

Establishing a Cash Rent in an Uncertain Economic Environment

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Negotiating cash rent or any other kind of rental arrangement is not an easy task. Even if one knew prices and yields faced at harvest, it would still be difficult to negotiate mutually agreeable cash rental rates. The increased variability of grain and purchased input prices being experienced in the current economic environment has only made this difficult task even more challenging. With the increased variability of grain and input prices, there is a greater chance that one or both parties to the lease may wish to renegotiate the lease terms once all the information is known. In this economic environment, it may be that a flexible cash lease that allows adjustments in the lease payment based on harvest price, yield, and cost information would provide a more equitable distribution of return from crop production.

As an example, consider the difficulty of establishing an equitable cash rent for 2009. Given price and cost expectations in September 2008, the estimated return to land and unpaid machinery and labor resources for a 2009-crop corn-soybean rotation was \$308 per acre. Given this estimate, a cash rent of \$200 per acre for 2009 may have been reasonable. During October 2008, cash corn and soybean prices went through a significant decline. Expected grain prices for Fall 2009 also declined. Using the futures market as a guide for prices for fall 2009, the estimated return to land and unpaid machinery and labor resources for the corn and soybean rotation in late October 2008 was \$200 per acre. In this case, a rent of \$200 per acre would not leave any margin for the cash rent tenant's unpaid machinery and labor.

There may be several fundamental changes in corn and soybean prices between now and when the 2009 crop is harvested and sold. There may also be additional changes in the prices of purchased inputs. Over the last few years purchased input prices have been trending sharply higher. But now with lower grain and fuel prices and a world-wide financial crisis, there is the possibility that prices for select inputs may decline. Given the high degree of uncertainty for both crop prices and input costs it would appear that specifying the "right" cash rental rate very far in advance is nearly impossible. For this reason there is considerable interest in alternative rental arrangements such as flexible cash rent agreements.

There are other rental arrangements commonly used, and each has advantages and disadvantages. The parties to the lease need to carefully assess their goals—including how long the current lessor-lessee relationship is expected to last—as well as how much risk each party is willing to bare. The ability and willingness of a landowner to share some of the margin risk using an adjustable cash rent lease may be a way to provide for greater average returns for the landowner in the long run.

Understanding the risk/return tradeoff

An important consideration in evaluating a cropland lease is the relationship between the amount of risk being taken and the average return. In general, an increasing level of risk is rewarded with a larger average return. The risk return trade-off for various types of cropland arrangements is illustrated in Figure 1 from the perspective of the tenant and the landowner.

For a tenant, providing custom farming services, while less risky, would not provide as much return as a cash rent situation. For the custom farming arrangement, the tenant receives a fixed payment for machinery services associated with tillage, planting, tending, and harvest of the crop. There is some risk

for the tenant in this arrangement; after all it is possible that fuel price could unexpectedly increase after the payment level is set. Of course it may be possible to include a fuel cost adjustor in such an agreement. This would lower the risk for the tenant. From a landlord's perspective the custom farming scenario should bring the highest expected return, but also presents the largest risk because the landowner must purchase the crop inputs and manage the production and marketing of the crop. All the risk associated with yields, grain prices, and input prices lies with the landowner.

With a traditional cash rent lease, the positions are reversed. The cash rent is a fixed amount that is known to the landowner. The payment to the landowner will not vary because of changes in yields, grain prices, or input prices. These risks are all borne by the tenant. The return under a traditional cash rent lease will provide the least risk for the landowner but returns should also not be expected to be as high as with other lease arrangements. From the tenant's perspective, a traditional cash rent arrangement should bring the highest average return, but also presents the greatest level of risk. Given the much wider range in input and grain price fluctuations, tenants will likely try to obtain a larger return for bearing these risks. The competitive nature of the rental market will make this goal difficult for tenants, but over time market rents are likely to adjust in a way that will provide tenants a larger return for carrying the increased risk associated with a traditional cash rent lease.

A way for the landowner to increase the expected return from being a farmland owner is to participate with the tenant in sharing some of the risks. Figure 1 suggests two possible ways of doing this – a crop-share lease and a flexible cash rent lease. The crop-share lease brings with it the need to divide the crop and therefore to maintain two sets of accounts. Under this arrangement landowners are also required to market their share of the crop and pay bills for some inputs. This may represent more joint decision making and management involvement than the parties to the lease desire. An alternative is a flexible cash rent lease.

Flexible cash rent has become fairly popular as it may be an answer to a larger share of the return to the landowner as well as less risk to the tenant. Given the terms of the lease, flexible cash rent can be the answer for the tenant concerned about being locked into a high cash rent that would subject their farm operation to unmanageable risks if grain prices move sharply lower and input costs remain high. If the landowner is willing to assume some of the risk, a flexible cash rent lease can reward that additional risk-taking activity with higher returns over time than a fixed cash rent. In summary, a flex rent may provide higher average income prospects to the landlord while still maintaining a bearable level of risk for the tenant.

