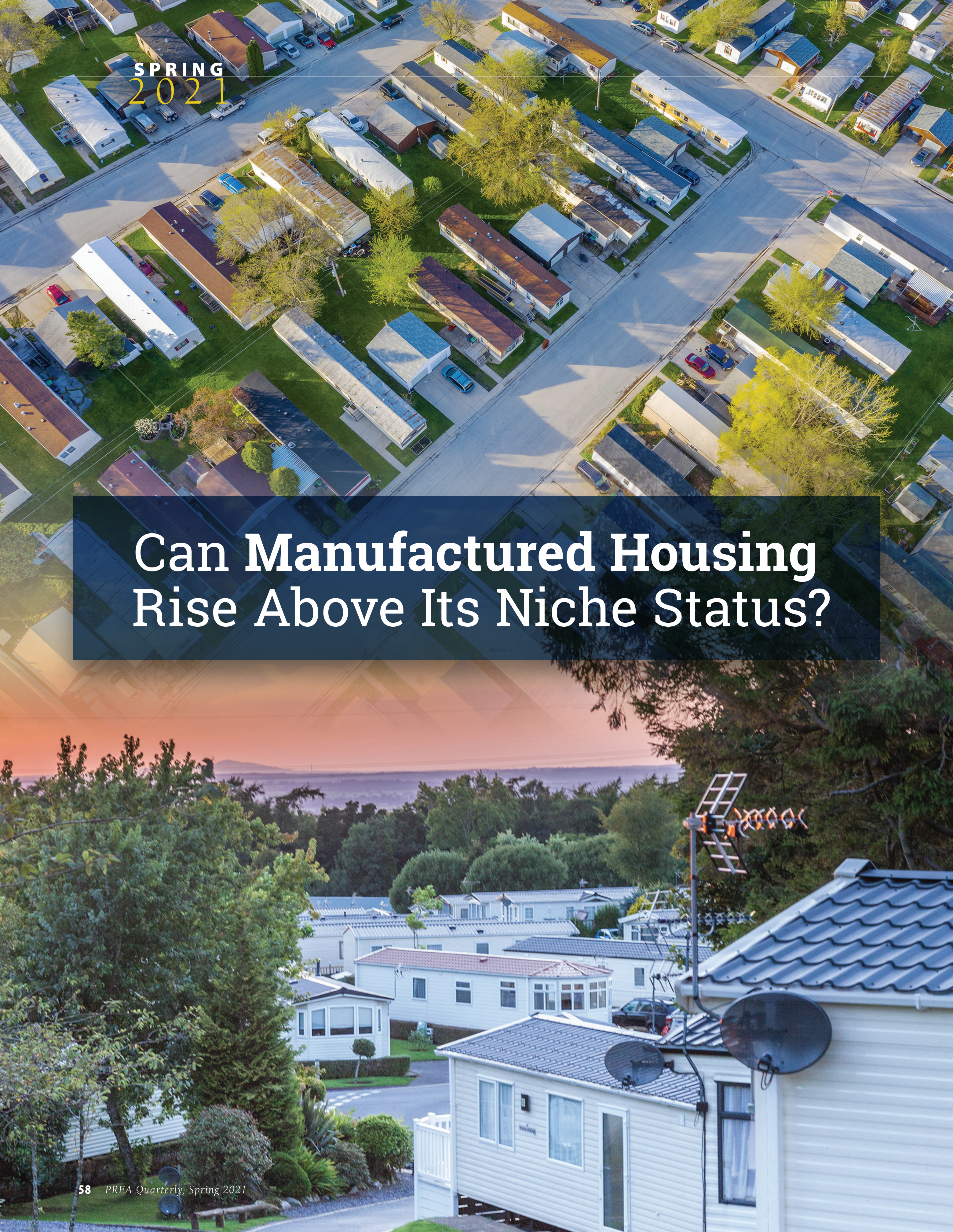

Can **Manufactured Housing** Rise Above Its Niche Status?

Given the need for affordable housing, manufactured housing seems like a good answer. It is inexpensive to build, features low rents, and can be built anywhere.

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Conditions in today's housing market seem ripe for growth in manufactured housing communities—the question is whether the industry has the capacity to take advantage of the demand.

