11-04 Lavin Mock 10/6/04 10:39 AM Page 1

THE RULES OF COMMUNITY RENTS

By Martin V. Lavin

Let me start by stating I have put off writing this article for several years. This is a highly challenging subject and likely to be controversial. Worse yet, I may get it wrong.

But, the various references I've made on the subject in other writings tell me there is significant interest about this topic in the industry. The few times I have written about it, I've gotten more feedback than on most any other subject. While I am hardly the leading authority on communities in the nation, since 1972, I have owned, managed, developed, designed, zoned, bought, sold, financed, brokered and had some involvement with mobile home parks/factory-built home communities. I view them as a great investment and have seen them magnificently fulfill their affordable housing role in many, many cases. So why am I writing this article now? Because I'm worried about some emerging trends in communities.

Bread and butter

Communities have evolved several ways in the last 30 or so years I've been observing them. Perhaps the greatest change in community ownership has been the substantial increase of consolidation in community ownership. Ownership has changed from scattered owner/developers to professional entities that hold the properties for the production of income and view them as a hybrid of apartments—except they don't own the apartment themselves, only the land on which the homes sit. And, many of today's community owners come from apartments for just that reason, let someone else own the dwelling unit! How great just to rent the ground—or so I thought.

Some will contest the following statement, but I believe most communities in the nation began as an effort to sell mobile/factory-built homes. No doubt the investment aspects of the community were comprehended in the end, but they were developed primarily with "home sales" in mind. It became obvious early that an enormous volume of home sales could occur in a well-located community that offered a good housing value and was very affordable. Many now-wealthy industry people saw and rode this trend the last 50 years selling homes into communities they developed, managed as income producing property and ultimately sold out for significant sums.

No period exemplified this trend more than the late 1960s and early 1970s, especially 1969-73 when a staggering number of communities were built nationwide and easy retail financing money combined to sell about 477,000 homes annually during that period including 575,000 spikes in 1972-73 when factory-built homes accounted for 50 percent of all new housing starts. (Grasp that number as 2004 limps towards 8 percent of housing starts!)

Go back over this article and focus on two descriptions concerning our housing: "affordable" and "value." While factory-built housing has many fine attributes, it is safe to say that the primary criteria it possesses is the fact our homes are affordable and present good value. Failing that, we'd be left talking about superior construction, which, while perhaps true, won't fly by itself.

These two root attributes are an industry advantage and limitation, which try as we might, we have not successfully exploited or escaped. We haven't exploited it as we now find, without question, the longtime trend line of around 20 percent of all housing starts contributed annually by the factory-built housing industry has come only at the expense of flawed retail lending. And, we haven't escaped it because despite our best efforts creating larger, better, upscale homes in sizeable numbers is not yet a factory-built housing conquest. After all these years, our limitations and best selling points still remain affordability and housing value.

I stated earlier our communities initially were conceived primarily to sell homes. These two concepts contributed to the success of the venture in the process of developing a community. Our homes going into communities were modestly priced and renting the homesite reduced the capital outlay at purchase. Not uncommonly, the real lot value was "subsidized" by profits from the home sale, creating even more affordability and value.

Remember, a factory-built home community in development is a real estate development venture in process and, until the critical mass of needed home sales occurs, the developer is at some substantial risk for the venture's financial success. How common is the original community developer's failure, with success coming only to the second, third or even later owners as home sales were too slow and unprofitable to power the debt service and other costs of a community in development? It is almost an industry staple.

Only after the community gained that critical mass of homes (too often 90 percent or better occupancy), could one say the venture had converted from development project to investment property. So, ease of purchase, affordability and more house for the money (value) fuels successful community ventures.

And what were and remain the attributes making most, if not all communities sound economic investments? First of all, the sum of the housing opportunity or what is offered to the resident must be the best or among the best for that style and type of housing in the local market. Therefore, the location, amenities,

11-04 Lavin Mock 10/6/04 10:39 AM Page 2

appearance, cost and consumer palatability must be superior in that market. This means, in general, our housing must represent great value in size, cost, location, amenities and so on when competing with other housing choices the buyer has and can afford. If not, the development process does not go well and the conversion from "development" to "income producing property" can be very difficult.

It is this on which communities have built their viability as investments and fueled the enormous factory-built home numbers sold into communities. Without affordability and value, about 100,000-125,000 of HUD Code homes would not have been built or sold annually. And it is this number of homes, which have recently been missing from industry sales. Why?

Fly-by viewing

Let's fly over the nation with our radar trained on communities. What we'll find is less than 30,000 of them are worthy of the name and less than 10,000 are "investment grade" or large enough and of sufficient quality to tempt institutional and other significant investors to own and manage such properties for income growth.

Another aspect we'll see is substantial vacancies. That's troubling, because in the past, these communities may have had high occupancy rates. The danger point is that sufficient vacancies essentially turn the property back into a "development," creating an investment risk.

