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## Cash Leasing Alternatives; 1998 in Review -- Dairy

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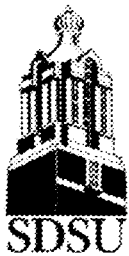
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# *ECONOMICS* *COMMENTATOR*

South Dakota State University

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## **CASH LEASING ALTERNATIVES**

by

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and  
Michel Haigh  
Extension Assistant

Because of the low commodity prices this production year, many producers may re-evaluate their lease agreements. The following article is an overview about leasing, some of the benefits and options available. Its' purpose is to help tenants and landlords come to a fair agreement based on evaluations of available resources, yield factors, and price fluctuations.

Cash rental agreements offer some advantages for tenants and landlords. When a landlord cash rents, he/she does not have input into the management decision making, easing tension with tenants. A fixed cash rent lessens the landlord's concern about yield and prices, and transfers the risk associated with price, cost, and production to the tenant.

Cash leasing can produce a tax advantage. Because cash rental income is not considered earned income, a tax advantage occurs. Under a cash lease agreement, rent received is not subject to social security taxes, nor will it reduce the landlord's benefit if she/he is receiving social security benefits.

There are also drawbacks to cash rent agreements. The main obstacle to overcome is the price differences that arise. Once a cash-rent is agreed upon, it is hard to pass a change in the rental  
(Continued on page 2)

## **1998 IN REVIEW — DAIRY**

by

Donald L. Peterson  
Extension Management  
& Marketing Specialist

The year of 1998 was certainly an interesting one for dairy farmers, with the thrills of a roller coaster ride. Record high monthly Basic Formula prices (BFP) were set in seven months, and all time record highs were set in three months. Butter set all time record high prices, as did cheese. These record high prices were set while other areas of agriculture were troubled with low prices, especially grain and meat production enterprises.

### **Price History**

The BFP for January milk was announced at \$13.25. February and March set new monthly highs at \$13.32 and \$12.81, respectively. Only two months later, the BFP was down to \$10.88 per cwt. One month after that (June), the price was up \$2.22 to \$13.10. Prices continued to increase through the summer and into the fall and winter. New monthly highs were set in July, August, October, November, and December. The October BFP of \$16.04 smashed the old, all time record high of \$15.37 set in September 1996. The October record high stood for only one month, being replaced by \$16.84 in November. That record, too, stood for only one month, when the December BFP was announced at \$17.34 per cwt.

Grade AA butter price at the Chicago Mercantile Exchange spot auction started the year at \$1.1250 per pound. It broke the old record high  
(Continued on page 2)



(Cash Lease . . . Cont'd. from p. 1)  
rate due to the price of commodities or the change in costs.

This has a negative impact on both the tenant and the landlord. The landlord may not receive his/her money for that year because the tenant can not afford to pay.

There are four methods used to determine a fair cash rental agreement. One is the cash-rent market approach. This method requires the landlord to evaluate the amount being paid for cash-rent in the area and to make adjustments for the level of productivity and improvements being made. This method is often hard to use due to the amount of estimating that occurs.

A second method is the landlord's ownership cost or desired return. This method allows the landlord to calculate the cost of resource ownership and the type of property. Land is valued at fair-market value and may include the value of assets (buildings, improvements, irrigation equipment) on the land. Real estate taxes are considered when using this method.

Adjusting for the landlord's net-share is the third method. This assumes the rent value should be related to crop-share benefit. This is usually lower since the landlord shifts all price and weather risk to the tenant. This method allows an average net crop share for good and bad yields. To determine a landlord's share of income and expenses, a producer should evaluate yield and cost values that are expected for the current production year and compare the average share arrangements of the area. Once this estimated value has been determined, a tenant and landlord can adjust this value for the increased risk of price and weather that has been placed on the producer.

The fourth method is used to determine the tenant's net return to the land. Some tenants can not afford all the land they bid for. Consideration must be given to the use of land, the fixed cost of machinery, and the variable expenses of labor and management after they are deducted from the value of the gross yield. A cash-rent-agreement-figure can be derived by combining all of these methods or using one.

The timing of the rent payment should also be addressed. Single payments may add stress. If this is the preferred method, it should be due at harvest time.

Some agreements consist of several payments. This may be preferred by both parties. These payments should coincide with major sales of crops or livestock.