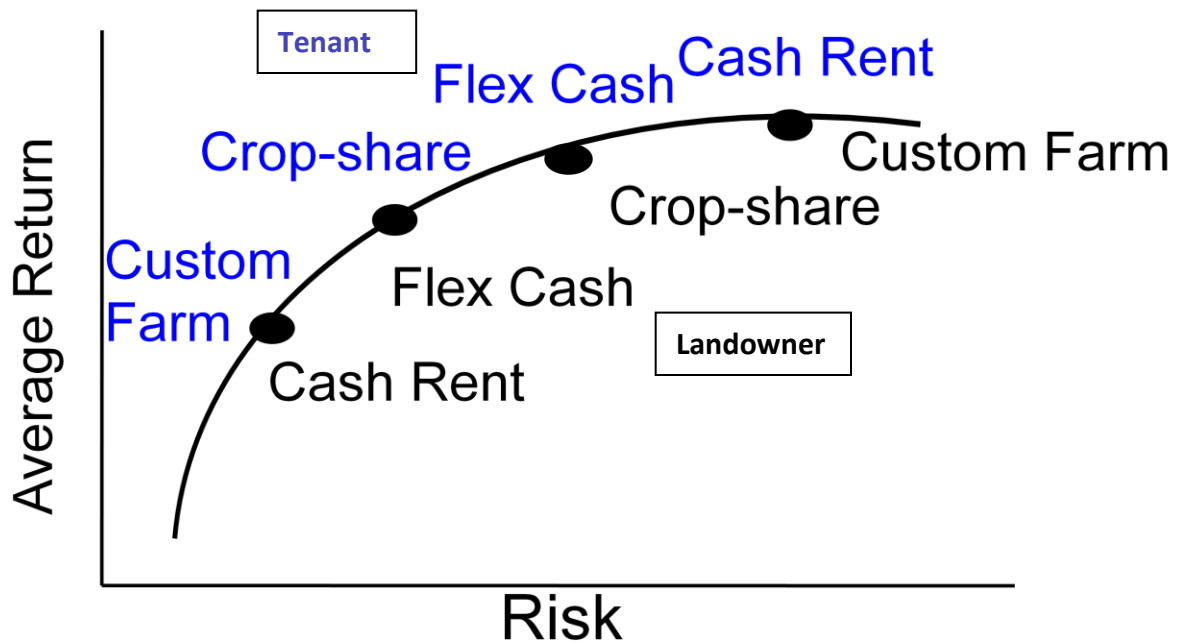


Figure 1: Tradeoff between risk and return for various types of land rental agreements.

Risk sharing negotiation

To develop a rental agreement that has the potential to result in a long-term relationship, the agreement must reward each party for the resources that are brought to the arrangement as well as for the risks taken. This implies a landowner will be rewarded with a higher average return over time under a flexible cash rent agreement than a traditional fixed cash rent arrangement. The reason being that the landowner's return is more at risk under a flexible cash rent arrangement since returns could end up being higher or lower than with a fixed cash rent.

When there is considerable volatility in input and output markets, it is unlikely that a fixed cash rent, negotiated months ahead of the production season, will correctly reflect the growing and economic environment by harvest time. A more flexible rental arrangement could benefit both parties in the long run, but both parties would need to be in a position to withstand the risks associated with a more flexible agreement. The main difference between a flexible cash rent lease and a traditional cash rent lease is that rather than agreeing on a price both parties agree on a price discovery mechanism. The final rent typically isn't determined until after the crop is harvested when actual crop yields and harvest prices are known.

There are various types of flexible leases in use today. Each one addresses a specific source of risk that may be of concern to one or both parties. General categories of flexible leases include leases where the cash rent is adjusted based on changes in grain prices, changes in crop yield, changes in total revenue, changes in net margin, or changes in a combination of these items.

Flexible cash leases can be relatively simple or they can be quite complicated. Simpler arrangements are probably better for landowners and tenants who haven't yet tried flexible cash rent leases. A relatively simple flexible cash lease, for example, might establish the cash rent equal to a fixed percentage of the revenue from each crop at harvest. Farm yields and the average cash price at a local elevator or terminal during the harvest period could be used to determine total revenue. Also, it is possible to limit the amount

of adjustment made when the final rent is determined by specifying that the flexible cash rent has a floor, ceiling, or range within which it must fall. For landowners who are used to receiving their cash rent early in the crop year, it is possible to establish a base rent or advance partial payment followed by a bonus payment at harvest. In this case the amount of the bonus will typically reflect changes in yields, crop prices, revenues, or net margin.

Because flexible cash rent leases are more complicated than fixed cash rent leases, they will require some time to be crafted in a way that addresses the desires of both parties. A higher level of trust is required between landowner and tenant. Developing such a lease will also likely require discussions between the tenant and landowner about yields, prices, and production costs. In evaluating the potential provisions of a flexible cash rent lease, estimating the potential return for various price and yield combinations will be an important step in assessing the ability to withstand the fluctuations that accompany this type of lease. A spreadsheet tool designed to assist with such an evaluation can be found at the [Purdue Farmland Leasing Resources](http://www.agecon.purdue.edu/extension/pubs/farmland_values_resources.asp) <http://www.agecon.purdue.edu/extension/pubs/farmland_values_resources.asp> Web site. This Website also has other information on leases.

Will the development of a flexible cash rent lease eliminate the need to review and renegotiate the terms of the lease on annual periodic basis? This will depend on the nature of the agreement but given the wide variation in grain and input prices in the current economic environment it is likely that both parties to this type of lease will want to review and update the terms of the contract regularly. Landowners and tenants who are interested in entering into multi-year lease arrangements may also find flexible cash leases better suited to achieving a more equitable division of returns over a multi-year period than is likely with a fixed cash lease.

While the process of understanding and developing a flexible cash rent lease can be long and tedious, it can serve as a method for strengthening the partnership between landowners and tenants as well as reward the parties involved with a long term profitable agreement. People who have made the effort to go through the process of crafting a flexible cash lease are typically satisfied and recognize the benefits that can be derived by a more flexible and less adversarial cash rental arrangement.