What's Keeping Farmland Values So Strong?

by:

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Wherever I go, the question people ask me most often is: What's keeping farmland prices so strong?

That was the question which USDA economists asked me to answer recently in a speech at the Ag Outlook Forum in Washington, D.C. More than 1,400 analysts, lenders, economists, editors and others from across the country attended this annual conference.

Lenders were especially interested, because farmland is the foundation of assets in farmers' portfolios. Nobody wants to see a replay of the 60 percent decline in farmland values we endured in the early 1980s.

Today's land market is far different from the highly leveraged land boom that tumbled 20 years ago.

1. Government programs shore up farmers' ability to hang onto land — and sometimes buy more.

2. Nonfarm land-buying dollars are becoming almost half the market.

3. Expanding farmers are competing aggressively to rent and buy land.

Those three forces of land demand funnel into a market that has slim annual commercial turnover of only $15 billion to $20 billion per year.

In 1987, a unique study by USDA Economist Gene Wunderlich

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found that an average farm or ranch changes owners once a generation — about 22 years. In more than 60 percent of the farmland title changes, the new owner is an heir or relative. This means six out of 10 farms change hands within the family and never test the open market.

Wunderlich's survey found that in 1987, 2 percent of privately owned U.S. farm real estate changed hands within families, via estate transfers and sales to children or other relatives. Less than 1.5 percent was sold in arm's-length commercial transactions.

New Census data for 1999 confirms that the slow land turnover rate persists. In 1999, farmers disposed of $15.75 billion worth of farmland. That's about 1.9 percent of total U.S. farm real estate value for that year. And 44 percent of the dollars received by sellers came from land sold for nonfarm uses of all kinds, from urban development to wildlife preserves.

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The Census data indicates that in 1999, farmers and nonfarm investors spent about $8.8 billion for farmland intended to remain in farming and ranching. If farmers are generating 60 percent of that amount and investors the rest, it means that farmers are putting only about $5.25 billion into land intended for farming use. About half the purchase price is borrowed. Farmers simply aren't using leverage to buy land as they often did in the late 1970s — which got them into cash-flow trouble in the 1980s.

Bottom line: Farmers need to find only about $2.6 billion per year of cash equity to support "their share" of land-buying demand. Put that amount into perspective against federal farm programs, which feed $15 billion to $25 billion into the farm economy each year. That much cash can have a lot of potential impact on annual land turnover.

Certainly the farmland market has anticipated action on a farm bill this year — and that fhas finally become a reality.

Farmers' cash needs for land investment look even tinier compared to receipts from sales of all farm commodities — about $204 billion in 2002.

Let's look closely at the three categories of demand supporting farmland values: government programs, nonfarm demand for land, and farmers' expansion buying.

Commodity and Conservation Programs Underwrite Farmland Values

A special Economic Research Service study headed by Charles Barnard estimates that federal farm program payments "have added nearly $62 billion to U.S. farmland values" the past several years.

Barnard and his colleagues point out that in calendar year 2000, direct government payments to agriculture made up almost 40 percent of U.S. net cash farm income. Of the $23 billion in payments that year, 92 cents of every dollar was commodity-related under the 1996 Farm Act or supplemental disaster and emergency payments. The other 8 cents came from the Conservation Reserve Program and other conservation incentives.

In the Corn Belt, the eight main program crops are raised on land with a total market value of $167.3 billion. This land's value is about 24 percent higher than it would be without the enhancing effect of government payments, estimate ERS analysts. In effect, the programs have underwritten $40.2 billion of assets on Midwest farmers' balance sheets.

In the Plains, 22 percent to 23 percent of current land value rests on program payments. Without these programs, about $12 billion would drop from land values in the Plains.

Tenant farmers see land costs rise as program payments stimulate rental competition. As one Midwest farmer puts it, "Cash rents keep rising until it takes a good crop to just break even. Any operating profit has to come out of the government payment."

Nationally, about 62 percent of the cropland in the major program crops is owned by non-operating landowners. Owner-operators own just 38 percent of the cropland in these program crops. Thus non-operating landowners get most of the benefit from programs that enhance the balance-sheet value of farmland raising those crops.

