DIFFERENTIALS

By Martin V. Lavin

If you have a fax machine, you probably get a lot of "junk faxes" for free trips to Nassau and Las Vegas. And, if you're like me, they usually end up in the wastepaper basket.

However, one of these junk faxes recently caught my eye. It was from a real estate mortgage company that sends rate sheets weekly. I couldn't believe what I saw—fixed rates in the 7 percent range with variables in the 6.5 percent range and less. I'm so used to double-digit rates for manufactured homes that these seemed unreal.

By primarily dealing with 12 to 18 percent interest rates, what impact will these lower rates have on this industry?

MH appeal

There are various reasons manufactured housing is so appealing: the ease of living; nicely constructed and decorated homes; the ability of the retailer to arrange financing; quick set-up (most accessories are available at the point of purchase); and the "total package" the purchase represents.

A customer could drive into a retail sales center and, in 24 hours or less, be watching satellite TV in his new living room. Speed and ease are just a few of this industry's greatest attributes. Even qualifying for financing is quick and easy.

Keys to the success of manufactured housing are the inherent value-per-dollar of the underlying product and attractive financing. The lack of a lengthy paper trail common in the highly standardized world of real estate mortgages is also a feather in the industry's cap.

Manufactured home interest rates top off around 18 percent with hardly any under 11.75 percent. In comparison with site-built mortgage rates, there is a difference of between 400 and 800 basis point (BPs) differential. (One percentage point has 100 BPs.)

What does this all mean? Do the math. Mr. Buyer wants to purchase a home and is considering manufactured housing. After visiting a retailer, he selects a $50,000 home that includes a rental community site. He has a 690 bureau score, a good job and family income, and qualifies for the loan.

With a 10 percent down payment and interest rate of 12.5 percent, he's financing $45,000 over 25 years. The rent is $350 per month and includes water, sewer, road maintenance and trash removal. The monthly house payment is $490.66, which added to the lot rent is $840.66 per month. He decides to think it over.

He searches the classified ads back at home and finds several houses for sale, but they are very expensive. He examines the lender's index of real estate mortgage rates and is surprised to see fixed rates in the 6.8 to 8 percent range, with down payments as low as 3 percent.

In fact, special programs through the state finance housing agency are even more attractive. However, these down payment programs require mortgage insurance.

He talks with a state financing agency broker from the classifieds and 15 minutes later, he qualifies for a 7.1 percent rate, with 3 percent down, a purchase price of around $100,000, but he'll need that mortgage insurance.

The monthly payment for the $100,000 loan at 7.1 percent for 25 years is $713.17 which, when combined with mortgage insurance, is cheaper than manufactured housing.

How can this consumer can get into a site-built home that's twice the cost of a manufactured one?

With a site-built home, real estate is acquired at the purchase and, in this example, the buyer is renting his land. It is this rental amount, in addition to the rate differential, which increases the cost of manufactured housing.

The interest rate differential is quite large. Here's the cost per $1,000 of value for 25 years from the examples above: Site-built housing at 7.1 percent is $7.13 per month and manufactured housing at 12.5 percent is $10.90 per month.

Currently, manufactured home sites are sold nationwide for $10,000 to $40,000 per lot. A general rule of thumb is that about 40 percent of the site rent pays for expenses associated with the lot, not debt service.

At a 10 percent cap rate to net the expected rate of return by lot value for the community owner, monthly rents can range from $150 ($10,000 lot value) to $600 ($40,000 lot value).

Since very few sites can be purchased for $10,000, rents have been increasing nationwide, affecting lending affordability as well.

Start making sense

The interest rate differential between manufactured housing and real estate mortgages for conforming loans is very high. This makes manufactured housing less attractive, while making site-built real estate more competitive.

Historically, manufactured home interest rates have been 175 to 300 BPs higher than site-built mortgages. That differential was due almost entirely to the greater costs-per-dollar of loan originations, servicing costs and losses on defaults.

With the events that transpired in securitization markets over the last two years, this industry has to pay a substantial premium which is passed on to the consumer and the rate differential, at double and triple historic levels, making manufactured homes financially less attractive.

Because of qualifying factors, down payment requirements and the cost of site-built housing, manufactured housing appeals to lesser credit worthy borrowers. However, severe losses caused by aggressive lending in the last three years to marginal borrowers has forced lenders to restrict loans.

