

# WHAT BUSINESS ARE WE IN?

By *Martin V. Lavin*

A recent issue of my monthly newsletter carried my lengthy remarks about the divisions occurring in the industry between those who sell historically modest HUD Code single- and multi-section homes and those who have decided their future lies with much more *upscale* homes, that look site built.

Apparently, my observations of these divisions stirred the proverbial pot. Much of it came from eloquent people, telling me why an "escape upwards" was the only answer for the

industry, and that the appearance and business model of modest HUD Code, chattel-financed homes was responsible for many of factory-built housing's ills. There was a feeling this escape had to happen to avoid the many disadvantages of selling and siting HUD Code homes, especially modest ones.

Since 1998, it's certainly true the upper end of the industry has weathered the storm better than modest homes, especially single-sections (multi-sections have outsold singles 4-1 during the past five years).

Also, the public is far less upset

with the placement of a factory-built home in direct proportion to its "site-built" appearance. Of course, the more site-built the appearance, the more acceptable the home. However, that increases the cost.

Meanwhile, total HUD Code shipments are rolling along from a 1998 high of 373,000 to a 2003 annualized rate of 130,000 homes or less. I wonder when that move to the upscale will start kicking in to help us...

If you are like me, you dismiss the chatter and watch the events unfold. Pieced together, they tell a troubling

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story, wrapped up in a financing crisis, public product animosity and other difficulties, all essentially directed at our "historic" homes.

However, some who tried to escape to the upscale ran into some market competition conditions they didn't believe were possible. Boxing legend Joe Louis' admonition about running and hiding came to mind.

### Placements

To better understand the problem, it's important to review the various means of siting factory-built homes. Each of these methods represents a market niche. Until there are more placement alternatives, our market-share will encompass the sum of these choices.

No other siting method is more identified with this industry than land-lease communities, also known as "mobile home parks" and, to still too many, "trailer parks." And none is more visible, controversial and in disrepute.

Interestingly, that disrepute rests more with the public than community residents, who generally are not upset with their surroundings. Conversely, the general public does not want to live in these communities. In fact, they would prefer these communities never existed. These beliefs are common among local and state regulatory boards, fueled by their perceptions of a public driving the agenda to restrict and even prohibit land-lease communities.

Land-lease communities arose as a means to reduce the land cost component of the home, by keeping land ownership in a third party instead of the home owner. They were densely occupied per acre, again keeping costs down by limiting the infrastructure and land costs per unit. As a result, homes sited in land-lease communities became true entry-level living, unmatched in monthly costs by any other means, save apartments.

Land-lease communities generally cater to residents who are marginal financially and are the only known alternative for non-subsidized housing. Other than living with your mother-in-law, the options for cheaper living are few.

The next siting alternative for a factory-built home is on a larger parcel of land, usually rural, that's owned by the home owner or his family.

The next placement up the ladder is a single-site, rural lot, owned by the occupant but not in a development. The owner/occupant will im-

prove the lot with utilities, driveways, foundations, landscaping and, not uncommonly, outbuildings.

The location is almost always in the country, away from urban areas to keep land costs low. Generally, many site- and factory-built homes of modest means are in the area. Most of these placements do not incur the displeasure of the public as much as the first two I described.

There has always been a variation of this single-site placement where the home is not in a rural location. They are instead placed in urban, usually older sites, where land costs are low because, due to the nature of the neighborhood these lots are not attractive to higher cost housing or other uses.

The location could be a transitional neighborhood, redevelopment zone, or just a forgotten lot surrounded by modest working class homes and apartments. This is the infill concept we've heard so much about recently, and one counted on by many in our industry to provide unit sales growth.

The final category is a single-family subdivision development. A land owner/developer subdivides large acreage and resells the lots for siting factory-built homes (usually provided by the developer). Housing types could be mixed, although more commonly they are either all site- or factory-built. Generally, the factory-built homes found in these placements compete with entry-level site-builders on price and looks. (Industry chatter has championed these placements and some have staked their financial futures competing in this realm.)

These examples are broad general categories of home placements, but there are overlaps and variations, including the floating homes in Miami and Ft. Lauderdale, which are nothing more than factory-built homes on water.

