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Timberland investing: Different ways to make a future buck

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It's been almost impossible not to make money in timberland for the last 100 years. Whatever type you bought, the only trick you had to know was to hold it for a long time. The trees grew, increasing the volume of valuable timber. The trees upgraded themselves from small-diameters to sawtimber diameters, and when this "in-growth" threshold was crossed it multiplied a tree's value per unit of volume many times over. You could cut some trees at the top of the stumpage cycle if you needed cash. And, finally, the dirt itself -- often called "bare land" -- appreciated as our population grew.

The "strategy" of holding timberland was based on the often unspoken or unexamined assumption that the U.S. economy would continue to grow over the long-term, that cyclical ups and downs would trend up over decades, that people would need to build wood-intensive houses and that wood products would continue to enjoy growing demand.

Most people who bought and held did just fine, because the underlying economic forces performed as expected and the trees grew.

In recent decades, investors have shortened the hold period. "Flipping" made both small guys and the big boys a lot of money. Buying a large tract at a wholesale price (timberland price), parting it out (cut some timber, divide the property and sell it for second-home/recreation buyers) and, maybe, putting a conservation easement on it for the tax benefits--this became a common investor strategy. Flipping shortens the hold period as much as possible.

You can, however, play the flipping game only so many times within a few years. The last flipper in line gets stuck, much like the last guy in a chain letter. The first investor buys 100,000 acres for \$1,000/A and might flip it in three chunks to second-tier flippers at \$1,400/A. Each of them might flip their 33,333 acres in ten chunks for \$1,700/A. The third-tier flippers might flip their 3,333 acres in ten chunks for \$2,000/A. And the fourth-tier flippers might flip their 333 acres in ten chunks for \$2,500/A. And sometime between the fourth tier or the fifth or the sixth, the game stops because the increasing smaller acreages have become priced above what the market will pay. At that point, the owner should simply hold and forget flipping.

Any flipper after tier 2 should be aware that the mark-up cap on resales is coming closer.

Most small timberland investors don't apply sophisticated analytical tools to their decisions. They look at the purchase price in relation to comparable values. Or they value

the assets in light of the purchase price; if the parts exceed the cost of the property as a whole, they buy. Or they estimate the value of selling some of the land's assets, earning annual income from others and then selling the remainder at some future date for more than they have in it.

Another way of approaching a purchase is discounted cash-flow (DCF) analysis. This technique values an investment by estimating its future cash production and then discounting that number by the time value of the money invested and the risk involved. DCF can be adapted to a single cash event (i.e., buy 100 acres for \$500,000 and then sell it for \$750,000 five years later, leaving \$250,000 in gross cash) or multiple cash events (i.e., a big tract of timberland that is managed to produce timber-sale and hunting-lease income each year, along with sometime sales of pieces of the land base). If the rate of return on the investment is zero or negative after all the costs over time are counted and all the discounts are applied, it's not a good deal. DCF analysis must incorporate assumptions about interest rates, risk and other factors that may be little more than educated guesses. An investment that is vetted with a DCF analysis may or may not work out.

I can't shake the feeling that we may be at a turning point in our economy, one where we can't estimate the future in the ways we've used in the past. A higher embedded riskiness may be our future. This would be the long-term impact of the continuing mortgage mess, all the efforts to address it and all the needed changes that don't seem to be on the national agenda.

Generally speaking, I continue to think that land and timberland will be better investments than stocks, bonds and commodities in the future. Land values will rise because of population growth if nothing else. As a finite resource, more people should mean continued demand and appreciating prices, even if the middle-class shrinks some as the consequence of structural changes in the economy. Timber markets, I think, will change, but the net shake out is likely to be something more diverse—traditional markets, plus biomass energy of different types. Faster growing species will bring down the cost of lumber and its products, increasing demand overall.

I'd look at timberland investments over a three-to-five year period or over a very long time, say 20 plus years. It's the in-between period that I think is unpredictable and chancy.

The rule of thumb I'd suggest to timberland investors is something like this: If the amount of merchantable timber on a property represents at least 50 percent of the purchase price, you're likely to make money either short-term or long-term.