Land Facts

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In this edition...

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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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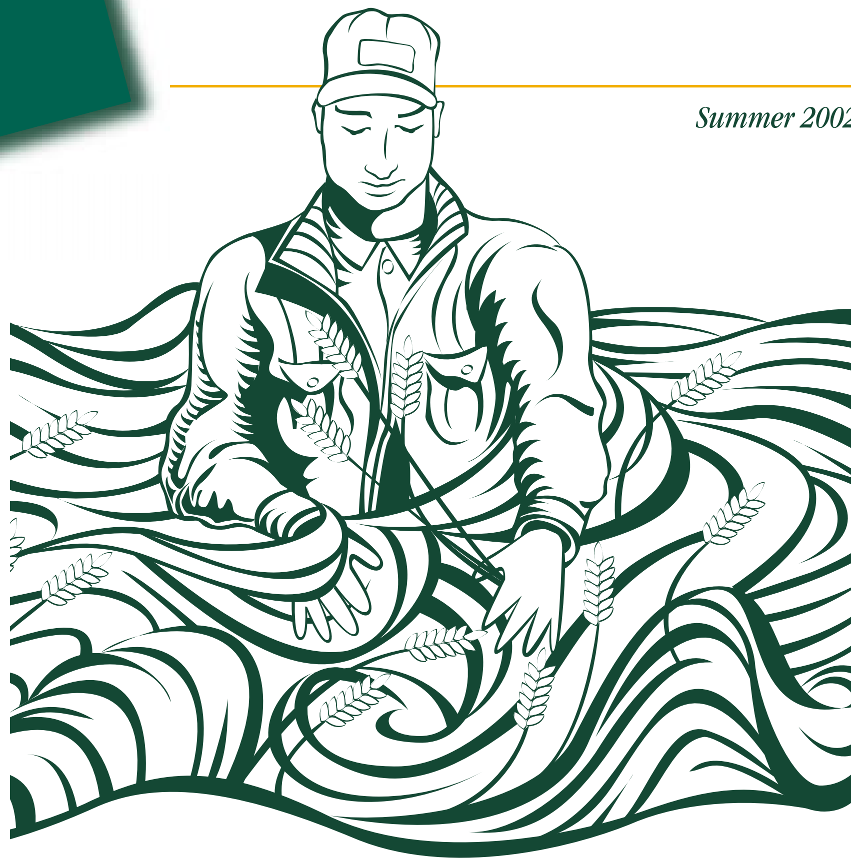

Agriculture and Land Values – Where to Now?

by John D. Moss, President

I received a letter recently from an absentee landowner (a potential client) wanting to know whether 2002 would be a good time to sell his family farm. In addition to the typical "what's my farm worth" query, he had *50* other questions that he wanted answered. He needed this information in order to feel confident that he was making the right decision. My reactions to his letter ranged from shock (how long will it take me to respond to his inquiries) to respect (he genuinely seemed interested in knowing as much as possible about the farmland market). One of his foremost questions was "Please discuss the most important factor that will influence agriculture in general, and farmland prices specifically, in the next three years." This seems like a very open-ended question, and one that can be answered several different ways. However, I believe that one recent event wins

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easily as "most important" – the passage of the "Farm Security and Rural Investment Act of 2002."

Already the facts regarding the new farm bill have been widely discussed in the media. It's been alternatively described as "the best assistance for farmers in years" (by commodity groups and the agricultural media) to "the biggest piece of pork barrel politics since Roosevelt" (by *The Wall Street Journal, Business Week*, etc.). For those who want more specific information about the new law, I would suggest visiting the website for the Farm Service Agency: www.fsa.usda.gov/pas/farmbill/. Whether you agree or disagree with the individual provisions of the bill (or perhaps the bill in its entirety) is irrelevant—it has been passed and signed. Thus, it is time to look down the road and see what effects or fallout we can expect from this new agricultural policy. Following are a few of the things that I can see in my crystal ball:

1. **Farms will get bigger.** Without any real payment limitations in place, average farm size will continue to grow. This isn't necessarily bad – some of the best managed operations I've seen are tilling thousands of acres. They have the ability to better utilize their equipment and receive bigger volume discounts for their input purchases. But as farm sizes increase, my next point is also true.

2. **More farmers will go out of business.** Perhaps this is inevitable anyway. Even with support payments from the government, it will be difficult for the small and mid-sized farmer to compete. Farming today is still primarily a volume business. The per acre profit margin is now so small that a small land base can spell economic catastrophe – or an off-farm job. And a quick method of expansion that is utilized by many larger operations – paying higher cash rents – is simply not available to or viable for many smaller-scale farmers.

