CHAPTER

1

Finances

Boosting Your Bottom Line

QUICK TIPS

Double up associates.

Add rookies.

Toughen criteria for higher splits.

Give associates more responsibility for ads—on both content and cost.

Diversify income streams.

Gene Ward, CRS®, added 15 associates in two years without expanding his office space. How'd he do it? The managing broker of the Lincolnshire office of Woods Bros. Realty in Lincoln, Nebraska, puts two, sometimes three, associates into a single office and also doubles them up in cubicles.

Cozy quarters wasn't the most popular move among the sales force, which numbered 130 at the time, but no one has left in search of solitude, he says. That's because he's made it clear to his associates that such cost-cutting is crucial for his office's survival in today's environment of rising business costs. And now, Ward says, he has the largest real estate office in his market.

At a time when sales associates are demanding greater commission splits and technology and marketing costs are eating more of the company dollar, brokers and managers are embarking on a variety of strategies to grow their profitability. Among other things, they're adding services to boost revenue and shifting more costs to associates. Some are also recruiting rookies to push down the average commission split they pay their associates.

"Our business is so competitive today and has so many more costs than it did years ago that you have to continually evaluate your operations to stay profitable," says Nancy Kinney, GRI, manager of Real Living Premier in Marion, Ohio.

The rise in the average commission split for veteran associates is at a crisis level in many markets, say some brokers and managers.

Years ago, the typical split for veteran associates was 60 percent to 65 percent of commissions. Today it's not unusual for associates to quickly earn 80 percent or more—sometimes as much as 95 percent. "Associates make a lot of money; brokers don't," says Ronda Needham, CRB, who oversees the Highland Park office of Ebby Halliday, REALTORS® in Dallas.

To combat the problem, Needham's company makes generous splits something to strive for, not a given. Most new associates start with a 50–50 split, but once they bring in $87,000 in gross commissions their split grows to 80 percent. The split increases to 90 percent once they bring in gross commissions of $260,000. Reaching that level is a reasonable challenge, Needham says, because the average sale price in her market is $583,000.

Chris Harris, GRI, who in 2004 oversaw the main office of Keystone Realty in Reno, Nevada, used a similar strategy for keeping splits down. He scouted real estate schools with the express purpose of affiliating rookie salespeople and quickly brought on 25 new associates at a 55–45 split. Veteran associates received an 80 percent split once they brought in $50,000 in gross commissions.

The result? An immediate jump in the company dollar, from about 22 percent to 27 percent, Harris says. He estimated that the lower commission splits of new recruits more than compensated for the fewer sales they generated and the added training and other costs they incurred. At the same time, given the strong market during that period, even newbies were quickly generating robust sales, as well as showing a lot of loyalty. "The new licensees appreciated what the brokerage was doing for them in terms of training and potential for greater splits," Harris said. "We lost few people."

Harris is now a broker with Coldwell Banker Village Realty in Reno.

Cost Cutting

Ebby Halliday's Needham is pleased to see associates reach the upper ranks of her tiered commission structure, because it shows they're performing well. But to keep costs down, she shifts some key expenses, including most property advertising, to associates, no matter at what level they're performing.

Her associates are generally amenable to absorbing the ad costs, because "they'd rather have the opportunity to make choices in how their properties are advertised," she says.

What's more, the company uses its big size to negotiate favorable rates for graphics work, so associates can get professionally designed materials at a discount. Plus, her office saves by not having to hire staff to create ads or stock paper. Needham estimates she'll save at least $35,000 annually by contracting with a design company rather than hiring someone to do it.

Kinney of Marion, Ohio, says she practices the meticulous art of analyzing her business—where her sales come from and where her expenses go—to better calibrate her costs. For example, within the past year she's pulled significant amounts of money out of newspaper advertising and plowed it into Internet and cable TV advertising, because those sources were generating more efficient uses of her ad dollars than newspapers.

"We're paying $14 a week for each house we show on a local cable channel. That represents 1,200 potential viewers of the listing a day and our biggest value," she says. "A lot of people in our market shop for houses on cable."

Expand Your Interests

Cost-cutting is an obvious source of increased profits, but many companies are looking at the revenue side, too, diversifying their services to reduce their reliance on sales as their main income source.

