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PRESENTATION

Operator

Good day, and welcome to the Redfin Corporation Second Quarter 2019 Earnings Call. Today's conference is being recorded.

At this time, I would like to turn the conference over to Elena Perron. Please go ahead, ma'am.

Elena Perron - *Redfin Corporation - Head of IR*

Thank you, Brad. Good afternoon, and welcome to Redfin's financial results conference call for the second quarter ended June 30, 2019. Joining me on the call today are Glenn Kelman, our CEO; and Chris Nielsen, our CFO. You can find the press release on our website at investors.redfin.com.

Before we start, note that some of our statements on today's call are forward-looking. We believe our assumptions and expectations related to these forward-looking statements are reasonable, but our actual results may turn out to be materially different. Please read and consider the risk factors in our SEC filings, together with the content of today's call. Any forward-looking statements are based on our assumptions today, and we don't undertake to update these statements in light of new information or future events.

During this call, the financial metrics will be presented on a GAAP basis and include stock-based compensation as well as depreciation and amortization expenses. In the event we discuss any non-GAAP measures today, we will post the most comparable GAAP measure and a reconciliation on our website. All comparisons made in the course of this call are against the same period in the prior year unless otherwise stated.

With that, let me turn the call over to Glenn.

Glenn Kelman - *Redfin Corporation - President, CEO & Director*

Thanks, Elena, and hi, everyone.

Redfin's second quarter revenues were better than we projected in our last earnings call, up 39% from the second quarter of 2018 to $197.8 million. Our losses at $12.6 million were near the middle of the range we projected in May. In the second quarter of 2018, we are in the $3.2 million profit. But in 2019, we're advertising more and investing more in software for new businesses.

In our core business of brokering home sales through Redfin agents and through other firms' agents working as our partners, revenues increased 17% year-over-year, an acceleration from last quarter's growth of 15% and the preceding quarter's growth of 13%.

Our share gains continued with an 11 basis point gain from the second quarter of 2018 to the second quarter of 2019. This is an acceleration from the 10 basis point gains we saw in the preceding 2 quarters.

RedfinNow, our business of buying and selling homes on our own account, grew revenues from $9 million in the second quarter of 2018 to $39.9 million in the second quarter of 2019. Over that same time, our other businesses, primarily mortgage and title services, grew 89%, an acceleration from last quarter's growth rate of 59%.

Up until now, Redfin has taken a deliberate approach in expanding our new businesses. RedfinNow started in 2017 and is available in 8 of our 92 markets. Our title business started in 2012 and still only serves 23 markets. Redfin Mortgage started in 2017 and now serves 40 markets. Now each is in a more aggressive phase of market expansion. We expect these businesses, which already contribute meaningfully to revenues today, to contribute meaningful gross profits 3 to 5 years from now.

The Redfin Mortgage and RedfinNow teams spent years building our own systems and processes for making loans and flipping houses. At first, sales in these new businesses went up and down as we experimented with different pricing and figured out which employees to base in the service center or in the field. Our title business bounced back and forth between the red and the black. Our homegrown loan origination software initially limited our productivity because it automated so few tasks. But now upgrades to that system regularly saved Redfin Mortgage employees hours per week, improving margins and pricing power. And though we still have plenty to learn, our new businesses are preparing for more rapid expansion to other markets with strong demand and happy customers.

Our goal is to be the first national provider of a complete real estate solution, which was a major premise of our 2017 public offering. The financial rationale of this strategy is obvious. If we make more money per customer than any other real estate company, we can spend more than any other company on finding and serving that customer. But we also believe that listing search, brokerage service, mortgage, title, instant offers and renovations are more than the sum of their parts and that we can, over time, combine these services in ways that let our customers buy and sell homes other people can't.

For starters, each new step in the buying process where we can save customers money adds up to more customer buying power. Beyond that, the thesis behind Mortgage and RedfinNow is to give our customers access to capital more quickly than others can. We believe that our renovations capabilities can one day transform listings nobody wants into one anybody would want. The homes listed by Redfin agents are already being promoted on our site directly to buyers in 2 markets, creating a more efficient marketplace for a faster sale at top dollar. No one else has worked so long on so many different pieces to this puzzle.

The success of these new businesses is only compounded by accelerating growth in our core brokerage over the last 2 quarters, a trend we expect to continue because of the acceleration in traffic and the increase in brokerage awareness we saw in the first half of 2019 and also because of continued support from repeat customers. Our primary challenge remains offering the on-demand home tours that drive so many homebuyers to give Redfin agents a shot while still investing in the personal service required to help each one succeed. We aren't just trying to improve the quality of the service but also to identify better the customers most likely to buy a home.

We recently analyzed the customers we met in 2018 and their buying activity through June 2019, concluding that improvements to our service have been offset by a decline in the likelihood of our new customers to buy a home at all from any brokerage, not just Redfin. Of the people who signed up for a home tour on redfin.com in 2017, our estimates are that about 1/3 likely bought a home via any brokerage within 6 months. For the customers we met in 2018, this number was 3 to 5 percentage points lower. We believe homebuyers' fits and starts have been an industry-wide trend, unrelated to any changes we made to our site, but instead driven by the housing affordability crisis and a more casual attitude about the services you can order from a phone.

We're still working hard to improve the quality of our home buying service, but we're now also investing more in software to identify the customers most likely to buy a home, based on their browsing history, and their answers to questions about the service they seek and the reasons they may be moving. In a world where some customers want simple property access and others an in-depth relationship with an agent, few other brokers will be able to pair different online customer profiles to different services from an agent.

This improved pairing will nonetheless take a year or more to roll out, which is why we expect homebuyers' success rate to decline again in 2019. In the meantime, we've learned to deal with that decline better. Agent productivity was up 6% in the second quarter over the same quarter last year, driven by an increase in the number of customers each agent serves and a system for assigning the most customers to agents with the best rates of customer engagement. If demand stays reasonably strong, this productivity should continue for the rest of the year.