3. **Cash rents will increase.** Aggressive bidding for cash rented land is typically the fastest way for a farm operation to increase in size. With larger farm sizes come the economies of scale that often spell profit. And despite the beliefs of many in agriculture, landlords don't drive cash rents, farmers do. As long as there are so many farm operators who want or need to expand, the demand for rented land and the accompanying cash rents being paid will move higher. Cash rent leases are here to stay. It's not a question of "what is fair." Rather, it's a question of "what it is."

4. **Land values will remain firm and probably move higher.** In itself, the new farm bill cannot take sole credit for potentially higher land prices. Other factors such as interest rates, tax laws pertaining to capital gains, and returns on alternative investments have some affect. But the new act provides a price support system that will allow many farmers to bid as aggressively for land to buy as they do on land to rent. Landowners will have the benefit of increased rents and improved returns. This may encourage them to buy more land, especially with the current volatility and sporadic returns of alternative investments.

5. **Public support for the American farmer will erode.** Whether you want to admit it or not, the public image of farmers took a severe beating with the passing of the 2002 Farm Act. Negative sentiment appeared not only in the national press – "too much money for too few people," but internationally as well – "the Americans say they want a level trading field but their new policies show otherwise." After scathing articles in major newspapers, on television, and on radio, the average citizen is starting to question the need for subsidizing farmers to produce commodities that are already in surplus. The idealistic view that many people had of the typical farmer is being replaced by images of large corporations and professional athletes cashing their farm program payment checks. In the short term, farmers may benefit financially from the new legislation. But in the future, I wouldn't count on the 98% of the American population not involved in production agriculture to be nearly as generous.

Fortunately for the landowner who wrote to me, my answers to his remaining 49 questions were not as verbose. So is now a good time to sell land? I think the question should still be answered on an individual basis. Some sellers truly need the money. Others are comfortable with the 3 to 6% return that land is now generating. As mentioned previously, I believe that land prices will remain firm or move higher. But I also recommend that all landowners analyze their investment on a regular basis to see where farmland fits in their overall portfolio. An accurate analysis (see the accompanying article by Doug Hensley) will give you the confidence you need to insure that farmland is the right investment for you.

The Real Value of Farmland

by Douglas L. Hensley

Farmland values, and their accompanying returns, can be some of the most misunderstood and miscalculated figures in agriculture. As a broker selling farm real estate on a daily basis, I often get the opportunity to discuss farmland value topics with clients, customers, and sometimes, coffee shop connoisseurs. Everyone has opinions about farmland values and rents (including where they are and where they should be), and with many people I will agree. But I also hear a lot of mis-information, mis-interpretation of market signals, and rumors subsequently made fact by their author. All of these things motivated me to discuss my perspective on what history has taught us and how that translates to current day in the expression of accurate financial returns.

The History of Farmland Values

Earlier this year, Iowa State University Extension economist Mike Duffy authored an article that highlighted some remarkable facts about the history of farmland investing. He did so using a benchmark against the Dow Jones Industrial Average. One of the most striking things that Dr. Duffy illustrated was that *timing* could be considered the ultimate key to a successful or unsuccessful investment, in farmland or equities. In his article, Dr. Duffy calculated the returns on $1,000 invested in Iowa farmland versus $1,000 invested in the DJIA during different points in time, figuring rent/dividend income and capital appreciation to compare returns for the two investment vehicles. All returns (losses) were assumed to be reinvested in the land or stock market, respectively. The following is summary of his study:

- **1950 Investment:** $1,000 would have purchased 4.6 acres of Iowa farmland or 4.3 shares of the DJIA. At the end of 2001, the value of the land bought with that $1,000 would be worth $239,111 versus a DJIA value of $286,970. *Stocks beat farmland by ~20%.*
- **1970 Investment:** $1,000 would have purchased 2.4 acres of Iowa farmland or 1.2 shares in the DJIA. At the end of 2001, the value of the land would be $37,880 versus a DJIA value of $36,880. *Farmland beat stocks by ~3%.*
- **1980 Investment:** $1,000 would have purchased ½ acre of Iowa farmland or 1 share of the DJIA. At the end of 2001, the value of the land would be $4,597 versus a DJIA value of $20,134. *Stocks beat farmland by ~340%.*
- **1990 Investment:** $1,000 would have purchased .8 acres of Iowa farmland or .4 shares of the DJIA. At the end of 2001, the value of the land would be $3,574 versus a DJIA value of $4,889. *Stocks beat farmland by ~37%.*
- **2000 Investment:** $1,000 would have purchased just over ½ acre of Iowa farmland or just under .1 shares of the DJIA. At the end of 2001, the value of the land would be worth $1,155 versus a DJIA value of $895. *Farmland beat stocks by ~30%.*

As Professor Duffy's research reflects, farmland can outperform the equity markets, depending on many things including when the investment is made. His study, in my mind, crystallizes the need for a balanced portfolio, especially since you don't know whether now, or 10 years from now, is the time to invest. This balanced portfolio idea was conveniently overlooked by most investors in the late 1990's. Dr. Duffy's experiment clearly shows how timing can affect the performance of an Iowa farmland investment, and I believe that roughly the same results would occur across the Midwest.

