Opportunities for Expansion in a Downturn

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An inevitable outcome of any downturn in the agricultural economy is producers experiencing financial stress. The present low price environment is no different, and with it comes the likelihood that producers will evaluate their options including exiting the industry. The reasons for exiting farming are numerous. Often producers are attempting to capture the remaining equity in their operation before its potential erosion. Certainly, no one likes to bask in someone else's hardship. However, one person's misfortune can be another's opportunity. A valid question for a financially stable and well-positioned producer is should they acquire the assets, particularly the land, of exiting producers?

There are multiple ways of taking on additional land including: leasing, purchase, FSA land contract guarantees, merger, and collaboration. This paper will focus on the purchase option with consideration toward leasing. For more information on merging and collaborating see (Knapek and Klinefelter).

The questions of purchasing an existing neighbor's land or other parts of their operation is essentially one of should you expand your current farm at what potentially could be a one-time opportunity at a discounted value. This question is more complex than it appears on the surface and leads to a number of things to consider both financial and otherwise. The first thing to figure out is, what exactly you will be acquiring. This sounds obvious, but the details matter. Just like you would never buy a house without a detailed inspection and you should never purchase farmland, even from a trusted neighbor, without first knowing exactly what you are purchasing and the condition.

A few things to consider concerning a new land purchase:

1. Has the property been surveyed? Are all boundaries and easements known? A modern GPS survey will almost certainly uncover minor discrepancies which will fall into the realm of common law. If there are any major disputes or claims, determine their legal status. Certainly, you don't want to have any surprises with physical elements of the land after you become the owner.
2. What are the base acres and payment yields associated with the land? Additionally, it is important to know what farm program (ARC or PLC) the base acres are currently enrolled.
3. What is the soil type and how productive has the land been in the past? Poor or neglected soil can take years to correct. If possible, get soil samples and request production records from the current producer. This information will help you estimate potential yields on the potential purchased land. Remember it may take a while to figure out how to farm the land at maximum efficiency.
4. Are there any drainage or flooding problems on the land? Are there places on the land that stay wet, or parts that suffer from water erosion? If issues exist, can they be addressed and at what cost?
5. Is there access to water and irrigation with the property? If there is no water on the property, is it possible to drill wells? Who owns the water rights? Irrigation is essential in some parts of the country, but is also becoming an important risk management tool against drought in places that receive adequate, but perhaps, untimely rains.
6. Who owns the mineral rights? It is important to know if the mineral rights are being included with the potential sale of the land and what your rights are if they are not.
7. Are there any current environmental concerns or conservation or land use easements of any kind? Not only should you consider the hazards such as spills, but also think about endangered species, special habitats, wet lands, and water regulations that apply to the land.
8. Who will be your new neighbors? Usually, this isn't a big issue, but you want to make sure that your potential neighbors are good stewards and honor the boundaries. Inquire if residential or commercial development is scheduled nearby

in the foreseeable future. It is also important to know about any informal arrangements the current property owner has with the neighbors. Many a new property owner has found out after the sale that a neighbor frequently hunts on the land, has turned out cattle on the property, or used the property for access to their land for decades. The sooner these prior arrangements are addressed, the better to avoid any conflict.

The previous is not a complete list, but these are important questions to have answered before moving forward with an offer.

After you have figured out exactly what you would be acquiring, the second question, is should you actually make this acquisition. Too often you hear of producers making an acquisition because they were afraid to miss a rare opportunity to purchase land that they never thought would be available. Certainly there is merit to taking advantage of limited opportunities, but make sure to do your homework. Before we get to the dollars and cents of the matter, remember there is more to consider than just money. It is helpful to think of the pros and cons of the addition, along with the new land's strategic fit into your existing operation. A small parcel of land that is nearby your existing operation will likely be fairly easily tucked into your current farming operation. However, larger parcels or entire purchases of other operations require more thoughtful consideration as to how your operation will change. Perhaps the essence of what one should consider when purchasing land is: how does the purchase affect my current operation going forward? Hopefully the answer is that it will make your farm more efficient and profitable which will be covered in the next section, but a few questions to answer about how the land will fit into your current operation include:

1. Will you have to take on additional or larger equipment to handle the new size or will your current machinery be sufficient? Perhaps the operator selling has equipment that is for sale that would fill this potential need? Your current operation may be efficiently optimized for its size. Adding land may be awkward both physically and managerially.
2. Will the added land require more labor? This is a particularly important question since qualified labor is becoming more valuable and scarce. As equipment gets more technologically advanced and expensive, farmers need more experienced and trusted workers than in the past to run the machinery.
3. Does the current manager want the added responsibility and work? If the added land calls for more workers, then the farm is responsible for another's livelihood and well being. Additionally, larger farm size could mean more time for planting, harvesting, etc. The land purchase may require a lifestyle change or adjustment. Schedules that have been routine may change significantly. Is the purchaser willing to take that step?
4. Is the manager capable of handling the added work and responsibility? This is a hard question to answer. It requires knowing what one's capabilities and limits are.
5. What is your timeframe to retirement? If a producer is near retirement, they might not want to take on expansion as fully implementing the land into the operation may take some time and effort.
6. Do you want to have the additional land in your retirement years and be a landlord or sell the property?
7. What kind of health are you in? Obviously, one would like to be in good physical condition when expanding your operation. A quick visit to the doctor would be a good idea if it has been a while since the last check-up.

To this point, this entire paper has been written with almost no mention of financial cost or benefit. Now that we have covered the non-cash aspects of the transaction, let's look at the financial portion of the equation. Financial considerations to make note of are:

1. What is the asking price? In most financial hardship sales, the selling price is usually discounted, but it is always good to check what comparable land has been selling for to compare.
2. What is the cost? Not only are we talking about the cost to purchase the land, but remember there are costs of ownership as well. Things like property taxes and utilities. Remember to also include any costs to bring the land up to your standards such as erosion control, installing drainage, or irrigation. Will you need to purchase more or larger equipment? New equipment may increase efficiency, but beware of total cash outlay involved with the expansion.
3. How will the land be purchased and how much cash will be used? Be aware of how much cash

is needed. If all available cash is used for the purchase, there will be no cushion if unforeseen expenses arise.

4. Will financing be needed? If the necessary cash is not available, or it is decided that it is not best to purchase the land with cash outright, are you able to obtain financing and at what terms? Interest rates are still at very low levels historically, but on large notes a small difference in rates can add up to significant money.
5. How will the purchase affect future cash flow? We may have buried the lead here by including this point so far down in the article, but cash flow is critical in any business. The purchased land should enhance your cash flow after it is paid in full and you need to prepare a *pro-forma* cash flow statement for your business to make sure you can handle cash needs while paying off the loan. You can find examples of cash flow statements from your extension specialist.
6. How is the loan going to be repaid and is there a backup plan if things don't go as planned? Are other assets available for liquidation to make payments if the farm doesn't generate enough cash flow to make the land payments? Is it feasible to subsidize the loan repayment from sources outside the farm?
7. How will the land help overall profitability? The new parcel should benefit the farm operations overall profitability. The first thing most folks think of with expansion is economies of scale or how the new land allows you to better utilize your current assets more efficiently. Economically, efficiency comes from spreading your fixed costs over more acres. Having to add more equipment to service the new land could potentially decrease these gains. Efficiency from scale can also come from volume discounts. Will your added size allow for better prices from input suppliers and output handlers? Checking with local input suppliers for potential cost savings is key. Performing Net Present Value and IRR analysis will help determine if the land in the end will return an economic profit.

What if you can't afford to purchase the land? There are other options to bring the land into your operation. A couple of ways to add scale in absence of purchasing the land yourself which are becoming more popular, are mergers and collaborations. A more common and well know method is to lease the land. Leasing has its positives and negatives which will be explored.

Certainly one of the biggest advantages of leasing versus purchasing is not tying up large sums of capital in land so it can be used for other purposes. Furthermore, leases are unusually short-term in nature (1 to 5 years) which allows an operator to adjust size and location of the farm by ending one lease and potentially adding another. Additionally, the short-term nature of leases makes them more flexible than a mortgage, and they can be renegotiated to current conditions upon each renewal.

The short-term nature of leases which has benefits can also be a negative. At almost any renewal, the lease can be terminated by the owner. This adds a level of uncertainty to the farming operation that isn't there with the purchase option.

The decision to purchase additional farmland is a complicated one and depends on many factors. Fully exploring these issues before making a purchase helps to ensure that the new land makes the entire operation more profitable and can eliminate some potential pitfalls from occurring after the deed changes hands.

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