Perhaps no single reason exists for the vacancies, but there are several reasons possibly causing it: inferior location, changing job patterns, poor neighborhoods, lack of amenities, inferior housing stock and so on. These reasons are economically quantifiable, meaning there is a price adjustment that can be made to accommodate the economic malaise causing the vacancies. Economics always prevail and have rather predictable outcomes. Given enough vacancy for a long enough time, someone (community owners and residents) is going to lose some money. Communities with major vacancies do not build value for anyone.

As vacancies have increased substantially in many communities, there is a widespread feeling that rent increases are passed along by the community owner without regard to what the rent could and should be. There is concern that improper measures used to determine rents and vacancies are being caused by faulty rent considerations. Let's explore some concepts, which will guide that endeavor.

Learning the rules

Let's go back to our dual point that factory-built housing must be affordable and a value, our two industry advantages and constraints. Every housing unit has some competition in the marketplace. That competition is every housing type in that marketplace that competes for the individual considering a change in housing. If price wasn't an issue, we'd all live in one of Trump's homes. But price does matter in all segments of society and to all people.

Cost among all housing types is predicated on the cost of the land component and its improvements, and on the cost of the actual home, its erection and finish. These are highly definable costs, subject to appraiser examination and standard formulas of costs and values.

Thus we have a dwelling unit, be it one of The Donald's homes or a modest single-section HUD Code home located in a community. For the purposes of appraisal methodology, they both perform substantially the same when viewed in square footage, land costs, comparable sales and housing demand to come up with a home value.

The portions of the above we want to dissect are:

• The relationship of the value percentage breakdown between the land and home (Rule 1)

• The cost of competitive housing choices in the marketplace (Rule 2)

These are the two components we must consider when working on our rules of community rents.

I wrote previously the industry had experienced substantial vacancies in leasehold communities and they have increased in the last few years. This has been caused by a couple factors. The first is the highly accommodative retail lending of 1994-2001 that pushed an enormous number of home sales into communities, causing vacancies to fill, allowing people previously locked out of home ownership to become buyers and fueling a housing demand in communities which was misunderstood by community owners as being a whole new wave of residents who were their customers today and tomorrow. This false security of high occupancy and powerful demand resulted in an entirely predictable pattern of increases in both home sizes and prices. Even the leasehold rent charged for the siting of the home in the community increased substantially. Demand in any product pushes costs, right?

But, the credit tiers and pricing routines employed by the industry came up against some hard realities. As the great number of people who purchased homes with that accommodative financing settled in, far too many purchased far too much home for their budgets and found the payments difficult to make. In addition, since very low down payments were made on homes marked up with high gross profits and generous extended loan repayment terms, many residents were unable to secure sufficient proceeds upon resale to repay their purchase money note, causing many to default. The homes had, for a variety of reasons, depreciated in value, no longer bringing close to their initial sales price on resale.

Tens of thousands of such defaults led to a further downdraft on housing prices and soon, even folks with good credit were in jeopardy.

But, aside from the above components gone wrong, other factors were at work, not the least of which was strongly accelerating community leasehold rents in some markets. Given the many people with poor credit capability and highly leveraged financial positions in our housing, any increase in their annual housing outlays is a default-potential event. With annual family incomes of $30,000-$40,000, lot rent increases of any size, let alone the significant annual increases seen in many markets during this period created a joint house/value depreciation and affordability destruction, which in retrospect is easy to see, but was not considered at the time. And, in many cases, is still denied by many as even having occurred.

The destruction of affordability is self-evident. Put a leveraged resident with a loan housing ratio of about 50 percent of total income into a home and raise his monthly rent more than what a Whopper costs and he is in trouble. Everyone understands that, or at least they do now. When the billions were flooding to factory-built housing retail for lending, it seemed not to be understood.

Less understood, with the results around us everywhere, is the concept that a specific housing unit has a definable value in the marketplace comprised of a house component and

11-04 Lavin Mock 10/6/04 10:39 AM Page 3

land component, and that all else being equal, as one increases, the other decreases. Simply stated, as the cost component or valuation of the land increases, the value of the house decreases which results in home depreciation. And where the land component cost decreases, the home value increases, fueling home appreciation. Arbitrary increases in either component do not change the total, only the allocation between the two.

Therefore, this fast and hard rule cannot be avoided: **Every dwelling unit has a market value comprised of two components: land and home values** . While in most housing types the ownership of the two components reside in the same entity, in leasehold factory-built home communities, they are bifurcated meaning the home belongs to the resident and the land to the community owners. Sense a problem here?

And here is where the community owner is all-powerful. Absent regulatory constraints (rent control) or contractual leasehold limitations, he is in a position to essentially increase monthly rents as he chooses. Bear in mind, there are market forces at work, but many community owners have failed to see or identify them properly. And the results may take time to manifest.

Rather, their rules for raising rents center on requirements for debt service, rents in other area communities and return-upon-investment formulas.

The above, then, is the second rule which we are powerless to change at a given moment: **A home in a leasehold community has a definable value as a housing unit in a given marketplace.**

In the first rule, in a given market, we can determine the allocation of value between the home and the land, which determines the market allowable percentage value of the "site,"—the primary concern of the community owner. In the second limitation we can determine the total value of the housing unit. We now know everything we need to know about the limitation of our range of rents in a leasehold community.

