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Transaction Costs, Firms' Growth and Oligopoly: Case Studies in Hong Kong Real Estate Agencies' Branch Locations

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Abstract

Centuries ago, there were some small scale real estate agency firms in Hong Kong. Many of them were small scale family business. As large scale shopping malls were uncommon at that time, these shops were opened on the streets. Nowadays, the market structure of real estate agency sector is an oligopoly. Ricacorp, Centaline, Century 21, Midland Realty, and Hong Kong Properties are the five major large-scale agency companies in Hong Kong. In the modern era, many of these agency firms open their branches inside the shopping malls beneath the large scale residential estates. To better understand the reasons for this phenomenon in Hong Kong, we have conducted two case studies. The case study of Ricacorp, one of the large-scale real estate agency firms in Hong Kong, shows that over half of the Ricacorp real estate agencies shops are opened in shopping malls that are owned by the major developers in Hong Kong. The second part of the case study explores some of the major shopping malls in Tseung Kwan O, a new town in Hong Kong. We find that many shopping malls have similar "content" and appearance because they have similar branded shops. Secondly, the agency firms also open their shops in different malls owned by the same developers. We therefore propose that the oligopoly market structure is caused by two factors: 1) lower transaction costs are incurred when the large scale agency owners negotiate with the mall owners in settling the terms of contracts: A) the mall owners do not need to draft separate contracts for the different agency companies. One piece of contract (or more or less the similar terms of contracts) fits all the agency branches owned by one single firm. B) there is no need to search for background information on each company if the shopping malls are contracting with a single agency company. C) By looking at the other shopping malls, the shopping mall designers can gather information and predict the success of the tenant mix easily. 2) Modern shopping centres usually locate below the towers of residential buildings. By opening the agency firms inside these malls, the consumer's search costs can be lowered. Despite both the small and large scale agency firms know that these shopping malls can help them secure better business returns, the large-scale companies can easily build up closer relationships with the mall owners (due to factor 1) find it easier to rent their units at a lower rent while the smaller firms find it hard to expand in the New Town's shopping malls. These small firms are forced to stay in lower profit margin regions in old estates where there are only street shops without large scale developer's renting administration. Therefore, it is sufficient to conclude that the shopping mall has imposed a relative higher costs to new comers should they wish to enter the real estate agency market in new town area.

Keywords: oligopoly, real estate agency, transaction costs, barrier to entry case study, Hong Kong

1. Introduction

Currently, the real estate agency sector is a large business in many places. In the US, the residential real estate brokerage industry alone has annual revenues of over $60 billion (Ford & Rutherford et al., 2005). In Hong Kong, number of Estate agent's Licensee holders reached 42949 in 2013 (Property.hk, 2013). Although housing can be sold through real estate agents or by the owners in many places (Jud & Frew, 1986), the real estate agencies provide useful information to buyers and sellers (Benjamin & Jud et al., 2000). In many areas, it has long been a common practice for home sellers to hire real estate agents to advertise and sell their homes (Jud & Frew, 1986) or for landlords to hire them to let their houses. Potential renters and buyers also contact real estate agents for home searches. When the agents are contacted by the buyer and the transaction is successfully made, the agents will receive compensation from the seller that is usually a fixed percentage of the sales price. Because of this compensation arrangement, quite often the agents will show potential buyers only those flats that the potential sellers have asked them to sell (Jud & Frew, 1986). From a legal perspective, the agents are engaged by the owners and landlords via an agent contract to obtain a buyer or a tenant for the property in question. This contract creates an agency arrangement between the two parties that is governed by a well-developed body of law referred to as the Law of Agency (Dunlap & Dotson et al., 1998). Over the last 10 years, the market for real estate agency companies has experienced many significant changes. One of the most important changes is the shift in the residential real estate agency industry to fewer, but larger, firms (Anderson & Fok et al., 1998). New market arrangements also emerge, such as interactive multimedia marketing arrangements that rely on the World Wide Web and e-mail services to complement the conventional use of a multiple listing service (MLS) (Anderson & Fok et al., 1998), E-commerce systems provide means to support the supply chain (Suchanek & Bucki, 2011). The real estate agency market has undergone structural changes over time. Nevertheless, although the internet offers useful tools for marketing, information resource banks, educational tools (Nwogugu, 2007) and even power economic growth (Li, 2011) some authors believe that the use of online agency services coupled with the commissioning system and the regulations have led to the decline of firms in some markets (Nwogugu, 2007). In recent years, many facets of real estate agency companies have been examined in the literature. There are a number of studies that examine characteristics such as firm size and other attributes and how they influence the agency firms; in addition, there are studies that examine the factors that influence the decisions of home buyers and sellers to use the services of a broker (Benjamin & Jud et al., 2000). Few or even none of them, however, have studied the market structure of the real estate agency firms. In this paper, the author speculates that there are two reasons which lead to the current oligopoly market structure in the real estate agency industry:

1) There are lower transaction costs when the large scale agency owners negotiate with the mall owners in settling the terms of contracts:

a) Mall owners do not need to draft so many separate contracts for the different agency companies. One piece of contract (or more or less the similar terms of contracts) fits all the agency branches owned by one single firm.

b) There is no need to search for background information for each of the company if the shopping malls are contracting with a single agency company.

c) By looking at the other shopping malls, the shopping mall designers can gather information and predict the success of the tenant mix easily, i.e. life of copycat is easier than innovator.

These lines of thought, however, pose the major barrier to new small scale real estate agency firms.

2) Modern shopping centres are usually opened beneath the towers of residential buildings. By opening the agency branches inside these malls, the consumer's search costs can be lowered, i.e. business returns can be guaranteed.

2. The Background of Hong Kong's Real Estate and Agency Market

Hong Kong's land and buildings play a critical role in the region's economy. These assets not only provide housing to the SAR's residents, but they also generate financial returns to property investors. Many of these developers are listed companies (Table 1). At the same time, the real estate agency empire is growing slowly. While many of these agency firms start as small scale real estate agency firms run by families in the past, there is a high market concentration in the hands of a few firms in modern era such as Centaline, Midland Realty, Ricacorp, Hong Kong Properties and Century 21. Dominated by a few major developers with strong links to other important business areas, and highly concentrated real estate agency firms, it is sufficient to conclude that the real estate market structure in Hong Kong is oligopoly (Lewis, 2010).

Table 1. Listed developers in Hong Kong (Lewis, 2010).

Developers	Stock code
Cheung Kong	1
Hang Lung Properties	10
Henderson Land Developments	12
Hong Kong Land	HK Land (Singapore)
Hopewell Holdings	54

Developers	Stock code
Kerry Properties	683
MTR Corporation	66
New World Developments	17
Shimao Property Holdings	813
Sino Land	83
Sun Hung Kai Properties	86
Swire Pacific Group	19
Wharf Holdings	4
Wheelock & Co	20

3. Factors Power and Restrict Firms' Growth

The crux of the issue, mentioned above, is why the real estate agency industry turns to oligopoly market structure, dominated by a few large firms? In fact, all the firm owners wish to see their firms grow. Large firms have sufficient funds to engage in research and development; they can also enjoy lower costs of production. Costs can be further lowered through discounts from their suppliers, greater specialization of labour, and reduction in interest rates from lenders. Accordingly, firms expand until the marginal benefit equals to the marginal cost, i.e. at the size just before the diseconomies of scale occurs (Li, 2009). Nevertheless, firms' expansion is a complicated issue with various factors alongside with costs, for example, the existence of competition law prohibits mergers (Li, 2013). Some of the firms stay small to avoid the severity and number of regulations that increase with the number of employees (Melchiorre & Rocca, 2013). Anderson et al. (1998) suggests that if firms become less efficient as the firm size increases, then further expansion should be determined by barriers to entry and exit. On the other hand, Hooper and Price (2010) proposes that firm size increase is partly due to merger activity, Wu and Lu (2012) suggest that community trust enhances the development of SMEs, Naslmosavi et al. (2013) concedes that firm size increases as auditor quality improves (Naslmosavi & Sofian et al., 2013). Besides, the market efficiency theory implies that if larger firms are more efficient, the movement towards expansion will continue (Anderson & Fok et al., 1998). Small firms in the market shall expand, leading to the disappearance of the less competitive firms in the market. Oligopoly market structure emerges.