We're also working hard to improve the quality of our service, building on 2018's programs for meeting customers more often with new incentives and performance standards for our agents. Which, should be fully in place as we start 2020. If and when these efforts increase our homebuyer success rate, we can lift agent productivity further which should have a compounding effect on profits and growth.

Our website and mobile applications continue to be an engine of our growth. Monthly visitors to our website and mobile applications averaged nearly 37 million in the second quarter, an increase of 27% over the same quarter last year. This was a major acceleration compared to the first quarter's 20% year-over-year gain and the 18% gain we saw in the quarter before that. Redfin.com has more than 4x the traffic of the next nearest brokerage competitor. This brings Redfin agents new customers but also new buyers for the homes we've been hired to sell. Our visitor growth will probably moderate some over the next 6 months but some of those gains should still hold up.

Fortunately, Redfin has also made great strides in being recognized as a brokerage, not a website. One of our biggest bets in 2019 has been on mass media ads, which ran in 22 markets through the first 5 months of 2019, 10 for the first time. As in past years, we aren't running ads in the second half of the year when people are less likely to buy or sell homes. The cost to place the ads was nearly $36 million, triple what we spent in 2018. In our last 3 earnings calls, we presented results from running mass media ads in test markets since 2015, showing that the ads are profitable over 3 years, while we also committed to telling about the in-year returns from our 2019 campaign.

The ads have been effective at making homebuyers aware of Redfin and somewhat effective at driving 2019 sales. We measure mass media ad sales impact by comparing new customer growth in markets with and without ads. Demand across Redfin's 92 markets has exceeded our projections, and unsurprisingly, demand has been strongest in the markets where we've advertised. But we expected new customer growth in the markets of mass media ads to outpace the other markets by a modestly wider margin than it actually has so far. This has been almost entirely because of smaller-than-expected gains in the 10 markets getting ads for the first time. In 8 of those 10 markets, at the start of 2019, our market share was below 0.70% and the percentage of homebuyers and sellers who listed us as one of the first 3 real estate brokerages to come to mind was 3% or lower. And it was these 8 markets where the gains in new customers attributable to mass media ads were most likely to fall short of our expectations. The ads were probably less credible with consumers who had never seen our yard signs or heard of our brokerage.

In the past, the magnitude of the customer response has been uneven from year to year but consistent across the years. We thus feel more confident about advertising's long-term impact, especially because of the awareness gains we've seen in mass media markets. In our 10 largest markets, unaided awareness of Redfin as a brokerage increased from 8% last November to 10% in June. And it also increased in nearly every market where the ads ran, from 1% in November to 4% in June for the markets getting mass media for the first time and from 15% to 19% in the markets where we've run ads for the past 5 years. The data on markets getting mass media for the first time excludes Hawaii and Rhode Island, which were too small to yield an accurate sample. The markets that have never gotten mass media ads were stuck at 4% awareness over that span.

We'll continue to compare new customer growth in markets with and without mass media ads but we remain fundamentally confident about advertising. As we've said in past calls, we plan to continue significant ad spending in 2020 and beyond but as a declining percentage of revenue.

What will make our ads most effective is having the most innovative products to advertise. One of these products is Redfin Direct, for unrepresented buyers to buy a Redfin listing via our website without their own agent. We first discussed this with you in our May earnings call after Redfin Direct's March 28 launch in Boston. On July 1, we expanded Direct to Northern Virginia, which led to 15 offers in July, 5 of which have been accepted. This has been a good result especially for our listing customers. In a Redfin Direct sale the homeowner pays a total commission of 2% when the fee typically charged by a traditional broker is 4% to 5% in Boston and 5% or higher in Virginia. Because our agents use our own software to prepare offers for Redfin's brokerage customers, we know how likely buyers are in Virginia or Boston to waive contingencies or pay more than the asking price. We know the average earnest money amount or the customary number of days allowed for an inspection to be completed. This local data never surfaced before to consumers but now embedded in the relevant pages of the Direct offer building tool is what makes it possible for an unrepresented buyer to put together a credible offer using redfin.com. And homebuyers have put our data to good use. Where we expected many of the Direct offers to be ludicrous or half-baked, the Direct offers have in fact been more likely than our brokerage customers offers to be cash offers, with no contingencies. Most Direct offers are within 5% of the asking price.

In the second half of the year, we'll accelerate Direct's expansion to other markets. We'll also begin optimizing the software so that more than 1 in 5 people who start an offer finish one. The percentage of Redfin listings in Boston and Virginia that sell through a Direct buyer is now in the low single digits. But as we systematically improve the offer development tool and begin using our site to educate consumers about self-service, we hope over time to be able to sell 10% of our listings to a Direct buyer.

We've also begun work on self-service property access known as Direct Access. First through the listings we own outright through RedfinNow but eventually for our brokerage clients. Using the Redfin mobile application, would-be buyers can now verify their identity and unlock the door of a Redfin listing. Early returns are promising since we launched Direct Access on June 26, the 15 listings, in our San Diego pilot have averaged over 5 self-service tours a piece. We launched Direct Offers and Direct Access in different markets but over time, the 2 will complement one another with anyone who tours our listing through Direct Access getting a notification to make a Direct Offer. Even better, the money we save the customers who sell their home to an unrepresented buyer will benefit us directly when RedfinNow is the owner of the property. We expect to have all 3 capabilitiesNow, Offers, and Access available in the same market for the first time in the third quarter.

With or without Direct, RedfinNow has continued to grow quickly with second quarter revenues up 344% year-over-year and purchases up more than that. Our entire 3-year experience continues to confirm RedfinNow's foundational premise, that running a brokerage is crucial to competing effectively as an institutional buyer. More than 60% of the homeowners requesting an instant offer are seeking to move up, which creates opportunities for our brokerage and RedfinNow to work together on the sale of one home and the purchase of another. One day, historians will marvel that America entered a period when low inventory and restrictive consumer credit made it nearly impossible for many families to move from one home to another without lenders or the government moving a muscle, but that is what has created today's iBuying market and it favors Redfin's integrated approach. This integration not only benefits customers selling one home in order to buy the next, but also those customers who just want to compare a brokerage sale to a RedfinNow offer. In April, we changed our website to let homeowners ask for a RedfinNow offer and a listing consultation in one meeting, training our listing agents to present the RedfinNow offer. Previously, a separate RedfinNow employee presented the offer in a separate appointment.

