CENTER FOR THE STUDY OF RURAL AMERICA
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Agricultural Credit Conditions: Booming Farmland Values

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Farmland values are booming across much of the nation and farm credit conditions are solid. There are few exceptions to these broad-based trends according to results of surveys of agricultural credit conditions conducted by several Federal Reserve district banks. Farm and ranch land values have been climbing in recent years, but have showed particular strength since mid-2004. Strong farm income, nonfarm demand, low interest rates, and tax advantages are among the forces supporting land values.

Farm finances are on solid footing according to survey respondents. Loan repayments are solid and loan renewals have been kept to a minimum. Looking ahead in 2005, lower crop prices and rising energy costs will dampen farm income. In general, producers are in a favorable position to service their debt.

Bankers in areas of prolonged drought, however, are watching their loan portfolios with caution. These areas are mostly scattered throughout the West.

Farmland values are booming

Booming farmland values are central to agriculturally related discussions across the country. Respondents to Federal Reserve Bank surveys as well as industry analysts continue to report strong gains in farmland values. A variety of factors are influencing these gains, depending on the location of the land; but nonfarm demand has emerged as a dominant force.

According to Federal Reserve surveys conducted at the end of the fourth quarter of 2004, gains in good quality (nonirrigated) farmland ranged from 8.7 to 15.4% (Figure 1). Ranchland values climbed at an even more impressive pace with double-digit gains being reported in all of the districts that track ranchland values. Irrigated land values had been sluggish in many areas, but they posted stronger gains by yearend. Although land values have been increasing steadily in recent years, the gains posted in the fourth quarter were particularly strong. In the Chicago district, the 12% gain was as high as any since 1979.

"Because of subdividing and investment purchases, land prices have gone higher than many farmers or ranchers can afford—making it very difficult for young people to get into farming or ranching."
—North Central Wyoming

The strong values reported by the Federal Reserve surveys are in line with those conducted by other industry analysts. In June of last year, for example, Purdue University reported that farmland values were rising more than 7% annually in Indiana. Moreover, a survey conducted at a February 2005 meeting of Indiana farm managers and appraisers revealed that farmland values had picked up to 11% above a year ago. Similarly, the Real Estate Center at Texas A&M University reports that rural land prices in Texas were up 16% in 2004 from 2003, with some regions posting gains of more than 35%.

Numerous factors are driving the strength in farmland values across the country, from strong farm incomes to recreational demand. Net farm income set new record highs in 2003 and 2004, which were quickly capitalized into farmland values. Healthy crop receipts and continued government payments have underpinned cropland values. Strong cattle prices and widespread drought relief have provided a boost to ranchland values. High energy prices, on the other hand, have kept irrigated land values in check.

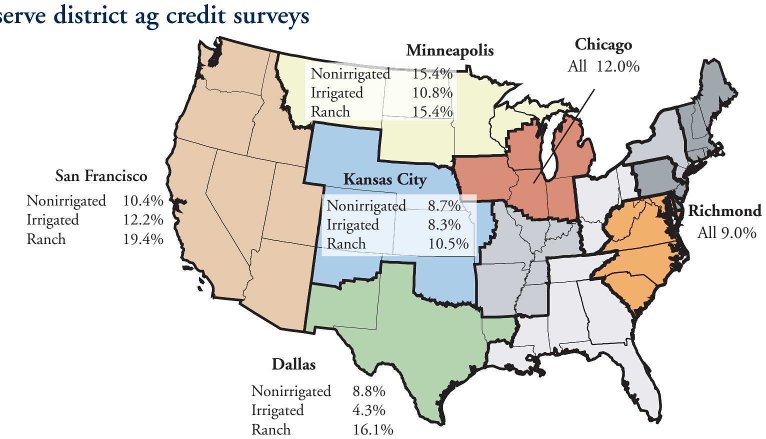
Low interest rates and tax exchanges have also provided support for land values. The cost of borrowing for both farm and nonfarm buyers has remained historically low in recent years. Interest rates have moved steadily higher over the last year and some analysts expect that this could cool land markets somewhat. Tax-deferred exchanges, or 1031 exchanges, allow property owners to sell a property and delay capital gains taxes if they use the proceeds from the sale to purchase a "like" property. Like properties might be real estate used for trade or investment. This is impacting farmland values far beyond cities as urban sprawl forces farmers to sell their land and make purchases in more remote farming regions. Investment property owners are also able to sell properties, such as an apartment complex, in exchange for farmland.

"Housing and urban influence are creating strong competition for ag land."
—Central California

Urban sprawl remains a major force behind the demand for farmland near metropolitan centers. As suburban areas expand, productive farmland is taken out of production at high prices. Urban residents are also pushing up farmland values by their desire to have a quiet retreat in the country. And, the sluggish performance of the stock market in recent years has led to demand for farmland by investors seeking a safe place for their investment dollar. According to a recent report by the Texas Real Estate Center, not only is investment driving up prices, but it has led to a significant decline in the size of land tracts for sale in Texas, including remote areas.

