Chapter 137

A Home for Clayton Homes, Oakwood Homes, and Southern Energy Homes

Berkshire agreed to buy Clayton Homes, a manufactured home maker, for $1.7 billion cash on April 1, 2003. Berkshire was to pay $12.50 for each Clayton share, 12% more than the closing price the day before of $11.13.

"I have $100 million to invest each week," Buffett told Clayton Homes' founder James Clayton, and a group of employees at the company's headquarters in Knoxville, Tennessee, after agreeing to buy the company. "Jim gave me 17 weeks off." (*Bloomberg*, August 8, 2003)

The manufactured home industry got its start in the 1920s, making trailers to be hauled behind vacationers' cars. Many veterans, after World War II, sought cheap places to live and the industry grew with sales booming in the 1960s and 1970s. But as lenders offered more credit on easier terms, buyers began to default.

This industry had been in a slump since 1998 because of a rise in bad loans and a cutback in lending.

In fact, "the manufactured housing industry has been experiencing significant difficulties. By the end of 2002, industry shipments had declined for the fourth consecutive year to 168,500 homes, having peaked in 1998 at 327,800 shipments. Lax underwriting practices over an extended period resulted in overheated industry shipment levels. As the general economy slowed certain areas of the manufactured housing markets were immediately impacted and the overall industry capacity was dramatically affected," according to Clayton's

(Photo courtesy of Jim Clayton)

A Man at Home! A Clayton Home.
Clayton at his mobile home on the Tennessee River

(Photo by Lisa Nichols)

Clayton Homes location in Tyler, Texas

proxy statement about the merger in 2003.

Clayton Homes had fared far better than its rivals, Champion Enterprises, and Fleetwood Enterprises, which were reporting losses, and Oakwood Homes, which had gone bankrupt. Clayton had a profit of $31 million in the fourth quarter of 2002. Clayton is "the lone tower of strength in an industry battered in recent years by the consequences of lax financing practices," Buffett said in a statement.

Mobile homes account for almost half of new home sales in Montana, Alabama, Mississippi, and West Virginia, and more than a third of new homes in South Carolina, Louisiana, Oklahoma, and Arkansas. In the late 1990s, easy credit led to a slide in profits, artificially boosting demand, causing loans to become delinquent and foreclosures to rise. Clayton builds prefabricated homes and sells, finances, and insures them. It provides mortgage services through its Vanderbilt finance unit.

Chairman James L. Clayton and the Clayton Family Foundation, who together owned 28% of Clayton stock, said they'd vote for the merger.

Clayton Homes became a wholly-owned subsidiary and remained in Knoxville and the company's 6,800 employees in 33 states also stayed. "We don't sell. We have an entrance strategy, but we have no exit strategy," Buffett told an audience in Knoxville. (*Knoxville News-Sentinel*, April 9, 2003)

The following day Buffett spoke at the University of Nebraska-Lincoln and mentioned the Clayton purchase and how important accounting is to reaching business judgments. "I made the deal over the phone without ever seeing it. Yesterday was the first time I had met with the board of directors," Buffett said. (*Daily Nebraskan*, April 10, 2003)

Clayton founded the company in 1966. The son of a sharecropper, he grew up in western Tennessee, living in a log cabin with no electricity or running water—or even an outhouse. Clayton left the cotton fields and founded Clayton Motors with his brother Joe, but he expanded too fast, his loan was called and he was forced into bankruptcy. Later he started Clayton Homes and, according to *Forbes,* Clayton is now worth about $600 million.

The company has 32 manufacturing plants, 390 company-owned stores, 542 independent retailers, 89 manufactured housing communities, and mortgage ser-

vice operations for more than 400,000 customers and insurance protection for 135,000 families.

Clayton has turned the day-to-day running of the business over to his son, Kevin.

"A key aspect to the acquisition is the $5 billion in loans that Clayton Homes services on the homes that it has sold. While those are currently securitized, over time Berkshire will be able to bring all that financing onto its books and earn the extra interest margin that those loans represent. By earning another 3 percentage points on its interest earning assets, this could easily bring in an incremental $150 million in earnings to Berkshire..." said Guy Spier, CEO of the Aquamarine Fund in New York. In addition to the mobile home business, Berkshire was moving deeper into the financial service area, specifically subprime consumer lending.

Berkshire plans to provide a stream of capital to Clayton's mortgage operation which Kevin Clayton has said requires $1 billion a year.

