



February 26, 2010

Ms. Tish Beltranena, Principal Planner  
MNS Engineering, Inc.  
201 Industrial Way  
Buellton, CA 93427

Re: Rancho La Laguna (the Property)

Dear Tish:

Pursuant to your request, I have performed a review of the Property for the purpose of understanding the viability of continued or intensified agricultural operations for the thirteen parcels (the Proposed Parcels) resulting from the proposed subdivision of the Property (the Subdivision). Part of my review included the prospect of future intensification of the agricultural operations in order to overcome non-agricultural economic pressures, and to promote the agricultural economic viability of the Property well into the future.

#### **DESCRIPTION OF RELEVANT INFORMATION UTILIZED**

##### Summary of My Experience

In performing this review, I rely upon my professional experience of over thirty years involving agricultural real estate. I graduated from Cal Poly, San Luis Obispo in 1978 with a degree in Agricultural Business. I was employed by Production Credit Association, a part of the Farm Credit System, in the Santa Ynez Valley for approximately eight years, where my job duties included real estate appraisal of agricultural properties, originating loans, and servicing loans for agricultural operations. I am a licensed real estate broker and owner of Rincon Corporation, which I founded in 1991. Rincon specializes in providing real estate services for agricultural properties, including brokerage, leasing, appraisal and management. In addition to my professional experience, I have owned ranches and cattle operations in California and Arizona.

Throughout my career, I have analyzed the viability of agricultural operations ranging from ten acres to over ten thousand acres in size and am familiar with the economic factors that determine whether an agricultural enterprise will be economically viable.

I am very familiar with agricultural operations and production in Santa Barbara County and I am familiar with Rancho La Laguna and surrounding agricultural properties.

### Summary of Documents Reviewed

For the purpose of this analysis, I have reviewed the following information:

- Agricultural Viability Study by Sage Associates dated September 2007, and update thereto dated 9/28/09 (Sage Report).
- Vineyard development potential analysis done by Mesa Vineyard Management.
- Proposed Tentative Parcel Map.
- Various engineering materials and aerial photographs provided by MNS Engineering including the proposed TPM, topo maps, current use maps, proposed access map.
- NRCS Soil map.
- Google Earth virtual images.

### **DESCRIPTION OF THE PROPERTY**

Rancho La Laguna (Property) consists of approximately 3,900 acres situated adjacent to and north of Foxen Canyon Road. The Property is located about 7.5 miles north of the town of Los Olivos and about 7.5 miles northeast of the town of Los Alamos. The Ranch entrance is at the intersection of Foxen Canyon Road and Alisos Canyon Road. The Property is currently utilized for cattle grazing, irrigated row crop farming, and dry farming. Topography for the Property is quite varied, ranging from flat and level, which is currently in irrigated farming operations, to steep, which is currently used for cattle grazing.

There are numerous water wells located on the Property, which according to the Sage Report are adequate to support existing and proposed irrigated farming, and additional future vineyard development, as well as providing water for livestock and domestic purposes. Structures currently on the Property include barns, corrals, and a manager's residence which I did not consider to be economically significant to my analysis.

The existing road system consists primarily of dirt "ranch roads" which currently provide access to each Proposed Parcel. The type of access necessary for vehicular access, for agricultural purposes, to each of the Proposed Parcels varies depending upon the type of production occurring on that Parcel. For cattle grazing, vehicular access (which can be supplanted by ATV) is necessary to visually check water, salt and feed for the cattle, to inspect and repair fencing, and to monitor the health of the cattle. For more intensified farming operations, such as row crops or vineyards, access must be adequate to move farming equipment and personnel into and out of existing or potentially intensified agricultural operations. Access generally must include all-weather access for production farming such as row crops, orchards and vineyards. Crops often are rotated as part of an integrated pest and disease management program. Orchards and vineyards generally require wet-weather access for pruning and/or frost protection.