Ancillary services account for 28 percent of Realty Executives of Phoenix's bottom line, says John Foltz, CRB, president. Specifically, the company generates revenue through mortgage and title services, even though it doesn't own the providers. Instead, it works through affiliated business arrangements with partners and takes a percentage of their net revenues. "That way we don't have to become experts in mortgage and title services," says Foltz. His company generates gross annual sales of some $5 billion and 30,000 transactions in 17 offices.

Long & Foster Real Estate, the mid-Atlantic regional giant headquartered in Fairfax, Virginia, takes a different approach to ancillary services. The company, which has about 10,600 associates in 200 offices in eight states and Washington, D.C., owns a mortgage company with Wells Fargo, the banking giant. The income adds "a lot" to Long & Foster's bottom line, says Wes Foster, president.

Foster's company also partners with a title company and owns an insurance business, both of which add some but not a huge amount to company revenue.

For big companies such as Realty Executives of Phoenix and Long & Foster, offering ancillary services is largely beyond debate. Consumers have come to expect large real estate companies to offer something close to one-stop shopping. But adding ancillary services can pay off for smaller companies, too.

Kerry Veach, broker-owner of RE/MAX Southern Realty, a three-office brokerage in Fort Walton Beach, Florida, launched a title company two years ago. The move is paying off well, generating about 10 percent of his company's bottom line this past year, he says.

Associates can buy stock in the title company in amounts based on the volume of sales they generate, giving them a stake in the affiliate's performance. The title service has about a 40 percent capture rate of the sales the associates bring in.

For the smallest brokerages, ancillary services may not be in the cards, unless they partner with an affiliated business. And even then small brokers may just prefer to stay focused on brokerage services. "I've been approached with opportunities to add services over the years, but I like to keep my operation as simple as possible," says Lydia A. Odle, broker-owner of Lydia A. Odle, REALTOR®, in Alexandria, Virginia, with 11 sales associates.

Whether you're running a one-stop shop or a boutique that focuses exclusively on brokerage, boosting profits requires constant vigilance over your operations. Analyzing every expense and every potential new revenue source is the surest path to greater profits.

—Robert Freedman, with additional reporting by Pat Taylor. This piece originally appeared in the July 2003 issue of REALTOR® Magazine.

SIX SMALL WAYS TO ACHIEVE BIG PROFITS

How are brokers and managers maintaining a healthy income? Here are a few ideas.

1. *Float commissions.* Every day John Foltz of Realty Executives of Phoenix deposits funds used to pay commissions into an interest-bearing account. That way, the funds draw interest between the time a commission check is written and the associate cashes the check. The practice contributes five percent to his company's bottom line.
2. *Balance your associate mix.* Nancy Kinney, GRI, manager of Real Living Premier in Marion, Ohio, says concentrating on a niche market can gain you visibility in that market. But it can be risky to your cash flow if sales in the niche take a turn for the worse. Affiliate associates whose market specialties fill gaps in your ranks. Several strong associates working middle-market sales can keep your cash flow strong, while a few strong performers in high-end homes can generate nice profits.
3. *Purchase advertising, such as classified space, in bulk to obtain price discounts.* Parcel out the costs with a small markup to associates who advertise their listings in the ads. Foltz's company charges his associates $5.50 per line, a nominal increase over the bulk rate the company receives.
4. *Charge consumers a set transaction fee.* It helps offset administrative costs per transaction, says Wes Foster of Long & Foster Real Estate in Fairfax, Virginia. "It's rare that consumers don't pay the fee," he says. But if they don't, the company and salesperson share the cost.
5. *Manage risk.* Apply tough, standardized quality control measures to each transaction to reduce liability and costs for E&O insurance and litigation, suggests Foltz. His company maintains a staff of three who review

every purchase contract to ensure all disclosures and other requirements are met.

6. *Charge online referral fees*. Foltz charges $800 to associates who receive qualified leads from the company's web site. The fee applies only to leads generated from houses not listed by the company but made available for viewing on its Internet Data Exchange (IDX)-enabled web site, and salespeople pay only if the deal closes and they receive a commission.

