Why Are Outside Investors Suddenly Interested in Farmland?

Jennifer Ifft and Todd Kuethe

There is a growing notion that a large volume of farmland purchases are being made by individuals and institutions outside of the traditional agricultural sector. Over the last 15 years, farmland has offered returns higher than the S&P 500, and farmland did not experience the price bust of residential housing. However, farmland price appreciation varies by regions.

Figure 1. Return on Investment for S&P 500 and Farmland, 1980–2007

While the rest of the economy struggles to overcome the recent recession, the agricultural sector is prospering as a result of high commodity prices, an expansion in agricultural exports, and rising farm income levels. The relative prosperity of the agricultural sector has attracted the attention of new investors, yet the agricultural sector offers few opportunities for outside investment. For example, only a small share of agribusiness firms are publicly traded.

The financial industry has responded by developing several new financial products that allow individuals to “invest” in the agricultural sector. The products include over-the-counter swaps, exchange-traded funds, and exchange-traded notes. In addition, several firms are working to create publicly traded real estate investment trusts that specialize in farmland.

The most direct avenue for investing in the agricultural sector remains direct purchases of farmland. Outside investors are recognizing the financial opportunities of purchasing farmland, and many suggest speculative forces are bidding up prices. Given historically thin farmland markets, or infrequent farmland sales, competition to purchase prime farmland has always been fierce. According to a recent USDA report, the average value per acre for farm real estate (defined as the value of all land and buildings) in 2011 is $2,350—a 6.8% increase over the previous year. The average value per acre for farm real estate in California is $6,600 per acre, a reduction by 1.5%.

Farmland’s Return on Investment

Farmland differs from other investments in that it is illiquid – or not easily sold, and buyers often purchase farmland as a long-term investment. Other investments, such as stocks and bonds, are easily transferred and are often held for much shorter investment horizons. The natural question is then, does investment in farmland or the stock market yield higher returns? To answer this question, we consider the return on investment (ROI) of farm real estate compared to the S&P 500, a frequently used measure of stock market performance. ROI measures the per-period rate of return on dollars invested, and for a single period, ROI is calculated as:

Return on Investment (%) = Net profit ($) / Investment ($)

The value of ROI would therefore increase as profit increases or the cost of investment decreases. To control for the effects of inflation, all prices are expressed in real dollars using the consumer price index.

The ROI in 2011 for farmland and the S&P 500 since 1980 are shown in Figure 1. The lines show the percent return for an investment of $1,000, in real 2011 dollars, in each year. For example, an investment of $1,000 real
dollars in 1980 would yield a return of 2.6%. The same investment in farmland at the U.S. average price yields approximately one-tenth of a percent return (0.1%), yet an investment at the average California price yields 0.8%.

The early 1980s were a period of record losses for farmland values throughout the United States and, as a result, the S&P 500 represents a more attractive investment in that period. On the other hand, investment in farmland at both the average California and U.S. prices would have yielded higher returns in more recent years.

California farmland consistently outperformed the stock market from 1991–2007. Further, in two periods (1997–2001 and 2004–2007), the stock market exhibited a negative ROI while California farmland returns were positive throughout. When farmland values were peaking in the early 1980s, ROI for the S&P was higher; the opposite situation occurred in the late 1990s when stock markets were booming. It should be noted, however, that the ROI calculated above considers only the value of the asset and does not include potential annual returns, such as dividends (in the case of the S&P 500) or farm income or cash rents (in the case of farmland).

Farmland vs. Other Types of Real Estate

The real estate sector has received considerable attention in the last decade. Throughout the early 2000s, residential real estate values rapidly increased throughout the country, but in the last several years, real estate values declined substantially. This boom-and-bust cycle was particularly pronounced in several areas throughout California. At the same time, however, farmland values have exhibited a consistent upward trend.

Figure 2 shows the average annual price change, while controlling for inflation, for farmland values in California as compared to state-wide residential real estate prices. The figure also includes the appreciation rate for non-metropolitan housing in California. Both residential price indexes were obtained from the Federal Housing Finance Agency.

The chart shows that over the period of 1995–2005, residential real estate prices appreciated more than farmland. For example, in the first part of the last decade, farmland prices rose at an average annual rate of 8.6%, compared to 13.9% for state-wide residential real estate. However, in the latter part of the decade, residential real estate values fell substantially at 8.8% throughout California and 8.7% in rural areas. Farmland values continued to appreciate throughout the same period at an annual average of 3.8%. Although farmland exhibited a less pronounced appreciation over 1995–2005, it yielded consistently positive gains.

Statewide Trends in Farm Real Estate Values

One of the challenges of measuring returns at an aggregate level is that it often masks significant regional differences. Trends in farm real estate could vary by region due to multiple reasons, such as differing degrees of urban pressure, type of commodity produced, and potential recreational uses for farmland.

Figure 3 divides agricultural counties into those with “high” growth in farm real estate values and those with “low” growth in farm real estate values, based on per acre estimates from the USDA/NASS June Area Survey. The dark-shaded areas experienced average annual growth in real estate values above the state-level median rate over the period 1998–2009, whereas the lighter areas represent counties below the median appreciation rate. The remaining counties are omitted due to insufficient observations for disclosure.

Farm real estate values in the Sacramento Valley, on average, appreciated more rapidly than in the San Joaquin Valley and agricultural counties in Northern and Southern California. Farm real estate values in the Central Coast and southern part of the San Joaquin Valley that specialize in fruit and vegetable production have also appreciated more rapidly.

In addition to the agronomic differences, the regional variation may be due, in part, to the influence of neighboring urban areas. Previous studies have shown that throughout the United States, farmland located near urban areas has higher values,
even when controlling for differences in agricultural production. A recent study by Kuethe, Ifft, and Morehart (2011) suggests that in California, urban influence appears to have the largest impact on farmland values in the Central Valley, yet the degree of urban influence is lower when compared to other regions in the United States. Although most of the state’s major metropolitan areas are not in agricultural areas, Sacramento is an exception, and the counties surrounding Sacramento also experienced higher appreciation rates.

Conclusions

Farm real estate remains the most direct method of investing in the agricultural sector. In recent years, the agricultural sector has provided consistently positive returns as a result of high commodity prices and rising farm income levels. The success of the agricultural sector has led to increased attention from investors outside of the traditional agricultural finance sector.

Our analysis shows that in recent decades, farm real estate returns have been greater than average returns in the stock market. In addition, farmland prices have not experienced the recent downturn observed in residential real estate values. California farmland values had an average annual appreciation rate of 3.8% over 2005–2010, while the value of residential real estate within the state declined. The growth in farmland values, however, has varied across the state over the past decade with the highest appreciation rates located in the Sacramento Valley and Central Coast.

Suggested Citation:

Jennifer Ifft and Todd Kuethe are economists at the Economic Research Service, United States Department of Agriculture, Washington DC. Initial research on this topic was supported by a Giannini Foundation grant while Jennifer Ifft was a Ph.D. Candidate in the Agricultural and Resource Economics Department at University of California, Berkeley. The views expressed are those of the authors and should not be attributed to ERS or USDA.

For additional information, the authors recommend:


Other Related Articles in Past Issues of ARE Update


