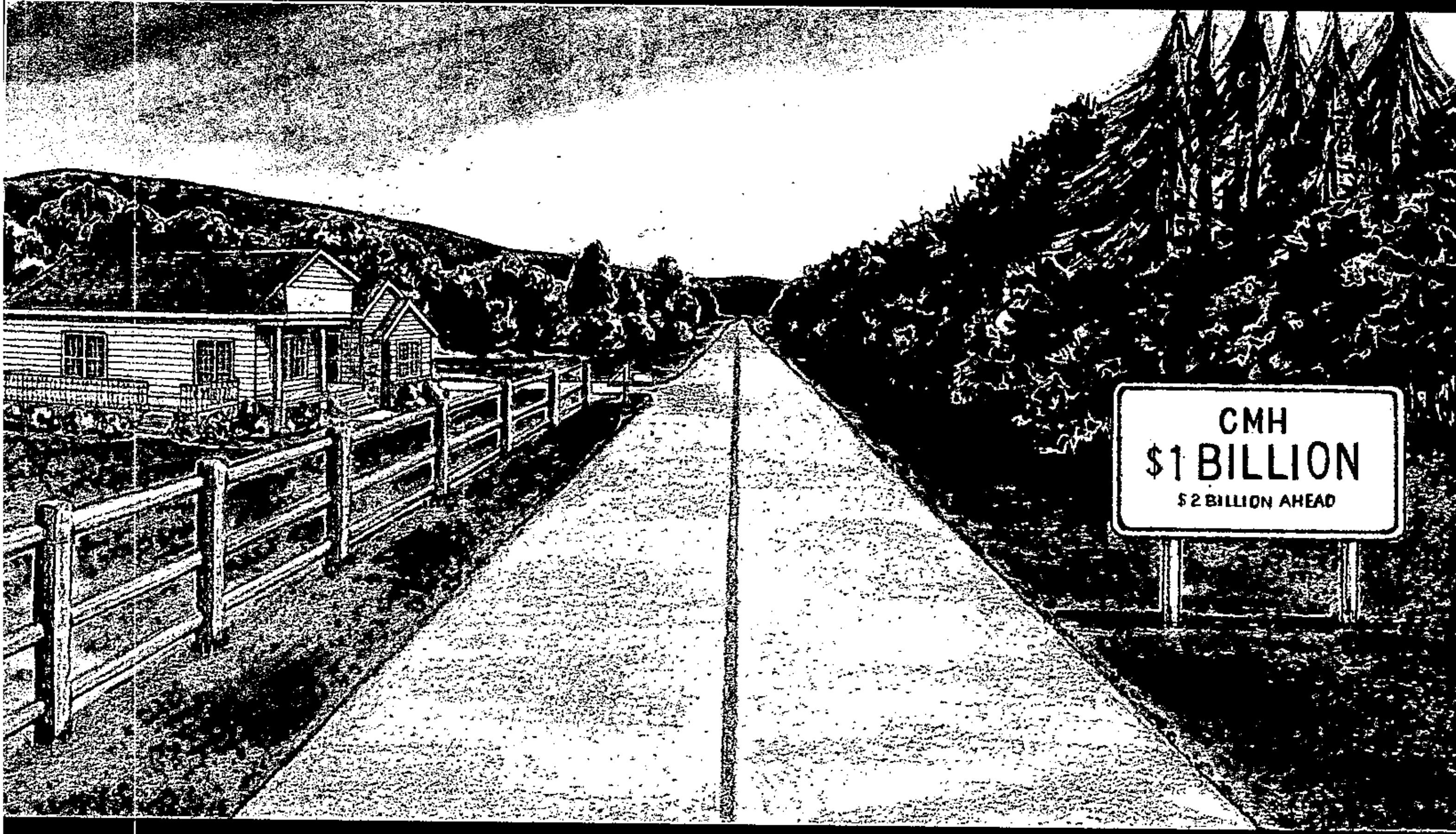
Clayton Homes, Inc.



Our road ahead

1997 Annual Report

COMPANY PROFILE

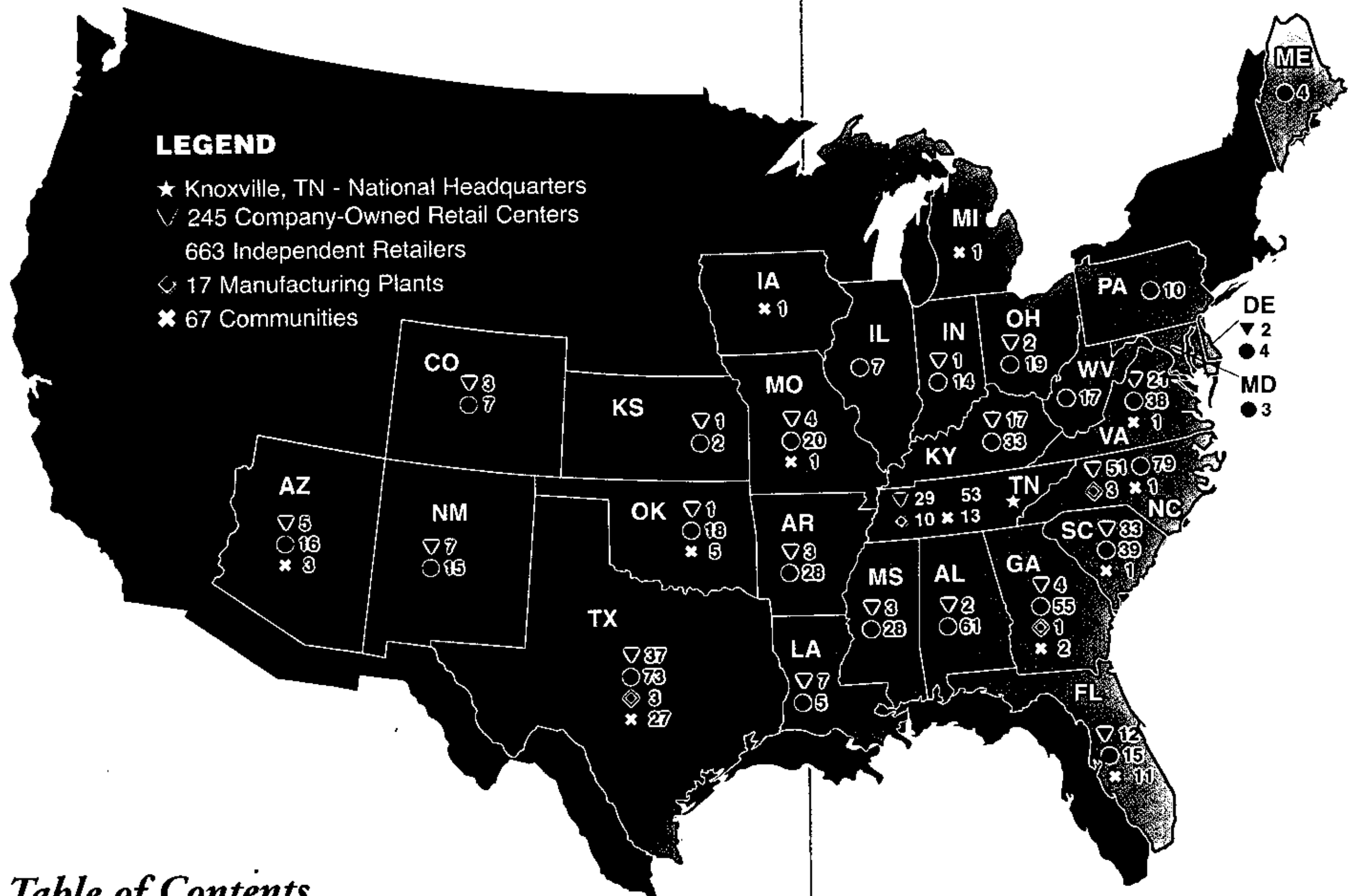
Clayton Homes, Inc. is a vertically-integrated manufactured housing company headquartered in Knoxville, Tennessee. Employing more than 5,900 people and operating in 28 states, the Company builds, sells, finances and insures manufactured homes, and owns and operates residential manufactured housing communities.

The ***Manufacturing*** group is a leading producer of manufactured homes with 17 plants supplying homes to 975 independent and Company-owned retail centers.

The ***Retail*** group sells, installs and services factory-built homes. At year end, there were 245 Company-owned retail centers in 21 states.

Financial Services provides financing and insurance for home buyers of Company-owned and selected independent retail sales centers through Vanderbilt Mortgage and Finance, a wholly-owned subsidiary.

The ***Communities*** group owns and operates 67 manufactured housing communities with 17,797 homesites in 12 states.



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About the Cover

Keeping the entrepreneurial spirit in a billion dollar company is the challenge we face as we turn our attention to the future and the road ahead.

The modular home pictured on the cover was produced in our Richfield plant near Charlotte, NC, and was designed to meet local community building and conventional financing standards. The cedar-sided multi-section home depicted on the back cover was produced in our Norris plant in Bean Station, TN.

FINANCIAL HIGHLIGHTS

(dollars in thousands, except per share)	Year Ended June 30, 1997	1996	Percent Increase
Income Statement Data:			
Revenues	**$1,021,703**	$ 928,741	10%
Income before income taxes	**192,700**	172,300	12%
Net income	**119,500**	106,800	12%
Earnings per share	**1.00**	.89	12%
Dividends per share	**$.076**	$.061	25%
Balance Sheet Data:			
Total assets	**$1,045,761**	$ 886,350	18%
Shareholders' equity	**$ 754,526**	$ 650,189	16%
Return on average shareholders' equity	**17.0%**	18.0%	
Portfolio Data:			
Loans serviced	**$2,044,000**	$1,638,000	25%
Delinquency % (over 30 days):			
Originated contracts	**2.0%**	1.9%	
All contracts	**2.1%**	2.0%	
Net losses as a % of average loans outstanding:			
Originated contracts	**0.0%**	0.0%	
All contracts	**0.2%**	0.3%	
Other Data:			
Total homes sold	**32,714**	31,049	5%
National market share	**8.0%**	7.8%	
Manufacturing plants	**17**	17	
Independent retailers	**663**	580	14%
Company-owned retail centers	**245**	216	13%
Communities	**67**	64	5%
Community homesites owned	**17,797**	16,780	6%
Employees	**5,991**	5,470	10%

Where appropriate, data in this report has been adjusted for the five-for-four stock split paid December 11, 1996.

TO OUR SHAREHOLDERS

1997 was a milestone in a series of record years for Clayton Homes with $1,022,000,000 in revenues and $119,500,000 in net income. This surpasses the strategic objectives set five years ago of attaining $1 billion in revenues and $100 million in net income. These goals were established when revenues were $370 million and net income was $39 million. Over this planning cycle, your Clayton team grew revenues at an annual compound rate of 22 percent while net income was increasing at 25 percent. Shareholders experienced an annual compound return of 18 percent for the five-year period, exceeding the return on the S&P 500. Fiscal 1997 was the 17th consecutive year of record sales and earnings, and marked the 44th consecutive quarter of sales and earnings increases.

The success of the last five years can be attributed to the Company's hard working, experienced and talented team members and to consistently expanding each component of the Clayton vertically integrated structure. Growth included:

- *Company retailers from 127 to 245*
- *Independent retailers from 312 to 663*
- *Manufacturing plants from 11 to 17*
- *Communities from 20 to 67*
- *Mortgage portfolio from $882 million to $2.04 billion*

While growing revenues and earnings during the five year period, shareholders' equity increased from $293 million to $755 million, and long term debt decreased from $193 million to $23 million. At June 30, 1997, long term debt represented only 3 percent of total capital.

A review of the industry for the past five years indicares average shipment growth of 14 percent after an eight year series of declines averaging 8 percent. During this eight year period, Clayton Homes increased revenues by an average of 21 percent annually as net income increased 32 percent each year.

