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Farmland bubble? 10-year rise raises red flags

Price rally faces ‘moment of truth’ as tailwinds become headwinds

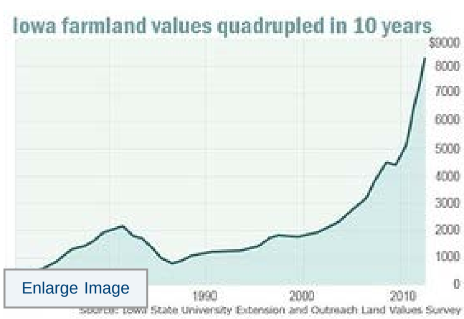
By William L. Watts, MarketWatch

An earlier version of this story incorrectly identified the location of a farm sale that took place in Grundy County, Iowa. The story has been corrected.

NEW YORK (MarketWatch) — Farmland prices have been on a tear for over a decade, barely slowing as the rest of the country suffered a housing collapse, leading economists and investors to worry that a dangerous bubble is forming in the heartland.

The average acre of Iowa farm real estate rose 20% in value to $8,400 in 2013, according to the U.S. Department of Agriculture. That’s up from $3,850 in 2009, and data show overall farmland prices have been on the rise for more than a decade. It’s a similar story across the Corn Belt and the Northern Plains. But it takes more than a string of big gains to blow a bubble. And while some farm real-estate professionals are wary, they argue that the evidence doesn’t justify bubble fears – at least not yet.

“In general, if you ask, is farmland in a bubble, I’ll say, no,” said John Taylor, national farm and ranch executive for U.S. Trust, a private bank that is part of Bank of America Corp. “But if you ask, are some people paying bubble prices, I’ll say, yes.”



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There are strong fundamental reasons behind the run-up in farmland prices. First off, farm income has surged over the last decade as commodity prices boomed. Ultralow interest rates also help.

But now, commodity prices are setting back and interest rates have started to move higher, albeit from very low levels. That’s why the next year or two will provide an important test.

“This is the moment of truth, I think,” said Brent Gloy, an agricultural economics professor at Purdue University in West Lafayette, Ind. If prices continue to surge in the face of intensifying headwinds, it would then be a troubling sign that a bubble was building in farmland, he said.

Up until recently, however, farmland values have risen in the midst of what could be termed a positive perfect storm, Gloy and others noted.

Economic data comes back this week

Kaitlyn Kiernan takes a look at today's market action, including three stocks to watch. Photo: Getty Images.

The so-called commodity supercycle saw prices for corn, wheat and soybeans soar as China and other emerging markets sucked up an increasing share of commodities from around the globe. Demand for biofuels added to gains for corn. Meanwhile, interest rates fell sharply as the Federal Reserve cut official interest rates toward zero in response to the financial crisis.

The Department of Agriculture has forecast 2013 national farm income to rise 6% to $121 billion, around $3 billion above the previous record set in 2011.

Ultralow interest rates have affected farmland prices in more ways than one, noted Jim Farrell, president and chief executive of Omaha-based Farmers National Company, a farm-management and land sales firm.

Low rates make it cheaper to finance land purchases, but they’ve also fueled a hunt for yield that’s helped boost demand for farmland. At the same time, worries that there will be nowhere to park the proceeds from a farm sale have helped limit the supply of farmland on the market, he noted.

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Mike Walsten, who tracks prices as editor of the Land Owner newsletter in Cedar Falls, Iowa, said that farmers are finding it “a little more difficult to get the prices they got six months ago.” He noted, however, that he and many others had anticipated a softening of the market last year, only for a drought to send crop prices soaring. Now, a softer market for farmland is most evident in Iowa and southeastern Minnesota, where the growing season has been especially difficult, Walsten said. There have been “no sales” at auctions where prices didn’t meet minimum bid expectations.

