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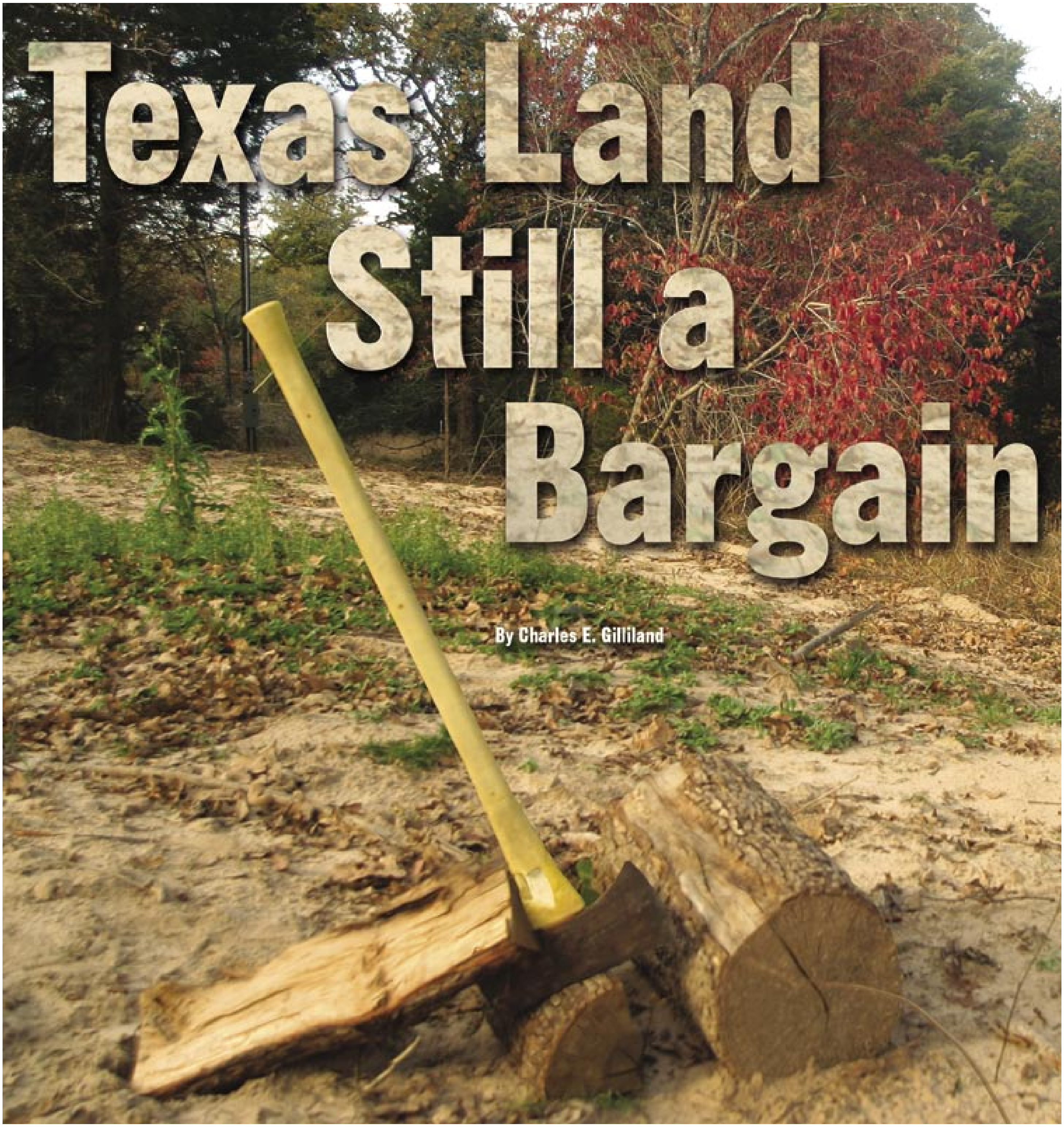
Texas Land Still a Bargain

By Charles E. Gilliland



With land prices at all-time highs, many wonder if this is a bad time to buy. Although some economic conditions have flashed cautionary signals, Texas land prices may never be more affordable than they are now. Here's why.