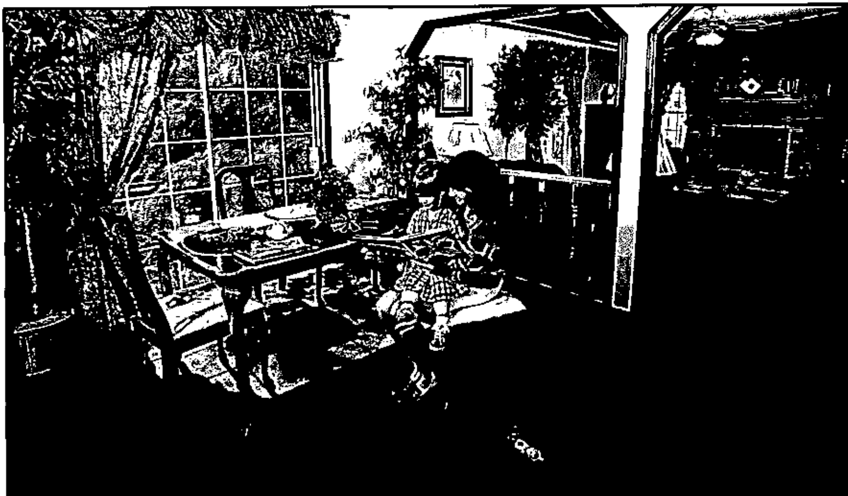
In the 12 months ending June 30, 1997, the industry flattened to a 1 percent increase over the prior year. Now we see a "return to normal" operating environment where backlogs tend to disappear in winter and build in spring. While our retailers prudently reduced inventories throughout 1997, we increased home shipments by 4 percent. Backlogs climbed 31 percent from the prior year end to $40.5 million, positioning our manufacturing plants well for the 1998 fiscal year.

Two communities were sold in the fourth quarter of 1996 adding 3 cents per share, making comparisons more difficult to the same period in 1997 when none were sold.

Clayton strategy normally has been to expand by building sales centers and manufacturing plants; however, from time to time, we will opportunistically acquire. Since 1993, we have expanded our home building capacity by developing five state-of-the-art plants with each costing less than $5 million.

The Company's 18th plant located in Sulphur Springs, Texas, began producing homes in July 1997, focusing on the growing multi-section segment of the market. There should be opportunities in the months ahead to purchase plants, sales centers and loan portfolios that meet our geographic, product line and profitability goals.

Dynamic team reaction to ever changing industry fundamentals has allowed your Company to successfully navigate through all phases of the housing cycles. Plans for the next five years are based on the assumption that the industry will grow at a low single-digit rate.



The industry now validates the vertical integration model as the most effective structure in manufactured housing. It is interesting to note that your management has enthusiastically embraced and pioneered this model for more than 25 years.

Clayton Homes' plans for the road ahead in 1998 include:

- *Growing the number of company stores toward 300*
- *Enlarging our independent retailer base*
- *Acquiring and building additional communities*
- *Increasing the portfolio of loans serviced*
- *Expanding the Million Dollar Business Units*
- *Improving returns by investing in new product capabilities*
- *Strengthening information services support*
- *Increasing same-store sales*
- *Establishing new geographic markets*
- *Escalating the production of multi-section homes*
- *Improving the return on assets in Communities*

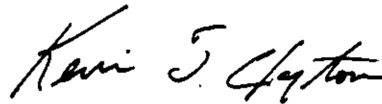
The 6,000 people working at Clayton Homes are motivated by our mission statement: "Create and market high-value products and services for the benefit of Clayton stakeholders: shareholders, customers and team members." Utilizing our special brand of "open" vertical integration, the industry's most respected model, should produce consistent and profitable growth as reflected in our five-year plan.

We thank our shareholders, team members, 70 percent of whom are Clayton shareholders, and all those whose dedication and support were vital to the successes achieved in 1997. We look forward to reporting our 18th record year in 1998.

Sincerely,

James L. Clayton
Chairman

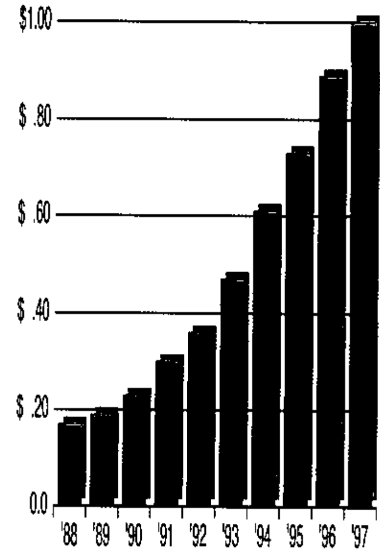
Joseph H. Stegmayer
Vice Chairman



Kevin Clayton
President

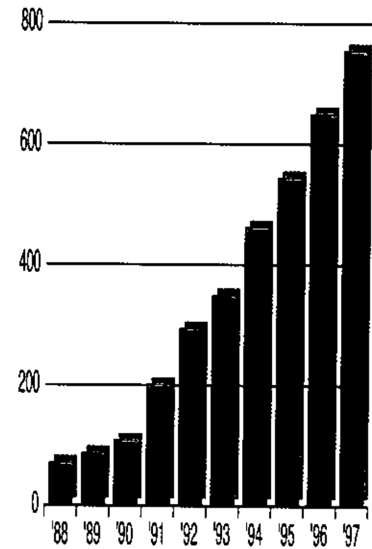
Earnings per share

(fully diluted)



Shareholders' equity

(in millions)



Q & A

James L. Clayton
Chairman of the Board and Chief Executive Officer

What challenges do you face running a billion dollar company, and what objectives have you established in your strategic plan?

The challenges are similar to the ones we faced at the $100 million and the $500 million revenue levels. With the right people, a strong balance sheet, and a supporting culture, we have a strategic plan in place that should double the revenues and net income by 2002 regardless of market conditions.

Describe current industry conditions. Where are we in the latest housing cycle?

The industry has stabilized at a relatively high level. Historically Clayton Homes has been able to increase its share of the market in any environment. I've been in this business six years...six times as we navigated successfully through the cycles. In the 1970s and 1980s we faced these same challenges and grew revenues and net income at a rate of more than 20 percent, even when the industry contracted 8 percent per year from 1983 to 1991.

What are your plans in developing new geographic markets?

We are now operating in 28 states which can readily accommodate our expansion plans for the next five years. Most of the growth will be generated in those states, and we will position the Company in new markets which will carry us on into the next millennium.

Are you likely to expand your product lines significantly?

The Company's homes are designed to cover the high-demand segments of the factory produced housing market. We will broaden the product line by adding additional entrepreneurial businesses, which we refer to as Million Dollar Business Units or MBUs, in Retail, Manufacturing, Financial Services, and Communities groups.

Describe the Company's MBU process, the benefits thus far, and the plans for the future.

Thirty-five years ago when we had auto dealerships, we saw an opportunity in manufactured housing. By investing time and capital, we created jobs for thousands and a profitable billion dollar company. The Million Dollar Business Units provide the opportunity to continue this entrepreneurial spirit. The MBU model enables us to start and test new internal businesses that have the potential to grow more rapidly than the Company as a whole.

In the past, vertical integration has successfully led Clayton to expansion into manufacturing, financing, and communities. What role will vertical integration play in future years?

Open vertical integration allows Clayton Homes to benefit from multiple profit opportunities from one business transaction. Seventeen percent of our annual revenues and 45 percent of our annual net income is assured at the beginning of each year from the recurring sources of income generated by the Financial Services and Communities groups.

Considering the consolidation in the industry in recent years, will the Company follow a different acquisition strategy than in the past?

We will be more acquisitive in the future. However our research indicates we can be very selective as to geography, price, market, products, and resources.

With virtually no debt on your balance sheet, what leveraging opportunities exist?

The strong balance sheet allows the Company to support the synergistic structure, develop new products, make acquisitions, and buy back stock.

Can you describe the Company culture which you have said is a key to your success?

We are frugal while willing to risk making decisions that invite well-contained mistakes. Out of these exercises we realize new opportunities while minimizing the chance of material loss. This environment supports entrepreneurism, motivation and "buy in" from teammates at all levels.

Do you expect the same profitability from each business group over the next several years, or will there be a shift in the segmentation?

Our goal is to achieve the same overall profitability that our shareholders have grown to expect, but the profitability from individual groups will vary from time to time. This structure gives us a lot of flexibility to accommodate less than stellar performance from some areas of our business for brief intervals.

Could you say a few words about the recent realignment of your management structure?

Our Company now has close to 6,000 motivated and excited people who embrace change. You will see the Company's leadership evolve over time to accommodate growth, succession, and cross-training as we pursue new opportunities.

As you look back over more than 30 years in the business, what have been the key success factors for your company, and will they change in the years ahead?

Attracting and retaining intelligent, talented individuals who subscribe to our frugal small-company culture is vital. Individuals who enthusiastically support teams while accepting responsibility for individual and team results will remain a critical success factor. Our 17-year record of growing revenues and net income, our vertical integration model, and our conservative approach to utilizing human and capital resources gives us a solid foundation for future achievement.

COMMUNITIES

This group best exemplifies the Company's vertical integration synergies. When Communities sells a home, there are five levels of potential profit including manufacturing, retailing, financing, insuring, and siting the home.

The Communities group made important strides in 1997, continuing the practice of targeted acquisition and expansion. The group took steps to bolster its operational strength and develop its construction capabilities including the addition of a director of development and two project supervisors to lead the expansion effort. Three parcels of land, two in East Tennessee and one near Austin, Texas, were purchased for development in the coming year.

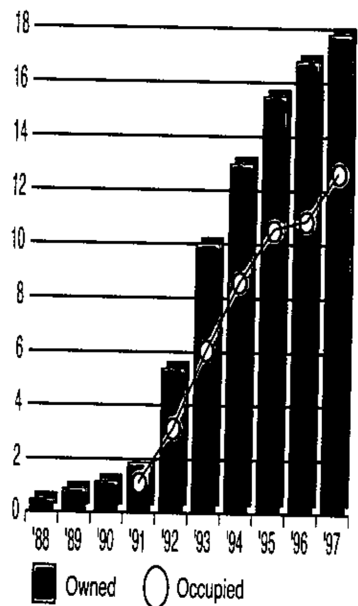
Four new properties with a total of 964 sites were acquired, and two existing communities were expanded. The Company now operates 67 communities with 17,797 sites, an increase of 6 percent. The occupancy rate for all homesites increased 6 percentage points to 70 percent. For properties owned at least one year, the occupancy level was 72 percent, with 16 properties having more than 90 percent occupancy. With the overall efficiency improvements in the group, income from continuing operations increased 19 percent for the year.

Success can be attributed to the hands-on management approach Clayton brings to the Community business. The Company remains committed to generating superior profits and long-term appreciation by acquiring under-performing properties and turning them around in an efficient timeframe.

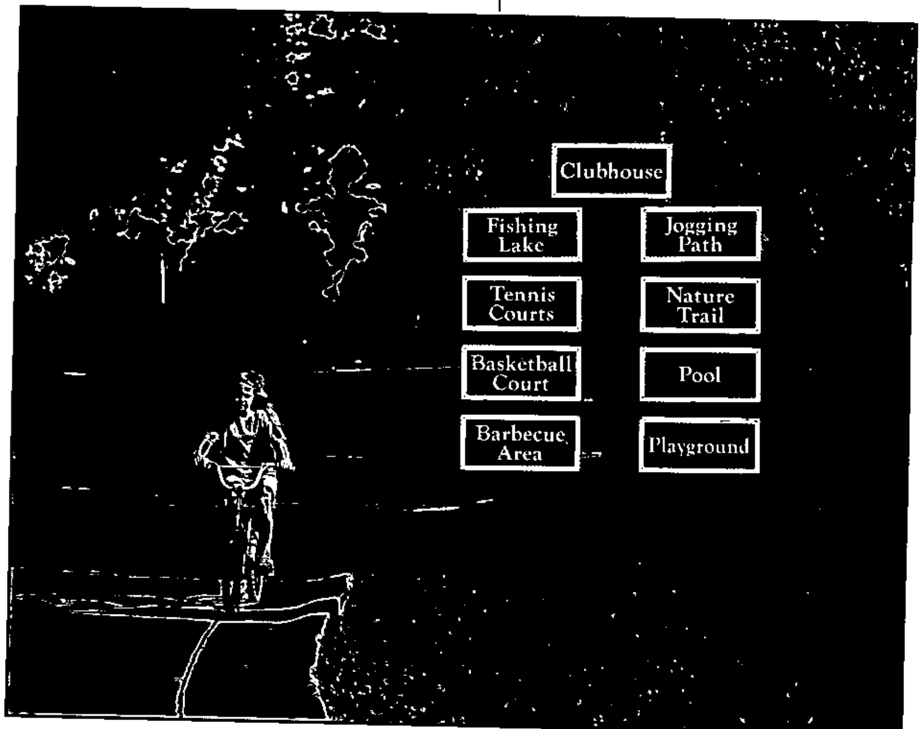
Communities increased its teaming with the Retail group, becoming more marketing and sales driven, and partnered with Retail on several successful promotional projects in 1997. In 1998, the Communities group will continue to focus on the basics of sound execution and attention to detail, especially in the development program. With a dedicated team and solid experience, the group is well positioned for continued profitable growth.

Homesites

(in thousands)



	June 30, 1997	1996
Home sites owned	**17,797**	16,780
Occupancy rate	**70%**	64%



MANUFACTURING

The Manufacturing group set new marks in all key measures of peformmance in 1997. Revenues increased to $540 million as we built 25,830 homes. Today, the group markets its homes in 26 states through 975 retailers, including 245 Company-owned retail locations and 67 communities.

