Worried about inflation? If you've got cash, patience and a green thumb, investing in raw land can be very profitable.

The ultimate inflation hedge

By Seth Lubove

OLD-TIMERS SAY this about raw land as an investment: It's a better place to bury your coffin than your money.

Such skepticism notwithstanding, raw land can be a wonderful investment. But picking the right land at the right price is a lot tougher than picking a stock or a mutual fund.

Consider a sampling of the land mines awaiting investors: Mortgage officers won't touch raw land; returns, if any, could be decades away; an endless tangle of state and local zoning rules restrict how the land can be used; if the land has ever harbored dangerous chemicals, you could be walking into an open-ended liability; you get no deductions for depreciation and, unless the land is farmland, you get no cash flow.

If that isn't enough, note that government has developed in recent years two new ways to confiscate property, with no compensation to the owner. All it has to do is find some wet spot or endangered species on the property in order to turn it into a protected wetland or de facto wildlife preserve.

And here's a sobering statistic: Among all types of real estate, undeveloped land plunged the most in value between 1991 and 1992 (19.5%) and is expected by the economists at Equitable Life to have the second-biggest loss this year (6.5%).

Grant all that. But it's also true that high risk means high reward, and investing in land can pay off if you know what you're getting into. And it's also one very good inflation hedge for people holding for a long time. TCW Realty Advisors, a Los Angeles pension adviser, has invested about $200 million of its clients' cash in commercially zoned land over the past five years. "I think lots of money will be made in land, but it's treacherous," says Roger Schultz, a TCW senior partner responsible for the firm's land investments.

To understand just how profitable land can be, settle into the passenger seat of Maury Carter's 1991 Jeep Wagoneer and take a spin around Orlando, Fla. as Carter and his son, Daryl, boast of their big scores in 30 years of land investing. Up ahead on State Road 15 are 7,000 acres Carter and his investment group bought for $5 million in 1978. The day of the closing, he flipped 160 acres over to the Greater Orlando Aviation Authority for $250,000. Five years later he sold 6,414 acres to a British country club developer for $30 million. He sold the remaining 426 acres in 1985 to a developer for $5.1 million, or

David Carter

TOP:
RTC property in Colorado
Proof of land's risk.
LEFT:
Maury and Daryl Carter
Orlando's land barons.

Ray Ng

more than the original purchase price for the entire site. Total profit: $30.4 million.

Over on the right are 474 acres Carter bought in 1983 for $1.6 million. A year and a half later, he says, he sold the property to William Jovanovich of Harcourt Brace Jovanovich for $4.5 million, for a $2.9 million profit.

What's the secret of success in this tricky business? Carter, 60, has an uncanny knack for buying into the path of growth. That's the key, but it's not easy to find the right lock. If it were easy, the federal bank liquidators wouldn't be trying to unload $16 billion worth of the stuff.

Carter's first deal was in 1963, when he and his brother-in-law scraped together the money to buy 40 acres situated southwest of Orlando for $1,000 an acre. Within a year they made most of their money back by selling citrus from some orange groves that came with the property, as well as from selling fill dirt for the construction of a nearby highway.

Carter—and the rest of Orlando—really hit pay dirt a year later when Walt Disney bought 30,000 acres 3 miles away for Walt Disney World, instantly tripling the value of Carter's property.

Did Carter know Disney was coming? No, but he figured somebody would. "I thought it was a good investment with or without Disney," says Carter, underscoring one of the basic lessons of land investing: Find some other way of getting a return from the land until it can be sold. "We try to get as much income off of a piece of land until it has some higher-priced use."

Carter has often recouped the cost of his investment with citrus, timber, hunting and fishing rights, sod, hay and the fill dirt that is necessary to build roads in Florida, with its high water table. When he digs out the dirt, which fetches 25 cents to 50 cents a cubic yard, he creates little lakes—nice amenities for residential development that boost the value of the land. Using the land for agriculture creates another significant benefit: as much as an 80% exemption from local property taxes.

So, there's a lesson: Speculating in land is not for your passive investor.

Here's another lesson: Don't speculate on borrowed money as you would with developed real estate. Even if you sell some of the dirt, the raw land is unlikely to produce enough cash to service debt; you could go broke waiting for the growth.

Carter pays cash, partly out of necessity, since it is almost impossible to get financing on raw land, and partly for a strategic reason: All-cash deals close more quickly and with fewer contingencies, so sellers are willing to take a lower price. In the 7,000-acre deal on State Road 15, for instance, Carter was competing against a bid that was $2 million higher than his. But the competing buyer wanted the seller to take some of the purchase price in the form of an IOU.

