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Cash Rent Increases When is the Right Time to Give Up a Lease?

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Cornhusker Economics

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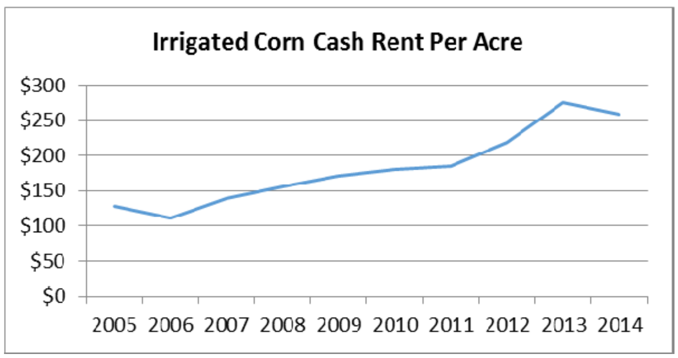
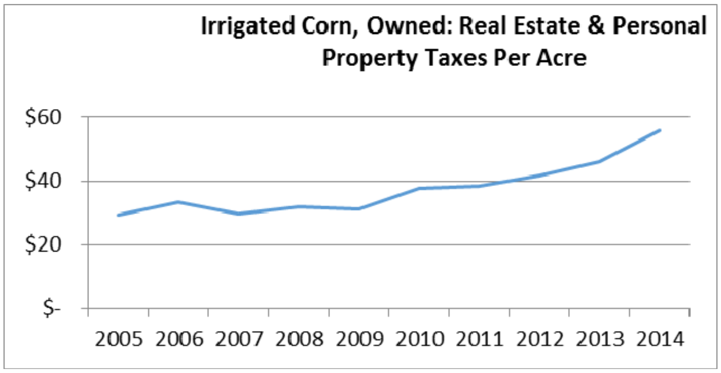
Market Report	Year Ago	4 Wks Ago	7/24/15
Livestock and Products, Weekly Average			
Nebraska Slaughter Steers, 35-65% Choice, Live Weight.	163.40	153.30	145.76
Nebraska Feeder Steers, Med. & Large Frame, 550-600 lb.	293.19	287.00	268.16
Nebraska Feeder Steers, Med. & Large Frame 750-800 lb.	240.61	*	243.94
Choice Boxed Beef, 600-750 lb. Carcass.	253.77	252.09	232.67
Western Corn Belt Base Hog Price Carcass, Negotiated.	125.94	75.51	75.24
Pork Carcass Cutout, 185 lb. Carcass 51-52% Lean.	131.92	80.87	83.52
Slaughter Lambs, wooled and shorn, 135-165 lb. National.	155.50	NA	155.80
National Carcass Lamb Cutout FOB.	360.24	360.80	355.32
Crops, Daily Spot Prices			
Wheat, No. 1, H.W. Imperial, bu.	5.59	5.42	4.50
Corn, No. 2, Yellow Nebraska City, bu.	3.45	3.98	3.70
Soybeans, No. 1, Yellow Nebraska City, bu.	12.52	10.18	9.71
Grain Sorghum, No.2, Yellow Dorchester, cwt.	6.04	7.93	6.57
Oats, No. 2, Heavy Minneapolis, Mn, bu.	4.12	2.85	2.66
Feed			
Alfalfa, Large Square Bales, Good to Premium, RFV 160-185 Northeast Nebraska, ton.	211.25	*	195.00
Alfalfa, Large Rounds, Good Platte Valley, ton.	100.00	72.50	85.00
Grass Hay, Large Rounds, Good Nebraska, ton.	100.00	90.00	95.00
Dried Distillers Grains, 10% Moisture Nebraska Average.	111.00	126.75	136.50
Wet Distillers Grains, 65-70% Moisture Nebraska Average.	41.00	42.50	42.50
* No Market			

There has been considerable talk for many years about the increases in cash rent. This chart shows the data collected by Nebraska Farm Business, Inc. for the average cash rent paid in the prior 10 years. The average cost has doubled from $127.71 in 2005 to $258.11 in 2014 (peak of $274.74 in 2013) . The cost now accounts for 31% of the total cost of growing irrigated corn. It's no wonder that in times of narrowing margins, producers are considering ways to reduce this major expense.



