HOW MANY STARS IS IT?

By Martin V. Lavin

I sat across from the banker making a proposal to gain financing to buy a factory-built housing community.

He looked across the desk and asked, "So, how many stars do you think this park is?"

"It is a four-star community," I answered quietly.

He nodded contently and moved on to other aspects, seemingly satisfied that the appearance or quality of the community was well within his lending appetite.

I'm not sure what he would have said had I answered two-stars. Instinctively, I can tell you gaining the financing might not have been so easy, perhaps even impossible.

In the manner I rate factory-built home communities, it had plenty of stars. The community had sound city-supplied utilities, an updated electric system, very low vacancy, was being purchased at a reasonable cap rate and in an area of heavy housing demand. In spite of whatever it might have rated in appearance, its financial profile was five-stars all the way.

Stars. What do they mean and why are they in such common usage to rate factory-built home communities 33 years after the last "Woodall's Mobile Home Park Directory" was last published in 1970?

According to George Allen's book, ***How to Find, Buy, Manage, and Sell a Manufactured Home Community***, "when Woodall's Mobile Home Park Directory ceased publication, 13,000 of the 24,000 mobile home parks then in operation were deemed of high enough quality to be rated, from 1 through 5 stars, and listed in the 950 page directory."

Has anyone in this industry not heard a community's quality expressed in stars? I have used the "ratings" since 1972 without having actually read the individual community's profile. I think that is true for most using the system.

While the Woodall System has been roundly criticized for being simplistic, inaccurate and influenced by the size and frequency of the community's advertisement in the directory, the system sure has legs. Here we are 33 years later and by default the Woodall Stars have been "accepted" by an entire industry.

What is the need?

Why have a system at all? For the same reason we have the words "handsome," "pretty," "beautiful," "fat," "short," "skinny," "tall," you get the drift. It is shorthand for describing a community without having to go through a list of attributes.

It is not that Woodall's system didn't specify attributes; it had a lengthy list within each star tier. It's just that the custom and usage has evolved to treat factory-built home communities within broad segments of appearance, without any reference to the financial aspects of the community as an asset held for investment or considering how the resident's house might fare for purposes of value appreciation or depreciation.

There are several areas where ratings could be used: The physical appearance, as an investment and as it affects home values. The information gleaned from Woodall's comes from the visual impact and attractiveness of the community; management is a minor component. Note almost half of the communities were deemed unworthy of even one star in the last directory published.

Woodall's tells us nothing about the attractiveness of the property as an investment, nor does it say much about the home's ability to reflect the value the property is creating or reducing.

While each of these three areas is meritorious of classification, at present, no industry-accepted classification system exists. The closest is the much criticized and long obsolete Woodall system. If the pathetic "trailer courts" in the older sections of U.S. Route 1 up and down the East Coast reflect the one-star or less classification, the extremely upscale gated retirement communities harboring well-tanned seniors justify five.

The Manufactured Housing Educational Institute's "First in Excellence Program" created a designation for communities. It is a voluntary program that rewards superior performance in the physical aspects, resident satisfaction and management training. This program requires applying for the designation, payment of a fee and actual inspections, surveys and attestations regarding that information. There has been little voluntary interest in the program to date and changes are in store.

What is driving the need?

Today, with the desirability of factory-built home communities as investments, classification has become highly important to buyers, sellers, investors and lenders. As ownership quickly consolidates into heretofore unimagined aggregations of communities (in some cases more than 60,000 homesites under one ownership) there is a need to adopt an acceptable classification system that takes into account the financial and physical attractiveness of the property.

Assuming that the consolidation of community ownership may still have some ways to go, the above-mentioned parties, especially investors and commercial lenders, may drive for their own system. This is of special importance to investors buying communities, many not being intimately involved in the industry and perhaps lacking expertise to define the assets. A uniform system is seen by some as an aid in a uniform defin-

ition of the community, so discussions all revolve around accepted classifications and what they mean.

Virtually every community owner has an internal classification system to template the due diligence in determining the desirability of any given community as an investment. Many are content with the financial template of a community and less concerned about the "post card" attractiveness so dear to outside investors. Without question, the commercial lenders and appraisers I speak with would champion such a system.

The closest is Allen's "The ABCD Classification System for MHCs." Coupled with an acceptable cap rate for each classification, it is widely used.