Asking the listing agent to present the RedfinNow offer alongside Redfin's listing pitch can lower our cost and let us expand more quickly since Redfin already employs more than 500 sellers agents. It's also better for consumers who can discuss our -- excuse me, who could discuss our cash offer with a local Redfin agent and compare it to the proceeds from listing their home.

Among homeowners comparing RedfinNow to a sale brokered by Redfin, almost 3x as many chose to list with Redfin over taking the cash offer. But what's most important is that more overall choose Redfin in one form or another where we can offer both choices in one meeting.

It's important to offer both choices because these consultations are often competitive. We've been eager to learn this year how we compete on price with other institutional buyers. So far, our sales growth has been strongest in markets with large competitors. We compete against Opendoor and Zillow in Denver, Dallas and Southern California's Inland Empire and with just Opendoor in LA and Austin. Neither Opendoor nor Zillow buy homes in the remaining RedfinNow markets, San Diego and Orange County. What we've learned so far is that each iBuyer's appetite for risk varies so much from home to home and also from market to market, but no one company can consistently pays more than another.

The other measure of our pricing accuracy is our margins. Gross margins were down 1.4 percentage points compared to the second quarter of 2018 but were largely consistent with our expectations. Margins declined as we staffed up our team to buy and renovate the homes we plan to sell in the second half of 2019. We also hired more folks to open new markets faster and to manage the people and programs of a much larger business. Our competitors are getting homes on the market faster. But because we invest more in renovations, our homes sell faster with a smaller percentage unsold after 90 days on the market. Over time, we expect our renovation cost to decline both from efficiency gains but also due to more discipline about the scope of renovations we undertake.

Because we can't expand RedfinNow fast enough to handle iBuying interest from website visitors and brokerage customers alike, we launched an Opendoor partnership this July in Phoenix and Atlanta in which Redfin earns a referral fee for every Opendoor purchase. The 2 companies have worked nicely together so far, and the partnership has been well received by Redfin's agents. Demand has been strong.

Some have asked whether Redfin still plans to complete all out with Opendoor in markets where we overlap. The answer is yes. For years to come, we plan to compete with Opendoor and to remain partners. There's ample precedent to this as Redfin has referred brokerage customers to partner agents at competing firms for more than a decade, generating the referral fees that constitute 5% of this quarter's revenue from real estate services. We send homebuyers to other lenders when Redfin Mortgage doesn't have the best loan for their needs.

We learned long ago that online demand fluctuates due to interest rates and season, acts of God and Google. The only way to give employees and customers alike a consistent Redfin experience is either to pay for idle capacity most of the year or to refer excess demand to a trusted partner like Opendoor. Even when Redfin Now expands to nearly every Opendoor market in the U.S., there will be times when we don't have the money or staff to buy and sell another home, and we hope a partner will take our place.

For now, we're not too worried about the market's up and downs. Even if the overall economy weakens just a bit, housing demand is strong and likely getting stronger. Mortgage rates approached 5% in November 2018 but are now well below 4%, keeping buyers in the market at a time last year when they were headed for the exits. The number of homes for sale began declining in mid-June for the first time since August 2018. So as sellers' see prices rising, more will likely venture on to the market. No one's more of a nervous Nellie about the market than me, but our data shows home sales will be strong in the second half of 2019.

With that, let's dig into Redfin's financial statements with Chris.

Chris Nielsen - *Redfin Corporation - CFO*

Thanks, Glenn.

Our year continued to play out as we expected. We again posted healthy top line trends with second quarter revenue of $198 million, up 39% from last year. Real estate services revenue, which includes our brokerage and partner businesses, grew 17% year-over-year. Brokerage revenue or revenue from home sales closed by our own agents was up 18% on a 20% growth in brokerage transactions.

Brokerage revenue per transaction was down 2% year-over-year reflecting a continued mix shift towards our listing business and lower home price appreciation as compared with the second quarter of 2018. Revenue from our partner agents is down 1% on a 2% increase in partner transactions as we continue to shift our transaction mix more toward our own agents. Revenue per partner transaction was down 3% year-over-year.

The properties segment, which consists of homes sold through our RedfinNow program, generated nearly $40 million in revenue up from $9 million in the second quarter of 2018. In July 2019, to support continued growth and investment in RedfinNow, we put in place an asset-backed credit facility which will provide up to an additional $100 million of borrowing capacity with an initial term of 18 months. We continue to expect that over time more of the capital to buy homes will come from lenders using the homes we purchase as collateral. Going forward with this facility in place, we won't be updating you each quarter as to our RedfinNow capital commitment.

Our other segment, which includes mortgage, title and other services contributed revenue of $5.3 million, a year-over-year increase of 89%.

Total gross profit was $48.3 million, up 7% year-over-year. Real estate services gross margin was 32.2%, down 260 basis points year-over-year primarily driven by a 90 basis point increase in home touring and field costs, a 70 basis point increase in occupancy and office expenses and a 50 basis point increase in listing expenses, each as a percentage of revenue. Properties' gross margin was minus 2.5%, down 140 basis points from a year ago primarily due to an increase in personnel costs including stock-based compensation, as Glenn mentioned.

Other segment had a gross margin of 2.2%, an improvement of 960 basis points from a year ago as our mortgage and title businesses continue to scale. Total operating expenses increased 42% year-over-year and represented 31% of revenue, up from 30% 1 year ago primarily driven by marketing. Marketing expenses increased by 87% year-over-year driven by our brand advertising campaign that ran through May. We do not plan to run any additional brand advertising for the remainder of the year.

Technology and development and general and administrative expenses both grew slower than revenue, increasing by 23% and 15% year-over-year, respectively.

