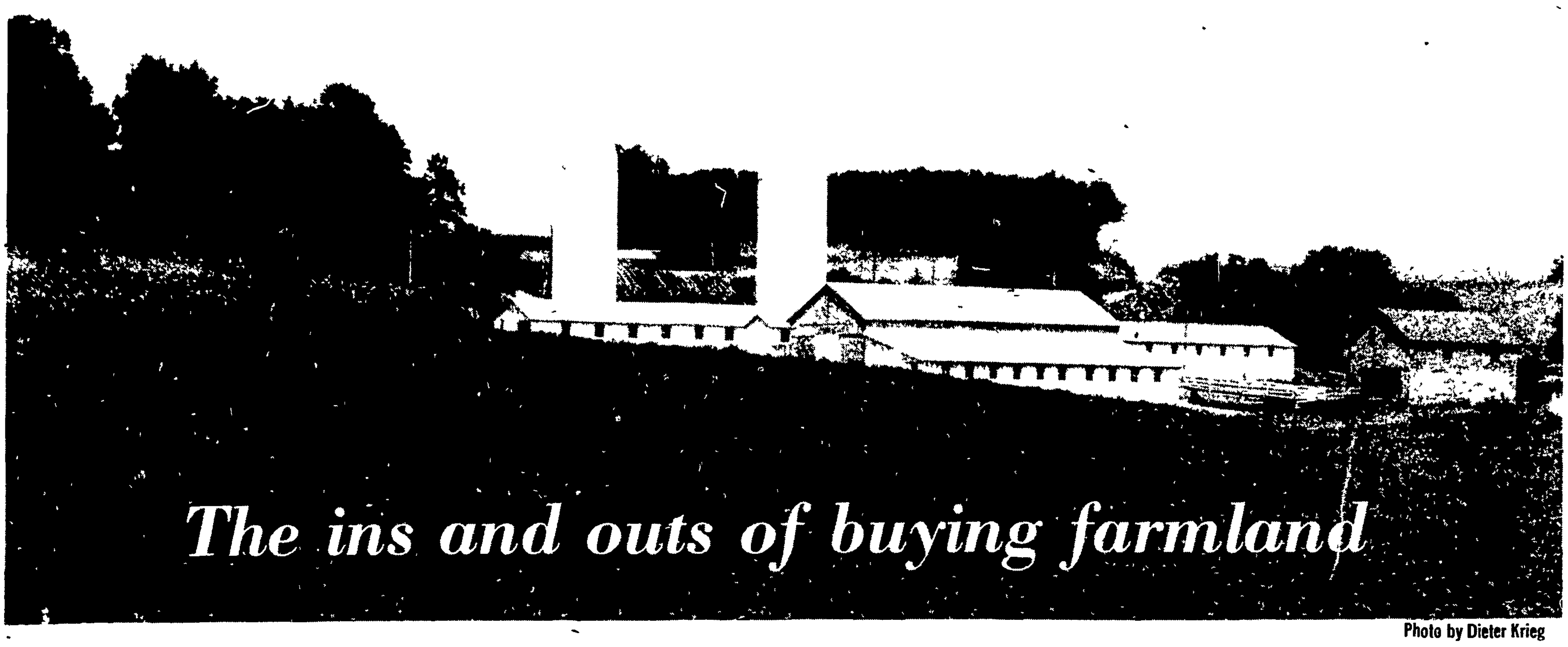

The ins and outs of buying farmland

Photo by Dieter Krieg

Editor's Note: The following article is based on a speech given by William Crowley, Natural Resource Economics Division of USDA. He made the presentation earlier this year at Michigan State University.

EAST LANSING, Mich. - To buy or not buy farmland - that is the question. And if to buy, is now the time? More than rhetoric, this problem is often a difficult one as farmers (and would be farmers) weight the merits of buying or leasing farmland.

The optimists on the one hand say that land just has to be a good buy since there's only so much to go around for so many people - an increasing population at that. And to back up their position, they point to the nearly continuous rise in farm real estate values since 1933.

The more cauious investors contend that farmland is overpriced in relation to its earnings potential. They argue that land should not be bought until either its price drops or its money-making potential improves. Moreover, they rightly point out that there's no guarantee that land values will keep rising.

Although both viewpoints have merit, they overlook the fact that trends in land prices and price-earning ratios are based on national averages. Therefore, regional or local deviances are hidden. Also, the individual farmer's situation is not taken into account.

As can be imagined, the prospective buyer's circumstances - such as his financial resources - figure heavily in any buying decision. In addition to money on hand or capital assets, other big factors are: producer and managerial abilities, debt repayment capabilities, levels of aversion to risk, short- and long-term land ownership goals, and alternative uses for available funds.

Assuming however, that the buyer is adequately financed and is or will be a reasonably efficient farmer or landlord, the present time appears to be reasonably favorable for buying farmland. Still, though, a little cautious figuring before the deal is closed-is definitely wise.

The first maxim to keep in mind is that farmland has value primarily because it is capable of generating income. Of course, land offers other benefits such as a sense of independence and security in owning a chunk of the earth, but the prime consideration should be financial.

And financial consideration goes far beyond the price tag. It involves projecting into the future expected annual net income from the land - a not so easy chore, particularly in light of environmental controls on agriculture.

Also, a discount rate must be figured into the projected income over the years, as the longer you have to wait to get that income the less it is worth to you today. For example, compare the worth - purchasing power - of today's dollar against one in 1950.

There's a mathematical equation — the income capitalization formula — that is based on this shrinking phenomenon of a constant dollar The formula is simply $v=a/r$ where "a" is annual net land income, "r" is the discount or interest rate, and "v" is the resulting implied value of the land

Use of the formula can help you determine a tract of land's breakeven price Assume you have your eye on a tract with a projected constant annual net earning power of $100 per acre. Figuring to keep the land indefinitely and that the discount rate should be eight percent a year, the breakeven price would be $1,250 per acre.

If this is more than the going market price, don't despair. Most land - regardless of the location - appears to be selling at a premium these days. That is, the asking price exceeds the present value of the anticipated income stream.

One angle the formula doesn't take into account is the price appreciation potential - a big factor in recent years with zooming farm real estate values. Particularly if the land is in an area where there is a strong demand for add-on tracts or where there are urban or other nonagricultural pressures, land holding can be a good investment in itself.

The lure of land appreciation can turn into a pitfall, though, if the situation is not realistically appraised. For example, if the land's earning power is too low - even if anticipated appreciation is high - the inbetween years can be financially lean ones.

Another factor to consider is that land appreciation is not certain, even though the near future looks optimistic. A possible cloud on the horizon could be land use controls such as measures to keep prime land in agricultural production. These controls would preclude or at least complicate the sale of farmland to urban, industrial, or recreational buyers - those usually most willing and financially able to pay premium prices.

If all these "ifs," "ands," and "buts" about buying farmland are just too much for you or if you're short on initial capital, don't give up - you might want to consider leasing. Leasing has its drawbacks in that you don't share in land appreciation and you might run into a nonrenewable contract, but it also has its good points.

The main advantage is that the cash flow from a leased tract may be more than that from an owned tract. Reason is that a tenant doesn't have to make mortgage or property tax payments.

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