Land Facts

THE LORANDA GROUP, INC.

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In this edition...

What's Your Farmland Investment Strategy?

by John D. Moss, President

When analyzing the current trends in Midwestern agriculture, I continue to be amazed with the number of people who want to purchase farmland. Every week I talk with at least two new investors who are aggressively looking for land to buy. And based upon the bidding activity and ultimate selling prices observed at some recent auctions I've attended, farmers also appear to have the same appetite for property. Do these buyers have a defined long-term investment strategy that includes owning agricultural real estate, or are they simply buying land because it appears to be the "investment du jour?"

Over the years, I have learned that land buyers have distinctly different motivations for investing. Farmers typically make purchases based upon their current financial situation and the availability of land in their immediate area. They don't necessarily have a defined plan regarding how much land they would like to own and haven't considered whether owning land is more profitable than leasing as an

continued on page 2

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What's Your Farmland Investment Strategy? continued from page 1

alternate method of controlling the farmland resource. It's more a case of "I have the money (or I can get the financing), a nearby property is for sale, therefore I'm going to buy it." It's a strategy that has worked well for some, and unfortunately, has bankrupted others. In contrast, the driving forces for investors can be: (i) tax avoidance, in the case of the 1031 tax deferred exchange buyer; (ii) a quest for more favorable and more stable returns (defined as anything greater than what the stock market or bank CDs are generating); or (iii) emotion—recalling the good old days spent on one's grandparent's farm.

I rarely question a farmland buyer's motivation, since there are many compelling and personal reasons to purchase. However, I do feel that some cautions or reminders are warranted:

Reminder # 1 ▪ Farmland is a long-term investment. If you're simply making a purchase to capture higher annual returns than what other investments are presently offering, remember that not long ago CD's were paying 6% and the stock market was generating long-term annual returns of over 12%. And I believe that we will see these levels of returns again within the next few years.

Reminder # 2 ▪ Farmland is not the most liquid investment you can make. If you own stocks, bonds, or CDs, normally you can sell the investment and have your capital within 24 hours. However, selling a farmland asset may take a minimum of 30 days (and often much longer than that) and can involve significant transactions costs (e.g., broker's commission, title insurance, survey costs, attorney's fees, etc.). Quick sales are certainly possible, though they often require a discounted purchase price.

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Reminder # 3 ▪ For farmers, the returns to owning land are often less than the returns to renting it. Unless you have unlimited access to capital, a land purchase can be counterproductive to your business goal of expanding your operation, i.e., buying a farm may prevent you from purchasing needed equipment or renting additional acreage in the future.

Reminder # 4 ▪ The value of your land can decrease as well as increase. Though I do not expect any near term farmland price decreases, remember that all investments go through cycles. As such, the ultimate profitability of your investment will depend upon the point in the investment cycle at which you make your purchase as well as the point at which you sell. For example, many of the early investors in technology stocks made considerable fortunes, while those that entered the market late experienced substantial losses.

I believe that farmland will continue to be a viable long-term investment for a variety of market participants. However, I encourage you to develop an investment strategy that looks at the big picture prior to making your purchase. Even if you already own land through prior purchases or an inheritance, you need to give some thought as to what you want your land holdings to achieve for you (e.g., an inflation hedge, source of income, portfolio diversification, enterprise expansion, personal enjoyment). If you are using farmland as a way of diversifying your asset mix, then it should perform admirably for you. However, without any defined goals you may simply be participating in the feeding frenzy that continues to drive land prices higher. Evaluate all aspects of the purchase and understand both the benefits and risks before you proceed.

The Benefits of the Sale-Leaseback Concept

by Douglas L. Hensley

Over the past ten years, the economics and scale of U.S. agriculture has changed in dramatic ways. Production equipment has become larger, more efficient, and more expensive; the production agriculture community has started to evolve and think more about a "specialty-first" based system versus the age-old "commodity-first" based system; and the scale of the normal operation has grown substantially. The one constant is that the demand for capital to fuel expansion is still a major concern for most farm businesses.

