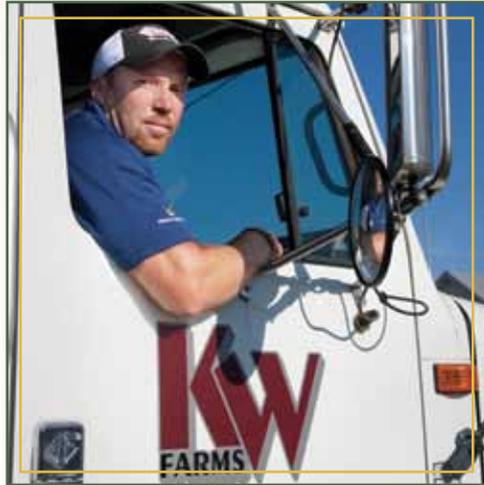


Growing value

Is the farmland boom sustainable?



When the owners of 200 acres of Nebraska farmland decided to sell their land last fall, Kevin Peterson saw a good opportunity.

Peterson, who raises hogs and crops near Osceola, Neb., had a good relationship with the family who owned the irrigated land, and in fact, he owned many of the improvements already on it. He had his eye on the land for some time and thought his private purchase offer was fair and would be accepted by the owners.

But it wasn't going to be that easy. The owners, like many others across the state, decided to sell the land through an auction.

"I thought we made a fair offer, but when you're hearing that the sale price could be 20 percent higher or more if you take it to auction, you're going to take it to auction," Peterson says. He ended up making the winning bid at the auction, but the final sale price was higher than Peterson's earlier offer and ended up costing him "a pretty penny."

"There's so much outside money coming into these sales that it ends up setting a high price floor," Peterson says. "Nothing is bought cheap anymore."

As crop prices pushed toward record highs in 2011, farmland values have followed. After slowing somewhat during the 2007-09 recession, cropland has surged since 2010, with values jumping 20 percent or more compared to a year earlier. In some cases, fertile land that sold for \$6,000 an acre in 2009 is now going for \$12,000 an acre.

But, this surge in farmland values has raised some concerns about its sustainability. Recent figures from the U.S. Department of Agriculture show that while farmland values have risen 40 percent since 2004, cash rents have risen only 17 percent.

Jason Henderson, vice president and Omaha Branch executive at the Federal Reserve Bank of Kansas City, says the Bank's data confirm this disparity. The Bank's Survey of Agricultural Credit Conditions found that land values were rising at nearly double the rate of cash rents near the end of 2010. Historically, the two have moved more closely together.

"The apparent decoupling of land values and rents suggests that other factors could

be driving the farmland value surge,” says Henderson, who recently examined the risks in the farmland market with former Bank economist Brian Briggeman. “One of these factors could be interest rates, which remain at historically low levels and are likely helping drive the rise in land values.”

Rising crop values

As has been the case in other commodity markets, the increase in crop prices since the end of the 2007-09 recession has been swift. Corn and wheat prices have doubled since June 2010 on strong export demand and tight supplies.

Much of the increase in export activity has been due to higher demand in countries

such as China, where rising incomes, improved diets and a weaker dollar are making U.S. agricultural exports more attractive. In addition, tighter crop supplies due to adverse weather conditions in some regions over the last two years have played a role in pushing prices higher.

“When you combine strong demand with tighter supplies, it’s a recipe for higher prices,” Henderson says. “In the case of U.S. crops, the result has been a doubling in some prices, and overall farm profitability has soared.”

The gains have continued into 2011. According to the Kansas City Fed’s second quarter Survey of Agricultural Credit Conditions, farmland values continued to rise, but the pace slowed from earlier this year.

KEVIN PETERSON, WHO RAISES HOGS AND CROPS NEAR OSCEOLA, NEB., keeps an eye on potential land deals and has watched values rise sharply in recent years. He has noticed a pickup in activity and interest at the land auctions he attends across the state. “There’s so much outside money coming into these sales that it ends up setting a high price floor,” he says.





Agriculture symposium examines farmland risks from many perspectives

Non-irrigated and irrigated cropland values edged up slightly and remained 20 percent higher than year-ago levels. Many respondents indicated that strong demand for land and tight supplies would keep prices at their current, elevated levels as farm and non-farm investors continued to snap up land at a quick pace.

Farmers, along with the industries that help support them, are reaping the benefits.

“Farm incomes across the region were booming earlier this year,” Henderson says. “And with that, farmers were buying land, tractors and equipment, and many have been paying off loans.”

At Farmers National Company in Omaha, business has been brisk.

“We have been seeing an extremely strong market in 2011,” says Jim Farrell, president and CEO of the firm, which is the nation’s largest farm- and ranch-management company, overseeing more than 3,700 farms in 22 states. Farmers National also operates one of the country’s largest real estate brokerages.

Farrell, who also serves as chairman of the Bank’s Omaha Branch Board of Directors, says 2011 has brought “unprecedented interest in purchasing farmland.”

Farrell estimates that about 70 percent of today’s pool of potential farmland buyers consists of farmers who are looking to expand their operations. The remaining 30 percent is made up of two kinds of investors: those who might have grown up on a farm and have some kind of agricultural background, and those Farrell described as outside investors looking for a place to put their money.

“The outside interest is accelerating,” Farrell adds. “We are being contacted every week by folks who I would say are strictly investors. They are people who might not have a lot of background in agriculture or row crops, but they are buying.”

Although the sharp increase in crop prices is driving much of the new interest in farmland, Farrell sees another factor in play: low interest rates. With rates on deposits so low, and with

With cropland values 20 percent higher than a year ago, and farm incomes soaring with higher commodity prices, some have suggested that agriculture has entered a new golden era.

