SCALING UP CROP ENTERPRISES

PART 4: DOES A LAND VALUE PREMIUM FOR SMALL SCALE LAND PURCHASES DRIVE A SIGNIFICANT DIFFERENCE?

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Part 4: Does a land value premium for small scale land purchases drive a significant difference?

In the last article (Part 3) we reported that capital gain and economies of scale driving cost efficiencies had a relatively minor impact on returns when comparing lease versus land purchase. Changes in lease price and changes in production leading to differences in income were different though and the analysis outcome was extremely sensitive to these factors.

This is the fourth article in the four article series about scaling up crop enterprises.

The current market signal is that small scale farm land prices are inflated relative to large scale farm land. In this article we analyse the effect that this has when comparing a small farm land purchase with a large land lease.

For more information on Agrista's Farm leasing for growth course, where we explore similar issues go to https://www.agrista.com.au/leasing-business-growth

Scale nuances in land markets

A transaction for an agricultural lease or an agricultural land purchase isn't like buying a bag of mixed lollies at the corner store where what you get is contingent on the amount you pay. (This analogy may be lost on those who can't remember the frustration of the shopkeeper when an 8 year old child with 50 cents was given the discretion to choose 50 x 1 cent lollies from a selection of 100 different lolly choices). The area of land on offer, rather than your budget, dictates the amount paid for a lease or land purchase. On this basis it is unlikely that a decision to lease or purchase will be as straightforward as what is presented in this analysis, but the aim of this exercise was to assess like for like.

Another complication with the approach taken in this analysis is that the market appears to be differentially valuing land assets based on scale. This means that more is being paid for smaller scale farms per unit of area relative to larger scale farms. While in some cases this is related to the relative weighting of value of land versus houses and other infrastructure this isn't necessarily always the case as many small scale farms devoid of infrastructure or improvements appear to be achieving high price premiums on a per hectare basis when compared with far larger scale farms.

Some of the many possible reasons for the apparent disparity in price per productive unit between small and large farms include:

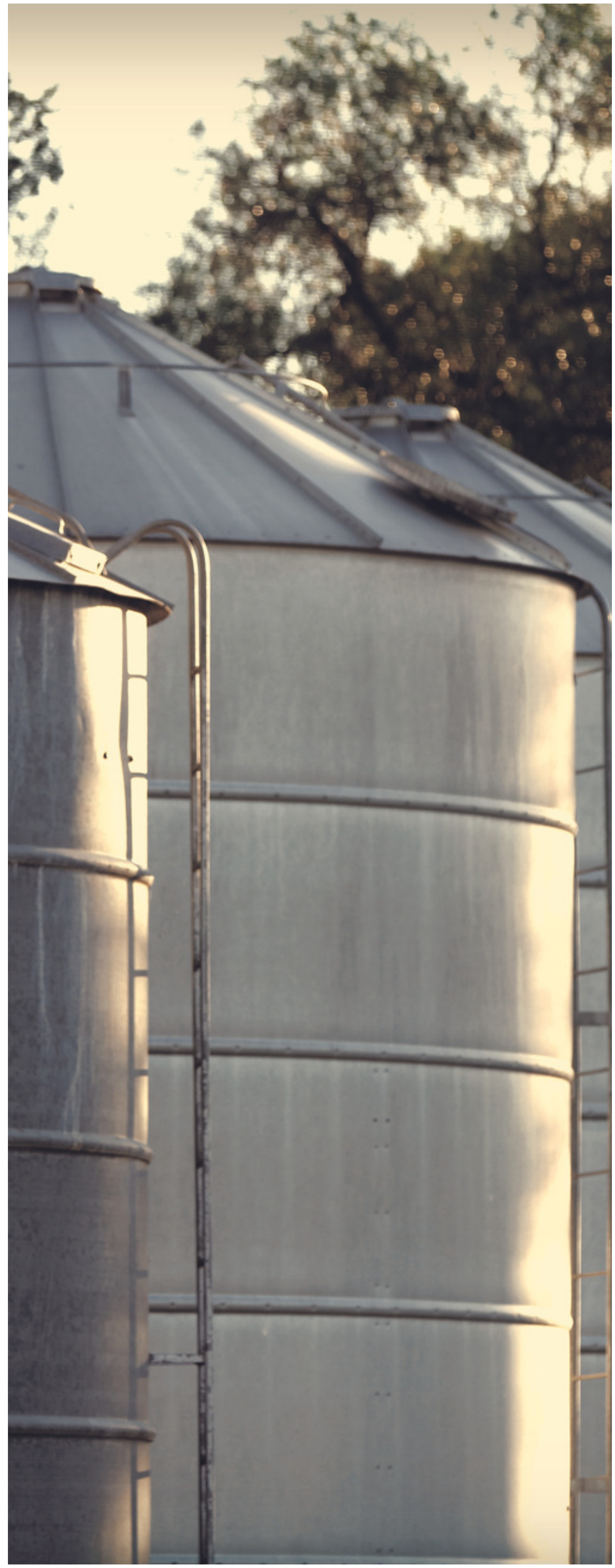
- ·The smaller scale is attainable to a greater proportion of prospective purchasers thus there is more competition driving price. In other words, there are more prospective buyers with access to $2 million in capital than there are prospective buyers with access to $20 million in capital.

