



BRIAN FREISE

**PRESIDENT/
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LAND BUBBLE?

A FARM OPERATING NOTE BUBBLE IS MORE LIKELY

It was recently reported that Iowa farm land prices soared 16% higher in 2010. Reports of \$8,000-\$10,000 per acre values for ordinary farm land are very common. Land prices are on a tear. When will they stop? This is a question that is very difficult to answer. However, this land price increase brings to the forefront an issue that must be closely watched.

Five years ago, land prices were being driven primarily by 1031 land exchanges and investor money. The 1031 land exchanges are less prevalent today. The same can be said for inflows of investor money. Currently, the primary driver of farmland prices is farmer interest. High commodity prices and good yields in many parts of the country have allowed producers to generate profits unlike any they were able to achieve five years ago. Many farm producers are funneling large amounts of their working capital towards down payments for farmland (or to pay higher cash rent). Those in the banking industry making farmland loans learned a valuable lesson in the 1980's. The higher the down payment, the less likely the loan is to go into default in the event of a downturn in land prices. This is a lesson that, to this day, lenders heed by continuing to require down payments in excess of 25%, with 40% being a very common requirement. The reality is this: The more "skin" the buyer has in the game, the greater the likelihood he will stay with the loan, regardless of what market prices do. One wonders why the housing industry does not recognize this! There are still ads in the paper for 0% down home loans.

These large down payments should actually help to insulate farmland values from a sudden collapse. As previously mentioned, large down payments, and high cash rents being paid by farmers are coming directly out of their working capital. Working capital is defined as current assets minus current liabilities. **Working capital is a tremendous insurance policy in and of itself.** High working capital levels allow producers to weather short term, or even longer term downturns in commodity prices. In essence, they will be able to absorb this impact more readily than those with lower working capital levels. In some ways, the banking industry also incentivizes this transfer of cash from working capital to long term liability (such as a land note), due to how their capitalization requirements work. The government also adds incentives by allowing up to \$500,000 of accelerated depreciation on many intermediate assets, i.e. machinery. As farmers deplete working capital, they rely more on bank operating loans for cash. One of the major variables that determine how much money a bank will loan for operating needs is commodity prices. If commodity prices go down, banks may reduce operating notes. This will be compounded by the fact that their cost of production (or the cost to plant the next year's crop), will not drop near as quickly as commodity prices do. The net result could catch some farmers in an operating note bind, and have them searching for new sources of operating cash. In some areas of the Midwest, where corn yields were lower in 2010, this problem would probably already be surfacing, if it were not for the presently high commodity prices. Will a down turn in commodity prices slow down the climb in farmland values? Possibly, but it will definitely impact producers the most who have depleted their working capital.

Working capital is incredibly valuable, as it creates independence. It is our advice that producers use these profitable times to build a significant cushion for themselves to prepare for the likely future commodity price decline. One way for a farmer to determine how effectively they are building their working capital is to analyze the size of their bank operating loan. If a farmer is profitable, and is not significantly growing their farming operation, their operating loan requirements should be decreasing. Many successful farmers set a goal of eventually eliminating their need for an operating line of credit. The only way for this to happen is to develop a plan, and then follow through. Please contact us if you desire assistance in setting financial goals for your farming operation.



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2011 A GOLDEN OPPORTUNITY

Continued from front page....

The lesson from this is that things can change fast. Simply stated, we do not feel our job is to pick the market top, but rather to mitigate risk. So how can we protect the 2011 crop? A producer could forward contract grain. This requires fighting against the psychology mentioned above as well as accepting a wide basis or a large HTA fee. Buying PUT options could be a solution; however, PUTS in the new crop months are very expensive and perhaps not very practical because of the excessive amount of time premium that must be purchased. It has been our experience that year in and year out federal crop insurance presents the best and most economical way to put both a revenue floor under the market and protect yield risk (which there is no other way to do). However, crop insurance premiums will be much higher in 2011. So the big question is will crop insurance still be the best way to preserve the *Golden Opportunity* that 2011 represents?

This is a question, along with many others, that we will be attempting to answer during our winter meetings. We hope to see you there! For those looking to protect price immediately we have recently implemented a strategy. If you have questions on what can be done right now to protect price, please plan on attending one of upcoming winter meetings; or, if you cannot attend the winter meetings, please give our office a call. We will be happy to help you in any way that we can!

WINTER MEETING DATES

FEBRUARY 8, 2011

**WEAVER RIDGE COUNTRY CLUB
5100 WEAVER RIDGE BLVD
PEORIA, IL 61615**

Or

FEBRUARY 10, 2011

**QUALITY INN & SUITES
154 PLAZA DR
DIXON, IL 61021**

***Don't miss this Golden Opportunity!
AgPerspective urges you to attend one of these
meetings focusing on a preview of the
2012 Farm Bill, Crop Insurance,
Hedging Strategies and Managed Futures.***

Please RSVP by calling our office at 815.284.9792