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How does division produce addition?

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One of the most tried and true business strategies for building wealth is also the most simple—in concept, at least.

Start with one square yard -- nine square feet -- of cotton cloth at $3. Take it home, and cut it into nine equal pieces. Hem each piece on all four sides. Then sell nine handkerchiefs for $1 each. Costs might total $6, and net profit might be $3. This'll work for most of us.

My hanky example is pushcart capitalism at its most primitive. Of course, investment bankers use the same logic when doing mergers and acquisitions, as does my neighbor when he parts out for $$750 a junked car he bought for $100.

Division for retailing is also used in real estate--by both buyers and sellers.

Buying a single large tract of land for division into parcels to be sold at a much higher per-acre price has been a successful investment strategy since our earliest colonial days. To be successful, the tactic needs the following:

1. The purchase price must be significantly wholesale to the retail price the buyer plans for the divided parcels. The right ratio of wholesale price to retail price depends on many factors—number of parcels that result from the division; current market price and demand for such parcels; existing inventory of comps; and cost of infrastructure and overhead (interest, carrying costs, legal, taxes, personnel, marketing, risk, etc.) required to bring the division into regulatory compliance and set it up for sales.

Land divisions can work with ratios as low as 1:3 where little infrastructure is required and the turn-around is likely to be short. But veteran rural lot developers typically look for a project where the ratio starts at 1:10, subject to project particulars.

2. The buyer must be able to carry the project for longer than he anticipates. Developers take on different types of risk, but it's very difficult to predict the ultimate cost of each identified risk when the developer/buyer is in due diligence. A downturn in the economy, a spike in mortgage interest rates, a tightening of lender standards on second homes, an unforeseen large cost—each, and all, can trash a business plan. The developer needs sufficient cash to weather contrary macro-economic forces and project-specific troubles that can rise up out of nowhere, extending the project for a year or two beyond the developer's best sales projection.

3. The division plan should have a back-up. Planning and zoning requirements lock in division plans at the project's start before anything bad, costly or unexpected has happened. If possible, buyer/dividers should have an optimal plan where most things work out pretty much as expected; a back-up plan where time, costs and money are running against the project and its numbers need to be recast; and a disaster plan where the project has to be drastically rescaled and rethought so that the developer is not crushed. I recommend showing all three plans to the authorities (and lenders) when seeking approvals.

Owner/sellers can play the division game too, using the same "sell-small/sell-retail" logic. In times like these, land buyers are still looking, but they're downsizing their expectations and searches to conform to current conditions. The 100-acre recreational buyer may now be looking for 50 acres.

Sellers who need cash might take the 2007 appraisal price for their 100 acres ($4,000/A = $400,000) and sell 50 acres in 2009 at, say, $4,000/A and two 25-acre parcels at, say, $5,000/A. That $450,000 sounds better to me than marking down the 100 acres to $300,000—but it will take some additional work. The numbers, of course, will vary.