For operations to grow profitably in the future, farmers will need to look beyond traditional sources of funding. The "sale-leaseback" concept, where the farmer sells his land to an investor and then leases it back, has proven to be a very effective means of "alternative financing." Over the past several years, this idea has expanded from a "need-to-sell" proposition, into a farm business growth strategy. Some farm owners and operators may have already implemented the idea of selling a farm and then leasing it back from an investor buyer. If so, by now they realize that there are many advantages to the farmer, the lender, and the investor when using this vehicle. For those who have not, the following are just a few of the considerations to keep in mind with this program:

Sale-Leaseback Benefits

- **Improves financial position for high-debt farmers.** For farmers with weak balance sheets, the sale-leaseback can offer relief from financial strain. Often, a sale of even a 40-acre or 80-acre parcel can improve the financial ratios, free-up cash flow, and allow for continued operation many years into the future. A sale can truly be a win-win-win situation for all parties involved.

- **Acts as a long-term growth strategy for a farm business.** The sale-leaseback concept can be effective with a single farm or multiple properties. Some astute farmers will buy several farms over time, improve them, and then sell them with a lease in place. This method of growth can contribute to substantial real returns and economies of scale. Or, in an area with a tight rental market that is cash flow and growth restrictive, a sale-leaseback can be the tool to keep the operation growing profitably without having to bid exorbitant cash rent amounts on different farms every year.

- **Allows the farmer some control of the asset, with more profit potential.** Studies have shown, that for most farmers, controlling land via a lease can be more profitable (in terms of return on equity) than actually owning the land. Since the typical investor wants a long-term relationship with the same farmer, the farmer has the opportunity to control the asset for an extended period of time while having some control over the original lease terms. In many cases the farmer can benefit from both a tenure and profitability perspective.

- **Simplifies the land purchase for most investors.** The biggest

continued on page 4

The Benefits of the Sale-Leaseback Concept, continued from page 3

concerns that most farmland investors have involve locating a good tenant, and then having some degree of certainty regarding their annual income. With a sale-leaseback transaction, a tenant is included as part of the sale, and pre-negotiated lease terms are established that can guarantee a certain amount of income each year. Quite simply, the investor has the ability to interview the operator, and approve the lease provisions, before the investment is actually made.

- **Provides a sense of security for the investor.** Since the farmer selling the property has previously owned it, generally it is safe to assume that the land has been well cared for. By nature, most farmers have pride in ownership and will take care of the land that they own—by improving the fertility, the drainage, etc. This provides the investor some comfort regarding the unseen aspects of the property.

Sale-Leaseback Realities

- **The farmer/seller gives up title.** The seller of any real estate asset gives up their ownership interest upon the closing of a sale. In doing so, a seller does not have the same control as when the asset was actually owned.
- **2–3 year lease terms are typical.** Many investors are in the market for the long-term. However, they do want the ability to make changes when tenants under perform or when economic conditions change. With an original 2-year or 3-year lease term (a proving period), the investor owner and the farmer tenant become familiar with each other. Assuming quality work, the investor is generally interested in continuing to lease the farm to the same tenant in the future. The comfort level between the investor and the tenant can be enhanced through regular communication, reporting, hassle-free business handling (for the landlord) and honest business dealings. Like most things, the simpler the farmer-landlord lease and relationship is, the more likely it is that the landlord will renew and extend a fair lease.
- **Investors prefer cash or "flexible" cash leases.** Savvy investors use farmland as both a solid long-term investment and as an annually cash-distributing asset. Thus, most investors are more comfortable with the known cash returns offered by cash leases. Flexible cash leases, where the investor assumes some yield and price risk, are becoming more popular to some investors. But most investors avoid crop share arrangements where they have to pay bills and assume too much risk.
- **Farmer/sellers must be price realistic.** Investors follow trends in land prices and rents. In addition, they normally have several farms to choose from when buying. Therefore, few leaseback sales include a substantial sale price premium or a large rental discount.
- **More time often required for a leaseback sale.** In the farm real estate market, there are essentially two groups of buyers—farmers interested in expanding their operations and outside farmland investors. In a sale-leaseback scenario, few farmers are going to step up as potential buyers. Why? Because most farmers want to farm the acreage that they purchase. The reality is that selling a farm with a leaseback may take a bit more time than selling it free and clear from a lease, thus advance planning is necessary when considering this strategy.

Conclusion

Over the past ten years, the economics and scale of U.S. agriculture has changed in dramatic ways. In response to the changes that have occurred, farm owners and operators have been forced to create and adjust to systems that make the current farm economy work for their specific position. The sale-leaseback concept, where the farmer sells his land to an investor and then leases it back, has proven to be a very effective proposition for all parties. While this strategy is not for everyone, when the sale-leaseback concept is properly implemented, it offers another tool for growth and an alternative to lessen financial burden.