

THE BERKSHIRE EFFECT

By Martin V. Lavin

I turned on my computer to check what e-mail came in overnight, coffee in hand and eyes still a little bleary early in the morning of April 2. My eye quickly caught the headline of an e-mail sent by BB&T's John Diffendal that read, **Berkshire Buying Clayton Homes**.

My heavens, could this be true? I checked to see it wasn't April 1, so I wouldn't be a fool. No, this was real all right. The greatest investor of this generation, Warren Buffett, "The Oracle of Omaha," was buying Clayton Homes of Knoxville, Tenn.

Wow! Warren Buffett!

Not too long after that came the torrent of phone calls and e-mails. Everyone had two things on their minds:

1. Why did this happen?
2. What does it mean for the industry in general and the Claytons in particular?

I chatted with many pundits and people of influence in factory-built housing. Many called to see if I had a different take or inside information of any sort. Let me be clear, everything I know is a matter of generally available information. I know and like Jim and Kevin Clayton, but I am not a confidante on these matters. That said, I was as shocked as everyone else about this impending sale.

Nuts and bolts

Last November, industry stalwart and one-time high-flyer, Oakwood Homes of Greensboro, N.C., had gone into Chapter 11 bankruptcy. Through a financial transaction, Buffett's investing arm, Berkshire Hathaway (BH), wound up effectively controlling Oakwood with debtor-in-possession financing. The control of Oakwood is more important than the details, as is the desire of BH to get involved in the factory-built housing business at any level.

Why were they there? At the time, many (me included) wondered if this was a precursor to further invest-

ment moves by BH in this industry. Shortly after the Oakwood announcement, however, they seemed to drop from sight for a while.

Oakwood went about the business of sorting out their affairs in an attempt to right themselves in a very stormy industry. Little was heard from BH for months with regard to any concrete industry-related news, although there were persistent rumors.

About a month after the Oakwood announcement and in a huge bind thanks to over-aggressive lending practices, Conseco Finance (formerly Green Tree Financial)—the one-time leader among industry-based financial institutions—filed for Chapter 11 bankruptcy protection too.

CFN Investment Holdings, a group of financial investors, appeared to be controlling the purchase of Conseco Finance. While other bidders were mentioned, little if any mention was made of BH's interest in Conseco Finance in news reports.

Then, at the Conseco bankruptcy auction held in early March, the news broke that BH had in fact bid on Conseco and, for a time, even seemed to be the leading player. But, in an apparent change of mind after battling aggressively over the rights to Conseco Finance, BH seemingly exiting the bidding process.

A complex offer they made to the bankruptcy court in Chicago was rejected as being too conditional to be viewed as real. It looked like CFN won the bidding as BH dropped out that day.

The next day, BH reemerged to make strong moves in an attempt to gain control of Conseco Finance, but the court ultimately ruled in CFN's favor. Disappointed, BH retreated, but not entirely without rancor, angry their bid had not prevailed.

What did all this mean? Was it a matter of one more financial intervention into a bankrupt company by BH to profit short-term from the disabilities of Conseco? Or, was it an attempt to purchase value with the servicing-

of-loan rights Conseco retained to a \$24 billion industry portfolio and maybe even return to loan originations?

That answer was unapparent to observers based on what was made public at the time. Most believed BH simply saw a short-term advantage to those huge servicing rights Conseco had, and little more. (Insiders have told me this is true.)

But clear evidence of BH's real intentions in factory-built housing became fully apparent shortly after their failed bid for Conseco about a month later. When BH announced the Clayton Homes deal, they emphasized this was the purchase of the premier company in an industry whose assets are generally vastly undervalued.

The classic Warren Buffett approach to investing was evident, swooping up a successful and profitable company run by people of integrity carrying out a clear and simple business enterprise understandable by a 10-year-old, and purchased at a price with a margin of safety to boot. That is a pretty acceptable investment philosophy. I'm sure Buffett's mentor, Ben Graham, would have been proud.

The Conseco effect

Why did the Claytons do this? Jim and Kevin don't ask for my consent, so this is mostly my speculation based on careful observation of the facts.