However, the most pressing need for a community classification system (CCS) springs from the retail lenders. They need to determine the value the home they finance will have when it's placed in a given community. This is the need driving the quest for a uniform system reasonably acceptable to the various stakeholders of interest, but most importantly to the lenders.

How are lenders doing it now?

Today, lenders compute the advance on the loan, which determines how much money they'll lend on a given home by determining a percentage of the home's invoice. Note that this presupposes the home will be worth the same regardless of the community in which it is sited. Or, at the very least, it means that the indicated advance is the minimum amount the home will be worth upon placement. That method is flawed.

Suppose the home is going into one of Woodall's two-star communities and all, or most, of the existing homes in the community are 20 to 35 years old. Single-section homes are reselling in the community for $2,500 to $7,500. The applicant wants to site an attractive, new, single-section home in this 100-homesite community developed in the late 1960s. There are several repossessions in the community as well as 10 or more "rent-to-own" homes and 10 percent physical vacancy. Rent increases have been frequent and aggressive.

The home has an invoice of $30,000 and the selling price is just over $40,000. What are the chances upon sale the home will return over $30,000 in the first five years? Not very good. The reason is the characteristics of the community are not conducive to that type of price. It is the classic "over-improvement" appraisers use to define too much home in too little area.

Now, consider an excellent three- to four-star community. It has a mixture of working class residents and some retirees. The property is well-located, very attractive, has no vacancy, is in an area of tight housing and elevated home prices and homes in the community are reselling well, with an average resale price of more than $25,000. Rent increases have been gradual and reasonable. The applicant wants to buy a resale in the community that has a NADA Value Guide appraisal of $17,950. The asking price, supported by comparable sales, is $25,250. Do you lend the money?

Based on the information I've provided it doesn't take genius to see the loan value in the first example, based on invoice for the new home, is a fool's game. Conversely, assuming comparable borrowers, the second example, a loan based on the fair market sales price, is a much better loan. It takes little expertise to understand why.

Since the beginning, sales going into communities have constituted at least 33 percent and often substantially more of all home placements. It is believed community placements at present are towards the low end of historic percentages. The reason for this down trend are many and a complicated subject. Just accept communities are not at this time the "housing value" they used to be and that has impacted their appeal.

Important impacts

Why do lenders need to classify communities and how will this help them loan more and better? The short answer is they need to know, with some specificity, the value of their collateral. If they are ever to topple the boom and bust cycles all too common in this industry (in fact almost assured), a better lending routine is needed.

These changes have a number of beneficial impacts. First, valuing the home with some degree of accuracy will assist not only the lenders, but the buyers as well. If we make the loan in the first example, we are tacitly telling the consumer that the home has an apparent value of $40,000. Surveys tell us most everyone believes the home will depreciate. But would we expect 25 to 50 percent depreciation on the day it is sold? Unfortunately, it is likely to happen.

By loaning properly in substandard communities, we redirect home placements to "worthy" communities, which will give the new homeowner a much greater measure of value. We also incite the substandard community to upgrade to save the property. Barring beneficial changes, it is in a death spiral and the owner might as well face it early, while there's still time to act.

In the case of the second example, by failing to take into account the true market value of the home, rather than that out of an often misused, shorthand NADA method, we punish many parties.

First, we shortchange the seller who is potentially giving up substantial home value, due to insufficient lender advance. We also risk causing them to default. Even good people will default, when frustrated in their attempt to resell their home for fair market value or for proceeds insufficient to payoff their loan.

We also punish the good community owner in that the lending with standardized formulas fails to reward for the value created for residents, leading to repossession vacancies and reducing, by lender fiat, all home values in that community.

It hurts the lender too because they will undoubtedly fail to get a good loan. The lender turns it down and not for credit, but for advance, based on faulty valuation.

Lastly, the industry is terribly injured, creating a self-fulfilling prophecy of depreciation, feeding on itself, as home values continue to tumble, caused by lender inattention to real values and undercutting true market actions. Often, today's new home loan is over-advanced and the resales under-advanced because of a disregard of the characteristics of a given community.

The damage this creates for the industry can be simply stated: How good can a product be that has such a great loan potential when purchased new and depreciates, or is made to depreciate, so much that during the ownership period many buyers are unlikely to resell advantageously enough to pay off their purchase money loan from sales proceeds? It is dead certain that people industry lenders want to finance generally have made good life decisions, leading them to their better credit rating. In droves, they have recently rejected our housing, especially in communities for this very reason.

