PODCAST TRANSCRIPTION SESSION NO. 172/GARY BEASLEY

Welcome to the Lend Academy Podcast, Episode No. 172. This is your host, Peter Renton, Founder of Lend Academy and Co-Founder of LendIt Fintech.

Today's show is sponsored by LendIt Fintech USA 2019, the world's leading event in financial services innovation. It's coming up on April 8th and 9th, 2019, at Moscone West in San Francisco. We've recently opened registration as well as speaker applications. You can find out more by going to lendit.com/usa

Peter Renton: Today on the show, I am delighted to welcome Gary Beasley, he is the CEO and Co-Founder of Roofstock. Roofstock is a fascinating company, they're relatively new, they've only been around a few years. They're basically a marketplace for buying and selling tenant-occupied investment homes and they're able to do this in an online fashion. We get into sort of the mechanics of this in some depth on the show, we talk about the type of yields investors can expect, we talk about their approach to data because this is very much a data-driven business. We talk about the financing process and what the future holds. It was a fascinating interview, I hope you enjoy the show.

Welcome to the podcast, Gary!

Gary Beasley: Thanks, Peter, great to be here.

Peter: So I like to get these things started by giving the listeners some context and a little bit of background about yourself and what you've done in your career before you started Roofstock.

Gary: Sure, originally I grew up in the Midwest and came out to the Bay Area for business school and sort of caught the entrepreneurial bug there and really have spent the majority of my career at the intersection of real estate and technology.

So I've done everything from running acquisitions for a luxury resort company for many years to running a boutique hotel company that was based here in San Francisco and then also was CFO of a company called ZipRealty and took that public back in 2004 as the CFO. So I've done sort of some traditional real estate, I've done some…ZipRealty was the first online residential brokerage and so sort of cut my teeth on a tech-driven residential model there.

My second real estate startup was Waypoint Homes which we actually took public 2014 as a REIT called Starwood Waypoint so this is I guess technically my third real estate startup here at Roofstock so combines a lot of my background in both real estate from a vertical perspective and technology.

Peter: What was the idea that led to the founding of Roofstock?

Gary: Well, as I mentioned, I was running a public company at the time and we had many thousands of homes we were trying to sell, a couple of hundred and it was difficult to find the right channel to do it. It was frustrating trying to sell leased homes through the Multiple Listing Service because typically the MLS is setup to sell vacant homes to consumers not leased homes to investors and my Co-Founder, Gregor Watson, was having a similar issue.

He was trying to sell 500 homes from one of his funds in Dallas and they were all leased and he just started calling real estate agents and the first agent he called said, you know, I don't have 500 signs (Peter laughs). I wouldn't have the first idea how to sell 500 homes. The next person he called said, well gee, when can you get the tenants out so I could sell them. So I have to give credit to Gregor who was actually...the genesis of the idea was his and then he approached me about it. He said, hey why don't we figure out how to sell homes with tenants in them?

We could do it directly to investors, get retail investors or institutions and not disturb the tenants, not have to go through with all the typical friction of a real estate transaction. So that was really the genesis of it, it was coming out the pain point of both of us trying to sell homes efficiently that we owned with tenants in them. The more we thought about it and started sort of whiteboarding it out, we realized that there was actually an opportunity for a really interesting marketplace idea that could cater to investors of all shapes and sizes and really break down the geographic barriers of real estate investing by building a technology platform.

Peter: So as someone not involved directly in this space, it's staggering to me. This is a very simple idea, you want to be able to sell a home with a tenant already in it and real estate is a very mature asset class. You've got all kinds of different vehicles for selling and buying real estate and yet this hadn't been done before, I mean, why do you think that's the case?

Gary: Correct, well, it's a great question. I think there were two sort of catalysts for the single family rental sector which it's called...which is all the homes that have long term tenants in them, there's about 16 million of them in the United States, it's about $3 trillion of assets. But up until the downturn in kind of 2007, started in 2007, no institutional capital had invested in this space so what ended up happening is during the downturn the prices got so low there was a great entry point for investors, professional investors, to come in and take a look at the asset class and start investing capital at scale. That's what I did with my last company and Gregor did as well so the catalyst was an entry point.