Our net loss including stock-based compensation and depreciation was $12.6 million compared to a $3.2 million net income in the second quarter of 2018. Diluted net loss per common share was $0.14 compared with a $0.04 diluted net income per common share 1 year ago.

Now turning to our financial expectations for the third quarter of 2019. Revenue is expected to be between $223 million and $233 million, representing year-over-year growth between 59% and 66%. We expect our property segment to account for $67 million to $72 million of that revenue.

We don't typically provide guidance on gross margin components because those are subject to a variety of business and market factors, but we wanted to comment on what we expect for real estate services gross margin in the third quarter of 2019 given the headwinds we've seen so far this year. We anticipate that agent productivity will continue to increase year-over-year in the third quarter. We believe, however, that third quarter real estate gross margin will be down slightly to flat year-over-year given we're seeing strong touring and other customer activity that may not pull through the revenue during the quarter.

Net income is expected to be between $3.4 million and $6.4 million compared with a $3.5 million net income in the third quarter of 2018.

Our guidance includes approximately $6.6 million of stock-based compensation and $2.5 million of depreciation and amortization. It assumes, among other things, that no additional business acquisitions, investments, restructurings or legal settlements are concluded and that there are no further revisions to stock-based compensation estimates.

And with that, we will open up to your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from Jason Helfstein from Oppenheimer.

Jason Stuart Helfstein - *Oppenheimer & Co. Inc., Research Division - MD and Senior Internet Analyst*

So kind of 2 questions, maybe to dig in a bit more on the Opendoor partnership. I mean it would seem you would kind of save a lot on fixed costs to do that. It totally makes sense why you would still compete in markets -- well, still operate in markets where they -- where you both don't compete. But I guess, anything about that. So the point of getting your agents to present those offers, really like that idea. But again, there's significant cost savings if you partner with Opendoor. So maybe just to kind of rationalize that a bit more because I think people like the idea of the synergy with Opendoor.

And then one of the things that we all struggle with is how to think about margins long-term, and apologize for the long-winded question. You talked about agents' productivity improving. How are you thinking about agent hiring for the rest of the year and maybe into next year? And yet we saw marketing G&A was lower this quarter. Just help us -- give us some more color on your thoughts about how to think about, I don't know, margins into next year and maybe longer term. And if you want to give us color by business line, that would be even better but I'll stop there. That was a lot.

Glenn Kelman - *Redfin Corporation - President, CEO & Director*

Jason, we always laugh because the operator says one question and then you immediately say only 2 questions, but they're both good ones. So first of all, the Opendoor partnership is not a replacement for RedfinNow in any market. And the reason it is and it's because there's too much demand for that business to let us outsource it to anyone else. We want to understand it better. We want to own that inventory. We want to be responsible for selling it. We have 14 years of history selling homes better than anyone else. We think we can build a better marketplace for those listings if we own those listings. So there's plenty of good vibes between the 2 companies. We really like one another, and we know that we're going to need one another for a long time to come, but we got to be in this property's business. So we're making a long-term commitment to that business because it's so strategic and because it works so well with all the other pieces of the puzzle.

And I can't even believe you started trying to get us to talk about 2020 because you know that we avoid forward-looking guidance like crazy. We are happy with the increase in agent productivity but we're also seeing significant increases in demand. We are not ready to talk about how many agents we're going to hire in the fourth quarter of this year or the first quarter of next year to prepare for 2020 just because we don't see how much demand there will be next year and because we just want to avoid forward-looking guidance on this call.

Chris Nielsen - *Redfin Corporation - CFO*

Just one other color commentary piece related to marketing expenses is that in the second half of the year, on a year-over-year basis, those marketing expenses will not be increasing significantly. We talked a little bit earlier about the fact that we won't be running off-line advertising in the second half of the year, and so we provided just that one additional piece of information that's related to marketing.

Operator

Our next question comes from Mark Mahaney from RBC.

Mark Stephen F. Mahaney - *RBC Capital Markets, LLC, Research Division - MD and Analyst*

I think I counted 3 questions by Jason, so I'm going to do 3 questions, too. Glenn, big picture. What percentage of homes in 10 years do you think will be bought via iBuying? Secondly, I got the point about the what, that you're not going to grow brand advertising in the back half of the year, but did you explain the why? It seems like that was relatively successful for you in terms of traffic. You gave a couple of really good brand awareness data points. So why not in the back half of the year? Is that just purely for seasonal reasons? And third is can you just talk about the attach rate you think you could get for these things like title and insurance or that you're seeing in your best markets? What percentage of sales do you think have you been able to attach those services or customers have wanted those services attached and so we could think about how big that opportunity could be long term?

Glenn Kelman - *Redfin Corporation - President, CEO & Director*

Wow, that was fast. Well done, Mark. In rapid fire, I think it's between 10% and 20% of all sales will be through iBuying, but that is a wild guess in part because we don't know what the cost of capital will be. It is such an ahistorical cost of capital today that has created this market. Middle Eastern money, Far East money, there's all sorts of capital coming in at almost no cost. So we can easily provide liquidity to a consumer who has no other way to get it. I'm not sure that will always be the case. So we need to see the margins of this business settle out and understand the true cost to the consumer because right now there's so much money being thrown around but it's hard to say what the value proposition will be 2 years from now, let alone 10. As for no brand advertising in 2019, for the remainder, it is seasonal. You pay a lot to advertise in Q4 especially because there's so much holiday shopping, and people forget the ads that you ran when the home buying season comes around in the next year. I would comment that we think most of our traffic growth is unrelated to advertising because the ads focus so much on the brokerage but also because we don't see significant traffic lift in the markets that run ads. It is a broader phenomenon than that.

And then the final question was about attach rate for title and mortgage. We feel a little cagey about that. But I would think of them separately because title is something where consumers have almost no preference. They don't do much price shopping. We do offer the best deal, of course, because of our consumer advocacy so we think that attach rates can be above 50%. Whereas mortgage, it really depends on how efficient we can get because we have to compete on price. We've seen encouraging results there but nowhere near 50% for mortgage and none of our models have that big dent.