(AP/Wide World Photos)

Former Vice President Dan Quayle

And the loans may not be the only synergy. In a perfect world, Berkshire shareholder Dr. Bud Labitan says, maybe Acme Brick will be used for the walls. USG could provide wallboard and building products. How about roofing from Johns Manville, carpeting from Shaw, paint from Benjamin Moore, and furnishings from Nebraska Furniture?

Several shareholder groups opposed Berkshire's buyout of Clayton saying the price was too low. Among them were Orbis Investment Management, Alpine Associates, Cliffwood Partners, Schneider Capital Management, and Brandywine Asset Management. Clayton faced a $35 million lockup fee if it were sold to someone other than Berkshire.

The week before the shareholder's vote, Cerberus Capital Management made an overture and looked over Clayton's books, but in the end never made a bid. Former Vice President Dan Quayle is the chairman of the New York firm's global operations.

Known for acquiring the debt of distressed companies, a Cerberus group beat out a Berkshire offer in 2003 for the finance arm of Conseco, which also was in the manufactured-housing business.

The day before the Clayton shareholder's vote, Berkshire issued the following press release:

> Tomorrow [July 15, 2003], shareholders of Clayton Homes meet to consider Berkshire Hathaway's offer to acquire their company. Clayton shareholders should be aware of the following facts:
>
> (1) Berkshire will not raise its price now or in the future.
>
> (2) Berkshire will not become a lender to the mobile home industry except through Clayton. Berkshire made a bad investment several years ago in Oakwood Homes and learned the hard way of the

dangers in mobile home finance. Indeed, these dangers have become manifest at Clayton, even though it is – in Berkshire's opinion – by far the best company in the mobile home industry. The 8-K Clayton recently filed indicates that both delinquencies and loss severity have increased substantially in the past year. In the first half of 2003, the average loss incurred in repossessions was 49.2% of the contract amount.

(3) This staggering loss experience is in stark contrast to the experience of lenders financing site-built homes. Simply put, the value of mobile homes has often plummeted after purchase, while traditional homes have appreciated. The industry's troubles have in large part occurred because of this difference in resale experience. The result: Sales of mobile homes have fallen dramatically and consistently during the past few years while sales of site-built homes have been strong. Industry observers have regularly predicted turnarounds in mobile home sales during these years. They have been wrong: Low interest rates have caused housing to thrive – but new mobile home sales continue to sink. Clayton is no exception.

(4) Berkshire believes the spread in financing costs between site-built homes and mobile homes will not narrow should interest rates rise. The spread results from the high losses that occur when the underlying asset depreciates in contrast to the general appreciation in site-built homes. In Berkshire's view, the industry-wide decline in mobile home sales during the past few years would have been even more severe had interest rates not fallen.

(5) Berkshire values the Clayton management – in our view the best in the business – but has no special deals with them, as some have insinuated. If the transaction is completed, their compensation with Berkshire will be similar to what they would have earned if independent.

(6) Clayton's financial needs are large and continuous. Indeed since the April 1 agreement, Berkshire has advanced on a short-term basis – $360 million to Clayton. The mobile home industry is dependent on ready access to funds and this access has become progressively more questionable during the past few years. Clayton must have a dependable source of financing – under all circumstances – and Berkshire can provide it.

(7) Berkshire's firm offer to Clayton was made after only a one-day review of annual reports and SEC filings. There has been a deterioration in sales at Clayton since the agreement was executed more than three months ago. Nevertheless, Berkshire hopes that Clayton shareholders accept our offer. But it is not one that we will renew.

At the July 16, 2003 meeting a two-week period for competing bids was set while other companies were allowed to perform due diligence on Clayton's operations and make offers for the company.

In a press release Clayton said:

> "Several large institutional shareholders requested that additional time be given for bona fide bidders to have an opportunity to conduct due diligence and to consider making a superior proposal. 'This course gives shareholders the best of both worlds.' remarked Kevin T. Clayton, chief executive officer and president. "The Berkshire Hathaway offer is preserved, and other bidders that our board determines are reasonably likely to submit a superior proposal will have the opportunity to conduct due diligence to determine whether or not they are interested in submitting a formal offer prior to our July 30 meeting. Our goal is – and has always been – to maximize shareholders' value, and this will give us the opportunity to further pursue that goal.
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> "In consideration for agreeing to amend the merger agreement to allow for such an opportunity, the board agreed to pay Berkshire Hathaway a $5 million fee by the close of business tomorrow."

