THE LAND/HOME CONUNDRUM

By Martin V. Lavin

I write frequent columns for this magazine and enjoy most of the comments directed my way by readers (it's nice to know someone is reading). A letter I received the other day brought back a subject often on my mind through the years.

I'm refering specifically to the land/home business, where a factory-built home, sited on real estate and secured by taking a lien on both the land and the home, is financed.

This has been an area of intense interest in sales and lending for the last 30 years. I have observed and participated in this type of financing since 1972, yet remain ambivalent on the subject. In fact, I'm still trying to understand how and why it fails to function well in this industry.

A long time ago...

I was general counsel in the early 1970s for a very large, multi-state retailer. All of our locations were franchised but, as was common, we were responsible for inventory financing. Obviously, we had a big stake in the financial dealings of our sales locations. (Imagine guaranteeing the floorplans for almost 100 retail sales centers?)

In 1972 and 1973, the industry delivered almost 580,000 new homes per year. As a reference, the industry delivered about 373,000 homes in 1998, its greatest number since 1973 and 193,229 in 2001.

Ours was then a large industry with phenomenal growth. No one questioned projections that forecast one million new home deliveries by 1980. We all believed it. To this day, I recall the excitement felt by most 30 years ago. Our young industry seemed to know no barriers to growth and profitability, except for retail financing and siting alternatives for homes.

I spoke with many of our franchisees from time to time, and began to see a trend. I would get a call from an excited retailer who would tell me he had just purchased 20 to 50 acres. He had gone to the local zoning authorities and was going to put in 100 or so quarter-acre lots with streets, sidewalks, water, sewer, buried power and phone lines. It was going to be a manufactured housing subdivision where he was going to site some of the best "double-wides," as they were then called, on lots. His intent was to sell more homes and go "upscale," bypassing the single-section models he usually sold in land-lease communities.

Even then, land-lease communities were difficult to develop, short on available lots and often closed to other retailers or required an entrance fee. Other siting alternatives were necessary to continue to fuel the growth that was occurring.

More than one of our retailers tried to create manufactured housing subdivisions. I quickly learned to anticipate the eventual outcome.

Usually, the retailer would call me several months later to report progress was slow. Because I was an attorney and did a lot of zoning work, he wanted advice. Extra studies by engineers had been ordered and the project was meeting a lot of resistance. The town halls were usually packed full of very interested citizens during zoning hearings. Most retailers were not financially or emotionally prepared to continue the process once it bogged down.

At some time in this development process, I knew I could pull a carefully executed floorplan financing check and find our friend SOT (Sold Out of Trust). In other words, the retailer had sold homes but hadn't paid off the floorplan.

He found the subdivision work had cost much more than anticipated. In addition, concentrating on the subdivision had diverted attention from his usual business, so he had used the sales proceeds to keep going. This usually resulted in closing the retailer down and a loss for us. I remember it well.

In a world where a home, financed as a chattel mortgage, is sold today, sited tomorrow in a community and the buyer moves in the day after, you get used to a pretty fast pace. Zoning hearings, lawyers, engineers, surveyors, boards of adjustment, subdivision permits and other elements of real estate development may be many things, but fast they are not!

Our retailers confused the fact that they wanted to sell more manufactured homes with what it takes to succeed in the land development business. The two are separate concerns.

The cost, time, effort and frustration of the development process all combined to sink many retailers. I am not sure that much has changed over time in the land development process for our product.

It is only incidental to the process of development that we sell factory-built homes. The zoning process is no more likely to take less time or to be easier with our product than site-built homes. In my experience, retailers developing lots on which to place our products draw more attention than site-built developers do. And neither can be said to get a free ride in most locales.

The zoning process wasn't the only problem. The development process is loaded with costs on the front end. You get your money back through home and lot sales, but only after you bought the land, obtained permits and put in the streets, utilities and foundations. These are big-ticket items that have to be funded up front. Where do the development money and the debt service come from during the process?

Then, your sales may not go as you

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had planned. Almost always, the sales rate was slower than planned. Or you went into the market during a down cycle and housing sales were in the toilet. In order to sell the few homes you could, you had to sacrifice them as well. It was not unusual for the second or even third developer to capitalize on the opportunity after the first one failed.

