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Equity Investment with Professional Farm Management: Developing An Alternative Policy to Debt Financing of Agricultural Land

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Farms

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A basic tenet of American farm policy is maintaining a sector of family-size owner-operated farms. This philosophy assumes existence of a means by which operating farmers can obtain title to or long term control of farmland.

Since farmland is owned by individuals, every generation of landowners has to refinance ownership: to buy out competing heirs, to pay inheritance and estate taxes, or to buy land from individuals who are selling. (Freshwater, 1987)

The major focus of this article is to propose an alternative policy to the long standing policy and practice of individual farm ownership as the only means to maintain family operation and control of U. S. farms. This proposal is to establish a Cooperative Farm Land Ownership System (CFLOS) that would supplement, but certainly not replace, individual ownership as it now exists. At the same time, this new institution would provide many opportunities for professional farm managers and rural appraisers to prove the many benefits of professional management and appraisal.

Recognition of Need

Fiske, Batte and Lee point out the weakened financial state of financial intermediaries. They suggest that the development of an efficient equity market for agriculture is the next step in the evolutionary process. Such a market would provide the means for farmers to have greater flexibility in attaining the desired capital structure of their business as well as the desired composition of their personal wealth portfolios. The conditions normally associated with financial stress, increasingly volatile commodity prices, interest rates and credit availability, and declining asset values demonstrate to some farmers that ownership of farmland is financially infeasible and diversifying their wealth portfolios is a desirable objective. (Fiske, Batte, & Lee)

In its 1987 resolutions, the American Farm Bureau Federation stated, "We should develop a plan that would assist in the recapitalization of production agriculture in the United States through an equity investment program using both public and private funds."

The AFBF resolutions also called for "a systematic plan for the sale of all Farmers Home Administration property which is foreclosed." (AFBF, 1987)

Harl proposed an Agricultural Financing Corporation (AFC) in 1986 to provide a mechanism for acquiring the farmland assets given up by farmers who are unable to develop a feasible cash flow/reorganization plan short of asset liquidation. The proposed AFC was to acquire land subject to foreclosure or bankruptcy, from lenders holding land in inventory, or from farmers who are unable to service the real estate debt. (Harl, 1986)

Harl called for a federally chartered corporation, as the basic vehicle with a governing board representative of production agriculture, public and private sector lending and agribusiness firms, and a significant consumer and taxpayer representation.

The AFC would acquire farmland and take over existing secured indebtedness. The land would be rented to farmers with preference to prior owners at a fair rental rate for land of that nature. (Harl, 1986)

Harl intended that the AFC would be a temporary entity to hold land until it could be sold back to the prior owners or to others who could get adequate financing. He proposed direct congressional appropriation to generate the needed financing or industrial development type bonds or a combination of federal state, and possibly local funding and private investor participation.

Harl recognized the problem to acquire private funds as a source of financing because of the difficulty of attracting investor interest and at the same time providing reasonable rental terms to those leasing the assets. The most feasible financing arrangements, he suggested, would be a partnership effort with federal funding and significant state funding, and a limited amount of private sector funds being paid a market rate of interest. (Harl, 1986)

As of March 31, 1987, the Farm Credit System had acquired 8,082 properties totalling 2,770,000 acres and Farmers Home Administration had 5,276 properties totalling 1,577,683 acres. As of December 31, 1986 life insurance companies had acquired 2,731 properties totalling 2,424,000 acres and commercial banks had acquired 1,212,000 acres, making a total acreage of 7,984,183 acres of acquired properties as a result of foreclosures, deeds in lieu of foreclosures, and bankruptcy. Lender policies on the sale of acquired farmland have generated considerable controversy, especially when the sale involves a large tract sold to an "outsider" or "corporate interest." (Agricultural Outlook, September 1987.) These lands could provide the initial land holdings of CFLOS.

Freshwater and Trechter listed government warehousing foreclosed farmland as an option to financing long term farm debt. They suggested that the benefits of a warehouse program would be: to improve the willingness of lenders to make farm loans, help to stabilize farmland values, increase cash flow and solvency of financially strapped lenders since they would not have to carry foreclosed farmland on their books, and a way to reduce surplus agricultural capacity if warehoused farmland was withdrawn from production.