MORE ONLINE

Brokerage Financial Management Courses

The Council of Real Estate Brokerage (CRB) Managers, an affiliate of the National Association of REALTORS®, offers a two-day financial management and planning course that provides help understanding financial statements, forecasting revenues, and developing an expense budget, among other finance areas. Learn about this and other CRB financial management courses, including instruction online and on CD-ROM, at the CRB web site, www.crb.com. You'll find information on the group's courses under "Education."

Taking Control of Your Accounting

QUICK TIPS

Digitalize your bookkeeping.

Stay abreast of ever-changing business tax deductions.

Know which IRS business-entity structure makes sense.

Orson Woodhouse, GRI, broker-owner of Woodhouse Group in Boise, Idaho, is paying 50 percent more for accounting services than he was at the end of 2002. He couldn't be happier.

That's because he replaced his old accounting firm with one that brings real estate and small-business experience to the table. His experience shows how critical it is to understand the ways accounting and tax issues can impact your bottom line.

The new firm proved its worth quickly by saving Woodhouse money on his taxes and creating more efficiency in his operations. "I didn't have a bad experience with my old firm," says Woodhouse, whose company specializes in new-home sales and relocation. "It just wasn't leading-edge in our industry."

Right off the bat, the new firm—Balukoff, Lindstrom & Co., in Boise—replaced Woodhouse's manual bookkeeping system with QuickBooks, which enables the brokerage to tabulate everything electronically, then e-mail quarterly and annual reports to the accounting firm. When there's a problem, the electronic system makes it easy to make changes. "We've seen a fivefold increase in bookkeeping efficiency," Woodhouse says.

The accounting firm also recommended changes in how Woodhouse categorizes expenses, saving him money on his 2002 taxes. Among other things, it recommended that Woodhouse take advantage of tax laws favorable to real estate professionals for income-property investment losses. "Practitioners can write off 100 percent of their income-property losses, an option not open to passive investors," says Michael Lindstrom, who was president of Balukoff when it worked with Woodhouse. Lindstrom is now a tax partner with Eide Bailly LLC.

The firm also recommended strategies that make sense for brokerages with independent contractors and a handful of employees. Among them:

Asset growth. Changes to federal deduction laws enacted a couple of years ago enable business owners to deduct $100,000 a year, up from $24,000, on business assets such as software. "We recommended that Woodhouse spend money on assets rather than pay taxes," says Lindstrom.

Family savings. Federal laws provide favorable tax treatment for employing family members to do odd jobs such as post For Sale signs. A certain amount of compensation to family members isn't subject to payroll tax. And children's income is typically taxed at a lower rate. At Woodhouse Group, Woodhouse's wife keeps the company books.

Large vehicle deduction. A business car weighing more than 6,000 pounds can be written off, although tax-law changes enacted in 2004 place new limits on depreciation amounts.

An accounting firm also can advise on how to structure your business entity, whether as an S, C, or limited-liability corporation. Each has advantages under certain conditions, and owners can change their structure as company goals change. (See "Match Company Structure to Your Goals.")

So, how do you pick the right accounting firm? Woodhouse assembled leads by talking to colleagues in his market. He interviewed five companies before settling on Balukoff. "You can always find someone who can get your taxes done correctly," he says. "It's worth it to pay more for someone who has your long-term health in mind."

—Robert Freedman. This article originally appeared in the November 2003 issue of REALTOR® Magazine.

MATCH COMPANY STRUCTURE TO YOUR GOALS

Here are three examples of how to structure your business to respond to your company's changing goals, according to Michael Lindstrom, a tax partner with Eide Bailly LLC, Boise, Idaho. For specific advice, consult an accountant.

C *Corporation*

Advantage: Put yourself on a salary and get 100 percent of employee medical insurance costs deducted from your taxes. Helpful if anticipating high medical bills.

Disadvantage: May be expensive if there are more than a few employees.

Limited-Liability Corporation

Advantage: Maximize retirement benefits up to a certain point.

Disadvantage: Benefits are limited if the owner reaches $200,000 in income. In these cases, it may make sense to adopt an S corporation structure.

S Corporation

Advantage: Get favorable payroll-tax treatment.

Disadvantage: Lose out on the ability to fund retirement plans.