Multi-section homes now represent 55 percent of industry shipments, and we have responded to the increasing demand for these homes. The new manufacturing facility in Sulphur Springs, Texas, opened in the first quarter of fiscal year 1998 to build high-value, low-cost multi-section homes enabling us to accommodate more of this growing segment. Now 14 of our 18 plants are capable of producing either single or multi-section homes in order to meet shifts in demand. Two single-section facilities have already been converted to include multi-section capability.

The Manufacturing group is test marketing a new product line using the Company's successful Million Dollar Business Unit model. This particular business opportunity involves producing and marketing commercial buildings for use as offices and classrooms. These multi-purpose units are available in single and multi-section styles. The product generated strong customer interest during its introduction at our 22nd Annual Factory Show and Sale in February.

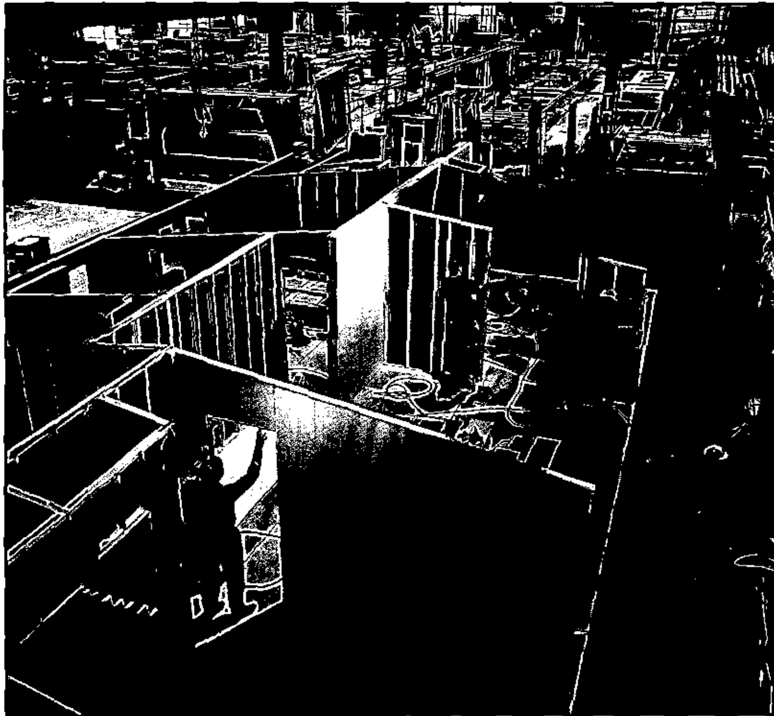
The group introduced a line of modular coded homes suited for subdivision development, and the homes were well received by builders and developers. Initial indications are that these new product introductions are being well accepted in the marketplace.

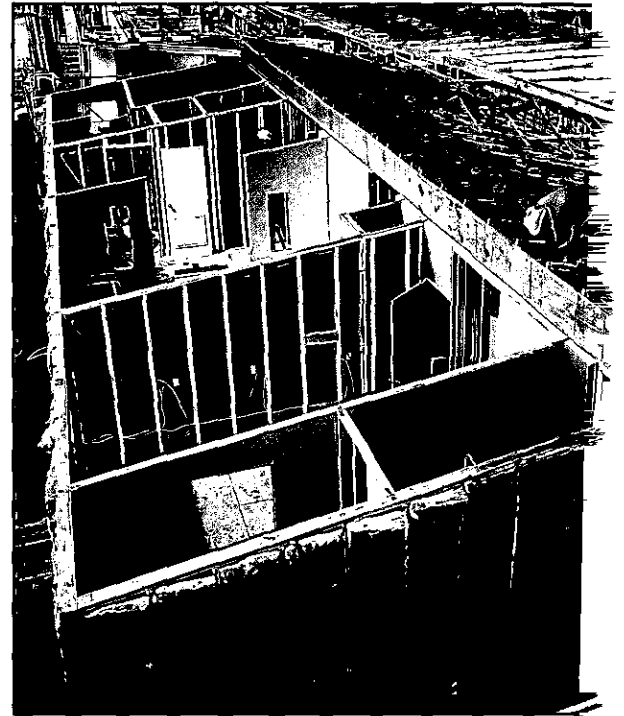
Manufacturing continues to utilize information technology with the first phase of our Service Tracking Program now complete. This application automates the processing of service requests and provides plant management with the information they need to better manage service expenses, quality feedback, and conduct root-cause analyses.

Standardization of building systems and materials continues to be a major area of emphasis, and during the year, we applied the process to frames and roof rafters. Benefits of standardization are reduced costs, simplified manufacturing processes, and improved quality.

Research and development of new products and more efficient production methods are important elements in maintaining our competitive advantage. The use of steel studs and floor joists, new glue systems and multi-story homes are some of the major items under review.

In 1998, the Manufacturing group will continue to focus on quality, value, technology and the prudent use of resources. As industry shipments have

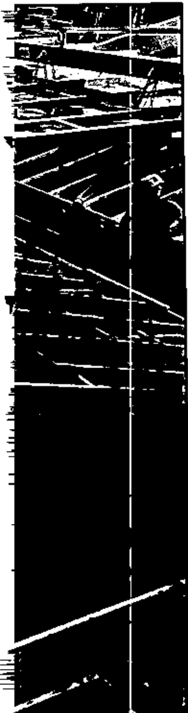


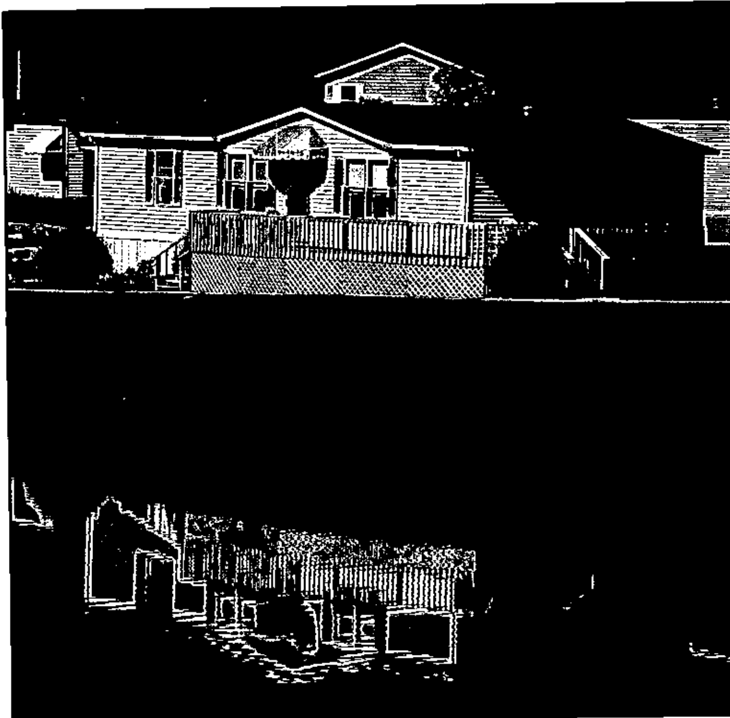


moderated, Clayton Homes has increased market share in the top 10 states. With state-of-the-art facilities, skilled people and a seasoned management team, we are well positioned to continue to gain market share in 1998.

	June 30, 1997	1996	Pct Chg
Sales (in millions):			
Independent dealers	**$288.0**	$278.1	4%
Intercompany*	**252.3**	229.8	10%
Total	**$540.3**	$507.9	6%
Homes built (units):			
Single-section	**16,697**	16,744	-
Multi-section	**9,133**	7,937	15%
Total	**25,830**	24,681	5%
Intercompany*	**(11,455)**	(10,613)	8%
Independenr retailers	**14,375**	14,068	2%

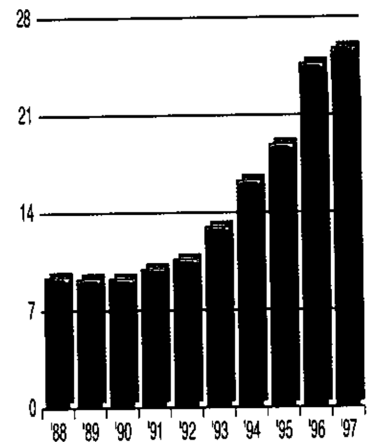
**Represents sales to the Company's Retail and Communities operations.*





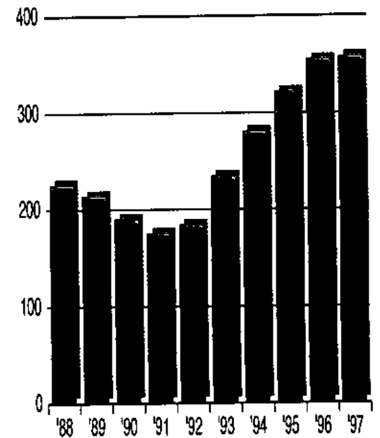
Clayton homes built

(in thousands)

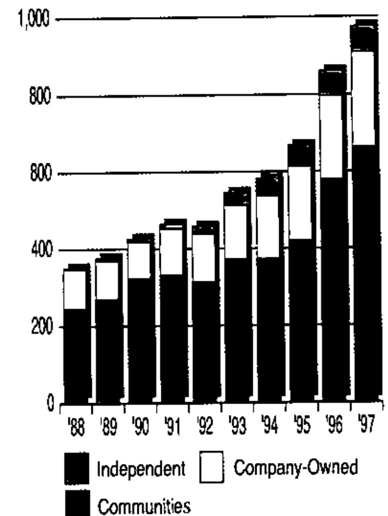


Industry shipments

(in thousands)



Distribution centers



RETAIL

The Retail group recorded another year of solid growth in revenues and income even as the number of competing retailers increased significantly. The group produced record revenues of $497 million delivering 17,046 homes, an increase of 8 percent in a stable industry environment. The performance history now consists of 20 consecutive years of increasing home sales reflecting the group's ability to achieve record growth year after year.

Multi-section homes represented 40 percent of home sales, and as we expand beyond original markets, these home sales will represent a greater percent of total revenues. This growth confirms the continuing shift in consumer demand for larger homes with more amenities and quality features. Single-section home sales are brisk in many of the regional markets where our retail sales centers are concentrated. Manufactured homes continue to offer the consumer quality, size, and features comparable to site-built homes at substantially less cost.

We continued our sales center expansion in 1997 by opening 31 new locations in 11 states while closing two under-performing centers. The Company was operating a record 245 sales centers in 21 states at year end. The number of sales centers will be approximately 300 by year end 1998. The challenge is to expand our presence and grow market share in an increasingly competitive industry. Mitigating the industry conditions is the opportunity to acquire independent retailers at reasonable values, and our acquisition strategy should serve us well in this environment.

The CMH Sales and Management Academy is recognized as the industry leader in recruiting and training, and continues to focus on maintaining a high level of quality standards for customer service. In addition to the Academy, our people receive valuable financial and operating direction from an exceptional group of highly professional area and regional managers.

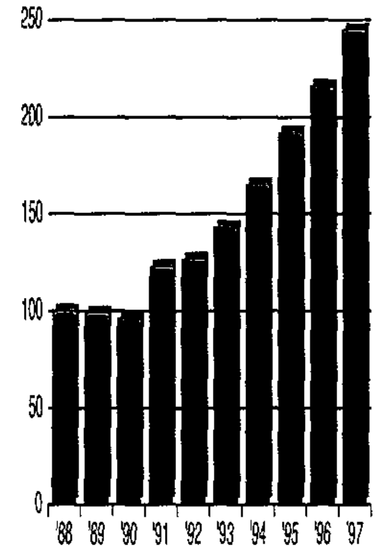
	June 30, 1997	1996	Pct Chg
Sales (in millions):			
New homes	**$459.3**	$421.3	9%
Used homes	**37.7**	30.1	25%
Total	**$497.0**	$451.4	10%
Homes sold (units):			
New single-section	**8,113**	7,697	5%
New multi-section	**5,312**	5,053	5%
Total new	**13,425**	12,750	5%
Used	**3,621**	3,039	19%
Total	**17,046**	15,789	8%

Top performers are rewarded for their individual achievements through a comprehensive compensation program that encourages them to concentrate on key elements that affect profitability, customer service, and loan portfolio quality. Teamwork is encouraged by the use of group incentives, recognition programs, and continual training. Long-term incentives, including an attractive 401(k) program and stock options for managers and sales representatives, encourage commitment and continuity and allow us to enjoy the lowest management turnover in the industry.