They observed the disadvantages of increased federal costs and increased production costs if rents were raised or if an artificial scarcity of land were created. (Freshwater and Trechter, 1987)

Collins and Bourn pointed out that for external equity to be a significant source of capital for farm businesses, the transaction must be viewed as being beneficial by all parties, the farmer, the investor, and the investment banker or whomever performs the intermediation function. (Collins and Bourn)

Establishing a New Institutional Structure

In the early 1980s, many farm owner-operators faced foreclosure and bankruptcy proceedings. Part of the cause was lending of funds by institutions to purchase land that was overpriced in terms of earning capacity to repay the debt. Farm operators who leased land and who were not buying land purchased during the 1970s have generally had fewer financial problems.

The new institution proposed in this paper to carry out a policy for alternative land ownership and financing would build upon Harl's proposed agricultural financing corporation but would be established as a permanent rather than a temporary institution and after initial start-up capital from public funds and acquired lands from FmHA and FCS, would get its major capital funding from private investment.

This proposed new institution--a Cooperative Farmland Ownership System (CFLOS) would:

1. Maintain the opportunity for individual farm operators with limited capital to continue farming operations and with professional counsel, the management of family type units.

2. Reduce the risks of major farmland purchases with the accompanying debt burdens that have caused financial distress and financial failures such as experienced by some U.S. farm operators in the 1980s.

3. Provide an opportunity for private nonfarm investors to acquire an ownership interest in farmland through purchase of equity shares in smaller amounts than required to buy large tracts of land.

4. Provide farm operators with the opportunity to have some equity ownership in farmland through purchase of equity shares in the CFLOS but without the debt burden associated with the purchase of a whole farm.

5. Provide the Federal government an opportunity (1) to share in stabilizing the farm real estate market, and (2) also to reach the long range goal of disposing of acquired lands from foreclosed Farmers Home Administration loans.

6. Provide the Farm Credit system with the opportunity (1) to dispose of its acquired farm properties at a minimum or no loss by exchanging title to farm land for equity shares in the CFLOS and also be relieved of land management, leasing, and sales operations, or (2) take the lead to develop a sister institution to its lending operations--the proposed CFLOS.

7. Provide professional farm managers and rural appraisers further opportunities to perform valuable professional services to the agricultural industry.

Establishment Procedure

The CFLOS could acquire farmland through (1) trades with Farmer's Home Administration, the Farm Credit System, and private lenders for equity shares, (2) direct purchase from retired farmers and nonfarm owners who wish to be relieved of management of their farm property, and (3) exchange the farmland debt of farm owner-operators for an equity share of their property (if possible) and for a lease that would involve annual rental payments.

To establish a working capital fund, a similar financing procedure used to establish the original federal land banks and production credit associations might be used. The Federal government would provide start up capital and receive bonds in the Cooperative just as they did in the beginning with the Farm Credit system or acquire an equity interest through stock shares. As the CFLOS makes operating profits, it could pay off the bonds or repurchase the equity shares of the federal government so that eventually the system would be owned entirely by private investors.

A major difference between the functions of CFLOS and the Farm Credit System, as it has operated through the years, would be the emphasis on equity ownership and professional management rather than debt financing of farm land. The CFLOS would be involved in professional management of its farm properties, appraisal of property to be purchased, buying property being offered or available for purchase, and selling property that does not fit into the system goals or is not profitable to operate.

Collins and Bourn point out that for external equity to be a significant source of capital for farm businesses, the transaction must be viewed as being beneficial by the farmers, the investor, and the investment bankers or whomever performs the intermediation function.

To attract private equity investment will require a return through dividends and potential for capital gain of equity shares. Classes of stock could be established to provide more return to certain classes of investors, if necessary, to attract the capital to purchase the properties offered.

To achieve earnings to pay stockholders, land would need to be professionally managed so that profits could be made and dividends could be paid to equity shareholders.

Organizational Arrangements

Farm operators who lease land from CFLOS would pay rent either in cash, crop shares, or set amounts of the crop, just as in current farm leasing practices. Professional farm managers would work out leasing arrangements in line with community custom, most efficient operating procedures, and to achieve the goals of farm family operation. Competent tenants on the CFLOS farms should receive long term leases and assurance of security for long term operations.

Business Organization

Since federal funds would be involved in its establishment, the CFLOS would require a Federal charter and initial capitalization, but also authority to operate in many ways as a private land holding and leasing corporation. To the extent possible, capital would be raised through stock offerings just like a private corporation, or through limited partnerships if this would be a more attractive investment package..

