

The Third Wave for Manufactured Housing Communities

By Randall K. Rowe, Chairman, Green Courte Partners, LLC

As real estate investors, we know change is inevitable. Successful investors anticipate change and adapt accordingly, often combining disparate bits of information to identify nascent economic and social trends that may impact future results. In recent years, the manufactured housing community sector has seen more than its share of change, leading to today's challenging investment environment. Last year, as my partners and I decided to form a new investment company that would, among other things, focus on making investments in this sector, we spent a lot of time considering the impact of the sector's recent changes as well as our collective experience in the sector since 1989. We concluded that the manufactured housing community sector is beginning to experience its third "modern era" wave of significant capital flows.

The first wave of large-scale ownership in the sector was by real estate investment trusts, or REITs. In March 1993, Manufactured Home Communities, Inc. ("MHC") became the first major company in the sector to go public. MHC used the umbrella-partnership REIT ("UPREIT") structure pioneered by Taubman Centers, Inc. in November 1992, which allowed sponsors to contribute assets to the REIT on a tax-deferred basis. This structure, in large part, led to the explosive growth of the REIT market between 1992 and 1995. In addition, MHC was fully-integrated, self-administered, and self-managed, a structure required by the public markets to eliminate conflicts of interest inherent in REITs from the 1960s and 1970s, when REIT sponsors also frequently owned outside management companies.

There were two primary reasons behind MHC's decision to go public. First, an IPO provided access to cheaper public capital for growth when limited private capital was available, giving MHC a competitive advantage and allowing it for some time after the IPO to consistently outbid its competition for assets. Second, the additional capital allowed MHC to reach "critical mass" quickly, providing operating efficiencies and reducing allocated G&A costs

MHC's public offering resulted in the first manufactured housing community company of significant scale that was comprised of institutional quality properties. At IPO, MHC's portfolio had 44 communities containing 13,276 sites; today it has 144 communities containing nearly 53,000 sites. Following MHC's IPO, other operators of similar scale also wanted access to public capital and followed suit. ROC Communities, Inc. went public in August 1993, and Chateau Properties, Inc. followed in November 1993; the two later merged. Sun Communities, Inc. went public in December 1993.

Interestingly, more than ten years later—even with the recent initial public offering of Affordable Residential Communities Inc.—there are only five public companies in the manufactured housing community sector:

- ▶ Affordable Residential Communities Inc. ("ARC")
 - ▶ 301 communities with 66,000 sites

- ▶ Manufactured Home Communities, Inc.
 - ▶ 144 communities with 53,000 sites
- ▶ Sun Communities, Inc.
 - ▶ 127 communities with 44,000 sites
- ▶ American Land Lease, Inc.
 - ▶ 29 communities with 9,100 sites
- ▶ United Mobile Homes, Inc.
 - ▶ 26 communities with 6,000 sites

Why? Consider the second wave of large-scale ownership, which began in 1997 with the advent of institutionally-backed private consolidators. Following a strong REIT run, institutions wanted to invest in the sector, but limited liquidity prevented institutional investment in REITs without significant stock price movements. Instead, large investors, such as Lehman Brothers, AEW, and several large pension fund investors, began to back private consolidators.

One such private consolidator was Hometown America, LLC. Hometown's goal was to build an operating company to take advantage of the significant amount of private capital that had become available. Market conditions gave these consolidators an advantage over REITs in bidding for assets, since REITs were limited to 45-50 percent leverage. Private investors could finance deals with 65-75 percent leverage, resulting in higher equity returns without a commensurate increase in perceived risk, so higher risk-adjusted returns were available to private investors.

Hometown attracted five institutional investors who committed \$150 million of equity. These investors wanted to be in the sector, but were unable to invest publicly without moving the market. By investing in Hometown, the investors were able to avoid overpaying for a public position, instead making a private investment with a higher initial return that maintained the potential for a public-market exit. In effect, these investors found a "best of all worlds" scenario. Their five-year strategy was to aggregate assets privately using high leverage but eventually to de-lever and go public. Several other private consolidators adopted the same strategy.

The public-market exit proved elusive for these investors. While the consolidators were building their operations, manufactured housing community REITs underperformed relative to their historical results and relative to REITs in other sectors. Then Conseco failed, reducing the availability of home financing for community residents. Spreads between conventional financing for site built homes and chattel financing for manufactured homes increased, reducing the cost advantage of manufactured homes. The slowing economy increased vacancy rates. Finally, operating-cost increases (real estate taxes, insurance costs, water and sewer charges, and trash collection charges) created additional challenges. Ultimately, other than ARC, the consolidators have been unsuccessful implementing their strategy to go public. As a result, some have experienced difficulty with their institutional investors, since institutions typically have five-year investment horizons and desire a public exit at that point.

In September 2002, Hometown successfully adopted a different strategy when one of its investors, the Washington State Investment Board, recognized the advantage of staying private and bought out the other four investors. Subsequently, Hometown agreed to buy Chateau

Communities, Inc. (“Chateau”) in May 2003. Hometown was successful because its private capital is priced for the long term, instead of quarter-to-quarter, and it can use higher leverage. MHC, a publicly traded REIT, had previously tried to buy Chateau but was unsuccessful; it could not afford the funds from operations (“FFO”) per share dilution that would have resulted from Chateau’s slow filling of vacancies or the cost of restructuring Chateau’s operating infrastructure.

The third wave is still coming in to focus, but it is clear it will also involve private capital, which is accessible to seasoned investment sponsors who have successful investment and operating track records. Private equity firms, such as Green Courte Partners, LLC (“GCP”), have no need for public capital. Instead, they aggregate a large amount of private capital, with no specific requirement for a public market exit strategy. Some funds, like GCP’s, have an investment horizon of at least ten years, whereas public capital generally looks at returns on a quarterly basis, and institutional capital often has a five-year time horizon. Private buyers can employ 70 percent leverage, whereas REITs are still held by the market to around 50 percent. Therefore, private buyers can be more competitive when bidding for assets.

The third wave will also involve a different type of organization. Without the need for public capital or a strategy driven by a planned public exit, there is no need to create a monolithic, self-managed, self-administered public company. Instead, private investors can utilize any structure that makes sense in the marketplace.

Savvy investors believe that while capital markets are global, real estate markets are local, so success depends on having quality partners. Implementing this philosophy, third wave companies will create a series of smaller, more nimble joint ventures with strong operators in the sector, aligning interests by creating performance-based incentive compensation structures. Third wave companies will access their partners’ unique local operating capabilities and deal pipelines and provide them streamlined access to equity capital. They will utilize a variety of structures as appropriate, structuring transactions to meet the needs of each partner and capitalizing on any structure that provides attractive risk-adjusted returns. Fully discretionary, long term capital will allow these firms to think like entrepreneurs on each transaction, structuring deals flexibly and creatively, and most importantly, maximize long-term economic value for both investors and operating partners.

About the Author: Randy Rowe is the Chairman of Green Courte Partners, LLC, a private-equity real estate investment fund focused on, among other sectors, manufactured housing communities. Rowe is the former Co-Chairman and Chief Executive Officer of Manufactured Home Communities, Inc. (1989-1995) and is co-founder and former Chairman and Chief Executive Officer of Hometown America, LLC (1997-2002). This article is based upon a presentation that Mr. Rowe made at George Allen’s International Networking Roundtable in September 2003. Contact him at 847-582-9400.