DEMISE OR REPRISE: WHITHER THE INDUSTRY?

By Martin V. Lavin

I write a monthly newsletter, *MHL Corp. News and Notes*, which is widely read and enjoyed by many industry people. The July 31 newsletter elicited one response far different from the usual praise I get. (The e-mail came shortly after the newsletter was sent.) Simply, I haven't had my butt spanked so hard since I was a fraternity pledge at DKE, all those years ago.

My "paddling" came from a good friend I greatly admire and a "Big Man" for several major industry lending programs for almost 30 years, who retired to view the growing "rubble" from his villa in Arizona. He is a pretty smart man who cares about the industry and has a huge experience base. When he talks, you sense reason and knowledge resonating in his words. He is not to be dismissed lightly.

Being aware of my generally cautious attitude about the industry over the last few years, he felt I had turned into a Pollyanna after reading my last newsletter. Let me review his comments point-by-point, and I'll answer his concerns. Those familiar with me know short answers are not my style (long, pompous answers are what I do best).

1. Repos per retailer location

I quoted a MHI report in my newsletter that estimated the average retailer had about three repos per location. The result of the estimated number of retailers in business (4,500) multiplied by MHI's claimed repos-in-dealer inventory figure per sales lot comes to about 13,500 repos. My friend says Conseco's inventory figure of 17,000 around the summer of 2002, would, by itself, equal all such homes in inventory. He believes both estimates greatly understate the number of repos out there.

Although his observation is correct, retailer inventories are not the only places one can find repos. To the contrary, a great number at any given time are located in communities, on scattered site placements, "repo depos," lender holding lots, abandoned along roadways and hidden everywhere.

In short, it is fair to say most are not in retailer inventories at any given time. That is not to say the industry doesn't have a surplus of repos or, even if they've crested, as I claim, we still won't have them with us for some time yet.

Having survived through several repo cycles, just when you think they will never end, they do. Due to a number of factors, this cycle is probably longer and steeper, than those in the past, but it will end. In fact, the process has already started.

2. Using 600-650 FICO scores

This is the big one. I wrote in my newsletter the industry must find a way to finance chattel-secured homes in this credit range. This will have a large bearing on the size of the industry in the future, particularly with chattel lending.

As you go down the FICO range, problems and repos mount, ultimately to meltdown. My critic argues the risk is too great to lend to this credit tier. We are experiencing severe effects now from lending mistakes made in the late '90s.

The list of casualties is truly overwhelming when you consider all the companies that no longer lend to the industry or have disappeared: The Associates, United Companies Funding, Bombardier (retail), GreenPoint, Deutsche and Access Financial, just to name a few. And what does the future hold for "injured firms" like Oakwood Acceptance and Conseco?

These financial institutions have had one thing in common: A deadly habit of buying too deeply into the credit tiers as they go down into the 500s. If you are dabbling to any great extent under 600, you will be eating your shorts.

I have spoken with large lenders who firmly believed in the late 1990s they could originate loans in the 540 range or even lower, and now admit they were terribly wrong. That paper simply could not be collected.

Moreover, even a portfolio heavily stacked with low 600 loans will be a problem. The preferred full line lender portfolio is composed of loans of equal percentages in the 600-700 range (about 40 percent 600-650 and 650-700 FICO scores) and 20 percent with above 700 scores. The general range of FICO portfolio averages would be from 640-655 (watch out below 635).

Portfolios originated from 1990-96 and securitized confirm this trend, with good (for this industry) performance. So it can be done, and still is by at least one very successful industry lender today.

3. Good FICO scores alone won't save you

Along with this type of buying, powerful servicing capabilities (collecting) are necessary. Good loan servicing will allow you to succeed with a 640 portfolio where others might fail with a 680.

Too often, I've seen capable servicing put in place by many lenders only after the fact to clean up the mess, rather than before to prevent it. "No, I want to do a $1 billion annually in retail originations with three young ladies in the back room to make collecting calls. Too expensive to do it any other way."

So, at a rate of $20,000-$25,000 per repo loss, you **can't** afford to hire people up front? Too often, new lenders do not comprehend the enormity of servicing our product, until it's too late. When you focus largely in the very low 600s and all 500s and

down, it's "too late" immediately.