First and foremost, there can be no question the stock short-sellers (people who put up money gambling that stock value will go down) have been beating up on Clayton stock unmercifully for quite some time, banking on it going down in value, at one point driving it down to about \$9 per share. The thinking of the "shorts" has been Clayton shouldn't be doing well in an industry in which everyone else was floundering and their turn would come to pay the price.

Never mind that Clayton had continued strong earnings, suffered the

least in terms of loan portfolio losses and was continuing to gain market-share even as the industry shrunk dramatically, down 55 percent from the last top.

All great food for thought, of course, but the short-sellers weren't buying—or eating it. They didn't believe in Clayton and kept up the pressure right to the end (the one-time share price of around \$11 reflected the short-selling pressure).

Meanwhile, the asset-backed securities (ABS) market—our industry's lenders' lenders—also were suffering from the "Conseco effect" that punished all securitizers of loans sold by our industry lenders to investors, because of portfolio losses. This made loan sales difficult and even unprofitable for most, although not for Clayton.

As you can imagine, Clayton Homes' lending subsidiary Vanderbilt Mortgage and Finance (VMF) soon began to fear the "Conseco effect" too. That punishment for the sins of others endangered the future of what had been orderly business plans at Clayton. Though they had kept their loan noses clean, VMF was concerned they could be punished right along with the worst of them.

Clayton is a fairly substantial company, with a strong balance sheet, of which they should be proud. But, the company wasn't made of gold, the last time I looked. The prospects for less-than-clean future securitizations into a very troubled ABS market were a cause for some concern.

Jim Clayton, the hard-driving businessman he is, had built a vast fortune doing things right in an industry famous for various defects. Jim must have wondered if he was going to be sacrificed at the altar of industry excesses, in which he did not engage. Or, that he would be victimized by the very industry to which he had made many positive contributions.

Were that to happen, endangering the enterprise and the Clayton family fortune, it would have been unfair in the extreme, but the damage would have had potentially devastating effects for the company, its investors, the Claytons and their 6,800 associates.

All those things considered, if you were the Claytons and Warren Buffett put an offer on the table for your company, I'm sure you'd seriously contemplate it.

Meanwhile, Jim Clayton, approaching 70, had given way to his son Kevin, who is about 40 and an

extremely talented and engaging young man running the business very successfully during this terrible industry downturn. (A good future for Clayton Homes would portend a good future for Kevin, so that must have been on their minds as well.)

And lastly, if you haven't been to Maryville, Tenn., you haven't met their talented, motivated and enthusiastic cadre of employees, all of whom seem to bleed "Clayton Blue" when it comes to their company.

I'm not alone in this observation. You cannot help but be impressed with the morale and efficiency of this group.

That attitude tells you something about how the Claytons do things. Make no mistake, Jim and Kevin are demanding and this is **their** business, but their associates respect and like them, and vice-versa. In the long run, Kevin says this sale was very, very good for the Clayton Homes "team." I know this was a major consideration in the sale, in doing something to perpetuate the company's growth, profits and success that bring on even greater opportunities to the team.

So, Jim turns his major asset into cash and goes on to the things he

likes doing, proud of his accomplishments. The sale locks in a fair value for Clayton Homes investors considering the industry downside and short seller persistence. Kevin gets to sell his share of the stock advantageously and, more importantly, remains in charge of the company, as is the Buffett way. And, the Buffett balance sheet brings Clayton a new liquidity unmatched by any other industry player, save Chase, which allows the entire enterprise to exploit the market even further. As one wag told me, "as if Clayton Homes needed more help..."

All of this preserves and encourages the Clayton Homes team to grow and prosper. In turn, Buffett gets the premier player in the industry with 40 years of culture and accomplishment, at the price he offered. If this thing isn't win-win for most involved, I can't imagine why, based on what I know.

I hear some investors would like to have seen a greater premium over the stock offer price of \$12.50 per share. That's certainly understandable, but I'm sure Oakwood and Conseco investors would have been happy to have gotten anything for their stock.

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Although Clayton Homes isn't like either of those companies, with industry conditions as they are, the war and the general economy, this could quickly be a \$8-\$9 stock as well. I suppose the short sellers weren't doing handstands either, as many got hurt financially.

The industry upside?

The BH move was good for most of the cast of characters I've discussed so far, but what about the impact of the transaction on the industry as a whole?

