CONNECTING SOME DISCONNECTS

By Martin V. Lavin

Editor's note: Part one of Martin Lavin's feature (January 2003) described past problems with factory-built home values and financing, fueled by misperceptions of the product and dips in the U.S. economy and how that same scenario is being played out in today's marketplace. In his concluding piece, Lavin offers insights based on a belief that, perhaps, the factory-built housing industry has lost sight of its roots.

In the scheme of things, how do those factors I've described (see January 2003, pg. 25) coalesce into what needs to be done that might make things better?

Perhaps, the first thing is to frame the business you are in. I believe we are in the **affordable housing business**. It's not the low-income housing business, because most of those folks can't afford our housing or any other kind without a subsidy. Ours is entry-level housing insofar as price goes. But that doesn't mean the buyer will necessarily be at the entry level.

This simple timeline explains, from my perspective, how the industry evolved into a less affordable housing alternative:

- Interest rates for the purchase of factory-built homes started increasing sharply in the summer of 1999.
- By early 2000, this industry fell behind the eightball factoring interest rates into the total cost of home ownership and large increases in land-lease community site rents occurring in the latter half of the '90s.
- In the early part of 2001, the drop in single-family real estate (site-built houses and condos) interest rates, started to widen the gap between it and factory-built housing.

These factors, along with repossessions based on poor lending decisions, led a downward plunge in factory-built home sales, both new and used, which hasn't stopped.

Simply, the low sales price of factory-built homes hasn't been enough to allow this industry to compete with interest rates in the 6 percent range for site-built housing. And if the factory-built home is a resale, the problem worsens as interest rates climb even higher.

What else has this industry lost or, even worse, given away?

Perceived value

Resales or used homes are treated far differently and worse than new homes, the consequences of which have hurt the industry and consumer.

This industry is a dichotomous one. On one hand, we build dwellings where people raise their families and pass most of their time apart from the workplace. On the other, the factory-built home *feels* somewhat like a car with a title which proves ownership, a year, make and model, size designation and, at least for some portion of its life, it comes with tires, axles and a trailer hitch so it can be transported over the road.

While the size, style, construction and design have changed dramatically over 8-foot-wide homes, many of which were less than 30 feet long at the birth of our industry, the perception of our homes has not entirely changed. To a disheartening number, especially the media, they are still "trailers."

The factory-built housing industry contributes as much to this perception as any other factor. This industry claims it builds modern, comfortable and well-constructed dwellings at a cost advantage over any other form of housing. Homes are delivered well-furnished, well-equipped and full of amenities.

Consumers can buy our products at a retail sales center, a business that displays homes and is staffed with people who can help them select a home, buy it, assist with financing, then site it for them, supplying such items as necessary to make a complete package.

Based on my experience as a lender and conversations with many industry peers, however, I've found the finality and proper completion of this transaction lacking a very high percentage of the time. Too often, we do not keep our promises.

After the consumer buys the home, loan prepayment speeds tell us the average contract will be paid off in less than eight years. Roughly, 12 percent of the homes will still have financing contracts after 10 years. Most homes will start being sold or paid off between years three through seven. Few will go beyond that. This prepayment speed is not much different in the site-built home realm.

Down payments in this industry tend to be few and far between. In fact, seldom will there be a "real" down payment of as much as 10 percent. The average consumer finances his home for 125 to 135 percent of the invoice price, and often much more. He will commonly finance his home for 25-30 years.

Study a mortgage amortization table for a loan over a similar term. Notice the small principal reduction that occurs over the first 10 years—the time most borrowers will prepay their houses.

Now, look at the depreciation of the collateral according to valuation guides and third-party appraisers. Almost the moment many new homes are sold, they depreciate 30 percent or more immediately. In other words, we believe this depreciation exists yet still continue to make loans on this product anyway. The result: There is no way with our popular, extended new home terms that sales proceeds

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will pay off the loan in most transactions.

In addition to this seeming depreciation, upon resale, the next buyer for this home will pay an interest rate premium to own it that is substantially higher than the new home rate. Thus, the home seller has a dual problem:

1. The sales price will not be guided by what a buyer is prepared to pay for the home. Instead, it is controlled by the loan a lender is prepared to make on the home. The loan will be limited by what the lender believes the collateral is worth.

