IT'S THE AFFORDABILITY, STUPID

By Martin V. Lavin

In 2000, the Asset Backed Securities GT/GP bomb detonated and the damage to the factory-built housing industry had been horrific, about two-thirds of the lenders had perished. Many went bankrupt, seeking protection from the damage.

Warnings were sounded by skeptics as the loan race heated up in 1996. But lenders claimed they could handle the new weapons being created (5 percent down, 30-year terms, lending to highly dangerous credit tiers and a new loan ease).

Although experts called for much greater verifications of details and were concerned about the explosive effect of such lending weapons, the participants seemed unfazed. Each new lending weapon was met by a one-up from another lender.

Complicit in this build-up were the big multi-national bankers, providing endless money to fund the build-up of loan weapons of mass lender and borrower destruction, asking few questions in the process. By 1999, the factory-built housing world stood on the edge of annihilation, but in spite of repeated warnings from wise loan men, few would listen. Ego, greed and lack of knowledge drove the industry to a precipice from which few could pull back and many would perish. Even the survivors were injured, many grievously.

I stand now in this post-apocalyptic lending world, on a high plateau surveying the damage. Only recently has there been any hope the damage may be ebbing. Going from 373,000 new HUD Code homes delivered in 1998 to 131,000 homes in 2003, that bomb took 67 percent of the industry with it. The power of that stealth lending bomb was even more devastating than the most astute analyst predicted.

Pretty horrific picture, isn't it. Sounds like a B movie with a story line that stretches credulity. The preceding is a true story and a proper representation of the damage done to the factory-built housing industry in the United States.

Now, in the sequel, we have to write a script that will miraculously save the survivors. (I've asked for Arnold Schwarzenegger to play me.) We must stabilize the fatal state of the industry and provide a fresh, new future to one of America's constantly under-performing industries.

How did it happen?

In a nation with millions of baby boomers retiring in the next 20 years and lower income, working class citizens, how can an industry that provides affordable housing stumble so deeply? It is *the* question we must ask ourselves. There is no doubt we are needed, and needed badly.

So, why was there such a deep fall and now, uncertain future? In a nutshell, here is what happened: Easy access to lending money led to many retail lenders entering the business, competition for loans resulted in over expansive lending, which created many defaults and repossessions, leading to lender failures, resulting in industry illiquidity, leaving a horrific mess which is just now abating.

The problems are real, the answers elusive and the future still highly uncertain. How can this be? Every Wall Street analyst with whom I've spoken foresees a vibrant future for this industry. Warren Buffett's purchase of Clayton Homes has that greatest of investors believing.

What is our problem?

About this business

Building homes seems to be what this industry does best. They are good homes that never fail to amaze even our most strident critics with their construction and appearance. But selling the nicest homes we've ever built has failed to fuel a resurgence—building good homes is simply not enough!

Where then, is our greatest competitive advantage? To paraphrase one of my favorite presidents, "It's the affordability, stupid." You know, modest single- and multi-section homes that compete only with apartments and other low-cost housing.

For detached, single-family living, occupant-owned, low cost housing, we are the ones, period. Why don't we use that to our advantage? Beats me, I have to defend that strategy repeatedly. Of course, there are people who do follow that strategy and have prospered, although none have entirely escaped the general industry malaise.

Does that mean no one in the industry should try to compete with higher cost housing? Heavens, no! The industry should build every home that can be sold at a profit. My concern is there are less than 40,000 upscale factory-built homes in play annually and even a strong performance in this segment is unlikely to regain our lost production any time soon. (Ahem, we *are* down 250,000 homes.)

Yes, you could try to increase the number of homes in that segment, but that strategy is open to question. It is unlikely to happen anytime soon, barring changed circumstances. These homes require adequate conforming financing and a more dramatic cost/price benefit over site-built competition. Why? Buyers do not perceive factory-built housing to be as good as site-built and won't pay the same price for it.

This leaves the greatest volume to come from the home shipment breakdown last seen in 1996, when 340,000 new HUD Code homes were delivered with an almost even split of single- and multi-sections, mostly of a modest price range.

If you review home shipments from 1975 through 1995, you'll conclude that we are an industry with about 240,000 new HUD Code homes per year, give or take 60,000 homes. Ignore 1970 to 74 and 1996 to 2000 as both periods were characterized by untenable lending regimes. (Make no mistake, as retail lending goes, so does the industry.)

So, is there hope? Poking around the alleys of factory-built housing, there is still more fatigue than hope, and for good reason. Every move we make is doubted and we seem less competitive at this moment than any time since "Wheel Estates" was founded.