In addition to individual and team incentives for people, we strive to recognize the importance of satisfying our customers. The Legendary Service Program rewards each sales center team that achieves 100 percent customer satisfaction during the year. Ninety-nine sales center teams were Legendary Service Eagle Award winners in 1997, representing a 27 percent increase from the previous year. This customer satisfaction focus resulted in a dramatic 32 percent reduction in consumer service issues.

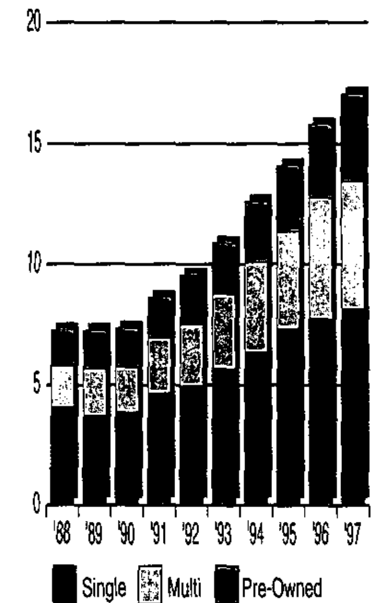
The Retail group's success is a result of emphasizing the basic factors required to compete in the current retail environment and grow market share. In 1998, we will continue to lead the industry by focusing on those same basics: attracting, developing and retaining top talent, unparalleled attention to operating details, targeted sales center expansion, and total dedication to satisfying our customers.

Company owned retail centers



Homes retailed

(in thousands)



FINANCIAL SERVICES

Fiscal 1997 was another record year for Financial Services with the group reaching $2 billion in loans outstanding. The group consists of three units: Vanderbilt Mortgage and Finance, CMH Insurance and the new Million Dollar Business Units. For the year, Vanderbilt's loan originations totaled $647 million, of which $158 million came from the MBUs, and net insurance premiums written were $43 million.

Vanderbilt Mortgage was the first finance company in our industry to offer variable rate receivables in an asset-backed securitization. Our fourth quarter securitization of $301 million included $107 million of variable rate mortgages. For the year, the Company completed four public offerings totaling $756 million and will continue to strive for the lowest cost funding alternatives.

Vanderbilt and the MBUs enjoy a relatively low cost of funds that can be attributed to their excellent reputation among the investment community. Diligent collection efforts resulted in delinquency rates of 2 percent, considerably below industry norms.

Financial Services' achievements are enhanced by a close alliance with the Retail group. Vanderbilt's credit professionals team with retail sales center managers throughout the origination and collection process of all retail-based loans. Additionally, retail managers share in the profit and loss of the loans they originate, keeping the entire team focused on the performance of the loan throughout its term. Financial Services' growth will continue to come largely from the Retail group's loan production which totaled $452 million in 1997.

The CMH Insurance group continues to grow, adding new products and increasing market penetration. In 1997, 90 percent of financed home sales included at least one insurance product. Total premiums for all lines increased 28 percent from last year. The Home Buyer Protection Plan, an insurance MBU, offers customers an extended warranty program. Written premiums for this product increased 102 percent compared to the prior year.

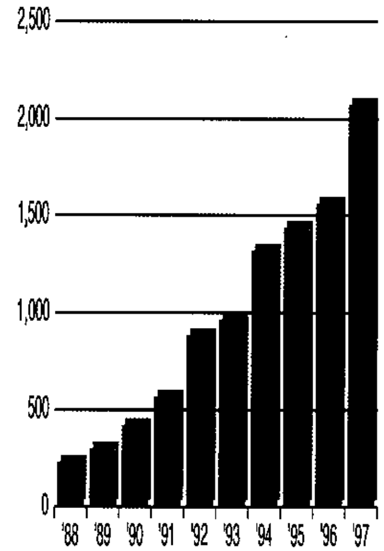
Million Dollar Business Units accounted for an increasing portion of Financial Services' total originations in 1997. MBUs allow Financial Services to leverage the talent and experience of current team members and offer exciting opportunities to gifted new individuals eager to join our Company.

	June 30, 1997	1996	Pct Chg
Loans serviced (in millions):			
Originated and purchased loans serviced	**$1,910**	$1,456	31%
Master servicing contracts	**134**	182	-26%
Total	**$2,044**	$1,638	25%
Loans serviced (# of loans in thousands):			
Originated and purchased loans serviced	**87**	75	16%
Master servicing contracts	**15**	18	-17%
Total	**102**	93	10%
Originations (in millions):			
Company-owned	**$ 489**	$ 412	19%
Independent	**158**	64	100+%
Total	**$ 647**	$ 476	36%
Acquisitions (in millions)	**$ 197**	$ 27	100+%

	June 30, 1997	1996
Delinquency (% over 30 days - VMF only)		
Contracts originated by VMF	**2.0%**	1.9%
Contracr portfolios purchased	**2.7%**	3.0%
Total contracts serviced by VMF	**2.1%**	2.0%
Net losses as % of average loans outstanding:		
Contracrs originated by VMF	**0.0%**	0.0%
Contract portfolios purchased	**1.8%**	1.4%
Total contracts	**0.2%**	0.3%
Number of repossessions on hand:		
Originared by VMF	**703**	635
Contract portfolios purchased	**52**	74
Total repossessions	**755**	709

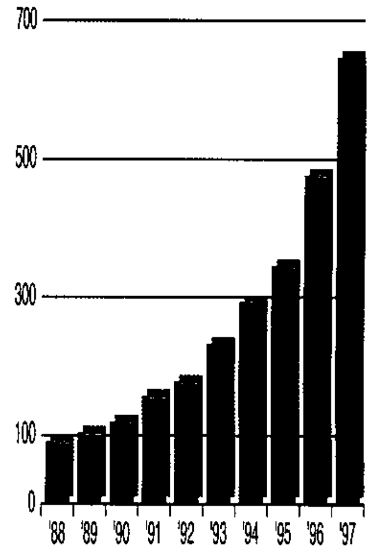
Loans serviced

(in millions)



Loan originations

(in millions)



ELEVEN YEAR REVIEW

(in thousands except per share)	**1997**	1996	1995	1994	1993	1992	1991	1990	1989	1988	1987
Income Statement Data:											
Revenues:											
Net sales	**$ 822,906**	$762,396	$621,351	$510,153	$384,491	$296,849	$257,557	$219,443	$208,624	$196,110	$166,272
Financial services and other income	**198,797**	166,345	136,741	118,083	91,750	74,330	62,392	40,316	33,270	28,671	20,659
	1,021,703	928,741	758,092	628,236	476,241	371,179	319,949	259,759	241,894	224,781	186,931
Costs and expenses:											
Cost of sales	**559,274**	521,200	431,826	357,698	267,201	206,049	176,374	153,786	147,982	138,468	117,538
SG&A	**270,996**	236,188	188,835	153,698	113,695	84,785	76,420	60,220	55,456	50,781	40,222
Financial services interest	**2,885**	3,649	5,533	8,196	11,819	16,585	18,198	11,595	9,911	10,127	6,628
Other expenses	**1,000**	0	0	0	0	3,300	3,772	2,213	1,539	2,010	1,863
	834,155	761,037	626,194	519,592	392,715	310,719	274,764	227,814	214,888	201,386	166,251
Operating income	**187,548**	167,704	131,898	108,644	83,526	60,460	45,185	31,945	27,006	23,395	20,680
Interest income (expense), net/other	**5,152**	4,596	3,902	(359)	(170)	(317)	(592)	(575)	(1,042)	(1,073)	(838)
Income before income taxes	**192,700**	172,300	135,800	108,285	83,356	60,143	44,593	31,370	25,964	22,322	19,842
Provision for income taxes	**(73,200)**	(65,500)	(48,800)	(39,000)	(29,600)	(20,800)	(16,000)	(11,500)	(9,714)	(8,370)	(9,486)
Income before accounting change	**119,500**	106,800	87,000	69,285	53,756	39,343	28,593	19,870	16,250	13,952	10,356
Cumulative effect of accounting change	**0**	0	0	3,000	0	0	0	0	0	0	0
Net income	**$ 119,500**	$106,800	$ 87,000	$ 72,285	$ 53,756	$ 39,343	$ 28,593	$ 19,870	$ 16,250	$ 13,952	$ 10,356
Income before accounting change per share:											
Primary	**$1.00**	$ .89	$ .73	$ .60	$ .48	$ .37	$ .33	$ .26	$ .22	$ .18	$ .13
Fully diluted	**$1.00**	$ .89	$ .73	$ .59	$ .47	$ .36	$ .30	$ .23	$ .19	$ .17	$ .12
Net income per share:											
Primary	**$1.00**	$ .89	$ .73	$ .63	$ .48	$ .37	$ .33	$ .26	$ .22	$ .18	$ .13
Fully diluted	**$1.00**	$ .89	$ .73	$ .61	$ .47	$ .36	$ .30	$ .23	$ .19	$ .17	$ .12
Average shares outstanding:											
Primary	**119,477**	119,346	118,628	115,076	111,500	105,895	86,912	76,814	76,350	76,211	77,869
Fully diluted	**119,477**	119,346	118,628	119,900	119,285	113,680	100,973	96,174	95,945	96,207	91,230
Dividends per share	**$.076**	$ .061	$ .038	—	—	—	—	—	—	—	—
Balance Sheet Data:											
Total assets	**$1,045,761**	$886,350	$761,151	$701,148	$587,032	$554,780	$488,817	$339,099	$294,754	$275,835	$232,159
Long-term debt	**22,806**	30,290	48,737	70,680	137,038	192,931	227,444	177,374	163,471	157,153	132,220
Shareholders' equity	**$ 754,526**	$650,189	$544,187	$462,154	$348,630	$292,950	$200,992	$108,334	$ 87,462	$ 70,651	$ 58,530
Key Financial Ratios:											
As a % of Revenue:											
Operating income	**18.4%**	18.1%	17.4%	17.3%	17.5%	16.3%	14.1%	12.3%	11.2%	10.4%	11.1%
Net income	**11.7%**	11.5%	11.5%	11.5%	11.3%	10.6%	8.9%	7.6%	6.7%	6.2%	5.5%
Debt as a % of total capital	**2.9%**	4.5%	8.2%	13.3%	28.2%	39.7%	53.1%	62.1%	65.1%	69.0%	69.3%
Other Data:											
Company-owned sales centers	**245**	216	192	165	143	127	123	96	99	100	88
Independent retailers	**663**	580	421	372	371	312	330	322	269	245	240
Manufacturing plants	**17**	17	16	13	13	11	10	10	10	10	8
Communities	**67**	64	55	46	33	20	12	9	7	4	—

Management's Discussion and Analysis of Financial Condition and Results of Operations

Results of Operations

The following table reflects the percentage changes in sales by the Company's retail and community sales centers and in wholesale sales to independent retailers. It also shows the percentage changes in the average number of Company-owned retail centers, communities and independent retailers, the average sales per location and the average price per home sold in each category.

	Year Ended June 30,	
	1997 vs 1996	1996 vs 1995
Retail		
Dollar sales	**+10.1%**	+20.7%
Number of retail centers	**+13.0%**	+14.0%
Dollar sales per retail center	**-2.6%**	+5.6%
Price of home	**+2.0%**	+7.7%
Wholesale		
Dollar sales	**+3.5%**	+25.0%
Number of independent retailers	**+24.2%**	+26.1%
Dollar sales per independent retailer	**-16.6%**	-0.8%
Price of home	**+1.3%**	-2.0%
Communities		
Dollar sales	**+15.7%**	+32.5%
Number of communities	**+10.1%**	+16.7%
Dollar sales per community	**+5.1%**	+12.3%
Price of home	**+6.6%**	+11.1%

Fiscal 1997 compared to Fiscal 1996

Total revenues grew 10% on an 8% increase in Manufactured Housing sales and a 20% rise in Financial Services and other income.

Net sales of the Retail group rose 10% to $497 million. This growth was the result of a 13% increase in the average number of Company owned retail centers and a 3% decline in the average dollar sales per location.

During the year, the Company opened or acquired 31 retail locations and closed two underperforming retail centers. The Company constantly evaluates specific local markets and opens, acquires, or closes retail centers as conditions warrant. Of the 31 new openings, 14 were acquired and 17 were greenfield start ups. Seventeen of the new retail centers were opened in the fourth quarter.

Net sales of the Manufacturing group to independent retailers increased 4% to $288 million and the number of homes sold rose 2%. The average wholesale price increased 1% due in part to a shift toward multi-section homes. Multi-section homes accounted for 35% of total shipments versus 32% last year.

Net sales of the Communities group rose 16% to $38 million principally as a result of a 9% rise in home sales and a 6% improvement in the average sales price per home. Four acquisitions brought the number of communities to 67 at year end.