The formal type of business organization could be (1) a federally chartered corporation, (2) a partnership with general and limited partners, or (3) a cooperative with ownership by the tenant operators who are also stockholders, the equity stockholders who provide the capital in the form of land or investment funds, and the professional managers who would provide management, appraisal, and financial services as direct employees or under contract.

Collins and Bourn suggested that a diversified pool of limited partnership interests in commercial farms could be held by a common entity that has publicly traded ownership interests. (Collins and Bourn)

Developing a new institution requires time and working experience. Although the system might eventually cover the entire United States, the initial trial for the system might be in certain midwestern or southern states where the volume of acquired properties is substantial and their transfer from Farm Credit System and Farmers Home Administration control would quickly establish a core of properties for beginning operations.

Management and Control

For the proposed CFLOS to succeed will require superior business management and carefully and professionally managed farms. Farm operators would have to accept advice and counsel of professional managers on matters that might be different than their accustomed ways of doing things. Cooperation between the CFLOS managers and the farm operators would be required. In a sense the farm operators would have to share management decisions and controls with the professional managers representing the CFLOS.

So for the reduction in financial risk, the farm operator, whether he has some equity shares in the system or not, will be giving up some freedom of decisionmaking that he once had. Hopefully, the loss of freedom will be small compared with the major gains in freedom from debt burdens and fear of foreclosure faced by some independent owner-operators of the 1980s.

Implications for Farm Operators and the Structure of Agriculture

Under this new institutional arrangement competent young farmers lacking capital to purchase land could lease from the CFLOS just like they would lease from an absentee owner. However, the CFLOS would provide management counsel to reduce risks of failure and sufficient land to make a viable operating unit.

The farm operator with a high debt to asset ratio could reduce his real estate debt by transferring his land debt and equity ownership to the CFLOS, yet continue to operate the farm under a standard leasing arrangement with professional management guidance.

A tenant farm operator who needed additional land to make a viable unit could apply for a lease on additional land to improve his volume of marketings and chances for a profitable farming operation.

A related question concerns the impact of developing a viable farmland equity market on the structure of agriculture. Innovative institutional arrangements will be required to facilitate this development. Without it, Fisk, Batte and Lee suggest that nonfarm equity flowing into agriculture would probably displace existing farm businesses rather than to share ownership with them as suggested under CFLOS. With development of CFLOS, the opportunities for existing farm businesses to remain in farming are probably enhanced.

Benefits for Lenders

Lenders could shed the burden of managing and overseeing acquired properties. A lender could receive a return on its equity interest instead of a drain of losses on property that is not properly operated and managed. Gradually lenders could sell their equity interest as other private funds became available for investment in farmland.

Benefits for Private Investors

Those investors who want to diversify their holdings would have an opportunity to buy equity shares that could provide annual dividends and an opportunity for capital growth if the farm land market recovers from its decline of the early 1980s. They would acquire professional management for their investment that they would not obtain if they purchased a single farm and they tried to manage it themselves.

If a market were established for the shares in the CFLOS, the equity investor would also have a liquid investment that could be sold more readily than a tract of land.

Summary and Conclusions

The foreclosures and bankruptcies suffered by farmers in the 1980s indicates some alternative policy is needed for financing farmland and handling lenders' acquired properties.

The proposed Cooperative Farm Land Ownership System (CFLOS) suggests an institutional model for initial federal funding for establishment, with eventual ownership by the investors, patrons and managers of the System.

Private investors who want to diversify their investments could find shares of farmland an attractive way to diversity and returns could justify their investment.

Professional farm managers and rural appraisers are available to provide management and appraisal services to establish a Cooperative Farm Land Ownership System and train future managers for the proposed system. If sufficient start-up capital could be brought together, a professional manager with business management know-how might be able to develop a cooperative land-holding corporation without government help.

The CFLOS would most likely start up with the primary objective to take over ownership of acquired properties from lenders who want to dispose of them and from farm owner-operators who want to relieve their debt burdens by transferring their land debt but remaining as the tenant on that land. As investment funds were available, direct purchases of desirable properties could take place.

Establishing CFLOS would not avoid capital losses due to the decline in land values. Such losses would fall upon the lenders who acquired the properties and upon farm operators who were foreclosed. But the establishment of CFLOS would hopefully prevent substantial losses by farm operators and lenders in the future and maintain a system of family operated farming units.

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