MORE ONLINE

Finding an Accountant

The National Association of Small Business Accountants maintains a database of member accountants, searchable by state, on its web site, www.smallbizaccountants.com. Before you select an accountant, the association recommends you check first about the types of businesses they specialize in, the accounting services they provide, and the amount of experience they have. The database is under "Find an Accountant."

Preparing for a Financial Turn for the Worse

In the college town of Amherst, Massachusetts, where the tide of real estate business ebbs and flows with the rhythm of the academic calendar, a broker's finances can sometimes be as barren as a New England winter. Between September and February, area home sales tend to drop by half, a major hit to brokers' bottom line, says Gerald L. Jones, CRB, GRI, broker-owner of Jones Town & Country Realty in Amherst.

To make sure his company is financially prepared to weather the annual fall-off in business, Jones:

Keeps higher amounts of working capital on hand than would otherwise be necessary. How? By making fewer draws for profit-taking or profit-sharing during the flush months. That way, in lean months, there's money available to cover costs, including profit-taking and profit-sharing.

Pays a year's premium for errors and omissions insurance in an upfront lump sum. You can negotiate a better rate that way, he says.

Buys (in cash) rather than leases some office equipment, such as copiers and the phone system.

Sets up a company line of credit during flush periods, when the money isn't needed, to handle unexpected costs, rather than waiting until lean months. The timing puts you in a better position for shopping around and negotiating the terms. "It's just a matter of living below your means rather than to the maximum of your means," says Jones, whose three-office company has 75 associates.

Even if your company doesn't face the sales extremes of a college town, preparing your bottom line to absorb unexpected hits is crucial for long-term viability.

Alan Mauldin, GRI, and Michelle Mauldin, CRS®, GRI, co-owners of Signature Realty in Edmond, Oklahoma, were surprised in 2002 to find that they faced a 100 percent increase in E&O insurance. They'd had no prior claims, but in the three years since they'd locked in a contract term, their sales volume had increased 65 percent. The Mauldins have been finding savings in other areas:

Health insurance. They took out a policy with a maximum $5,000 deductible and maintain a health savings account to pay for costs incurred up to the deductible. That has saved them hundreds in monthly insurance premiums while allowing them to build up a savings account that's exempt from federal income taxes.

Vendor costs. They've reduced their advertising costs with local print publications 20 percent to 25 percent, for example, by leveraging the volume of business they give the publications.

Other tips from brokers include:

Own your office and lease it back to your company. You build your equity while locking in your lease payments. My company is a Subchapter S corporation. An LLC owns the real estate itself.

Reed Simmons, CRB, broker-owner,
Dickson Realty Inc., Reno, Nevada

Accumulate reserves during flush months and make loans to yourself to cover unexpected costs or capital projects.

William D. Seawell Jr., CRS®, GRI, broker-owner,
Seawell, REALTORS®, Greensboro, North Carolina

Face it: Real estate business income is in constant flux. But a few simple moves may be all you need to prepare your company's bottom line for those financial cold spells.

—Robert Freedman. This article originally appeared in the August 2004 issue of REALTOR® Magazine.

Calculating Associate Compensation— The New Rules

QUICK TIPS

Separate fixed from variable office costs.

Calculate amount each associate adds to variable costs.

Match splits to costs.

Factor in costs of teams, personal assistants.

Don't overpay for top performers.

Janice Grupido, CRB, GRI, would like to rely on a little less art and a little more science in setting compensation plans each year for the dozens of associates who work in her offices in the Troy and Rochester areas of Michigan. Ideally, the broker-owner of Countryside GMAC Real Estate would look at what each salesperson consumes in brokerage resources to generate revenue.

That's a challenging thing to do. Yet, it's becoming more important as brokers look more to treating each sales associate as a separate profit center, each of whom comes with a unique set of costs and an ability to generate revenue.

"Start with a view that each associate operates as an individual company; then you try to determine if each individual generates more revenue than it costs to keep the person on board," says David Cocks, managing partner of Charlotte, North Carolina-based Compensation-Master, a consultant on real estate brokerage compensation plans.

That approach differs from what's done typically in residential real estate brokerages, where setting compensation plans requires a bit of alchemy—part art, part science. For the most part, brokers apply a desk-cost approach that might be likened to the way a manufacturer sets the price of a product based on its per-unit production costs. If each unit costs $1 to manufacture, then to earn a profit the manufacturer must charge something above $1 for each unit.