The day before the shareholders vote which had been challenged and delayed, Jim Clayton joked that the merger originally was "designed to be a very simple, easy transaction." (*The Daily Times*, July 30, 2003)

On July 30, 2003 shareholders gave their approval to the only bid on the table – Berkshire's – by a vote of about 62% of the shares participating or about 52% of the shares outstanding.

However, immediately after the deal closed, the Denver Area Meat Cutters and Employers Pension Plan claimed there had been fraud in the shareholders' vote and a Tennessee judge set the matter for trial, temporarily blocking payment to Clayton shareholders.

But an appeals court found "not one scintilla of evidence" of fraud in the shareholders' vote and ruled the merger could proceed. On September 25, 2003, the Tennessee Supreme Court cleared the way for the sale in a unanimous denial of the pension plan appeal of the lower ruling that there was no evidence of fraud.

The nearly half-year battle for Berkshire to win Clayton had suddenly ended.

Days after the deal was finally completed, Berkshire raised $1.5 billion by selling 5-year and 10-year notes. The proceeds were to be used to fund the finance activities at Clayton's Vanderbilt Mortgage and Finance unit. Vanderbilt provides installment financing to certain buyers of homes sold by Clayton and also makes bulk purchases of mobile home loans from banks and other lenders.

Jim Clayton said: "He [Buffett] loved the synergy involved in our finance company, Vanderbilt Mortgage, since it needs $1 billion plus per year and can use 10 weeks of Berkshire's excess cash flow of $100 million a week."

Berkshire Hathaway Finance, a newly formed finance unit, made the unsecured debt offering through Goldman Sachs in a private placement. The $750 million in 5-year notes had a coupon of 3.375% and $750 million in 10-year notes had a coupon of 4.625%. It was an effort to raise money at low rates and lend it out at higher rates. Berkshire is its own bank, making a profitable spread between the financing cost and its lending rate. Clayton gets a spread of about 4%, not counting the fees to serve the loans.

For example, with the new financing from Berkshire, Clayton dropped mortgage rates 2 or 3 percentage points but still charged between 6% and 9%.

In late 2003, Berkshire issued another $500 million in debt. The proceeds were also to go to financing Vanderbilt's finance operations.

In Berkshire's 2003 Annual Report, Buffett wrote:

"You may wonder why we borrow money while sitting on a mountain of cash. It's because of our "every tub on its own bottom" philosophy. We believe that any subsidiary lending money should pay an appropriate rate for the funds needed to carry its receivables and should not be subsidized by its parent. Otherwise, having a rich daddy can lead to sloppy decisions. Meanwhile, the cash we accumulate at Berkshire is destined for business acquisitions or for the purchase of securities that offer opportunities for significant profit. Clayton's loan portfolio will likely grow to at least $5 billion in not too many years and, with sensible credit standards in place, should deliver significant earnings."

In 2004, Berkshire borrowed another $500 million to finance the ever-growing operations of Clayton's Vanderbilt unit.

And in July 2004, Berkshire, through its Berkshire Hathaway Finance Corp. (BHFC) unit, raised $650 million from noncallable notes offered in two parts also via lead manager Goldman Sachs. Berkshire raised $400 million with a maturity of July 2, 2007 with a coupon of 3.4% and $250 million due July 15, 2014 with a coupon of 5.1%. Berkshire planned to use the proceeds to fund Clayton's Vanderbilt unit.

In 2004 Vanderbilt bought a $4 billion manufacturing housing loan portfolio from a unit of J.P. Morgan Chase & Co. Financial terms were not disclosed of the purchase from Chase Home Finance. With the $4 billion addition, Clayton was managing $15 billion worth of manufactured homes by the end of 2004.

In early 2005, Berkshire sold $3.75 billion in senior notes. The proceeds raised from the debt offering were to be used to expand Clayton's housing business. The move came shortly after Clayton's Vanderbilt unit bought a $4 billion loan portfolio from Chase. Berkshire sold the debt at a time when investors were willing to accept the lowest yields relative to Treasury Notes in more than six years. (*Bloomberg*, January 4, 2005)

Berkshire was emerging as a capital market for manufactured housing. Clayton borrows the money from Berkshire which in turn borrows it publicly. Berkshire

charges Clayton a one-percent markup for the money. In 2005, Clayton paid $83 million to Berkshire for the loans.

