Land Facts

THE LORANDA GROUP, INC.

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The Impact of $4.00 Corn on the Land Market

In the last issue of Land Facts, we discussed in detail the potential obstacles facing land values in the near term. These obstacles included the diminishing pool of 1031 tax-deferred exchange buyers, the disappointing land value reports emanating from the various farm real estate reporting agencies, the oversupply of agricultural properties on the market, and the lukewarm outlook for commodity prices. Admittedly, we were not optimistic at that time that the land market could sustain record price levels. Little did we (or even most commodity traders) know that a major storm called ethanol was about to hit the grain markets. And hit it has, with old and new crop corn futures up nearly $1.75 per bushel and old and new crop soybean futures up nearly $2.20 per bushel, all in less than 6 months. It doesn't take an economist (or even a real estate broker!) to tell us that there is a *lot* more money flowing through the grain side of the agricultural sector today than there has been for some time.

How will these high grain prices affect the land market in the short term? The impact may be substantial, but it also depends upon the *buyer type*. Remember that there are two groups of people that buy land – farmers and investors – and the forces that will drive each group to buy in the future can vary substantially:

The Farmer:

Higher grain prices have historically encouraged farmers to make capital purchases, mainly equipment and land. If the price of John Deere stock is a good barometer, then these historic spending patterns will continue in the near future. In addition, reports of higher land sale prices from across the Midwest have also reflected a confidence in farmers that these high grain prices and profits will persist. The biggest potential obstacles in 2007 may be the number of corn acres – plant too many and grain prices may pull back—or an isolated drought. As can be expected at current land price levels, most farmers only have enough capital or borrowing capacity to purchase tracts under 160 acres in size. Thus, smaller tracts should remain in demand.

The Investor:

Interest from the investor market is more uncertain. As predicted, the number of 1031-exchange buyers looking to purchase land has dropped precipitously across most of the Midwest – commercial/industrial developers are still somewhat active, but the residential market continues to flounder. For the past several years, the trade buyer has paid a premium when purchasing the larger farm (i.e., farms over 160 acres). Motivated by time, tax avoidance, and convenience, many of these buyers paid whatever it took to complete their exchange. Fewer exchanges may likely lead to fewer premiums being paid for the larger parcels.

However, rumors of new (and renewed) interest from pension funds, hedge funds, and other institutional investors are surfacing. This investor segment is driven by the potential for continued appreciation in land values, along with increasing returns that farm properties will generate. These buyers also have the ability to buy large tracts of land, although they will rarely pay a premium simply to make a purchase.

See **$4.00 Corn** *on page 3*

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ETHANOL, ETHANO

"Hello—my name is Ethanol and I'm here to solve all of your energy and agricultural problems." That was the mindset I encountered while attending the recent *Farmland Investment Fair* in Joliet, Illinois. During my many conversations with fair-goers, I was completely awestruck by the number of times I heard the word ethanol. In a matter of just a couple of months, it seems that our new golden goose has stolen the attention from previous headline phrases like "1031 tax-deferred exchange" and "new farm program". Has the "*irrational exuberance*" that former Federal Reserve Chairman Alan Greenspan once spoke about in the equity markets made its way into agriculture in the form of this home-grown super fuel? Corn-based ethanol and its trickle-down possibilities are certainly exciting to consider, yet I wonder if Midwestern agriculture has lost some focus on one of the basics—*proven long-term profitability*—and is becoming paralyzed once again by the next sure thing.

Don't get me wrong—I am a believer in creating and utilizing domestic sources of energy. I'm convinced that ethanol *can* become one of the big alternatives to oil tankers coming from the Persian Gulf. However, I also think that many people are putting a great deal of faith in corn-based ethanol, getting somewhat caught up in the news-cycle craze. In addition, I believe that it's spilling over into the Midwestern land markets, as evidenced by recent $300 per acre cash rents and $6,000 per acre land sales for farms used strictly for row-crop agriculture. And I wonder whether corn-based ethanol will be the *long-term* cash cow that many people are convinced it already is. The grain markets are certainly responding as if corn-based ethanol and $4 corn are here to stay for a while. And, in all honesty, I want to be excited. However, I'm also nervous for agriculture, based on a few key challenges that the ethanol craze must overcome to become viable in the long-term:

Challenges

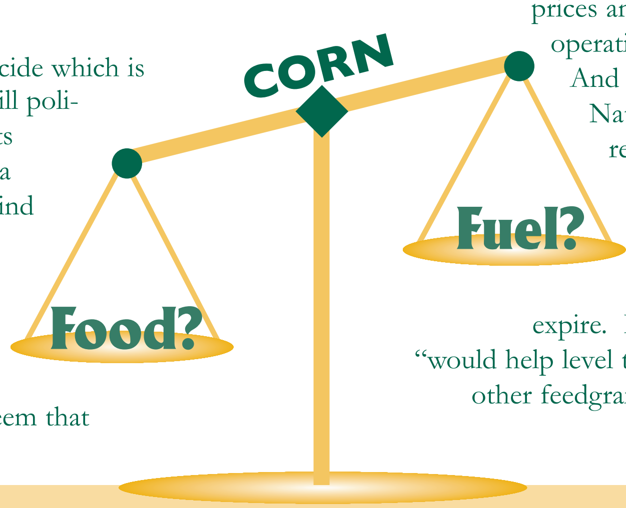
■ Will policy-makers let the *market* decide which is more important—food or fuel? Or will policy-makers get involved once food costs reflect a 100% increase in the cost of a basic ingredient like corn? Keep in mind that there is a significant segment of our larger population that does not consume an abundance of fuel (they use public transportation or walk) and may be indifferent to the wonders of ethanol. However, it would seem that those same folks consume roughly an equal amount of food as someone who does use the fuel. Yes, most Americans want to support the American farmer. But I think this support may erode quickly when the current support for ethanol—in the form of subsidies that are largely unseen—are replaced by higher food prices that are quite visible to the average consumer on an everyday basis.

■ Oil companies can transport their end-products very efficiently (e.g., thousand-mile pipelines spanning multiple countries). Ethanol, on the other hand, must be shipped by train or by truck at the present. Most railroads are already running at nearly full capacity. And you have to wonder whether semi-trucks that haul ethanol will create more pollution than the product itself is supposed to help eliminate.

■ With corn prices at current high levels, many of the experts believe that corn acres could increase in 2007 by as many as 10 million acres. Farmers are naturally responding to the higher corn prices—they want to grow more corn. But what does a large acreage shift mean for crops like soybeans, wheat, and cotton —and the cost of the end products from those crops that are being shifted away?

■ If *all* the corn currently produced in the United States was dedicated to ethanol production, estimates are that only 12% of the nation's energy need could be supplied by ethanol. Thus, it seems that the market will eventually find another way to produce ethanol. In the meantime, will corn growers permanently damage relations with their current customers (industrial firms, other countries, the livestock industry), forcing their end-users to the economic point where they find substitutes?

■ Who would have thought that corn growers and cattlemen (and other livestock producers) might "lock horns" on the subject of ethanol? Significant increases in corn prices and other feedgrains have created higher operating costs for those in the cattle business. And the response has been swift. The National Cattlemen's Beef Association recently issued a policy resolution that supports reduced dependence on foreign energy—and also calls for letting the 54-cent import tariff and 51-cent fuel blending tax-credit for ethanol to expire. In doing so, the cattlemen believe it "would help level the playing field for cattle producers and other feedgrain users."



L, ETHANOL!

By: Douglas L. Hensley

■ Ethanol might be the answer, but is corn-based ethanol the primary source? Sugarcane, sugar beets, and switchgrass are examples of alternative crops that can be used to produce ethanol. At the present, however, these crops are not economically viable on the scale of corn-based ethanol. That being said, billions of private and public sector dollars are currently being funneled into researching alternatives to corn-based ethanol, and a more cost-efficient substitute may be closer than you think.

■ Will the allure of high corn prices draw millions of environmentally fragile acres back into production? For many years the federal government, via the Conservation Reserve Program, has encouraged marginal acres to be taken out of production. This helped reduce erosion and somewhat stabilize crop prices by reducing the number of acres that would be planted to crops. In the future, will these same marginal acres be used to produce "ethanol crops"? This goes beyond the filter strip and waterway acres that we are familiar with in Illinois—think about entire farms that have been enrolled in CRP out in the plains states, that once off contract, could potentially grow corn again, or switch-grass, or a like crop.

■ Ethanol is currently riding the wave of popularity – after all, it's home grown! However, is there an alternative to ethanol being developed that will be cheaper to produce, friendlier to the environment, and require fewer taxpayer subsidies?

Convinced?

With all of these challenges to overcome, are you still totally convinced that corn-based ethanol will become a mainstay of American life and the long-term solution to support the higher grain prices that farmers long for? It's possible, and let me reiterate that I believe that we should continue to pursue ethanol as an alternative energy source. Farmers and ethanol producers will (and should) take advantage of the marketplace when the opportunities are there, like they are now. But both groups need to recognize ethanol's limits in the larger economy, and keep their eye on the future. Ethanol may change the landscape of agriculture in the U.S. But like most fundamental changes, our expectations of today and the realities of tomorrow may be quite different.

