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Soil erosion

A full section of Iowa farmland is expected to fall under the auctioneer's hammer on Sept. 26. Good land, though far from the state's most fertile, the 616 acres—a square mile's worth, situated in the town of Holstein in northwest Ida County and in one family's possession since 1883—may fetch up to $9,000 a tillable acre. With an estimated 2015 cash rent of $300 an acre, the potential buyer would be looking at a gross yield of 3.3%. After taxes, insurance and other such indispensables, the economic yield would sink to about 3%.

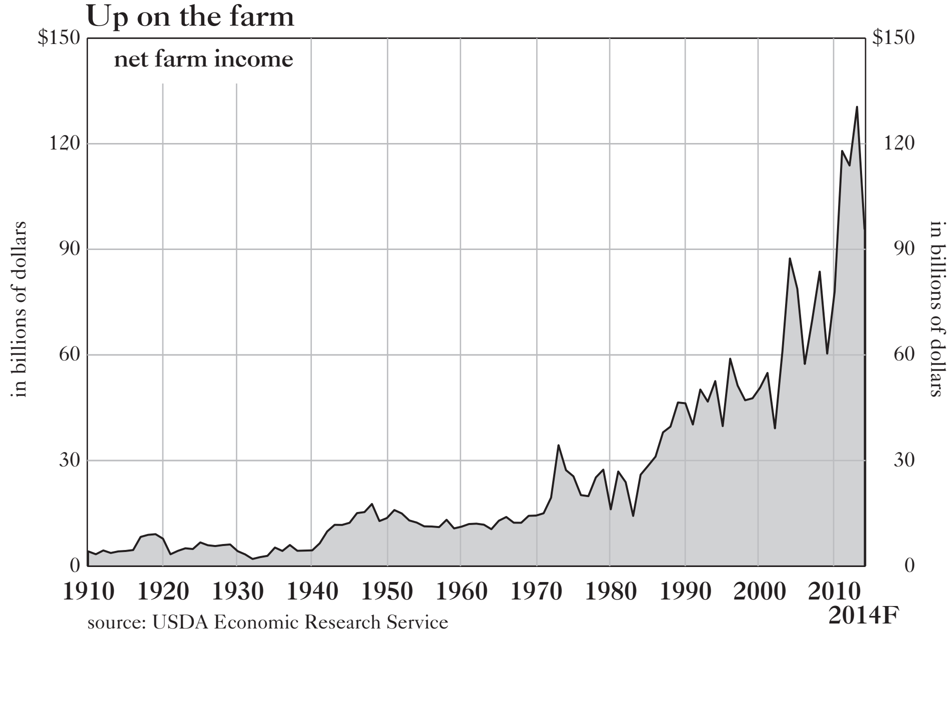
Now under way is a new edition of the *Grant's* farm report (for the two previous installments, see the issues dated Feb. 7 and March 8, 2013). We write for urbanites, suburbanites, exurbanites and agriculturalists alike. Most of us buy beef (the price of which is through the roof) and hold inflation-sensitive financial assets. Some of us buy and sell agricultural implement stocks. Not a few of us own—or have designs on one day buying—broad, majestic acres. As to the last point, falling grain prices are tugging at near-record land prices. We're penciling in a 20% markdown in land values over the next two years.

It isn't every day that so many contiguous Iowa acres come up for sale. Nor is it just any season when coast-to-coast growing conditions are as salubrious as they've been in America this summer. Average corn production could reach 165.3 bushels per acre in 2014, the highest since 1866, says the U.S. Department of Agriculture (the existing record, 164.7 bushels per acre, was set only in 2009). If so, ending corn stocks could push to 1.8 billion bushels, the highest since 2005, a year when, between July and November, corn prices skidded to $1.95 a bushel from $2.70 a bushel. As recently as March 2013, corn fetched $7.35 a bushel. It's half as much at this writing.

Farm Aid is still in business almost 30 years after the low ebb of the land-price cycle, though not a few farmers these days are candidates for wealth-management services instead of philanthropy. Net farm income, which vaulted to $130.5 billion in 2013 from $60.4 billion in 2009, may decline to $95.8 billion in 2014, the USDA projects. Even so, it would amount to $8 billion more than the average of the past 10 years.