### **DESCRIPTION OF THE PROPOSED SUBDIVISION**

The Proposed Subdivision of the Property would result in thirteen (13) Proposed Parcels in lieu of one existing parcel. These Proposed Parcels would vary in size from 160 +/- acres to 605 +/- acres. Each Proposed Parcel includes a proposed designated residential home site location (RDE) that would not hinder agricultural operations. Proposed Parcels number 1 through 8 are the smaller of the Parcels, located closest to Foxen Canyon Road, and contain most of the prime farm land. Proposed Parcels number 9 through 13 are the larger parcels and are located on the northern part of the Property where the topography is steeper with less prime farm land and more slopes. See Exhibit C for a Proposed Tentative Parcel Map.

## **ANALYSIS OF THE PROPERTY'S ECONOMIC COMPONENTS**

### **The Property Comprises Several Different Economic Components**

Grazing land is the least productive agricultural land in the County of Santa Barbara. Most grazing operations are subsidized by other uses, whether royalties or leasehold income from energy projects, intensified farming on the better farm land, vineyard leasing, or the owner's personal wealth. If those subsidies decline or cease, or if estate taxes come into play, these larger land holdings are subjected to development pressures, or alternatively, to capital demands in order to intensify the agricultural production to maintain or increase the income generated by agriculture. On some portions of these land holdings, slopes or poor quality soil may limit productivity to livestock grazing while the remainder of the land is dedicated to more lucrative agricultural pursuits. As the agricultural production intensifies on larger agricultural parcels over time, the individual agricultural economic components of that Parcel eventually evolve to their highest and best use. When a large agricultural parcel is fairly homogeneous in its Ag Production Criteria (topography, parcel shape, access, soil type, climate, micro-climate, water availability, drainage, etc.), the entire parcel can be intensified as one economic unit, which is common in the San Joaquin Valley. However, when a larger agricultural land holding substantially varies in its Ag Production Criteria, such as is the case with the Property, the optimum economic components of the property will form a number of units that cluster around the Ag Production Criteria relative to the highest and best use, provided by that group of criteria. These I refer to as Economic Components.

The Property varies substantially as to the Ag Production Criteria. The groupings of these criteria provide for the following types of Economic Components for the Property as they relate to types of agricultural production, listed in order of highest and best economic use:

1. Irrigated row crop land
2. Vineyard development land
3. Dry farm land
4. Irrigated pasture
5. Native cattle pasture

### **The Problems With Mixed Economic Components Within A Large Parcel**

In Santa Barbara County, many of the larger agricultural properties outside of the Santa Maria Valley and the Lompoc Valley have a mix of Economic Components within each individual property. The larger the parcel, the higher the probability of this mix occurring and the greater the magnitude of its economic impact. With smaller ranches, a farmer is more likely to provide the fencing necessary to lease the non-prime land to a cattle operator, who either will stock the land with year-round cow/calf units or stockers (seasonal grazing). The rainfall in Santa Barbara County, and resulting carrying capacity of the land, is such that few landholdings provide sufficient year-round forage so many cattle operators enter into leases for grazing land with landowners who are not cattle operators. This is necessary in order to accumulate a critical mass of grazing land to support a commercial cattle operation. Some cattle operators even move their cattle from state to state for the same reason. The lease income to the landowner is modest (usually at an economic return well under one percent of the market value of the land) however it supplements the farming income while providing fire management on the non-prime land.

Mixed Economic Components within a parcel have adverse impacts on the following:

- Management - Of the five Economic Components of the Property listed above, only irrigated pastures and native cattle pasture are uses that are typically operated by the same management. The other uses -- irrigated row crop, vineyard development (and operations) and dry land farming -- are typically mutually exclusive as to the management

skills necessary for the successful operation of each. Not only are the production skills mutually exclusive but the markets and marketing for the products are completely different from each other and the equipment into which the operator must invest varies widely. A cattle operator doesn't need expensive planting and harvesting equipment and a row cropper or vineyard operator doesn't need livestock truck/trailers, horses and trained dogs, portable chutes, squeeze chutes, and the like.

