How to determine whether farmland is a good buy

There are a number of financial analysis tools that can help you put a value on land

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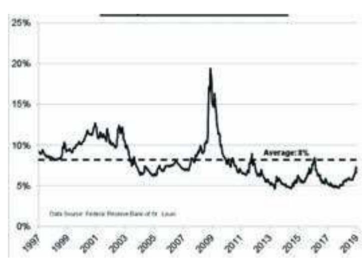

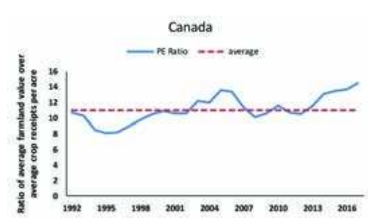

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A regular topic of conversation at farming events is the value of land. Is it expensive? Will it keep going higher? Should I be buying more? These questions come up regularly but there doesn't seem to be a consistent way to answer them.

Part of the reason is that there are so many moving parts when trying to determine if it makes sense to buy more land. This article will offer some insights and provide some guidance on this important issue.

A recent FCC Ag Economics report starts by saying, “the Canadian farmland market has been strong for the last decade. But a question on people’s minds is ‘does it makes sense?’ To answer this, let’s examine the relationship between farmland values and farm income.”

To track that value of farmland relative to crop receipts, FCC uses the Farmland Price-to-Earnings Ratio (PE ratio). It says “it measures the price of farmland as a multiple of crop receipts. Used to assess other financial assets, the PE ratio is one measure of the affordability of farmland compared to its long-term average.”

This is a useful approach since many other assets do indeed use a similar metric to determine value.

Stocks are regularly measured by their PE ratio; you could even use a similar ratio for corporate bonds and loans.

The PE ratio is just a measure of the profit, cash or earnings an investment generates based on the amount invested. In essence, it shows how much the market is paying for $1 of profit. Expressed another way, the inverse of the PE ratio is the earnings yield; it’s like the percentage cash flow return.

It’s just the earnings divided by the price. For instance, $1 of profit on a $10 stock gives a PE ratio of 10 and an earnings yield of 10 per cent. Let’s look at a few companies familiar to the farming community to see some current PE ratios in the stock market.

Nutrien Ltd. has been trading at US$50 with expected annual earnings of $3 per share so its price-to-earnings ratio is around 17 (simply $50 divided by $3).

Deere & Co. trades at US$156 but is expected to make around $7.50 profit per share this year so its PE ratio is about 21. Bunge has a PE ratio of 11 given its stock trades at US$53 and makes about $5 per share a year. Meanwhile, ADM earns US$3.50 per year and trades at $43 so its PE ratio is about 12.

Overall, the U.S. stock market, as measured by the S&P 500 index, has a PE ratio of 18 times. In Canada, the TSX Composite Index PE ratio is around 16.

The earnings yield for these would be six per cent for Nutrien (simply the $3 of earnings per share divided by its share price of $50), Deere’s earnings yield is 4.8 per cent, Bunge’s is at 9.4 per cent while ADM’s is 8.1 per cent.

The broad stock market earnings yield is 5.6 per cent in the U.S. and 6.3 per cent in Canada.

These figures give a sense of how the market is valuing different stocks. However, it’s not as easy as just comparing PE ratios to determine if a stock is cheap or expensive, whether it’s a good buy or not and if it’s going to go up or down.

Some asset valuations are higher, some are lower, depending on their history, perceived riskiness, profit track record and, of course, current demand and supply dynamics for the asset.

So using FCC data, the PE ratio for Canadian farmland since 1992 has ranged between about eight and 14, averaging about 11 (see chart) with a corresponding average earnings yield of about nine per cent. The figures for U.S. farmland are basically the same.

In this same time frame since 1992, the PE ratio for U.S. stocks has mostly been between 15 on the low end and 30 on the upper end with an average of 25. This gives an average earnings yield of four per cent. For a whole basket of higher-yielding BBB and BB rated U.S. corporate bonds, the "PE ratio" based on the interest rate yield has typically been between eight and 22 with an average of 14. The equivalent yield has usually been between five per cent and 12 per cent, averaging eight per cent over that time (see chart 'US Corporate BBB & BB Bond Yields').

So, looking at all these numbers over time, farmland can have similar valuations to both stocks and corporate bonds, although with less volatility and less extreme readings at both ends.

And just like stocks, many factors will impact both the earnings and the price component of farmland.

For farmland earnings, it's important to ask: What are the prices of the commodities you produce going to do? What is the cost structure and net profit for the farm? What is past weather, precipitation patterns and yield history like on the land? As for land prices, how productive and fertile the land is, proximity to transportation logistics and potential buyers in the area are just some of the key variables.

For example, maybe a new foodprocessing plant is moving in to the area or a major city is expanding towards your land and is skewing prices.

Bottom line, all these factors will vary greatly from one quarter section to another so the PE ratio and value of the land will vary as well.

Usually, PE values are somewhere in the mid-range so this analysis provides an overall guideline to help determine where you think farmland prices might be going. At higher or lower PE levels, the ratio can help you determine whether price is cheap enough to buy an additional parcel or if prices are high, perhaps it's compelling to sell some of your land as part of a longer-term transition plan.

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