Let me be plain, by no means do

lenders deserve all the blame. There is plenty of blame to go around. Do you think the retailer who sold the new home into the substandard community had no idea what the value of the home would be once placed therein? Did the community owner's lack of sound management leading to rent-to-own, overly aggressive annual rent increases and lack of constant improvements to the property impact the loss of value? Did the homeowner fail to maintain the home or site and destroy its attraction at resale? Too often, all of the above are true and combine to create the loss of value.

Location and management

It all seems to be so easy to decipher when we know the above facts in trying to determine home values based on community characteristics. More often than not, the primary factors in the indication of value are size, age and condition of the existing homes within a community coupled with resale values, area housing demand and monthly rent trends. Of course, other factors count greatly, but none as much as these, because they encompass everything else.

Yes, a community can have wide concrete roads, great landscaping, excellent appearance, strong amenities but located next to rural cornfields with long-standing excessive vacancy, the homes aren't worth more than a used home at a retailer's sales center plus the set-up charges. In this situation, the home achieves none of the underlying site value. Because there is no shortage of sites, the rent is already capitalizing its value. If the community had a real attraction, it would not have the continual vacancy affecting it. This is a perfect example of visual attractiveness and amenities adding little or no value to the home.

Conversely, a community with very average appearance and older homes can have resales selling for strong prices (see California communities). This is an example of some portion of the value of the site being transferred to the home. After all, if we bought a used home from a retailer and added the cost of placement, it would not remotely equal the customary sales prices in many of these desirable communities. We can only explain the increased value due to the site value being partially transformed to the homeowner, because the rent charged annually is less than the capitalized site value. This transfer of value can occur by the actions of the community owner or through regulatory action, such as rent control.

Again, much of this is unconnected to overall appearance but to housing market demand, location, the community's management and rent structure. The community owner can degrade the home value and render it almost valueless by leasehold rent, frequency, severity of increases and other management practices. Make no mistake, much of this is occurring now, leading to severe home depreciation and vacancy rates. Retail lenders want to know this.

The main characteristic lenders really need to access is the resale price of homes resold therein. Yes, a complete community profile is important, but more so are the resale values which incorporates location and management practices, each a reflection of value and stability of value.

If new ownership of a community started a rapid rent escalation, home values, which had been very high, are likely to diminish in the future as less of the site value is allowed to transfer to the house and is being recomputed by the community owner's actions. Sales prices would be a lagging indicator, but given a trend of rapidly rising rents, we are likely to see diminished home prices. (Note that location hasn't changed nor have the homes.) Lenders need to know that.

The goal

The aim of all of this from the lending side is to get a snapshot of the known characteristics of the community and those factors leading to destruction or creation of home value. And to do it as easily and inexpensively as possible.

If an independent third-party appraisal is done on the home, those factors leading to home values and the values themselves are best done in a uniform manner so each lender, community owner, retail loan investor, regulator and any other entity involved has the same mindset. It may well be lender conclusions reached with the same facts differ, but for obvious reasons uniformly of format and information are highly desirable.

If the resale value of homes and management characteristics are the most important, what are the general factors we must consider?

Most important are resale value of homes and appreciation/depreciation trend; management and monthly rental trend; and area housing demand.

Other factors include general information as to size, age, location and ownership of community; community features including the physical aspects of the property; appearance of homes, sites, model breakdown, age of homes, landscaping and upkeep; amenities provided other than the homesite; community management, lease terms, staff and performance; and community owner appeal, reclassification and update. Greater detail in each of these areas can be found in various CCS proposals.

All of the above information combines to give a very complete community picture, but like so much in life, three important bits of information may give more valuable insight than 20 less relevant factors. The trick will be to keep it simple to allow easy use of the CCS, but sufficiently telling to allow a reasoned loan advance without putting so much into play that it becomes cumbersome and not very useful.

Will a system be adopted or is this one more failed effort along the way since Woodall? I would argue that the industry *has* adopted a system. Even today, the Woodall Stars rule. But I also would argue that whether we like it or not, the lenders' need for this information is already well down the road to several classification systems. Some may be arbitrarily imposed or suffer from a lack of expertise that could be gained from different stakeholders. That expertise needs to be sought. That is why it is important for all interested parties to participate. Failure to do so may lead to a less-than-accurate system. But failure to participate is unlikely to deter its adoption and use by retail lenders.

It seems intelligent for the industry to coalesce over a uniform system that none will entirely love but all can reasonably accept. ∩