Land Facts

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The Loranda Group, Inc. is a diversified agricultural services firm headquartered in Springfield, Illinois. The company offers personalized, professional services in agricultural real estate brokerage, auctions, acquisitions, and consulting. Land Facts *is published periodically. We welcome your comments and questions, or give us a call if you would like to discuss the farmland market in your particular area.*

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Market Outlook

The Midwestern Land Market – Is the Price Correction Over?

By John D. Moss

Less than six months ago, little optimism existed in Midwestern agriculture. Commodity prices were at their lowest levels in nearly 20 years. Newspapers, farm magazines, and market watchers alike were predicting a collapse in both farm profitability and the land market. Several land sales late in 1999 did result in weaker than expected prices. But since the first of the year, the attitude in the countryside has improved dramatically, as have selling prices. Will this enthusiasm be short lived, or is the downtrend in land prices over?

To answer this question, we need to consider how some of the fundamentals have changed recently. First and foremost, we have seen an increase in commodity prices. While corn and soybean prices are still not ideal, they are substantially above where they were last summer and fall. Higher prices not only improve current profitability, but they also generate the expectation of enhanced future profitability. This provides land buyers with confidence that projected earnings will support the prices they are currently paying for land.

Secondly, even though commodity prices were low last fall, most farmers had higher net income in 1999 than anticipated. Admittedly, a large share of the revenue came from government sources, but this money still paid the bills. While farmers and landowners may not

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expect to receive large payments from the government in the future, it is safe to assume that adequate aid will be forthcoming this year if it is needed — the presidential election this year will help to ensure this. A majority of farmers today are much better off financially than they expected, thus allowing some of them to make major land and equipment purchases.

Thirdly, investors have continued to be active buyers in the farmland marketplace. They include individuals completing tax deferred exchanges, and those who have made money through non-agricultural employment or investments. Several investors we work with have purchased farms recently after exercising stock options or selling a business.

Finally, and perhaps most importantly, a limited number of farms were offered for sale this past fall and winter. In other words, demand continues to exceed supply and there remains a shortage of quality farms for sale. While the demand for land decreased somewhat as commodity prices tumbled, the lack of supply more than offset any reduction in buyer numbers in many areas.

Although the sale prices of most quality farms in the last 3 months have been higher than expected, prices for land with below average soils remain weak. This does, however, depend somewhat on the area. It reinforces the old adage that high quality farms are always in demand, but interest in less

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attractive farms will suffer in times of uncertainty. Below average properties, in terms of soil quality, suffer from increased production uncertainty. Farms that have not been well maintained or are more difficult to farm (e.g., cut by waterways, irregularly shaped, or below average access) have also lagged somewhat in price. These properties are more difficult to farm and often require a greater level of management. With today's large equipment, tracts that require multiple turns and point rows can severely limit the production and equipment efficiency of these operations. Farmers often pay a premium for large rectangular fields while discounting smaller, less efficient tracts. This applies in both the sales and leasing market.

Land for hunting and recreational uses has continued to be in great demand. Particularly at public auction, we have seen this property type sell for a higher per acre price than the tillable land that was adjacent to it. Most of the buyers reside in urban areas, and have enough investment capital to support a purchase of 40, 80 or even more acres. In a typical week, our office will receive several calls from sportsmen looking for land to acquire within a reasonable driving distance. This has forced the price of recreational land near many metropolitan areas much higher than prices for more remote locations.

In which direction will land values move over the next twelve months? If the supply of available farms remains modest, values will continue to be steady to slightly higher. In most neighborhoods, there are several established farmers with the cash to purchase land as it becomes available. These farmers, along with the occasional investor purchaser, will continue to bid aggressively for the best quality farms. The possibility of a drought this summer, in theory, should reduce the amount of income that farmers have to spend on land purchases. But meteorologists have been commenting on the dry weather and soil moisture conditions for months, providing farmers with the opportunity to purchase insurance to protect against the risk of a crop failure. Though it's difficult to consider a drought a positive experience, it would certainly raise commodity prices and may not be as devastating to farm income as the unexpected dry weather problems of the past.

In summary, the short term prognosis for the land market appears favorable. Despite the possibility of reduced yields this year, I believe that there will be enough income generated the next two to three years to keep farmland values moving higher. ▪

Does a FARM LEASE INFLUENCE Selling Price?