The range of homes that can be found in a land-lease community can range from \$1,500 repos placed in a U.S. Route 1 "park" in West Palm Beach, Fla., to \$150,000 and more for a retirement home in a North Ft. Myers, Fla., leasehold community, security gates and all.

The "family-sited" rural placement on a single leasehold lot is likely to have modest homes, primarily pier-supported, with lots of vinyl and scant concern for exterior appearance. Owner pride in these placements varies widely, but is generally a "working need" dwelling.

Then, some single scattered-site

home placements can be indistinguishable from adjacent site-built homes, expensive, multi-storied and sitting on concrete foundations. Their owners may well be professionals by occupation. The whole can have the appearance of Ozzie and Harriet in "factory-built housing land."

### Questions

I reviewed these options as a reminder of the variations of markets we serve and to convey the broad spectrum of products we need to produce and demonstrate the opportunities for sales. These sales, declining 70 percent from 1998, serve as the basis for the remaining discussion.

I believe the industry is struggling to answer these three simple questions:

1. What product composes our national markets?
2. Where can we compete successfully?
3. What is the volume level in these markets?

The answers to these questions are the key issues today, as they have been for the past 30 years. Depending on how these questions are framed, your responses, coupled with your execution, will determine the industry's future as well as your own.

Conversations with industry professionals tell me our industry is the "King of Value" at the modest end of the spectrum and begins to lose its edge the more upscale, larger and customized it becomes.

Single-section, 1,100-sq.-ft. HUD Code homes have no competition in cost per square foot. On the other hand, 2,250-sq.-ft., two-story modulars have plenty of site-built competition.

As you well know, financing, its cost, the ease of acquisition and availability all have a very direct and drastic impact on sales volumes and placement alternatives. In fact, the availability of financing for each of the home and placement types I've discussed will determine the demand for each housing type from the very low-priced older, single-section home for the marginal buyer on a chattel (home-only for collateral) basis, to that same kind of financing for retirement enclaves of the near wealthy from local banks.

The most affordable alternative financing is conforming real estate mortgages for factory-built homes that meet all of the stringent requirements for placement, construction and appearance that serve as collat-

eral for the loan, along with the real estate on which it sits. The cheapest alternative, however, requires the most expensive homes and most extensive placement improvements.

For scattered-site, rural locations not meeting conforming mortgage guidelines, industry lenders offer a hybrid financing vehicle known as the land/home program where the home is taken as chattel (home only) security and a security interest (a mortgage) is taken on the land as well.

Non-conforming bank loans, which may have some land/home mortgages, also exist but are more expensive than conforming mortgages but less costly than industry lender land/home loans. Banks also build portfolios of these loans and can offer these mortgages at lower rates than industry lenders.

These different financing methods have great bearing on the success of the industry, either spurring or decreasing sales—making us more or less competitive with other housing types.

Without exception during the last

50 years, the highest interest rates have been assessed to chattel-financed homes. While the difference between chattel loan and conforming real estate rates has typically ranged from 175 to 350 basis points (bps), today's spread is much greater. (One hundred basis points equal 1 percent.)

Even today's most creditworthy borrower is charged around 300 bps more for a chattel loan than the average conforming mortgage interest rates, and up to 1,200 bps more for older single-section home loans to marginal applicants.

No wonder there are so few chattel loans! The credit capability needed to secure them requires far more than most potential factory-built housing applicants offer, especially considering real estate interest rates presently sit at 40-year lows.

Those rates and the ready availability of conforming mortgage programs have seen substantial activity and emphasis within our industry. Some industry participants have made major moves to generate more real estate conforming mortgage busi-

ness, which has led to the creation of HUD Code homes more likely to fit the loan parameters and appeal to the client base of that housing level.

Granted, an industry exploiting a good financing vehicle for increasing sales of their products seems natural and intelligent. However, is a good financing vehicle for a product sufficient by itself if it is not necessarily a persuasive market choice, enjoys no particular cost or quality advantage and is viewed by potential buyers to not be as compelling a choice as another?

Not only is that question a mouthful, it is one of heroic proportions for the future of this industry. Never before has there been such a combination of poor chattel lending with such attractive real estate financing. I question whether building upscale homes to attract more advantageous financing terms will be enough by itself to return to this industry's historic volumes.