Uncle Sam is already America's largest farm cash-rent tenant, paying an average of $46.75 per acre in 2002 on 33.7 million acres under 560,249 CRP contracts. That's a cash flow of $1.576 billion annually on cropland that has, by definition, marginal productive value. Most of this cash rent flows to landowners, not tenants. The House and Senate bills both expand the Conservation Reserve Program cap to about 40 million acres, potentially pumping out another $300 million annually in CRP rentals.

If a year's CRP rental income was all spent as a 50 percent down payment to buy farmland, the nearly $3.2 billion in rental payments and borrowing would absorb roughly 20 percent of U.S. farm and ranch land offered on the commercial market in a year.

> ***U.S. landowners sold 787,000 acres for nonfarm use in 1999 for an average price of $8,826 per acre. That's more than four times the price of land sold for farm use — $2,059 per acre.***

Capital Gain Tax Rules Encourage Re-investing Land Profit Back Into Land

In DeKalb County, Ill., three-fourths of our farmland sales are to Section 1031 tax-deferred exchange buyers. These farmers are replacing highly appreciated farmland sold to developers or to public entities which are trying to preserve land against development.

Landowners have a huge incentive to defer taxes with a like-kind exchange, which stimulates the land market twice: Once when developers or preservationists bid for highly appreciated land in collar counties, and a second time when the owner bids up replacement land farther away from the path of urban growth.

The benefit of like-kind exchanges, plus the increasing use of farm listings on the Internet, is broadening the farmland market from a neighborhood to a national marketplace.

Data just released from the 1999 special Census of Agriculture indicates that rural U.S. landowners sold 787,000 acres for nonfarm use in 1999 for an average price of $8,826 per acre. That's more than four times the price of land sold for farm use — $2,059 per acre. From our firsthand observation of the land market, we assume that at least 70 percent of the nearly $7 billion received in transfers of land for nonfarm use would have been rolled into other land via tax-deferred exchanges. That $4.9 billion of cash would absorb 55 percent of the land which Census data indicates was "disposed of for farm and ranch use" in 1999.

Leveraged with an equal amount of borrowed cash, exchange money would provide all of the purchasing power needed to absorb the $8.8 billion land which the Census says was disposed of for farming use in 1999.

Farm and Ranch Land "Preservation" Pumps Billions into Farmland Across the Country

In some public efforts to preserve the scenescape, whole farms are being bought and the farmsteads razed to restore a pristine, natural look.

Kane County lies between our home DeKalb County and Chicago. The Kane County Forest Preserve District is paying up to $16,000 per acre for farmland. The Preserve converts this farmland to timber and trails. Kane County passed a $70 million referendum in 1999 to fund this preservation and scenic effort.

This is typical of hundreds of local and state ballot initiatives. Urbanites are buying up billions of dollars' worth of farmland outright.

They're also spending billions for conservation easements. My son-in-law, Glen Chown, is executive director of the Grand Traverse County (Michigan) Regional Land Conservancy, which is paying an average of $4,000 per acre to acquire development rights on land in his rapidly developing area.

The Conservancy has spent about $20 million for easements on 5,000 acres. The money comes about equally from local initiatives, state and government funds, and private foundations. The value of local land for farming is about $2,500 per acre.

What do you suppose a farmer does when he transfers a development easement for $4,000 an acre? He probably looks for a like-kind exchange into more farmland.

Two associations of such preservationist groups (The Land Trust Alliance and the Trust for Public Land) report:

— Since 1998, Americans have passed 529 local and state ballot initiatives, voting to tax themselves $20 billion to preserve rural space.

— In 2001, local voters passed 137 ballot measures raising $1.7 billion to buy land and easements for parks, greenways and other "viewscapes." A year earlier in the 2000 presidential election, nearly 300 local and state ballot initiatives voted more than $8 billion for acquisition of land and development rights.

America's largest land preservation organization, The Nature Conservancy (TNC), has put more than 12.6 million acres into 1,400 preserves. In addition to the $1.3 billion worth of land currently owned by TNC, it has purchased and resold much more land in cooperation with government acquisitions.

The Nature Conservancy has raised $885 million of a planned $1 billion "Campaign for Conservation." This is the largest private land preservation campaign ever undertaken.

