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South Dakota Agricultural Rental Agreements: What is a Fair Lease Arrangement?

Burton Pflueger, Extension economist

Both tenants and landlords agree that a fair lease is equitable or fair to both parties. However, in practice, it is much easier to talk about an equitable agreement than to actually negotiate one.

The problem is that what one party may see as equitable may differ considerably from what the other party sees as equitable. It comes down to this: History and tradition have more to do with leasing arrangements than do economics or fairness.

According to economics theory, the cash rental rate should be the rate that equates the amount of land that landlords would be willing to rent and the amount of land that tenants are willing to rent, for that given price. While landlords secretly hope to receive the highest possible rate, and tenants secretly hope to pay the lowest possible rate, both parties are willing to negotiate to determine a rate that is fair to both.

In general, cash rental rates depend on several factors including last year's rental rate, expected crop prices and production costs, government farm program provisions, and the availability of and competition for rental land in the community. Differences in cash rents among different parcels of land are influenced by the productivity, size, location, accessibility and configuration of the parcel, government farm program yields, base levels and production restrictions, facilities included (buildings, irrigation equipment), and the relationship between landowner and tenant. No two parcels of land

are exactly equal, and so each parcel could have a different "fair" value and related rental rate.

The following will help you design an appropriate and equitable lease arrangement.¹

The Owner Is Entitled to a Return on Investment

Land is a capital item and is entitled to a return on investment. Consequently, landowners expect a return on their investment based on the income earning potential of the land. But how much return is reasonable?

Two approaches (gross rates of return and net rates of return) can give you information on current rates of return to agricultural land.

Gross rent-to-value ratios (gross cash rent as a percent of land value) are calculated from reported cash rental rates and estimated values of leased land. This is a measure of the gross rate of return obtained by landlords before deduction of property taxes and other landlord expenses.

In 2006, the statewide average gross rate of return (rent-to-value ratio) was 5.2% for nonirrigated cropland and hayland, 4.3% for rangeland, and 4.7% for all agricultural land.²

The net rate of return (percent) that landowners could expect can also be estimated. Appraisers refer to the

¹ Adapted from <http://www.ces.uga.edu/Agriculture/agecon/pubs/paychargerent.htm> and <http://www.ianrpubs.unl.edu/epublic/live/g1387/build/g1387.pdf>

² Information obtained from South Dakota Farmland Market Trends 1991-2006: The 2006 SDSU South Dakota Farm Real Estate Survey; C271.

current annual net rate of return as the market-derived capitalization rate, which is widely used in the income approach to farmland appraisal. The net rate of return is a return to agricultural land ownership after deducting property taxes, real estate maintenance, and other ownership expenses.

Average net rates of return for 2006 varied from 4.2% for nonirrigated cropland to 4.0% for hayland and to 3.8% for rangeland and pasture, averaging 3.9% for all agricultural land. Regional differences in rates of return reflect the consistent pattern of cropland rates of return exceeding rates of return to rangeland.

The projected difference between gross and net rates of return to agricultural land ownership in 2006 is 0.8 percentage points for all-agricultural land and varies somewhat across regions and agricultural land uses. Most of the difference between gross returns and net returns is caused by property tax levies.

Data on the rates of return to South Dakota farm ground is contained in Table 1.

Tenant / Operator Has Limits on Rental Price

Those who rent land are willing to pay for its use, but the amount that can be paid is limited by: 1) the production potential, 2) the expected commodity market price, 3) the history of weather patterns (drought and/or recent wet years), and 4) the managerial ability of the farm operator.

The fundamental factor in determining rental value is the ability of a particular piece of farm ground to generate income. An estimate of the expected net income can be determined from the expected yield, commodity prices, farm program payments, and purchased input costs including equipment costs.

Expected revenue and purchased input costs should be projected for the entire lease period. Subtracting the cash rent leaves the amount the operator would have left for payment of the operator's labor, management, capital including borrowed funds, and overhead. The operator must then decide whether the expected return is attractive enough to accept the rent.

Alternatively, a value can be placed on the operator's labor, management, capital, and overhead. The rental value is then calculated as a residual.

