THEY WERE ALL DRIVING TOWN CARS: LEARNING ABOUT COSTS THE HARD WAY

By Martin V. Lavin

I was employed by a large manufactured housing retail organization as corporate counsel in 1972. We already had more than 50 retailers franchised and we were in a "go-go" mode.

All our retailers drove Lincoln Town Cars, as did their wives and/or girlfriends. All had second homes in Florida and were accomplished golfers. And business was booming!

Our plans were to grow, and grow we did. The next year, we acquired another group of retailers. I think we got about 40 in one shot. By the time 1973 came to a close, we had retailers from New Brunswick, Canada to Florida, and almost every state in between. We were big and we were selling homes.

We peaked out at more than 5,000 homes in 1973, which was a lot of homes. But everyone else was selling a lot of homes too. A staggering 580,000 new homes were delivered in both 1972 and 1973. Between 1969-73, 2,461,500 homes were delivered, an average of 492,300 homes per year.

Using a population figure of some 210 million in the U.S. in 1973 as a measuring stick, that would be the equivalent of delivering more than 787,000 new homes based on our current population. And we thought the 373,000 homes we delivered in 1998 was a big number.

A familiar ring

In late 1973 and early 1974, the first fuel shortage hit. People waited in line for their every-other-day fill-up and interest rates quickly climbed to 10.5 percent. As a country and an industry we were never the same again. Easy money became expensive and home deliveries plunged, dropping 63 percent in two years to a low of 214,000 homes in 1975. Lending dried up as repossessions surged to peaks unknown and interest rates spiked.

Doesn't this sound familiar?

The second homes in Florida were repossessed or sold. Town Cars were replaced by Pintos. As an organization, we went from 100 retailers to 60, 30, six and, finally, none. Except for a handful of our guys who decided to tough it out as independents, our organization ceased to exist. We all went on to other things thinking the industry had died.

What happened? We found out what many are finding out now: The profits that come during the good times from owned or controlled distribution points, such as retailers, can be replaced by the hangnoose of expenses when lowered volume hits.

A number of organizations, both pure retailers and vertically integrated companies, wound up with huge sales networks from 1996-99 as home sales volume surged. It seemed to many the best way to control sales and profit from the enormous potential was to open or purchase as many retail stores as they could. And so they did, just as we had in the early '70s.

These locations not only created instant distribution channels you could direct and exploit, they produced expenses that became **your** expenses.

Opening a retail sales center entails a real estate lease or land purchase, office equipment and an office, paving, landscaping, employees, insurance and inventory. You get my drift. One can expect to pay $35,000-50,000 for monthly fixed costs for a retail location.

In other cases, retailers came via a purchase and that entailed the expenditure of scarce resources (cash), taking on debt and increasing exposure.

Interestingly, I heard many experienced industry professionals gasp as this process reoccurred in the late 1990s. This had happened at least once before, perhaps twice, and the fallout had been terrific. Now, in retrospect, with the industry again headed for at least a 50 percent decline, the doubters look prescient. Indeed, many retail chains closed. Other locations were given to sales managers or sold to third-parties. And it is still happening.

Why?

As the mid '70s wound on, our franchised retailers were dropping like flies. More then than today, one of the serious problems retailers faced, among many, was unearned income. They had been pre-paid for seven years on insurance commissions, 15 years or more on finance participation, pre-paid payments on volume bonuses. There was other income, mostly unearned, too.

When sales were growing, the chargebacks were less than new income so it presented no problems. But as sales fell precipitously, the unearned income that people wanted back became a real problem.

Our retailers started folding one at a time, leaving us inventory buybacks, floorplans sold out-of-trust, leases to pay, unpaid bills and all the other problems closing causes. It became obvious as the process continued the industry was collapsing at a frightful rate and so were we.

Part of the responsibility to our lenders was the disposal of repossessed inventory. By today's terms it may seem gentle, but one dusty field in North Carolina held more than 250 of our repos that we liquidated over the next two years. We thought they'd never end.

Even though we did not own these sales locations (they were franchised), we still reeled from the losses. While we were spared the operating losses on the front end, the inventory financing, prepaid income, leases to the real estate, guarantees on retailer loans and other obligations hit us like a sledgehammer.

During the growth period, these obligations were no particular problem. During the retraction, however, they were crippling. So when I saw manufacturers buying sales centers and paying more than nominal prices for them, I rolled my eyes. It wasn't because I knew what the outcome would be with certainty, but there was a *high probability* of the outcome based on past performance of the industry.

Total meltdown

The Great Depression of 1929-35 was a terrible economic time by any measure. Unemployment reached some 25 percent and the economy contracted about the same.

Our industry shrank 63 percent in 1974-75, 43 percent from 1988-91 and what could be another 50 percent or more in 2002 from 1998, the year of the last industry high.

Factory-built housing has this disturbing trend of what amounts to total meltdown with alarming frequency. Just imagine real estate, site-built housing or automobiles having those sorts of sales swings: They would bring the country literally to its knees. And it has brought the factory-built housing industry to its knees.

The interesting aspect is our industry is so little known, so small and so obscure that no one seems to know or care. Some investors have followed the events, but what about the public? From conversations I have with people outside the industry, they seem completely unaware of our plight. And frankly, if they knew, it hasn't affected them at all.