The second key factor is technology so without cloud and mobile computing, investors could not manage these homes at scale efficiently so it's kind of a confluence, if you will, of the kind of the right timing in the market as well as the right technologies being available to where you could actually manage these rental homes very much like a distributed apartment building; whether you have four of these or 4,000 it's just like four different apartment units and the operating margins are actually quite similar to apartments when you break it down. So that's I think why it has taken a while for this to actually to come together.

Peter: So I was actually chatting with my wife this morning, I was telling her that I was going to be interviewing you today about your company and she said, well how can you convince investors to buy a house they've never seen. Investing in real estate is something that you do physically, you go visit, you walk through the house, you check out the neighborhood and yet here you are with an online platform. Obviously, you offer some sort of virtual kind of ways of doing that, but to me that seems like it would be a major sticking point, is that correct?

Gary: That was the giant leap of faith that we had to make when we launched the platform. I can't think of another marketplace that sells $150,000 items, when you really think about it. So we threw a party and we weren't sure if people were going to show up or not, (Peter & Gary laugh) fortunately, they did, but basically when we were trying to assess what it would take for people to buy homes sight unseen, we thought about it as investors ourselves.

Why do we physically need to see a home, why do we need to walk through it and it really came down to two things that we needed. One is to see the condition of the property to see how much work, if any, it needed and how much that would cost and two was to assess the viability of the floor plan as a rental property and ultimately, something that could be sold in the future. Once we got comfortable with both of those things, everything else can be done from a desktop.

So what we did was we figured out how to do a virtual tour and put that online that strips out all of the furniture so if you go on to our site you can take virtual tours. They're 3D animated tours because these homes are occupied, but it strips out all of the furniture and you can kind of see what the finishes look like and it generates a 3D floor plan so you can see what the floor plan is like. We also have inspection reports that have been done by inspectors who have walked through the homes and prepared detailed reports with cost estimates. That all gets factored into your bid and factored into our underwriting so that was the premise.

I think that the main reason this has worked is this is not an emotional transaction, it's an investment so if you and your wife are looking to buy a home in Atlanta to live in, you would certainly go see it, you want to see the exact color of the cabinets and the flooring and kind of see everything. When you're buying a home as an investment, you're thinking about it relative to other uses of your capital and you're much more interested in the cash yield than the color of the cabinets and that's what we have discovered. You can really do a lot today remotely.

You know, I would say the latest stats I saw, over 90% of our buyers live over 250 miles away from where they're buying homes so very few people are actually even driving by the homes. The other thing that we've done is instituted a 30-day money back guarantee, sort of no questions asked if you buy something through our site and for whatever reason you're unhappy, we will resell it for free and make you whole if we have to sell it for less, if it doesn't sell, we'll buy it. So that has helped, it hasn't been something many people have even inquired about because we've had some pretty good customer satisfaction, but it does happen.

Occasionally, people get buyer's remorse and we want to be there to make sure we can handle that. So that has actually helped a lot with a new marketplace. You have to build trust. The hardest thing is starting from zero and kind of going to one. So I think a combination of making sure that the inventory is curated and that we kind of do a number of things to help reduce the risk of the investment. We could talk about our certified property managers and all that kind of stuff, but then also having this money back guarantee has been helpful to get people to participate.

Peter: Right, right. Okay, so I'm on your website right now, you've got 326 properties, it looks like, available.

Gary: Yeah.

Peter: And they're ranging in price, looks like the low is like $40,000 up to $150,000. I think $174,000 is the highest I can see on your home page, on the first page. Obviously, these are not Bay Area, you know, 3 bedroom houses that are a million dollars.

Gary: They're not even Bay Area garages Peter (Peter laughs), it's one of the reasons so many of our investors are actually kind of...they live on the coasts and live in incredibly expensive real estate markets and they look at what they could get in a market like Memphis, or in Atlanta or Indianapolis or Pittsburgh and it's incredible that the value and the yields that you can get relative to what you get in these expensive markets, so yeah, I would say that the typical homes on our site are probably $75,000 to $150,000.