The Residual Return to Land Approach

A residual return-to-land approach is based on the premise that the return to land is what is left after all other input costs have been paid. Since land is the "most fixed" or permanent resource in the agricultural production process, it is, as economists say, the "residual claimant."

Using this approach to arrive at a cash rental rate involves identifying all of the non-land inputs involved in the production process and assigning appropriate costs to each.

Both the landowner and tenant operator may work up such estimates either independently or together. The key is to come to mutually-agreeable accounting of all non-land input costs as well as anticipated revenues, so that an appropriate cash rent can be determined.

A worksheet is provided on the next page to list anticipated revenues and the non-land input costs. Subtracting the latter from the former will result in a land residual that should be the maximum per-acre rent paid given the assumptions made. This worksheet is designed to help arrive at an equitable rental price.

Table 1. Estimated rates of return to South Dakota agricultural land by type of land and by region, 1991 – 2006

	2006	2005	2004	2003	2002	2001	Average								
	GROSS rate of return (%)							1991-2000	2006	2005	2004	2003	2002	2001	Average
Type of land-statewide	GROSS rate of return (%)								NET rate of return (%)						
All agricultural land	4.7	5.2	5.8	6.2	6.5	6.7	7.3	3.9	3.9	4.3	4.5	4.5	4.8	5.4	
Nonirrigated cropland	5.2	5.7	6.6	7.1	7.4	7.6	8.0	4.2	4.5	4.9	5.0	5.2	5.4	6.0	
Rangeland & pasture	4.3	4.8	5.2	5.4	5.7	6.1	6.8	3.8	3.5	3.9	4.1	3.9	4.3	4.8	
Hayland	5.2	5.7	6.5	7.1	7.2	7.3	7.9	4.0	4.0	4.4	4.8	4.7	5.1	5.5	
Region	GROSS rate of return (%)								NET rate of return (%)						
Southeast	5.0	5.5	6.2	6.7	7.1	7.2	7.4	4.1	4.5	4.9	4.6	5.0	5.4	5.8	
East-Central	4.4	4.9	5.6	6.7	6.7	6.9	7.6	4.1	4.7	4.7	4.6	5.0	5.5	5.5	
Northeast	4.9	5.1	6.8	7.4	7.6	7.6	8.1	3.9	4.3	4.8	5.5	5.5	5.6	6.1	
North-Central	5.2	5.8	6.2	6.5	7.0	6.5	7.9	4.4	4.4	4.6	4.9	5.6	6.1	6.1	
Central	4.6	4.9	6.0	6.2	6.6	7.5	7.7	4.1	4.1	4.4	4.1	4.7	4.6	5.3	
South-Central	5.1	4.9	6.2	6.0	6.3	6.6	6.9	4.0	4.0	4.2	5.1	4.2	4.6	5.2	
Southwest	4.2	4.7	5.4	5.6	5.7	6.7	6.7	3.1	3.2	4.0	4.2	3.4	4.0	4.4	
Northwest	4.7	5.5	5.2	5.6	5.9	6.1	7.1	4.0	3.4	3.7	3.9	3.9	4.0	5.2	

Other sources of information can be helpful in evaluating rental rates and in identifying adjustments taking place in the market. One such piece of information is the going rate of cash rent in the area.

Going Rate of Cash Rent in the Area

Current cash rental rates provide an indication of the current market. Cash rental rates for different types of cropland by different regions of South Dakota can be found in C271, South Dakota Farmland Market Trends 1991-2006: The 2006 SDSU South Dakota Farm Real Estate Survey, on the internet at <http://agbiopubs.sdstate.edu/articles/C271.pdf>

Both the ranges and the adjustments over time provide guidelines for setting and adjusting cash rental rates to reflect area market conditions. Unfortunately, updates typically become available after the current rental agreement is determined, but they still can help you see if the adjustments were consistent with the market.

Comparable Crop-Share Rents

Another possible approach to determine cash rent rates is to base the cash rent rate on the calculated crop-share rent. A crop-share lease places more risk on the landowner than a cash lease; therefore it would be expected to provide a higher return to the landowner.