Based on this experience, I viewed the pursuit of subdivision work as hazardous activity to the average retailer who usually was not well positioned financially or lacked experience that would have allowed him to complete the project successfully. Of course, some have pulled this off in our business, but many have struggled. Failure has not been uncommon.

The next generation

Fast-forwarding about 15 years to 1988, I was involved with a lender operating in the Northeast where scattered-site home placements on private land were possible and popular. Rental communities with high rents and occupancy rates were in average to less-than-average condition. At the same time, rural residential lots were plentiful and cheap. Usually where that combination of factors exists, the single-site, land/home business is strong, as it was there.

The demand was there all right. At any given time, we had a “pipeline” of loans in progress that was truly impressive. My duties included responsibility for the land/home department. Therefore, I kept a close watch on the pipeline and funding.

It didn’t take too many months to see this enormous pipeline was *constipated*. Much was going in, but very little seemed to be coming out the other end. The majority that did were withdrawn loans, quickly replenished by ever-greater numbers of new applications starting the process.

The first few months, the people in charge of the program told me it was taking time to fill the pipeline, and a 60- to 90-day lag time was necessary for the appraisals, sitings, title searches and the like. I nodded my head and didn’t question it. But, as the months went by, I began to see a pattern that was unsettling in the extreme: a giant pipeline but a very low funding rate. Hardly anything seemed to be closing.

What I found as I did autopsies on failed transactions were barriers to land/home funding that didn’t exist in the chattel business. It starts with the fact the land/home business has a cast of characters involved in significant roles that don’t exist in the chattel business. Most of these characters are third-parties—independent contractors—we don’t control.

In the chattel business, it is hardly unusual (in fact it is quite common) that the buyer can purchase his home and have it sited in a community or even the buyer’s land or that of another, and have the whole transaction handled by the retailer and his employees.

These folks tend to operate on your time frame and the retailer can get the home sold, financed, sited, occupied and paid for relatively easily, usually in just a few days. That’s one reason the chattel business has been so popular.

Once land is involved as security, however, the cast of characters changes radically and you do not control most of them. Financing may come from one of our industry lenders or a variety of other places, including the local bank. Since it is real estate, an appraisal of the home and land will be necessary. Since land is involved, a lawyer or title company will undoubtedly be involved for a title search and perhaps title insurance. The appraisal and title work may require the customer to pay for these services out of pocket, in advance, without necessarily knowing he is going to close because of an inability to meet loan conditions.

In addition, depending on the site, substantial site work might have to be done, usually by third parties. Again, this work is not usually under the direct control of the retailer or home owner. This can include a foundation, septic and water systems, electrical connections, driveway, patio, garage and deck.

Are you getting the picture? The “slam-bam” ease of chattel loans is replaced with the complexity of land/home packages.

Because land/home loans are frequently “stage-funded” (cash disbursements made as certain activities are completed), the greatest risk is during the process of siting the home. Careful attention must be paid to actual satisfactory completion of each stage to ensure funds are not being improperly advanced. It sets up a whole series of potential problems that can and do occur with great frequency.

Timing can be a problem as many of these characters do not meet time schedules and, in many cases, do not perform well, or at all. Friction commences between the buyer and the retailer, regardless of whether or not one or the other is to blame. Things being what they are, disputes arise, tempers flare and the setting is there for a disagreement leading to a loss for someone.

I am not sure this is true anymore, but the single most common civil lawsuit in this country at times has been litigation between the home buyer and builder. In this case, the “builder” is the retailer, usually not the factory, although even the factory may be drawn into the fight. The lender, who has the money out on a loan, will most likely be involved.

Recently, the industry has streamlined lending on land/home transactions to avoid many of these problems. Make no mistake, they have not all gone away. Quite the contrary, field personnel for large lenders tell me problems arise constantly and usually involve a lot of people when things get out of kilter.

It is not unusual for the lender to be left with a large problem with no recourse except repossession. In addition, industry lenders tell me the low yields and high origination costs are a further irritant to them. Any lender that doesn't get caught with a large bill for unused appraisals is lucky indeed!

A new hope?

A new trend has occurred recently, the impact of which remains to be seen. It has become very common for mortgage brokers to bring retailers a new source of financing at substantially lower rates than the land/home rates generally offered by industry lenders.