Finally, demand for farmland for recreational purposes is increasingly cited as a major force behind rising land values. For areas fitting the traditional definition

Figure 1: Farmland Values
Federal Reserve district ag credit surveys



*Percent changes are 4th quarter 2004 over 4th quarter 2003.
Sources: Federal Reserve Banks of Kansas City, Chicago, Dallas, and Minneapolis (San Francisco computed by Kansas City).

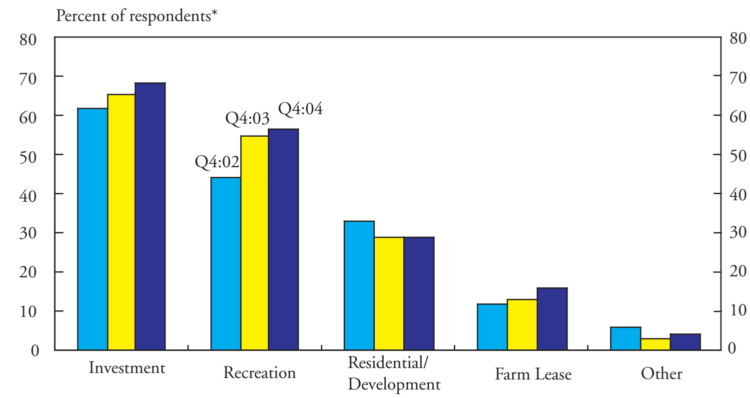
of "scenic," the impacts of recreational demand are not new. However, recreational demand is expanding into more remote areas. Land suitable for hunting, fishing, and other recreation activities is increasingly in high demand. A special question periodically asked on the Kansas City survey provides some insight. Asked to list the most common reasons for farmland purchases by individuals other than farmers, respondents gave investment and recreation as the two leading answers (Chart 1).

Booming farmland values are viewed favorably by some but with more skepticism by others. Many older landowners consider their ownership in farmland as their retirement, thus the stronger the gains the better. And the boost in equity for landowners with debt on their properties is welcomed by bankers. On the other hand, bankers also recognize that new loans for land at high prices are risky and often cannot be serviced with farm income alone. Lenders are making loans on land that may not be used solely for farming, adding a new challenge to doing business. And high land prices make it difficult for producers wishing to enter the farming business or expand their current operation. The high values create barriers, especially for young and beginning farmers with limited farming and farm credit histories.

Farm credit conditions are healthy

Farm credit conditions ended 2004 on a solid note. Two years of strong incomes helped improve farm loan portfolios. Repayment rates on farm loans, as reported by the Federal Reserve surveys, have risen in the last two years (Chart 2). The Chicago district in particular saw a surge in repayment rates in 2004 due to the strong incomes for the high concentration of corn and soybean producers in that district. The number of requests for renewals or extensions on farm loans has also improved. In the fourth quarter, the share of respondents reporting more requests than the previous year fell in the majority of districts, bringing this indicator well below 2002. San Francisco was the exception as 25% of bankers reported more requests for renewals or extensions. According to call report data for all commercial banks in the U.S., less than 1% of agricultural operating and real estate loans were noncurrent in the fourth quarter, a slight improvement over recent years[1].

Chart 1: Reasons for Farmland Purchases by Nonfarmers



*Respondents were asked the most common reasons for farmland purchases by individuals other than farmers. Respondents could choose more than one response and therefore percentages will not sum to 100.
Source: Federal Reserve Bank of Kansas City.

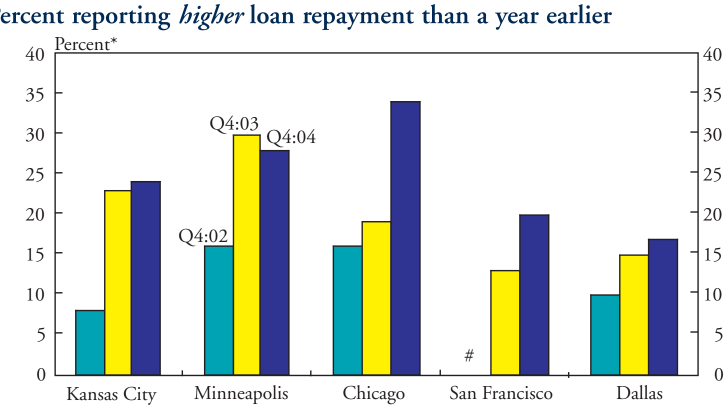
Loan demand in all of the surveyed districts moved higher in the fourth quarter of 2004, likely due to strong incomes that spurred capital spending. Although demand was up, bankers did not give any indications of a shortage of funds. The majority reported that the availability of funds was about the same as in the previous year, with about a fifth in the Minneapolis, Chicago, and Dallas districts reporting an increase in fund availability.

