

THE SKY'S THE LIMIT

HOW HIGH CAN LAND PRICES GO?

BY CHARLES E. GILLILAND



Preliminary analysis of land sales reported in first-half 2006 reveals that intense demand for acreage continues to drive Texas markets, raising prices to record levels.

Recreation- and investment-minded buyers boosted the median price of an acre of Texas land to \$1,681, 18 percent more than the 2005 first-half median of \$1,423 per acre (Figure 1). Final 2006 figures will likely show Texas markets posted more than a 10 percent increase for the fourth straight year.

But when it comes to land prices, how high is too high? Is now a good time to buy Texas land?

Rapid price increases have prompted market participants to wonder if a "correction" is in the offing. By adjusting prices over the past 40 years to their equivalent values in 2006 dollars, the answers become clearer.

Land Markets Overpriced?

For years, inflation-adjusted land prices were less than the market prices of the 1960s. Figure 2 shows past prices adjusted to 2006 levels and the ten-year return for land purchased over four decades. Land purchased in 1966 traded at \$775

per acre in 2006 dollars; it sold in 1976 for \$1,169 per acre. That investment resulted in a 4.2 percent annual yield over the ten years.

Comparing investment yields with prices paid indicates that prices paid for land from 1976 to 1988 resulted in negative returns for the ten-year holding period. During that time, Texas land prices approached or exceeded \$1,200 per acre in 2006 dollars. The market peaked in 1984 at \$1,419 per acre. History suggests that paying more than \$1,200 per acre will earn investors meager, if not negative, ten-year returns.

Currently, Texas land prices greatly exceed \$1,200 per acre, the approximate maximum amount paid by investors earning a positive return in the 40 years ending in 2006. Conventional wisdom suggests that the current price of \$1,681 per acre has surpassed the price prudent investors should pay if they expect to see a positive return on landownership in ten years. That wisdom implicitly assumes the next ten years will unfold much like the previous 40.

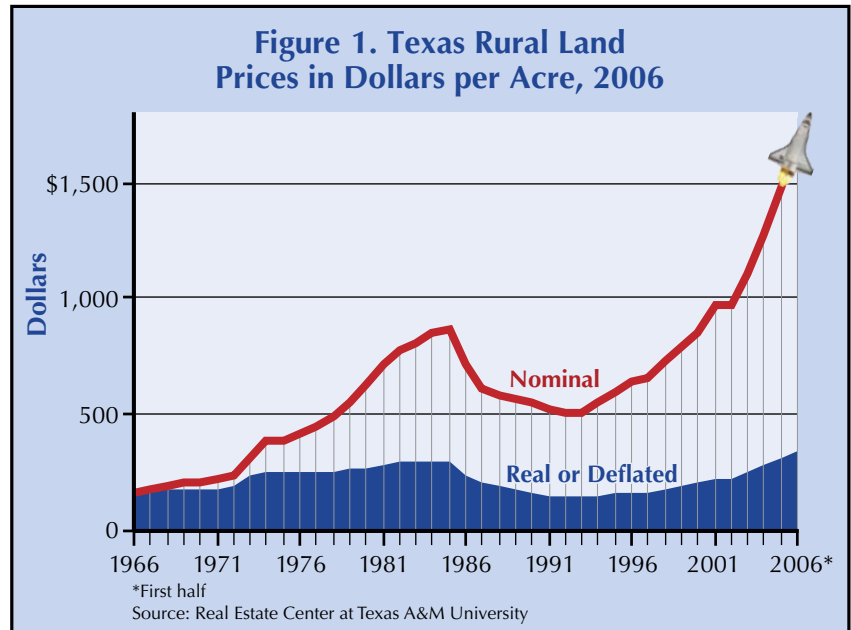
For investors who believe the past four decades provide a reliable guide to future market performance, the land investment traffic light is flashing yellow if not red. For those investors, current buyers are poised to become victims of the "greater fool theory" of investing. Meanwhile, the land market continues to thrive.

Current buyers may not be as foolish as the historically focused analysis might suggest. Several factors cast serious doubts on the assumption that past market trends accurately portend future investment trends.

First, the negative returns on a ten-year land investment in the past 40 years largely resulted from the meltdown of a leverage-driven land market in 1986. Remember, land purchased in 1976 would sell in 1986 for the ten-year investment. That retreat in the state's land prices is the only documented period of price decline in the history of Texas land market research. United States Department of Agriculture statistics indicate Texas land prices remained flat even during the Depression.

Second, a convergence of negative influences struck the Texas market in 1986. Specifically, the Tax Reform Act of 1986 eliminated much of the tax-shelter motive for land ownership,

Figure 1. Texas Rural Land Prices in Dollars per Acre, 2006



and oil prices plummeted, sending the Texas economy into a tailspin that resulted in declines in population growth and numerous job losses.

In this environment, many land sales supported by borrowed funds collapsed. Lenders found themselves owning unwanted properties as available market supply grew, and many financial institutions sank into insolvency.

Faced with an excess of properties, land markets languished from 1986 through 1993. Eventually, lenders and government agencies transferred most of the surplus property to private hands at vastly reduced prices. By 1994, the land glut had ended, and markets began a recovery that continues today.