Operator

Our next question comes from Brent Thill with Jefferies.

Alexander Joseph Giaimo - *Jefferies LLC, Research Division - Equity Analyst*

This Alex Giaimo on for Brent. Just on the market share gains in the quarter, anything specific to call out as to what drove the acceleration there? Is it mostly driven by the marketing campaign or maybe an improvement in agent efficiency? And then Glenn, just wanted to get your thoughts on the recent partnership between Amazon and Realogy. Whether you think that signifies a bigger push by Amazon into real estate, maybe how those dynamics might play out.

Glenn Kelman - *Redfin Corporation - President, CEO & Director*

Sure. I don't think our market share gains are driven by agent efficiency. I think they're driven by increased demand. So we're having more people come to our website and more of those people signing up for home tours. The only challenge we really have is getting them to stick with the brokerage and buy a house because there's an affordability crisis -- because people just hit a button on their phone and see a property without thinking a thing of it. So the market share gain just has to do with our increasing presence online and an increasing affinity for the service. I wouldn't attribute much to mass media. It's sort of like a Delayed Blast Fireball, if you've ever played Dungeons & Dragons. We get more of the benefit in following years. We get some now, but really there was just a very broad lift in mass media markets and outside those markets.

As for the Amazon and Realogy deal, nobody is more afraid of Amazon than me. I mean those guys are animals. But what they're doing here, I'm not sure is a really serious move into the real estate market. They're giving away merchandise that some people will want but some people won't care much about. I don't think a senior executive was really involved in that deal. I don't think they're a major demand channel for people seeking real estate services. You see deals like this from USAA and Costco who are big retailers or insurance companies say, "We'll save you a few bucks if you sign up for a real estate agent through us." And I see this deal as similar to that. If Amazon were to get out of putting goods in boxes and shipping them to your doorstep to deliver soft services like real estate, I think that would be a different kind of challenge, but it is well outside their strike zone.

Operator

Our next question comes from Heath Terry with Goldman Sachs.

Heath Patrick Terry - *Goldman Sachs Group Inc., Research Division - MD*

I was wondering if you'd give me a sense, as we look at the declines in gross profit this quarter in the core business, any expectation or anything that you can sort of give us in terms of what's driving that, particularly as we see the improvement in agent efficiency. I just feel like those 2 things are potentially a bit counter. And as we look towards the second half, obviously, see the leverage coming out of the changes in marketing spend. But wondering if we should expect to see anything on the gross line as well there.

Chris Nielsen - *Redfin Corporation - CFO*

Sure. So on the gross margin line, if you're looking at the second quarter, the biggest headwind was related to home touring and field costs. And the way to think about that is that we do have a lot of top-of-the-funnel customer demand, people who are interested, in particular, in purchasing homes. That has us incurring an expense to tour those customers through homes. And as Glenn mentioned on the call, we're still not seeing the kind of close rate improvement we would like over time. So incurring the expense with not getting all of the revenue that we would like to over time, and so that's the biggest single headwind that we have in the second quarter as it relates to gross margin, specifically in the real estate services portion of the business.

And then I did provide a little bit of commentary on the call as it relates to what to expect in the third quarter. We do expect to see some of that continued headwind and what we would like investors to think about, in our best view, on the third quarter as the real estate gross margin will be slightly down to flat year-over-year as we get into the third quarter.

Glenn Kelman - *Redfin Corporation - President, CEO & Director*

And I just want to add that there's 2 components to that. And Chris has described the main one, which is that it's harder for people to buy a house. They have to see more properties than they did before and some of them get turned off by the high prices. I think also when you have some acceleration in demand, you're paying it forward where you're paying more for tours in 1 quarter and hoping that it closes in the other quarter, but we want to temper some of those expectations around how many closes we'll get. Usually, we're very happy to pay high touring costs because those chickens are going to come home to roost. It's just that every year we're seeing it get harder and harder especially in coastal cities for people to pull the trigger.

Operator

Our next question comes from John Campbell with Stephens.

John Robert Campbell - *Stephens Inc., Research Division - MD*

Congrats on a great quarter. Glenn, thanks for the updates on Redfin Direct. That seems like one of the kind of more compelling long-term opportunities for you guys. But you made some comments around, I guess, just further expansion. But I'm curious about the pace of expansion and maybe if you could, the 1 or 2 key metrics you guys are kind of tracking on those pilot markets that helped influence or kind of drive the expansion phase?

Glenn Kelman - *Redfin Corporation - President, CEO & Director*

So we think when we can expand this business much more quickly than other businesses because we don't have to hire people to do it. This is technology that can easily scale across the country. We do have to train the system to understand the vagaries of different markets because we have different data sets and different offer forms about whether to include this contingency or that contingency, but we can scale it pretty fast. And all we're looking for is a homeowner who's hired us to sell their house being absolutely thrilled that they got an unrepresented buyer. And therefore, we're able to put more money in their pocket. We have just begun to fight on optimizing the forms. If you've got the 55 question form that you haven't optimized, I guarantee you the drop-off is going to get much better over time. Should I avoid words like guaranteeing future results? Let me temper that. I'm pretty darn confident. Anything can happen, but I just feel like we put something up to see if it would work. We got a better response than we expected. We're scaling it fairly quickly, but at the same time, we're going to go back and put a bunch of data science to figure out exactly where people drop off, what they're getting nervous about and how we can comfort them so that more and more folks feel comfortable buying a house over a website. Not everybody's going to do that. I want to be clear on that point, but more and more people will.

Operator

Our next question comes from Ygal Arounian with Wedbush Securities.

