

The long progression of capital gains is interrupted only once, in the mid 1980s. In total, the capital gain rate, expressed as a continuously compounded rate of return, has averaged 5.4% since 1970 for the U.S. in total (48 states included). These returns measures are, of course, in addition to whatever current income the farmland generates. A long-held view of the land market puts the “main” source of return as capital gains.

What do others say? Illinois may be a good barometer for the remainder of the Midwest which has been experiencing high rates of land value increases. The Illinois Society of Professional Farm Managers and Rural Appraisers (ISPFMRA) conducts an annual survey where 10 regional committees examine actual sales data, discuss and judge the representativeness by type, category, and productivity, and compile the results in an annual publication about the state’s farmland values and lease markets. In the most recent survey, through the end of 2003, the ISPFMRA found an even more rapid rate of appreciation. *Table 1* summarizes their findings. (More detail can be found in the annual publication, or at: <http://www.ispfmra.org/springag.html>)

The ISPFMRA also conducts a mid-year survey. Through July 2004, their members were estimating a 10% first-half-year increase in farmland values. Their evidence is supported by a similar survey in Iowa which finds an average increase of 15.6% statewide in 2004 (Complete results are available at www.econ.iastate.edu/faculty/duffy/). The punchline is that land values were up again strongly in 2004. The natural question that follows is of course — Why?

Major Influences on Farmland Values

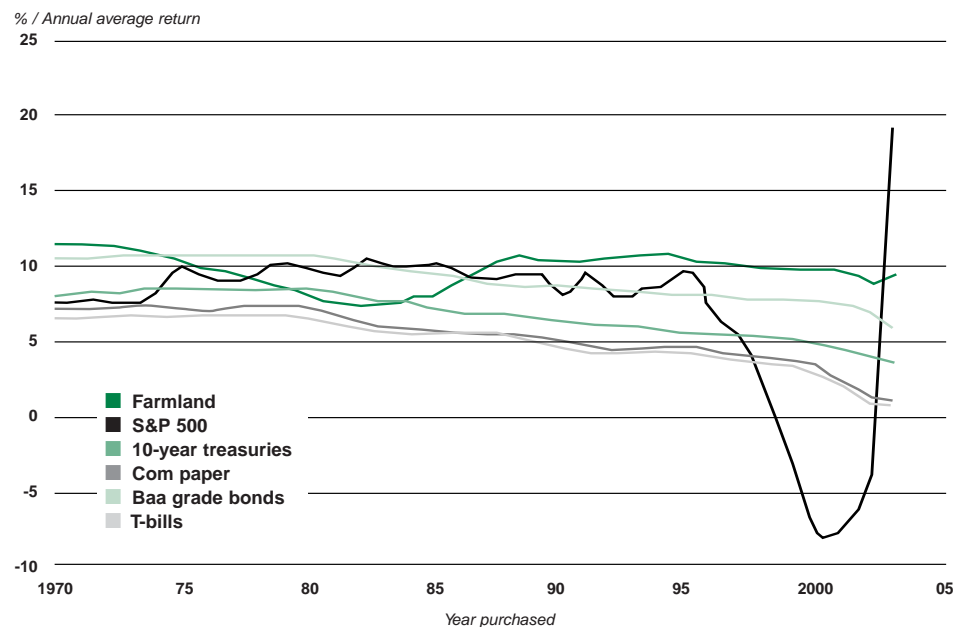
The list of factors that may help explain farmland markets is extensive and not location independent. Many of the following may be in play in most circumstances:

- Performance relative to alternative investments
- Recent relatively high farm incomes
- Changing composition of returns
- “New” government programs
- Relatively low interest rates and low associated discount rates

Table 1. Annual change in the value of Illinois farmland by type and region

Area	Prime Farmland	Good Farmland	Average Farmland	Recreational Land
Northern Region	15%	13%	17%	N/A
Central Region	10%	9%	10%	N/A
Southern Region	N/A	5%	7%	11%

Graph 2: Returns on Alternative Assets – Held Until 1/1/04



- Development pressures and the option for future development
- 1031, 1031, 1031 (or location, location, location)

Performance

The first of these is often referred to in the context of the “investor’s portfolio problem.” Farmland total returns have had the fairly remarkable historic features of low or negative correlation with most other financial asset returns, and thus provide good diversification benefits. Further, the vast bulk of the academic research has shown that farmland has low systematic risk, and provides a decent hedge against inflation in the process. The past few years have reinforced the statistics even further — farmland has simply been a great risk-adjusted performer relative to most other alternative investments.