The common share arrangement in the area may not be a fair deal for a particular parcel. Higher-than-average-productivity land, for example, should have a larger landowner share. The landowner share should also be higher when the landowner furnishes items such as the irrigation pipe or pivot.

The landowner's crop-share net of shared costs is the rent in a crop-share and can be used in estimating a cash rent. This method is particularly useful when a crop-share arrangement is being converted to a cash lease. The historical crop-share rent can be adjusted to a cash rent that is deemed appropriate by both parties to account for the shifting of risk away from the owner to the tenant operator.

Even without historical precedent for establishing crop-share returns, you can construct realistic estimates of returns under crop-share leasing, given typical yield and commodity price estimates as well as typical landowner/tenant shares and costs of shared inputs.

For example, assume

- a 60-40 tenant/landowner crop-share pattern for dry-land cropland,
- expected farm program payments and projected yields and prices give an average dollar revenue of \$260 per acre, and
- shared input costs for fertilizer and crop chemicals total \$40 per acre.

In this situation, the crop-share rent for the landowner would be \$88 per acre ($\$260 \times .4 = \104 minus expenses of $\$16 (\$40 \times .4)$).

There is some transfer of risk from landowner to tenant with a cash rental agreement. For example, if this crop-share rent were adjusted downward 10% for the lower risk for the landowner associated with cash leasing, then the estimated cash rent would be \$79 per acre (90% of \$88).

The potential pitfall in using a crop-share rent to estimate cash rent is that the crop-share arrangement may not be fair, i.e., the crop-share is not equal to the cost-share. The alternative is to calculate the revenue remaining after all non-land costs are covered, i.e., determine the residual return to land.

Negotiating a Rental Rate

The rate of return approach can indicate the minimum price a landlord should accept and the residual return approach could indicate the maximum price a tenant could afford pay.

If they were equal, there would be no need to enter into negotiation. Negotiating a cash rental rate can be uncomfortable. The landowner may want a relatively stable rental income—upward adjustments when the outlook is favorable and otherwise no change from year to year in the amount of rent charged.

Alternatively, the rental rate could be set annually based upon expected costs, prices, and farm program payments for that year. This may result in substantial annual swings. Pre-season expectations often will not be realized, and making annual adjustments in rent may not reflect rental value any better over time than periodic adjustments.

Agreeing on when and how to adjust rents is probably more important than how often they are adjusted.

An approach that some landowners have used to determine a rental rate is to offer the land on a bid basis.

Generally it would be expected that an auction would realize the maximum possible rent. But it is possible the tenant who bids the maximum may not follow production practices deemed desirable by the landowner. Also, other tenants may not be attracted to a bid process because they expect it will result in an excessive rent.

Whatever the method or methods used to arrive at a reasonable cash rental rate, the final negotiated rent may reflect a number of issues and provisions pertaining to the specific rental arrangement itself. For example, the tenant operator may be willing to provide some additional services which represent a partial payment-in-kind. If so, the final rental rate may be closer to the lower end of the negotiation range.

An alternative to frequent renegotiation of the cash rent is to negotiate a base cash rent with adjustment according to the revenue generated during the year. This arrangement is commonly called a flexible cash lease. See other Extension Extras in this series for further discussion of this and other alternative arrangements.

Keys to Successful Leasing

- Given the dollar value of the asset involved and the complexity of today's economy and technology, writ-

ten agreements, with details spelled out, should be considered. Even leases between family members can lead to misunderstanding and ill will if details are not specified in writing. Care must be taken to protect your rights in the written lease. Consult a lawyer!

In addition to the cash rental rate, a number of other considerations should be spelled out in writing.

Among these are

- timing of payments,
- provisions for renegotiating rates,
- resource management and maintenance questions,
- provisions for subleasing (such as for winter stock grazing), and
- termination procedures including arrangements for compensation to the tenant for long-term investments (lime, for example) that are still providing benefits at the termination of the relationship.

- The most important key to successful cash leasing is good communication on the part of both landowner and tenant operator.

This means that goals and expectations should be stated clearly, revealing a consensus of a common set of objectives for the land resource and its use. Given legal and environmental aspects along with the economic considerations, a smooth (and frequent) flow of communication is vital.