



Is There a Bubble in Canadian Farmland?

Description

Since 2010 it's been good to be a farmer in Canada.

The weather has largely cooperated, which has led to some terrific years. Crop yields were up each year from 2010-13, with 2013 yields being the highest ever. Last year's harvest was down, but was still historically decent.

Commodity prices have also been strong. The price of wheat has done well, spiking up to \$9 per bushel in 2012. Currently it trades at US\$5.25 per bushel, which is 50% more than a decade ago. Canola has also done well, and the price for beef is flirting with a 10-year high.

As you'd expect, the price for farmland has soared. According to Farm Credit Canada, the price of land increased 14% in 2014, 22% in 2013, 19.5% in 2012, and 14.8% in 2011. Nationwide, farmland hasn't had a negative year since 1993.

The return during the last seven years has been nothing short of staggering. The value of Canadian farmland has surged more than 267% since the beginning of 2007, handily outperforming just about every other asset class.

Why are values up so much?

Farmland has been boosted by a combination of new interest in the sector, low interest rates, and successful farmers expanding operations.

Let's tackle the last reason first. Not only have successful farmers been expanding, but thousands of new or returning farmers have been attracted to the higher commodity prices and good yields. Yes, technology has helped, but for the most part good crops are a by-product of good weather.

These farmers are competing with other buyers for the land. Successful farmers are flush with cash after years of nice crops. But even farmers who aren't sitting on piles of retained earnings are still doing fine thanks to low interest rates bringing down the annual cost of buying land.

Add all that to demand from foreign buyers, and we have a bonafide bull market. Even though it's against the rules for non-Canadians to own more than a token amount of land, buyers are getting around that by using recent Canadian immigrants as proxy buyers.

What does it mean for your portfolio?

Folks who are relentlessly bullish on farmland can get a cold shower by looking at what values did during the tough economic times between 1985 and 1992. With the exception of 1989's 4.2% gain, farmland declined each year as much as 10.2% in 1987.

For investors who only have farm interaction when they bite into a steak, the health of Canada's farmland sector can still matter to their portfolio. Both **Agrium Inc.** (TSX:AGU)(NYSE:AGU) and **Potash Corp./Saskatchewan** (TSX:POT)(NYSE:POT) look likely to take it on the chin if there's a prolonged downturn in the sector.

Look at it this way. If you're a farmer, making the payments on the land is the most important thing. After that, other input costs are all on the table. This could include cutting back on everything from insurance to fertilizer, which is obviously bad news for North America's two largest suppliers of the latter.

It could also spell bad news for farm machinery dealers, including **Rocky Mountain Dealerships Inc.** (TSX:RME). When times are tough, farmers will be more likely to stretch out the life of combines and seeders for another year or two. That might mean more in repair and parts revenues, but they're not as profitable as selling a new unit.

There's also the overall economic effects. It took more than a decade for farmers to recover from the last downturn, which filters into other parts of the economy. Farmers are the lifeblood for some of Canada's small towns.

After the value of farmland has nearly tripled in less than a decade, I can't help but think that the market may be overvalued. With investors in the sector being satisfied with sub-3% yields and a flood of money chasing the same small supply, this has the potential to end badly. For Canadian investors, this likely means it's time to avoid anything linked to the sector, whether it's fertilizer or machinery stocks.

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