Volume 7, Issue 5

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"MODELS EVOLVE"

MAY 2007

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Marty's News & Notes

Featuring news about the Factory-Built Housing Industry
Contributing to the industry discussion...

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ANNUAL MEETING

Friends

Omaha, Nebraska. On May 5, **Berkshire-Hathaway** held its annual shareholders meeting. My wife, Pat and I attended, guests of **Clayton Homes of Maryville, TN**, to an event which is quite amazing.

We found Omaha a far nicer city than one conjures, its downtown spotlessly maintained, home to several giant multinational companies, including Berkshire. There we joined **Gary McDaniel** and **Jim Grange**, the driving forces at **Basecamp Capital of Denver, Co.**, both formerly major shareholders of **ROC Properties** and its successors. Gary was also **MHI chairman** a few terms back.

We also met **Keith Holdbrooks**, and his wife **Jacqueline** (ah, not "Jackie") of Addison, Alabama. Keith is the **CEO and President of Clayton subsidiary, Southern Energy Homes**, where his turnaround of that company's fortunes are a study in rational management. He is also the incoming MHI chairman at the end of **MHI Chairman Barry McCabe's** present term.

Those of you who have met Keith know he is a charismatic, amiable man. Blunt spoken, but with a ready laugh. He is an easy man to like. And Mrs. Holdbrooks? Well, she is a very bright, attractive and fun lady to have at a dinner party. She gets little zings in gracefully and is quick witted. Unfortunately for me, even this very pleasant lady was unable to extricate me from the **Annual Meeting of the Flat Earth Society** held at our dinner table, as my brain and wine mixed poorly. She tried.

The Big Party

Omaha was abuzz all week anticipating the Berkshire party with shareholders and interested parties arriving from all over the world. **Berkshire-Hathaway Chairman Warren Buffett's** genius, reputation and iconic status have turned him into a John Wayne-type figure, his fame reaching into ordinary citizens' grasp, though they may know little of his business. But they know and like him as a person.

The meeting is held at the giant sports arena in Omaha, and it's like an NBA championship or Final Four showdown, with an absolute swirl of people, barkers, food and whatnot, and as you enter the giant arena, I was reminded of the impact on me of the first time I entered **Fenway Park in Boston** all those years ago. First impressions only come once, and the Berkshire meeting, with over 27,000 attendees, plus the venders, employees, guides and attendants is some event. If you are not impressed by this, you've seen a lot in life.

What were my main impressions you ask? In the end, they revolved entirely around Mr. Buffett and his "partner", **Charlie Munger**. While both are very comfortable in the limelight, especially Warren, their incredible depth of life experiences and common sense approach to investing scream at you. Yes, Warren seems all "aw-shucks" and it's an appealing façade, and he still lives in his first home, and, oh well, we all know the mythology, probably all real, and probably all carefully nurtured.

What is most real is the grasp, the easy response, and the ability to simply voice complex thoughts that both Warren and Munger do so well. Munger with very few, well considered words and Warren, with flowing paragraphs, wonderfully composed and delivered. Well rehearsed through constant use, you say? Yah, so what? It didn't diminish the impact for Pat and me.

Munching Chocolates

That was what struck me, two 70+ years olds munching **See's Chocolates** (one of their companies) literally spending hours on stage, with a full-court schedule preparing and executing the meeting, and handling it with the energy of 20 year olds and the wisdom of sages. Pretty impressive stuff. And so was the guest list of luminaries which included Microsoft's Bill Gates and Margaritaville's Jimmy Buffett.

The other feeling you had as you sat in that huge packed hall full of energy was how much you admired the event unfolding before you and how you wished you were a part of it. I think this feeling of success and accomplishment drives the Berkshire employees to greater effort, as success breeds more success.

