Manufactured housing: An expected beneficiary from subprime mortgage disruption

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The story is familiar

In the early 1990s, manufactured housing lending was characterized by high lending rates and little competition. In the mid 1990s, lenders began to more aggressively utilize a new source of liquidity—the securitization market. In response to attractive yields and structures, investors snapped up all the manufactured housing bonds offered to them, and clamored for more. Securitization volume grew from approximately $6 billion in 1995 to more than $12 billion in 1999.

High lending rates, scant competition and a rapidly growing investor base combined to attract more lenders to the market. At first there was room for all of them to make money. That's because the manufactured housing industry was in the midst of a recovery in demand that would last almost the entire decade of the 1990s (Figure 1).

As the rate of growth in demand slowed, competition increased among a growing number of lenders in manufactured housing. Lenders responded by adopting more aggressive lending practices in order to protect and increase their market share. They relaxed underwriting guidelines and eased loan terms. For example, questionable credit histories were overlooked, terms were extended to as long as 30 years, and borrower rates declined.

What followed were large-scale borrower defaults and foreclosures, which caused rapid deterioration in the performance of securitizations. This led to a dramatic withdrawal of liquidity from the manufactured housing market. For an industry whose lifeblood was access to the capital markets, these events decimated the industry.

Such was the story of manufactured housing in the 1990s and early 2000s. Today, at Advantus, we believe a similar scenario unfolding in the subprime mortgage market will, paradoxically, help manufactured housing make a comeback. For investors, we expect this often overlooked sector to offer opportunities.

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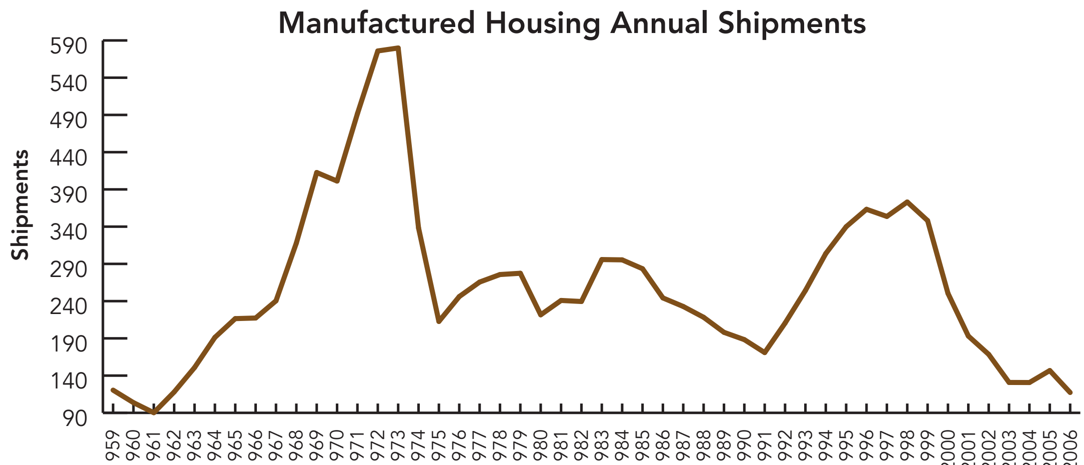
Figure 1



Source: U.S. Census Bureau

What is a manufactured home?

A manufactured home is constructed entirely in a factory. It must be built to comply with the Federal Manufactured Home Construction and Safety Standards administered by the U.S. Department of Housing and Urban Development. A manufactured home sits on a chassis with axles and wheels and is movable. Unlike a site-built home, a manufactured home does not require a permanent foundation. Once completed in the factory, the home is transported to, and installed at, its destination: privately owned land or a manufactured housing park where the land is leased.

Those were the days

While the industry has been trending towards more land-home transactions, it remains that the majority of manufactured homes sold and financed are considered chattel (movable personal property), more like a car than a conventional site-built home. Also similar to a car, a manufactured home is a depreciating asset. Relaxed underwriting, slowing demand and the depreciating nature of manufactured housing proved lethal to the industry. Declining home values quickly placed borrowers in a negative equity position, giving them greater incentive to default on their loans.

When manufactured home borrowers found themselves in that situation in the early 2000s, increasing numbers of them walked away from their obligation. Widespread defaults and foreclosures ensued and created a massive inventory of repossessed homes. Lenders, in turn, sold those repossessed homes for pennies on the dollar. The damage was so extensive that it further depreciated values throughout the industry, which perpetuated the downward cycle.

In the face of deteriorating loan performance and mounting losses, the capital markets shut off the flow of dollars. Companies that specialized in making and selling manufactured housing loans exited the market, some voluntarily and others involuntarily. At the peak of the market in the late 1990s, there were 13 major, active manufactured housing lenders. By 2003, the number had dwindled to three.

Losing out to subprime

During the recent housing boom, growth in subprime mortgage lending cannibalized the manufactured housing market. Until the beginning of 2007, subprime lenders appeared to have near open-ended support of the capital markets (similar to manufactured housing lenders in the 1990s). This environment gave borrowers access to site-built homes they previously could not afford. Adjustable-rate mortgages, interest-only loans, longer-term amortization schedules and other subprime lending innovations meant borrowers could purchase a site-built home for the same payment or less each month than they might pay for a manufactured home.

That said, we believe current disruptions in the subprime lending market will help the manufactured housing industry recover. The industry appears poised for a recovery: shipments remain at historic lows, the glut of repossessed manufactured homes has been significantly reduced, and underwriting excesses have long been eliminated. The next several months should offer a clearer picture.