Unfortunately, after only a few years of offering increased conforming mortgage lending for this indus-

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**IDENTITY CRISIS?**  
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try, kinks in the armor have already developed. Government supported enterprises (GSE) like Fannie Mae (FNMA) have announced tighter lending guidelines for factory-built home loans, which likely will reduce the availability of this financing option for potential purchasers.

Obviously, this is viewed negatively by the industry and calls into question how much this will impede the escape upward.

Historically, the ease of chattel financing and the low cost differential between it and real estate has resulted in the greatest number of all loans being done on a chattel basis. By my estimates and discussions with leading industry lenders, chattel has accounted for up to 85 percent of all loan volume, with traditional real estate lending financing the remainder.

After all, since land/home packages enjoy only a 25 bps decrease over chattel loan rates, you can hardly call it real estate financing, being 150-300 bps higher than conforming mortgage loans, and even more.

Non-conforming loans, most commonly originated by hometown banks as portfolio loans, have generally been more expensive than conforming mortgages, but at a cheaper rate than chattel or even land/home loans. That was the penalty the borrower absorbed for not having a fully conforming house and paying for site costs.

Are you beginning to see a trend here?

**Statistics**

A home of higher quality that's larger, more expensive and sited on a permanent foundation means a lower

interest rate. The smaller the home, the shabbier its appearance, the poorer the siting, the less real estate involved and a less-than-permanent foundation signals a higher interest rate.

Moreover, inexpensive, lesser quality homes appeal to the least credit-worthy, or at least are purchased by that group. On the other hand, larger, better sited, more expensive and better constructed homes appeal to and are more commonly purchased by more credit-worthy buyers, which in a risk-based-pricing world can make interest rates even lower, by several hundred bps than chattel loans.

The actual cost of home ownership is so dependent on both the purchase cost of the dwelling and the interest rate for the financing. In Figure 1 (below), you can see why an intelligent consumer would try to buy a home that is more expensive, costs about the same each month and with a greater upside potential to appreciate.

If you ask what business we are in, it is the affordable side of the general housing spectrum. Figure 2 (on page 25) describes the various niches this affordable housing industry of ours currently inhabits. Those were the same market segments that existed in 1972 when I joined this industry.

Nothing has really changed in more than three decades in the markets we are trying to reach. And we need to be successful in **all** of these categories. What has changed, however, is the discomfort in chattel financing over the last four years, which has affected these market segments substantially.

It started with troubles in the chattel loan markets, as poorly underwritten and originated home-only loans started defaulting in great numbers, creating a repo glut and large lenders losses. The resulting events made chattel lending much harder, accommodating only a narrower tier of qualified applicants.

Lower credit tiers were forced out of contention by new underwriting standards, so the industry was cut off from that market. Based on my calculations, this removed about 30-40 percent of our historic market.

At the same time, the better credit tiers found our chattel lending very expensive compared to conventional loans for site-built homes, for which they also qualified. In a short period of time, we were hemmed in at the top as well. This probably removed another 20-30 percent of the potential market we have enjoyed.

That didn't leave much of a market to exploit, forcing a five-year sales shutdown now reaching rather nightmarish lows. By year's end, we will have witnessed the greatest industry retreat on a percentage basis of its existence.

Most of this pull back came directly from an enormous falloff in modest single-section homes. Multi-section homes have not been unscathed, just a bit less traumatized.

Because lenders have favored getting real estate security when possible, the industry's land/home business has increased the percentage of business transactions, if not necessarily the actual number of loans. Lenders who require their borrowers to have land for their homes have been less impacted than those in the leasehold community business, where sales and resales have been devastated.

In response to this constraint in chattel financing, many industry participants shifted abruptly upscale, selling homes costing twice as much or more than the homes they once sold. While the financing options were seemingly better on the conforming real estate mortgage end, that vehicle and the product financed through it were not without its problems.

