4/25/11

Assessing the Land Value Boom

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Farm real estate has been the investment of choice for the last decade, particularly in row crop and grain regions with premium soils and water availability. In my travels and lectures to various groups, many see parallels to the 1970s with concerns of a bubble followed by a crash. With farmland values doubling in nominal terms since the year 2000 and a 58 percent rise after adjusting for inflation, one might contend that there is some validity in the comparison. Recently, Sheila C. Bair, Chairman of the FDIC, hosted a symposium on farm land prices with experts from academia, government, agribusiness, and lending sharing their views. Let us examine the land value boom, the possibility of factors for correction, and its implications on lending risk.

The Land Value Boom

The land bubble 40 years ago was a result of many factors, including international market expectations, accommodative farm policy, high rates of inflation, and low opportunity yields in other investments such as stocks and bonds because of market corrections. International oil shocks, producers 30 to 40 years removed from the Great Depression, and, finally, aggressive credit use and lending practices contributed to the bubble as well.

Contrasting the 1970s land bubble to current times finds that the robust land values are not a credit bubble fueled by aggressive and loose lending standards this time. The current land value boom is an asset bubble as a result of some factors that are very similar to the 1970s. Emerging markets with increased standards of living fueled by loose monetary policy by central banks in the United States and abroad have resulted in strong commodity prices that are being capitalized into land values and cash rents. Second, government policy has been very accommodative to the ethanol industry, which has utilized a growing share of the corn crop, which has rippled as a supply shock in other commodities. Of course, low value of the dollar has been supportive of export markets, while weather abnormalities in major production regions of the world have drawn trader money to the table for high expectations in commodity prices. Interest rates have been historically low for an extended time period, and, similar to the 1970s, opportunity investments in stocks and bonds have yielded low returns with high perceived risk.

Further, if one analyzes the debt to asset ratios amongst commodities, the conclusion would be that this is not a credit bubble in grain enterprises. Debt is now concentrated in livestock enterprises, hogs, and dairy, with debt to asset ratios of 20 percent to 25 percent, contrasted to 10 percent in grain commodities.

A Land Price Correction

With this analysis in mind, what factors could result in a 20 percent to 30 percent land value correction? First, it would take a confluence of events to create a profitability issue that results in long-term negative margins. This, in turn, would create a liquidity crisis, followed by reduction of equity on the balance sheet.

Let's name these potential converging events. A slowdown in the emerging markets to a 5 percent or negative growth rate would reduce demand for commodities. This could be the result of a pullback of central-bank stimulus, trade sanctions, or currency issues in major economies. A change in government policy concerning ethanol could be a major game changer. Interest rates increasing to normal levels as a result of inflation, and sovereign debt issues could contribute to a correction. A convergence of all of these factors along with a natural or man-made disaster, such as an oil crisis stifling global economics, would reduce the price of land, which accounts for 90 percent of the value of the farm balance sheet.

Risk Management Concerns

The first crack in the risk management armor will be expanding producers with long term rental contracts that are leveraged with little liquidity or modest equity where profits are focused on growth. The next crisis most likely will show its beginnings on the operating loan side, with input suppliers and lenders focused on lines of credit.

The second wave will come when producers are unable to fulfill contracts because of market disruptions and negative margins. This time large amounts of land in certain areas will be on the marketplace at the same time, creating a land glut at discounted rates sold in a distressed market that would be in line with a worldwide reduction of commodity prices. This, in turn, will let some steam out of the land bubble over a five to seven year period, similar to the housing market in distressed areas.

The key in this assessment is that land asset values are cyclical, driven by macroeconomic events. Similar to 40 years ago, all the game changers are positive resulting in paper wealth gains. A series of negative converging events will be necessary to correct paper gains, resulting in an emphasis on earned net worth, liquidity and cash.

The leading economic indicators, for example, the Conference Board Leading Economic Index® (LEI) and the LEI diffusion index, as well as the PMI, are still in a very positive mode, but they do not reflect how higher oil prices could quickly become a deterrent to the turnaround in the economy. In other words, the lead economic indicators could actually be laggards this time.

Housing starts at 549,000 are still way below the 1.1 million necessary to fully employ one in seven American workers. Unemployment is still a major issue. The official rate is reported at 8.8 percent, but it jumps to 15.7 percent if discouraged workers, those settling for part-time employment, and marginally-attached workers who have looked for work in the past 12 months are included. The unemployment rate has been above 8 percent for over 25 months, the longest period above 8 percent since the Great Depression. Automation in all industries and cautious business owners uncertain about federal budgets and debt are some reasons for not hiring.

Factory utilization of 77.4 percent is still below the 80 percent metric. Core and headline inflation are quickly rising, which may result in Federal Reserve action later in the year. Oil price is the critical variable. If oil price rises above $135 a barrel on the NYMEX it could result in a second recession, particularly if unrest and rising tensions in the Middle East, and particularly Saudi Arabia, continue or escalate. The yield curve remains somewhat steep, but S&P comments about the downgrade of the U.S. sovereign debt rating could quickly change this variable.

Indicator	Green	Yellow	Red
The Conference Board Leading Economic Index® - LEI	✓		
LEI Diffusion	✓		
Purchasing Manager Index - PMI	✓		
Housing Starts (millions)			✓
Factory Capacity Utilization		✓	
Unemployment Rate			✓
Core Inflation	✓		
Headline Inflation	✓		
Oil Price ($/barrel)			✓
Yield Curve		✓	

Lender and Business Dashboard Economic Indicator Benchmarks

Indicator	Green	Yellow	Red
The Conference Board Leading Economic Index® - LEI	Increasing	Flat to Decline	Decline 0.3% for 3 consecutive months AND >1% over the period
LEI Diffusion[1]	>60%	40%-60%	<40%
Purchasing Manager Index - PMI	>50	41.7-50	<41.7
Housing Starts (millions)	>1.5	1.0-1.5	<1.0
Factory Capacity Utilization	>80%	70%-80%	<70%
Unemployment Rate	5%-6%	6%-8%	>8% or <5%
Core Inflation	0%-2%	3%-4%	>4% or <0%
Headline Inflation[2]	0%-3%	3%-5%	>5% or <0%
Oil Price[3] ($/barrel)	<$50	$50-$100	>$100
Yield Curve[4]	Steep	Flattening	Inverted

[1]Ten indicators make up the LEI - measures % that are increasing; [2]Includes food & energy; [3]Consumer's perspective; [4]3-Month Treasury Bill rate to 10-Year Bond rate