$4.00 Corn

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Despite all the current optimism, there are still a lot of the unanswered questions to address about the *long-term* stability of the land market:

1. Can ethanol provide the long-term support for grain prices, and hence land values, that many are predicting? *Please see the accompanying article by Doug Hensley about the challenges that may be facing this fuel.*

2. Will farmers take their increased profits and bid up land prices, or bid up rents? *For a farmer, control of the land resource is the key—being aggressive in the rental market is a shorter term and perhaps less risky commitment than buying a farm. As proof of this, note that the increase in cash rents the past few months has been much more dramatic than the increase in land values.*

3. Will the annual cash returns to grain farms increase enough to entice both individual and institutional investors to become buyers again? *Unlike the trade buyer who is driven by tax avoidance, institutional investors must be convinced that the hype behind ethanol and other bio-fuels will lead to long-term profitability, thus resulting in increased annual income and continuing capital appreciation.*

4. Will lenders remain responsible and keep a close watch on credit use? *Many still believe the farm crisis of the 1980's was exacerbated by the easy credit standards of the time.*

5. What decisions will the government make in response to current farm economics? *Consider the possible ramifications from – changes in the new farm bill that brings millions of Conservation Reserve Program acres back into row crop production; or changes in tax policies that raise or eliminates the favorable capital gains tax rate; or an increase in interest rates in order to slow the inflation caused by higher food prices.*

In summary, high grain prices for the next 12 to 18 months will be the foundation to support land prices at their current levels, at least for smaller tracts. The price premium that large tracts used to command may disappear if deep-pocketed investors are not drawn into the marketplace. Longer term, we are certain to see increased volatility across the Midwest – in grain prices, with land values and land rents, and with farm profitability. The increased risks and opportunities that stem from this volatility are bound to create an interesting ride.

Hunting for Recreational Income

By: Eric L. Sarff, Recreational Land Specialist

Over the course of the last decade, we have seen a tremendous change in the way recreational land is viewed. Timber and other non-tillable acres were once viewed as waste land - the thought was "if it can't be cleared and farmed, then it must have no value". The new mindset recognizes the potential for these non-tillable acres, as they do hold a very real value.

As a landowner you may be asking, "What are some of my options for getting the most out of my non-cropped acres?" The thing to keep in mind is that the 40 acres of timber on your property can be an income-producing asset just as the adjoining 40 acres of corn or soybeans can be. Let's discuss some of the options available to owners of recreational land:

1) Lease the acreage to an individual for hunting. This practice is very much like a lease a landowner may have with a farmer for the tillable acres on his/her property. Most hunting leases are on a year-to-year basis and payments are usually made in annual or semi-annual installments. Payments can vary widely (from $10/Acre to $30/Acre and perhaps higher), depending on many factors such as property location, size, and hunting potential.

If a landowner decides to go this route, it is recommended they check with their insurance provider to make sure that their current policy will cover hunters. It is also recommended that the landowner put the terms of the lease in a written contract and that every hunter who will be on the property be required to sign the lease.

2) Lease the acreage as part of a hunting package. This option will typically be more time consuming than the first alternative, but it offers the landowner an opportunity to earn more income. Many hunters (especially ones traveling long distances) would rather purchase a short-term hunting package (3 – 4 days), versus leasing for the entire hunting season. Some landowners provide lodging, meals, and even guided hunts. Others will simply point the hunters to where the hunting area is and the hunter is on his/her own. Most packages are for 3 to 5 day hunts and prices will vary (from $500 to $4,000 and up) depending on property location, services offered, and the length of the hunt.

Again, landowners need to confirm that their insurance policy covers all potential risks with having hunters on their property. If a landowner decides to go this route, they should also check with their state's Department of Natural Resources office for any additional requirements. In Illinois, for example, if a landowner provides any services to the hunter such as lodging, deer stands, and advice, that landowner must apply for an Outfitter Permit through the Illinois Department of Natural Resources.

3) Lease the hunting rights to an "outfitter" for the entire hunting season. This alternative is somewhat of a combination of the two previous ideas. Outfitters are groups or individuals who lease the hunting rights on a property with the intention of selling individual hunts on the acreage. A landowner's agreement with an outfitter will be very similar to the lease with an individual hunter. As with the other options, lease prices will differ depending on the size, location, and hunting potential of the property.

The benefit to the landowner in leasing to an outfitter is that it takes the majority of the responsibility and risks out of the landowner's hands. Outfitters will often pay a premium for a high quality tract of hunting land and will manage the property as their own, as it is in their best interest to do so. They want repeat business! Outfitters are also required to carry their own liability insurance, but landowners will want to stipulate that they are named as a co-insured or additional insured party on the outfitter's policy.

As a landowner, it is important to realize that the potential for the non-tillable acres on your farm can vary widely. If your goal is to maximize your income, I would suggest leasing out individual hunting packages. If your goal is to increase the income on your farm without greatly increasing your workload, I would recommend leasing the hunting rights to an outfitter.

The Loranda Group works closely with outfitters and hunters throughout the Midwest and can help you to create the scenario that best fits your needs. We would welcome the opportunity of discussing the various options with you in more detail.

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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.