

Rental Arrangements Changing with the Times Part 2 – Flexible Cash Leases

Tom Dorn
UNL Extension Educator

The March NEBLINE Farm Views page featured an article describing traditional cash and crop-share leases. In this issue of the NEBLINE, we will discuss “flexible” cash leases, why landowners are starting to develop flexible leases and how flexible leases work.

The March NEBLINE article delineated some of the reasons why tenants have been showing a preference for cash leases over crop share leases in recent years. A brief summary is:

- Greater management flexibility.
- Greater capture of returns for the tenant for their management abilities.
- Greater opportunity to compete in rental land market.

Reasons given in the March article for landlords showing a preference for cash leases included:

- Less management responsibility because the landlord does not pay for any of the crop inputs.
- Landowners receive their payment in cash. This eliminates the need to sell crop to receive their income for the year as in the case of crop share leases.
- Income for the year is known up-front so the landowner takes no production or price risk.
- In the past 10–15 years, cash leases have often resulted in greater returns for the landowner than crop share leases.

The net result of these developments is traditional leases may no longer represent an equitable business arrangement between the two business partners, (landowner and tenant). This has prompted some landowners to develop flexible cash leases. Flexible cash leases return to the concept of having the landowner share some of the production and/or market price risks. This can open up possibilities for the landowner to realize higher returns if total crop revenues are higher than expected but will result in lower returns for the landowner in down years.

Flexible Lease Provisions

In the leasing workshop, Dr. Bruce Johnson listed the advantages of flexible cash leases as:

- Actual rent paid adjusts automatically to yield and/or price shifts.
- Risks, up-side and down-side, are shared.
- Owners are paid in cash, not crop.
- Reduced need for frequent re-negotiation.

He listed disadvantages to flexible cash leases as:

- There is no universal model for how a flexible cash lease is written.
- If the rental rate is flexed on yield risk, then direct and counter-cyclical payments must be shared by tenant and landlord.
- Lease detail is needed for determining flex mechanism.
- Since flexible leases are based on crop

Table 1. Changes in Nebraska Land Value and Cash Rents 2002–2007

Region and Land Type	Percent Change in Average Values	Percent Change in Cash Rents
EAST: Nance, Platte, Colfax, Dodge, Washington, Merrick, Polk, Butler, Saunders, Douglas, Sarpy, Hamilton, York, Seward, Lancaster, Cass		
Dryland Cropland	71%	30%
Center Pivot Irrigation	52%	21%
Gravity Irrigation	45%	18%
SOUTHEAST: Clay, Fillmore, Saline, Otoe, Johnson, Nemaha, Nuckolls, Thayer, Jefferson, Gage, Pawnee, Richardson		
Dryland Cropland	80%	35%
Center Pivot Irrigation	56%	25%
Non-Tillable Grazing	50%	20%

Table 1 shows the average increase in land values versus the increase in cash rents paid for the five-year period of 2002–2007. This information was presented in a recent leasing workshop by Dr. Bruce Johnson, professor of Agricultural Economics at UNL.

As can be seen, the average increase in cash rents has lagged behind increases in land value during the five-year period. The “fair” rate of return on the investment in land value constitutes an opportunity cost which is borne by the landowner. An unavoidable, out-of-pocket cost is the property tax, which is also based on land value. As this data shows, on average, the return on investment is not as favorable as it was at the beginning of the five-year period, since cash rents have not kept pace with increasing land values.

Commodity prices on average increased dramatically during the period 2002–2008. Landowners understandably want their share of the bounty resulting from higher commodity prices. Tenants, on the other hand, will argue one must consider the net return, not the gross return, when computing a fair rental rate. Increased commodity prices have been accompanied by large increases in the cost of energy, seed, fertilizer, pesticides, machinery and labor. As one farmer told me, “It ain’t all gravy.”

revenues but not crop input costs, they can get out-of-sync if input costs shift rapidly.

Verification is Needed with Flexible Rental Agreements

Yield may be determined by:

- scale tickets
- combine yield monitors
- storage bin capacity, if the crop is stored on-farm.

Price may be determined by:

- The price at a local elevator or other buyer near the date the final rent payment is due.
- Local cash price at a co-op or processor on a specified date or an average price over a specified period.
- Futures market price minus normal basis value for the location.

Key Variables the Landowner and Tenant Should Agree On

- crop rotation
- base rent
- yield and price for establishing base revenue
- landowner percentage if gross revenue above or below base revenue to “flex” base rent

Parameters

If cash rent is going to change with gross revenue, a key parameter is what percentage of the gross revenue has gone to the land owner under traditional cash rental agreements. Dr. Johnson calculated the average cash rent as a percentage of gross revenue for center pivot irrigated corn and soybeans and for rain fed (dryland) wheat, corn and soybeans in eastern Nebraska for the period 2003–2007. He found the average rain fed (dryland) cash rent was 33% of gross revenue for corn, 37% of gross revenue for soybeans, and 50% of gross revenue for wheat. The average center pivot irrigated cash rent for the five year period was 34% of gross revenue for corn and 42% of gross revenue for irrigated soybeans. We will use 35% of gross revenue as the factor to adjust cash rents in the two example flexible irrigated leases in this article.