Perpetuating the problem

I'm not sure we represent much value in the manner in which the industry has evolved. There are just too many outstretched hands out along the way asking our customers for something they have in very short supply: money, money, money.

The builders have been profitable some of the time, wrecked mainly by the vicious pullbacks and ramp-ups so common in this industry. In six years, the chain went from 373,000 homes to 131,000, a 67 percent reduction. How can you plan for that? What other industry endures such elasticity? Yet, their invoices not only create as much profit as competition allows (OK), but too often the invoice is larded with "blue sky" charges, adding to reduced consumer value (not OK).

The retailers boom when lending is sound, stuffed with unearned volume bonuses, money showered on them at every turn, their numbers increasing like lemmings, but ultimately suffering mass extinctions. I review loan applications daily and it isn't hard to see that attempts at 50 to 100 percent mark-ups over true cost are standard operating procedure, even today. This degree of mark-up to consumers and their lenders results in immediate and drastic home depreciation.

Community owners have become like apartment owners, religiously raising rents. Most operating manuals encourage raising rents annually, if only nominally. But the apartment landlord deals primarily with a stop along the way in people's lives, a year or two at a time. Our resident stays with us for years (the average being 7.5 years), many stay longer. Rents increase annually, even when vacancies are rampant, as they are now.

Then, the lenders at the bottom of the chain are commonly subjected to losses at the end. They try to protect themselves, which, in lending, is partially accomplished by increasing interest rates. Charging a marginal borrower 15 percent on a resale and 8.5 percent on a new home for one with very good credit is common today. We know the 8.5 percent customer has less than a 5 percent probability to default, while the marginal borrower may be in the 30 percent or higher tier. And we've "protected" ourselves? In a world of 60 to 80 percent charge offs on repossession, I don't think so.

Simply stated, there is just too much money being taken from customers to purchase and dwell in a factory-built home. The prime attribute—affordability—has been eroded. Our cost of ownership is not only too great, but its cost is not determinable during the 10 years most will own their homes. With annual family incomes of $20,000 to $40,000, even modest, unanticipated costs, like a roof leak or rent increase, can torpedo their lives, resulting in repossession.

What can we do?

There are many thoughts on how to improve sales and profits. The following are the changes and enhancements that some say need to be made by each segment of the industry to help right the ship.

Lenders

• Greater use of third party appraisals for a real determination of home value once it is sited, especially in land/home situations.

• Adoption and implementation of a uniform national Community Classification System (CCS), to determine the home's site quality which impacts its fair market value to enhance community sited chattel lending.

• Industry-wide adoption of a Manufacturer's Statement of Retail Price (MSRP) to allow consumers to comparison shop fairly and reduce our "wheeler-dealer" reputation.

• A standardized serial number system or Manufactured Housing Identification Code (MHIC) that allows subsequent lenders and homeowners to know exactly who built the home and when, the model and other information to allow absolutely certain home identification for financing as a resale.

• A computerized databank of previous home serial numbers from all available builder's records to ascertain the same information as discussed above, which negatively impacts proper resale financing.

• Resales must be accepted as an important part of our industry and business practices must reflect it. We must break the belief we are a throw-away commodity.

• The general lending terms on chattel and land/home secured homes have changed to a shorter repayment term to allow the measures above and should continue to shrink.

• Reduce gross margins per home to stop the enormous depreciation on first sale. This has to be offset through increased volume, which is the normal economic result.

• MARI, the database of the industry's bad actors and TIPS, the truth in invoicing MHI program must be adhered to by all players.

• Protect yourselves at all times realizing that your actions protect the industry as well.

Builders

• Build homes that sell to retail customers at a profit, not only to retailers or community owners.

• Understand industry lending is under pressure and accommodations might have to be made.

• Remember affordability. MHI reports the annual median family income of HUD Code housing is $29,000.

• Never forget there are 3 to 5 million obsolete homes in communities that need to be replaced, but size restrictions apply.

• Embrace a Consumer Satisfaction Index (CSI), use it and live it.

• Your warranty must be longer and more comprehensive. Remember, it is your warranty, not the seller's.

• Take the lead in accepting the final responsibility for proper set-up of the home.

• Encourage affordability coupled with building consumer value through MSRP, CCS, TIPS, MHIC and a database of previously built homes.

• Continue to build a great product and innovate daily, always with the goal of delivering more home for less money.

Retailers

• Fraud is bad for you, your consumer and the industry.

• One of these days, retailers are actually going to have the financial capability to enter this business and succeed in it.

• Negotiate protected territories so you can control your business.

• Understand a low volume/high gross profit sales model keeps continued pressure on lenders, reduces consumer value and contributes greatly to industry turbulence which damages you as well.

