes out of the pocket of the stockholders.

In the case of the venture-capital investors in Compass, Inc., the stockholders apparently make no objection to ever steeper commission splits. Indeed, giving away the store today in hopes of building a much bigger store tomorrow is integral to the company's business model (see "Just call it the 'bizzle,'" from the May 17 issue).

On July 30, Compass announced another $370 million infusion of equity (including a contribution from SoftBank Group Corp.) at a $6.4 billion valuation, up from $4.4 billion in September. With the latest round, the newcomer overtook Realogy's $5 billion enterprise value. The still cash-burning unicorn, founded in 2012, deploys some 13,000 agents vs. Realogy's 50,000 in its brokerage business and 142,000 in its franchise business. And while Compass bleeds red ink, Realogy still produces lots of the black kind.

"There's a lot of money and ideas and efforts out there being thrown around to try to disrupt the business," Anthony Paolone, senior analyst and

Employees' peak payout?



source: company reports

co-head of U.S. real-estate stock research at J.P. Morgan, tells Santin. "The traction has been minimal, but that doesn't mean people aren't trying. And if at some point some business model or some people or system were to crack that code, that would be an issue."

Redfin Corp. takes a different approach to creative destruction. A heterodox low-cost real-estate brokerage firm, it seeks to capture property listings by charging the usual 5% commission and then rebating a portion, say 1.5%, to the seller. And rather than keeping commission-only independent agents on staff, Redfin pays its realtors fixed salaries.

Founded in 2004, a birth year it shares with Facebook, Redfin went public in July 2017 at $15 a share. Today's $18 share price looks extravagant in the light of subsequent operating results. Thus, despite the absence of profits—net losses totaled $42 million last year, $191 million in 2017—Redfin's equity market cap stands at $1.7 billion vs. $560 million for Realogy. At last report, Redfin commanded 0.8% of the domestic residential brokerage market compared with Realogy's 16.4%. And Redfin's fixed operating expenses, measured as a share of revenues, tower over those of the incumbent, 34% to 25.5%, according to analysts at credit-research firm CreditSights; the lower the fixed costs as a portion of overall expense, the easier for management to adapt to hard times.

Another variation on the old brokerage theme is the so-called iBuying business model. An algorithm searches for buyers and, lickety-split, finds them; there's no more hassle, only simplicity, or so claim the digital pioneers. Though adaptation to date has been limited, the possibilities for disruption embolden the Realogy bears.

"There's going to be something to stir up here that's probably going to be good for the industry, good for the consumer," Glenn Reynolds, CEO and co-founder of CreditSights, advises Santin. "But the idea that somehow these legacy players with all these [realtors] on the ground, licensed by the state, branded and on the MLS system, are somehow not going to be useful to generate revenue is kind of strange. And I think [that the bearish narrative is] trying to foment fear a little bit, because this thing is under secular pressure and is seeing deteriorating performance, [but] that's different from seeing financial stress. That's a reason to dump [Realogy's] stock. That's not a reason to panic about the ability of them to service their debt.

"If you're a bear on this company, or if you're short," Reynolds goes on, "everything is going to come out under the worst possible scenario. . . . There's only one scenario—if earnings are going down, it's like a plane landing. They won't level off, they won't take action, they'll just crash. The reality is that the company has a lot of free cash flow, they see what they have to do, they just have to execute."

"Realogy's equity market cap trades at 5.3 times 2019 earnings but, given the meaningful leverage, enterprise value is the better measure of value," Santin points out. "The sum of equity plus net debt works out to 8.3 times 2019 adjusted Ebitda. For comparison, food franchise businesses, such as Restaurant Brands International, Inc. and Domino's Pizza, Inc., trade at about 20 times adjusted Ebitda; and hotel franchisors Marriott International, Inc. and Wyndham Hotels & Resorts trade at multiples of 14.7 and 11.8 times, respectively. Certainly, for Realogy, at least some of the bad news must be in the price."

And perhaps the market likewise reflects the margin-diminishing upcreep in the share of commission income apportioned to the agents. "For instance," Santin continues, "the agent's commission share rose to 68.9% in 2016, from 66% in 2011, or by 58 basis points a year. Coincidentally or otherwise, with the arrival of Compass in 2014, the trend accelerated with a 170 basis-point hike in 2017 and a 180 basis-point jump last year. But with Realogy now paying agents 72% of commissions for the quarter ended March 31, up only 46 basis points from a year ago, the uptrend might have run its course. Compass is said to have lured realtors with a 100% commission payout in the first year, followed by a 95% one in several succeeding years."

There's no love lost between Realogy and Compass. The former sued the latter on July 10, charging theft of proprietary information from its computer systems. A second allegation holds that Compass's co-founder and CEO, Robert Reffkin, "personally solicited Realogy to enter into an illegal price-fixing agreement where the two companies would agree to limit agent compensation and 'compete on brand,' but not on price." Just maybe the business stratagem of giving away the store is losing its allure.

Interestingly, Realogy has been holding its own in transaction volume, moving to 16.4% in 2018 from 16.0% seven years earlier. A decline in house prices and sales volume would be hard on everyone, but Realogy is arguably better armed for bad times than the small fry, especially the profitless ones.

"Then, too," Satin observes, "notwithstanding all the tech investment in real estate, including the so-called iBuying algorithms, people still use human beings as intermediaries to buy homes. Perhaps the human element becomes more important when a 15% down payment is de rigueur, as it is in many market segments today. Data from the National Association of Realtors shows that 87% of home buyers used a real-estate agent in 2018, up from 77% in 2004."

"The thing about real estate that is different from a lot of other businesses is that every property is absolutely unique," comments Paul Evans, founder and CEO of real-estate data firm REsource Analytix. "If you have a commodity kind of thing like insurance, or a travel agency, the disintermediation part of it is pretty straightforward because the service being provided is relatively easy to generalize and commoditize. The thing with properties is that a) they are unique, and b) they are all freaking complicated. There is location, quality of construction, zoning, condition, fixtures, etc. They're pretty far away from being commodities."

The second half of calendar 2018 saw a 7.4% drop in the sales of "existing," or previously owned, homes, perhaps on account of the relatively high prevailing 4.57% average 30-year mortgage rate. Today's 3.87% average rate may work no miracles, but it presents an attractive comparison to the cost of borrowing a year ago.

In a pinch, Realogy has an asset that could facilitate a faster pace of deleveraging. This is the aforementioned Cartus unit, which generated $86 million in adjusted Ebitda last year.

Glenn Reynolds and his CreditSights colleague Nathan Wenger speculate that Cartus could fetch an enterprise multiple greater than that of Realogy itself. At 10 times adjusted Ebitda, for instance, Cartus would be worth $860 million, a figure which could cut net debt by a quarter.

Although Bloomberg has yet to create a tracking function for credit-analyst recommendations (the CreditSights analysts assign the 9⅜s of 2027 the rating of "outperform"), the bearish sentiment surrounding Realogy is stamped on the common stock. Of the eight analysts on the Realogy case, two say sell, six hold and none buy. Insiders, though, make a bullish case in deeds, if not in words, having snapped up $1.4 million in shares over the past 12 months, including CEO Ryan Schneider's purchase of roughly $1 million's worth in May, when the share price was 68% higher.

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