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The 2009 Outlook for Texas Rural Land Values

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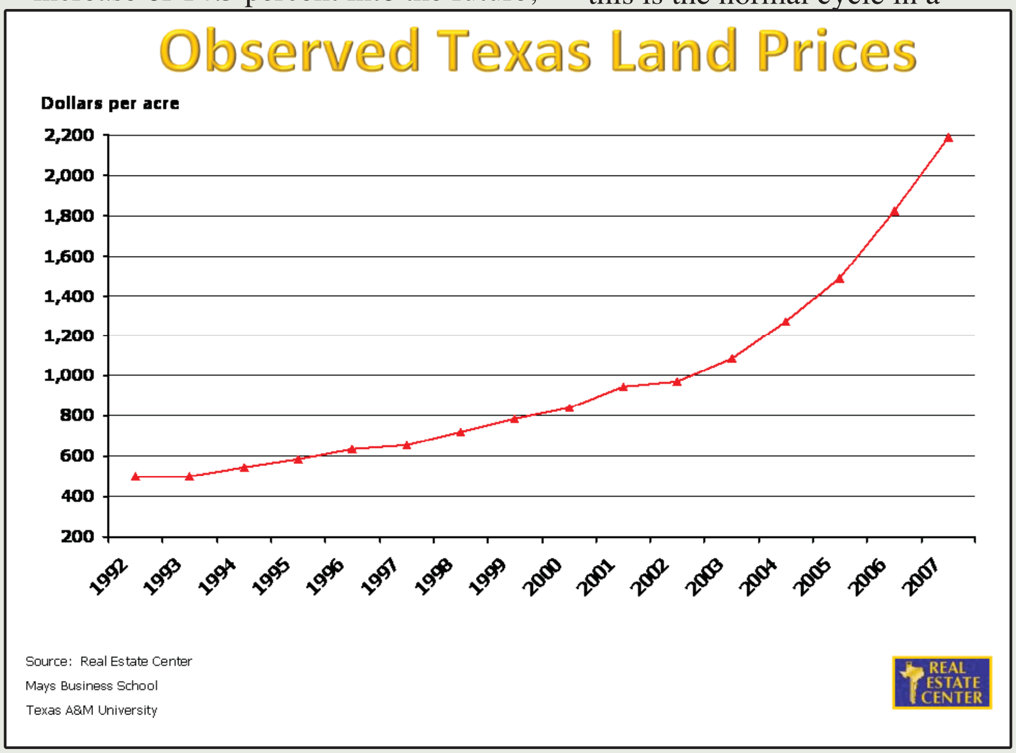
Land Price Increases:

The strong uptrend in agricultural land prices is likely to flatten out overthe next year.

Whether values actually fall will depend on the length and depth of the recession in the general economy, how much farm income declines, and whether tighter credit and lower income will result in an increase in properties on the market. Any build-up in the inventory of properties for sale would obviously have a depressing affect on land prices. The effect would be compounded if able buyers elected to sit on the sidelines because they believed prices were going to go lower. The reality is that investor psychology is a very important factor in determining both the upside of bull markets and the dowside of bear markets.

Statewide rural land values have been driven by cropland prices in the Panhandle, recreational properties and smaller tracts around urban areas. If farm and general economic conditions continue to soften, these demands are likely to be reduced for some time. A decrease in demand for crop land by investment funds and 1031 exchanges will be another dampening factor on the rate of rural land value increases. Overall, Texas rural land values have increased from 10-19 percent annually since 2003. That rate may be difficult to sustain given the current economic climate. If one assumes a continues average annual increase of 14.5 percent into the future, the median price of $2300 per acre as of mid-2008 would increase to $4600 by sometime in 2013. Keep in mind the “Rule of 72” which says that if you take the annual growth rate and divide it into 72, that’s how many years it will take for values to double. The current economic climate does not suggest this rate of growth is sustainable in the near term.



Reasons for Concern:

Farm income in 2009 will likely decline from the record levels of 2006- 2008. In part, this is the normal cycle in a commodity based industry. Long periods of high income are not sustainable. The function of a competitive market is to allocate scarce resources among competing uses. If the market is efficient, the return to the average producer is driven to breakeven through supply and demand responses. Remember, the economic definition of breakeven includes covering the opportunity cost of a return to owner equity capital, labor and management at what it could earn in its next best alternative use. When a market is in equilibrium, only the top end of producers would actually earn an economic profit through superior management, while the producers at the bottom end of the spectrum would be losing money and exiting the industry.

Several factors are coming into play that will put downward pressure on land values. First, falling grain prices. Oil prices and a cheap U.S. dollar have driven grain prices. If oil prices fall back to under $70 per barrel, if the dollar strengthens as interest rates increase and the global economy weakens, then the price of ethanol and commodities produced for export are likely to decline in order to remain competitive.

Part of the decline in commodity prices is occurring not just because of supply and demand responses for the basic products, but because many of the speculative funds that have accumulated large long futures positions over the last several years are liquidating those positions. Their rapid exit from liquidation of those positions is currently putting excess downward pressure on prices.

While cheaper oil and a stronger dollar should help to slow or even reverse some of the increase in input prices, including rents, it is generally true that input prices tend to lag income declines. This creates a cost-price squeeze that lowers net farm income.

Second, credit is tightening. Creditworthy borrowers, those with strong financial positions and good income track records, should still be able to borrow what they need. However, interest rates, down payment/equity requirements are increasing, stronger capital debt repayment capacity margins are becoming more important, and loan terms are shortening.

Assuming they didn't have problems in their investment portfolio, independent banks who rely on local deposits to fund their loans may be in a strong competitive position at the moment; but, they are also limited by their source of funds and the size of loans they can handle internally. While they can make arrangements to participate overlines with other community banks, eventually the pool will be loaned up and the ability to trade participations will limit out. In part, this will occur as interest bearing deposits require higher rates to remain local and capital ratios become strained by additional loan demand.

The uncertainty in the financial markets and the economic downturn are already causing lenders who compete in the nation's markets for funding and deposits to pay higher rates to attract those funds. The interest rate yield curve has changed from being relatively flat to increasing significantly for longer term rates. Even though amortization periods of 15-25 years may still be available, prudent lenders are going to require shorter note maturities in order to keep their loan portfolios marketable and to manage their own asset:liability price risks. Borrowers will likely find that it also makes sense for them to shorten maturities as well because fixing longer term rates will be significantly more expensive.

Another factor that will cause interest rates to rise is the federal debt. About a third of this debt is held by foreign investors, e.g. China, Japan, oil exporting nations, etc. The slowing global economy will mean we have to pay higher rates to attract and hold those funds. The nearly trillion dollars of new debt needed to fund both the deficit and the bailout will also have some crowding out effect, i.e., rates will go up as the government competes with the private sector for additional funds.

What Does It All Mean:

The basic message is that producers need to increase their emphasis on financial and risk management. Now is not the time to be leveraging up or over committing debt repayment capacity based on the assumption that recent levels of farm profitability will continue over the next few years. Getting debt structured properly, improving working capital and managing costs will be at a premium. Managing downside commodity price and yield risk will be as important to sustainability as minimizing taxes and trying to capture market highs. Last but not least, get your planning for next year done and start communicating with your lender earlier than you typically have, i.e., know where you stand.