Without the 600-650 presence, however, our role as a housing alternative is greatly reduced. We see that now. As my old friend Bill Ehlers, of the former GE Commercial Credit, once said, "That's why they pay us 250 to 300 basis points in interest more than other housing forms and we earn every bit of it."

While I agree with my Arizona friend that not everyone could or should buy in the 600 to 650 range, it still must be done as part of the mix, if the industry wants to serve its niche. But once we slip into heavily buying the low 600s and all 500s, we tread into "Hiroshima" territory. Small FICO score changes make big differences in this territory.

4. Shorten the term, reduce the advance

I trace the decline of the industry in the late '90s to the "Big Three": fraud, terms and credit (the anagram FTC does have a good ring to it). In this lending sector, there are some basic portfolio characteristics that must be recognized.

Over time, the average home borrower (including the factory-built home buyer) repays his or her loan in about 7.5 years. During refinance booms (like the one going on now in the site-built real estate market) that interval shortens. When times are tight, that term seems to lengthen.

Almost 90 percent of all factory-built home borrowers will repay or attempt to repay their home loans in one way (repo) or another (sale) within 10 years. If you superimpose on your loans the lengthy 25- to 30-year repayment terms so common from 1996-2001 (and at present still too long), and the 150-165 percent advance over invoice on the average home, how does a borrower pay his home off during that 10-year period when you add in a claimed, average home depreciation of more than 30 percent immediately upon purchase?

This is the scenario that existed in the late 1990s and still continues today. It's a nearly impossible situation because the borrower cannot gain sufficient proceeds from the sale to satisfy the full payment of his loan, especially since the large number of repos have created continuing and apparent home value depreciation. Even good credit risks are likely to default in these circumstances and are doing so today. (Note these are not credit-tier driven repossessions and they are happening in large numbers.)

To offer chattel loans on factory-built homes successfully, lenders must reduce the advance, shorten the term, combine it with substantial servicing capability and originate wisely, knowing most borrowers won't be able to pay off their home with sales proceeds otherwise.

Some lenders contend this will destroy their competitiveness. Others say it just can't be done. To demonstrate how it can work successfully, look at an aggressive, successful lender like Vanderbilt Mortgage and Finance. Their average loan repayment term is 17 years, which does not seems to be bothering their sales or financing success.

Wonder of wonders, primitive that they are, Vanderbilt is still selling their clients monthly payments. Who would have thought? This means low-price homes being sold and rapid payoffs, resulting in more secure loans. Yet, the general industry has an average 25-year loan term, almost all their customers are buying too much home and the lengthy contracts have them upside down long into the loan term—a lethal combination.

So it can be done and has been done and, ultimately, must be done across the board to rescue chattel lending. It will take some unwinding of the current industry model. Terms and advances are being scaled back already. More is needed, and will happen.

Until these changes occur, however, there will be increased repos and an inability for most lenders to take a chance on borrowers with FICO scores in the 600-650 range. This will prolong the downturn and postpone the recovery.

5. Fraud in the industry

My friend complained bitterly about the level of fraud in our industry, and who can blame him? I deplore how deeply it's ingrained in the industry too. And it continues as I see misrepresentations on more than 50 percent of all transactions I review.

Why? Too many lenders do not protect themselves to the extent they should. I have written at length on the subject in the past ("The Elimination of Sales Fraud," November 1998 and "Delivery," August 2001). Many, if not most of the protections I suggested, are still not common industry lending practices. They are expensive, but not as much as the ravages of fraud.

Lenders must do far more verifications and rely more on third parties for confirmations, but not from sellers or borrowers. Industry lenders must be the cops, rooting out fraud, cutting off those abusers and ensuring such schemes don't pay. Besides, is passing on fraud-riddled business a bad thing?

Unfortunately, even adopting all of the protections I urge won't save you every time. However, it will reduce the incident of fraud dramatically.

6. Real estate creates better value

My friend's wife, who is in the real estate industry, easily showed him how a real estate mortgage for $100,000 was cheaper than a chattel or land-home loan package for $50,000-$60,000. I agree. (I addressed this problem in the January 2001 article, "Differentials," an article I think was underappreciated at the time.)