Calculating Accurate Returns

As Dr. Duffy clearly showed, history has taught us a great deal about the importance of timing. But how does history and timing impact current conditions? Most noticeably, history and timing will establish the tax basis and present day rates of return for an asset. However, history does not tell the whole story as it relates to current return analysis. Point in case—during a recent sales meeting, I was discussing farmland returns with a prospective client. Our conversation focused on the returns that he was receiving from all his investments, including his stocks, bonds, and farm real estate assets. My prospective client informed me that he had been making more than 10% on his farmland asset. Having researched the farm, I knew the approximate value of his land…and a 10% return suggested a rent level in the $250 per

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acre range. In discussing the topic a bit more, he told me that he calculated his returns based on what he had *paid* for the farm, not what it might be worth today! After informing him that returns should be figured using current market values, he looked rather sheepish. And rightfully so! He could not believe that the reality of his farm investment was only a 3.5% net return, and his delight with the asset quickly turned to disappointment.

This meeting brought a topic to light for me…many farmland owners do not accurately calculate the returns on their ownership. Not that today's returns are any indication of future benefits. But having an accurate measurement for comparing all your investments can provide a confidence that your overall portfolio contains the asset mix, and returns, that meet your investment objectives.

To accurately calculate returns, we must include both current income and current market values into the equation. The following example might help clarify the correct way to calculate accurate returns, and the underlying variation that will occur based on current market conditions:

- **Return in 1990 to farmland investment made in 1990 on an 80-acre farm (taxes included):**
  - $130 cash-rent on 80 acres = $10,400 rent income
  - $15 per acre taxes = $1,200 taxes
  - $1,800 market value in 1990 = $144,000 total market value
  - (Rent Income-Taxes) / Market Value = Net Return
  - $9,200 / $144,000 = **6.39%** After-Tax Return

- **Return in 2002 to farmland investment made in 1990 on same 80-acre farm (taxes included):**
  - $175 cash-rent on 80 acres = $14,000 rent income
  - $28 per acre taxes = $2,240 taxes
  - $3,400 market value in 2002 = $272,000 total market value
  - (Rent Income-Taxes) / Market Value = Net Return
  - $11,760 / $272,000 = **4.32%** After-Tax Return

As this example reflects, when you purchased your property, and what you purchased it for, can have dramatic impacts upon returns! In this case, the difference in returns is substantial! And while this example is for illustrative purposes only, the figures used in the example are not out of line for the respective time periods.

Now, let's re-create the scenario that I ran into during my meeting…inaccurate return calculations. I will use the same scenario as above, but will use the original purchase price for figuring current day returns as he did:

- **Return in 2002 to farmland investment made in 1990 on an 80-acre farm (taxes included):**
  - $175 cash-rent on 80 acres = $14,000 rent income
  - $28 per acre taxes = $2,240 taxes
  - $3,400 market value in 2002 = $272,000 total market value
  - (Rent Income-Taxes) / Value = Net Return
  - $11,760 / $272,000 = **4.32%** After-Tax Return

- **Return in 2002 to farmland investment made in 1990 for same 80-acre farm using original purchase price (taxes included)**
  - $175 cash-rent on 80 acres = $14,000 rent income
  - $28 per acre taxes = $2,240 taxes
  - $1,800 purchase price = $144,000 total market value
  - (Rent Income-Taxes) / Market Value = Net Return
  - $11,760 / $144,000 = **8.17%** After-Tax Return

What a difference accurate figures make! As you can see, the difference between the correct calculation (4.32% after-tax return) and the incorrect calculation (8.17% after-tax return) is significant. Let me point out that my analysis included calculating only the *current* return to your farmland investment. When including the capital appreciation/depreciation of your farm over time, the *total* return to your investment may be different. While the merits of using either calculation can be debated, I have found that most investors analyze the returns of their non-farm investments on an annual basis. My analysis simply assists in comparing different assets in the same manner. And incorrect figures do little for helping you improve your financial standing in the long run.

Bottom line to farmland owners—be sure that you are using up-to-date and realistic figures to calculate your current returns. With inaccurate figures, many people are deceiving themselves about the true returns of their asset. But by staying informed and being realistic, you can be accurate and profitable over the long-term—and you just might be able to outperform the equity markets!