That's more or less the approach taken by Shorewest, REALTORS®, an 18-office independent brokerage based in Brookfield, Wisconsin—although what goes into the calculation is more complex. "All of our costs are divided by the number of desks," says Rick Murry, CRB, GRI, sales director. "That's how we establish the minimum income we need."

In taking this approach, brokers isolate their fixed costs and then peg commission splits to the amount of variable costs associates are responsible for. In general, the more variable costs covered by the broker, the bigger the broker's share of the commission split.

Thus, you often see brokers splitting commissions on something close to a 50–50 basis at the beginning of the year, then raising that split once associates' revenue covers their share of fixed costs and they can assume responsibility for more of their variable costs.

Looking Closer at Associate Costs

Treating each associate as a separate profit center goes beyond the desk-cost approach by identifying variable as well as fixed costs.

Although zeroing in on precise amounts is difficult, brokers aren't entirely in the dark about what their associates cost them.

Marian Benton, GRI, operating principal of Keller Williams Realty in Ann Arbor, Michigan, says she needs to generate $18,000 each from at least a third of her 176 associates to ensure her fixed costs are covered. "We look at rent, overhead, leased equipment—everything—to see how much money we need to break even," says Benton.

To create an income cushion, she sets her annual budget assuming that one-third will earn enough in gross commissions to meet the $18,000 in commission splits to the company, the splits of another third will reach about half that, and the splits of the remaining third—mainly newer associates—will reach a few thousand dollars.

The splits to the brokerage are set annually as a percentage of gross commission income (GCI), and there's flexibility in how the percentage is set. Many associates take a 70 percent split until the 30 percent contribution to the broker equates to $18,000. Once that happens, they get 100 percent of their commissions. They may also opt for a higher, 80–20, split up front in exchange for guaranteeing the $18,000 to the brokerage before the end of the calendar year. On top of the $18,000, each associate pays a franchise fee, which is capped at $3,000.

Unlike offices in many other real estate companies, though, Benton doesn't need to worry too much about the amount of variable costs generated by her associates. In the Keller Williams model associates mostly pay variable costs themselves, even making spending decisions collectively through a salesperson council. The council works with the broker to determine the services it wants and how to allocate the costs among the ranks. "If they want a color copier or an extra fax line, they can have those, but they pay for those types of costs," she says.

Getting the commission split right becomes more important when the broker pays all or a portion of associates' variable costs. Those are harder to peg to individual associates than fixed costs, which can simply be allocated on a per-person basis.

At the same time, brokers can face market pressures on where to set commission splits, and those pressures can lead to split levels that won't necessarily accord with what makes sense for your company.

"If every other broker in your area is offering associates a 90 percent split, you must consider offering a 90 percent split, whether or not that makes sense from a cost standpoint," says Grupido. "About five years ago, we had a 50–50 split that graduated up to 80 percent depending on volume; then there was a big push in the market to drive that up, and that push still hasn't dissipated," she says. "Now associates can get up to 90 percent." But she's not bringing in new people at that split; they have to work for it.

Identifying Actual Costs

Getting compensation right becomes particularly important when associates seek help from brokers on big-ticket items, such as personal assistants, or when they have sales teams.

A desk-cost approach to compensating associates with a personal assistant can miss the mark, even if the associates pay the assistants from their share of commissions, because of the way the assistants raise costs to the brokerage.

"The associates may say the assistants don't cost the broker any more, but those assistants need to have a phone line and they use other services," says Cocks. "In the accounting department, someone has to cut them a check, and the broker is still responsible for them, even though they're working under other associates."

Costs from personal assistants can be even more of an issue if an associate taps a less-productive associate in the office to be the assistant. That's because the broker's increased commissions from the associate with the assistant might not be enough to compensate for the loss of the commission from the low producer.

"If the low producer is doing $12,000 in gross commissions a year and is paying the broker a 50–50 split, that's $6,000 you would need to recover if that person goes to work for another associate," says Cocks. And that may not be that easy to do. "If the other associate is on an 80–20 split, that person would have to generate much more business from the assistant than $12,000 for the broker to recover the $6,000."