Let's take an easy example. In Rule 1, for housing in your general area, the land value constitutes roughly 25 percent of the total value of the housing unit and the house itself about 75 percent of the value. That sets the parameters for Rule 1.

We now determine that in this market the major competition for your working class community are 2- and 3-bedroom apartments with about 1,000 square feet for $700 per month. This would set the amount for Rule 2.

The computation is 25 percent of $700 or about $175-$200 that can be allocated to rent and the remaining $500-$525 to the purchase of a home in monthly payments.

Note that as lenders have scaled back their repayment term length, this amount will no longer buy an expensive factory-built home. It will, however, buy a home of sufficient quality to keep your community housing stock current. Increasing the rent above such an allowable amount will result in home degradation, starting a downward spiral in your community as people buy cheaper, older homes.

You might be tempted to seek greater rent than that for yourself, but that results in violating what people in your area generally believe the land component percentage should constitute. Taking more in rent than the area allows risks setting your community into a non-competitive position.

It also starts a downward home depreciation with all the difficulties that introduces. The problem starts with home depreciation, then progresses to repossessions and ultimately vacancies. Why? Because you made your community a non-competitive place to buy a home and live in. (Perhaps not a non-competitive place to rent a home in, but that's a different problem.) To say nothing of the fact that chattel lenders now understand this condition and are hesitant to loan in these communities.

Before I go on, know that I do not pretend these rules provide the absolute certainty we'd all like, but our basic understanding of the rules and their application gives great guidance.

Knowing the rules

How to apply the rules? One's first chore is to determine their housing segment and identify competition. Where do residents come from? First-time homebuyers in a blue-collar community often come from apartments. (Some folks consider other forms of housing.) If your residents come from apartments, review the range of monthly rents for apartments in your area. That generally gives you, a lump sum value, which should equal roughly the total of the monthly purchase payment at normal interest rates for the type of home you want in your community and the monthly-capitalized value of the community lot for rent. To the extent the total of the two is higher than the range of apartment rents or the monthly-capitalized cost of whatever your other housing competition is, your total housing costs in your community are too high. Danger! Danger! Danger!

This could happen because the resident has placed an expensive home in your community, the classic "over improvement" in real estate or your leasehold charges are too high or even both. Certainly other reasons could prevail, but still, you **must** be priced competitively with your housing competition.

When you go to the second step, you can determine the pro-ration between the home and land value components in your area. The pro-ration is definable in all markets and, in order to proceed, contact appraisers, real estate agents or municipal appraisers. You've got to get this percentage or range of percentages in order to proceed.

At this point, you may be thinking: "But Marty, weren't many of these conditions we were seeing caused by the repo glut, tightened retail financing and strong competition from real estate financing?"

Yes they were, but these are all economic factors that have to be taken into consideration and affect your pricing. Normal economic activity would dictate rents in communities plagued with these conditions would be static or dramatically reduced in some cases. But in most communities, such has not been the case.

Instead, the owners told themselves that at 85 or even 70 percent occupancy, they are collecting the same amount of total rent as with lower rents with only 5 percent vacancy. Never, ever fool yourself when market conditions create more than 10 percent vacancy. Something is amiss in your community or area and the vacancies are screaming that at you. And never confuse collecting the same amount of money from your community with 100 percent occupancy as opposed to 70 percent. With substantial vacancies, you've lost control of your property and your margin of safety is gone. You are back in the development phase and should act accordingly.

Interestingly, some of the vacancies could be related to non-existent or

11-04 Lavin Mock 10/6/04 10:39 AM Page 4

unsuccessful home sales efforts in the community. Perhaps area retailers, struggling with chattel financing today have gone off to the modular wars and are missing from HUD Code home sales. This is happening in many markets today, as chattel loans for community placements are challenging.

Perhaps you misunderstood that although you purchased the community as an investment and were not interested in sales, successful communities are often made so by competent home sales efforts to resell homes in the community, avoiding defaults caused by unsuccessful resales and tending to increase home prices through a well-organized brokerage or resale effort.

As an added benefit through this activity, one decreases the age and increases the quality of the housing stock in a community through sales of new homes. This fights the natural tendency for vacancy, which occurs without such efforts, as the housing stock ages and depreciates, taking with it your ability to gain higher rents. Remember, the rules look at the two components and its housing competition. The computation fails when the housing unit reduces in value because your rent component becomes a reduced dollar amount of the same percentage of a lower value home. Bingo!

A $3,000 valued 1972 Lavaliere single-section home is hardly ever true competition for a $750 2-bedroom apartment in excellent condition. It may, however, be competition for a rundown apartment in the back end of town with all that portends. Always, you get what you encourage.

Is this a highly complex area? Yes it is and the values and computations have to take in local conditions. Do not compare rural upstate New York with populous southern California. But the totality of what I've outlined here will prevail, if properly applied. After going through the exercise, how do you stand in your community? ■

Writer's Note: Thanks to George F. Allen for his guidance with this article.

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