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SNL NASHVILLE NOTES

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Farm prices and ag lending — good as gold

By Jeff K. Davis

In case you missed it, Andrew Wolcott had an excellent article on agricultural lending March 4. I wanted to add a few thoughts for those who are or thinking about investing in banks based upon an agricultural theme.

As is widely recognized, the farm economy is booming. How much of the boom is attributable to a growing global population compared to the impact of the Federal Reserve's interest rate policies on commodity prices is debatable. I have visited several agricultural-focused banks in recent weeks. When I told the CEOs that Chairman Ben Bernanke was adamant that there was not much inflation, all laughed. One noted that the average cost to produce an acre of cotton last year was pushing $600, up from $250 five years earlier. Farm values in all areas were up sharply, too, though only one or two farms in a given county may trade each year. A lot of factors can influence value, including commodity prices, the productivity of the land, interest rates and whether the farmer located next to the selling farmer is positioned (i.e., unlevered) to acquire the land.

The USDA's National Agricultural Statistics Service in its Land Values 2012 Summary noted that the aggregate U.S. farm real estate value averaged $2,650 per acre in 2012, up 11% from 2011. The cropland subset rose 15% over 2011 and 29% over 2008 to $3,550 per acre in 2012; however, the Corn Belt (Illinois, Indiana, Iowa, Missouri and Ohio) experienced a 19% increase to $6,010 per acre, and the Northern Plains (Kansas, Nebraska, North Dakota and South Dakota) experienced a 30% increase to $2,360 per acre. The Delta region (Arkansas, Louisiana and Mississippi) posted just an 8% increase to $2,220, though my bank contacts indicate the increase and the average price per acre in the Delta plain on either side of the Mississippi river is much higher. Farmers, like bankers contemplating selling, may have a propensity to pick the highest multiple transaction in a comp group as a representative indication of overall value.

There is no shortage of capital flowing into the sector. Famed investor Jim Rogers has been vocal in his bullish thesis for agricultural commodities, farm land and mining interests for many years, given projected growth in the global population to 9 billion by 2030, according to the U.N., from 7 billion today. I would add that very low interest rates for capital-intensive businesses such as farming tend to support higher asset values as was the case in the 1970s when real rates were last negative.

Wolcott's article noted that there was about $140 billion of bank loans that were secured with farmland or financed production as of year-end 2012 (production-related loans will be higher mid-year once the crops are in the ground). The balances may understate farm related loans somewhat since Call Report data is classified based upon collateral rather than purpose, plus there is no way to measure loans where the borrowers' business is indirectly tied to agriculture.

U.S. banks are not the only financiers of the farm economy. Insurance companies and credit-focused institutional investors are increasingly active as long-term lenders, while institutional investors and foreign investors have stepped up farm purchases as an inflation hedge and perhaps a play on Rogers' population-commodity thesis. Not surprisingly, the biggest lending competitor to the banks is the same entity that backstops their deposits, the federal government. The Farm Credit System (FCS), a government-sponsored entity that was created in 1916, funded $192 billion of loans at year-end 2012, up 56% from year-end 2006. Pretax income of $4.3 billion, which rose 3% over 2011, equated to a pretax ROA of 1.80%. (The 2012 annual statement for the FCS can be found here.)