- ·A small scale farm with little infrastructure may hold strong appeal to those with existing assets as they perceive that they are not paying for infrastructure that is surplus to needs.

- ·A small scale farm with lots of infrastructure may hold strong appeal to lifestyle farmers. These are typically people with an affinity or interest in agriculture but they may have no requirement or imperative for the farm to generate an operating return as the interest payments can be met with surplus funds from elsewhere.

- ·The value of cost efficiencies driven by increased scale to neighbouring farm owners is very high.

It appears that the market may also be pricing in economies of scale to new, small scale farm purchasers. Previously there was a compelling business case to add small scale farms to an existing block as there was a significant marginal increase in profit due to cost efficiencies driven by a low marginal overhead cost structure on every additional hectare purchased. This meant that there was a high likelihood that a small scale purchase could "wash its own face". In other words, the marginal profit from the purchase was more than adequate to service any additional debt.



With the economies of scale priced in to purchases it becomes increasingly likely that cash surpluses from elsewhere (the existing business or off farm typically) will be required to fund any shortfall.

It is also possible that timing of access to capital is a driver of the high pricing on small scale land offerings. In a recent discussion with a client looking to purchase a large scale asset they relayed that the agent conducted 50 inspections but there were only 6 registered bidders at auction. The inference was not that the property wasn't suited to the 44 prospective purchasers that weren't registered bidders, it was that they were limited by their capacity to access the finance in a timely fashion which prevented them being a competitor in the auction process.

The key point of this market nuance is that a differential in pricing between small and large scale land assets weights the business case back in favour of a lease, all other assumptions remaining constant. This occurs because the difference in operating scale between leasing and purchasing increases to a magnitude of 14 times.

The inference of this disparity is that the outcome of the analysis will be sensitive to the disparity in land price between a larger scale lease and a smaller scale purchase. An assessment of the extent to which disparity in land value influences the net return from purchasing is shown in Figure 1.

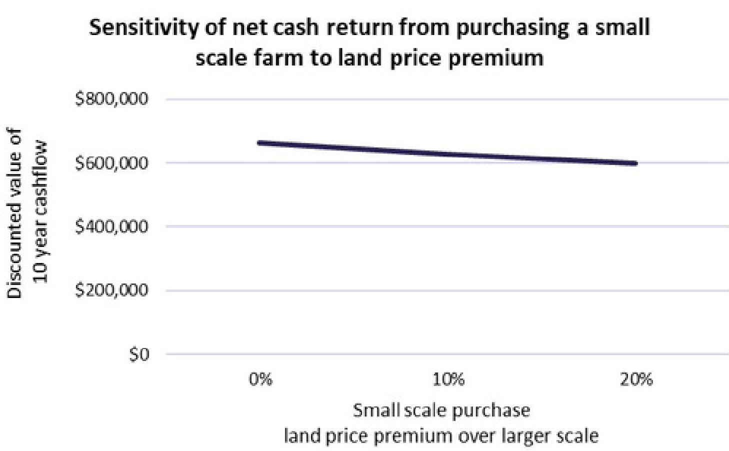


Figure 1. A premium paid for a smaller scale purchase results in a relatively minor change in net wealth.

Figure 1 shows that each 10 percent premium paid for a smaller scale purchase results in a change in the discounted value of net wealth of approximately $30,000.