Borrowers with low 600 bureau scores and especially those under 600 are almost entirely shut out, and with good reason. But this segment has constituted a meaningful proportion of manufactured housing business over the last several years.

The net impact is a 25 percent decrease in 2000 volume. What remains to be seen is whether the industry hits the lows of the early 1990s as the lending squeeze continues.

MH vs. site-built

Rental communities have become very valuable commodities and are purchased at high lot values. In order to meet their expected rate of return, rents have increased dramatically nationwide.

It's no secret owners keep rents below expected rates of return to reduce service demands. They don't have debt or shareholder attention on their backs, giving them a luxury new community owners don't enjoy.

A return on your investment is necessary and only sound business, however, this does have consequences. As rents increase, especially in better communities, residents are more likely to be paying the real value of the site. Just like increases in interest rates, this makes manufactured housing more expensive and cuts the cost advantage over site-built housing.

Even when a manufactured home is not sited in a rental community, there is not much relief for the borrower. It's not unusual for land/home rates to be 25 BPs less than home-only financing. Except for the rare federal financing or special programs by hometown banks, manufactured homes financed as real estate are several hundred BPs higher than site-built mortgages.

Rapid finance approvals and closing processes have held a competitive advantage over site-built mortgages, but that extra speed has been a disadvantage for loan quality.

The customary speed of this process has made adequate verification of loan details prior to closing more difficult. A large land/home lender recently said their loan originations slipped 18 percent in a 90-day period after they implemented down payment verification.

Down payment verification is a staple of site-built mortgages and has recently become popular with manufactured home lenders. While it increases loan quality, it decreases loan volume, especially poor quality loans. However, several lenders are moving in this direction.

When it comes to resales, the rate differential disadvantage is even more dramatic—rates are 500 to 1000 BPs higher than site-built mortgages. The buyer most likely to pay this premium is the one who wants his own home but is unable or unwilling to qualify for a site-built mortgage. Most lender programs no longer accommodate this low-end borrower or do so only at very high rates.

Answers

This industry must find alternatives to the securitization of loans as the primary means of funding the loan conduit or structure originations to create a comfort zone for securitized paper buyers. This will help narrow the rate differential.

A good alternative is bank lending. Institutions such as SouthTrust, Washington Mutual, Peoples Heritage and National City don't have a major presence in the marketplace, but together, they bring liquidity. Also, their presence puts downward rate pressure on larger lenders who risk losing the best loans to them.

Additionally, as loan originations by larger lenders are influenced by their need to meet securitization desires of their investors, loan quality improves and rate differentials decrease.

While this can't come too soon, the question again will be the near-term impact on annual volume as loans below 600 (and perhaps 625 bureau scores) are strongly constricted.

The industry may accelerate its move to risk-based pricing to charge what it costs to finance the customer's credit profile. Presently, pricing pivots off the collateral rather than the credit profile results in high interest rates without regard to the borrower's potential.

This is interesting as defaulted collateral costs the same in losses whether the borrower is weak or strong. The ideal situation would be to have rates affected by the borrower's credit profile. After all, a borrower in the 550-575 range is six to 10 times more likely to default than the over-700 borrower. But many lenders still have one-size-fits-all pricing and terms.

The net impact is increased rates while discouraging better borrowers and making a higher percentage of loans to weaker borrowers. As the losses mount, the rates increase, further discouraging the good borrower while appealing to the less desirable. The process seems self-defeating.

Some of the big guys like Chase Manhattan and The CIT Group have either fully implemented risk-based pricing or are doing so now. The intent is to have rates that attract better borrowers by decreasing the rate differential and charging the weak borrower his true cost in hopes this will attract the former and discourage the latter.

The industry must continue the present move to rationalize pricing and loan quality. This could be the only way to recapture the marketplace held in 1998 and before.

Get good borrowers back by getting pricing back to where it historically has been vis-a-vis site-built real estate lending.

It's all worth asking if **any** pricing formula will allow some of the very low credit profiles to secure profitable loans. □

Martin V. Lavin is an attorney and 28-year veteran in the manufactured housing industry with special emphasis on lending. He is vice chairman of MHI's Financial Services Division and represents Mortgage Services Inc. and Mobile Home Lending Corp. Contact him at 802/862-1313 or MHLMVL@aol.com. 270 College Street, Burlington, Vt. 05401.