Match Splits to Costs

When it comes to top producers, splits can require even more finesse.

To be sure, the large volume that top producers generate can help a brokerage in many ways, including intangibles such as the increased visibility that comes from getting more signage out into the market. Go-getters can also help you up your ancillary income by sending more referrals to, say, your mortgage services. But if splits don't adequately reflect costs, top performers can still be a losing proposition for brokers.

Cocks recounts one case in which a broker gave a highly advantageous split and other perks, including use of a company car, to a top performer. The salesperson in fact brought in tremendous volume, but when the broker analyzed the arrangement, the findings were startling: The brokerage was absorbing a $45,000 annual loss on the person. It wasn't until the broker conducted a detailed accounting review that it became clear the costs of the perks were far more than the company splits the associate generated. It made more sense to let the associate go and bring in other associates, at lower splits, to replace the lost volume. And that's what the broker did.

Realistic Look at Savings

You need to look carefully at associate savings as well as costs. Clearly, an associate working from home costs a broker less than one occupying office space. But how you price such savings is tricky.

With the exception of lower occupancy costs—maybe a few thousand dollars a year, depending on where the office is and whether the company owns or rents its space—costs tend not to drop, says Cocks. That's because the associates are still big consumers of brokerage resources, and the fixed costs for such services as phone lines and utilities don't change.

Plus, the drain on some resources can increase, such as the time a broker spends supervising. "You're making more calls, sending more e-mail," says Grupido.

Cocks says it's possible for brokers to get a relatively clear picture of what each associate costs them and to customize compensation plans to each associate based on those figures. His company sells a proprietary software program that calculates what each associate generates in variable costs. The company also touts a survey it conducted among a sample of its clients, both 100 percent and commission-split companies, finding broker revenue increasing almost by a third in the first year of implementing compensation plans for associates based on estimates of what those associates cost to maintain.

Some of CompensationMaster's Findings

Average pretax profit: 6.1 percent (not counting ancillary income).

Average company dollar: 39.1 percent.

Average revenue increase: 31.3 percent.

Those are strong figures when pegged against comparable industry figures, Cocks claims. Anecdotally, average company pretax profit industrywide is 2 percent to 3 percent, according to David Colmar, head of Colmar and Associates in Rancho Santa Fe, California, a real estate research firm. Average pretax profit tends to be higher, near 6 percent, for the country's top performing companies, Colmar says.

Limiting brokerage costs to just fixed costs can also produce stronger brokerage profitability.

At Keller Williams, average brokerage share of gross commission income is considerably less than in the 500 largest brokerages in the country—16.8 percent at Keller Williams offices compared with 29.2 percent for other companies—according to David Jenks, vice president of research and development at Keller Williams Realty International, based in Austin, Texas. Jenks compared Keller Williams figures with industry figures compiled by REAL Trends, a residential real estate information provider.

But Jenks says the company's pretax profits are higher because its brokerage expenses are lower. For the 500 largest companies, brokerage costs average 25.7 percent, leaving a 3.5 percent pretax profit. Costs at Keller Williams offices are 9.6 percent of GCI, which leaves a 5 percent pretax profit after 2.2 percent of income is taken off the top for a company profit-sharing program.

The analyses suggest that accounting for variable costs is the key to setting compensation plans that maximize brokerage income. So, whatever mix of art and science you use to set your plans, make sure you have a clear picture of how much your associates cost you.

—Robert Freedman. This article originally appeared in the January 2004 issue of REALTOR® Magazine.

MORE ONLINE

Latest Thinking on Compensation Planning

The National Association of REALTORS®' Information Central maintains a field guide on compensation plans that includes links to more than a dozen articles and books on setting compensation plans for sales professionals. Access to some of the material requires a fee or a site user name and password, available only to NAR members. The field guide is at www.realtor.org, under "Library."

Calculating the Right Compensation Split

A title that's been around for many years is *Compensation Planning: The Key to Profitability*, by David Cocks and Larry Laframboise, 1995, of CompensationMaster. Originally published by the Council of Real Estate Brokerage Managers, an affiliate of the National Association of REALTORS®, the book is now available as a PDF file online at the web site of CompensationMaster, www.compensationmasterusa.com, under "Resources."