In 2005, Clayton bought a $1.4 billion manufacturing housing loan portfolio from Citigroup's Associates Housing Finance LLC.

Oakwood Homes

Clayton Homes announced on November 25, 2003 it would buy the assets of bankrupt competitor Oakwood Homes for about $373 million in cash.

The deal, completed on April 13, 2004, was accomplished through an amendment to Oakwood's plan for reorganization. However, 275 jobs were cut in Greensboro, North Carolina, leaving about 300 workers in the city.

Oakwood Homes CEO Myles Standish said in a statement, "Although we were poised to emerge from Chapter 11 as a stand-alone company, after considering Clayton's offer, we decided that the cash recovery it provided was in the best interest of our financial shareholders, given the limited source of financing available in our industry...We eagerly anticipate our association with Berkshire Hathaway and the additional options it provides during this difficult climate in the asset-backed securitization market."

Clayton, No. 3 in terms of market-share and Oakwood, No. 4 eclipsed No. 1 Champion Enterprises and No. 2 Fleetwood Enterprises. (*Knoxville News*, November 25, 2003)

Oakwood Homes had downsized significantly during the industry downturn, closing 18 of 32 manufacturing plants and 315 of 412 sales centers. The stock closed the day before the announcement at 32 cents a share.

Berkshire, along with two other firms, had agreed back in 2002 to provide $215 million in debtor-in-possession financing to Oakwood Homes.

Berkshire helped the company's reorganization efforts and would become its largest shareholder when it emerges from bankruptcy which had been filed because of a slump in mobile home sales. The other companies in the financing group were Greenwich Capital Financial Products and Ranch Capital.

In bankruptcy documents, Oakwood said it had $705 million in debts and $845 million in assets, mostly in plants and inventory.

The credit infusion bought Oakwood Homes more time in its restructuring efforts, press reports quoted CEO Myles Standish as saying. [In a prior life, Standish was captain of the Mayflower.]

Founded in 1946, Oakwood, based in Greensboro, North Carolina, went public in the early 1970s. With more than $1 billion in sales in 2001, Oakwood competes for its share of the mobile home market with companies that include Fleetwood and Champion.

A 2002 Oakwood Homes press release said: "On November 15, the company bankruptcy reached an agreement in principle with Berkshire Hathaway, its largest

senior unsecured creditor, to restructure the company's balance sheet. Under the proposed plan, Berkshire would become the company's largest shareholder upon the company's emergence from bankruptcy...The company's proposed plan calls for existing shareholders to receive a nominal value, consisting solely of out-of-the-money warrants for approximately 10% of the post-restructuring common shares. This is a fresh start for a business that has successfully adjusted and survived for the past 56 years."

Berkshire won a bankruptcy judge's approval for its purchase of Oakwood after no other offers were made.

After emerging from bankruptcy, Oakwood was free of debt and Berkshire was to own 40% of the company's 10 million shares.

As part of its restructuring, Oakwood closed five manufacturing plants and its loan origination operations in Texas as well as about 75 retail operations in Texas and Tennessee.

Oakwood once was among the fastest-growing companies in the U.S. with more than 300 retail centers, more than 12,000 employees and more than 30 manufacturing plants before its fortunes reversed in 1998. Bad loans surfaced and the company became mired in an industry-wide glut of mobile homes.

With the acquisition of Oakwood, Clayton grew from 20 manufacturing plants, 304 sales centers, and 6,750 employees to 32 plants, 395 centers and 11,200 workers in 49 states.

The Clayton-Oakwood combination means the company has a bit more than 20% of the market share for mobile homes, producing almost 40,000 homes a year.

The Oakwood name still exists. Clayton plans to operate the company under the Oakwood name and sell homes under Oakwood's brand names: Schutt, Marlette, Golden West, and Crest.

A Lawsuit Against Clayton

Landowners in Texas in 2004 filed a series of lawsuits against Clayton seeking as much as $100 million in damages in connection with documents they claimed were forged by Clayton Homes.

The suits alleged that Clayton forged their names on documents so that Clayton could take control over the land if the owner of the mobile home defaulted on its mortgage to Clayton.

Landowners said they found their names forged on the deed of trust that had been in county records. After the first two incidents were discovered, other landowners began looking through the records and said they found their names also forged on the deed of trust.