My colleague, along with many others, believe the days of chattel lending are virtually over, and real estate lending will create a 135,000-150,000 homes-per-year industry at best. He asked how I would counsel my son if he wanted advice on buying a factory-built home on a chattel or land-home mortgage versus a site-built home.

Assuming my son could afford all of them and was young, I would advise him to buy real estate housing. That said, however, I would ask my friend, "If real estate is such a great investment, instead of the $200,000 house you live in, why don't you live in a $2 million house and get 10 times the return?" (I would ask *Automated Builder's* Don Carlson who wrote the "26 Year Mistake" opinion piece earlier this year the same question: If some is good, why not buy more?)

Virtually everyone has an expectation and affordability problem. Generally, we buy houses we think we can afford, usually toward the upper end. That limits our choices.

Many are not buying factory-built homes because, at our current nonconforming loan interest rates, we are not affordable or competitive. In fact, many buyers, especially those with good credit, avoid us entirely.

Lenders have increased interest rates to pay for actual (and possible) losses, because their lenders—the asset-backed securities markets—increased their rates substantially, based on losses they've experienced and the lack of industry candor on

(continued on page 22)

continued from page 21

prior sales of loan portfolios.

How do lenders react when you mislead them, deliberately or inadvertently? As the expected return on investments (ROI) dwindle, higher interest rates, greater guarantees of performance and outright refusal to buy certain assets are ways lenders hedge their bets. So it is now with factory-built home securitizations.

Even with the turmoil going on as a result of lending mistakes, the retail customer could care less if the industry has repos or not. They do not matter to him. And, frankly, repos should not devastate new home sales. Industry demand is driven by demographics, the state of the economy and ownership cost of our product.

Demographics, meaning demand, are good for us now. The state of the economy is great for real estate and should be good for us as well. But the cost of owning our product, which presently reflects purchase price, financing and siting, are highly noncompetitive with other housing alternatives.

These conditions are generally unrelated to repos except as they replace new home sales. I believe it probably impacts resales far more than new home sales.

Most buyers who can afford real estate financing should go that route. Others should still have the chattel alternative, even if on an economic basis it is not the most desirable.

There is a concept at work here that goes something like this: It costs money to be poor. The poor pay for everything several times over, buy everything on credit and at high interest rates. Therefore, they do not get as much bang for their buck as the wealthy.

For our target customers, reduced housing costs that save money, a result of their usual downscale housing choices—factory-built homes and apartments—are consumed, not reinvested. The money invested in real estate by the more affluent creates greater ROI, over time, as they are investing more money, and in a better vehicle.

This is not to say factory-built homes cannot appreciate, even on a chattel basis. I've been around too long to know better. But in chattel loans, you start with a substantially lower value, higher carrying costs and therefore get less of a total and percentage return on your investment.

How would that change if the chattel buyer purchased his home wisely, financed it shrewdly, sited it in an attractive and value appreciating location and re-invested his housing savings rather than spend it?

Obviously, there would be a much better return. Note all this investment talk says nothing about how your housing choice impacts you emotionally and what it tells the world about who you think you are. That aspect cannot be discounted.

Nevertheless, for most buyers, the factory-built home is an economic, not emotional choice, although realistic expectations tend to merge the two. In my opinion, most factory-built home buyers would opt for a bigger dwelling that's financed and sited as real estate, if that was a viable economic choice.

Regardless what we may think or say, most of our client base comes to us because they are on a limited housing budget. Arguing the "what ifs" of real estate being a better housing choice which could be cheaper and a better investment, is like telling me the advantages of owning my own Lear Jet instead of flying USAirways. I recognize the advantage but can't afford it.

7. We need more lenders

My Arizona friend says a retail, chattel lending resurgence will require a new corps of lenders without repo problems that can bring low cost funds to market to bolster their currently thinning ranks.

One thing the industry does not need is a new cycle of firms aggressively pursuing loan volume as was done between 1996-2001 without regard to quality. There *is* sufficient lending capacity, if not the desire, to fuel a substantial industry resurgence already in place.

With real estate-secured lending running around 55 percent and more of all homes sold and about 10 percent cash purchases, this accounts for 65 percent of a very depressed total market of about 175,000 to 180,000 new homes shipped this year (about 120,000). That's a far cry from the not-too-distant past when chattel-financed factory-built homes were three to five times more common than real estate-secured ones.