4. Oligopoly, Expansion of Firms and Various Forms of Barriers to Entry

Why the small scale agency firms find it hard to survive? While small agency firms may not be able to enjoy the advantages of scale economies, large agency firms can specialise in sales activities or listings and can better utilise sharable inputs. Oligopoly market structure may slowly develop when some firms continue to expand to a level where only a few dominate the entire market share. It may also occur when the firms merge (Salvo, 2010). In fact, he oligopoly market structure can be found everywhere. For example, a large proportion of Australian industries are oligopolies: there are two major supermarket chains, four big banks, two main miners and so on (Kay, 2010). In China, there are only 4 enterprises which produced more than 500,000 automobiles (Ding & Xiao, 2010) and there are only three major market players telecommunications industry (He, 2009). Other industries, such as postal services and finance have the insurmountable barrier to entry, leading to an inevitable oligopoly market structure (Wang, 2012). In Korea, the media industry display an oligopoly market (Sa, 2009). In the UK, the British British casino industry has enjoyed an oligopoly market structure for more than 40 years (Etches, 2011). And even in the private prison industry, it is an oligopoly of two major corporations: Corrections Corporation of America and Geo Group, Inc. (Kish & Lipton, 2013). Likewise, in designating the Nationally Recognized Statistical Rating Organization, the Securities and Exchange Commission grandfathers the existing firms such as Moody's, Standard and Poor, deliberately excludes new entrants and thereby creates an oligopoly (Sternberg, 2013). Indeed, among all the above mentioned industries, they illustrate features of an oligopoly as a few large firms with significant barriers to entry. The modern theory and definition of oligopolistic markets was developed in the 1950s, resulting from the two processes of economic change:

1) The process of differentiation: industries become concentrated oligopolies and produce homogenous product (electricity, basic chemicals, steel, cement), while differentiated oligopolies are found in consumer goods markets (automobiles, computers, insurance and banking);

2) The process of concentration, i.e. the market share of a particular industry consists of the largest four, six or eight firms (Valance, 2012).

Although the barriers to entry are key factors which lead to the existence of different market structure, there are different ideas on how barriers operate. There are seven types of entry barrier including the Bain's advantage of established sellers in an industry and Stigler's cost borne by firms seeking to enter but not borne by firms already in an industry. McAfee et al.'s proposal on the new classification of entry barriers: antitrust barriers (a cost that delays entry), ancillary barriers (reinforce others), economic barriers (cost based) and primary barriers (operate on their own) (Valance, 2012). To certain extent, because of the existence of various types of barriers, the problem of oligopoly has been identified as a "supergame" and as a sequence of static non-cooperative games among the sellers (Kirman & Sobel, 1974).

5. Transaction Costs

As we have imperfect information in our real World (Li, 2012), there is false information embodied in worthless promises and unenforceable contracts (Li, 2010), transaction costs exist and exchanges are not costless (Royer, 2011). In general, transaction costs refer to the costs that do not exist in one man economy (Li, 2010). They are the costs resulting from the property rights transfers between agents. They are also known as the "costs of running the system" and the possible opportunity costs of making inferior governance decisions. They may arise in the form of direct costs from managing people's relationships (Kabadayi, 2011). Transaction costs theory states that depending on the behavioural assumptions (opportunism and bounded rationality) and the dimensions of the transactions (uncertainty, asset specificity and frequency), the economic agents will choose organisational forms, institutions, and transactions that minimise the cost of exchange (Royer, 2011). They can be decomposed into four separate costs related to transacting: search costs, contracting costs, monitoring costs, and enforcement costs (Dyer, 1997) (Table 2). These costs can also be identified as ex ante costs, such as search costs, and ex post transaction costs, e.g., bargaining, monitoring and enforcement costs after the transaction or exchange. These costs vary independently of the products exchanged and the competitive prices (Kabadayi, 2011). Transaction cost theorists propose that in absence of transaction costs, there is no economic basis for the existence of the firm. They also suggest transaction costs recognize that there are costs of using the pricing system and costs as such give rise to various forms of economic organizations (Jin, 2009). Firms enlarge to different size (Li, 2009) and adopt different structures ranging from hierarchical to market to reduce their transaction costs (Kabadayi, 2011). Other examples of transaction costs reduction include, the usage of internet, different contractual arrangement, medicine put on shelves are classified as invitation to treat instead of invitation to offer (Li, 2010b; Li, 2011c; Li 2011b).