Financial Services and other income grew 20% to $199 million, mainly due to VMF, $20 million, and earned insurance premiums and commissions, $7 million.

Interest and loan servicing revenues increased 10% to $78 million. The average balance of receivables owned rose 3% to $224 million with a weighted average interest rate of 12.2%, down from 12.8%. The average balance of receivables sold rose 28% to $1.4 billion and the weighted average loan service spread was 3.5% compared to 3.8%.

Financial Services interest expense decreased $.8 million, or 21%, to $2.9 million. Debt collateralized by installment contract receivables dropped 25% to an average of $26 million and the weighted average interest rate moved to 11.1% from 10.8%. Loan covenants preclude prepaying these relatively higher cost obligations.

Gross profit margins improved from 31.6% to 32.0%. The increase primarily results from a greater mix of Clayton manufactured product sold to the Retail group. Manufacturing sales to Retail were 54.9% of new retail sales compared to 54.5% in 1996.

Selling, general and administrative expenses were 32.9% and 31.0% of sales for the years ended June 30, 1997 and 1996, respectively. Expenses associated with the start-up of 31 new sales centers, acquired communities and initial costs of the Financial Services' MBUs were primary causes of the increase.

Net losses as a percentage of loans outstanding for fiscal 1997 decreased to 0.2% from 0.3% last year while delinquency rates on all loans increased slightly to 2.1%. On June 30, 1997 reserves equaled 1.6% of outstanding loans owned or on which the Company has contingent liability.

The changes in inventory levels at June 30, 1997 compared to June 30, 1996 are shown below in millions:

	Increase (decrease)
Manufacturing	
Raw materials	$(1.4)
Finished goods	(1.2)
Retail	
Net increase of 29 Company-owned sales centers	11.8
Decrease in average inventory levels at 216 Company-owned sales centers	(14.1)
Communities	
Inventory at 4 manufactured housing communities acquired during the year	0.7
Decrease in average inventory levels at 63 manufactured housing communities	(0.6)
	$(4.8)

Management's Discussion and Analysis of Financial Condition and Results of Operations *(Continued)*

Fiscal 1996 compared to Fiscal 1995

Total revenues grew 23% on a 23% increase in Manufactured Housing sales and a 22% rise in Financial Services and other income.

Net sales of the Retail group rose 21% to $451 million. This growth was the result of a 14% increase in the average number of Company owned retail centers and a 6% improvement in the average dollar sales per location. During the year, the Company opened or acquired 29 retail locations and closed five underperforming retail centers.

Net sales of the Manufacturing group to independent retailers increased 25% to $278 million and the number of homes sold rose 28%. The average wholesale price declined 2% as the product mix shifted toward single-section homes. Multi-section homes accounted for 32% of total shipments versus 35% in 1995.

Net sales of the Communities group climbed 33% to $33 million principally as a result of a 19% rise in home sales and an 11% improvement in the average sales price per home. Nine acquisitions brought the number of communities to 64 at year end.

Financial Services and other income grew 22% to $166 million from $137 million. Significant contributors were a $5 million gain on sale of two communities, a $5 million increase in rental revenues from Community operations and $6 million of growth in earned insurance premiums and commissions.

Interest and loan servicing revenues increased 19% to $71 million. The average balance of receivables owned rose 6% to $218 million with a weighted average interest rate of 12.8%, up slightly from 12.7%. The average balance of receivables sold climbed 25% to $1.1 billion and the weighted average loan service spread was 3.8% compared to 3.6%.

Financial Services interest expense decreased $1.9 million, or 34%, to $3.6 million. Debt collateralized by installment contract receivables dropped 36% to an average of $34 million and the weighted average interest rate moved to 10.8% from 10.6%.

Gross profit margins improved from 30.5% to 31.6%. The increase primarily results from a greater mix of Clayton manufactured product sold to the Retail group. Manufacturing sales to Retail were 54.5% of new retail sales compared to 49.8% in 1995.

Selling, general and administrative expenses were 31.0% and 30.4% of sales for the years ended June 30, 1996 and 1995, respectively. Expenses associated with the start-up of a new plant in the third quarter and from additional reserves in the insurance group were the primary causes of the increase.

No provision for credit losses and contingencies was made in 1996 or 1995 because of excellent loss and delinquency experience of receivables for which the Company is directly or contingently liable. Net losses as a percentage of loans outstanding for fiscal 1996 increased to 0.3% from 0.2% in 1995 while delinquency rates on all loans remained constant at 2.0%. On June 30, 1996, reserves equaled 1.2% of outstanding loans owned or on which the Company has contingent liability.

The changes in inventory levels at June 30, 1996, compared to June 30, 1995, are shown below in millions:

	Increase (decrease)
Manufacturing	
Raw materials	$ 5.9
Finished goods	(1.2)
Retail	
Net increase of 24 Company-owned sales centers	11.4
Increase in average inventory levels at 192 Company-owned sales centers	17.2
Communities	
Inventory at 9 manufactured housing communities acquired during the year	1.6
Increase in average inventory levels at 55 manufactured housing communities	.9
	$35.8

Fourth Quarter Results

The increase in revenues and net income during the fourth quarters of fiscal 1997 and 1996 are not indicative of future operating trends but rather reflect the seasonality of the manufactured housing industry. In recent years, approximately 31% of the Company's sales have occurred in the fourth quarter.

Liquidity and Capital Resources

During fiscal 1997, the Company originated and acquired approximately $844 million of installment contract and mortgage loan receivables. The Company financed these originations and acquisitions primarily with $782 million in proceeds from the pooling and sale of installment contract and mortgage loan receivables. Additional funding came from operating cash flow and collection of installment contract and mortgage loan receivables. Utilizing cash generated from operations, the Company invested approximately $10 million in the acquisition of land or existing manufactured housing communities and $9 million in related rental units, $7 million for the opening of Company-owned retail centers, $8 million including the construction of one new plant and the improvement of existing manufacturing facilities and $2 million for other fixed assets.

The Company expects to invest approximately $25 million in 1998 in the acquisition or construction of manufactured housing communities, up to $12 million for new Company-owned retail centers, up to $13 million for the construction and improvement of manufacturing facilities and to originate $725 million of installment contract and mortgage loan receivables. Cash needs for 1998 and thereafter are expected to be met with cash flows from operations, current cash balances, and sales of installment contract and mortgage loan receivables and GNMA certificates.

Quarterly Results (Unaudited)

(in thousands except per share)	First Sept. 30	Second Dec. 31	Third Mar. 31	Fourth June 30	Year
1997					
Revenues	**$236,204**	**$234,672**	**$226,624**	**$324,203**	**$1,021,703**
Operating income	**40,099**	**41,953**	**42,014**	**63,482**	**187,548**
Net income	**25,603**	**26,676**	**26,298**	**40,923**	**119,500**
Earnings per share	**$.22**	**$.22**	**$.22**	**$.34**	**$1.00**
Equivalent shares outstanding	**119,903**	**119,628**	**119,214**	**119,163**	**119,477**
Price range of stock:					
High	**$17.90**	**$17.20**	**$15.38**	**$15.25**	**$17.90**
Low	**13.80**	**12.60**	**13.00**	**12.63**	**12.60**
Close	**17.60**	**13.50**	**13.13**	**14.38**	**14.38**
Dividends per share	**$.016**	**$.020**	**$.020**	**$.020**	**$.076**
1996					
Revenues	$ 215,312	$ 211,183	$ 211,374	$ 290,872	$ 928,741
Operating income	35,113	34,986	37,400	60,205	167,704
Net income	22,563	22,713	23,954	37,570	106,800
Earnings per share	$.19	$.19	$.20	$.31	$.89
Equivalent shares outstanding	118,736	119,140	119,733	119,774	119,346
Price range of stock:					
High	$15.60	$18.64	$17.70	$16.90	$18.64
Low	10.56	14.96	14.70	14.30	10.56
Close	15.20	17.10	16.70	16.00	16.00
Dividends per share	$.013	$.016	$.016	$.016	$.061

New Accounting Pronouncements

In February 1997, the FASB issued Statement of Accounting Standards No. 128, *Earnings Per Share* (EPS). The Statement simplifies the standards for computing earnings per share by replacing the presentation of primary earnings per share with a presentation of basic earnings per share. Additionally, the Statement requires dual presentation of basic and diluted EPS on the face of the income statement and requires a reconciliation of the numerator and denominator of the diluted EPS calculation. The Company plans to adopt the provisions of the Statement in fiscal 1998 and had the Statement been in effect for the fiscal years presented herein, basic earnings per share would be equivalent to primary earnings per share as reported.

In June 1997, the FASB issued Statement of Accounting Standards No. 130, *Reporting Comprehensive Income,* which requires that an enterprise (a) classify items of other comprehensive income by their nature in a financial statement and (b) display the accumulated balance of other comprehensive income separately from retained earnings and additional paid-in capital in the equity section of a statement of financial position. This statement is effective for fiscal years beginning after December 15, 1997 and is not expected to have a material effect on the Company's financial position or results of operations.

Additionally, in June 1997, the FASB issued Statement of Accounting Standards No. 131, *Disclosures about Segments of an Enterprise and Related Information,* which requires that an enterprise (a) report financial and descriptive information about its reportable operating segments and (b) report a measure of segment profit or loss, certain specific revenue and expense items, and segment assets with reconciliations of such amounts to the enterprise's financial statements and (c) report information about revenues derived from the Company's products or services and information about major customers. This Statement is effective for fiscal years beginning after December 15, 1997.

Effects of Inflation

Inflation has had an insignificant impact on the Company during the past several years.

Forward Looking Statements

Certain statements in this annual report are forward looking as defined in the Private Securities Litigation Reform Law. These statements involve certain risks and uncertainties that may cause actual results to differ materially from expectations as of the date of this report. These risks include, but are not limited to, adverse weather conditions impacting sales; inventory adjustments by major retailers; competitive pricing pressures; success of marketing and cost-management programs and shifts in market demand.

Consolidated Balance Sheets

(in thousands)	June 30, 1997	1996
Assets		
Cash and cash equivalents	**$ 89,695**	$ 47,400
Receivables, principally installment contracts and residual interests, net of reserves for credit losses of $4,917 and $4,787, respectively and unamortized discount of $2,853 and $4,359, respectively	**478,691**	402,039
Inventories	**119,434**	124,280
Securities held-to-maturity, approximate value of $19,988 and $19,774	**20,361**	20,361
Restricted cash and investments	**70,997**	70,403
Property, plant and equipment, net	**214,072**	184,271
Other assets	**52,511**	37,596
Total assets	**$1,045,761**	$886,350
Liabilities and Shareholders' Equity		
Accounts payable and accrued liabilities	**$ 99,498**	$ 91,064
Long-term debt	**22,806**	30,290
Deferred income taxes	**14,074**	5,680
Other liabilities	**154,857**	109,127
Total liabilities	**291,235**	236,161
Shareholders' equity		
Preferred stock, $.10 par value, authorized 1,000 shares, none issued	**—**	—
Common stock, $.10 par value, authorized 200,000 shares, issued 118,497 at June 30, 1997 and 118,864 at June 30, 1996	**11,850**	11,886
Additional paid-in capital	**166,153**	172,265
Retained earnings	**576,523**	466,038
Total shareholders' equity	**754,526**	650,189
Total liabilities and shareholders' equity	**$1,045,761**	$886,350

The accompanying notes are an integral part of these consolidated financial statements.

Report of Independent Accountants

We have audited the accompanying consolidated balance sheets of Clayton Homes, Inc. and Subsidiaries as of June 30, 1997 and 1996, and the related consolidated statements of income, shareholders' equity, and cash flows for each of the three years in the period ended June 30, 1997. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Clayton Homes, Inc. and Subsidiaries as of June 30, 1997 and 1996, and the consolidated results of their operarions and their cash flows for each of the three years in the period ended June 30, 1997 in conformity with generally accepted accounting principles.

As discussed in Note 1 to the consolidated financial statements, the Company changed its methods of accounting for securitization of installment contract receivables in 1997 and securities in 1995.

COOPERS & LYBRAND L.L.P.

