TEXAS INCOME PRODUCING FARMLAND - CASH OR CAPEX?

A farm manager's perspective.

by Kyle Amos, AFM

Landowners may ultimately return cashflows to themselves in a variety of ways. One profitable alternative is to reinvest those cash flows, or a portion thereof, back into the asset in the form of land improvements or operational improvements. We all know these activities as "Capital Expenditures" or CapEx.

What is it?

CapEx may take many forms, but it usually occurs as something like an irrigation improvement, drainage upgrade, fencing and land clearing. It could also include a new building, grain storage, grain processing, above ground fuel storage, etc... What these items have in common is the potential to increase income and efficiency for whomever is operating the farm. That increase in income will then be realized by the landowner as increased cashflow from rent and/or property appreciation.

Why do it?

The benefits are economic and for the public good. They include increased rent, increased yield, lower cost of production, competitive tenant pool, IRS accelerated depreciation, capital gains basis increase, water security, conservation and stewardship.

Landowners may influence the production capabilities of their property. Today's professional farm operators, whether they are growing cotton or backgrounding calves, are deeply interested in efficiency. They are aware of increased labor costs, energy costs, water regulations, the importance of timing their operations with mother nature. They are searching, and willing to pay competitive prices, for properties that possess strong production efficiency characteristics.

The great Texas heavy equipment manufacturer RG Letourneau said, "A man is worth what he can produce, and I build big machines that help him produce more."

His point: 500 men with shovels can be very busy and get a lot done; but put one man on a LT300 bucket scraper and he can safely and comfortably do the same job, with less cost, in less time, with higher quality. Again, production agriculture professionals are generally willing to pay more rent when these types of efficiencies are found on the farm. Landowners can, over time, develop highly efficient and productive farm environments that will positively affect the bottom line of all involved.

Which project?

Choosing the right project can be tricky. If a landowner or farm manager is to influence farmland productivity in a responsible and economically sound manner, it is useful to have an awareness of where we are in the business or commodity cycle, and then make strategic decisions for the future. And with the inherent 'Illiquidity Risk' associated with farmland and other real estate, it is lucrative to be thoughtful and strategic when implementing capital re-investment projects.

A few first questions are: Will this project increase productivity? Does it benefit a stakeholder? Does it lower operating costs for a farmer? Decrease field variability? Add a fresh revenue stream? Increase yield? Provide habitat for wildlife and (paying) sportsmen? Finally, is it a regional best practice or cultural practice fit?

When?

The timing may be appropriate during a lull in commodity prices or a non-aggressive leasing period.

Relevant to our place in the current commodity business cycle, it is human nature to delay or defer capital expenditures during times of depressed returns, low appreciation periods and general periods of uncertainty. Market illiquidity often accompanies these periods of the business cycle, further aggravating the capital expenditure decision process. Also, there seems to be a property appreciation lag, whereby it takes some time for the capex to 'bake in' and increase the value of the property.

Perhaps in these times we could benefit from the old adage of "when everyone is running away, we should be running in". CapEx costs can be historically underpriced during these periods.

In Closing, the philosophy of capital reinvestment is similar to that of Berkshire Hathaway, Amazon, or even Texas Pacific Land Trust. These companies, with a few exceptions, generally do not pay out a dividend. They choose to reinvest their cash flows back into their businesses. The result is the return of wealth to shareholders through appreciation of share price as a result of increased earnings.

There are very appropriate times within the farmland cycle to return cashflows to the farm as capex. CapEx must qualify by increasing productivity and therefore, be of benefit to landowners, businesses and other Texans along the way.

As a part of NCREIF Directed Research, Dr. Chinmoy Ghosh said, "(As) we analyze the relationship between capital expenditures and performance we find persistently strong positive relationship between capital expenditures and cumulative returns."

"Persistently strong positive relationship" should get everyone's attention. With some experience and thoughtful planning, CapEx is a lucrative decision.

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Resources:

The following is a short list of organizations that offer assistance for private land improvement projects that reflect resource conservation, as well as return on investment.

ASFMRA, USDA, NRCS, TDA, TPWD, Ducks Unlimited, The Nature Conservancy and The Conservation Fund.*

TPWD also publishes a comprehensive guide to conservation resources available to Texas private landowners.

**The Texas Chapter of the American Society of Farm Managers and Rural Appraisers (ASFMRA) is considered the Texas premier resource for farm management and agricultural property valuation.*