We've had homes over $1 million on our site, we've had plenty in the kind of $250,000 range, but that's kind of the sweet spot, kind of $150,000 plus or minus and we find that that works quite well because what's interesting about investing in housing is the yields or let's just say the rents don't scale with the home prices. So $100,000 home, the rent on that...or the rent on a $1 million home is not 10 times the rent of that on a $100,000 home so your yields go down generally as your prices go up. So the less expensive the property, generally, the higher the yield and that's why some of these properties that are sub $100,000 get so much interest on our site because the yields are quite attractive.

Peter: So tell us a sense of what are those yields because obviously you've got lots of costs involved. You've got to pay property taxes, you've got to pay management companies so tell us what can investors expect.

Gary: Sure, so when you buy a property, you get your rent from your tenant, you pay a local property manager unless you want to self-manage. People generally buying through our site pick one of the property managers we've certified in the different markets. So they generally charge 7 to 8% of rent to handle the repair & maintenance oversight, collecting rent, doing the leasing, making sure it's occupied, those kinds of things. So you've got that, you've got property taxes, you've got insurance and you've got the ongoing sort of maintenance and repairs of the home.

Typically, if you look at it broadly, expenses might be about 40% of your revenues, kind of 40 to 45% of your revenues would be your expenses so if you had $1,000 of rent, you might expect $500 to $600 of cash flow a month from that property. So if that's a $100,000 property and you're getting say $6,000 a year as cash flow that would be sort of a 6% current yield if just look at it on an asset basis and that's pretty typical. Some of our homes in more expensive markets might be in the 4.5% range, plus or minus, but those are more appreciation plays and so we have people buying homes in more expensive markets that might…the yields might be in the 4's, but they like the long term appreciation prospects.

And then you have homes that might be less expensive with 7%+ yields that may or may not have the same sort of appreciation characteristics, but have a really nice kind of current coupon and everything in between. When we calculate our returns on our site, we do a number of things, but we look at the current rent that the tenant is paying, we compare that to market rent, which could be higher or lower, we put in an estimate of what real estate tax assessments should be post purchase based on what you're paying, we estimate insurance costs and repair & maintenance based on the age and sort of vintage and condition of the home and put together a 5-year financial projection.

And we have a pretty robust set of tools so you can say, you know what, I want to increase this expense or I don't think home price appreciation is going to be 3%, I want to dial it down to 2% and see what that does to my return. So we have kind of a whole series of adjustments that people can make and we encourage people to do that in their underwriting to kind of stress test it and see which investments meet their criteria the best.

Peter: So we haven't talked about yet financing, I imagine, I mean you tell me, but I imagine most of these houses are financed and that's not a simple process even today. I mean, I know there's lots of fintech companies out there trying to make it a simple process, but as of right now, it's still somewhat of a cumbersome process. Tell us a little bit about how you kind of go through that challenge.

Gary: Sure. So today the actual purchase of the home, we've gotten to a fully paperless transaction so we use DocuSign and so investors, if they're buying for cash, don't have to deal with paper. The challenge does come in, as you correctly point out, when financing is introduced. That is currently, as you say, is a big opportunity for someone to reinvent.

We work with several lenders and we try to simplify the process the best we can, we encourage people to get pre-approved which can then allow the process to be a bit more streamlined so they really know sort of their buying power and we can just help coordinate and hold people's hands through the financing process, but yes, you are still getting a loan so you do still have to produce a lot of documentation and there are a lot of things to sign. I think this will be very different a few years down the road, but today it's still being reinvented.

We are working on some ideas which I hope to implement over the next couple of years which would, you know, allow sort of staple financing where perhaps the valuation could be done upfront so there is no need for an appraisal, for example, so you could know exactly how much you could borrow on a particular property that could really turn a 30-day closing into a 10-day closing, a 10 or 12-day closing, so we're working on some of those things. It will change over time, but today you are right, that is the long pole in the tent with our closings.