Assume that number of real estate financed homes holds, or even increases. That means if we can grow the chattel-financed home market up to the same number or more, I can easily see 235,000 to 250,000 shipments as an absolute slam dunk, realistic number.

On the downside, many are concerned the industry could be in the very process of blowing up the real estate financing bridge through poor industry practices. If that was compromised, sales would fall again, complicating things even further.

The 135,000 to 150,000 annual new home sales being forecast down the road by the doubters, including my friend, seems to fly in the face of the numbers—a pretty constant 240,000 new home shipments per year from 1975-1995. (This figure excludes the large volume bulges of the early '70s and late '90s.)

With a growing U.S. population, good entry level and retirement demographics and some beneficial legal mandates converging, I'm not sure how better factory-built home sales performance can be avoided!

Contrary to conventional wisdom, sufficient financing capacity easily exists to fuel the dollars needed. The present problem: The industry is almost entirely populated by limited portfolio lenders that do not loan on the full range of products and necessary credit tiers. Moreover, the credit tiers these lenders do desire (borrowers with FICO scores higher than 650) view our product as noncompetitive at present.

So much money is earmarked for 680-750 FICO paper, there would be a lending stampede to the industry if able borrowers with those profiles existed. Sad to say, way too few of these folks exist, so no lender I know is so busy with volume in that range they can't return phone calls. Hence, the funds are sitting at the railroad station waiting for the "High FICO Express," but the tracks are empty, with the occasional caboose rolling through.

Two things new lender entrants should do to improve their survival:

- Push current lenders by lowering their rates.
- Become "full line" lenders.

If you don't think this can be done, spend some time in Knoxville with the Claytons at Vanderbilt Mortgage and Finance or study the portfolio characteristics of GreenTree Financial, Bank America Housing and other securitizations from 1990-95.

Let me caution you, however, the things I'm talking about here are easier said than done. Nonetheless, you have to start with the proper model as a first step. A trend toward lower interest rates, reduced advances and repayment terms and an increased appetite for lower tier loans in the 600-650 range will make a significant

difference in chattel lending volume.

Now, the industry must convince their money lenders that portfolios will perform far better than originations from 1997-2001 did.

8. This industry can get to you

I suspect my retired friend just sees this very troubling industry landscape and fears we've downsized permanently.

I first saw it in 1974-75 with people leaving the business in droves. Many players disappeared forever. Even the survivors, some of whom are still prominent today, were bowed and broken, their checkbooks depleted.

My then boss and mentor left the industry after an illustrious but meteoric industry career. After pronouncing it dead in 1975, he purchased a great business outside the industry the following year. That's where he sits today, a very wealthy guy, for him a good decision made.

Is he as wealthy as *Forbes* says Jim Lee Clayton is? No, the industry did not actually die and Clayton is hardly the only success story to be found since 1975.

The sad part is that for every fortune made in this industry, several were lost. Careers of competent men and women were cut short by vicious industry downturns of cataclysmic proportions. This continues today.

Lately, that deep gloom has set in again and I hear the industry is dead, just as it was supposed to be in 1975 and 1991. I believed it in 1975, feared it in 1991 but simply cannot be fooled again. Factory-built housing won't die until it stops serving a market need that continues to increase.

For that very reason, I fully believe we will see a great resurgence in chattel lending, hopefully with greater safeguards this time around. Heaven knows, this all is disheartening, but present industry conditions are not necessarily the permanent condition. Yet, the past does tend to foreshadow the future.

So assuming a long life, I'll probably live through another resurgence and, who knows, another meltdown. Once again, I'll be "staring at the rubble of factory-built housing in tornado alley," according to industry analyst John Diffendal.

9. Changes are coming

I do see the basis for an industry bottom being formed. This vision does not account for horrific events—war or terrorist acts—that could change our landscape, perhaps forever.

I dare not think about those events. I can only deal with what I know and see, and I would say to my good friend in Arizona that I recognize and respect his skepticism. It is entirely warranted.

Every time this industry has a core meltdown, it stops barely before hitting China. Like a weed you've plucked, it soon springs back to life.

I don't know when, but I am sure it will all happen again. Regroup, return, resurgence, reprise, repos, reluctance, retract and retreat, as the cycle of life continues. ∩

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