"I've polled a lot of landowners and 2014 is not going to be a bad year," Jim Farrell, president and CEO of Omaha [Neb.]-based Farmers National Company, farm and ranch managers, tells colleague David Peligal. "We've got, at least if we catch another rain or two in the Midwest, the makings of a very strong crop. We had a very nice support price with crop insurance for corn at $4.62 per bushel and for soybeans at $11.36 per bushel. Those prices were set in February. So if you buy crop insurance, you can insure up to as high as 85% of your actual average yield on the property. And so if the corn market falls to $3.25 or $3.50 per bushel, you get paid an indemnity. If you look at that, plus at Farmers National, we had 40% of an average corn crop sold at prices between $4.75 and $5 per bushel. That was available until the last couple of months really, and that

Up on the farm



source: USDA Economic Research Service

was for new crop corn, so October and November delivery through March of 2015. So there were opportunities to sell at a pretty good price."

Besides, $3.50 corn is music to the ears of beef producers, who are enjoying some of the fattest operating margins they've ever known. "We've never had cattle supplies this tight before with this kind of beef demand," Troy Vetterkind, owner of Thorp, Wis.-based Vetterkind Cattle Brokerage, was quoted as saying by Bloomberg on July 30. "At some point in time, we're going to cool things off, but it doesn't appear to be this week. It's a historic thing that we'll probably never see ever again."

"Certainly," Peligal observes, "there are few signs of distress in recent Iowa land auctions. On June 12, the Acre Company auctioned off 630 acres in Dickinson County, situated in the northwest part of the state, for an all-in price of $6.5 million, a little over $10,000 per acre. A local farmer wrote the check (no Farm Aid for him). Two days earlier, 390 highly coveted acres in north central Mitchell County commanded $7.2 million, or $18,560 per acre. A neighboring farmer paid that fancy price to create a large contiguous property. 'Sales like this don't come around every day,' a local realtor was quoted as saying in the June 18 *Mitchell County Press-News*,' and people are willing to pay.' And pay this buyer did, as the property sold for more than 40% above its pre-sale estimate. Dan Sullivan, co-owner of Sullivan Auctioneers, which conducted the sale, told the paper, 'People are saying that land prices are going down, but I would disagree 100 percent. The prices are not going down, especially when it comes to good, productive farmland like you find here in Iowa.'"

Nor does Iowa hold a monopoly on full, QE-incited, ZIRP-inflated land prices. Indiana, too, has seen some mighty levitation. "We thought we had a great chance of buying," Brandon Zick, director of acquisition and portfolio management at Ceres Partners, tells Peligal about a July 23 auction of 525 acres in South Bend, Ind.—"our backyard," Zick adds. And he continues: "We had strong rent numbers from our tenants. It was an area that we thought, generally, the farm bid should not be that strong, given the soils and shape of the farm. We thought we would be able to buy this farm for about $6,000 per acre plus a value on the grain storage facility." Unfortunately for Zick, the Newton Farm, whose eponym, Robert Newton, co-founder of Hoosier Racing Tire, died in 2012, sold for $4.5 million, or $8,571 per acre. A local farmer paid the equivalent of about a 3.5% cap rate.

"Although these examples suggest that the farmland market seems to be holding steady, or even powering ahead," Peligal goes on, "one does get the sense that 2014 feels a bit different than the prior few years. Yes, we're still seeing $20,000 per-acre sales in Sioux County, Iowa, as evidenced by a June 9 sale of 80 acres that was led by Farmers National Co. But we're seeing less of the outright euphoria as when Jimmy John Liautaud, founder of the Jimmy John's sandwich chain, paid about $14 million, or only a little less than $15,000 per acre, to acquire 960 acres of farmland in east central Illinois near Champaign last November. 'Usually,' Zick tells me, 'when you see a price of $15,000 or $20,000 per acre, it's for 80 acres. It's just something that a farmer feels he must have. I don't know what this guy's reasoning was behind paying almost $15 million for 1,000 acres, but he had some reason for it. We were only willing to pay $7,500 per acre for that property. We actually thought it would sell for $9,000 to $10,000 per acre because it's just a very competitive area. That price [$15,000], in my mind, was insane.'"

Ultra-low interest rates may not account for every last bull-market uptick in farmland prices, but they've certainly contributed to the bullish atmospherics. Peligal invited Farrell to speculate on the possible consequences of a rise in interest rates. "I'm on the Omaha branch bank board for the Kansas City Federal Reserve and we often discuss how low interest rates have impacted the farm economy, particularly land values," Farrell said. "I think a rise in rates is going to have as great an effect on the land market as the income side, personally. This is because it affects multiple areas. When rates rise, it's going to have an effect on the value of the dollar, and as we look at exports, that always enters into the picture. It's going to have an effect on how many people are out there buying, based on the fact that I can't get any return from my money, so I'm willing to invest in land and take 2.5% or 3% or 3.5% return. And then, of course, borrowing costs will go up, affecting the cost of operating and land loans for farm operators, who today make up 85% to 90% of the farmland purchasers."