The numerous Berkshire companies all had stands in the display area, a huge room. There, prominently displayed in the far corner was a very appealing Clayton home, selling for about $140,000, well landscaped, with 1,000 people in line waiting to go through it. I passed on waiting, but was impressed with the appearance of this medium upscale, neatly rendered home. The long line clearly showed the appeal.

Big One

The big question on everyone's mind, as I spoke to several large shareholders I met there, is who will replace Warren, and how many will it take to do it? The bigger question must be: can anyone generate a compounded 22% annual return over the next 40 years as Warren, and yes, Charlie, have done over the past 40 years? That is the question, isn't it? Replace Warren's total personal and investment performance? I wouldn't hold my breath.

A NEW, OLD MODEL EMERGES

Funeral

We've dealt frequently with the lingering final burial of the old industry model which held sway in the industry from 1950 until around 2000. It was in 2000 that the industry retreat went from being a nasty cyclical pullback to a screaming collapse, as two-thirds of industry home shipments disappeared.

We have identified that, in our opinion, the shipments declines have occurred primarily in chattel financed homes going into land lease communities. That sector was really roughed up, and the rocking chair ease of managing LLC's with **Green-Tree/Conseco Financial's** accommodative chattel lending up to 2001 destructed as Conseco's MH lending arm failed. Since then chattel lending, especially into LLC's has been a challenge. (The lending process itself has become more rigorous and finding the borrowers lenders seek is not easy.)

Big Changes

Loan performance analysis, by the location of the home, revealed that even "A" credits sited into LLC's were problematic. (See **Tim Williams', of 21st Mortgage**, loan performance chart on my website.) It was further found chattel financing on scattered site placements was far safer and any loan with a tie to owned real estate even better. Loans formerly made as a daily common practice were almost entirely withdrawn from approvals unless the underwriting medicine men liked the glint of the borrower's eyes. Suddenly, a great many LLC's became a challenge and vacancies started to climb. Repos and more constrained lending conspired to cut financing for homes in LLC's.

Sell Homes

While a little slow to bend, after all, if you don't like the present MH lending attitude, just wait a minute and "accommodative" money will return, many LLC owners begin to see that LLC's were meant to sell homes into, not take orders at a retailer location, send the 610 FICO borrower to one of the "big boy" lenders, and place another home into the LLC. And many LLC owners who had jettisoned their sales efforts, relying on the 10-12,000 retailers scrambling to sell homes during the late 1990's, reopened their own sales location. Often they were opened to buy repos in their own and other parks and resell them or rent them. From these efforts, once again LLC owners, many who came to the industry as pure land-

lords, have again started dedicated sales efforts, just like the old days.

With constricted chattel lending and not more than 2,000 retailers last year who sold as many as 20 new HUDCode homes or more, LLC owners found that they could no longer depend on that avenue to keep their LLC's full. There has been a wholesale return to the past model of LLC's, where virtually every LLC had a dedicated sales effort at the communities. This not only was a profit center, but kept the LLC occupancy levels much higher than otherwise. (Never throw those neckties away, they'll be back.)

Pressures

It also brought two important concepts back clearly into focus for the LLC owners. First, in order to sell homes to people who often have other housing choices, the sales price and other aspects of the transaction had to be buyer-friendly, especially as to the gross markup and the price of the home. Wanna keep the LLC full of buyers with good credit? Make the sales price attractive.

The second concept which quickly arose is that the buyers we need and want, do have better credit capability, and with that comes those other housing alternatives for them. Not only must the sales price of the home be reasonable, but so must the monthly rent for the homesite. Whatever your housing competition is at the LLC, you must compete in that arena. Once low-credit capability customers could no longer be financed the "deadly duo" of LLC's, high gross home profit and high land rent, were under attack. Those failing to have good sales efforts or maintaining a competitive price of total homeownership suffered vacancies.

LLC owners begin to recognize the new reality that making their community successful begins with these two concepts, although it does not end there. Good management, maintenance, application of rules, area housing demand, and other factors all impact.