Table 2. Types of transaction costs (Dyer, 1997; Li, 2008; Kabadayi, 2011; Spisak & Sperka, 2011; Li, 2012b)

Types of transaction costs	Definitions
Search costs	The costs of gathering information, for example, identify and evaluate potential trading partners and find out the pollution generators.
Information costs	The costs of knowing a product, for example, the components of a camera. In financial market, transaction costs are mainly the costs of obtaining and interpreting the information.
Contracting costs	The negotiation costs and costs from writing an agreement.
Monitoring costs	The costs of monitoring the agreement to make sure that each party fulfils the predetermined obligations.
Enforcement costs	The costs after bargaining and sanctioning associated with a trading partner who fails to perform according to the agreement.
Bargaining costs	The costs associated with the negotiations between partners. Parties to long-term agreements, i.e., a manufacturer and its channels, periodically negotiate to modify contractual terms and enhance contracts.

Transaction and search cost savings accrue to home buyers in the agency market in a number of ways, particularly for those out-of-town buyers who have limited time to spend. Agents provide information on neighbourhood amenities, e.g., they have ample information about neighbourhood recreation opportunities, school quality, shopping centres and a variety of other information that is often time consuming for home purchasers to collect on their own (Jud & Frew, 1986). From sellers' point of view, the decision to list the properties by agency companies rather than attempting to sell by them depends on the transaction costs in the housing market, in particular, the owner's time costs. Sellers with a high income are substantially more likely to use an agent than others. From the buyers' perspective, the decision to consult an estate agent during a home search depends primarily on the buyer's knowledge of the housing market and the opportunity cost of the buyer's time. Higher income buyers and those who are moving to a new area are more likely to consult a real estate agent. Furthermore, new homes are more widely advertised by the developers and they are easier to locate without the agents' assistance (Benjamin & Jud et al., 2000). After the buyer has selected a home, the agent will also provide advice on the availability of mortgages, how and where to apply for a loan, how to make the offer and how to handle the closing. In deciding whether to find an agent or not, the rational homebuyer must balance the generally higher cost of the agency service payment against the savings from lower information and search costs in the market (Jud & Frew, 1986). Therefore, it is fairly reasonable that most of the agency firms are opened near the housing estates. From mall owners' perspective, tenant mix is one of the major key factors which lead to the success of the shopping malls (Kirkup & Rafiq, 1994). A well-planned shopping centre with desirable tenant mix or possibly anchor tenant creates agglomeration economies (Eppli & Benjamin, 1994; Shanmugam, 2013) i.e. what kind of shops exist in the malls play an important role in attracting customers. As the success of the other mall provides valuable information to mall designer and owner, the author proposes that this can be one of reasons where similar brand of firms appear in one mall first and then the other copies. This eventually provides an invisible barrier to the small scale real estate agency firms at the infant stage but nurtures those large scale agency companies.

6. Research Method: Case Study

A case study is the best tool for social analysis when the following three circumstances come together: 1) when asking questions that include "why?"; 2) when the research focuses on a real-life context; and 3) when the questions being researched require an in-depth and extensive description of the research object (Fernández-Quijada & Ribes, 2011). These three criterion fit our present study perfectly. Furthermore, case studies enables the researchers to obtain in depth information (Li & Poon, 2013)*"[b]y adopting a case study design and integrating multiple sources of data…new insights [are] uncovered about the knowledge informing this process. The integration of several data sources means that the strengths and limitations of the different methods are counterbalanced to add rigor, depth and breadth"* (Appleton & Cowley, 2008). They also illuminate a set of decisions or a decision' rationales (Li, 2006). In view of these reasons, we conduct 2 case studies to better understand the oligopoly market structure in the Hong Kong real estate agency sector 1) Ricacorp Real Estate Agency--one of the 5 major real estate agency companies in Hong Kong and 2) a study of a new town in Hong Kong--Tseung Kwan O. In the Ricacorp case study, interviews were conducted to learn more about the agencies' selection criteria for their locations. The official locations for all of the branches have also been collected. The author has also made site visits to the real estate agency shops in Tseung Kwan O to better understand the branch distribution for the five major real estate agencies in this new town. Information from developers and real estate agencies has also been collected.