We just closed a transaction yesterday in 11 days which from when somebody hit buy so we can do it pretty quickly, that was a cash buyer, but it's typically when someone's getting a loan, you know, 30 days, plus or minus, for the process to go through. A big part of that is the appraisal piece.

Peter: Right, right. So are all the houses on your site, do they all have tenants in them right now? Obviously, what's the process like because that's a really critical piece. You've got this asset, you really need to have...you don't want to go a month or two without tenants so what percentage of them have tenants in right now?

Gary: Yeah. So the vast majority of them have tenants. The ones that don't have tenants, we offer a rent guarantee program so it's really a lease up guarantee so the idea is you either buy a house with a tenant in it, or you know with certainty it will be leased in a reasonable period of time and if it's not, Roofstock will cover the rent. What our rent guarantee...the way it works is we'll pay 90% of market rent until it leases after a 45-day period. So if it doesn't lease up within 45 days of you buying it, our rent guarantee will kick in and we will cover 90% of the rent until it does.

It's a pretty rare circumstance that that happens which is why we're happy to do it and stand in that position. You have to be using one of our certified property managers who, obviously we have confidence in and the reason it's 90% is that is essentially which you would get anyway after paying your property management fees. You're sort of being made whole there and we're happy to offer that on homes that are vacant so that's another way we help people get comfortable with the asset class.

Peter: Right, right. Okay, so let's talk about the investor, I mean, obviously this is real estate, you do not need to be an accredited investor to buy an investment home so I imagine you work with all kinds of investors. Maybe give us some sense of the typical investor on your platform, like how much they put in, how many homes do they have; just tell us a little bit about them.

Gary: Yeah, so the demographic skews a little bit younger obviously because we're an online model. I would say 35 to 55 is kind of the sweet spot of our investors, they do come from all over the country, certainly all over the world actually and the average retail investor is buying about 1.7 homes, so far, so not quite 2, but I think a lot of people are buying one home now and are looking to maybe buy a home a year as part of a retirement program.

There are a lot of advantages to buying real estate, as you know, it's tax efficient and all that, leverage is readily available so that is something that our advisors can kind of work with people to help them figure out...okay, if you have long term objectives, we can help you figure out how can you get there over time.

And then we have institutional investors as well who are large institutions and they come from all over as well, they tend to be cash buyers and don't necessarily need our property management services or anything like that. But as a marketplace, both on the buying and selling side, we encourage participants of all sizes.

Really at the founding of the company, part of the premise was we would like the average investor to have access to the same homes and the same tools at the same prices as the largest institutional investors do and that's what we're doing. You could call it sort of democratizing the asset class is one of the terms we use here internally. There are barriers for people to be able to really invest in the asset class if you're not a professional investor.

So we're trying to take a lot of the knowledge and tools that we had at our prior large institutional platforms and make them available to everyone and as you say, you don't need to be an accredited investor, the majority of our retail investors are not accredited, some are, but the majority are not.

We are actually going to be launching a new product shortly that is for accredited investors so I'd be happy to...if any of your listeners are interested in that product, we'd be happy to...if they want to email me just at gary@roofstock.com I'd be happy to put them on the list and we could get them some information on that, but that will be for accredited. That's a pretty revolutionary product and approach to investing in real estate that we're excited to talk about.

Peter: Okay, so we're getting close to our time and I really want to dig into this piece because it strikes me that this is a very data-driven business. I see two things; one, you've got to decide...you go in here and obviously you're in Akron, Ohio or Indianapolis, St. Paul, Minnesota, Memphis, Tennessee so you've got to go into a city where...you firstly have to choose a city out of all of the cities in this country, you've got to choose the cities that are going to be right and then within that city you've got to choose the houses that are most appropriate. So tell us a little bit about that selection process, how you go through that.

Gary: So what we do is we have a pretty good size data science team here and we look at all sorts of data, as you might imagine. We rate neighborhoods, we look at trends, we look at yields, we look at home price appreciation forecasts and try to identify markets and sub-markets that look interesting. But what's an important point to make is also as a marketplace people are free to make their own decisions on whether Atlanta is a good market or a bad market. Just because it's on Roofstock doesn't necessarily mean it's a good market, it means that it's a market that has buyers and sellers and obviously there's two sides of every trade.