New Realities

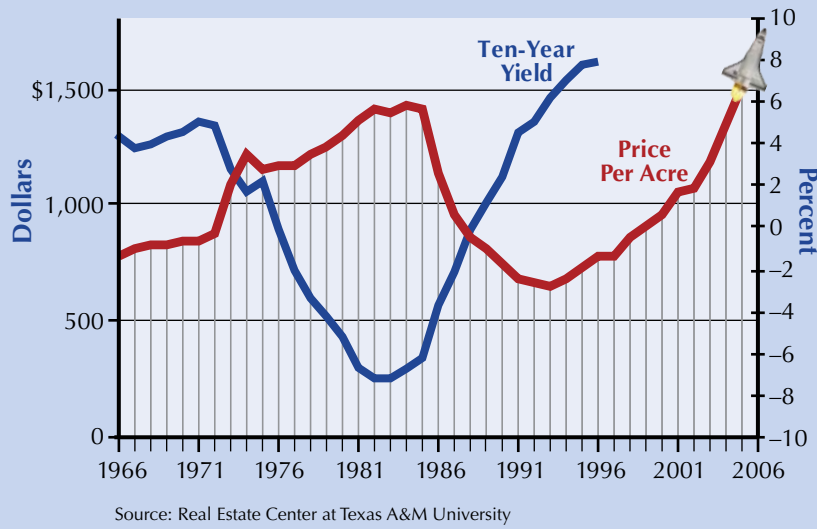
From the tax environment to energy prices to market leverage, 2006 conditions were a world away from the 1980s milieu.

When oil prices exploded last year, costs increased

across the economy and fueled a boom in the energy sector. Increased royalty payments and energy industry profits continue to funnel income to would-be land buyers. Today, many buyers insist on paying cash for land, eliminating the high degree of debt that made the 1980s market so vulnerable to foreclosures.

Texas' population will increase by 16 percent between 2006 and 2016, according to

Figure 2. Texas Land Investment in 2006 Dollars



growth cannot persist indefinitely. They wonder if markets will moderate or collapse like those in 1986, and they fret over possibly locking their funds in illiquid investments at the peak of a bull market. Past buyers, who paid less on an inflation-adjusted basis than today's prices, waited many years to see their investments recover just the invested principal. These factors understandably prompt investors to question the wisdom of acquiring land now.

On the other hand, the growing population, relatively low real estate prices and a dearth of alternative investments suggest that Texas land markets may only now be shifting into high gear.

the State Data Center's population growth projections. That figure will rise to 32 percent by 2026. A growing population increases the demand for land, which results in rising prices. Comparing Texas land prices to population provides a relative measure of current prices to population demand for space.

The number of persons older than 65 will increase dramatically. That group will inherit wealth and retire in ever-growing numbers. Many of these well-heeled retirees are likely to seek quiet places in the country.

Real estate prices in other states have soared far above prices for comparable properties here. Investors from those states see Texas prices as bargains. They are coming to Texas to buy and bringing plenty of cash.

Many institutional investors have set portfolio diversification goals that require real estate acquisition. And current economic conditions have some investors anticipating inflation. Those concerns drive purchases of tangible assets, such as real property.

In 1966, Texas per-acre land cost was \$73.43 (in 2006 dollars) per million Texans (Figure 3). By 1974, the price was \$99.12, an all-time high. In 2006, the cost of an acre of Texas land per million Texans was \$73.39, a return to the 1966 level. This suggests that rather than being overheated, Texas land markets have simply returned to sustainable levels.

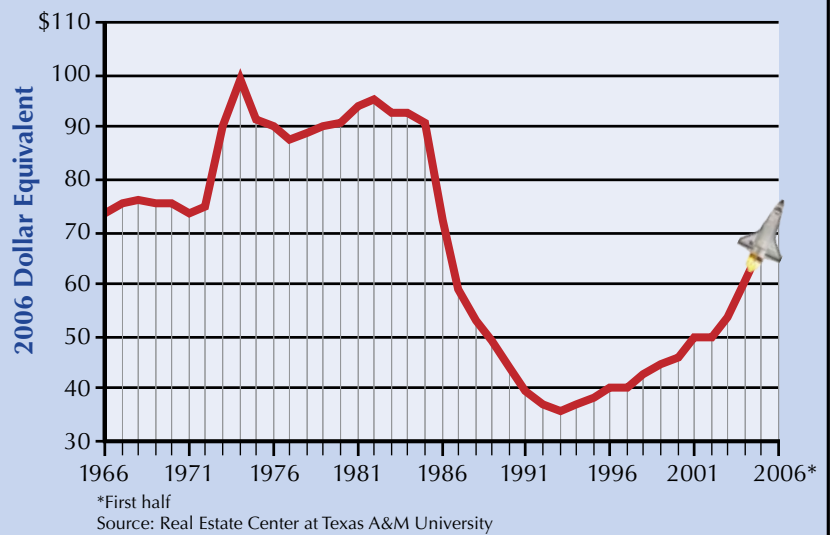
Market observers worry that eliminating agriculturally based property tax appraisals would hit land owners hard. And altering 1031 exchange tax policy could eliminate an increasingly significant source of funds for land markets. However, no policy changes appear imminent.

The world political and economic climates spur demand for secure investments. From continuing corporate accounting scandals to escalating wars, the daily news convinces investors that acquiring assets like land can preserve their wealth.

Stop! Go! Caution?

Many potential buyers and current owners view the rapid run-up in land prices with uncertainty, reasoning that such

Figure 3. Texas Land Investment Per One Million Residents



Out-of-state buyers with cash to invest may propel markets to a permanently higher price level. Adjusting for demographic estimates seems to hint that Texas markets overall may still have some upside potential.

For many investors, these developments signal a need for caution. For others, they signal an opportunity for investment gain. ➔

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THE TAKEAWAY

Texas land prices adjusted for inflation have soared to a record high of \$1,681 per acre. Past market dynamics suggest that investors should pay a maximum of \$1,200 per acre to avoid negative returns. However, current statistics suggest an upside potential for Texas land markets despite historically high prices.



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