Land Facts

THE LORANDA GROUP, INC.

FALL 2006

The 2006–2007 Farmland Market

Let the Seller BeAware

Overview

Since last spring, there have been some interesting developments in the farmland market. First, the reports being released from many of the governmental and industry groups that track land values have reflected little, if any, price increases. Second, there are far fewer 1031 investors or trade buyers looking for land today. This group has been the backbone of the market the past several years, aggressively competing against farmers to purchase land. And finally, the number of properties for sale, as reflected by the number of advertisements in trade publications, has been increasing.

Yes, there have been a few sales at record breaking price levels, but I have also seen more "no-sales" of property offered at public auction this past summer than I have seen in the past decade. This convinces me that the next few months may not be totally painless for those who want to sell their farms. Do I anticipate a full-scale meltdown in the market? Not at all. But those landowners who need to sell in the next few months need to be aware of what they can expect.

Near Term Market Outlook

1. Prices may likely be 0–10% lower than a year ago in certain areas.
2. The time it takes to receive an acceptable offer (even at a lower price) may increase significantly.
3. Top quality farms (those with the best soils) will hold their value better, and sell more quickly, than lower quality properties.
4. Some brokers or auctioneers will promise you last year's price *plus* 10%, simply to get your signature on the listing agreement or auction contract.
5. Land buyers will be much tougher negotiators, demanding concessions on contract terms that they may have agreed to in the past.
6. A successful sale will require a thorough marketing effort—something more than the small newspaper advertisement that may have worked the past few years.

As stated earlier, there will be transactions that are exceptions to these rules. Some areas are nearly recession proof. In addition, the long-term impact that new ethanol plants will have on farmland values is still unknown. However, in general, the land buying frenzy is over and seller's expectations will have to adapt to the new marketplace.

Seller Expectations

Real estate sellers have traditionally had lofty expectations. For example, many want a high price and want it now! Unfortunately, many of these expectations (like what a high price should be) are driven by a misunderstanding of how the real estate market works, be it for residential, commercial, or agricultural property. Unlike the stock market, where a share of General Electric stock will cost the same whether you're in San Jose, CA or San Jose, IL, the value of real estate is almost completely determined by its location. Ignoring the location principle can be problematic. For example, The Loranda Group was fortunate to sell a recreational tract last summer that adjoined a state park for over $5,000 per acre. Shortly thereafter, we started receiving calls on a daily basis from landowners who wanted us to sell their recreational land for $5,000

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per acre, even though their properties were located many miles away where comparable sales reflected values of $2,500 to $3,000 per acre. These sellers often feel that their land is "just as good as what Loranda sold." That may be true but it's located in an entirely different market area.

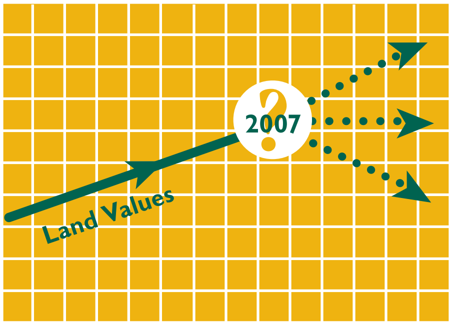
In addition to location, a "high price" for a tract is determined by factors such as soil quality, drainage, fertility, percentage of tillable acres, and who adjoins the property. Timing can also be critical. Have two trade buyers at an auction who are on the "reinvestment clock" and prices will move up quickly. Have no trade buyers at an auction and you may have a "no-sale."

With the recent shift in market conditions, land owners will need to adjust their price expectations or it's very likely that their property won't sell. How can you determine what a realistic price may be? Do a thorough and honest assessment of the property (not every farm is the best in the county) and study recent local comparable sales to gain an idea of market value, so that your "high price" hopes are in line with the reality of the marketplace.

Sellers: What To Do Now

If you need to sell land in the next few months, then you should decide if you have the expertise to handle the transaction yourself. Setting a realistic price will be the first critical step. Too high a price will result in no offers and a "shop-worn" reputation, thus making it even harder to sell later. Establishing a realistic price must be followed by the creation of an effective marketing plan to reach all potential buyers (local, regional, and/or national), realizing that the local buyer pool may be much smaller than in the past.