It is not unusual to see mortgage rates 200 to 300 basis points (bps) or less than traditional land/home rates. Additionally, those borrowers so unwanted by industry lenders—with bureau scores under 600—have a much greater chance of approval with mortgage brokers. How can this be?

The easy answer is what shouldn't be can't be, meaning over time mortgage brokers are likely to promise more than they can deliver. While they are the talk of the industry at present, all the folks I've spoken with see what is occurring and can only shake their heads in anticipation of the problems.

Many of these loans will go to unwary lenders not educated in values, how they are originated and the servicing required of this type of loan. Others will go down the path toward what looks like a closing only to have it become a dry hole, just as I found out so long ago with that big pipeline. I get reports like this daily.

Understand I'm not condemning all of this activity. There are excellent people specializing in industry mortgage lending. But the truth is good programs are scarce and low interest rates generally bring loan conditions difficult to meet with regard to the type of home, how it's sited and many other factors.

If not, the federal government's guaranteed mortgage lending programs would have annual loans volumes many, times greater than they now originate. There must be a reason.

So, after all this enormous interest over the last 30 years, how big a factor has the real estate-secured, factory-built housing loan become? Recently, a report on lending produced by one of the independent industry watchers noted the immense interest of our industry to originate land/home transactions, the constant industry chatter about these programs and their growth potential.

Yet, the report said while some lenders appeared to be originating as much as 30 percent of their loans on a land/home basis, their best estimate of total industry land/home volume was about *15 percent*, not more than 20 percent of total dollar originations.

This jives with reports by many industry participants I have polled. Yet, here are sane people of intelligence, who believe current land/home financing originations are approaching 50 percent of all new home sales. I doubt it, although no one knows for sure. MHI has just started polling for this information. In the future, we'll know more.

I know from my conversations with a wide tier of industry participants that growing factory-built housing's reach by expanding land/home opportunities is top drawer stuff. Some

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segments seem bent on replacing much of their chattel originations with mortgage originations through expanded rural site placements.

In the past, and as I write this, chattel loans for homes sited on borrower-owned real estate are hardly rare and usually good business. Lenders think it would be better if they were fully real estate secured, however.

A different segment of our industry really views land/home transactions to mean single-family subdivisions with factory-built housing replacing site-built housing. This is, and has been, pushed by some of our builders and others in an attempt to sell more and better homes.

In a sense, this type of placement doesn't compete with subdivision housing: It *becomes* subdivision housing. This would potentially open a massive new marketplace for our manufacturers and really depart from the industry we have known since the end of the Second World War. Not that changes haven't occurred during that time, but this would move us into a different category and be truly monumental.

And it doesn't replace our present business either. What we do now is create housing for folks who want to spend $30,000 to $60,000 for a new home. Yes, we sell homes that are cheaper and more expensive, but that's our most common market. Obviously, subdivision housing, with the amenities generally required, will be more expensive than the aforementioned price range.

That's why it is viewed as viable only by replacing certain segments of site-built subdivisions, what with their difficulty of labor shortages, uncertain and noncompetitive square-foot costs and other maladies. Whether they are right or not remains to be seen. Presently, it is without a doubt one of the most discussed issues in the industry and its future.

While I view manufacturers to be the primary beneficiary of a successful expansion by the industry into subdivision housing, they may not be the sole recipients. Community owners are a large and powerful group of companies, many publicly held and may well benefit from this change. Some financially strong firms are already involved in land development for the purpose of creating and expanding rental communities and may view this as a natural adjunct to their desire to expand factory-built housing to an upscale clientele.

While it flies in the face of some community developers who traditionally rent land for homes, becoming a subdivision developer may simply be viewed as an extension of the housing they already provide. Many of the same concepts and people involved in community development can be used in subdivision development, giving them an advantage most other industry participants do not share. Yet, it is a different business so there will be a learning curve. Their liquidity should allow them time for the education, however.

What is more certain is, in most cases, financing the sale of these subdivision homes will be done by traditional real estate mortgage lenders. Further, the distribution of the homes will most likely be through the subdivider, not an area retailer.

As I found out many years ago, subdivision development is best done by people who do it as a primary occupation. When organizations like factory-built home retailers take on the subdivision role, they are generally ill suited for success. Therefore, most will stick with their strength—chattel and single-site land/home placements. That is our primary business now and it will not go away. It will be the rare retailer who succeeds in future attempts at diversification into subdivision development.