Meanwhile, groups like Ducks Unlimited and Pheasants Forever continue their legacies of converting farmland to habitat. Ducks Unlimited (DU) has protected 160,000 acres with conservation easements — most of it farm and ranch land. In its 65 years, DU has raised $1.5 billion for wetlands restoration and conversion of farmland to waterfowl habitat.

Pheasants Forever has spent more than $10 million to buy 65,000 acres for 600 permanent habitat sites.

Land purchased by these groups typically drops out of the land market — permanently.

When the preservation groups or government agencies buy conservation easements, this restricts the supply of local development land. It diverts buying power toward the smaller supply of neighboring land still available for development.

Lawmakers have been quick to see that land "preservation" is politically popular. The Senate's latest version of the Conservation and Reinvestment Act, (CARA) S. 990, would pump $3 billion into land acquisition for "conservation" over five years. An even larger CARA bill in the U.S. House would authorize about $1 billion every year to buy land and conservation easements. An ERS study (AER-803) estimates Americans would be "willing to pay $1.4 billion to $26.6 billion per year to conserve rural lands."

Available data indicates that land trusts and other preservationist groups are already injecting at least $2 billion per year into the U.S. marketplace for rural land. What if the preservation buyers push their spending just a little further toward that $26.6 billion level which ERS sees as a real potential?

The Federal Reserve Bank's Low-interest Policy Also Helps Stabilize Today's Farmland Market

During the current U.S. debt-liquidation cycle, the Fed is nursing an economic recovery with its easiest monetary policy in 40 years. Cheap financing has helped keep housing starts rolling. The resulting demand for development land generates cash for exchanges into replacement farmland. Also, easier money makes farmland cheaper to finance.

Nonfarm Buyers Want Land for Urban Uses and I)nvestment

In the eastern Corn Belt — which can be considered one huge suburb — sellers often carve up an 80-acre farm into eight or nine "farmettes" to attract a wide array of residential and recreational buyers.

In such sales, land for an acreage or hunting site frequently brings more per acre than cropland. Hunters are paying $1,500 to $2,000 per acre for 50 percent-wooded rolling farms in northwest Illinois.

We are advertising some of our farm listings in hunting publications! Buying country land for hunting and hideaways reaches into the most rural areas.

Farmland Rental Offers Safety and Earnings Which Compare Favorably to Stocks and Debt Paper

In fact, farmland looks relatively safe compared to traditional paper alternatives like common stock — a point that our corporate newsletter, *Seasons*, made two years ago this spring, before the NASDAQ index lost two-thirds of its value.

I'm estimating that nonfarm investors — those buying farmland with intentions of renting it out or custom farming it — bring as much as $2 billion to the farmland market each year.

Farmers Compete Aggressively for Cash Rental and Add-on Acres

Today's crop technology enables one operator to handle such large acreages that there's no early end in sight to farm consolidation.

The bigger, more aggressive producers compete first with aggressive cash rents, typically using their AMTA payment to underwrite the rent. A higher rent in turn "justifies" a higher land price in the eyes of the owner. This trend of greater farm operating efficiency and cash-rent competition is helping underwrite stable to strong farmland values.

National data and our own observations indicate that landowners are willing to own quality farm and ranch land for a lower rate of return than they accepted 20 or 30 years ago. In short, they'll pay more per acre for a dollar of prospective net income.

On prime Illinois land, our appraisers often use a "capitalization rate" of 3 percent to 4 percent to help determine market value. If you apply a capitalization rate of 3.5 percent and $130 net cash rent after property taxes, this would point to a market price of $3,714 per acre.

That's close to actual market for prime northeast Illinois farmland in early 2002.

Actually, we hardly ever have a farmland buyer bring up the subject of "rate of return" on land. Americans are shifting toward the European philosophy of land ownership: The main objective is not current cash return, but preserving real long-term security for the family through future generations.

As farmers bid for expansion acres, they'll defend their turf by bidding hard against the incoming developers, preservationists and nonfarm investors who just want to own a piece of land.

Our challenge now at Martin, Goodrich & Associates: Satisfying all of the potential farmland buyers! jal