Inflection point

Still, there are outliers. A piece of “exceptionally prime” farmland in Grundy County, Iowa, brought in a record $17,600 an acre, Walsten said, while a recent sale in Lincoln County, South Dakota, saw an 80-acre parcel bring $12,450 an acre. And prices in the eastern half of the Corn Belt continue to show strength, with prices still on the rise in Illinois, while Indiana and Ohio have seen record highs.

Farrell said he agrees that the farmland market is likely at an inflection point that bears watching. But like many observers, he notes there are significant differences between the current situation and the late 1970s, when a credit-fueled land-buying frenzy sowed the seeds of the subsequent decade’s farm crisis.

Brokers and other observers note that lenders, who aggressively pushed loans for farm purchases in the 1970s, are much more circumspect today, at least when it comes to land purchases. In many cases, lenders won’t provide more than around $6,000 an acre in credit for a farmland purchase, Walsten said.

There are other differences. For one, farm incomes were declining heading into the 1980s, while now they are on the rise, Farrell noted.

Also, while there’s been talk of hedge funds and other big speculators jumping into the market, farm purchases are still predominantly made by other farmers, experts say. An annual land survey conducted by Iowa State University found that 78% of farm purchases in 2012 were made by farmers.

A large chunk of other purchases were made by people who live close by, such as retired farmers or business owners. That’s not to say there isn’t still a significant speculative element to those purchases, land brokers say. But a relative lack of leverage has helped soothe fears of a repeat of the 1970s and 1980s.

“You will find that some of our ag banks clearly remember some of the issues they faced with collateral-based lending,” Kansas City Federal Reserve President Esther George said in July, according to Reuters. “So in the banking industry, we do not see the levels of leverage that characterized what we saw then.”

Still, observers question whether lenders have as strong a grip on their farmer clients’ balance sheets as they think. Farmers have often been quick to use their cash reserves for land purchases. That means they could be hitting up those lenders for larger operating loans in the future, said Purdue’s Gloy, adding that the cost of inputs, including seed and fertilizer, are also running high.

If you buy today at the market high, you’re kind of betting on the next five years being as good as the last five—

Brent Gloy, Purdue University

Unsurprisingly, operators are also dealing with a strong rise in cash rents, which could add to a squeeze if commodity prices see a sharp drop.

That said, analysts say it’s still difficult to see what, at this point, would trigger the waves of forced selling and foreclosures that would make for a new crisis.

‘You just walk away’

Professional investors are finding they need to be much pickier about purchases. Shonda Warner, managing director of Chess Ag Full Harvest Partners, which manages a series of farmland investment funds, says she would be willing to buy around one in five farms that she looked at when she founded the business in 2006. Now it’s closer to one in 20.

U.S. Trust’s Taylor said it has become harder in the last 12 to 16 months to find farms that fit the institution’s criteria. While cash rents have risen, they haven’t kept pace with the sharp rise in farmland prices.

“We’ve seen a lot of farms come up for sale and we can’t understand how they paid the price they paid,” he said. In such cases, the buyers are looking at a return of around 2%, he said, noting that U.S. Trust looks for a gross lease rate of 5%.

In such cases, “you just walk away,” he said. But like others, he expects farmland prices to return to a more normal trend.

“If you continue to see people pay prices not justified — and if they start to do it with debt — that would be a warning sign,” he said.

On a continuous basis, corn futures are down more than 36% in the year-to-date, with the December contract changing hands around $4.41 a bushel. Soybean futures are down around 8.2% year-to-date, leaving November futures just below $13 a bushel, while December hard-red winter wheat futures are off more than 10% since the start of the year to trade near $7 a bushel.

Those are still attractive prices, but a decline toward the $3 level for corn and a continued slide for other crops would take a toll. Corn futures spent a large chunk of 2011 and 2012 north of $7.

“The last several years have been phenomenally profitable. If you buy today at the market high, you’re kind of betting on the next five years being as good as the last five,” Gloy said. “That’s a pretty steep wager.”