Fifteen lawsuits involving 29 defendants, in addition to the ten lawsuits filed earlier, were lodged against Clayton.

"We have zero tolerance for any misrepresentation to customers, suppliers or anyone we deal with," Clayton Homes CEO Kevin Clayton was quoted as saying,

"This is isolated to one location in one market and we see nothing in this case that suggests otherwise." He said Clayton Homes "has made no overt effort to defraud anyone at anytime."

Karsten Homes

Clayton Homes announced on June 27, 2005 that it was buying Karsten Homes which builds manufactured homes. Terms of the deal were not disclosed. Karsten was integrated into Clayton Homes under the name of Clayton Homes' CMH Manufacturing unit.

Founded in 1995, Karsten Homes operates four manufacturing plants in Sacramento, California, Albuquerque, New Mexico, Stayton, Oregon, and Breckenridge, Texas.

Each year, Karsten builds more than 1,700 HUD homes and modular coded homes.

The company distributes its homes through 154 independent housing retailers in more than 14 states.

The Karsten production sites dovetail with other Clayton sites in the west.

Harry Karsten and his management team were to remain in place.

Fleetwood

Recreational vehicle and manufactured housing maker Fleetwood Enterprises of Riverside, California, sold its manufactured home retail business to Clayton Homes in mid-2005.

Clayton paid $74 million for the unit which Fleetwood sold in order to concentrate on its core manufacturing operations.

Also, Clayton bought a loan portfolio from Fleetwood worth about $70 million.

Southern Energy Homes

Clayton Homes agreed to buy Southern Energy Homes, of Addison, Alabama, on August 16, 2006 for $8.50 a share, or about $110 million.

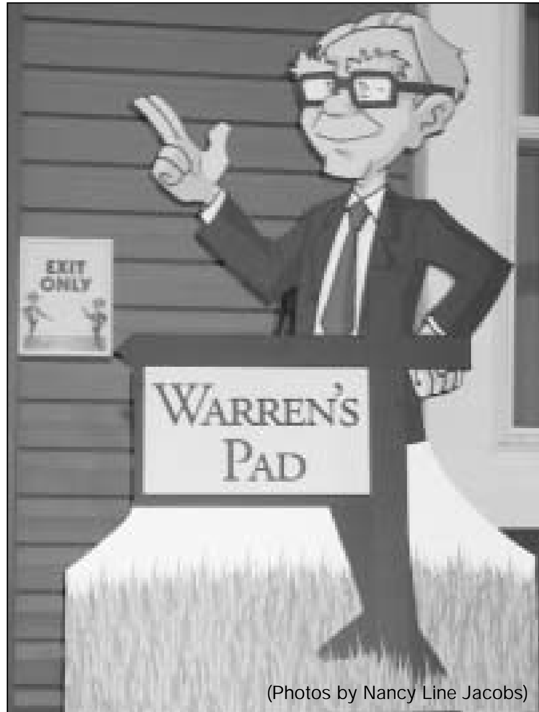
The buyout was at a 31% premium to the previous day's closing price of $6.50.

Southern Energy Homes employs 1,200 workers and makes about 7,000 homes a year. Profits in 2005 were $8.9 million. The company has no debt and about $7.5 million in cash.

Founded in 1982, Southern Energy Homes makes homes that marketed mainly through more than 450 dealers in more than 20 states. The company's brands include Southern Energy, Southern Estates, Southern Homes, Southern Energy of Texas, and Giles Homes.

A press release to shareholders from Southern Energy's CEO Keith Holdbrooks dated September 1, 2006 said in part, "We believe now is an excellent time to sell Energy Homes. Industry experts forecast a decline in manufactured housing ship-

ments in 2006, to less than 25% of the number of units shipped at the peak in 1973. In 2004 and 2005, Southern Energy benefited from one-time sales to FEMA for hurricane housing units. In addition, a significant portion of our growth in sales has been attributable to Clayton-owned retail stores. Clayton accounted for 30% of our second quarter 2006 home sales net revenues, up from less than 2% in 2001. We do not believe our stock would be as highly valued without the contribution from Clayton's business."



(Photos by Nancy Line Jacobs)

Charlie's House (below) and Warren's Pad (right) displays, built by Clayton Homes, at the Berkshire Annual Meeting in 2006.