Ygal Arounian - *Wedbush Securities Inc., Research Division - Research Analyst*

I just want to parse into the revenue guidance for the next quarter a little bit. It's up -- the revenue growth is up meaningfully over 2Q. And it looks like the RedfinNow revenue is also stepping up meaningfully. So is it -- is the strength in overall revenue coming more from RedfinNow revenue? Is it -- is this strength from both -- Glenn, you've always given really detailed commentary on the overall market strength or weakness. Maybe just how we could think about where the overall strength is coming from. And then kind of related, as RedfinNow is gaining traction and you're seeing a lot of demand for it, you've talked about being a little more afraid of stepping deep into the iBuyer business. And you've been more measured there, I think, well, most certainly than some of the biggest players. How do you think about that? Are you planning on accelerating that business as we go forward? And particularly as it relates to the Opendoor partnership, if you can accelerate and step into it more or kind of lean back and work the Opendoor partnership as you continue to steadily roll out RedfinNow?

Chris Nielsen - *Redfin Corporation - CFO*

Sure. So this is Chris. With regard to revenue guidance, I really would think about it as 2 pieces. One is the set of businesses excluding RedfinNow. And there -- really, the year's playing out the way we expected it to, which is the contributions from the mass media that Glenn talked about, continued traffic growth. Those things would set up a period of time in the second half of the year where our revenue growth would accelerate, and that's exactly what we're seeing as we're getting to that moment. So we're just really pleased to see things pulling through on that chunk of the business in the way we had planned for it to happen.

And then the second piece as it relates to RedfinNow, Glenn can comment more, but what this reflects in terms of our guidance is the kind of pickup that we're seeing from the combination of having purchased homes and then turned around and put those back on the market where it seems really just across the whole set of markets where we're operating in that business, have seen good customer involvement in both sets of activities, and so that's what's reflected in the numbers.

Glenn Kelman - *Redfin Corporation - President, CEO & Director*

And I just wanted to talk about my attitude or our attitude toward iBuying. As we tried to make clear over the past 6 months, the demand is real and it's very strong. So we are quite committed to this business, but anyone in this business should be scared. And if they aren't scared, you should be scared because we are taking significant capital risk and most of the folks in the space are losing tons of money and you have to have a clear path to profit. So you have to know exactly how scale is going to let you renovate homes more efficiently. You have to know exactly how you're going to be able to market those homes directly to the buyer. And it's hard to pull apart because when you're growing really fast, you're paying forward some of your growth and that limits your margins, but you're also trying to get more efficient. And whenever you're going to get more efficient and grow at the same time, it's just a real challenge. And so we're just trying to be eyes wide open about those risks, and I think that's the way you would want us to be. And what drives me crazy about this space is that almost everybody in the space accounts for their margins differently, which makes it hard for you to give an apples-to-apples comparison of who's really making money and who's losing money and how much money they're losing. That's the reason we invented accounting principles. I wish we would use them more consistently.

Ygal Arounian - *Wedbush Securities Inc., Research Division - Research Analyst*

Okay. But just as a follow-up, as you think about expanding into new markets, do you see the pace of that accelerating as you kind of see the demand pick up?

Glenn Kelman - *Redfin Corporation - President, CEO & Director*

Yes. So we're expanding as fast as we can, that isn't as fast as we would like. And what's limiting this is how operationally intensive the business is. So clearly, being able to use our own sales force from the brokerage to present RedfinNow offers makes it easier to expand faster. We already have 500 listing agents in 50-plus markets, and we're going to put them to work presenting these offers. But there's also a renovations capability that I think is probably the toughest nut for us to crack. We started using third-party software and switched over to homegrown systems so that we can really have someone walk through the property and say exactly what's wrong with it using an iPhone and then have a centralized call center, manage all the vendors who have to get the place fixed up. And just getting that right has been hard, but the primary signal you should have heard from the call, I just probably wasn't as clear about it, is that we're trying to hit the gas on almost all of these businesses. That mortgage was really in purgatory late last year where we couldn't figure out what our margins were going to be and where we should price the product. We couldn't figure out whether to have centralized mortgage advisers or people out in the field. And now we've got good product market fit. With RedfinNow, we really had some questions about margin. We haven't answered all of those but we've answered more and more, and we figured out a really good distribution system through our own agents. So we're going to try to expand more quickly than we have before. And what's going to be gated by -- what's going to be gating it isn't my courage or anything like that but our operational capacity. We know the demand is there.

Operator

(Operator Instructions) Our next question comes from Naved Khan from SunTrust.

Unidentified Analyst

This is Robert on for Naved. Where do you guys think you are in your efforts to optimize lead agent efficiency? To specify, you guys mentioned the benefit of increasing customer loads, but that conversion rates may be negatively impacted. So just how should we be thinking about lead agent efficiency by total transactions? Or any more color on conversion rates would be greatly appreciated.

Glenn Kelman - *Redfin Corporation - President, CEO & Director*

I think we're in the middle of it. I wish we were at the end of it. But in all candor, this is a problem we've been working on for a long time. It affects everyone in the industry, how to take someone off a website who's clicked the button and deliver them into the right home 6 months later efficiently. That's just become the challenge of our times. And we're much better at it, we think, than anyone else, but we still need to get even better because the consumer is changing over the past few years. She's much more fickle, more worried about prices, struggling harder to be able to buy the home but also just more casual about ordering a service where you don't have to pay to get a real estate agent to show up. So I think we're going to be building significant new systems over the next 1.5 years to make that better. That there's some opportunity for leverage in 2020. You've already seen a little bit here with the 6% productivity increase. But we're already thinking about 2021 and 2022. It's a long haul, baby. And I'm really confident that we're going to make progress on this but I don't want you to expect overnight miracles.

Operator

Our next question comes from Tom White with D.A. Davidson.

Thomas Cauthorn White - *D.A. Davidson & Co., Research Division - Senior VP & Senior Research Analyst*

A quick one on guidance and then a bigger picture one for Glenn. So -- well, maybe a question and a half. Just on third quarter net income, the midpoint implies a little increase year-over-year despite, I guess, homes in the properties business kind of ramping up pretty quick. And now it sounds like real estate gross margins are sort of flattish to down maybe a little bit versus your prior expectation of maybe up. So can you maybe just help me kind of bridge what are the other factors that are contributing to that uptick in net income? Is it other OpEx, et cetera?

