Land with assets can pay for itself
By Curtis Seltzer
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BLUE GRASS, Va.—Many years ago, I didn't have any money. That meant I didn't buy much.

So with pennies dug out of the couch, I paid 25 cents for a used book at my local library book sale, George Bockl's, How to Use Leverage to Make Money in Local Real Estate, 1965. I felt this was a prudent investment inasmuch as it was a hardcover and had a dust jacket to boot.

This was my first real-estate book. Bockl described commercial real-estate deals he had done in Milwaukee. More important, he showed how to use imagination and research. Thought short on cash, I was long on think time.

Financing, he showed, was not the hard part; thinking out a deal was.

While I knew nothing about industrial buildings, I got what he was saying. I understood that if you kept turning a problem, sooner or later you would find an angle of solution.

About that time, a 430-acre farm was coming on the market. The seller was using a sealed-bid system with a $350,000 minimum.

The problem I set for myself was simple: How could I buy this farm with no money? I announced this to my wife, Melissa, a lawyer, who said simply: "You're NUTS!"

Melissa comes from a family that always paid full price and bought retail. She thinks ten percent off is pretty exotic. She was not raised to do leverage.

Given her encouragement I smoked a cheap cigar and started to think.

I would have to get money from somewhere other than my own pocket. That was simple enough.

The first pocket I looked into was the farm itself. I divided the entirety into core assets and severable assets, that is, pieces I wanted to keep and pieces I was willing to give up in order to keep what I wanted. I would part with the farmhouse and 30 acres, some or all of the merchantable hardwood timber 16" in diameter and larger and 100 acres on one side that we came to call the Secret Valley.

I figured I could get $100,000 for the farmhouse and the same for the Valley. That would leave me with about 300 acres -- half good pasture, half woods -- and the need for about $150,000.

A consulting forester cruised the woodland to determine the volume of merchantable timber, which should be thought of as only that timber a timber buyer will pay for. A woodlot may have much more volume than what is considered merchantable. A big-diameter tree can be worth several thousand dollars or nothing. A forester knows to not tally volume from trees that are poorly formed, diseased or economically impractical to cut.

A cruise looks for several types of merchantable timber value: sawtimber, which, around here, is trees of 16" diameters and larger with at least one eight-foot-long log in the stem; pulpwood/firewood; and wood that has special uses, such as locust for fence posts and sugar maples that can be tapped. The consulting forester I hired estimated merchantable volume, disaggregated by species and two-inch diameter classes. Sawtimber in diameters smaller than 16" is called pre-merchantable, and it represents future timber value.

Landowner money is found in hardwood sawtimber of the high-value species --red oak, sugar maple, and black cherry. Volume in 16+ mid- and low-value species, such as chestnut oak, hickory and black birch, counts as sawtimber, but didn't contribute much to merchantable value.

The forester presented different options for making a first harvest and then managing the woods. I decided to take a cut that netted about $65,000 after his 10 percent commission. He marked each tree to be cut, estimated the volume by species and diameter class and handled the sale as my agent. He organized a competitive sealed-bid sale rather than negotiations with a single buyer. Had

I made a private deal with a local logger, I would have probably gotten about $45,000. His pre-sale estimate of the high bid was right on the money.

I was still about $85,000 short. I could borrow that against the 300 acres and make most of the P&I payments from running cattle myself or renting the pasture. Figuring in tax deductions, I was buying 300 acres for no money out of pocket.

Which I did. Thank you George Bockl. Melissa remained suspicious for years.

I had learned two lessons. First, buyers should value a potential acquisition of rural property in light of its component parts, particularly those that can be quickly sold for a profit. To avoid taxes and transaction fees, the sale of the unwanted assets can be arranged during escrow and scheduled as a simultaneous closing.

Sale of parcels always brings a higher per-acre price than what was just paid for the entirety. One hundred acres might be bought for $3,000 per acre, and sold in four 25-acre lots for $6,000 per acre, or more. The more of the entirety you sell, the more likely it is that you will pay nothing for what you keep.

Second, I started to learn how to use timber as an acquisition tool. A good consulting forester provides the critical evaluation and information a buyer needs before he submits an offer. You need a consulting forester to tell you whether 75 acres of woods on a target property has a merchantable value of $100,000 or zero, either of which is possible.

