AgriLIFE EXTENSION
Texas A&M System

E-550
3/09

Agriculture and the 2008 Credit Crisis

The 2009 Outlook for Texas Rural Land Values

Danny Klinfelter*

Land Price Increases

The strong uptrend in agricultural land prices is likely to flatten out over the 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 increase the number of properties on the market. Any build-up in the inventory of properties for sale would obviously depress 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 downside of bear markets.

In Texas, rural land values have been driven by crop land prices in the Panhandle and by the prices of recreational properties and smaller tracts around urban areas. If farm and general economic conditions continue to soften, the demand for these properties is likely to be smaller for some time. A decrease in the demand for crop land by investment funds and 1031 exchanges will be another dampening factor on the rate of increase in rural land values. Overall, Texas rural land values have increased 10 to 19 percent annually since 2003. That rate may be difficult to sustain in the current economic climate. If one assumes a continued 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 is 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

*Professor and Extension Economist–Management, Texas AgriLife Extension Service, The Texas A&M System.

in equilibrium, only the top producers would actually earn a profit through superior management, while the producers at the bottom 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. The first is falling grain prices. High oil prices and a cheap U.S. dollar have driven grain prices up. If oil prices remain at less than $70 per barrel, if the dollar strengthens, and if 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 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, input prices usually decline more slowly than income.

The second factor affecting land values is the tightening of credit. Creditworthy borrowers—those with strong financial positions and good income track records—should still be able to borrow what they need. However, risk premiums in interest rates and down payment/equity requirements are increasing, stronger capital debt repayment capacity is becoming more important, and loan terms are shortening.

If they don't have problems in their investment portfolios, independent banks that 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 with other community banks, eventually the loan pool will be used up. 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 to 25 years may still be available, prudent lenders are going to require shorter note maturities to keep their loan portfolios marketable and to manage their own asset:liability price risks. Borrowers will likely find that it 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 overcommiting 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 the best course. 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, it is important to plan for next year soon and communicate with lenders earlier than in the past.

Produced by AgriLife Communications, The Texas A&M System
Extension publications can be found on the Web at: *http://AgriLifebookstore.org*

Visit the Texas AgriLife Extension Service at *http://AgriLifeextension.tamu.edu*

Educational programs of the Texas AgriLife Extension Service are open to all people without regard to socioeconomic level, race, color, sex, disability, religion, age, or national origin.

Issued in furtherance of Cooperative Extension Work in Agriculture and Home Economics, Acts of Congress of May 8, 1914, as amended, and June 30, 1914, in cooperation with the United States Department of Agriculture. Edward G. Smith, Director, Texas AgriLife Extension Service, The Texas A&M System.