And then just the bigger picture thing. Glenn, I was hoping maybe you could share your thinking around kind of the positioning of the real estate brokerage space or maybe the vulnerability from lawsuits like the Moehrl versus NAR lawsuit around anti-competition and stuff like that. And then specifically, how do you think you guys are sort of positioned there?

Chris Nielsen - *Redfin Corporation - CFO*

I'm not sure we'll provide a whole lot more in terms of disaggregating the guidance. As we indicated, we do think that the chunk of business excluding RedfinNow will continue to grow pretty significantly year-over-year. The gross margin on the real estate services business may be slightly down to flat. And I think maybe just a third component to call out is that in the second half of the year, we don't believe that marketing expenses will be meaningfully up from the dollar values they were in the second half of 2018. And when you kind of put all those things together, you end up with a mix that looks a lot like our guidance. So I think that's probably the best information to provide there.

Glenn Kelman - *Redfin Corporation - President, CEO & Director*

And the lawsuits that you referenced are going to have one effect, which is that websites like Redfin are going to be able to publish how much the homeowner is offering to pay a buyer's agent. And this has been a battle we've been fighting for a long time because we refund part of our commission, and it only confuses consumers who think the buyer's agent is free. So we're offering a refund of the service that they think is free, and it limits the appeal of our pricing power. And so our hope is that once people realize how much a buyer's agent is paying, they're going to think twice about how much they should get from that buyer's agent. And also I think it's going to increase the number of people who consider buying a home unrepresented. So just showing where the money goes will always help the people who save the customer money.

Operator

Our next question comes from Jason Deleeuw with Piper Jaffray.

Jason Scott Deleeuw - *Piper Jaffray Companies, Research Division - VP & Senior Research Analyst*

So on the RedfinNow business, have you expanded the buyer box at all? Or is the demand just strong and you kind of kept your buying criteria of the types of homes that's still the same? And then in terms of home sellers that turned down the RedfinNow offer, how many were -- what percentage or any help you can give us on of thinking what percentage of them then want to use a Redfin agent? And then also, who are the typical sellers to RedfinNow? Are there any categories that you can kind of call out?

Glenn Kelman - *Redfin Corporation - President, CEO & Director*

Got it. So we haven't expanded the box much. We're fairly disciplined about the kind of homes that we buy and sell. The name of the game here is to make sure you can flip it. Once we get margins right, then we can start experimenting with wacky properties. But the best way to really make money in this business is to know the kind of homes you can sell for more.

As for the upsell question, it's such a good question. We know that most people turn down an offer and end up listing the property. The only challenge we have is if we come in with a low offer from RedfinNow, we tell them their baby is ugly and they're less likely to turn that baby over to us for any other reason. So I think that we have to get better in that area. They often choose another broker instead of Redfin to list the house. And today, we don't have many returns from this integrated listing consultation because it used to be that the RedfinNow offer would whiff and then a few days later, we'd talk about listing the property. But now it should be one meeting where we can say, "Look, this is what we'll give you for the house now in cash but we think we can sell this house for more money and put more of it in your pocket," and that should be a more consultative conversation. And I think the customer should view it as a benefit. Certainly, it has already helped RedfinNow offer acceptance to have a real estate agent present that offer and say, "Look, I know the market. It's a good offer or it's not."

Oh, and then you'd asked about the typical RedfinNow seller. Most of them are move-up buyers. We came in to this business with the premise that there was more distress or investors where people had gone through a divorce or had a death in the family and they just didn't care about the proceeds or it was an investor who wanted to sell the property from 12 states away. That happens, but more of them are move-up buyers. And that particularly suits us well because we have a lot of buyer's agents who are helping people buy houses and then they see the home of their dreams and say, "Oh my gosh, I got to sell my other place right now so I can have the cash to win this bidding war." And then RedfinNow swoops in and gives them the liquidity to compete.

Operator

Our next question comes from Jack Micenko with SIG.

John Gregory Micenko - *Susquehanna Financial Group, LLLP, Research Division - Deputy Director of Research*

I guess maybe one question for each of you. Chris, the sort of delta between the $3.4 million and the $6.4 million, what are the swing factors there that would drive that differential? And then Glenn, in the past we've seen a lot of commentary from you publicly that talks about how iBuyer is maybe not a lead generation tool. And I -- just listening to you on the call today, it sounds like your mind has changed a bit. Am I interpreting that correctly?

Chris Nielsen - *Redfin Corporation - CFO*

Sure. So the variation on the net income guidance is primarily related to volume, related to the revenue that we would earn in the quarter. We do have a set of fixed costs associated with our agents and our staff and so as we have different volume levels, that plays through to the bottom line.

Glenn Kelman - *Redfin Corporation - President, CEO & Director*

As for Redfin Now as a lead generation tool, I think if you're offering to buy someone's house, you can't bluff. You've actually got to intend to buy the house, and you have to be able to deal with the consequences. So I would never be so cynical as to say it's a lead generation tool. We earnestly, when we make an offer, want the customer to accept it if it's in the customer's best interest. But we think that every customer should have a choice and should make an informed choice. If we're just pitching one product or the other, I've met too many homeowners who list their property and can't get the place clean because they've got a dog and 3 kids, because they've got an anxiety disorder and they worry about whether it's going to sell today or tomorrow and they should not be listing. They should take an instant offer. But I've also got all sorts of people who need the money. And you don't want to be taking advantage of anyone with an offer unless it's really in their best interest. So my real position on this is that everybody's going to want to know. Everybody's going to want to know before listing their house what they could get from a cash offer. If you've got an envelope with a check inside of it in the middle of a listing consultation, you're not going to be able to talk about anything else until people say, "What's inside that envelope?" And usually, what's inside that envelope, there's a discount to it because of all the risk that we're taking. And some people are going to want to take that risk on themselves and some people are going to grab the money.

Operator

Our next question comes from Brad Erickson with Needham & Company.