- Capitalization for ag intensification – Future intensification of the agricultural operations will be necessary to respond to changing market demands as well as to counter economic pressures from non-agricultural forces. The ability to capitalize future improvements to facilitate ag intensification is dependent upon the economic return to the capital, be it debt or equity. Of the five economic components of the Property, vineyard development is the most capital intensive, with the non-land cost of vineyard development in the \$25K to \$30K per acre range. These costs include grading, soil amendments, trellising, planting, irrigation systems, frost protection, reservoirs, and cultivation for the first few years of non-production. Orchards are the next most capital intensive, with the combination of initial capital for acquiring and planting the trees and the longer-term investment in tending the trees until they are of sufficient bearing capacity to bring a return on the investment. Irrigated row crops follow closely behind, with capital improvements that might include grading and leveling, soil amendments, irrigation systems, tiling, drainage and retention.

When a property has a mix of Economic Components within it, the ability of the owner to obtain the capital required to intensify the agricultural operations is severely restrained. This is because a capital source, whether equity or debt, will only be interested in capitalizing one of the uses. The capital source must have comfort (i.e. knowledge and experience) with the particular agricultural operation's (and operator's) ability to generate a reasonable return on that capital.

- Marketability - In my experience as a real estate broker for ag properties in Santa Barbara County, I have encountered many examples of mixed Economic Components within ag parcels and have observed the negative market reaction to the mixed components. I often refer to this as the "apples and oranges syndrome". When a buyer comes into a market looking for a particular type of property, they seldom have the interest, the management ability, and the capital sources for more than one Economic Component. That buyer may be wanting to buy "apples" but with mixed Economic Components, he is forced to buy "oranges" as well, even if he doesn't have a use or desire for oranges.

Looking at the five Economic Components of the Property, they really need to be divided into two major categories. The irrigated row crop ground and the vineyard or orchard development ground are generally acquired by someone in the commercial business of growing irrigated crops, orchards or vineyards, and are purchased with an economic return in mind. Dry farming, irrigated pastures, and native pastures have very low income return relative to their market value. Therefore, the buyer of these properties is generally looking to buy a property for the lifestyle it provides. When this is the case, such non-economic factors as aesthetics, views, privacy, etc. become more critical in determining market value than do the income of the Economic Components.

A good example of how the resistance to mixed Economic Components operates arose in the sale several years ago of a large cattle ranch in the Los Alamos area. The buyer was a major commercial vineyard developer/operator. The ranch consisted of nearly 5,500 acres, of which approximately 1,000 acres were deemed plantable for vineyard. The market value of plantable vineyard ground at the time was \$10,000 per acre. This ranch sold for \$10 million which represented full value of the vineyard plantable acreage and zero value for the remaining 4,500 acres of pasture land.

Had that ranch been purchased by someone seeking a large cattle ranch, which would have been for lifestyle purposes due to the low income as a cattle ranch, the market price likely would have been \$5 million to \$6 million. The cattle ranch buyer would not have had the management ability to develop and operate 1,000 acres of vineyard, nor been able to attract the necessary capital to do so (\$20 million +/- at the time), and therefore would not fully value the developable vineyard ground.

- Financing - Financing for ag property, or the ability to attract debt capital that is secured by the property, is necessary for:
  - Acquisition of the property
  - Capitalization of ag intensification (see above)
  - Financing working capital for the ag operation
  - Paying estate taxes
  - Marketability of the property

Lenders on agricultural properties are primarily banks, insurance companies, and Farm Credit. A lender is required to use various underwriting criteria when evaluating a loan request, the most significant which are the borrower's credit, the loan-to-value ratio, and the income producing capacity of the land.