But, could the glint of banner profits turn out to be fool’s gold? That question brought nearly 200 agricultural banking and business leaders, government officials and academics together for the second annual Agricultural Symposium, “Recognizing Risk in Global Agriculture,” July 19 and 20 in Kansas City.

“A lot of people are looking at the prospects of 9 billion people on the planet having to eat, most of them in developing countries, and the future for agriculture appears to be bright,” said Vice President and Omaha Branch Executive Jason Henderson, who organized the symposium. “Yet, we heard the same things in the 1970s, and the 1980s turned out to be one of the most devastating decades for agriculture.”

Each symposium session focused on potential risks to future profitability in agriculture. The first day centered on food and fuel, while the next morning considered the financial health of agriculture as well as strategies that farmers and agribusiness have used to manage emerging risks.

“We were successful in bringing agricultural lenders, agribusiness leaders and academics together to really discuss the future of agriculture—not only the opportunities, but also some of the potential risks and hurdles that agriculture will have to overcome to remain prosperous in the future,” Henderson said.

Presentations from the symposium are available at KansasCityFed.org.

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PHOTO BY GARY BARBER

THE KANSAS CITY FED examined the risks to future profitability in the agriculture sector during a symposium this July. The symposium featured speakers representing lenders, agribusiness leaders and academics to talk about the future of agriculture. Pictured from left are David Fischhoff of Monsanto Co., Jason Henderson of the Kansas City Fed and Michael Baroni of Archer Daniels Midland Co.

many investors seeking out better rates of return than what might be available with bonds or other investments, farmland has presented a good opportunity for some, he says.

Those factors have helped produce a seller's market, and as a result, land prices are higher.

Risks to values

The quick rise in farmland values over the last couple of years has led to questions over whether the increase is sustainable, Henderson says.

"Usually, when land prices go up, there are concerns about whether they can continue to rise, especially during periods of low interest rates," he says. "Low interest rates help

strengthen farm revenues, while also pushing down the rate at which those revenues are capitalized into asset values. Both factors work to drive farmland values higher."

In general, Henderson explains, people prefer to have a dollar today over the promise of earning a dollar in the future. As a result, future income streams are valued less—or discounted—compared to current income. The amount of this discount depends on interest rates: Lower rates result in a smaller discount of future income, and smaller discounts lift current land values.

"If you have low interest rates in place, the bidding for agricultural real estate becomes much more competitive, as investors bid the price higher and higher in an attempt to gain ownership of the land and capitalize future revenues into current land values," Henderson says. "Lower interest rates mean investors require a lower rate of return on alternative investments, such as CDs, which makes farmland a more attractive investment and pushes farmland prices higher."

Based on his and Briggeman's analysis of current conditions, and taking into account averages for corn prices, yields and capitalization rates, prices for some irrigated cropland in eastern Nebraska appeared to be in balance with market conditions. However, farmland values still face "significant" risks if interest rates rise, the researchers found.

"If higher interest rates lead to higher rates of return on other investment options, capitalization rates could increase, which would push farmland values lower," Henderson says. For example, if corn prices remain constant, but capitalization rates rise to their more-historic levels, the value of irrigated cropland in eastern Nebraska "could fall by nearly a third," he says.

In addition to higher interest rates, declining farm revenues could push land values lower. This remains a real possibility if

U.S. farmers, as expected, increase their crop production in response to higher agricultural prices. The U.S. Department of Agriculture estimates that by 2013, higher corn inventories will push prices lower to \$4.10 a bushel, down from around \$7 a bushel this summer.

If corn prices end up falling close to \$4 a bushel, the same irrigated eastern Nebraska land could drop in value by 20 percent, even if capitalization rates remain unchanged at their current historic low levels, Henderson says.

“Time and time again, farmers tend to produce themselves out of prosperity,” Henderson says. “If the USDA projections for prices and yields hold, farmers would be facing yet another risk to their land values.”

Of course, the worst-case scenario for land values would be a combination of higher interest rates and lower crop prices, Henderson adds. Such a scenario played out in 1981 when higher interest rates pushed capitalization rates to historic highs, while higher exchange rates led to a decline in U.S. agricultural exports, forcing commodity prices and farm revenues to decline. From 1981 to 1987, this double-whammy contributed to a 40-percent decline in real farm values, Henderson says.

“We could see those dynamics at work in eastern Nebraska and other regions if similar events occur,” Henderson says. “If capitalization rates return to their historic average of 7.5 percent and corn prices fall to \$4 a bushel, we could be looking at cropland prices being cut in half from their current levels.”

The outlook

For now, agricultural market observers don't see a high probability that crop prices will fall soon. Lee Vermeer, vice president of real estate operations for Farmers National, thinks it will take at least a couple of years for crop supplies to increase enough to push prices lower.

“I don't think we're going to see a huge crop this year,” Vermeer says. “We should be holding prices close to these levels through next year. The threat might be going into 2013.”

As a result, aggressive bidding at land auctions appears to remain in play for at least the near term. Peterson, the Nebraska farmer, sees little to dissuade bidders from snapping up land.

“You have people with money to spend who are interested in the rate of return on farmland,” he says. “The return on farmland is simply better than what you can get on bonds, for example, and people are taking advantage of it.”

Even those not interested in buying land are interested in getting a front-row seat to the action.

“Everyone shows up to a land sale—even if they're not interested in buying—just to see the fireworks,” Peterson says. “There could be dozens of folks in the room you don't recognize. Everybody can tell who the investors are.”



BY BILL MEDLEY, TEN CONTRIBUTING WRITER

FURTHER RESOURCES

“WHAT ARE THE RISKS IN TODAY'S FARMLAND MARKET?”

by Jason Henderson and Brian Briggeman
KansasCityFed.org/publications

COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.