6.1 Case Study 1: Ricacorp Real Estate Agency

Established in 1981, Ricacorp primarily serves Hong Kong's real estate market but expanded its business to mainland China in 2009. It is one of the five largest scale real estate agency firms in Hong Kong. Today, over 50% of Ricacorp's shops are opened inside shopping malls (Ricacorp 2012). Many of these malls are owned by large-scale developers such as Cheung Kong, Henderson, Sun Hung Kai Properties, MTR and so on.

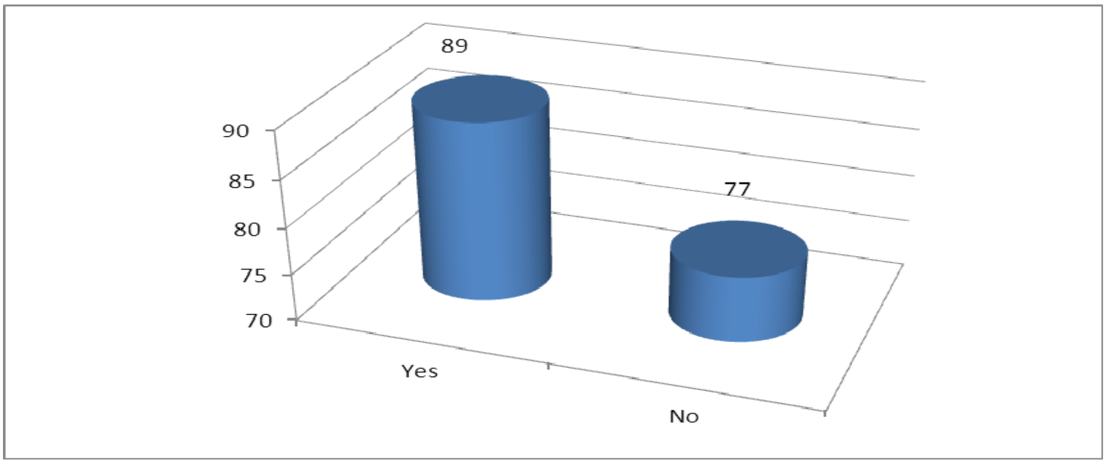

Figure 1. Number of Ricacorp branches located in shopping malls (Ricacorp, 2012)

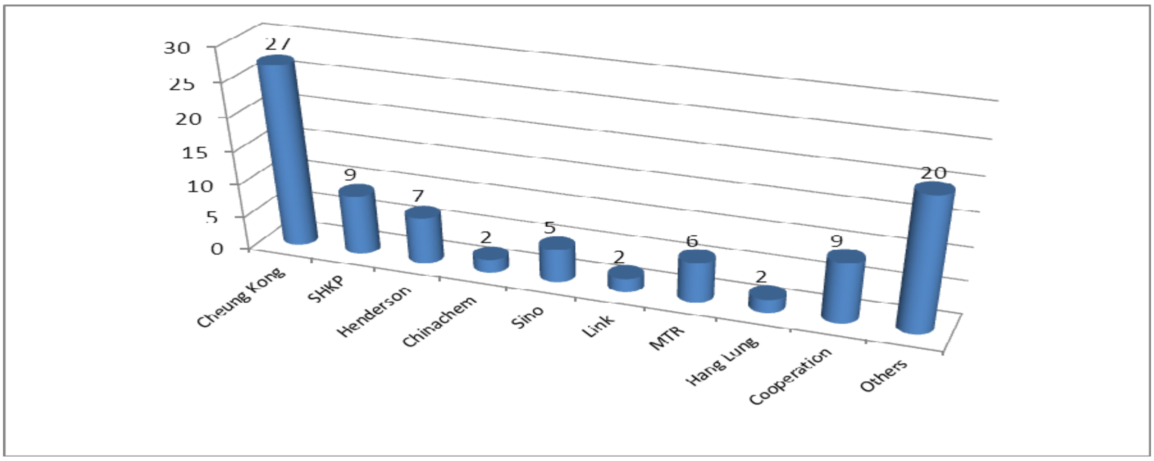

Figure 2. Number of shopping malls by owner (developers)

