RIDING THE THIRD WAVE TWO YEARS LATER

By Randall K. Rowe and David B. Lentz

It has been almost two years since we first described the three major waves of capital flows into the manufactured housing community sector. You might recall that real estate investment trusts (REITs) were the first large-scale owners in the sector, beginning with the March 1993 initial public offering of Manufactured Home Communities (MHC), which was later renamed Equity Lifestyle Properties. The offering provided MHC with access to cheap public capital at a time when limited private capital was available, allowing it to outbid its competition for some time afterward. Today, however, despite some promise during the REIT boom of the early 1990s, there are only five public companies in the sector, and only two closed significant community acquisitions in the last year.

The second wave of large-scale community ownership began in 1997 when institutional investors, who had witnessed a strong REIT run but could not invest publicly without causing significant stock price movements, began to back private consolidators such as Hometown America. The consolidators planned to aggregate assets privately before exiting via the public markets, and because they could obtain higher risk-adjusted returns by employing greater leverage without materially increasing perceived risk, the consolidators suddenly enjoyed a competitive advantage over the REITs. As market conditions evolved, however, the planned public-market exits proved elusive, and ultimately only the investors in Affordable Residential Communities (ARC) achieved a public offering. Hometown America adopted an alternate strategy when one of its institutional investors bought out the other four. Later, Hometown America's private capital allowed it to prevail in the bidding for Chateau Communities, then the largest public company in the sector, in May 2003.

The third wave is being led by private investors such as Green Courte Partners. Today's private equity firms also aggregate large amounts of private capital, but, unlike the consolidators of the second wave, they have no specific requirements for a public market exit. Some funds, like Green Courte's, have an investment horizon of at least 10 years, whereas public capital generally looks at returns on a quarterly basis, and institutional capital often has a three- to five-year time horizon. Private buyers can employ leverage in excess of 70 percent, whereas REITs are still held by the market to around 50 percent. Therefore, private buyers today can be more competitive when bidding for assets. In addition, the long life of today's private companies has allowed them to utilize a variety of flexible transaction structures that are optimized to meet the demands of today's marketplace.

A little help from George

It is difficult to track the acquisition and disposition activity of private companies in the manufactured housing community sector, but one source for such information on both public and private companies is the "Allen Report," published annually by George Allen. To appropriately compare companies' net acquisition activity during 2003-04 using the "Allen Report," the data must first be adjusted for the fact that the activity of Equity Lifestyle Properties was substantially concentrated in recreational vehicle parks. Once these adjustments are made, it becomes clear the sector's private companies led the public companies in net acquisition activity during these two years. According to the year-end 2002 and 2004 editions of the "Allen Report," there were five public and 20 private companies among the top 25 companies in the sector. After the adjustments described above were made, the five public companies owned about 170,000 sites at the beginning of 2003 and the top 20 private companies owned about 230,000 sites. Over that two-year period, net community acquisitions by public companies were actually negative by about 650 sites; in other words, the public companies' portfolios shrank by about .3 percent. The private companies, however, showed a net increase of more than 10,000 sites, or about 4.4 percent of their total portfolios. In this case, however, the data alone does not tell the entire story. Over this time period, Hometown America, a private company of about 15,000 sites, successfully acquired the publicly-traded, 70,000-site Chateau. During that same period, ARC went public at a price of $19 per share, but the stock recently traded at only about $13 per share, another indication that the private markets are currently more favorable for the sector. To further underscore the public/private disparity, the data referenced above accounts for the activity of all the public companies but only the top 20 private companies, whereas the "Allen Report" actually tabulates portfolio data for more than 100 community owners nationwide.

As mentioned previously, there are several reasons for the strength of private companies in the current acquisition environment. Today's firms have long investment horizons of 10 years or more and measure their results based on a transaction's internal rate of return, rather than its initial yield. These firms can lock in today's low financing rates at high leverage for 10 years and therefore enjoy an advantageous cost of capital. In contrast, firms limited to short-term financing face significant refinancing risk and public companies limited to lower levels of leverage must use more expensive equity. Ob-

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viously, these limitations must be priced into companies' acquisition projections. For sellers, the private buyers' use of higher levels of low-cost, long-term debt translates into a cost of capital advantage that ultimately results in higher selling prices. In addition, long investment horizons allow today's firms to utilize performance-based contingent consideration to close the gaps between buyer and seller expectations or use customized structures that help defer a seller's capital gains and depreciation recapture taxes for longer periods of time (see "Deal Structures that Work!" by James R. Goldman March 2005). Today's private companies also can avoid the burden of a large headquarters operation, instead creating multiple joint ventures with regional operators who can capitalize on superior local market knowledge. Without the expensive, monolithic structures required to own 100 percent of each asset and manage these assets internally, today's firms can operate with lower overhead and again be more competitive when bidding for acquisitions.

Each of these factors has been an element in Green Courte's success since we closed our first community investment in August 2004. Since that time, we have structured three partner relationships, each tailored to capitalize on the unique strengths, both geographic and operational, each partner delivers. We have invested in 11 communities representing total assets of approximately $89 million, and our pricing was aggressive partly because we were able to lock in extremely advantageous 10-year financing, with spreads as low as 100 basis points over the 10-year U.S. Treasury bond and typically with three years of interest-only payments and 80 percent leverage. Where sellers were reluctant to commit to a price because they believed occupancies would reach previous peaks sooner than we could comfortably underwrite, we were able to create earn-out structures that result in additional payments if the sellers' expectations are reached. Finally, in one transaction we were able to invest in a manner that met the needs of multiple partners who had disparate tax and estate planning needs by structuring a variety of securities customized to meet the needs of each partner.

So where do we go from here? Both the overall real estate investment environment and community sector present unique challenges that require creative, entrepreneurial thinking to overcome. As an example, the historical "sweet spot" for manufactured housing has been a total monthly payment (home loan and site rent) priced between local two-bedroom apartment rents and the monthly payment for an introductory site-built home.

Today, with rent specials abounding in a soft apartment market and low interest rates continuing to make site-built homes well within reach for many of our traditional residents, community owners often find it hard to compete with either apartments or site-built homes. In addition, the strong growth of the sub-prime lending market has allowed buyers with poor credit quality to finance site-built homes, whereas the fallout from the Conseco bankruptcy continues to limit the supply of chattel financing for our homebuyers. Finally, on a more "macro" level, the loss of manufacturing jobs to innovative, growing economies like China's will place pressure upon our traditional resident base. Given these challenges and the resulting need for more entrepreneurial and creative approaches to structuring transactions, we believe market conditions will continue to favor third wave companies for some time to come. ■

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