THOMSON REUTERS

Bradley D. Erickson - *Needham & Company, LLC, Research Division - Senior Analyst*

Just a couple -- I guess Glenn, and I apologize, I know you've been over this a few times already. I just think it still needs some clarification. You made some comments around the impact of the marketing that seemed a little bit at odds with itself. So can you clarify which piece wasn't as good as what you thought versus some of the more positive comments you seemed to be describing looking out to next year? And then second for Chris, just as we evaluate cash burn, can you help us unpack what's going on with the cash flows in the quarter relative to the core business versus the investments being made in the properties business?

Glenn Kelman - *Redfin Corporation - President, CEO & Director*

Sure. So there are 3 phenomena. Number one, Redfin generally, somewhat unrelated to the marketing, is growing traffic. It's growing traffic in markets with media, in markets without media. We generally have more demand than we would have hoped for. Number two, the marketing has increased customer demand in year, but it has not increased it as much as we could have hoped. It's been good but not great. And then number three, the awareness gains have been wonderful. And the whole way we try to set up the marketing investment, we're not selling an Ab Cruncher where we're trying to get you pick up the phone right now and order 3 of them. We know that most people think a long time about whether to buy a house. And so we have a multiyear model for ads being profitable where awareness is extremely important. So we wanted to be candid with you and say the in-year contribution, the first response from customers has been good but not great, and the awareness gain has been great.

Chris Nielsen - *Redfin Corporation - CFO*

And just in terms of cash, you do see us using our cash in the second quarter to buy homes, to buy inventory recorded on the balance sheet. As I mentioned on the call, we do now have a facility in place that will -- we will use for funding some of those purchases going forward. And so that should reduce our cash utilization there. There's just one more callout I wanted to make related to the cash flow statement in the second quarter, and that's that we did set up a set of investments that are recorded as short- and long-term assets, where we have funds that were previously in cash invested. And so you see that influencing the way that statement looks.

Bradley D. Erickson - *Needham & Company, LLC, Research Division - Senior Analyst*

Got it. And just -- maybe just a quick follow-up, if I could. Is there any disclosure in terms of like the homes you bought and sold or held in the quarter?

Chris Nielsen - *Redfin Corporation - CFO*

There's no further disclosure on details and the numbers associated with that beyond the raw inventory dollar values.

Operator

Our next question comes from Brad Berning with Craig-Hallum.

Bradley Allen Berning - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

I'll stick to the rule and ask -- actually ask one question. Can you compare and contrast the factors that are driving in markets where you're gaining market share faster than the company average? And what are the key attributes that drive the inflection points when markets start to accelerate?

Glenn Kelman - *Redfin Corporation - President, CEO & Director*

So I think the factor that we haven't completely addressed is just operational excellence. When we have someone running that market really well with a crackerjack team of agents, there's no way to really characterize that in the earnings script but it makes a difference. Other than that, it's traffic, media and conversion. And there are markets where we do better in terms of traffic. There are markets where we're spending more on media. Conversion is fairly consistent. So it's just a combination of things. And of course, you have to understand advantages of our markets, the places where we've been the longest have the highest share. But because it's a retail business combined with an online business, there are markets that we open 5, 10 years after other markets that have lower share. And I'm assuming that most folks on the call understand that.

Bradley Allen Berning - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Yes, I know. I mean the pace of share gains. I think some of the markets you've been in the longest not just have the largest share but they're also growing the fastest share. So I'm just wondering if there's a repeat and referral component to an inflection point of time in a market, if that's part of the factor as well.

Glenn Kelman - *Redfin Corporation - President, CEO & Director*

Yes. I think there's 2 components of critical mass, and one is that you get credit for time served. As a brokerage, it can be a hard business to cold start unless you're doing a roll-up of some kind. So eventually, you have customers who bought a home from you 5 or 6 years ago who come back. And certainly, you have customers who refer, and that has been a major driver of our growth.

The second part of critical mass is just that brokerages are intrinsically viral, that you cannot sell one customer's house without that customer running an ad or your brokerage to sell other houses. That's a yard sign. And what we've seen is that the media is more effective once there's some validation. You see the billboard or hear the radio jingle but then notice the yard sign in the neighborhood or hear from a friend that she went on a tour and it was fantastic. So we do think that there's some compounding effects that have been the reason that instead of kind of really growing faster than tailing off, we've been able to sustain strong share growth even in markets where people have asked, "Is there a ceiling?" Or if you reached some kind of asymptote, we haven't.

And one more question. This is it. You get to close the show.

Operator

(Operator Instructions) And ladies and gentlemen, as we are out of time, we will take our final question from Tom Champion with Cowen.

Thomas Steven Champion - *Cowen and Company, LLC, Research Division - VP*

I guess the question is around agent productivity and the 6% increase year-over-year that -- that's really positive but falls below the -- I think it was 12% or 13% increase in the customer agent cap. And I'm just curious if that delta represents something that's kind of structural or the declining success rate that you've talked about or whether or not you can kind of chip away that delta going forward. Any thoughts on that would be really helpful.

Glenn Kelman - *Redfin Corporation - President, CEO & Director*

I should be clear, just because we're candid about our challenges doesn't mean we aren't confident about addressing them. We think that agent productivity or gross margins are on an inexorable march up. There will be some bumps in the road but we think they are going up. And you're right, the challenge is that there is a change in the homebuyer and that homebuyer is more fickle. They're having a hard time affording the house. They have a different relationship with any kind of service that they order online, where they just kind of shrug and hit the button. And that's the reality that we're working with, and we're going to do better each year. So it won't be a short journey. It'll be a long journey but it is a journey headed up. And the fact that the agent loads have increased more than agent productivity is indicative of the fact that you've just got more and more people clicking this button to go see a house and more of them realizing, "Holy moly, I don't have the dough to buy it."

So that's it. Guys, I just wanted to thank you. They're brilliant questions. It's so fun answering them. We are going to go work our fanny off to kill it in Q3. Thank you, everyone.

Operator

Ladies and gentlemen, this concludes today's presentation. You may now disconnect your phone lines.