Old is New

Over the last couple of years an old concept has likewise arisen. This is the "partnering" of LLC's with friendly lenders. The trade-off is that "friendly lender" can be far more accommodative if the LLC owner follows the above pricing rules, AND, effectively and quickly assists the lender in reducing the usual home value loss penalty the lender suffers upon default and resale of the home.

The LLC owner already has staff at the property where the financed home is sited, they can make quick visits for late payments, take possession of the home upon default, refurbish the home quickly and effectively, and remarket the home, often with little or no loss to the lender. The lender on his own cannot cost-effectively perform as quickly and effectively as the LLC owner. No one wants defaults and I'm not sure this method substantially reduces them. But I am sure, that if properly done, the losses upon default are far less, and in the end that is the savior. Defaults by themselves are not the major problem leading to losses, it's the loss upon resale of the collateral which bites.

It's not that site-built housing doesn't have borrower difficulties, it does. But there, once in trouble, the borrower can usually sell his home, or if repossessed, a whole network of third parties move in, handle the repo for the lender, and the loss is usually not great. What the "special relationship" set up between MH lenders and the LLC's does is to substitute for the strengths and attributes of site-built housing, bringing it to chattel financed homes, by reducing defaults to some degree, but especially severely reducing the losses upon the default and resale of the collateral.

Diligence Required

Again, this is not new stuff, we had this very relationship with lenders in the 1960's and 1970's and to some on-going degree since then. The big potential problem is that this type of partnership requires both sides to act fairly and diligently with each other to make things work. As credit quality for the borrowers declines, both parties will face increased costs and effort. It can work and I am seeing some efforts which have now been on-going for several years with extremely high success. But if either party fails to act as it should and defaults mount, and remarketing lags, the process breaks down.

It seems pretty obvious that more of this will be done and if its success spreads, even more will occur. For the moment it seems to be a rediscovered elixir to create better sales activity and increased occupancy at LLC's by gaining deeper lender buying, while preserving lender profitability. But as in all of life, there is no free lunch. The benefits of this program must be worked and earned.

THE MERGER IS TABLED

Chicago

Less than a year ago private talks arose between the honchos at the two industry trade associations, **The Manufactured Housing Association for Regulatory Reform (MHARR)**, guided from the start by the **association director, Danny Ghorbani**, and **Manufactured Housing Institute (MHI)** were initially guided as talks began by the now departed **Chris Stinebert**, and since succeeded by new **MHI President, Gail Cardwell**. The existence of merger talks seemed to become public information at the time of the famous (infamous) "Chicago Meeting" last summer attended by leaders from both associations, if not by their association directors, Ghorbani and Stinebert, who apparently were not invited to the Chicago meeting.

Let's just say that early meeting in Chicago hardly went unnoticed by the industry at large. Rumors floated that one of the measures discussed there was a new trade association representing only the home-builders, sort of a **MHARR on steroids**. That would have left all other industry segments such as the lenders, suppliers, retailers, LLC owners and others to keep MHI going, without most builders. These segments were viewed as **"after market"** by those leading the "super builder" association, and just so much baggage, unneeded by the builders. The intent was to create a clear builder voice, unhampered by another association, or other industry segments.

Builder Loyalty

Apparently, there was substantial **builder loyalty to MHI** and its role in advancing the whole industry agenda and in keeping all of the industry stakeholders together. The talks then reverted to having the non-MHI members of MHARR come into the MHI fold. That waltz went on for some months, but even as the talks for merger were occurring, the forces looking for a "super-builder association" kept up their efforts, convinced shedding the "after market" group was wise. Having them in the association was viewed by that group as blunting the focus necessary to carry out the builders' own agenda.