Knoxville, Tennessee
August 12, 1997

Consolidated Statements of Income

(in thousands except per share data)	1997	Year ended June 30, 1996	1995
Revenues:			
Net sales	**$ 822,906**	$762,396	$621,351
Financial services	**148,515**	115,987	102,108
Other income	**50,282**	50,358	34,633
	1,021,703	928,741	758,092
Costs and expenses:			
Cost of sales	**559,274**	521,200	431,826
Selling, general and administrative	**270,996**	236,188	188,835
Financial service interest	**2,885**	3,649	5,533
Provision for credit losses	**1,000**	–	–
	834,155	761,037	626,194
Operating income	**187,548**	167,704	131,898
Interest income (expense), net/other	**5,152**	4,596	3,902
Income before income taxes	**192,700**	172,300	135,800
Provision for income taxes	**(73,200)**	(65,500)	(48,800)
Net income	**$ 119,500**	$106,800	$ 87,000
Net income per common share:			
Primary	**$1.00**	$.89	$.73
Fully diluted	**$1.00**	$.89	$.73
Average shares outstanding:			
Primary	**119,477**	119,346	118,628
Fully diluted	**119,477**	119,346	118,628

Consolidated Statements of Shareholders' Equity

(in thousands except per share data)	Total Shareholders' Equity	Common Stock	Additional Paid-In Capital	Retained Earnings
Balance at June 30, 1994	$ 462,154	$ 11,766	$ 166,252	$ 284,136
Net income	87,000	—	—	87,000
Purchase of 396 shares of common stock	(5,156)	(50)	(5,106)	—
Dividends declared ($.038 per share)	(4,675)	—	—	(4,675)
Issuances related to stock incentive, employee benefit plans and other	4,864	91	4,773	—
Balance at June 30, 1995	544,187	11,807	165,919	366,461
Net income	106,800	—	—	106,800
Purchase of 125 shares of common stock	(1,893)	(16)	(1,877)	—
Dividends declared ($.061 per share)	(7,223)	—	—	(7,223)
Issuances related to stock incentive, employee benefit plans and other	8,318	95	8,223	—
Balance at June 30, 1996	650,189	11,886	172,265	466,038
Net income	**119,500**	—	—	**119,500**
Purchase of 840 shares of common stock	**(11,349)**	**(84)**	**(11,265)**	—
Dividends declared ($.076 per share)	**(9,015)**	—	—	**(9,015)**
Issuances related to stock incentive, employee benefit plans and other	**5,201**	**48**	**5,153**	—
Balance at June 30, 1997	**$754,526**	**$11,850**	**$166,153**	**$576,523**

The accompanying notes are an integral part of these consolidated financial statements.

Consolidated Statements of Cash Flows

(in thousands)	1997	Year ended June 30, 1996	1995
Cash Flows from Operating Activities:			
Net income	**$119,500**	$106,800	$ 87,000
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	**13,058**	11,163	8,296
Gain on sale of installment contract receivables, net of amortization	**(21,541)**	(11,315)	(14,744)
Gain on sale of property	—	(4,828)	—
Provision for credit losses	**1,000**	—	—
Deferred income taxes	**8,394**	(3,702)	2,124
Increase in other receivables, net	**(27,383)**	(16,972)	(22,964)
Decrease (increase) in inventories	**4,846**	(35,825)	(11,138)
Increase in accounts payable, accrued liabilities, and other	**39,249**	25,633	5,516
Cash provided by operations	**137,123**	70,954	54,090
Origination of installment contract receivables	**(646,624)**	(476,467)	(345,260)
Proceeds from sales of originated installment contract receivables	**614,588**	394,087	369,873
Principal collected on originated installment contract receivables	**39,668**	35,199	25,003
Net cash provided by operations	**144,755**	23,773	103,706
Cash Flows from Investing Activities:			
Acquisition of installment contract receivables	**(206,937)**	(36,105)	(26,074)
Proceeds from sales of acquired installment contract receivables	**167,138**	36,007	7,112
Principal collected on acquired installment contract receivables	**3,439**	16,935	17,760
Acquisition of property, plant and equipment, net	**(42,859)**	(40,829)	(44,462)
Proceeds from sale of property	—	21,271	—
Decrease (increase) in restricted cash and investments	**(594)**	(4,189)	3,141
Net cash used in investing activities	**(79,813)**	(6,910)	(42,523)
Cash Flows from Financing Activities:			
Dividends	**(9,015)**	(6,835)	(3,162)
Proceeds from short-term borrowings	**198,963**	208,949	111,394
Repayment of short-term borrowings	**(198,963)**	(208,949)	(136,394)
Repayment of long-term debt	**(7,484)**	(18,447)	(21,943)
Issuance of stock for incentive plans and other	**5,201**	8,318	4,550
Repurchase of common stock	**(11,349)**	(1,893)	(5,156)
Net cash used in financing activities	**(22,647)**	(18,857)	(50,711)
Net increase (decrease) in cash and cash equivalents	**42,295**	(1,994)	10,472
Cash and cash equivalents at beginning of year	**47,400**	49,394	38,922
Cash and cash equivalents at end of year	**$ 89,695**	$ 47,400	$ 49,394
Supplemental disclosures of cash flow information:			
Cash paid during the year for:			
Interest	**$ 3,912**	$ 4,016	$ 5,823
Income taxes	**$ 62,269**	$ 63,366	$ 54,725
Supplemental disclosure of non-cash activities: In 1995, pass-through certificates aggregating $9,500 were received coincidental with the sale of receivables.			

The accompanying notes are an integral part of these consolidated financial statements.

Note 1 - Summary of Significant Accounting Policies

Consolidated Financial Statements

The consolidated financial statements include the accounts of Clayton Homes, Inc. (CHI) and its wholly-owned subsidiaries. CHI and its subsidiaries are collectively referred to as the Company. The Company is a vertically-integrated manufactured housing company headquartered in Knoxville, Tennessee. Employing more than 5,900 people and operating in 28 states, the Company builds, sells, finances and insures manufactured homes, as well as owns and operates residential manufactured housing communities. Significant intercompany accounts and transactions have been eliminated in the financial statements. See Note 11 for information related to the Company's business segments.

Income Recognition

Sales to independent retailers of homes produced by CHI are recognized as revenue upon shipment. Retail sales are recognized when cash payment is received or, in the case of credit sales, which represent the majority of retail sales, when a down payment is received and the customer enters into an installment sales contract. Most of these installment sales contracts, which are normally payable over 36 to 180 months, are financed by Vanderbilt Mortgage and Finance, Inc. (VMF), the Company's mortgage banking subsidiary.

Premiums from family protection, physical damage, and home buyer protection plan insurance policies reinsured by the insurance subsidiaries which represent single payment contracts with terms of one to ten years, are recognized as income over the terms of the contracts. Claims and expenses are matched to recognize profits over the life of the contracts. This matching is accomplished by means of the deferral and recognition of unearned premiums and the deferral and amortization of policy acquisition costs.

Installment Contract Receivables and Mortgage Loan Receivables

Installment contract receivables and mortgage loan receivables originated or purchased by VMF are generally sold to investors through an asset backed securities facility, with VMF retaining servicing on the contracts. Certain purchased mortgage loan receivables are sold to financial institutions with servicing released. In 1997, $769 million in installment contract receivables and mortgage loan receivables were securitized with VMF retaining servicing, while $12 million in mortgage loan receivables were sold with servicing released.

Installment contract receivables held for sale of $254 million and $226 million in 1997 and 1996, respectively, are included in Receivables and are carried at the lower of aggregate cost or market. Certain of the installment contract receivables are purchased in bulk at a discount. The purchase discounts are allocated between unamortized discount and the reserve for credit losses based on management's assessment of risks existing in the portfolio. Unamortized discount is amortized over the life of the related portfolio after giving consideration to anticipated prepayments. Adjustments between the reserve for credit losses and unamortized discount are made to reflect changes in the estimated collectibility of each portfolio purchased. Estimated principal receipts under installment contract receivables for each of the five fiscal years subsequent to 1997 are as follows:

1998	$227,000,000
1999	20,000,000
2000	16,000,000
2001	13,000,000
2002	11,000,000

The estimated principal receipts are based on the scheduled payments and estimated prepayments of principal of the installment contract receivables. Estimated principal receipts for the year ending June 30, 1998 include amounts relating to the sale of $220 million of installment contract receivables in August, 1997. VMF provides servicing for investors in installment contract receivables. Total contracts serviced at June 30, 1997 and 1996, including contracts held for investment, were approximately $2,044 million and $1,638 million, respectively. Most of the installment contract receivables are with borrowers in the east, south and southwest portions of the United States and are collateralized by manufactured homes. Interest income on installment contract receivables is recognized by a method which approximates the interest method. Service fee income is recognized as the service is performed.

Effective January 1, 1997, the Company adopted Statement of Financial Accounting Standard No. 125 (SFAS 125), *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.* SFAS 125 utilizes a financial components approach, requiring that the carrying amount of the receivables sold be allocated between the assets sold and the assets (liabilities) created, if any, at their fair value at the date of sale. The assets (liabilities) created are: 1) an interest-only strip valued as the discounted present value of the excess (deficiency) interest due the servicer (VMF) during the expected life of the contracts over: i) the stated investor yield; ii) the contractual servicing fee; and iii) estimated credit losses; and 2) servicing asset (liability), representing the discounted present value of the contractual servicing fee over the cost of servicing the contracts. Profit (loss) recorded at the time of the sale is computed as the difference between the allocated carrying amount of the receivables sold and the proceeds realized from the sale. The adjustment to income in 1997 was immaterial with respect to the adoption of this statement.

(in thousands)	
Servicing Assets recognized in 1997	$7,080
Amortization	(1,436)
Balance, June 30, 1997	$5,644

The balance represents the estimated fair value of the aggregate servicing assets recognized during 1997. The estimate of fair value assumes: 1) discount rates which, at the time the asset was created, approximate current market rates; and 2) expected prepayment rates based on loan prepayment experience for similar transactions.

Investment Securities

Effective July 1, 1994, the Company adopted Statement of Financial Accounting Standards No. 115 (SFAS No. 115), *Accounting for Certain Investments in Debt and Equity Securities.* Investments in certain debt and equity securities are classified as either Held-to-Maturity (reported at amortized cost), Trading (reported at fair value with unrealized gains and losses included in earnings), or Available-for-Sale (reported at fair value with unrealized gains and losses excluded from earnings and reported as a separate component of shareholders' equity).

Premiums and discounts on debt securities are recognized in interest income on the level interest yield method over the period to maturity.

Gains and losses on the sale of securities are determined using the specific identification method.

Inventories

New homes and raw materials are valued at the lower of cost, using the last-in, first-out (LIFO) method of inventory valuation, or market. Previously-owned manufactured homes are valued at estimated wholesale prices, which are not in excess of net realizable value.

Property, Plant and Equipment

Land and improvements, buildings, and furniture and equipment are valued at cost. Major renewals and improvements are capitalized while replacements, maintenance and repairs, which do not improve or extend the life of the respective assets, are expensed currently. When depreciable assets are sold or retired, the cost and related accumulated depreciation are removed from the accounts, and any gain or loss is included in earnings for the period. Depreciation is computed primarily by the straight-line method over the estimated useful lives of the respective assets.

The Company evaluates the carrying values of property and equipment for impairment losses by analyzing the operating performance and future cash flows of the various business activities. The Company adjusts the net book value of the underlying assets if the sum of expected future cash flows is less than fair market value.

Reserves for Credit Losses and Contingent Liabilities

Reserves for credit losses are established related to installment contract receivables. Actual credit losses are charged to the reserves when incurred. The reserves established for such losses are determined based on the Company's historical loss experience after adjusting for current economic conditions. Management, in assessing the loss experience and economic conditions, adjusts reserves through periodic provisions. The Company also maintains a reserve for contingent liabilities related to guarantees of installment contract receivables sold with recourse. Reserves and the applicable provisions related to guarantees are considered as part of the Manufactured Housing business segment.

Earnings Per Share

Earnings per share is computed based on the weighted average number of shares of common stock outstanding during the periods presented, adjusted for subsequent common stock splits and includes common share equivalents arising from stock options.

Cash Equivalents

For purposes of the statements of cash flows, all unrestricted highly liquid debt instruments purchased with an original maturity of three months or less are considered to be cash equivalents.

Other

Per share and share data have been retroactively adjusted to reflect 5-for-4 stock splits in December 1996, December 1995, and December 1994. Certain reclassifications have been made to the 1995 and the 1996 financial statements to conform to the 1997 presentation.

Restricted Cash and Investments

Restricted cash and investments represent reserves required by: 1) certain VMF servicing and debt agreements to be maintained until such time as specified minimum repayments have been made, 2) trust account cash balances required by certain VMF servicing agreements, and 3) insurance reserves required by escrow or trust agreements.

Management Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Note 2 - Inventories

Inventories at June 30, 1997, and 1996 are as follows:

(in thousands)	1997	1996
Manufactured homes:		
New	**$ 81,963**	$ 89,699
Previously-owned	**22,805**	18,458
Raw materials	**14,666**	16,123
	$119,434	$124,280

If the first-in, first-out (FIFO) method of inventory valuation had been used, inventories would have been higher by $18,196,000 and $17,637,000 at June 30, 1997, and 1996, respectively.