• Professionalism (acting and dressing the role) and consumer satisfaction are not words without meaning. They are the keys to your prosperity.

• Get a sales system, follow it religiously and sell homes people can afford and want to buy. (Sell Hondas, not Oldsmobiles.)

• It may take more than trying to sell two or three homes per month with 50 to 100 percent mark-up to succeed.

• If you have decided to sell modulars with conforming mortgages, you better be prepared. It is a different business, needs even greater capitalization and presents many challenges.

Communities

• Rents go up and down, and that often affects whether vacancies go up or down.

• Residents do not come shackled with a ball and chain restricting their mobility.

• Review the totality of the housing opportunity you are providing to residents and determine whether you are a value for the type of resident you need to attract to prosper.

• Retail lender relationships are all-important and must be cultivated to assure success, which includes industry lenders and banks.

• You are under special scrutiny in many cases, as residents are lower-income working class folks and retirees, both of whom merit protection from regulatory authorities.

• If you believe communities only appeal to residents with FICO scores under 600, review the ABS loan performance from 1996 to present.

Suppliers

• Deliver an ever-decreasing priced product, with ever-increasing quality.

• Give your builder clients the benefit of the expertise you have acquired.

• Spread your highly ethical business practices wherever you sell.

Trade associations

• Remember, "it's the affordability, stupid."

• No matter what you personally like, all homes and sitings that can be profitable for the distribution network above must be championed.

• Strive to create networking opportunities, encourage information sharing, intercede to protect from unwise legislation and lead industry betterment. But remember, you are ill-equipped to give market guidance.

• Accept and implement an industry database on the Internet, including a multiple listing service (MLS), previous serial numbers, MHIC, CCS and other data necessary for the rationalization of this industry.

• Create and guide an industry-wide image campaign to educate the public on the role this industry serves.

When all of the above is done, we'll be OK, right?

I have an uneasy feeling all of that will not be accomplished and even if it is, I still fear for our future. I see a 30-year trend of dropping sales in both actual home numbers and on a population-adjusted basis. Even if our annual home delivery numbers were holding at 240,000, we are going backwards as the population grows rapidly.

How can we stem it? I wish I knew with certainty, but as I analyze our housing, I come back to affordability. Oh, I know, factory-built housing is a life-style choice, but the affordability of that lifestyle is the predominate attribute!

Let's try this!

Is there something to be learned from our automaker friends in Detroit? They *are* great marketers. Notice how they've grown unit sales with the population and not only put most people in a vehicle, but several at the same time—even in modest households. Autos usually cost $15,000 to $50,000. Don't we build homes commonly in that price range?

They've learned along the way that the ease of purchase and the "total cost" of ownership fuels auto purchases. Loans with little or no interest, lengthy warranty periods, free service at intervals, no-charge loaners, enormous ease of purchase and great transparency, these are their marketing strategies.

I can go to any bookstore and tell you the "true dealer cost" of every vehicle and its options in 10 minutes. Yet most auto dealers are quite profitable and have been for the last 20 years. And we are still resisting Truth-In-Invoicing and MSRP? It clouds the mind!

Essentially, what the auto companies have done is fix the cost of ownership for five to 10 years, make it easy to buy and own, and offer financing terms to easily pay the vehicle off in five years or less. With our homes costing the same amount, we look to 15- to 25-year terms for the same amount. Instead of zero percent, we charge nine to 15 for the purchase money. Instead of fixed community costs, the homeowner is often in an endless bout of rent increases, leading to home depreciation.

All of us in the industry have our hands out every step of the way, adding to the cost. As costs mounted in the 1990s, we tried to stretch the repayment term to continue to sell more expensive homes. That move came up against hard realities. We must face the facts—people have figured us out.

In addition, for site-built housing, the conforming mortgage business created an even more user-friendly application and closing process. It culminated in an easier, cheaper mortgage transaction, co-opting one of our hallmarks: ease of transaction. We are now often harder to get closed, require more down payment, need higher credit capability and are more expensive than comparable site-built housing. They've taken much of our desired customer base in the process.

Can someone in the industry who builds, sells, finances and insures homes and owns communities create a new industry model that will allow a near certainty of home ownership costs for five to 10 years, building on our affordability cornerstone? Can disparate industry players partner to create the same result? If it is not being discussed, it should be and quickly. Value and affordability, the two sides of the same coin, must be restored.

The current industry move to partner with lenders such as the Park Waiver Agreement, as good a move as it is, does precious little to deliver value to customers. If lenders have been left holding the bag too often, it was because the bag was first inserted in our customer's back pocket. Then, they obligingly transferred it to the lenders as they sensed the reality of the situation.

Is there hope? It's the affordability, stupid.

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