I personally believed the merger would never occur. Not because the people involved were not men and women of integrity and substance, but because the names tell the story. MHARR believes to its core that industry salvation will come from "regulatory reform", that things like how many smoke detectors and where they are required in the home is the key to success. They seem less concerned with a Consumer Satisfaction Index or an Image Campaign. Salvation for them lies with endless "clarification" of wording on lengthy proposed statutes and meanings of enacted laws. Ten page "position papers' are dutifully distributed with arcane arguments which strain my credulity for importance.

Still, these are intelligent people laboring over these things and it is my sincere hope that the 20+ year crusade to have all this the way the builders want, comes to fruition. I'll follow it closely for impact if and when it finally happens.

The Others

Meanwhile, another group of builders is definitely intrigued by occasionally tweaking the regulators' nose, and to be kept abreast of what the regulators are trying to do for them and to them, but that is not their entire reason for belonging to an association. Many builders have said to me, "I'm not wild about some of the things they (the regulators) propose, but frankly so long as all my peers are in the same situation and we all have to live with the same mandates, I'll find a way to compete." I like the ring of that!

And, they like an association which **speaks for the whole industry**, without a fragmented message, and that is what led to the merger discussions in the first place; a desire to speak with a single, clear voice. But, if you can believe me, and my discussion to the beliefs of each of the association, then you might be hard pressed to have been convinced that this merger would ever happen given the current conditions. Philosophically, there was a significant divergence on future directions. MHARR generally believes salvation is in Washington, while MHI generally believes salvation is at the sales locations.

Price Too High

The price of bringing the MHARR group into the MHI fold was seen as too high by both at this point, and while the two associations continue to speak of a continued effort to reach common ground, for the moment, the chasm seems too wide to bridge.

Would it be better if the industry can reliably speak with one voice certain? Well, yes it would. But in order to do that the message to be voiced has to be settled upon. That has not yet happened.

CHATTER OR PERFORMANCE?

Rebound

The MH stock analysts are still touting an industry rebound. In their view the very modest increase in the builder's orders backlogs and the discord at sub prime real estate lending are both drivers for better MH industry action. I find this reasoning curious. First, the orders backlogs are modest, at best. Pleasing, but modest. And why the discord at sub prime real estate lending will benefit MH in any substantial way is puzzling to me.

In general, I'm unconvinced because of several considerations. I still get many internet solicitations from lenders active in real estate sub prime. If they are no longer as "inventive" as before, their loan appetite seems little abated. That lending segment (sub prime) for ABS offerings is 400-500 times larger annually than the MH ABS.

ABS investors still seem not to be flocking to MH ABS. While **Origen Financial's** ABS bond offerings have behaved themselves wonderfully for years, and their access and cost have decreased substantially, it still is more difficult than the industry would like to access ABS money and pay its cost.

Low FICO's

Additionally, to some substantial degree, the MH ABS offerors have their hands bound as to the type of credit quality they can finance. Going down, say 20-30 FICO points in their portfolio makeup, might create havoc for the MH issuers ability to sell their paper effectively. It's a real concern. Yet, even an average decrease of 20-30 FICO points on the portfolio, say down to an average of 690 FICO would greatly benefit the MH ABS lenders. To my knowledge, none dare try it, yet.

Still, some of the financial world watching MH seems under the impression far better days are ahead. The "cyclical retreat", (save me, Jesus!) is over and we are back to the races. However, I have yet to speak with an analyst who, though they may be positive on future industry action, see a quick return to even 130,000 homes. Some recovery.

Awaiting Report

As I go to press, the early June flash for April shipments has not been released. The March shipments number brought the 2007 shipments rate to around 95,500 homes. My shipments analysts advise me they do not expect much of an increase in the 2007 rate based on April figures, probably remaining under 100,000 homes. Remember, last year the total shipments including FEMA homes was 117,510, and 113,503 without FEMA. We expect few, if any, FEMA homes in 2007. Now we wait for the April number to light the way. A blockbuster April shipments number would confirm the analysts' expectations. A muted one would confirm my suspicions, at least for the moment.

