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PRICING THE GOOD EARTH

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In the rush for hard assets over the past few years, some investors have planted farmland in their portfolios hoping to harvest nice gains.

On paper, at least, they have. U.S. land values are rising on strong prices for agricultural products, fueled to a great extent by robust exports to emerging nations. Advocates for owning farmland include big-name investors like Marc Faber and Michael Burry. But skeptics wonder whether the boom is setting up investors for a rerun of the crash that ended a similar period almost 30 years ago.

Back in the early 1980s, the sector was plunged into crisis when overleveraged farmers went bankrupt as interest rates skyrocketed to nosebleed levels during the last of the Carter years and the start of the Reagan administration.

Could a bubble be forming again in the heartland? Even Sheila Bair, chairwoman of the Federal Deposit Insurance Corp., urged caution recently, alarmed that

land prices, now 58% above 2000 levels in inflation-adjusted terms, foretell another bust—which could put more pressure on the already battered banks whose deposits her agency insures. But excessive leverage, a big villain in the crash of the 1980s, doesn't appear to be a major threat to farmers today.

"I would say we are perfectly priced for the current environment right now. If it changes radically, we could be mispriced in a new environment," says Michael Swanson, an agricultural economist for Wells Fargo, one of the largest lenders to commercial-farming operations.

Fundamentals are supporting the farm economy, says James McCandless, a managing director of UBS AgriVest. Farm income is strong, he says, while debt is low and crop productivity is increasing. In 1990, UBS AgriVest became one of the first firms to invest in U.S. farmland for tax-exempt institutions. Its farmland investments had a gross value of $544 million at the end of the third quarter.

While pockets of farmland—in the Dakotas, Nebraska and Kansas, for example—have risen strongly lately, most of the latest gains have been modest. In August, the Agriculture Department reported that the average price of farm real estate nationwide had been $2,140 an acre, as of Jan. 1, 2010, up 1.4% from the level a year earlier—but 86.1% above the level a decade before. And the National Council of Real Estate Investment Fiduciaries Farmland Index, which measures investment property, shows a third-quarter total return of 1.03%.

Gary Schnitkey, a professor of agricultural and consumer economics at the University of Illinois, says that farmland prices in his state—one of the nation's major agricultural producers—are in line with current interest and lease rates (also known as cash rents). Capitalized value, which is defined as the cash rent divided by the interest rate on a 10-year note, now equals about 95% of land prices, he says. In 1981, capitalized value soared to a heady 267%, while from 1990 through 2010, it averaged 107%. Farmers' debt-to-equity ratio is currently 12.8%, according to the U.S. Department of Agriculture, versus 13.6% in 2008; it was as near 30% in the mid-1980s.

One factor working against the development of a bubble is that big institutions—some of which were burdened by illiquid alternative investments, such as timberland, in the recent financial crisis—have done more talking about buying farmland in recent years than they've done purchasing. "There's a low level of participation by institutions...It's mostly individuals who own it, especially in the U.S.," says Jose Minaya, head of TIAA-CREF's natural-resources group, which has $2 billion in farmland investments in the U.S., Brazil and Australia.

It's not easy for the typical small investor to get into farmland, which is mostly used to produce crops but can also be used to graze cattle. A few funds do invest for pension plans or endowments, but there are no publicly available real-estate investment trusts specializing in the sector. Some private-equity groups are starting to buy land to develop private REITs. But these will be open only to qualified individuals—people who can show that they can comfortably handle the risks of such an investment—and they won't necessarily stick to the U.S.

In addition, there's not much U.S. farmland available. McCandless and Brian Newcomer, executive vice president of agricultural lender Rabo AgriFinance, in St. Louis, say that, with the prices of many types of crops very strong, farmers aren't motivated to sell. "What other alternative investments do farmers have?" Newcomer asks. "Stocks haven't performed that well."

Another caveat: Farmland investment isn't about quick gains. In fact, anyone thinking of buying farmland and leasing it out should think very long-term: 20, maybe even 30 years. "Farmland is illiquid. Expectations for profit can be too high. Well-bought land, however, at the right price can be part of many portfolios," says Shonda Warner, managing director of Chess Ag Full Harvest Partners, a private-placement fund based in Clarksdale, Miss., with $50 million under management.

An investor with $250,000 to $500,000 available has options in this sector. The easiest is to use a farm-management company, like Farmers National, an 81-year-old Nebraska company, which can handle everything from buying to leasing, for a fee. Investors going in on their own should research the prevailing rent-to-value ratio when pricing land, says Dan Manternach, ag-services director for Doane, a St. Louis commodity-market risk-management firm. That's determined by how much investors pay for an acre of land and what they can get by leasing it. The higher the figure, the better. If an acre goes for $5,000 and it can be rented to a farmer for $300, the rent-to-value number is 6%, which Manternach views as a good return.

Returns on farmland can, of course, vary, but a study done by Terry Kastens and Kevin Dhuyvetter, at Kansas State University in Manhattan, Kan., compares broad farmland returns to the Standard & Poor's 500's, starting in the 1950s. The study, published in December 2000, showed that from 1951 to 1999, when combining real returns and capital gains, farmland returned 10% to 12% (the real, inflation-adjusted return only was about 5%), for unleveraged properties. In the same period, they note, the S&P's nominal return, with dividends included, was 14.3%, while its dividend-only return was 4%. The study's authors view cash rents as farming's version of dividends.

If you don't have at least $250,000 to invest, stick to equities, says Dan Basse, president of agricultural-consultancy AgResource, in Chicago. "Buy stocks in companies that help farmers produce, like Deere & Co. [ticker: DE] or Potash [POT]," he advises.

Investors in farmland must realize that, while the sun is shining now, clouds can quickly form. A big rise in interest rates would hurt capitalized values and farm income. Crop prices can vary wildly. Even though farmers have low debt-to-equity ratios, they often get loans for operational costs. Currently, rates from commercial banks or the Farm Credit System, a government-sponsored entity for farmers, are generally just under 5% for a 20-year fixed-rate loans.

In sum, farmland can be an attractive investment, but the lessons of the 1980s must be heeded. A crash isn't likely anytime soon, but if interest rates go up and crop prices go down, farmers and farmland investors would suffer. Any individual inexperienced in agricultural investing should dig in only after harvesting a lot of advice from veterans—and with the determination to stay in for the long haul.