6.2 Agents' Viewpoint on the Shopping Mall Location

To better understand why many of the Ricacorp Estate Agency branches are located inside of shopping malls, 10 Ricacorp employees were interviewed. These employees were asked to identify at least 2 major criterion for branch locations. These employees stated that the most important criterion is convenience for buyers and sellers; a convenient location enhances market share and allows the agency to build up a sales network. As one of the employees noted, "*Firstly, the relationship between the property agencies and large developers is a major concern… Developers rely on agencies to sell or promote their new estates or offices or shops to individual investors or customers. Meanwhile, property agencies also rely on developers' products and offers to maintain the profits and enhance their business or exposure. Therefore, it will be a win-win situation if property agencies locate their branches in shopping malls that are close to the residential area. For example, the new estate that have grown rapidly in past few years like Tseung Kwan O, Tung Chun and Tsing Yi,* are examples of places that Ricacorp selected to intensively open their branches. *Moreover, a good relationship built with the developers may also bring some rental discount for the agencies (even though it is hard to verify). The second reason is the convenience for both buyers and sellers. Property agencies nowadays always face keen competition. They are always concerned their market share…their profits come from the commission given by the clients… This is the reason that property agencies are primarily concerned about the accessibility mainly concerning the accessibilities of their branches to enhance their market share"*

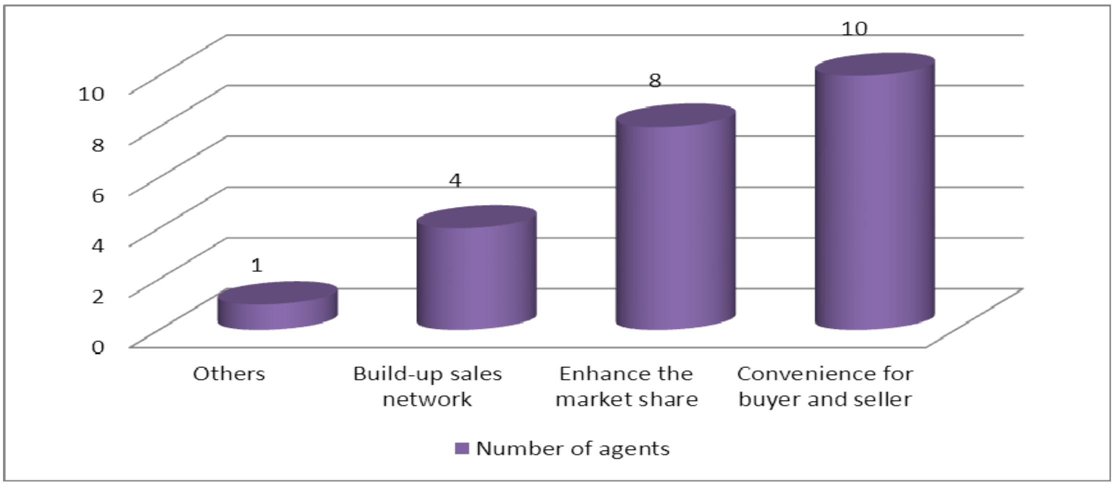

Figure 3. Reasons for choosing the branch locations

Apart from convenience, some of them propose that other major concerns when they expand depend on whether the new branches can help them build up the sales network and enhance the market share. Therefore, the interviewees support the author's second speculation why a lot of the estate agency firms open their shops inside the shopping mall.

6.3 Case Study 2: Shopping Centres in Tseung Kwan O.

In recent years, the shops in many shopping centres have begun to look similar to one another, i.e., many branded stores appeared in many different new malls in Hong Kong. Real estate agency companies are no exception. The towers of residential units nurture the shops located in the shopping malls locate beneath them (see a typical design for new housing estates in Hong Kong in Figure 4).