Environmentalists and developers don't generally get along. Carter turns this antagonism to his advantage. He maps out entire residential and commercial developments on the property, spending the $500,000 to $3 million it now costs to secure local and state approvals. But the very difficulty of subdividing makes subdivided property more valuable.

Carter has even made money selling land to the state for parks and nature preserves. The Carters once owned 6,092 acres on the Wekiva River north of Orlando that they were going to use for residential development. The state wanted to preserve the land, today called Seminole State Forest, and paid Carter $21.4 million in 1990 for property that had cost him

Marc Solomon

Ross McClintock, an Equitable investment manager, at California almond orchard
Better than bonds.

$9 million between 1981 and 1986.

Suppose you need an inflation hedge and can afford to tie up some of your money in a very illiquid, long-term asset. Land might be an appropriate holding for a chunk of your investment portfolio. Here are three ways to go about investing.

Method I is to buy parcels purely for their development potential. Do this close to home—where you live or have a second home, know the zoning codes and how they have evolved in recent years, and have some sense of the path of development. In the mid-1970s Carter looked at a map of central Florida and saw that Orlando's southeast quadrant, the location of the airport today, was still underdeveloped compared with the rest of the area. That was the foundation of his subsequent strategy. Orlando's airport has grown faster than any other in the country.

Keep in mind that getting an accurate sense of a fair market value for raw land is very difficult. Land in rural areas changes hands infrequently, meaning comparable sales are hard to come by. The Carters say they've gotten separate appraisals on the same piece of property at the same time that differed by a factor of two.

Should you consider land being offered in a distress sale? Warily. Says Maury Carter, who gets his properties by being plugged into the local real estate grapevine, "We question when a bank has a property for sale. Most of the time there's a problem, because the bank wouldn't have it otherwise."

Method II is to go farther from the cities in search of farmland. It may lie in the path of development ten years out. In the meantime you become a farm landlord. You have to find a tenant farmer—who could be the farmer who sold you the land in a sale-leaseback transaction. But get a large enough parcel that plenty of other farmers in the area would be interested in bidding for the right to work the land. How large a parcel would that be? For a Midwest corn and soybean farm, ideally at least 100 to 160 acres, which will cost you upwards of $150,000.

Before bidding, hire a farm management firm with a local presence as a consultant. Review histories of crop yields on the parcels you are interested in; be aware that two farms across the street from one another could have radically different values per acre, because of differences in soils or irrigation. Once you buy, you'll probably have to hire a farm management firm to negotiate a contract with a tenant farmer and oversee the operation.

What kind of yield can you get buying a crop farm far from urban areas? Averaging good crop years with bad, and allowing for all expenses, you should look for an annual operating profit equal to 4% to 6% of your purchase price, says John Scott, a professor of agricultural economics at the University of Illinois at Urbana-Champaign. That may not sound like much when corporate bonds yield 7.5%. But farmland, over long holding periods, is a darn good inflation hedge—which bonds most certainly are not. Both land rents and land prices have more than held their own in real (inflation-adjusted) terms over most of this century. Bonds are destroyed by inflation.

If you buy closer to developed areas, your cash return will be lower, but your prospects for capital gains that much better.

The third approach in buying land is to hire a professional to do it for you. Equitable Agri-Business, Inc. is one of the many firms that offer participation in portfolios of agricultural land to pension funds and institutional investors. Other firms are Metropolitan Life Insurance Co. and Hertz Real Estate Services in Nevada, Iowa.

Equitable Agri-Business portfolio manager Kenneth Binkley says the company is getting an 8% return on annual crops, plus a 2% to 4% return on the land's appreciation.

The advantages to a professionally managed pool are diversification and somewhat greater liquidity. The disadvantage is cost. The managers typically want a fee of 3% to 6% of acquisition prices during the buying phase, 7% to 10% of the annual cash return (in the case of agricultural pools) and 3% to 10% of the capital gains, if any, on liquidation of the pool. But a managed account may be your only plausible option if you can't devote a lot of time to this portion of your investment portfolio.

So raw land is one of the trickiest of investments. "Contrary to Will Rogers' saying that they aren't making any more of it, the reality is that today we have enough," says Douglas Healy, an executive vice president of Equitable Real Estate Investment Management Inc. But not at all times and all places. For those willing to be more than just casual investors, land remains a great inflation hedge. ■