When a home trades somebody feels like they're getting a good deal buying it and somebody feels like they're getting a good deal selling it. So we're not going to go into areas that we feel are dangerous or really, really bad areas to invest in so there's sort of a minimum bar where we feel that these are good rental markets that have good rental demands and should perform reasonably well over time. But there are people who look at the same market and say, well geez, I'd never invest in that area and others look at it and say, well, that's exactly what I'm looking for.

So how do we do that? We put a lot of data out there and we have ratings of neighborhoods that are a proxy for risk so you could invest in a 4-star neighborhood that has very high school scores and high levels of owner occupant residency and very low levels of crime, birds chirping, etc., pretty low yield, but probably pretty stable.

And you could go into areas that might be in our neighborhood rating...maybe it's a 2-star neighborhood where the home prices are a bit lower, there might be a bit higher turnover, but the yields are quite high so it's almost...are you an investor that wants a triple A bond, or a government treasury and you're going to get a low yield with certainty of repayment, or do want to buy a junk bond and get paid for the risk.

So real estate is very similar and to my knowledge there really aren't other platforms out there that are trying to really assess and give people an ability to associate sort of risk with return. That's what we're doing and so we're continuing to have our data science team improve those models and, you know, we're looking to add more and more kind of features there to create more and more sort of transparency and more ability for people to decide what is good for them. That also being said, we're working on some pretty interesting algorithms that are individual recommendation engines.

For example, based on you and your profile and your objectives, we could recommend a very specific investment strategy or portfolio that is right for you and that's in beta right now. We're working on some of those tools that can help separate and synthesize the...you know, out those 300 and some odd homes that are out there, what might be the three to five homes that are ideal for you. Right now, the way we do it is people sort of do it themselves or they talk with one of our advisors here who could held them think through those strategies and that works well too. But as we're gathering more and more data, we're going to be able to do that more in an automated way and allow people to do it for themselves.

Peter: So then how do you choose...obviously, if you go into a city you've got to have inspectors in place, you've got to have management companies in place. You've got to have a whole bunch of infrastructure I imagine in place and I presume you're not in all the cities you want to be, I mean, like how are you thinking about expanding and when will you be in all the cities you want to be in?

Gary: Yeah, so we're in roughly 30 cities around the country now. We've sort of probably doubled in the last year, we're rolling out about a city a month. So with our model, we've gotten entering into a city down a bit to a science where we go and identity the best local property managers, we find great local inspectors, they use our app to do the inspections so we can roll into cities pretty easily. I would say as we look out over the next year, my guess is we'll add another dozen to 15 cities.

I know there's at least a hundred that are on our long term target list where we'd like be and we'll just kind of methodically roll out to them, but what we found is, it's interesting, unlike some models that do have a lot of infrastructure requirements, ours is actually pretty light so we can go broad as opposed to necessarily going deep in expansion and there's some network effects that we're finding. By going to multiple markets, we can service sellers who have properties across lots of markets.

Actually, some of our sellers have encouraged us to go into certain markets before we had planned on doing it because they may have a few hundred high quality houses they wanted to sell and we could use that as a catalyst to go into a market. We went into Charlotte that way, for example, for one of our larger clients and we were live in Charlotte and that's been a great market for us.

Peter: So then are you constrained by growth on the supply side of inventory of homes or the investor side or are they both matching perfectly?

Gary: (laughs) That's the one thing I can tell you (Peter laughs) it's never matching perfectly as a marketplace.

Peter: I know. (laughs)

Gary: We kind of joke that it's sort of like you've got scaffolding on two sides of a wall, you build up one side and then you look and you're like, whoa, I need to build up the other side. So, depending on what day it is, Peter, I'll tell you, I'm either more focused on supply or demand which...I would say, generally with this product supply is probably a bigger challenge than demand. I don't want to say there's limitless demand, but our product is unique, the way we acquire and curate the inventory is unique and what we find is when it's the right inventory and it's presented properly, it sells very quickly.