Timber prices have trended up over the long term. Stumpage price -- what a timber buyer pays a landowner for trees he's purchased -- has increased for most, but not all, species in both federal and private stumpage sales.

Federal stumpage prices for all eastern hardwoods rose from $80.90 per thousand board feet in 1985 to $336.50 in 2005, expressed in 1997 dollars. The price of sugar maple increased five-fold. Douglas fir and southern pine rose, but ponderosa pine and western hemlock fell during that period. Federal stumpage prices are generally lower than private-sale prices.

It might take six or seven 16"+ hardwood trees to total 1,000 board feed on the stump. Hickory might fetch $100/1000bf; red oak, $350/1000bf; sugar maple $650; and black cherry $1,000. Veneer-quality logs bring much higher prices that ordinary sawtimber.

Each species of hardwood and conifer has its own market, though generally speaking, stumpage prices as a whole track new-house construction. Stumpage prices follow a wave cycle that has trended up over time.

Woodland brings other financial benefits. Many states offer property-tax breaks for timberland enrolled in their managed-timber programs. The requirements are usually minimal, and the reduction can cut annual property tax in half. Some states tax standing timber or timber sales.

Enrollment in a state's managed-timber program helps to establish that a taxpayer is engaged in the business of timberland management and production. A business is afforded more favorable federal tax treatment than an individual owner who is not organized as a profit-seeking business. Consider setting up newly acquired woods as a timberland-management business with a Schedule C or other type of entity.

Timber sold after one year of ownership is subject to the federal capital-gains rate (now a maximum of 15 percent) rather than the ordinary-income rate, which is likely to be higher for most buyers. Timber taxation is discussed at www.timbertax.org.

Basis in timberland is divided between basis in the land and basis in the timber, which is established by a forester's cruise at the time of acquisition. Timber-sale revenue up to the taxpayer's timber basis is free of federal income tax at the time of the sale. A well-counseled taxpayer can avoid some or all of the tax on both timber-sale gain and appreciation by folding his timberland into the tax-free portion of his estate.

For woodland with environmental value, a landowner can donate a development-limiting easement without affecting timber production. Such conservation easements can bring the taxpayer substantial federal, state and local tax savings.

Woodland, even small parcels that have no timber value, may qualify in the future for trading on a carbon exchange where a landowner receives income for the amount of carbon his trees are storing. Carbon emitters would buy these credits.

Finally, woods are interesting. They provide solace, recreation, exercise, wildlife, conservation benefits and aesthetics.

As an investment, timberland beats stock.

Stocks show an average gain of seven percent a year when the data are controlled for inflation, according to Professor Jeremy Siegel of the University of Pennsylvania's Wharton School. This average is derived from looking at many stocks over many years. It may or may not work for any individual stock; it doesn't work for the three lousy decades in our memory—the 1930s, 1970s and this one.

Adjusted for inflation, a dollar invested in the S&P 500 in April, 1999 produced no gain at the end of March, 2008. The performance of big U.S. stocks amounts to an average annual rise of 1.3 percent during the past decade when dividends and inflation are counted in. (E.S. Browning, "Stocks Tarnished By 'Lost Decade,'" Wall Street Journal, March 26, 2008.)

In contrast, a study by the James W. Sewall Company shows timberland beating the stock market since 1960, up an annual average of 12 percent for stocks but nearly 14 percent for timberland.

In 2007, timberland showed a total return (income plus capital appreciation) of 17.45 percent, according to the National Council of Real Estate Investment Fiduciaries (www.ncreif.com), which has tracked timberland and farmland for many years.

Timberland's total return beat stock's seven percent average in 17 of the last 21 years, usually substantially. (Click on the Timberland Index at www.ncreif.com.) The four years when the specific annual timberland total return did not beat stock were 1998, 2000, 2001 and 2002.

One of George Bockl's sentences that I underlined many years ago was this: "Ideas create wealth."

Not one idea, several ideas harnessed toward a single objective. Ideas that are based on experience and coupled with tools and technique. The formula is always the same, whether it's science, literature, real estate or lollipops.

It even worked for me.

Now, when I return from the annual library book sale, Melissa asks if I've bought another 25-cent real-estate book.