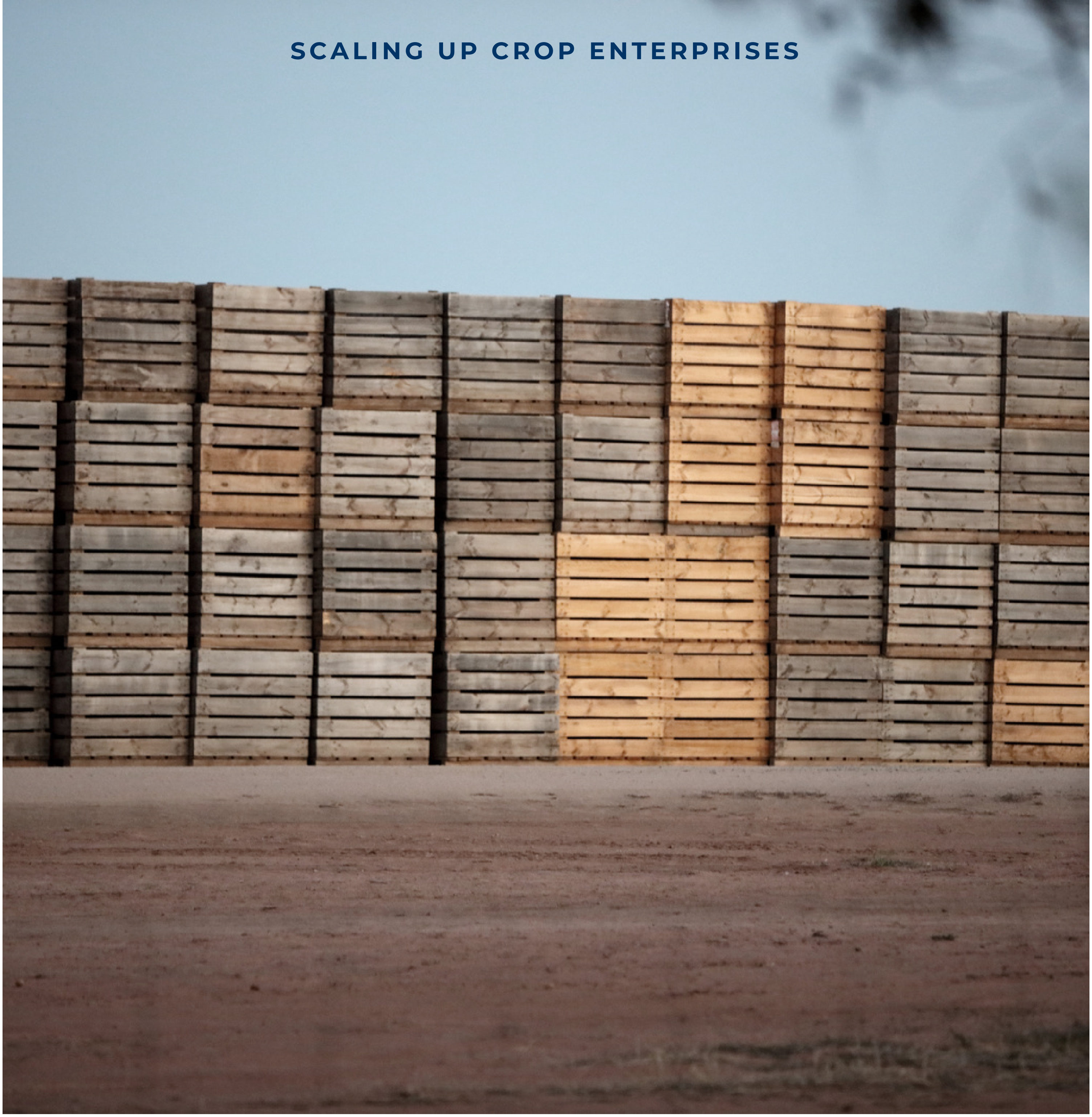
This loss in wealth is primarily made up of loss in operating return rather than capital return. The loss in operating return occurs due to the smaller scale. Where there is no price difference 151 hectares can be purchased with $2 million compared with 127 hectares at a 20% land price premium.

As the difference in operating scale due to the price premium is relatively small so is the difference in operating return. The capital growth does not change significantly as the analysis assumes the same rate of capital growth irrespective of initial purchase value.

What this means to you?

This analysis demonstrates that a premium in the order of 10 to 20 percent paid for purchased land relative to a larger scale lease has a low level of impact on the analysis outcome.

The analysis is not particularly sensitive to land value premiums for small scale purchases because the effect of the premium is to lower the area of land purchased with the $2 million capital outlay. This reduces the operational return as there is less land being farmed. As the operating component only drives 20 percent of the total return in the land purchase it has a small impact.



This completes our four part analysis of large scale leasing versus small scale purchasing. We hope you enjoyed exploring the factors that are often overlooked in what can be an issue with far greater complexity than it first seems.

This is the type of analytical approach and presentation of data delivered in Agrista's recently released Farm Leasing for Growth Course. Further details on the course can be found here www.agrista.com.au/leasing-business-growth.

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