Housing, particularly stock that is affordable to low- and middle-income households, is in short supply. According to the National Association of Realtors, housing inventory for sale in the US dropped below 500,000 in March 2021, less than half of pre-pandemic levels and two-thirds below levels in 2016. That has led to bidding wars and soaring home prices. The average home price in the US increased 12% year over year to $238,800 in February 2021, according to the Case-Shiller Index.

Meanwhile, multifamily occupancy rates and rents are rising outside urban cores in gateway metros. The average monthly US multifamily rent rose $10 to an all-time high of $1,417 in April 2021, according to Yardi Matrix, and rents are up 2.5% or more year over year in most secondary and tertiary metros.

Given the need for affordable housing, manufactured housing seems like a good answer. It is inexpensive to build, features low rents, and can be built anywhere. However, the industry hasn't broken through in a big way because of several factors, including NIMBYism, the sometimes-irregular business model that has drawn fire from consumer groups, and the limited growth potential needed to draw institutional investors.

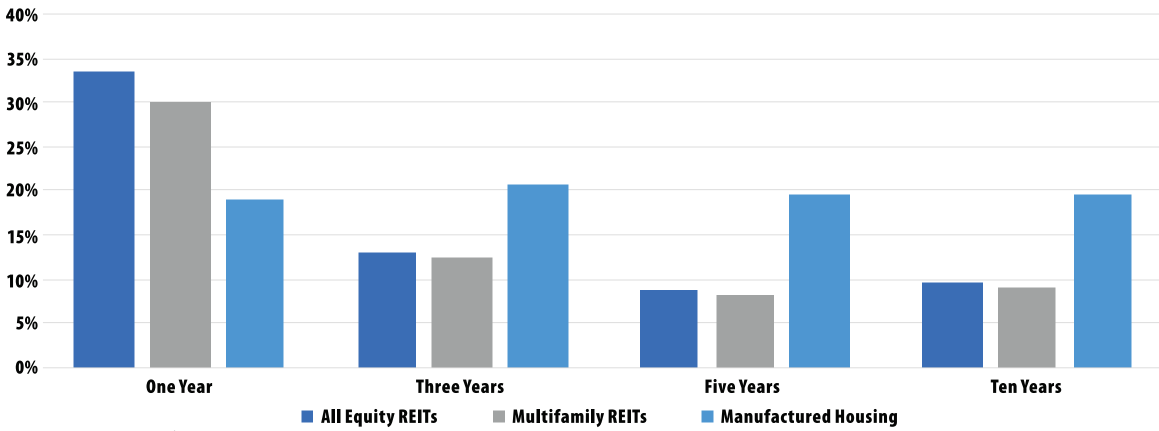
Manufactured housing is often overlooked as an asset class in commercial real estate because of its small market capitalization and the unique operational structure, but it has been rewarding to investors that have the right business model. The sector has a low cost of entry, competitive yields, and low operating expenses, helping it produce annual returns just shy of 20% over the past decade, the highest returns of any REIT asset class over that period, according to Nareit.

Stable, Long-Term Investment

Manufactured housing is an established portion of the housing market. There were 8.5 million manufactured homes in the US in 2019, representing 6.1% of total housing stock nationwide, according to the American Community Survey. More than 90,000 new manufactured homes were delivered in 2019, per the Manufactured Housing Institute (MHI), roughly one in ten new homes in the US.

Manufactured homes are less expensive to build and buy than standard single-family construction, which is an important feature given the dearth of homes affordable to low-income families. The MHI

Exhibit 1: Compound Annual Total Returns



Sources: Nareit, Yardi Matrix

says that the average new manufactured home sold for $78,500 in 2019, slightly more than one-third the cost of a free-standing home. The cost of entry is low because parks are purchased on inexpensive land away from metro areas with minimal capital expenditures for utility build-outs. Because homes are built indoors in climate-controlled facilities with factory precision, a manufactured home can be built in as little as two days, with the most elaborate designs completed in five weeks.