**No escape**

For one, participants transacting conforming mortgage business found the average consumer still believes factory-built homes are not as desirable as site-built dwellings. Therefore, to sell and market factory-built

**Figure 1**

Home Type	Multi-section	Single-section
Cost of Home	\$129,000	\$47,000
Loan Type	Conforming Mortgage	Chattel
Interest Rate	5.30%	11.90%
FICO Tier	650	650
Downpayment	\$4,000 (3%)	\$2,350 (5%)
Finance	\$125,000	\$44,650
Term	30 years	20 years
Payment Monthly	\$694.13	\$488.53
Lot Rent (MHC)	0	\$200.00
Total Payment	\$694.13	\$688.53

Figure 2

Category	Foundation	Location	Method Financed
Communities	Mostly Piers	In Parks	Chattel
Other Leasehold	Mostly Piers	Scattered Site	Chattel
Single Site	Piers	Infill, Rural	Land/Home
	Slab		Non conforming
	Full		Conforming
Subdivision	Piers	Subdivision	Non conforming
	Slab		Conforming
	Full		

homes that take on the appearance of their site-built brethren to better credit-capable clients more successfully, sellers had to offer a **cost benefit of 20-25 percent over comparable site-built homes**, or so industry experts believe.

By comparable, that means in looks, designs, fitments, foundations, sizes and every other aspect. Too often, the industry got the better price by compromising on some or all of these things.

The industry is finding that contending with entry level, single-family site builders is not easy. While those folks have many problems with labor, the weather and other factors, they have always been, and remain, difficult competition.

To be competitive, I've often seen retailers doing \$100,000-125,000 transactions, but generating no more gross income than one makes on a \$45,000 single-section, chattel-financed home, while taking on much more work and risk.

Secondly, funding of the construction process to improve the lot, foundation installation and home erection as well as to complete the home for occupancy was often done for a client who had been unable to get a construction loan.

If he or she wanted the sale, the retailer was forced often to have substantial sums of money outstanding in home installation prior to the final closing on the home loan. In many cases, this led to a "sold out of trust" to the inventory lender.

Since the construction and erection of all homes has always been troublesome, it was not unusual for many problems to occur during the site development process, leaving the retailer to sort out a mess. In fact, this has been all too common.

Lastly, while the conforming mortgage business has helped many industry participants survive and some

to even prosper, the volume at the average retailer is quite low. Average retail home sales range from 18 to 30 homes a year. Volume much above that is unusual.

It is pretty obvious gaining large industry sales from this tier of homes is most improbable, no matter how attractive the product, given the problems I've discussed.

Does the industry have any true prospects for an escape upward? For the factory-built housing industry to return to the median 250,000 shipment per year would have to be built and sold within the conforming mortgage tier, coupled with 100,000 or more chattel-financed homes.

Based on conditions that have existed over the last five years, one would have thought if an escape upwards were ever to happen, this would be the time. Constrained chattel financing, a great housing boom nationally, historically low conforming mortgage rates, accommodating programs from GSEs like FNMA, and a heavily increased industry focus on this housing type. Yet, there's no breakout. If not now, then when will conditions be more favorable? The answer is in the indeterminate future.

Although upscale homes are a very important component of the factory-built housing business, it is not now, nor is it likely to be in the near future, its greatest numerical component. I just don't see the conditions in place that would favor this yet. What's certainly true is this market niche has suffered the least of any industry component and continues to have great future potential.

Meanwhile, if we are truly in the factory-built "affordable" housing business, the majority of the homes we produce, sell, insure and finance cannot be confused with site-built housing. They will be modest single

and multi-section homes. Many of them will be sited in communities or in daddy's backyard.

While a number of distressing industry conditions have come together to gut this historic end of the business, things have a way of rebalancing over time. The prospect for chattel- and land/home-financed factory-built homes to rebound is very great, returning to where it has been in the past.

Better financing will be necessary, just not the "Russian Roulette" kind. Can it happen? I bet it will. Unfolding industry events, like the Berkshire Hathaway/Clayton Homes merger and recent entries by companies like U.S. Bank, bolster that belief.

In closing, I'm not in love with \$35,000, single-section HUD Code homes. To a lender, they are simply collateral. But as long as people with reasonable credit need this type of housing, I want to find a way to make a business out of it. By the same token, I don't dislike those two-story, 2,250-square-foot factory-built homes that mirror site-built models in appearance either. Quite the contrary, I like them.

Although I believe we should attempt to build and sell as many as we can legally, morally and profitably build, I just do not see the numbers supporting the totality of even our modestly sized industry—only a small segment of it.

The song you're hearing today that we are only a few steps from transforming this industry to an upscale home market was the same one I heard in 1972. Exactly the same!

Because I've become skeptical of people who "cried wolf" far too often, I simply stopped listening to what they were saying and watched what really happened.

And I didn't see it happening, then or now. n

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