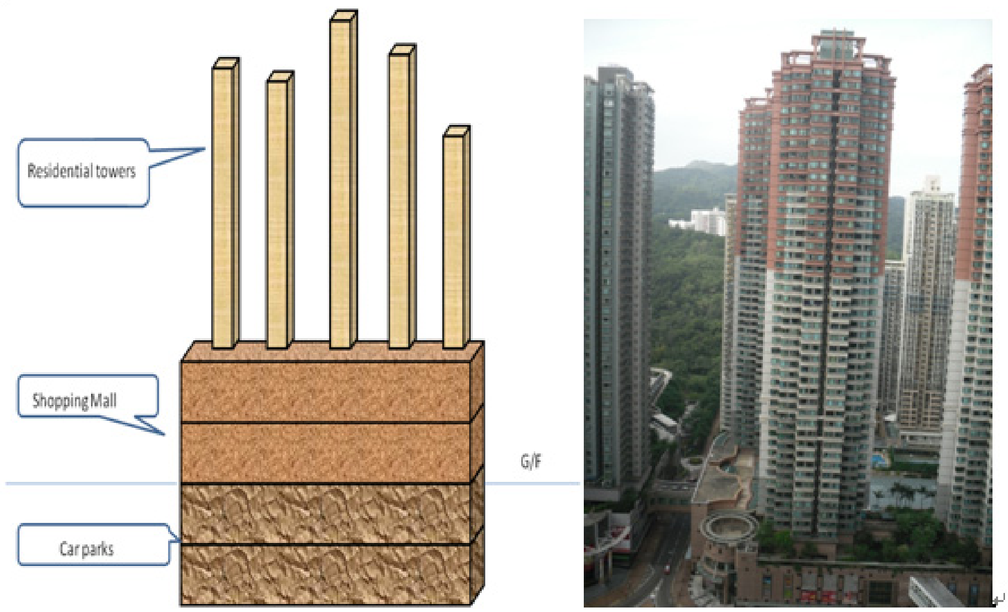

Figure 4. Typical shopping mall, residential towers and car park design in Tseung Kwan O.'s housing estates (author's drawing and photo)

The author visited shopping malls in Tseung Kwan O. to check whether these shopping malls favour the growth of large-scale companies and hamper the growth of small ones, leading to the oligopolistic development of the real estate agency sector. Many of the real estate agency firms that open their shops in Tesung Kwan O. are large-scale companies. Moreover, the majority of these agencies locate inside of shopping malls underneath residential towers. Except for two real estate agency branches that were located in the Hou Tak shopping malls owned by the Link Real Estate Investment Trust (very close to East Point City) and one branch in Bauhinia Garden. On top of that, all of the agencies in shopping malls were owned by one of the 5 major real estate agency firms. A Tai is one rare example where a relatively small real estate agency has successfully survived in Metro City Phase 1 (Figure 7), which is a large shopping mall in Tseung Kwan O. The real estate agency branches in these malls are copycats of each other. For example, the real estate agency branches in Metro City Phase 3 (Figure 5) and Nan Fung Plaza (Figure 6) along the roadside are the same. The indoor real estate agency branch designs also look similar in Metro City Phase 2 (Figure 7), East Point City (Figure 8) and the Resident Oasis (Figure 9).

Figure 5. Hong Kong Properties, Centaline, Midland Realty and Ricacorp in Nan Fung Plaza (author's photo)

Figure 6. Ricacorp, Centaline, Hong Kong Properties and Midland Realty in Metro City Phase 3 (author's photo)

Figure 7. Century 21, Ricacorp, En Tie, Midland Realty and Centaline in Metro City Phase 2 (author's photo)

Figure 8. Ricacorp, Hong Kong Properties and Midland Realty in East Point City (author's photo)

Figure 9. Midland Realty, Centaline and Ricacorp in Resident Oasis (author's photo)

7. Discussion

There are over 4000 real estate agency firms in Hong Kong, dominated by a few branded large scale companies. This phenomenon has a close relationship with the popularity of shopping malls in large-scale developments. In recent decades, the majority of housing estates have been developed as large-scale properties. Shopping malls are usually provided as one of the selling points of these developments. As the malls are usually opened beneath the residential towers, and the tenants and residents provide a major source of business. On the other hand, the mall managers often prefer to negotiate with a few large scale agency companies, such as Centaline, Midland Realty and Ricacorp due to the ease of negotiating with a single large firm representative or a team of representatives. As the mall manager only needs to contact one representative from each of the companies, such as Centaline, for all of their shopping malls, it saves a lot of transaction costs, such as search and negotiating costs.