Manufactured home communities also can produce stable cash flow. Occupancy rates are difficult to track, but industry executives say the rates are healthy, with average resident tenure typically lasting a decade or more. Manufactured housing REITs have been both extremely successful and consistent over time. As of late April 2021, the segment has produced compound annual returns of 19.0% over one year, 20.1% over three years, and 19.7% over five and ten years, according to Nareit (Exhibit 1). The ten-year returns are the highest among all REIT sectors, and the three- and five-year returns are second only to those of industrial.

A Different Breed of Asset

With all those positive features, why is the sector perpetually mired in slow growth? Several main reasons relate to the business model and reputation the industry has developed. Manufactured housing is unique among asset classes in that it begs the question "is this real estate?" The answer to that is a resounding "sometimes."

The most common investor play is to purchase land, known as manufactured home parks, and rent lots to homeowners. The main advantage of this operating asset class over other asset classes is that land is the only significant acquisition cost. When a manufactured home is purchased and placed on a plot of land owned by the same person or entity, it is for all intents and purposes a single-family home. However, 37% of all new manufactured homes are placed on land that is leased from another entity. The park owner is responsible for groundskeeping and common area maintenance, but the actual houses are owned and maintained by the residents.

These parks are attractive to investors because the bulk of acquisition cost is in land alone; however, zoning restrictions make building new parks within municipalities difficult. These communities are often the target of NIMBY protests that are based on outdated stereotypes about "trailer parks," even though in many cases new manufactured homes are practically indistinguishable from site-built homes.

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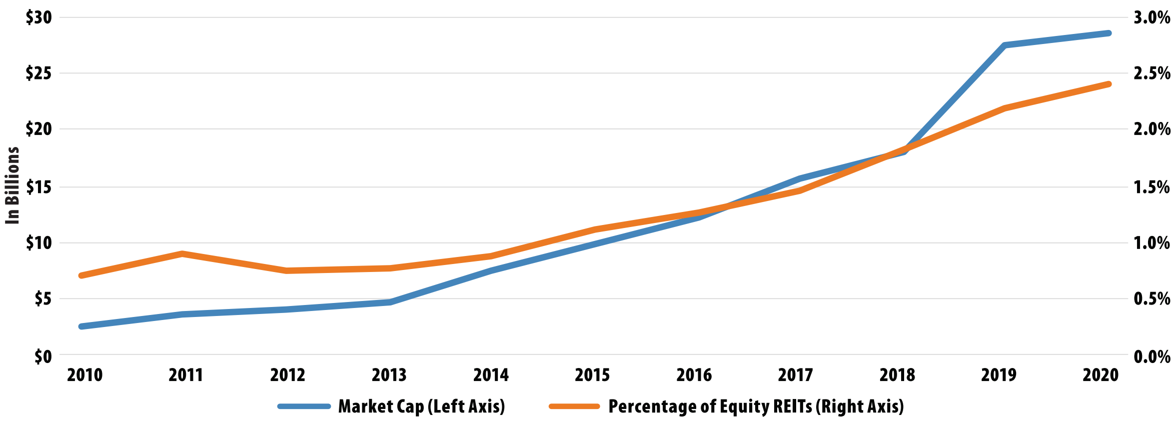
Exhibit 2: Manufactured Housing REITs Total Market Cap



Sources: Nareit, Yardi Matrix

The manufactured housing industry also has an unfortunate and sometimes deserved reputation for being predatory. The median income for manufactured housing residents is less than half that of traditional homeowners, according to the National Low Income Housing Coalition. As a result, manufactured housing residents can find themselves trapped in a difficult financial situation for a variety of reasons, including steep rent increases, predatory lending, and deceptive sales practices.

Manufactured home park residents have two fixed monthly costs: the ground lease on their lots and debt service on the financing of their structures. Because the structures are not eligible for conventional mortgages unless the purchase also includes land, purchasers wind up with high-interest (so-called chattel) loans on the homes. Manufactured home park residents lack many of the consumer protections afforded to homeowners because their homes are considered personal property rather than real estate.

The way the structures themselves are sold can also be problematic. The buying experience is analogous to purchasing a vehicle rather than a home. Salespeople typically downplay additional costs such as transportation and installation, which can add tens of thousands of dollars to the sticker price, leading some buyers to feel bamboozled.