2. The loan interest rate for the used home will ordinarily be much higher than the rate when it was sold new. People prepared to pay "mafia" rates are generally less creditworthy and do so only because they have no other options or, worse still, may never intend to repay the loan in full.

In the event of resale, the borrower will be hard pressed to get enough sales proceeds to pay off his loan.

The progression of these steps describe a repossession in the making.

The great unspoken

Without a doubt, this industry's unspoken belief in home depreciation is very much at the heart of many of its present problems. Overly generous new home lending programs and the prospect of meager resale financing make orderly, arms-length resales by their current owners a difficult proposition.

It's hard to feel any sense of security as a lender making a new home loan if you know the borrower is unlikely to sell his home profitably or gain sufficient proceeds to pay off his note. Barring this, our lending model becomes a fool's game in which we put the borrower and ourselves at risk.

In fact, surveys tell us most folks do not see our product as an appreciating asset. Nevertheless, I do not believe people who finance their new HUD Code homes as chattel—and in many cases even land/home packages—are aware loan repayment from sales proceeds will be difficult, if not impossible. This loss of value is currently at the heart of our seemingly dead-end trap. Without a strong lending component, especially chattel, we have not yet figured out how to make a very big industry out of HUD Code housing.

While the mistakes of improper lending to weak credit tiers from 1996-2001 have ended with screaming finality, the two remaining loan components—repayment terms and advance-to-value—have yet to be rationalized.

Home valuation methods of homes remain unclear even four decades after my mentor Dan Mendl left that meeting at "Manny Hanny."

Should this industry require market appraisals or is using the value guide sufficient? Present industry lender experience shows only those lenders with the shortest terms and tightest new home advances are prevailing, foreshadowing what the industry direction will be. It is the only sensible solution.

While this primarily affects new home lending terms, it will gradually impact resale lending terms for the better. For one, a tighter advance means much less depreciation for the buyer and will allow a more orderly resale market as value depreciation recedes. Second, a shorter repayment term forces a much more rapid paydown of the note which, combined with a more restricted advance, allows most borrowers to resell their homes for sufficient proceeds to payoff their loans.

If the twin problems of rapid and drastic new home depreciation and the attendant steep loss of buyer value are solved, the lending segment will be transformed to the betterment of all.

Even as I consider the implications of the necessary corrections to our lending model, that Manny Hanny meeting from more than 40 years ago still resonates with me today. Proper repayment terms, advance amounts, valuations and the yo-yo of depreciation/appreciation of resale homes, all of these inherent disconnects of financing still bedevil me.

This much I do know: If a five-year term was too short for chattel-financed homes in 1965, 25- to 30-year repayment terms on chattel and land-home loans are too long today. If the 80 to 85 percent advance of invoice on new homes in 1965 was too stringent, today's expansive advances on new homes, with bloated invoices and add-on costs, are too rich.

Forcing resales to depreciate through restrictive resale financing programs destroys the value of new homes immediately when they're sold. Consequently, many more new homes will become repossessions. It is preordained.

Try as we might, today's industry lending model seems as difficult to decipher as the Mayan Code. Amid a sea of better constructed homes, larger floorplans, more appealing exteriors and interiors and an industry attempting to "escape" to an upscale clientele through real estate financing, how little has really changed. Sad to say, lenders are still grasping for knowledge 40 years later.

I was there when the George Jetson era ended in 1974, as the industry took the first of several lending meltdowns. Never again would the unbridled promise of the factory-built housing industry again catch the imagination of the public as it had until 1973.

The following year, George Jetson died and so did the industry dream that everyone would live in factory-built housing, changing homes at will as the mood struck them.

Today, we're still struggling to find the proper role for our housing. The most current move centers on a belief that the cost competitiveness of factory-built homes coupled with real estate financing at lower, more attractive rates dictate a move toward battling site-builders for the entry-level, single-family market.

We'll see how that works in good time, although my experience over the last 30 years makes me skeptical.

Notice part one that described the problem was a lot longer than this month's followup about the cure. I believe that is the proper ratio of problem continuing to problem solved.

Where is George Jetson when you need him?

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