If you aren't comfortable trying it on your own, then you will need to hire someone else to market the property on your behalf. In Illinois alone, there are nearly 75,000 individuals who are legally licensed to sell farmland. However, there are probably fewer than 100 who have the integrity and the expertise to sell it for the highest price. A true story—a landowner contacted two brokers about selling a Central Illinois farm. "Broker A" researched recent sales in the area and found a range in value from $3,500 to $3,800 per acre from which a list price of $4,000 per acre was suggested. "Broker B" did no research but suggested a



list price of $4,400 per acre because "some trade buyer from St Louis will pay that much." It may be no surprise that "Broker B" got the listing. An offer was submitted early on for $3,800 per acre but was rejected because the farm was worth $4,400 per acre, at least according to the broker. After languishing on the market for nearly a year, the farm ultimately sold for $3,600 per acre. Whether "Broker B" was unethical (offering to list the property for a high price simply to get the listing) or incompetent (not knowing what local market conditions were) is open for debate. But in the end, the owner gave up nearly $75,000 in price and significant time because of his broker's actions.

Hiring a professional isn't as difficult as it seems. All you need to do is ask some basic questions to determine if this person deserves your business:

1. What do you think my property is worth and why? Have them provide a list and/or map of recent *local* sales so you can determine if they are realistic or are simply puffing the price to get your business.
2. Who do you think the possible buyers are (farmer versus investor) and how do you plan on promoting the property? Have them provide a written summary of their proposed marketing plan. If they won't furnish something in writing for you, chances are they have no plan.
3. What kind of experience do you have in selling property similar to mine and do you handle these types of transactions on a regular basis? Have them furnish examples of brochures as evidence and see what other business interests would interfere with their devotion to your transaction. For example, (i) are they trying to sell your farm while they have 30 houses listed; (ii) are they trying to sell your farm between court cases; or (iii) are they trying to sell your farm during a break in a machinery auction?

If you aren't satisfied with the answers to these questions, then interview other people. While the commission issue is important as well, don't let that be the deciding factor. In the real estate industry, as in most industries, you definitely get what you pay for. Yet, as the Central Illinois landowner discussed earlier learned, the stakes can be much higher. Paying a lower commission actually *costs* you money if the ultimate selling price is less (or less timely) than could have been achieved by another broker.

Summary

The days of selling farms for high prices with little or no effort are likely over. Land owners need to "be aware" of changing market conditions and act accordingly or they may suffer the financial consequences. It won't be impossible to sell land, and prices aren't likely to collapse, but there will be many more challenges to overcome before a successful sale is completed.

Farmland Assessments–The Basics

PART 1 OF A SERIES

By Dwight D. Raab, Associate Appraiser

While the area utilized for farming and timber makes up the majority of the *land acreage* in Illinois, farm real property (land and improvements) surprisingly only comprised 3.0% of the state's total property tax billed in 2002 (the most recent year for which Illinois Department of Revenue data are available) and 3.6% of the equalized assessed valuation (EAV) of real estate in Illinois (Illinois Property Tax Statistics, 2002). Like many states, Illinois assesses farmland based on its agricultural use-value rather than its market value. Assessing land based on how the property is actually being used leads to preferential, i.e., lower, assessments.

An actual farm parcel may consist of a farm home site, a farm residence, farm buildings, and/or farmland. How are each of these components assessed? The home site and residence are assessed as any other residential property at one-third of market value. Farm buildings are assessed a bit differently, at one-third of their *contributory* value to the productivity of the farm. Farmland assessments take into account the productivity of the soil, assuming the land is being farmed, and consider other factors that may detract from its productivity. In Illinois, there are four categories of farmland: 1) cropland, 2) permanent pasture, 3) other farmland (e.g. woodlands), and 4) wasteland. Permanent pasture is assessed at or third of cropland value for the given soil type, and other farml assessed at one-sixth of cropland value. Wasteland is assessed contributory value to the farm parcel.