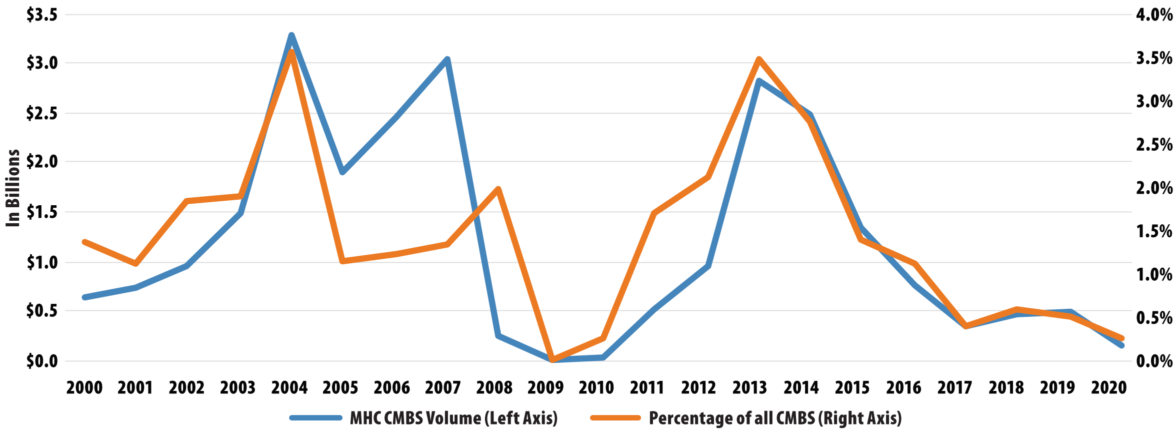
Multifamily rent is restrained by the fact that residents can move if rent increases too quickly. Manufactured home park residents, however, would have to spend at least $5,000 to relocate their homes. That often gives them few options other than to pay increases or risk losing their homes.

Threat of Regulation

The impact of chattel loans and rapid increases on ground leases can be severe for low-income residents, leading to congressional inquiries and pressure among activist groups to implement fairer practices. Although few federal laws regulate manufactured home parks, 18 states offer residents some level of consumer protection. These restrictions have the unfortunate effect of making transactions take longer to complete and creating complications for investors on exit.

The threat that regulations may be expanded and adopted in more states presents an uncertain level of political risks for investors. Future regulation may make it challenging for value-added deals to meet their targets if rent increases are throttled and eviction restrictions cut into net operating income. Although many manufactured home communities have no complaints about predatory practices and have stable operating metrics, the industry's growth has been tarred with a broad brush.

Exhibit 3: Manufactured Housing CMBS Volume



Sources: *Commercial Mortgage Alert*, Yardi Matrix

Another limiting factor to investment is that deals are simply too small and rents are too low for the institutional world, even if the property-level yields are attractive. The market capitalization of the three manufactured housing REITs was $27.4 billion as of year-end 2020, a tiny fraction of the $1.2 trillion REIT sector (Exhibit 2).

Total sales of all new manufactured homes in 2019 were roughly $2.7 billion, and just over a third of that was in communities as opposed to on single lots. Investors' focus has been on value-added assets in existing parks rather than on speculative construction of new sites. In recent years, robust returns and limited supply have spurred institutions, including Brookfield Asset Management, Blackstone Group, and Equities Lifestyle Properties, to enter the sector.

Lenders are willing to finance manufactured housing communities, but that sector remains a small portion of the overall commercial mortgage market. Though it benefited greatly during the recovery from the Great Recession, it now occupies a small but stable percentage of CMBS issuance (Exhibit 3).

Smart Niche for Patient Investors

Manufactured housing is a unique asset class with the potential to solve at least some of the problems associated with the US housing market. It can be built cheaply and quickly and is within the means of the millions of households for whom traditional homeownership is impossible.

Before the industry can truly grow, however, it must address the issues that have prevented it from rising above niche status. Hurdles to overcome include the threat that regulation may impact the investment and the stigma that makes many municipalities averse to the idea of developing communities in their borders. Ultimately, the manufactured housing segment is likely to continue to grow slowly, although it can be profitable for investors that have the expertise to operate efficiently and have the patience to deploy capital over the long term. ■

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