Motives for land purchase are complex. Some people buy for agricultural production, recreation or environmental preservation. But underlying these intents is an implied belief that the land represents a solid store of wealth that will grow in value over time.

Conventional wisdom has viewed land as a safe investment that can return substantial capital gains to owners. Prior to the 1980s, market observers were fond of reciting the mantra, "Land has never gone down." However, the severe recession of the late 1980s precipitated the first collapse of Texas land prices in more than 100 years. Today, beset with rising interest rates, climbing gas prices and dwindling support for agricultural programs, some wonder if markets are headed for a similar fate.

The 1980s crash that played out as the aftereffect of inflation-driven investment and soaring oil prices had its roots in the 1970s when oil prices mounted and stuffed the pockets of Texas royalty owners with cash. The oil industry boomed, and an unemployed rust belt population migrated to Texas.

At the same time, in response to sizable purchases of wheat by the Soviet Union, prices for agricultural commodities escalated. Inflation then became so rampant that, after adjusting for the declining purchasing power of the dollar, real interest rates were actually negative.

In the early 1970s, it paid to borrow money and pay back the loan with cheaper dollars. In that environment, the successful farmer continuously borrowed to buy tangible items such as equipment, livestock and land. Spiraling appreciation added to net worth despite the heavy debt load.

Land buyers reveled in this miracle of financial leverage until inflation bubbled over into hyper-inflation late in the decade. Reeling from the economically corrosive aftermath of that explosion in inflation, the Federal Reserve determined to rein in those forces that had produced a 21 percent prime interest rate. Reversing course, the Fed tightened the money supply, and borrowing suddenly became expensive.

Borrowers were now faced with the prospect of paying back loans with more expensive dollars than those they had borrowed. Strengthening the dollar also made U.S. goods, including wheat and cotton, much more expensive on foreign markets. Agricultural incomes dried up. Farmland prices in the Panhandle broke in the early 1980s, followed by the collapse of the remaining land markets in 1986.

The mid-80s decline in land prices resulted from the oil price bust and changes in federal tax laws that made owning real estate less profitable after taxes. Statewide, land prices fell precipitously, and markets remained lackluster until 1992 when prices settled more than 40 percent below the previous high. Meanwhile, the Texas population expanded by almost 28 percent, from 14.2 million in 1980 to 18.1 million in 1993.

By 2004, Texas land prices had soared to 253 percent of 1993 levels, lifted by strong demand for recreational land and

investment properties. The market relentlessly rose from 1993 through 2001. Following the 9-11 attacks, the appetite for land ownership intensified, sparking a 30 percent growth in prices between 2002 and 2004. The feverish price growth coincided with a 33 percent jump in sales volume. This acceleration contributed to the feelings of uneasiness expressed by many rural land professionals.

The current situation, however, differs from that of the 1980s in a number of ways. First, from a historical perspective, current prices do not seem out of line with reality. After adjusting prices for inflation, the 2004 real price of land generally matches early 1980s prices. Further, the deflated price is slightly lower than the 1985 price despite a nearly 48 percent increase in population since 1980.

Second, unlike the 1980s situation, many current transactions involve little or no borrowed funds. Markets do not appear to be threatened by the prospect of foreclosure. Rising interest rates should have limited impact on markets because current purchases are largely based on all-cash investments.

Third, Texas land prices are relatively low compared to those in other states, and out-of-state buyers have discovered the disparity in the past year or two. In a market in which investors are competing for a limited number of lucrative investments, more of these buyers are likely to appear in Texas markets. Finally, despite threatened cuts in farm program spending, the United States Department of Agriculture projects robust growth in farm income.

Taken together, these factors indicate land markets with assets in strong hands are priced at historically justifiable levels. Currently, no one is forecasting the kind of financial meltdown that occurred in the 1980s. If the economy does slow as current Federal Reserve policy envisions, land prices should not face the kind of hostile conditions encountered 20 years ago. The most likely impact on land markets would be a sharp reduction in the rate of price increase rather than an actual downturn in prices.

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