When a lender makes a loan for a particular ag parcel, it will often ignore the value Economic Components that are outside the purpose of the loan. For example, if a land owner comes to a lender for a loan of \$3 million to develop 100 acres of vineyard on a parcel of 1,000 acres, the balance which is native pasture, the lender typically will consider only the appraised value of the finished vineyard and will ignore the value of the other 900 acres of land. This is because, in the event the lender ends up foreclosing and having to resell the property, the new buyer will not fully value, or will not value at all, the other 900 acres of land (see Marketability above).

Furthermore, a lender typically will consider only the income of the Economic Component of the property when underwriting the income producing capacity of the land. Either the omitted appraised value or the omitted income from non-Economic Components can be the constraint that prevents optimal or even feasible financing. In short, the "extra" land can operate as a detriment to underwriting because it can generate an unwanted expense and risk. Unused grazing land can pose a fire hazard, but the low income potential of grazing land may not offset the cost of fencing necessary to contain the livestock.

Another component to consider is that of the landowner's desire to avoid the risk involved in encumbering the entire ranch to raise capital needed for only a portion of the ranch. Given the choice, a landowner would prefer to encumber only the portion of the property dedicated to the use for which the financing is sought (e.g., the plantable vineyard area), preserving the remainder of the landholding in the event of foreclosure of the loan. Under the Subdivision Map Act, it is not legal to finance a portion of an undivided parcel. No knowledgeable lender would agree to collateralize a loan with an undivided portion of a parcel, or with a tenant-in-common undivided interest in a larger parcel.

- Estate Taxes - Unfortunately, it appears that estate taxes will again be back in the mix for owners of ag properties. The estate tax historically has been the bane of family owned agricultural operations and properties, forcing the sale of many ranches despite the best intentions of the families to continue in agriculture. This occurs because the large asset size of a property necessary for commercially viable agriculture triggers substantial amounts of estate tax with the passing of a generation. Typically, family ag operations

are "land rich and cash poor" and need some kind of liquidity event in order to pay the estate tax. This liquidity event may be financing with debt capital or it may require the sale of the asset. If the entire ag operation is located on a single parcel, it will require the sale of the entire ag property and thus the operation, resulting in the loss of a family farm. The advantage of multiple parcels, particularly with mixed Economic Components, is that one of the smaller parcels can be sold without endangering the continuation of the family owned operation.

- Distribution to Heirs – One of the most disappointing events with which I have been involved during my career is the dissolution of the family farm and the resulting dissolution of family harmony following the death of a parent. Unfortunately, this is not an uncommon occurrence. This may or may not be triggered by an estate tax. Often it occurs as the family tree grows over the generations, resulting in multiple beneficiaries to the major family asset -- the family ranch or farm. Typically, a family owned ag operation is run by one member of the family, while the number of non-involved family members grows over the subsequent generations. Because the income potential of the ag property, particularly grazing land, is low relative to its market value, often only one family member can make a full-time living by living on and operating the ranch or farm. The other family members, whose inheritance is tied up in the property, become anxious to realize the value of their share of the asset, especially when they don't live or work on the property. Over time, Santa Barbara County has seen more and more local farming and ranching families split up as the children and grandchildren move to metropolitan areas where they can make a living, having found it difficult to find adequate jobs in this area. County regulations that restrict the number of principal residences on these farms and ranches makes it difficult for these family members to live on the land in which they have an ownership interest. This creates pressure for the sale of the asset which often causes dissention between the operating members and the non-operating members of the family. The property is sold, the long time family member running the operation is displaced, and another family farm succumbs.

The proposed division of the Property into viable agricultural units results in a scenario that allows more than one branch of the family to live on the Property (because of the resulting separate parcels), to operate their farms and ranches as individual viable units or to share the management responsibilities based upon skill and interest levels. This also provides an opportunity to sell a parcel or two to satisfy the family members desiring a liquidity event, or for the payment of inheritance taxes, while retaining the stand-alone agricultural viability of every one of the Parcels.