> ***"The land is becoming so expensive, many of our old ranch customers are selling their land for high prices, taking those lands out of production." — Southwest Texas***

Underscoring the health of farm loan portfolios is the debt capacity utilization indicator calculated by USDA. This indicator is the ratio of actual farm debt to debt that could be serviced with current income. In recent years, this ratio has been less than 50% and is expected to remain below that level in 2005 (Chart 3). In the early 1980s prior to the farm crisis, this ratio peaked at just above 100% indicating that farmers had borrowed more than they could actually repay with their income stream. Although overall debt levels have been on the rise in recent years, by historical standards, farm producers appear to be in a favorable position to service this debt.

Chart 2: Loan Repayment Rates

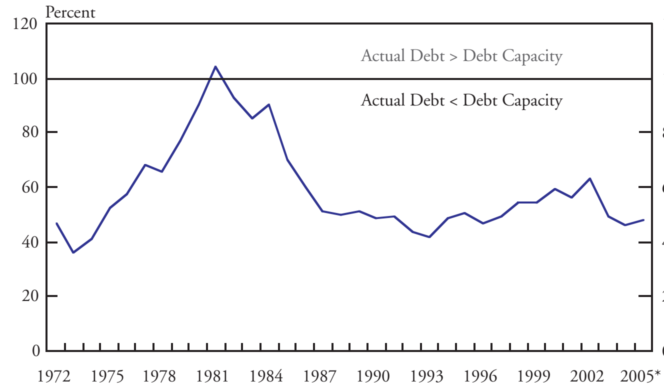
Percent reporting *higher* loan repayment than a year earlier



*Percent of respondents reporting more requests for renewals or extensions relative to the previous year.
#Data unavailable for San Francisco prior to 2003.
Sources: Federal Reserve Banks of Kansas City, Dallas, Chicago, Minneapolis, San Francisco, and Chicago.

Chart 3: U.S. Debt Capacity Utilization

(Actual Debt/debt that could be serviced with current income)



*Forecast
Source: USDA

Softer prices will trim farm incomes in 2005

Net farm income posted a record high in 2004, but incomes will likely fall short of the $74 billion mark in 2005. Strong prices and large harvests led to record livestock and crop receipts last year. Although the farm income picture was bright for the nation as a whole, there were continued pockets of concern. Most notable was the lingering drought in the western states that trimmed crop production and caused forage problems for livestock producers.

The outlook for 2005 remains bright despite the expectation that farm incomes will fall. Net farm income is still forecast to be the second largest on record, largely due to continued strength in livestock prices. Crop prices, however, will dip well below last year due to large supplies. As a result, nearly 40% of farm income will be derived from government payments, which are expected to reach a record $24.1 billion in 2005.

> *"Our local area had an excellent year but very little progress is evident in outstanding loan obligations due to increased input costs and capital spending." —Central South Dakota*

Farm input costs have put a damper on income expectations for 2005. Although cattle producers are enjoying lower feed costs, the high cost of feeder cattle are pinching feedlot profits and making it difficult for some producers to expand their herds. Bankers are especially concerned about rising prices for inputs related to energy prices. Costs of fuel, fertilizer, irrigation, and transportation have all risen significantly.

Surveys conducted by Kansas City, Minneapolis, and San Francisco ask respondents about their expectations for farm income, farm capital spending, and farm household spending in the upcoming quarter. At the end of 2004, the bankers in all three districts expected stable farm income in the first quarter of 2005. Still, more than a fourth of respondents in Minneapolis and San Francisco expected farm incomes to be lower than the previous year. After reporting significantly higher capital spending in the fourth quarter, bankers expected capital spending to moderate in the first quarter, especially in the San Francisco district. Farm household spending showed a similar pattern with increases reported in the fourth quarter, and the expectation that spending would be mostly the same as a year ago in the first quarter of 2005.

ENDNOTES

[1] Noncurrent loans are reported in bank call reports as those loans that are 90 days past due or nonaccruing.

Surveys of agricultural bankers conducted by district Federal Reserve Banks provide valuable insight into agricultural credit conditions. The surveys are of particular interest during turning points in the agricultural sector. Surveys are conducted by the Chicago, Dallas, Kansas City, Minneapolis, San Francisco, and Richmond Federal Reserve Districts, which account for roughly three-fourths of the nation's agricultural cash receipts. Because surveys are not conducted by all twelve Reserve Banks, this summary will focus primarily on regions covered by surveys.

The goal of this summary is to give lenders, producers, and agricultural finance researchers a sense of how credit conditions in one region compare with those in other regions. Since conditions can vary greatly from one region to another, the intent is not to provide "national" statistics, such as an average land value for all districts. This summary will focus on three areas: the trends in farm and ranchland values, agricultural credit conditions, and the outlook for the agricultural sector. Comments provided by survey respondents will also be featured.

Fed Survey Summaries on the Web

***Chicago:** www.chicagofed.org/economic_research _and_ data/ag_letter.cfm*

***Dallas:** www.dallasfed.org/research/agsurvey/index.html*

***Kansas City:** www.kansascityfed.org/agcrsurv/Agcrmain.htm*

***Minneapolis:** http://minneapolisfed.org/pubs/agcredit/*

Note: Summaries are not available for San Francisco and Richmond. Information from their surveys can be found at: www.federalreserve.gov/releases/e15/