Let me leave no margin for misunderstanding that this is wonderful news for the factory-built housing industry, especially the HUD Code, chattel-financed portion of it.

Clayton Homes, along with its VMF subsidiary, is essentially a modest housing, chattel-financed provider of shelter for the entry-level home buyer. They make no apologies for that business plan and have been diligent in not overselling or exploiting their ability to finance clients through their own framework. They don't "over-finance" homes for too long a term, destroying the buyer's investment and impairing their company's loan quality.

From where I sit, the industry is following Clayton's lead now more frequently as the surviving lenders get on the same winning page.

The lending world is a monkey-see, monkey-do world. In this latest lending episode, it became rather obvious to me as more industry lenders exited the market, even more followed suit. **Nobody** wanted to offer lending to the factory-built housing industry.

Never mind that the last couple of years, for a disciplined, highly liquid lender (like GMAC), this industry has presented one of the all-time opportunities to get into this sector, choose from the very best loans and take charge of an industry's lending that was ripe for the picking. But it was generally perceived there was an inability to profit because others were struggling within the industry.

Forget that those struggling had hardly loaned on a rational basis, and should have expected loan problems, which they got. New lending institutions would not have had to deal with that overhang of problems, clearing the way to lead. However, this all presumes strong liquidity on the part of any who would be the leader, to say nothing of having pretty large nads.

The lenders in today's industry constitute two classes:

- Those who want to step up and lend properly but aggressively, but don't have the juice to do it.

- Those with the juice who didn't want to loan aggressively, not really believing in the market and waiting for it to have a crystal clear direction.

There are few rewards for the latter course and only better liquidity can cure the first. Clayton, through its VMF lending arm, pulled it off better than anyone, lending properly, but aggressively. Still, the company finally grew increasingly concerned about ABS markets failing to provide the kind of liquidity Buffett does. As a result, Clayton is about to have the ability, desire and liquidity to do it right, big time!

As you read this, corporate officers in boardrooms of various companies are probably having conversations that go something like this: "Have you seen what Warren Buffett did with Clayton Homes?" "Yes, I heard. What do you make of it?" "Well, I think there must be an opportunity in financing 'trailers' and we ought to look into it. Look into it."

I expect significant interest from the investment community with the potential to bring fresh, new money to the industry. I have always believed this would happen on its own, but this could really accelerate it, helping to turn the industry into a growth mode once again.

Investors have been following Warren Buffett around for a long time. The people at Clayton Homes using Buffett's money are sharp, experienced operators, so I'm not concerned about them. Will the rest of the money and the people attached to it following Buffett's lead into the industry be as smart? We'll see.

I believe the message Buffett sent this industry was that chattel-financed, modest homes are what he is banking on. Those who firmly believe that the industry needs to leave this tier of HUD Code housing behind should know they are doing so for BH and Clayton Homes to exploit and control.

These two seem comfortable for the present to remain in that position and, based on the success of each, perhaps giving the industry pause to contemplate the breadth of product necessary to make a success.

There's one more thought about this pending deal that needs to be voiced: Before the announcement, it never crossed my mind Clayton Homes needed to be "saved" or that they were looking for a savior. Cer-

tainly, Clayton didn't need it. The company saw about \$120 million in cash generated by operations in 2002. That type of money will keep Clayton Homes bubbling at a good business clip with strong prospects for success.

Although everyone in business faces challenges from time to time, the Knoxville Boys have an uncanny knack of taking advantage of the misfortunes around them to create greater profits for themselves. They are a sound, well-run company with good future prospects.

The BH umbrella has turned them into a HUD Code home juggernaut with incredible potential to truly capitalize on the market they now serve and future potential for other excursions for growth. Moreover, forgetting the upside potential, the sale foreclosed the "bad case" scenario for Clayton Homes investors and associates. It just seems like a no-brainer to me. What's to question?

As I write this, that's how the world looks to me. Many things could change by the time you read this. Nevertheless, many of the things I've discussed here have currency whether Buffett goes to Knoxville or decides to stay in Omaha.

As Yogi Berra said, "It ain't over, till it's over," and this is not a done deal. But the contemplation of it all, at least for the moment, is delicious in the extreme. n

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