Option 1. Flex on commodity price - yield assumed to be constant

Assumptions (as negotiated between the two parties) are:

- yield set at 200 bushels per acre
- base rent of \$175 per acre
- base revenue 200 bushels x \$3 = \$600 per acre

Table 2. Flexible Irrigated Corn Lease

Yield held constant at 200 bushel. Base price \$3 per bushel. Base gross revenue = \$600 per acre. Base rent=\$175/acre. Bonus = 35% of gross over or under \$600.

Corn price Dec. 1	Base rent \$/ac	Gross revenue at 200 bu/ac	Gross revenue less base revenue	Bonus (35% of difference)	Total rent base + bonus
\$2.50	\$175	\$500	(\$100)	-\$35	\$140
\$2.75	\$175	\$550	(\$50)	-\$17.50	\$158
\$3.00	\$175	\$600	\$0	\$0	\$175
\$3.25	\$175	\$650	\$50	\$17.50	\$193
\$3.50	\$175	\$700	\$100	\$35.00	\$210
\$3.75	\$175	\$750	\$150	\$52.50	\$228
\$4.00	\$175	\$800	\$200	\$70.00	\$245
\$4.25	\$175	\$850	\$250	\$87.50	\$263
\$4.50	\$175	\$900	\$300	\$105.00	\$280
\$4.75	\$175	\$950	\$350	\$122.50	\$298
\$5.00	\$175	\$1000	\$400	\$140.00	\$315
\$5.25	\$175	\$1050	\$450	\$157.50	\$333
\$5.50	\$175	\$1100	\$500	\$175.00	\$350

Table 3. Flexible Irrigated Corn Lease

Flexed on actual gross revenue (actual yield x price)

Base rent = \$175 per acre. Bonus = 35% of gross revenue over or under \$600.

Corn price Dec. 1	Base rent \$/ac	Yield bu/acre	Gross revenue bu/ac x price	Gross revenue - base revenue	Bonus (35% of difference)	Total rent base + bonus
\$2.50	\$175	180	\$450	(\$150)	-\$52.50	\$122.50
\$2.50	\$175	200	\$500	(\$100)	-\$35	\$140
\$2.50	\$175	220	\$550	(\$50)	-\$17.50	\$157.50
\$3.00	\$175	180	\$540	(\$60)	-\$21	\$154
\$3.00	\$175	200	\$600	\$0	\$0	\$175
\$3.00	\$175	220	\$660	\$60	\$21	\$196
\$3.50	\$175	180	\$630	\$30	\$10.50	\$185.50
\$3.50	\$175	200	\$700	\$100	\$35	\$210
\$3.50	\$175	220	\$770	\$170	\$59.50	\$234.50
\$4.00	\$175	180	\$720	\$120	\$42	\$217
\$4.00	\$175	200	\$800	\$200	\$70	\$245
\$4.00	\$175	220	\$880	\$280	\$98	\$273
\$4.50	\$175	180	\$810	\$210	\$73.50	\$248.50
\$4.50	\$175	200	\$900	\$300	\$105	\$280
\$4.50	\$175	220	\$990	\$390	\$136.50	\$311.50
\$5.00	\$175	180	\$900	\$300	\$105	\$280
\$5.00	\$175	200	\$1000	\$400	\$140	\$315
\$5.00	\$175	220	\$1100	\$500	\$175	\$350
\$5.50	\$175	180	\$990	\$390	\$136.50	\$311.50
\$5.50	\$175	200	\$1100	\$500	\$175	\$350
\$5.50	\$175	220	\$1210	\$610	\$213.50	\$388.50

- flex rent: 35% of gross revenue above or below base revenue

Table 2 shows the total rent (base + / - bonus) over a range of prices with yield set at 200 bushels per acre.

Option 2. Flex on commodity price and actual yield

Assumptions (as negotiated between the two parties) are:

- 200 bushels per acre average yield
- base rent of \$175 per acre
- base revenue 200 bushels x \$3 = \$600 per acre
- flex rent: 35% of gross revenue above or below base revenue

Table 3 is figured on actual yield and price. Base rent is \$175 per acre based on 200 bushels per acre and \$3 per bushel = \$600 gross revenue.

Caution: As this is being written, the new 2008 Farm Bill has not been passed by congress. It is likely flexible rental agreements which set rental price on bushels of crop raised, will be treated as a crop share arrangement necessitating the FSA to split the Direct and Counter-cyclical payments between the landowner and tenant. The percentage of the payments going to each party will depend on the circumstances of the lease.