To put this issue in context, data on the total return (capital gains plus current income) from alternative investments from 1970-2003 were collected and hypothetical investments assumed to have been begun in each year since 1970 and held

until the end of 2003. *The Returns on Alternative Assets, Graph 2*, makes a pretty astounding point: farmland has performed extremely well in total returns relative to many competing alternative investments.

The biggest caveat is that the transactions costs are relatively high for adjusting one’s holdings of farmland and the markets are extremely thin, so it can be a challenge to acquire and hold farmland long enough to dilute the transactions costs sufficiently.

Farm Incomes & Investment Returns

The second and third bullet points are fairly straightforward — recent farm incomes are probably above the long-term averages and may lead to “cash chasing land” and increasing cash rents. The other point is that competing uses for farmland are becoming ever more common “interest stories” with anecdotes abounding about high hunting lease rates, high premiums for conservation attributes, and recreational features supporting land values.

“New” Farm Bill

The not-quite-so-new Farm Bill has been in place for a couple of years and there now has been a fair amount of analysis of how it compares to previous versions. While the specific mechanisms of support have evolved, the relative desirability of the new program can probably be summarized in terms of the amount of income support it provides, and the degree to which the program provides a safety net in the form of higher payments when income is otherwise lower.

The punchline seems to be that the 2002 Farm Bill is likely to add about \$8 per acre in total payments to typical Midwest farmland. Perhaps as importantly, the 2002 Farm Bill does at least as good of a job at reducing income variability, again contributing to the support of farmland values. (More details of the study can be found at: www.farmdoc.uiuc.edu/policy/digest/pdfs/policy_irpd-sp2004.pdf).

Discount Rate

At a 10% discount rate, an increase in income of \$8 would mean that a buyer could afford to pay \$100 more per acre if that average increase were viewed as risk free and permanent. Speaking of discount rates, if interest rates fell, and the discount rate applied to that increase in income was now 5%, the increase in land value would now be \$160. The specific “required” rate of return to hold farmland is not obvious, but it is fairly safe to say that the interest rates have fallen to historically low levels, again providing a likely support to the farmland market.

Location, Location, Location

A common land value saying is that the three most important features of real estate are location, location, and location. The most commonly asserted reason for “local” buyer pressure in the seminars we have conducted was a profound increase in buyers using 1031 money. The IRS Code 1031 provision allows a seller to defer capital gains taxes by purchasing “like kind” assets if the transaction is completed within six months of the sale.

To put context to this issue, the ISPFMRA survey in 2002 estimated that 22 percent of land sales had a “1031” influence. The summer survey in 2004 estimated 49% of all sales had a 1031 influence. The general argument is that in order to avoid 18% total capital gains tax (15% Federal, 3% or higher for most state-level taxes), buyers with 1031 money were willing to bid up to that much more than a buyer without such opportunities.

To get a better handle on the magnitude of the competing pressures, we looked at actual farmland sales data around Illinois (the only location in which we can get sales data) for a period of approximately 10 years, (around 68,000 parcels, all arms-length and greater than five acres). In addition to parcel characteristics of size and productivity, we included measures of the distance to Chicago and other metro areas with over 50,000 in population, the county’s Beale code (a measure of the “ruralness” of the county), the disposable non-farm income in the area, the population density, livestock activities (intensity and scale) and inflation.

What we find is that, all else being equal, the productivity of the land explains a great deal about its rental value and hence capitalized income value. However, all else is never equal, and the sharp regional differences in farmland markets appear to have at least as much to do with non-farm income explanations as with the income to farming. In particular, distance to metro areas has an incredibly strong influence, as do population density and non-farm disposable income. The ruralness index — probably a good proxy for the probability of development for non-farm uses — likewise has the expected sign in that the less rural, the greater the land value in addition to that due the farm income it can generate.