And we have, you know, lots and lots of customers who are online waiting to get notifications of properties that meet their buy box. We know what those buy boxes are because people fill it out and we go try to find that inventory to fill those orders. I would say, if I had to pick, it's more kind of a supply challenge long term. We've done some interesting things, speaking of data science, we've mapped all 16 million rental homes in the country and we know who owns them and we have a view on their value and their rents and we know how to contact them.

Peter: Interesting.

Gary: So that was a big data science project, took us about a year, but now we can reach out specifically to owners of properties that we think are excellent candidates for our marketplace and help kind of secure inventory for our clients who are saying, hey, I want these types of homes. So that's kind of a way to help fill that supply bucket in a very targeted way using our data science.

Peter: So can you give us a sense of the scale you guys are at, I mean, how many closings are you doing a month these days?

Gary: Yeah, I'll just sort of give you a sense, so in 2016, we sold about 320 houses, that was our first year of operation. It was about $40 million of property value. Last year, 2017, we sold just under a billion dollars worth of property through the marketplace, it was about $970 million, that was about 4,300 homes. But keep in mind, there are about a million investor transactions a year nationally and we did 4,300 so we feel like we're literally scratching the surface, but that's one of the reasons that I think real estate, fintech or proptech is so interesting, is the market is so big. It dwarfs pretty much any other industry out there, real estate does, especially residential.

So we look at that and we say, well gosh, 4,300, why shouldn't it be 43,000, right, that's still tiny compared to the overall market so there's a lot of headroom there, but that just kind of gives you a little bit of an idea of the scale and the trajectory.

Peter: Right, so then leading into my last question, what's your vision for Roofstock? Do you want this to be...you know, 50% of that market, what is your long term vision?

Gary: Well if we could get to five I'd be very happy (Peter laughs). So we have kind of near term and then longer term visions. So clearly building out this marketplace and single family rental domestically is a big part of our current plan, but ultimately we want Roofstock to be a global exchange for real estate across property types.

So when you think about the opportunity to do what we're doing in single family rental which is a $3 trillion addressable market. Across small multi-family, for example, which is another $3 trillion market just domestically...when you think about doing this in other markets around the world, there's...and building an exchange where these properties or fractional interests in these properties could be traded really efficiently, that's the long term vision.

So you'll see when we launch our new product, which I referenced earlier, that is a product that ultimately can unlock value in a very, very efficient way and can be fractionalized. So ultimately, I'd like Roofstock to be viewed as sort of the NASDAQ, if you will, of real estate and we've got a long term multi-year plan to do that. It's a pretty bold vision, it's not going to happen overnight, but we like to say around here...oftentimes, we have 20 years of ideas (Peter laughs), we're trying to do them faster than that, but there's no shortage of ideas. I'm looking at our whiteboard right now in our main conference room, there's a lot, but there's a lot of opportunity.

Peter: Okay. Great, well we'll have to leave it there. Fascinating having you on the show today, Gary, I really appreciate it.

Gary: Alright Peter, enjoyed it. Thanks.

Peter: Thanks. See you.

Gary: Okay.

Peter: You know, one of the things that I really love about the Roofstock model that they have pioneered here is it enables individual investors, obviously non-accredited or accredited, to create a real estate portfolio in a way that is hand-curated. You can have a diversified portfolio across different kinds of geographies, across different kinds of neighborhoods across geographies. What struck me after we hung up the phone is that a lot of people own their own home or they have significant equity in that home, but that is one home in one location, and obviously that is not diversified.

It is far better when you look at your real estate bucket of your portfolio to be a lot more diversified. I really believe, whether it's Roofstock or other platforms like it, I think people who will want to make an investment in real estate, this is going to be the way they'll do it; it's simple, it's effective and it's a way to build a portfolio that is truly diverse.

Anyway on that note, I will sign off. I very much appreciate your listening and I'll catch you next time. Bye.

Today's show was sponsored by LendIt Fintech USA 2019, the world's leading event in financial services innovation. It's coming up on April 8th through 9th, 2019, at Moscone West in San Francisco. Registration is now open and we are also taking speaker applications. You can find out more by going to lendit.com/usa

(closing music)