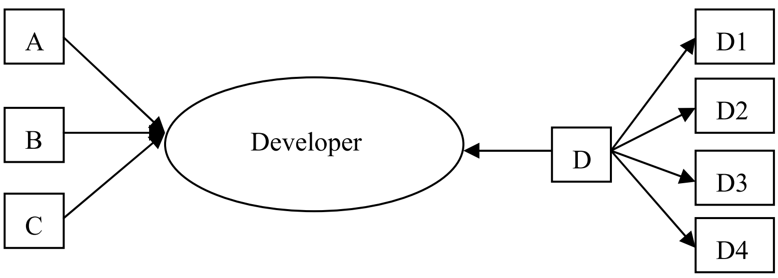

Figure 10. Contractual relationship between shopping malls and real estate agency companies (author's figure)

For example, if the shopping malls make contracts with three different real estate agency companies, A, B, and C, three separate contracts must be written, as shown in Figure 10. The mall managers also need to check all of the background information for these companies. If the developer rents out space in all the malls to the same brand estate agency, D as shown in Figure 10, they only need to check that the information of D (or do not need to check detail information when they have already built a long term relationship) and rent out shops for D1, D2, D3 and D4 which all belong to the same parent firm D. Therefore, the "cooperation" between mall owners and shop owners not only increase efficiency (Li, 2009a; Li, 2011a), the transaction costs from contract negotiation and enforcement can be greatly reduced. By making contracts with these large-scale companies that have a strong credit history previous transaction records, the developers can also reduce the risk of not receiving rent.

Besides, from the perspective of the mall owners, incorporating similar branded shops in their malls reduces the information costs of gathering the best tenant mix. The mall owners can simply stroll around the nearby malls and know what types of shops and brands of shops should and should not be included in their malls.

Thirdly, by locating the agency firms inside of these malls, the consumer's search costs can be lowered and the estate agencies can stay close to their potential clients. These malls are located below a large potential market (the shopping malls are below the residential towers), and the agency becomes one of the likely choices for these residents. Because every agency company owner wishes to obtain the best location for their business (refer to the interview with Ricacorp), there is keen competition for these locations. Nevertheless, only the large-scale companies that have closer relationships with the developers will find it easier to rent these units, even possibly with a lower rent. Even if smaller real estate firms are willing to pay a higher rent, they might find the mall owners more interested in a large-scale firm for the reasons listed above. These considerations imply that small estate agencies may lose their ability to obtain a favourable location, i.e., shopping malls. These small estate agencies are forced to locate in older districts, such as Sham Shui Po, Tin Hau, etc., or inside "small house" districts with a sparse population where 1) there are no modern shopping malls and 2) the shops are not under the control of large-scale developers. Moreover, the turnover in older and small house districts (especially sales) is much smaller than it is in the large-scale developments. All these factors have led to the shrinkage of small-scale real estate agency companies in Hong Kong.

8. Conclusion

In Hong Kong, the market for real estate agency companies is an oligopoly, dominated by a few large scale agency firms: Ricacorp, Centaline, Midland Realty, Hong Kong Properties, and Century 21. As the population live near the shopping malls, they can provide a steady source of customers to these agency firms. These malls then become the ideal place for opening the estate agency shops. From the mall managers' perspective, working with one large company can significantly reduce the transaction costs of negotiating the terms of rental contracts. It is no wonder why many of the malls in Hong Kong look similar: the same branded chain shops are opened in many of the malls managed by the same developers. To certain extent, the popularity of location in shopping malls favours the development of large-scale real estate agency companies too. It, however, hampers the branch expansion of the small scale agency firms. Small firms can only survive in the older and sparsely populated districts where there is no keen competition for the shops but profitability level is also low.

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