Note 3 - Securities Held-to-Maturity

At June 30, 1997 and 1996, manufactured housing contract senior/subordinate pass-through certificates have been classified in the consolidated financial statements according to management's intent. These securities can be reasonably expected to mature after ten years.

Note 4 - Property, Plant and Equipment

Property, plant and equipment at June 30, 1997, and 1996 are as follows:

(in thousands)	**1997**	1996
Land and improvements	**$135,027**	$115,647
Buildings	**104,560**	88,749
Furniture and equipment	**28,200**	24,445
	267,787	228,841
Less: accumulated depreciation and amortization	**(53,715)**	(44,570)
	$214,072	$184,271

Depreciation charged to operations was $13,058,000, $11,163,000, and $8,296,000 for each of the years ended June 30, 1997, 1996, and 1995, respectively.

Note 5 - Long-Term Debt

Long-term debt at June 30, 1997, and 1996 is summarized as follows:

(in thousands)	**1997**	1996
Debt collateralized by installment contract receivables:		
Maturing in fiscal years through:		
1998 to 2004: weighted average rate of 10.10% at June 30, 1997	**$22,013**	$27,380
1998 to 2002: adjustable rates, weighted average rate of 10.20% at June 30, 1997, weighted average maximum rate 14.27% at June 30, 1997	**228**	1,091
1998 to 2001: adjustable rates, average rate of 7.06% at June 30, 1997, no maximum rate	**429**	1,666
Other notes payable	**136**	153
Total	**$22,806**	$30,290

Expected principal payments of long-term debt collateralized by installment contract receivables for the five fiscal years subsequent to 1997 and thereafter are as follows:

1998	$6,857,000	2001	$3,144,000
1999	4,131,000	2002	2,805,000
2000	3,314,000	Thereafter	2,419,000

The estimated principal payments are based on the scheduled payments and estimated prepayments of principal of the installment contract receivables collateralizing such debt.

Certain debt agreements require fixed payments which approximate the scheduled payments of the underlying installment contract receivables.

Certain of the long-term debt have various covenants, which among other things, require a minimum tangible net worth and the maintenance of certain financial ratios.

Note 6 - Reserves for Credit Losses and Contingent Liabilities

An analysis of the reserve for losses on installment contract receivables and reserve for contingent liabilities for the years ended June 30, 1997, 1996 and 1995 is as follows:

(in thousands)	**1997**	1996	1995
Balance, beginning of year	**$7,766**	$11,895	$14,082
Provision	**1,000**	—	—
Losses, net of recoveries applicable to installment contract receivables:			
Purchased	**(2,337)**	(2,494)	(1,900)
Other	**1,622**	442	(287)
Reserves associated with receivables purchased (sold)	—	(2,077)	—
Balance, end of year	**$8,051**	$ 7,766	$11,895
Reserves for credit losses	**$4,917**	$ 4,787	$ 8,329
Reserve for contingencies	**3,134**	2,979	3,566
	$8,051	$ 7,766	$11,895

The reserves for credit losses are netted against receivables and the reserve for contingencies is included in other liabilities on the consolidated balance sheet. The Company is contingently liable as guarantor on installment contract receivables sold with recourse. The installment contract receivables and related contingent liabilities are shown in the table below.

Total Installment Contract Receivables (in thousands)	Contingent Liability %	Contingent Liabilities (in thousands)
June 30, 1997		
$ 23,000	**30% - 88%**	**$ 8,000**
36,000	**11% - 25%**	**7,000**
182,000	**10% and below**	**18,000**
$241,000		**$33,000**
June 30, 1996		
$ 33,000	30% - 88%	$ 13,000
56,000	11% - 25%	11,000
203,000	10% and below	20,000
$ 292,000		$ 44,000

There were no proceeds from receivables sold with recourse in 1997; $12 million, and $7 million, during 1996, and 1995, respectively. Approximately 90% of the installment contract receivables both owned and sold with recourse have fixed rates of interest and approximately 10% are at variable rates of interest based on either the prime rate, U.S. Treasury rates or LIBOR.

Virtually all of the Company's servicing arrangements are based on interest spreads with fixed rates or variable rates with ceilings.

Note 7 - Shareholders' Equity

Stock Option Plan

In 1983, 1985 and 1991, the Company established Stock Option Plans for a total of 8,616,829 shares of common stock which provide for granting "incentive stock options" or

"non-qualified options" and stock appreciation rights to officers and key employees of the Company. In addition, non-management members of the Board of Directors have, with shareholder approval of prices and provisions for exercise, been granted options to purchase shares of common stock. The option prices were established at not less than the fair market value as of the date of grant. Options are exercisable after one or more years and expire no later than 10 years from the date of grant.

Activity and price information regarding the plans follow:

	Shares	Stock Option Price Range	Weighted Avg Exercise Price	Stock Options Excercisable	Weighted Avg Excercise Price
Balance June 30, 1994	3,860,538	$ .84 - $12.93	$ 5.66	924,386	$3.62
Granted	590,770	$ 9.02 - $10.18	$ 9.11		
Exercised	(694,008)	$ .84 - $ 9.26	$ 1.95		
Canceled	(265,740)	$ 1.16 - $12.93	$ 5.58		
Balance June 30, 1995	3,491,560	$ 1.16 - $12.93	$ 6.99	1,289,298	$4.95
Granted	840,373	$10.64 - $17.12	$12.64		
Exercised	(628,845)	$ 1.16 - $10.37	$ 4.28		
Canceled	(378,975)	$ 2.20 - $17.12	$ 8.69		
Balance June 30, 1996	3,324,113	$ 1.16 - $17.12	$ 8.74	1,145,403	$6.65
Granted	**569,684**	**$12.90 - $16.00**	**$14.38**		
Exercised	**(161,144)**	**$ 1.38 - $10.37**	**$ 4.37**		
Canceled	**(199,095)**	**$ 1.78 - $17.12**	**$11.84**		
Balance June 30, 1997	**3,533,558**	**$ 1.38 - $17.12**	**$ 9.67**	**1,511,148**	**$7.90**

Options available for future grant at June 30, 1997 and 1996 were 803,019 and 1,183,139, respectively. Options were held by 611 persons at June 30, 1997.

The following table summarizes information about the plan's stock options at June 30, 1997:

	Options Outstanding			Options Exercisable	
Range of Exercise Price	Number Outstanding at 6/30/97	Weighted Avg Remaining Contractual Life	Weighted Avg Excercise Price	Number Exercisable at 6/30/97	Weighted Avg Excercise Price
$ 1.38-$ 2.70	375,771	2.03 years	$ 1.88	224,454	$ 1.92
$ 4.55-$ 6.31	425,718	4.50 years	$ 5.22	260,635	$ 5.16
$ 9.02-$12.90	2,209,007	7.15 years	$10.14	945,791	$ 9.29
$14.32-$17.12	523,062	8.46 years	$16.93	80,268	$17.12

The Company has adopted the disclosure-only provisions of Statement of Financial Accounting Standards No. 123 *Accounting for Stock-Based Compensation* (SFAS 123). Accordingly, no compensation cost has been recognized for the stock option plans. Had compensation cost for the Company's stock option plans been based on the fair value at the grant date for awards from 1996 and 1997 consistent with the provisions of SFAS 123, the Company's net earnings and earnings per share for 1997 would have been reduced to the pro forma amounts indicated below:

	June 30, 1997	1996
Net income - as reported	**$119,500**	$106,800
Net income - pro forma	**118,481**	106,309
Net income per common share - as reported	**1.00**	0.89
Net income per common share - pro forma	**0.99**	0.89

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions used for grants issued from 1996 and 1997; dividend yields ranging from 0.46% to 0.73% with a weighted average yield of 0.55%; expected volatility of 0.311%, risk-free interest rates ranging from 6.44% to 6.57% with a weighted average rate of 6.47%; and expected lives ranging from 7.50 to 9.75 years with a weighted average life of 8.19 years.

Note 8 - Income Taxes

Components of the provision for income tax for each of the three years ended June 30, 1997, 1996, and 1995 are as follows:

(in thousands)	**1997**	1996	1995
Current tax provisions:			
Federal	**$58,591**	$63,274	$41,292
State	**6,215**	5,928	5,384
	64,806	69,202	46,676
Deferred tax provision/ (benefit)	**8,394**	(3,702)	2,124
	$73,200	$65,500	$48,800

The sources and tax effect of temporary differences at June 30, 1997 and 1996 are as follows:

(in thousands)	**1997**	1996
Reserves for credit losses and contingencies and discounts	**$ 4,712**	$ 4,584
Insurance reserves	**5,377**	4,919
Unearned premiums	**5,074**	3,952
Total deferred tax assets	**15,163**	$13,455
Residual interest in installment contract receivables	**(16,881)**	(8,863)
Deferred costs	**(3,904)**	(3,123)
Other	**(8,452)**	(7,149)
Total deferred tax liabilities	**(29,237)**	(19,135)
Net deferred tax liability	**$(14,074)**	$ (5,680)

The provision for income taxes reflected in the financial statements differs from income taxes calculated at the statutory federal income tax rate of 35% in 1997, 1996 and 1995 as follows on next page:

(in thousands)	**1997**	1996	1995
Income taxes at statutory rate	**$67,451**	$60,305	$47,530
State income taxes, net of federal benefit	**4,040**	4,150	3,769
Other, net	**1,709**	1,045	(2,499)
	$73,200	$65,500	$48,800

Note 9 - Employee Benefit Plans

The Company has a 401(k) profit-sharing plan covering all employees who meet participation requirements. The amount of the Company's contribution is discretionary as determined by the Board of Directors, up to the maximum deduction allowed for federal income tax purposes. Contributions accrued were $2,874,000, $4,274,000, and $3,461,000 for the years ended June 30, 1997, 1996, and 1995, respectively.

Note 10 - Commitments and Contingencies

Leases

Certain operating properties are rented under non-cancelable operating leases which expire at various dates through 2009. Total rental expense under operating leases was $3,705,000 in 1997, $2,722,000 in 1996, and $2,721,000 in 1995. The following is a schedule of minimum rental commitments under non-cancelable operating leases, primarily for retail centers, in effect at June 30, 1997:

1998	$3,320,000	2001	$1,558,000
1999	2,612,000	2002	991,000
2000	2,083,000	Thereafter	2,246,000

Repurchase Agreements

Institutions financing independent retailer purchases require the Company to execute repurchase agreements. As a result of these agreements, the Company is contingently liable for repurchasing homes in the event of a default by the dealer to the lending institution. These agreements are customary in the manufactured housing industry, and the Company's losses in the past have not been significant.

Guarantor of Installment Contract Receivables

Please see discussion of contingencies at Note 6.

Other

The Company has lines of credit totaling $145 million for working capital needs of which zero borrowings were outstanding at June 30, 1997. Additionally, the Company has letters of credit of which $48 million was outstanding at June 30, 1997, primarily related to insurance reserve requirements.

Note 11 - Industry Segment Information

The Company operates in three major business segments: Manufactured Housing, Financial Services and Communities. The Manufactured Housing segment is engaged in the production, wholesale and retail sale of manufactured homes. Financial Services includes retail financing of manufactured homes, reinsuring risk on family protection, physical damage, and home buyer protection plan insurance policies, and certain specialty finance products. Communities is engaged in marketing and management of manufactured housing communities. Operating income consists of total revenues less cost of sales, operating expenses and financial interest expense. The following items have not been included in the computation of operating income: non-operating income and expenses and income taxes. Identifiable assets are those assets used in the operation of each industry segment. Corporate assets primarily consist of short-term investments.