MOVING QUICKLY

Dynamic Duo

The new leadership team at MHI, McCabe and Mrs. Cardwell, have set a quick pace on many fronts in a very short time. Dealing with the proposed MHARR merger, GSE programs, the HIA 2000,Title 1 reform, and the upcoming Summer Meeting has been demanding. This Summer Meeting will be the first test of the new meeting format at MHI, which has created a number of study committees. If this will all work is still unproven. Substantial discussions and study of industry problems, much of it quite effective has been accomplished in the last 7-8 years. Yet, much of what was determined and the recommendations to correct went unaddressed, virtually no action taken. I guess thinking about it, discussing it and proposing counter measures were deemed sufficient.

This is not to imply this can't work. Only that if we follow past occurrences, good research will not be followed to effective fruition. Little has been put into practice.

Penance or Profit?

One of the crippling aspects of this inaction has been the continued attempt to force greater industry lending access to HUD or the GSE's, often making it a penance to finance MH for them. Too often the industry has defined "helping the industry with lending" as not just requesting a lower financial return for the lenders on those loans, but actually demanding pricing and underwriting and terms which are highly likely to create **substantial lender loan losses**. Seems palatable for the lenders, eh?

I've read the underlying provisions of the new Title 1 lending program for personal property. These will undoubtedly lead to terms and provisions which are likely to cause industry heartburn. The Title 1 program has gone inactive for years, in my opinion as a defense by HUD to the losses the program has endured in the past. Leave the program essentially unusable and save yourself losses. If the new program isn't properly administered, at Title 1 or elsewhere, the ultimate result will once again predictably create problems. The past history of lending on MH is clear on this point. And still as an industry we insist asking for the easy way, too often making lending a penance.

Until the industry helps create and accepts rational lending programs which make MH lending a commercially viable business endeavor, it will be a niche loan product, its arcane nature perhaps benefiting a small number of lenders, but keeping the industry constrained and on the same downward path it has followed since 1973, when it topped. (Yup, it topped in 1973, 34 years ago.)

And make no mistake, not everyone wants the GSE's "reforming" MH lending. I well remember a comment to me by a well-known and respected lender at a Financial Services meeting. He groaned as one of the GSE's appeared at the meeting. I asked him the problem and he responded "the bastards will take all the profit out of it." So there is some ambivalence.

We'll see if all these new study groups recognize this situation and do something positive about it.

CREATURE OF DEMAND

Wrong Profile

Sinking in slowly is the concept that *demand* for MH *continues unabated.* I see the same consumer demand today at 100,000 shipments as I saw in 1998, at the last top. **But the demand still comes from a segment of potential buyers whose credit profile won't pass muster today.** Hundreds of thousands of people, coming to our sales lots, often with great desire to buy, and we can't help most of them. We now know that under the present conditions we cannot finance most of these folks, profitably.

It's pretty obvious by now that the financeable portion of our shoppers is simply not big enough to fuel the size industry we want. The people we need have enough credit capability so other housing options are open to them. Most of these folks never shop us, and those who do often make another choice. We are starved for a greater credit-capable base of shoppers. Many continue to advocate "opening up" lending by the GSE's or HUD/FHA to these folks our industry lenders can't or won't finance. If our lenders can't do it, how will those lenders we keep pushing in this direction prevail?

Our Image

This is where the **Image Campaign**, often discussed in these pages and elsewhere needs to kick in and do so quickly. We cannot rebound our industry until we get more of the shoppers we need. Yes, of course, we need to do a better job once they arrive, but we need more of them; now! Is there a better way to get to the consumers we need than through an intelligent campaign to educate, excite and entice more of our desired shoppers? If there is, you might inform Budweiser and Miller Lite.

QUICK CONTEST

Who is the prominent Congressman representing a large industrial state, who is deemed to be a firm friend of the MH industry, but whose state has sold fewer than 500 new HUD homes annually average for the last 30 years, in spite of the fact it has an enormous affordable housing shortage, and plenty of land on which to place it? The first correct response will get an autographed copy of "Global Warming: The Final Religion."