I suggest you decide which of the two you want to do and go to it. As I see it, the typical retailer will be an unneeded third-party in the distribution channel of subdivision housing. But I do not see what will replace our existing leasehold and scattered-site business.

Subdivision housing will be financed by the conventional mortgage lenders for a variety of reasons.

• These subdivisions are essentially indistinguishable from the site-built products they finance now.

• Rates in mortgage financing, with their conforming loans guaranteed by government, will always be lower than factory-built home rates.

• The giant and powerful conventional mortgage industry will **never** cede the single-family subdivision marketplace to us. No way.

Less or more?

What does this all mean? Generally, I've seen fewer changes in land/home financing over the last 30 years than you might think. Lender land/home programs have become more borrower- and retailer-friendly than ever. But there are still no breakthrough programs likely to overcome the big lead chattel loans have on land/home transactions.

This is because, at the most basic point, the borrower has to have greater capability to qualify for a land/home loan. While that may seem just the opposite today, this condition is unlikely to continue.

No matter how user-friendly we try to make it, I have serious doubts about the availability of enough capable borrowers for the industry to greatly expand this business, unless the country goes into a precipitous long-term decline of depression proportions, which would bring higher credit home buyers down to us. That's unlikely to happen and nothing we should wish for in any event.

Some may view the factory-built home subdivision as the big move for the industry, but I don't believe the vast majority consider it a part of our business. Large entry-level, single-family developers and others in this business already use factory-built housing. Panelizing, sectional, modular and Heaven knows how many other types of factory-constructed homes are utilized daily in subdivisions.

The mere fact some of our current industry participants may choose to compete in that segment hardly transforms it into the factory-built housing business. It simply means those from our industry participating there have joined the real estate subdivision business.

Make no mistake, the folks already working in the site-built subdivision business are no pushovers. They will make powerful competitors.

In fact, I doubt our next leg up in new home volume will be led by land/home financing. Chances are the 15 to 25 percent of land/home sales volume being originated now will likely never reach 50 percent, except in a permanently declining chattel sales market. For that to happen, we would need a new round of severe belt tightening by lenders which would continue to crowd out the chattel loan business as it squeezes even more.

At the heart of all this, as we go up the housing cost ladder very competitive housing already exists with more attractive financing than we can offer. (See January 2001 issue pg. 36.)

I made presentations in a dozen or so states when I was doing zoning work for communities in the 1970s. Even then, the endeavor was front-end loaded with costs, lengthy and challenging to say the least. However, communities today are being developed nationwide, probably in greater numbers than anytime since the early 1970s.

Perhaps our industry needs to make a renewed and expanded attempt to develop far more quality and better-sited communities. This would encourage the better clients we all covet to consider our product.

In addition, we must create communities that will accommodate the enormous number of baby boomer retirees seeking us out shortly. This may be the future of the industry, rather than a migration to subdivisions.

One thing I can say with certainty: In the 29 years I've been in this industry, there has been a continuous desire to change the business to something better. Repeatedly, I've heard calls for this move or that to happen. Always the call was made for better homes to better credits and abandoning the entry-level housing that has been the hallmark of this industry, among others.

These are all laudable goals. But every attempt to effect these changes came up short with the reality that the transformation we desired already existed. It is called entry-level, single-family housing, whether it is detached or not.

Every attempt to supplant this product with ours has fallen short, repeatedly. Yet the business we want to forget (chattel and scattered-site land/home transactions) has close to 10 million homes in existence, sells around 200,000 new units a year, three to four times as many resales annually, and provides close to 25 percent of all new single-family homes sold.

Those participants who have paid strict attention to this existing industry have done better than those who have tried to change it. Yet the desire to join the "other" industry prevails. Curious.

It just seems that what I heard in 1972, I heard again in 1980, 1990 and again yesterday. As an industry, we keep seeking ways to transact more business and zero in on land/home packages as the best option.

The first question retailers ask any lender about is the status of its land/home program. They want to know all the details. However, what they really want to know is "Mr. Lender, do you have a land/home program that is as easy to qualify for as chattel loans, I can close as quickly, that has no upfront costs and doesn't need appraisals and title searches?"

Wow, *that* would be a land/home program! But don't call me. I know of none. □

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