### **THE OBJECTIVES OF A SUBDIVISION RELATIVE TO THE PROPERTY'S ECONOMIC COMPONENTS**

The Proposed Subdivision should be configured to meet two primary objectives:

- Each Proposed Parcel should have sufficient critical mass of one or more Economic Components in order to maintain economic viability of that Parcel.
- The number of Proposed Parcels should be sufficient to provide maximum flexibility to optimize management, capitalization, and financibility of different operations dictated by the Economic Component, while providing an optimum number of parcels to allow for future liquidity events that will help respond to estate taxes or family distributions.

The two above objectives must be balanced with one other. For example, the more Parcels resulting from the Proposed Subdivision, the better the optimization for providing liquidity to meet the future needs for estate taxes, family distributions, and financibility. However, too many Parcels would result in individual Parcel sizes that are too small to retain long-term agricultural viability.

The Proposed Subdivision appears to be designed to achieve an effective balance between these two objectives. Parcels 1 through 8 provide plantable vineyard ground ranging from 78 acres to 143 acres, all of which are sufficient critical mass for a commercially viable operation. They could each house a small winery for processing the grapes grown thereon, and lots 1 through 4 would be most attractive for a winery given their frontage on Foxen Canyon Road. These eight parcels alternatively provide prime farming ground ranging from 38 acres to 81 acres, all of which could be commercially viable agriculturally. Parcels 9 through 13 are the larger parcels, with a major Economic Component being cattle grazing, but each with sufficient area for prime production such as row crops, orchards or vineyards. See the Agricultural Viability Study by Sage Associates dated September 2007, and update thereto dated 9/28/09 for further discussion about the economic viability of each Proposed Parcel.

### **CONCLUSION**

The long term agricultural viability of the Property is enhanced by the Proposed Subdivision by creating economically efficient units of Economic Components. The resulting thirteen parcels provide maximum flexibility to match management, capitalization, and financibility for each Parcel to meet future changing market conditions and agricultural intensification, while maintaining Parcel sizes that provide economic viability of each Parcel, and therefore the continued sustainability of the Property's agricultural operations.

Please do not hesitate to contact me if you have any questions or desire further information.

Sincerely,



Larry Lahr  
President

## **List of Exhibits**

Exhibit A	Rancho La Laguna Ag Economic Units of Proposed Parcelization
Exhibit B	Proposed Access Plan
Exhibit C	Proposed Parcel Map with Existing Use and Topo Data
Exhibit D	NRCS Soils Map
Exhibit E	Vineyard Development Analysis Map

# EXHIBIT A

## RANCHO LA LAGUNA

### AGRICULTURAL ECONOMIC UNITS OF PROPOSED PARCELIZATION

	GROSS	NET	PRIME AG VINEYARD	GRAZING VINEYARD	TOTAL VINEYARD
Lot 1	202.16	197.62	74.59	68.37	142.96
		100%	38%	35%	72%
Lot 2	166.42	161.79	54.46	62.72	117.18
		100%	34%	39%	72%
Lot 3	166.41	163.06	53.41	59.44	112.85
		100%	33%	36%	69%
Lot 4	191.63	191.07	81.41	28.58	109.99
		100%	43%	15%	58%
Lot 5	160.01	160.01	40.00	37.97	77.97
		100%	25%	24%	49%
Lot 6	161.23	161.23	37.80	55.83	93.63
		100%	23%	35%	58%
Lot 7	206.00	206.00	64.73	62.19	126.92
		100%	31%	30%	62%
Lot 8	259.01	259.01	48.75	34.91	83.66
		100%	19%	13%	32%
Lot 9	438.44	438.44	20.12	2.65	22.77
		100%	5%	1%	5%
Lot 10	596.84	596.84	7.18	9.00	16.18
		100%	1%	2%	3%
Lot 11	428.80	428.80	20.41	0	20.41
		100%	5%	0%	5%
Lot 12	369.07	369.07	39.46	0	39.46
		100%	11%	0%	11%
Lot 13	604.73	600.75	14	0	14.00
		100%	2%	0%	2%
TOTAL	3950.75	3933.69	556.32	421.66	977.98
		100%	14%	11%	25%