So what is up in the farmland markets? Everything, it appears. There have been few indicators to suggest that the recent forces supporting farmland values have changed, and I continue to expect good returns to farmland. Remember, I have been wrong on the value increases for at least five years in a row.

Bruce Sherrick,

Professor of Agricultural and Applied Finance at the University of Illinois, teaches graduate courses in financial theory along with undergraduate courses in agricultural and applied finance, and financial modeling. The recipient of numerous recognitions and awards as a teacher, Sherrick conducts academic research and helped create and maintain farmdoc, an award-winning, agricultural-decision-making support program from the University of Illinois (<http://www.farmdoc.uiuc.edu>).

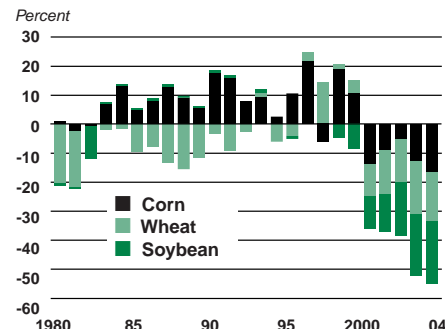


China’s Demand cont. from page 1

China quietly became the world’s largest importer of soybeans. Although soy-based foods, such as tofu, have long been mainstays in the Chinese diet, it was only during the 1990s that demand for soybeans took off. Livestock producers began including more high-protein soy meal in animal feed rations, and Chinese consumers developed a taste for soy-based cooking oil. Demand outstripped China’s production capacity, and China now relies on imports for more than half of its soybean use. China’s demand has become a key factor in the world soybean market.

Chinese officials would prefer the country rely less on imported grain and soybeans, but China cannot be self-sufficient in all food products. Boosting soybean production would entail a reduction of corn output since the two crops compete for the same land area. In 2004, officials sought to boost production of grains. Production did rise in response to higher prices, subsidies, and good weather. However, low profitability, dwindling water supplies, and loss of farmland to urbanization will prevent China from attaining grain self-sufficiency. Chinese farmers could produce enough grain and soybeans to meet all of China’s needs, but they would have to divert land from production of horticultural crops, orchards, livestock, and aquaculture, which earn much higher returns per hectare.

China’s demand for corn, wheat, and soybeans has outpaced supply since 2000



Note: Chart shows difference between production and estimated domestic use for each year.

Source: U.S. Department of Agriculture, World Agricultural Outlook Board, “World Agricultural Supply and Demand Estimates.”

Farmland IN PERSPECTIVE

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LAND REALTOR® OF AMERICA

Winnie Stortzum, ALC, GRI, ARA, REALTOR® and appraiser at Boyd Real Estate, Inc. of Arcola was recently honored as the 2004 Land REALTOR® of America by the REALTORS® Land Institute (RLI). Stortzum was selected from a field of 1,500+ members of RLI – all farm and land brokers in the United States, Canada and Mexico.

Winnie Stortzum
ARA, ALC, GRI

This prestigious award recognizes dedicated service as a REALTOR® and land broker, participation in community activities and related business activities, and high ethical standards. RLI, an affiliate group of the National Association of REALTORS®, is a national organization of real estate professionals specializing in all aspects of land sales – farms and ranches, commercial properties, vacant and recreational acreage and investment properties.

Stortzum has been selling and appraising farmland at Boyd Real Estate, Inc. in central Illinois since 1981. She has previously been recognized as the 1994 Illinois Farm and Land Broker of the Year; the 1992 Associate-REALTOR® of the Year from 35,000+ members of the Illinois Association of REALTORS®; and the 1991 REALTOR® of the Year by the East Central Illinois Board of REALTORS®.

Stortzum has a B.S. in Education with Honors from Eastern Illinois University and a M.A. in Teaching from the University of Illinois. She holds an Accredited Land Consultant (ALC) designation with RLI; a Graduate, REALTOR® Institute (GRI) designation with the National Association of REALTORS®; and an Accredited Rural Appraiser (ARA) designation with the American Society of Farm Managers and Rural Appraisers. She is also an Illinois Certified General Appraiser.

With her specialization in farm real estate sales, rural appraisals, and consulting, Winnie Stortzum can be an invaluable resource for you. Please give her a call or return the postage-paid card for further information or help with any questions you may have. *Thank You!*



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