Nor will tenants be prepared to pay the same rents at $3.50 corn as they were at $7 corn. "High cash rent is not going to be sustainable," Doug Adams, a 39-year-old Iowa farmer, was quoted as saying in the July 24 *Wall Street Journal*. "We can't rent farms and lose money year after year."

Greyson Colvin, managing partner of Colvin & Co. LLP, an agriculture-focused investment firm, seconds those sentiments. "We just sat down to discuss some of our leases that expire at the end of 2014," he tells Peligal. "It's scary to see how these things are changing—just from the perspective of the rent we were getting before and the fair market rent for this year. I would probably say, on average, our leases would drop $50 to $75 per acre. So I have one going from $400 per acre and we're now modeling in $340 per acre. And some that were $350 per acre that we're now modeling in at $275 per acre. So that will certainly affect the cash flows that we're getting from these properties in the future."

By rights, we city dwellers at *Grant's* judge, land prices ought to be falling. Farrell, with a greater store of knowledge, is a little less categorically bearish. "I'm not going to dispute the fact that I think values are probably going to take a correction at some point," he ventures. "They aren't driven distinctly, though, with income. Looking back to when I graduated college in the late 1970s, incomes were not going up at that point, but land values held pretty sticky for a while. And then when the ability of farm operators to borrow operating capital went away, that's when we started to see long-term loans go bad and eventually land values fell. Right now, farmers are still not borrowing a lot of operating capital, and they probably won't be until next year. So it's not manifesting itself in the market yet. It probably will. If we stay at these levels, I agree that we'll see some correction in the land market. There's no question we will." Besides which, Farrell adds, the North American corn crop is only prospectively bin-busting. It's yet unmade.

Asked what concerns the Iowa farmers with whom he deals, Jeff Obrecht, an agent and auctioneer at the Peoples Company of Iowa Falls, replies "commodity prices. The $3.50 per bushel corn price speaks a lot different than a

$7 corn price does. Everybody is concerned by their bottom lines. A lot of guys over the last three to five years have made some reasonably big expenditures. I think, fortunately, for a number of them that have done that, a lot of that was done with cash money. It wasn't borrowed money. The last three to five years, some of these guys have made more money probably than they had over their whole lifetimes—as did I. Usually, when farmers have good incomes, they do one of two things. They either buy iron or they buy dirt—one of the two. That's their livelihood and that's what they invest in."

Back in the big city, the bloom is off the agricultural-implement stocks. Short interest is rising and the sell side is wary. In a July 2 research bulletin, Piper Jaffray related that inventories of used combines have risen by 30%, year-over-year, for six straight months, with predictable bearish effects on equipment pricing.

"Falling commodity prices negatively impacted farmer sentiment, and demand for agricultural equipment softened across end markets in North America and Europe while remaining weak in South America," Martin Richenhagen, AGCO's chief executive officer, was quoted as saying in the second-quarter earnings release. Down by 18% in the year to date, AGCO (the name is the ticker on the Big Board) trades at 10.5 times the 2015 consensus sell-side earnings estimate and at 8.5 times trailing net income; the shares yield 0.9%. Deere & Co., quoted at 11 times the arguably inflated 2015 consensus earnings estimate of $7.60 a share, has traded between $80 and $90 a share for the past three years. If William Blair & Co. is on the beam, Deere will earn just $5 a share in the trough year of 2016. So, then, a short sale of DE? Not for us, we think, considering (*a*) the acknowledged excellence of Deere's management, (*b*) the storied devotion of the Deere customer base and (*c*) the 1% of Deere shares in possession of a Nebraska investor named Warren.

"On July 30," Peligal winds up, "Murray Wise Associates auctioned off 1,342 acres of contiguous Illinois farmland in western Greene County, a couple of miles from the Mississippi River. A pair of local farmers wound up paying $9.51 million, or $7,086 per acre, for the property. While an almost $10 million purchase price is nothing to scoff at, it was still maybe 5% or 6% less than many expected. If corn prices stay where they are or continue to tumble, there will be many more such disappointments—or, reciprocally, for value-minded buyers, many more such opportunities. Anyway, the farmland boom of the past several years may soon be a distant memory."

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