Productivity index is also an important factor in farmland asse ments. A productivity index measures the potential of a given s produce a crop and is merely a way to compare the productiv a specific soil relative to other soil types. Each soil type is assi to a soil productivity index by the soil scientists in the Departn of Natural Resources and Environmental Sciences in the Colle Agricultural, Consumer, and Environmental Sciences at the Un versity of Illinois at Urbana-Champaign (Bulletin 810). There hundreds of soil types with productivity indexes ranging from 130. So, it is possible for two different soils to be assigned the productivity index, thus resulting in the same assessed valuation for both soils.

Agricultural *use* value is calculated at each productivity index for the soils in Illinois. Agricultural use value is defined in the Illinois Compiled Statutes (35 ILCS 200) as follows:

$$\textbf{Agricultural Use Value} = \frac{\textbf{Gross Income/A}^{1}\ \textit{less}\ \textbf{Non-Land Production Costs/A}^{2}}{\textbf{Capitalization Rate}^{3}}$$

[1] *Gross Income Per Acre* is calculated as follows: Crop Yield[A.] *times* Commodity Price[B.] *times* Crop Rotation Percentage[C.]

[A] *Crop Yields* are a function of the soil productivity assigned to each soil type and not actual yields.

[B] *Commodity Prices* are an average of monthly prices received by farmers for a twelve month calendar year. This data is obtained from the USDA-Illinois Agricultural Statistics Service.

[C] *Crop Rotation Percentages* are taken from a sample of farms in a database located at the University of Illinois at Urbana-Champaign in the Agricultural and Consumer Economics Department.

[2] *Non-Land Production Costs* are taken from the same University of Illinois dataset as the *Crop Rotation Percentages.*

[3] *Capitalization Rate* is a five-year dollar weighted compilation of interest rates on originated mortgage loans by AgriBank, FCB covering an eleven state area. This rate is published by the Internal Revenue Service annually and is referred to as the '2032a interest rate'.

In the next issue, we will expand our discussion of this topic by exploring the concept of effective tax rates on farmland. To be continued…

Are Interest Rates Affecting Farmland Values?

By Douglas L. Hensley

The increase in agricultural land values the past twenty years, along with the factors driving the run-up, has been well documented. Now that the market appears to be losing some of its steam, perhaps it's time to visit some of the variables that may be factoring into this slowdown.

Farmers typically use excess profits to make capital purchases. If they aren't currently making money, or aren't confident about the future, then they will delay any major purchases like land. In our recent conversations with several farmers, they cite several areas of concern:

1. Increased input costs for chemicals, fertilizer, and fuel;
2. The uncertainty of the new government farm program;
3. The current high price of farmland; and
4. Increased borrowing costs.

Investors rely on outside sources of income, along with current operating income generated from their land, to pay for their farm purchases. Many of them are also losing their enthusiasm for land citing the following:

1. The current high price of farmland;
2. The increased returns from alternative investments;
3. The low capital gains tax rate (for 1031 investors); and
4. A lower cash return on the farmland investment.

For both groups of land buyers, interest rates are a factor. To help clarify their thoughts, the following table includes interest rate data from both the borrowing and investment angles, along with returns to farmland.

When analyzing the trends, it's easy to see why land buyers are not as confident as they once were. Obviously, the capital appreciation component has not been included in this analysis, but very few people still believe that future land appreciation will match the increases we've seen over the past 10 years.

Year	Average Farmland Value/A—Corn Belt[1]	Average Cash Rent/ Acre—Corn Belt[1]	Gross Farmland Returns—Corn Belt[2]	One Year U.S. Treasury[3]	Average Interest Rates on Real Estate Loans[4]
2006	$3,040	119	3.91%	5.02	7.67
2005	$2,720	117	4.30%	3.62	6.91
2004	$2,300	114	4.96%	1.89	6.19
2003	$2,130	110	5.16%	1.24	6.14
2002	$2,030	108	5.32%	2.00	6.91

[1]Source: USDA Land Values and Cash Rent Summary—August, 2006

[2]Gross Returns is calculated by dividing average cash rents by average farmland values. Real estate taxes have not been included in the equation.

[3]Source: Federal Reserve Bank

[4]Source: Federal Reserve Bank of Chicago, Agricultural Newsletter—August 2006

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The Loranda Group, Inc. is a diversified agricultural services firm headquartered in Springfield, Illinois and licensed throughout the Midwest. 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.