Information concerning operations by industry segment follows:

(in thousands)	Manufactured Housing	Financial Services	Communities	Corporate	Total
1997					
Revenues	**$827,383**	**$124,076**	**$ 70,244**	**$ —**	**$1,021,703**
Intersegment income	**8,432**	**93**	**—**	**(8,525)**	**—**
Operating income	**95,958**	**77,459**	**14,131**	**—**	**187,548**
Identifiable assets	**219,321**	**610,642**	**147,814**	**67,984**	**1,045,761**
Depreciation and amortization	**8,348**	**—**	**4,710**	**—**	**13,058**
Capital expenditures	**$ 21,404**	**$ —**	**$ 21,455**	**$ —**	**$ 42,859**
1996					
Revenues	$761,111	$ 99,443	$ 68,187	$ —	$ 928,741
Intersegment income	7,436	103	94	(7,633)	—
Operating income	89,504	62,600	15,600	—	167,704
Identifiable assets	197,938	493,622	142,331	52,459	886,350
Depreciation and amortization	6,671	—	4,492	—	11,163
Capital expenditures	$ 16,483	$ —	$ 24,346	$ —	$ 40,829
1995					
Revenues	$621,474	$ 88,749	$ 47,869	$ —	$ 758,092
Intersegment income	11,406	274	1,194	(12,874)	—
Operating income	67,898	54,800	9,200	—	131,898
Identifiable assets	176,632	413,072	122,408	49,039	761,151
Depreciation and amortization	5,132	—	3,164	—	8,296
Capital expenditures	$ 21,933	$ —	$ 22,529	$ —	$ 44,462

Note 12 - Other Assets and Liabilities

At June 30, 1997 and 1996, other assets and liabilities consisted of:

(in thousands)	**1997**	1996
Other Assets		
Interest receivable and future servicing rights	**$ 26,229**	$ 17,312
Prepaid expenses and other	**26,282**	20,284
	$ 52,511	$ 37,596
Other Liabilities		
Investors payable	**$ 69,847**	$ 40,286
Reserve for contingencies (Note 6)	**3,134**	2,979
Escrow deposits	**15,220**	14,495
Unearned insurance premiums	**50,610**	39,628
Other	**16,046**	11,739
	$154,857	$109,127

Note 13 - Fair Value Disclosure of Financial Instruments

Statement of Financial Accounting Standards No. 107 (SFAS No. 107), *Disclosures about Fair Value of Financial Instruments,* requires that CHI disclose the estimated fair values of its financial instruments. The following methodologies and assumptions were used by CHI to estimate its fair value disclosures for financial instruments.

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. The estimates do not reflect any premium or discount that could result from offering for sale in a single transaction CHI's entire holdings of a particular financial instrument. The lack of uniform valuation methodologies introduces a greater degree of subjectivity to these estimated fair values. Comparability to financial instruments between similar companies may not be reasonable because of varying assumptions concerning the estimates of fair value.

Cash and Cash Equivalents

The carrying values for cash and cash equivalents, including those restricted by agreement, equal the fair value of the assets.

Residual Interests in Installment Contract Receivables

Residual interests in installment contract receivables are calculated using prepayment, default and interest rate assumptions that the Company believes are appropriate at the time of the sale of the installment contract receivables. Projected performance is monitored after the sale; the Company alters the underlying rate at which the future estimated cash flows are discounted once the sale has been recorded. The fair value primarily revolves around an appropriate discount rate to be applied to the asset as a whole.

The Company used a discount rate and such other assumptions as it believed to be used for similar instruments. The Company has estimated the fair value of its residual interests in installment contract receivables to approximate its carrying value as of June 30, 1997 and 1996.

Contracts Held For Sale and as Collateral

Contracts held for sale are generally recent originations or purchased portfolios which will be sold with limited or no recourse during the following year. CHI does not charge fees to originate loans, and, as such, its contracts have origination rates in excess of rates on the securities into which they will be pooled. CHI estimates the fair value of the contracts held for sale using expected future cash flows of the portfolio discounted at the current origination rate.

The carrying values of contracts pledged as collateral to long-term lenders are estimated using discounted cash flow analyses and interest rates being offered for similar contracts. The carrying amount of contracts with a variable rate of interest is estimated to be at fair value. The carrying value of accrued interest adjusted for credit risk equals its fair value.

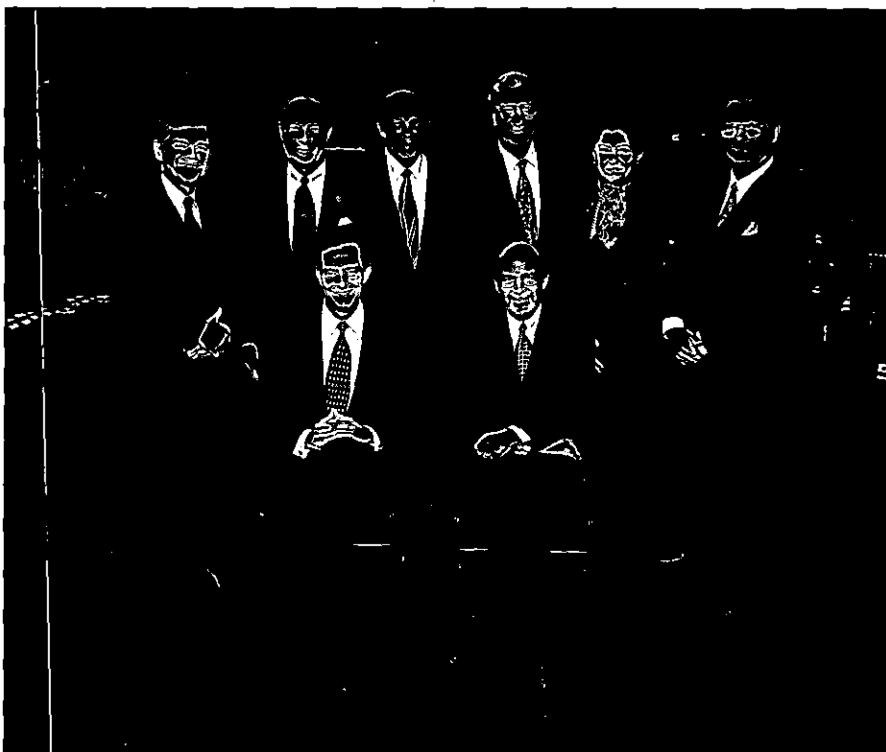
Long-term Debt

Long-term debt consist primarily of debt collateralized by contracts with maturities that coincide with the underlying contract maturities. The fair value of these financial instruments is based on the current rates offered to CHI for debt of similar maturities using a discounted cash flow calculation. Loan covenants preclude prepayment.

The carrying amounts and estimated fair values of CHI's financial assets and liabilities are as follows:

	June 30, 1997		June 30, 1996	
(in thousands)	**Carrying Amount**	**Estimated Fair Value**	Carrying Amount	Estimated Fair Value
Financial assets:				
Cash and cash equivalents, including restricted investments and securities held-to-maturity	**$181,053**	**$180,680**	$138,164	$138,157
Residual interests in installment contract receivables	**135,208**	**135,208**	85,020	85,020
Contracts held for sale and as collateral, including accrued interest receivable	**283,378**	**293,268**	263,719	264,477
Financial liabilities:				
Long-term debt	**$ 22,806**	**$ 25,859**	$ 30,290	$ 34,003

DIRECTORS & OFFICERS



***Board of Directors** - Seated left to right, Joseph H. Stegmayer and James L. Clayton. Standing left to right, C. Warren Neel, James D. Cockman, B. Joe Clayton, Wallace C. Doud, Wilma H. Jordan and Dan W. Evins*

Board of Directors

James L. Clayton
Chairman of the Board and Chief Executive Officer, Clayton Homes, Inc.; Director, Dollar General Corporation and Chateau Communities, Inc.; Chairman of the Board, BankFirst

B. Joe Clayton
Chief Executive Officer, Clayton Automotive Group; Regional Director, First Tennessee Bank

James D. Cockman (1)
Chairman of the Board and Chief Executive Officer, American Culinary Equipment, Inc./A.S.F.

Wallace C. Doud (2)
Vice President, Commercial and Industry Relations (Retired), IBM Corporation; Director (Retired), Motorola Corporation

Dan W. Evins (2)
Chairman of the Board, Chief Executive Officer, Cracker Barrel Old Country Store, Inc.

Wilma H. Jordan (1)
Chief Executive Officer/Co-Chairman, The Jordan, Edmiston Group, Inc.; Director, LIN Television Corporation

C. Warren Neel (1)(2)
Dean, College of Business Administration, University of Tennessee; Director, O' Charleys, Inc., Proffitts', Inc., American Health Corp., Inc., and Promus Hotel Corporation

Joseph H. Stegmayer
Vice Chairman of the Board, Clayton Homes, Inc.; Director, The Cardinal Funds, First Enterprise Financial Group, Inc.

(1) Audit Committee (2) Compensation Committee

Corporate Officers

James L. Clayton
Chairman of the Board and Chief Executive Officer

Joseph H. Stegmayer
Vice Chairman of the Board and Chairman of the Executive Committee

Kevin T. Clayton
President
President, Financial Services

David M. Booth
Executive Vice President
President, Retail

John J. Kalec
Senior Vice President
Chief Financial Officer and Secretary

Richard D. Strachan
Vice President
President, Manufacturing

Paul W. Boyd
Treasurer

Shareholder Information

Form 10-K
Clayton Homes, Inc. Form 10-K Annual Report to the Securities and Exchange Commission is available without charge to shareholders upon written request to:

Investor Relations
Clayton Homes, Inc.
623 Market Street
Knoxville, TN 37902

Counsel
Bernstein, Stair & McAdams
Knoxville, Tennessee

S.E.C. Counsel
Baker, Donelson, Bearman and Caldwell
Nashville, Tennessee

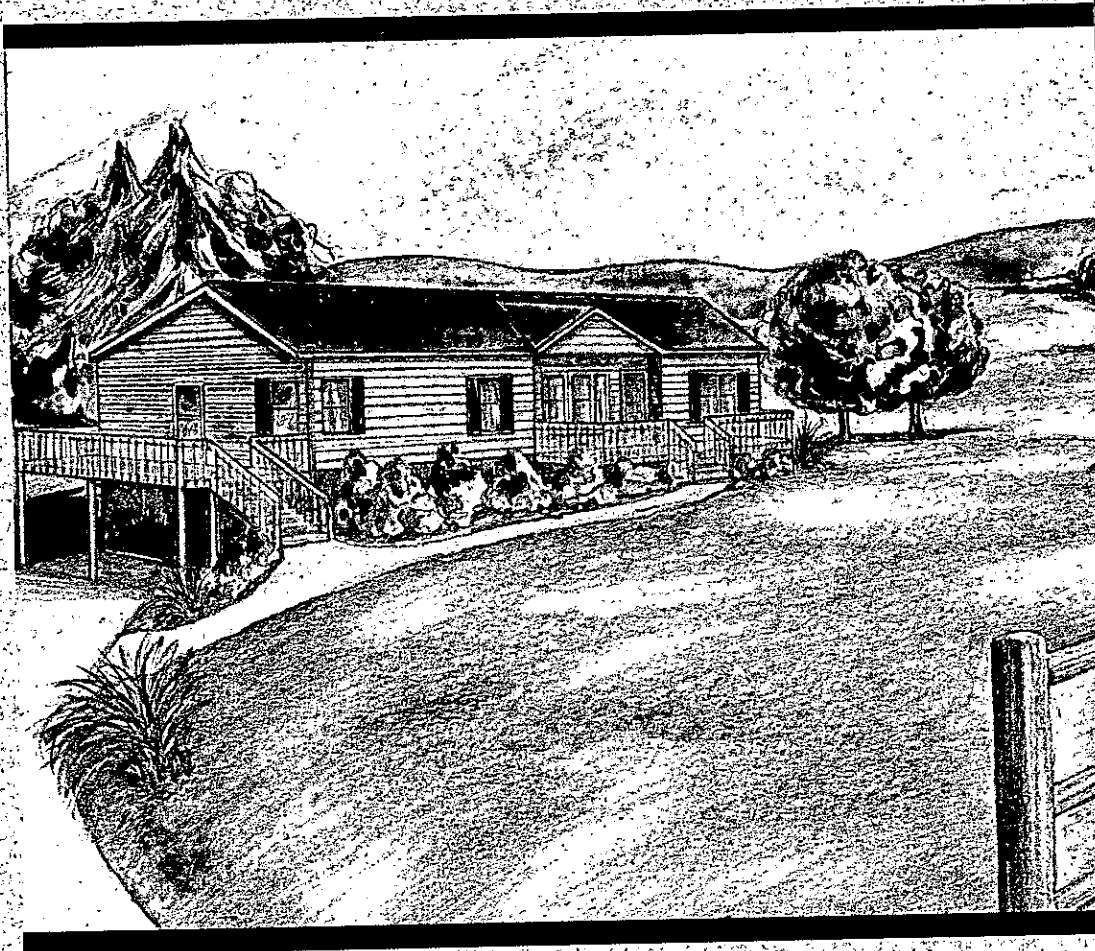
Independent Accountants
Coopers & Lybrand L.L.P.
Knoxville, Tennessee

Stock Exchange Listing
The Company's common shares are listed on the New York Stock Exchange, symbol CMH.

Shareholders
There were approximately 54,000 beneficial holders of common stock on June 30, 1997.

Registrar, Transfer Agent, and Dividend Reinvestment Plan Administrator
SunTrust Bank
P.O. Box 4625
Atlanta, Georgia 30302
(800) 568-3476

Annual Meeting
The annual meeting of shareholders will be held on November 12, 1997, at 10:30 a.m. (EST) at the Louise Mandrell Theatre, 2046 Parkway, Pigeon Forge, TN 37863. Shareholders of record at close of business on September 16, 1997, will be entitled to vote.



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Human resources: recruiting@clayton.net