When was the last time your hometown newspaper had a story about the 50 percent retraction in home deliveries for factory-built homes or the 100,000 repossessions expected this year? I haven't seen any, except the occasional story buried in the *Wall Street Journal*.

Figures 1 and 2 demonstrate how serious this problem is. Consider the long-term trend line decrease. The obvious analysis we can make from the two tables:

• In the last 30 years, we've had three vicious pullbacks in our industry.

• We are selling fewer homes than ever, especially on a population-adjusted basis, with 1991 and projected 2002 numbers both at long-trend bottoms.

If we dig into home figures for the period from 1970 to the present, one trend becomes crystal clear. In 1973, we sold about 75 percent single-sections and 25 percent multi-sections. As recently as 1996, the year we almost topped out in home deliveries for this cycle, the balance was about 50-50. So far in 2002, with the lowest projected home volume since 1991, shipments are running about 76-24 multis versus singles.

In other words, we haven't yet figured out how to make this a big volume industry without healthy single-section sales.

There's no question this industry has emphasized and promoted multi-section homes since 1972 (the year I came into this industry).

The industry definitely would prefer to go upscale if at all possible. Industry chatter has us heading that way and certainly MHI believes that, as do most pundits. Some would say the reason multi-section numbers have held up is they are more desired, thus less affected in sales downturns.

Our lenders, who have wisely adopted risk-based pricing, are not enamored with single-section homes, nor are the asset-backed securities markets—our lenders' lenders. Thus, the pricing for singles can be dramatically higher than multis. All these factors promote multi-section sales.

Since 1996, multi-section sales were off at the rate of about 35,000 homes and single-sections some 135,000 homes for 2001. Looking at the numbers, it's pretty easy to see where the collapse is centered.

Yet, lenders I talk to believe single-section homes, even with comparable customers, fare worse in all performance standards than multi-sections. This area may need more study to confirm their beliefs, but it certainly partially explains the decrease.

Chattel lending, for both single- and multi-section homes, has contracted because of portfolio performance. Consequently, that shrinkage

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Fig-1. Decrease By Homes

TOP SALES YEAR	BOTTOM YEAR	PERCENT DECREASE
1973—580,000 Homes	1975—214,000 Homes	63%
1984—295,000 Homes	1991—170,000 Homes	43%
1998—373,000 Homes	2002—180,000 Homes*	52%+

Fig-2. Decrease By Homes Based On U.S. Population

YEAR	U.S. POPULATION[1]	HOMES SOLD	RATIO[2]	TRUE DECLINE[3]
1973	211,908,788	580,000	1/365	Benchmark
1975	215,973,199	214,000	1/1009	Down 64%
1984	235,824,902	295,000	1/799	Down 54%
1991	252,127,402	170,000	1/1,483	Down 75%
1998	270,298,524	373,000	1/725	Down 50%
2002*	284,616,700	180,000*	1/1,581	Down 77%

* Projection based on annual rate after March 2002 shipments.

1. Population from Census Bureau with most years estimated.
2. Home delivered divided into total U.S. population.
3. As compared to the 1972-1973 industry highpoint.

INDUSTRY BY THE NUMBERS

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affected sales for both types of homes. But, obviously, singles have been affected far more.

What happens if the industry is unable to transform the multi-section business into residential real-estate-secured subdivision housing to increase sales substantially and find a winning formula for selling and financing single-section homes? We may be in for a prolonged fight to get back as high as 235,000 to 250,000 new home deliveries, the average trend line since 1975 for the industry, forgetting the late 1990s blip.

It seems every time the industry gets much above that volume, it suffers a serious contraction. Simply, the higher the top end, the greater the contraction. An interesting and most disconcerting problem.

What most of today's players have again found out (with some notable exceptions) is chains of retailers owned by factory-built home manufacturers can, in fact, control much distribution. Like the automobile factories, we may reach a point in home production where the covered costs boost profitability geometrically.

Obviously, all factories want to reach that level. It is only logical to do so. More and better distribution channels appear necessary to obtain that goal. What better way to control distribution than through your own retailers?

For builders, it seemed easier or quicker to buy locations from existing owners than to open new ones. What seemed like very fancy sums were paid for these locations. Many sellers did well as they sold out. Initially, the volume provided by these "new" locations appeared to be a good way, not only to control distribution, but also to make profits on sales.

In an industry that might fluctuate 8 to 10 percent on a pullback, those decreases would hurt, but not devastate. However, the huge pullbacks during factory-built home cycles have been devastating, and they've torpedoed that approach during this cycle.

I believe the intelligent people who worked on these decisions must have discounted as highly unlikely the industry would have this type of a pullback once again, or that it would come so quickly after the market skied in 1998. Presumably, things were perceived differently this time and the industry reacted in kind. Although we perceived them differently, we now know they were not. They just *looked* different.

As volume plunges, locations close. Daily, both factories and independent retailers bite the bullet and make hard choices as the reality of the 50 percent decrease forces their hands. They are now going through what we went through.

I saw it in 1974 and 1975, the late '80s, early '90s and again at the millennium. Things, most unfortunately, were not much different this time.

I wonder if all the Town Cars will go the next time too. n

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