The longer the withdrawal of liquidity in subprime lending persists, the greater the likelihood of a recovery in manufactured housing. We believe as potential new borrowers consider their options in the current subprime lending environment, they will conclude manufactured housing is an attractive alternative. Indeed, according to one of the manufactured housing lenders we speak to regularly, they are now experiencing increased loan application activity.

Finding value in an overlooked sector

The historical challenges in the manufactured housing industry do not mean the sector is without benefits for investors. Lending practices are much different today than in the late 1990s. Widespread underwriting excesses of that time are largely gone and the capital markets have not allowed manufactured housing lenders to match subprime loan innovations.

The benefits of better underwritten collateral can be seen in the credit performance of structured transactions issued within the past three years. Delinquency and cumulative loss levels for 2005 and 2006 vintage deals are a fraction of what they were

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for early 2000 vintage deals (Figure 2 & Figure 3). This recent vintage performance relative to current credit enhancement levels looks to provide attractive protection for investors.

There is another reason to like the sector. This market can offer better protection from prepayment risk than the prime, Alt-A or subprime residential mortgage markets. Even if interest rates go down, manufactured housing borrowers have few, if any, refinancing options. The prepayment stability of the borrower is a significant plus for investors.

Bringing it home

Manufactured housing is not a market that rewards casual involvement. Earning its rewards requires diligence and an eye for detail; knowledge is what we are after. Periodic onsite originator/servicer visits allow us to meet management and gain firsthand knowledge of their systems. Careful due diligence and thorough analysis allow us to skillfully select investments. Finally, continuous monitoring using our proprietary surveillance system allows us to stay on top of our investments in this sector to monitor whether they are on track with projections.

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Figure 2

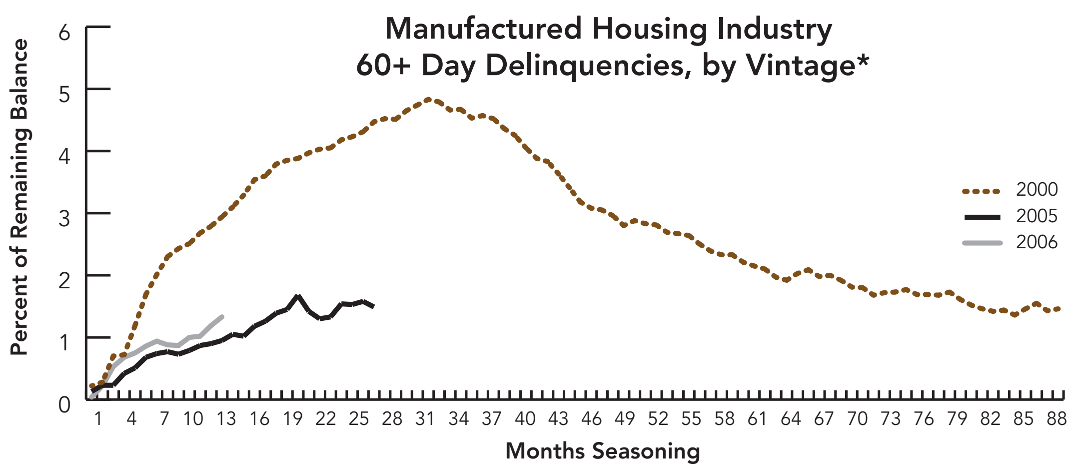
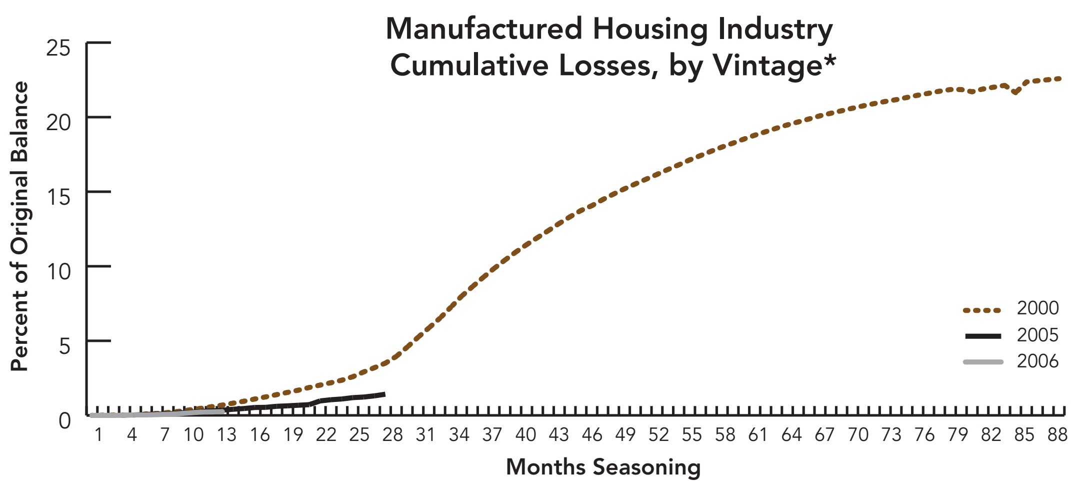


Figure 3



**Source: Intex Solutions, Inc.*

Figure 2 and Figure 3 2000 vintage composites created using Conseco Finance securitized deal performance. 2005 and 2006 vintage composites created using Origen Financial securitized deal performance.

Despite past challenges in the manufactured housing sector, investors continue to support those companies that have proven track records. Discriminating investors can enjoy attractive relative spread levels investing in this sector.

At Advantus, we believe manufactured housing will continue to offer value for knowledgeable investors who know where to look. As subprime liquidity problems continue to restrict the market for site-built homes, we look for manufactured housing to stage a comeback that will increase opportunities for investors to participate profitably in this sector.

This is intended to provide information to institutional investors and their consultants and should not be construed as a recommendation or as investment advice.

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