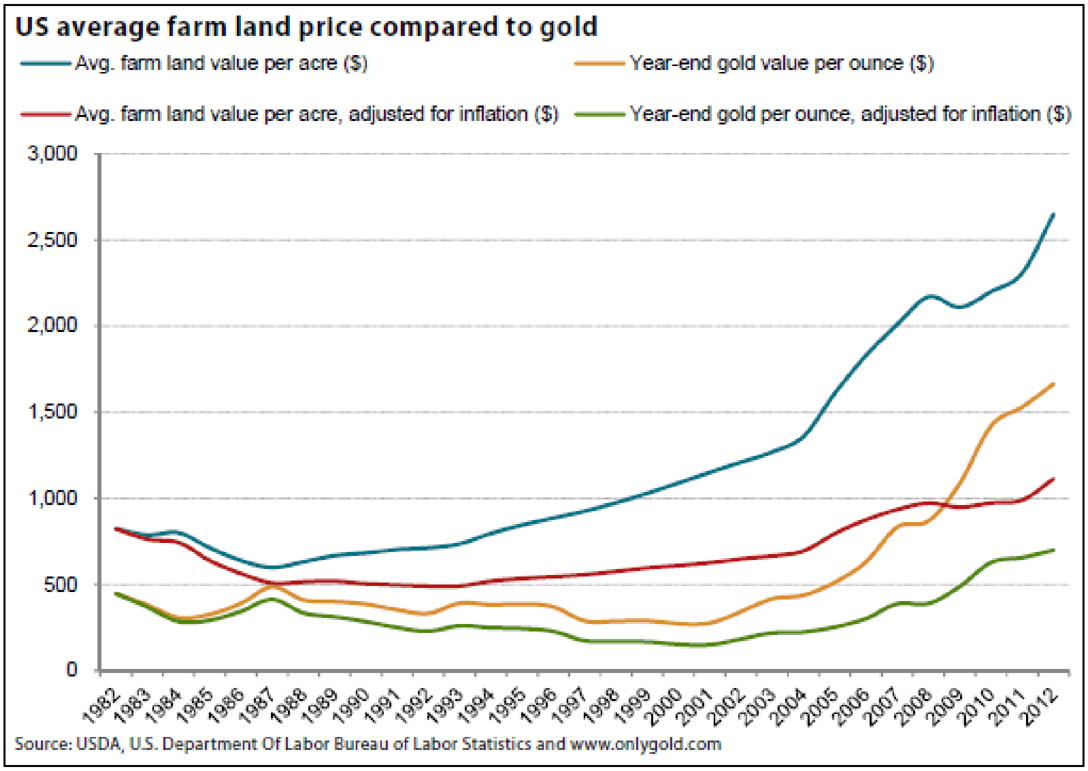
The FDIC released its quarterly banking profile Feb. 26, which highlighted the highest quarterly net income for FDIC-insured institutions since the fourth quarter of 2006 of $34.7 billion (+37% Y/Y). Full-year net income was $141.3 billion, up 19% over 2011 as a result of sharply lower credit costs and higher mortgage banking income. Most probably overlooked the 1,537 banks designated as agricultural focused in the FDIC Quarterly Banking Profile. It would be easy to do, because they are not significant in the scheme of the U.S. banking industry. These banks, which represented 22% of the 7,083 insured institutions at year-end, had $240 billion assets, or just $156 million on average. As of year-end, FDIC-insured institutions had $14.5 trillion of on-balance sheet assets.

When asset values are rising, banks that lend against the asset usually perform well. Pretax ROA in the fourth quarter of 2012 for the agricultural banks was 1.32% (~$800 million) compared to 1.14% for 3,497 commercial-focused banks and 1.01% for 827 banks less than $1 billion of assets that did not fall into one of the FDIC's type classifications. Agricultural-focused banks have produced a higher pretax ROA (many small banks are S-corporations) since 2007 than other bank subsets. According to the FDIC's state profile, energy-rich North Dakota had the highest median pretax ROA for third quarter 2012, at 1.62%. Nebraska, Iowa, Oklahoma and South Dakota were not far behind at 1.46 to 1.49%. Florida and Georgia, of course, anchor the other bookend at 0.46% and 0.56%, respectively. Contrarian investors will prefer these states rather than those with current momentum.

Investing in banks whose fortunes are directly tied to agriculture is tough. The largest farm-related loan portfolios are housed inside large U.S. bank holding companies such as Wells Fargo & Co. or domestic subsidiaries of foreign bank holding companies such as BNP Paribas SA's BancWest Corp. and Rabobank Group. Focused plays on the sector require investing in the common equity, preferred and parent debt of micro-caps and privately held banks for the most part. Dubuque, Iowa-based Heartland Financial USA Inc. is one of the larger ag-exposed banks with a growth profile in the Farm Belt and Intermountain West, yet only 12% of its portfolio is directly tied to agriculture.

So, are farm values on the cusp of falling and bringing ruin upon banks (and FCS) that lend to farmers? Suspicion is a reasonable emotion, given the move in farm prices the past few years. My guess is no, though prices may move sideways for some time, since many believe prices paid for farms today cannot produce an acceptable return on capital unless commodity prices move higher. Foreign capital and institutional money may not care much if the purchases are designed as an inflation hedge.

In any event, it was not until Paul Volcker pushed short rates materially above the inflation rate that land, gold, oil and other hard asset values cracked in the early 1980s. Interestingly, since 1982 farm values based upon the USDA's aggregate value per acre has proven to be nearly as good of an investment as gold given an increase in nominal dollars of 222% versus 271% for gold. To note the obvious, Paul Volcker is not chairman of the Federal Reserve Board of Governors.



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Jeff K. Davis, Managing Director of Mercer Capital's Financial Institutions Group, is a regular contributor to SNL Financial. He can be reached at jeffdavis@mercercapital.com or 615.345.0350.