FOCUS ON FINANCING

Misspent Youth

Having misspent much of my youth hanging around MH lenders, I have observed around 35 years of activity and results at that endeavor. The short conclusion of my lengthy observations; lending on MH, especially on a chattel basis, is a highly challenging activity, especially if you want to make a profit. It's hard work even if you can live without a profit, and history clearly reveals most have transacted it without any profit, and a significant number with large losses. The other observation gleaned over all those years is a predilection by many who have virtually no MH lending knowledge, becoming loan performance experts as they exhort the GSE's or HUD or others to lend in some fashion the lenders themselves find inconsistent with safety and soundness. As an example, the industry has been after both HUD and the GSE's to support the industry with expanded lending. What I have not heard or seen offered by the industry is loan performance data and policies and procedures to reach that loan performance. It's always, "Trust me", or something like that.

Instead I've heard assurances that certain lending will work, and the aforementioned lenders should introduce this program or that, and often we will lobby friends in Congress to break some knuckles to compel.

Gotcha!

The current focus to revise the **FHA Title 1 re-**

form bill has essentially for years followed the process I outline above. But in reading some of the key elements of the new proposed bill I find two provisions I find highly interesting. The program is to be guided by these two:

The first states:

- **Authorize an up-front premium for each loan of up to 2.25% of the loan amount, and an *annual* premium of up to 1% of the loan amount.**

Assuming the full premiums are charged, and that the average portfolio turn is 7 years, then we will have a "premium" amount of almost 10% of the amount financed. The only comment I can make is that subject to the underwriting and servicing this will be either barely adequate or wholly inadequate. Seems like a thin margin of safety, absent more.

Couple that with the second provision:

- **Require HUD to revise its underwriting criteria for FHA personal property manufactured home loans *to ensure that the program is financially sound.***

I guess that means FHA will be required to create an underwriting platform that will allow the program to survive and profit. The cost of money at FHA from GNMA should be quite attractive, but as you "open" the program to lower credit, underwriting will necessarily have to increase the interest rate until a point is reached where defaults are so high that even the high rate won't save you, especially if you care about how many people lose their home to foreclosure. Methinks that crash I heard is "easy money" demands made of FHA taking a fall.

So as the industry chases the GSE's and HUD I dare say the two above provisions might well limit the ability of these entities to be bullied into programs the industry often pushes, without backup and all the while trying to avoid any loan liability to themselves.

Again, I strongly suggest we endeavor to make MH lending **a viable commercial endeavor instead of a penance**. There is a growing realization within the industry that this approach is a proper course. Others apparently still think that MH lending is like taking castor oil; hold your nose, swallow it and suffer the consequences, which are not immediate, but will be felt.

THE MHL CORP ANNUAL SHIPMENTS CONTEST

March shipments saw a slight bump up from the February-ending pace of **91,400 homes** to the March-ending **95,500**. One could still categorize that as disappointing, but it is moving up, though still down almost 20% from the final 2006 pace. Ouch!

And who was the pessimist who was closest to the shipments pace? Why it was **Patrick Hoffman of Marcus and Millichap** of Southfield, Michigan, the LLC broker, with a prediction of **97,000 shipments**. He replaces **Scott Slezak of Foremost Insurance**, who at **93,141** homes has been the contest leader previously. But if we are to believe the MH stock analysts Patrick should soon be left behind in the dust as the industry recovers. We'll see. I for one will be delighted to be proven wrong and that the April shipments took a big jump up.

The stories from the field do not indicate any blazing action out there. While some individuals and companies have adjusted their operating model to more effectively control the market, the prevailing story I hear is of a changed but still challenging market, with low energy and velocity, both chattel and real estate. How long does this continue before we try PLAN B?

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