Prices and operational expenses are volatile. Tenants and landlords hate to commit to a long term contract. Adjustable cash-rent contracts allow flexibility for price yields. By having a flexible agreement, the landlord can share the additional income and tenants reduce their amount of risk.

For more information on cash leasing alternatives contact an extension specialist or look at reference article NCR Extension Publication 75.

(Dairy Review . . . Cont'd. from p.1)

price of \$1.9500 set in October 1997 on June 26, 1998. The butter price went over \$2.00 on July 24 and then set new record high prices for seven consecutive weeks, peaking at an unheard of price of \$2.8100 per pound. It stayed there for three weeks, then it fell \$1.59 cent in ten weeks. It recovered 25.25 cents in the next three weeks and closed the year at \$1.43, 30.5 cents higher than a year earlier.

The CME stopped trading Grades A and B butter at the close of the business day on June 26. So little was being traded that the prices meant nothing to the market. The USDA, which used the price of Grade A in its price setting activities, now uses the price of Grade AA less 9 cents as a proxy. Multiples used in pricing cream are now based on Grade AA butter.

Cheese prices also went on a joy ride during the year. Forty-pound blocks started the year at \$1.43 per pound. They dropped to \$1.18 by May 1, which was a big factor in the low BFP for the month of May. Block cheese prices then started a fairly steady climb, setting a new record high price of \$1.7050 on September 11. The old record was \$1.6950, set in September 1996. Over the next thirteen weeks, new record high prices were set every week, peaking at \$1.9000 on December 11.



The price held there through the end of the year, breaking away on January 8, 1999. The price of barrels followed blocks, but by the end of the year was a dime under the price of blocks. (The normal difference is about a nickel.) This put financial pressure on makers of barrel cheese, because they had to bid against the block makers and butter/powder plants for milk.

The CME began trading cash cheese on a daily basis the first of September 1998. The amount of cheese traded per week increased through the end of 1998. During Christmas week, 45 car loads of cheese were traded in a three day period, the most cheese ever traded in any week, either at the CME or the old National Cheese Exchange. The next week, the week of New Years, 70 cars were traded.

### **Causes for the High Prices**

Reduced milk production, especially in California, the nation's biggest milk producing state, was a big factor in triggering the high milk prices of 1998. In California, bad weather created muddy lots and stress on the cows. In the Pacific Northwest, the availability of top quality alfalfa was short to nonexistent, making good rations very difficult to achieve. Prior to the financial crisis in Asia, that area, mainly Japan, was a strong competitor in the high quality hay market. When the financial crisis hit and the value of the Yen fell against the dollar, Japan was priced out of the market. This increased the amount of quality hay available for lactating cows, but by then the peak production period was passed. The South and Southeast was troubled with excessive heat and drought last summer, which stressed milk cows and reduced milk production.

On the demand side of the equation, the demand for dairy products remained strong. Export subsidies helped the export market. The hot summer created good demand for ice cream. Resorts and fast food operations maintained a strong demand for process cheese. The higher price of cheese was partly offset by lower beef prices, allowing them to hold their prices steady. The use of butter remained surprisingly high, given the high prices. The demand for high fat holiday items, such as dips, cream cheese, eggnog and other items, helped support prices. The holiday demand for cheese remained good, and the Super Bowl, which

is the peak of cheese use, is yet to come. After that, consumption tends to drop significantly.

### **Consequences**

The good times carry the seeds to their own destruction. The strong milk prices and very low feed prices have encouraged dairy operations to expand. The December milk:feed price ratio was an unheard of 4.35:1, compared to 2.80:1 for December 1997. For many years, milk cow numbers have been declining. But, 1998 ended the year with 12,000 more milk cows than did 1997. Some butter users were priced out of the market, and it will be difficult to coax them back as users, especially bakers. When more normal production levels return this coming spring, we can expect a major jump in production and corresponding declines in prices.

The futures markets are already anticipating this occurrence. Since the first of the year, the February BFP contract has declined \$2.44 to \$11.65, and May is down 30 cents. Block cheese prices at the CME cash auction have declined 60 cents to \$1.2500 per pound. With these signals, it behooves dairy producers to take some kind of price protection action against additional price declines.

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## ***Midwest Market Analysis***

**On South Dakota Public Television  
Friday at 9:30 PM (CST)  
and  
Saturday at 12:30 PM (CST)**

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