By LeeAnn E. Moss

A lease transfers the rights of possession and use of the property for a specified time to the tenant.

The market value of a farm is influenced by a variety of factors including location, productivity, access, visual appeal, and drainage. Sellers readily understand the importance of these characteristics in establishing an offering price or understanding the relative selling price of their real estate. However, property rights have an important influence on value that can sometimes be overlooked. In counseling sellers, the leasing status of the farm is one of the issues we address. Is it currently leased? Are the lease terms representative of the market? Can the seller provide evidence of a legally appropriate written termination of the lease? In short, a farm encumbered by a lease typically does not have the same market value as one that's not.

To understand how or why a lease can influence market value, we first must understand property rights. Landowners actually own "real property." Real property includes not only the real estate itself (i.e., the physical land) but all of the benefits, interests, and rights that are inherent in its ownership. Real property ownership includes a "bundle of rights." Fee simple owners possess all of the property rights. If this bundle is conveyed or divided in any way, it can influence value and a lease is a common example of this. A lease divides the bundle of rights, in that it transfers the rights of possession and use of the property for a specified time to the tenant. The landowner no longer has a "fee simple" estate. He or she has a "leased fee" estate, and the property is encumbered by the lease. Though this does not prevent the transfer of title between a seller and buyer, the rights to use and occupy the property have been conveyed to the tenant. As such, this limits the use of the property and can reduce its value.

To understand how and why a lease can influence value, let's think like a potential buyer. Generally, farmland buyers can be divided into two groups — farmers and investors. An investor purchaser needs a farm tenant, so one may conclude that an existing lease should not be an issue. However, they may have other tracts in their investment portfolio and as such already have a working relationship with another farmer whom they trust and prefer. The existence of a lease is therefore a detriment. Additionally, the

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type of lease in place can also limit this investor's interest. An existing cropshare lease is of little interest if the investor prefers a cash lease. Even if the lease type is consistent with the investor's preferences, the lease terms may not be. If they are not consistent with typical market terms (e.g., the "contract rent" is less than "market rent"), the investor's interest still may be limited. Examples include a below-market cash rent, or atypical terms in a cropshare lease (e.g., the landowner pays combining expenses).

A farmer who wants to buy land also discounts a leased property. He prefers to farm the property himself, instead of acting as a landlord. The price discount is directly related to how soon they can have full possession and use of the property. For example, a leased farm sold in September of the lease year will be discounted less than a leased farm sold in January of the lease year.

So how much does a lease discount the value of the property? Again, it depends directly on the type and terms of the lease in place at the time of sale. Let's first consider an extreme case. Several years ago, our company sold a property for an owner who had just signed a 20-year cropshare lease with his tenant. The atypical duration of the lease eliminated interest from farmer-buyers and severely restricted the enthusiasm of most investor purchasers. It took nearly two years to locate a willing buyer, in a market where typical marketing/exposure times were 30 to 60 days. Moreover, the selling price was approximately 30% less per acre than sales of fee simple interests in similar farms. Now, consider an example from the opposite end of the spectrum of possibilities — a property that sells in the summer with a lease that expires after the crops are harvested. In this case, the discount to selling price may be slight or even negligible, if (i) the seller is willing to include the landlord's share of the crops with the sale, or (ii) the seller is willing to delay closing until fall, when the buyer gains full possession. In general, a farm encumbered by a one year lease will sell for from $100 to $300 dollars per acre less than a similar but unencumbered property, depending of course on factors such as lease terms or the time of sale in the lease year.

If you are thinking about a long term lease for your farm, consider including a provision that allows the lease to terminate in the event of a sale.

If you are thinking about a long term lease for your farm, consider including a provision that allows the lease to terminate in the event of a sale. This will protect you in case you need to sell, yet still give your tenant the security you wish to provide. Also, if you have any thoughts of selling your farm after the crops are harvested, go ahead and terminate your present tenant in writing as required by state law. If you decide to sell, you will not be forced to do so subject to the tenant's leasehold interest. If you decide not to sell, you can simply enter into a new lease arrangement before spring.

This discussion is not to discourage landowners from signing long term leases with your farm operators, but simply to point out the potential financial consequences of doing so if the sale or conveyance of the farm is a possibility. And in general, be sure to consider all possible consequences of conveying any property rights (e.g., minerals, hunting leases, easements) before you do so. They can significantly affect the market value of your asset. ■

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