Unfortunately, reducing cash rent isn't a one-sided story. Landowners have seen their own rapidly increasing costs. The average personal property and real estate taxes paid per acre has also been increasing. In the same 10-year period, this cost has also increased from $29.22 to $55.71. Unlike cash rent, the cost for 2015 will certainly be another significant increase. Although this increase has only been $30 per acre versus a $125 per acre increase in rents, it's not fair to discuss cash rents without discussing the increases in landlord costs.



So the question remains, what to do with the high cash rents. It seems many tenants feel they are stuck between a rock and a hard place. It's hardly anyone's desire to work all year knowing one will lose money, but giving up ground is a long-term and often emotional decision.

The following table shows the average costs/returns of the 1/3 of the farms included in the NFBI averages with the lowest net return. If we assume these are the projected costs for an operation for 2015, we can talk about the decision of whether or not it's time to give up a cash-rent lease.

Average Costs/Returns from 1/3 of Nebraska Farm Business, Inc. Operations wth Lowest Net Returns per Acre.

	$ per acre
Gross Income	819.36
Direct Expenses	863.08
Return over Direct Expenses	-43.72
Overhead Expenses	75.32
Net Return	-119.04
Family Living*	55.02
Net return over all costs	-174.06

* The average per acre amount each farm contributes to family living expenses.

There are three types of expenses listed:

Direct Expenses are those that are directly tied to production, such as seed, chemicals, fuel, irrigation fuel, etc. These costs would not be part of your operation if you didn't farm these acres.

Overhead Expenses are those expenses that don't go away (or increase) with a change in acres. Things such as farm insurance, utiltiies (outside of irrigation), depreciation of equipment, building repairs, etc. are included in overhead expenses.

Family Living Expenses are non farm costs that must be covered by farm income. These expenses include food, clothing, health insurance, home rent/repairs, etc.

In an ideal, long-term situation there would be enough gross income to cover all expenses. This is certainly the situation we've had in the previous 8-10 years. It's hard to go back to realizing that in some situations we are going to have to accept less. So how to do you make the decision?

If at any time your net return over all expenses is negative, it's important to back up and see where you have a profit. If you have a positive net return before family living, you are making money farming, but not more than you are spending to live. There are two ways to fix that problem. You spend less for family living or subsidize your farm income with non-farm income to lower the amount that must come from the farm. You can continue to operate in the short term with a negatvie net return over all costs, but eventually without adjustment, it will cause you to lose enough net worth to put an end to the business.

If net return before family living is negative, we need to step back again and see if we have a positive income over direct expenses. If this is positive, you are better off continuing to farm that ground in the short term. This means that you are making enough gross income to cover the direct expenses and contribute to the overhead expenses. Remember, those overhead expenses wouldn't go away if you didn't farm that particular piece of ground so any contribution to those is better than nothing.

Let's go back to the table with returns from the low 1/3 producers. If this was your projection, you would have a tough decision. Economics would say you are better off not farming this piece of ground. The return over direct expenses is -$43.72 so you would make more money to not farm it another year.

The reality is this decision can't be just about the numbers. The likelihood of ever having the opportunity to farm that ground again once you give it up is slim. It is also tough to find additional ground to farm when the markets turn around. The scarcity of the income-producing resource (the land) makes the decision to give up high cash rent land extremely tough. Knowing that a weather scare, a disaster in another area of the Midwest, or even major legislation could change this outlook in an instant gives validity to continuing to pay higher cash rent than what the land will actually support. It's also important to remember that giving up the ground may reduce your risk, but it also cuts the opportunity to make money.

The final decision as to whether to continue the high-risk lease may come down to the overall financial health of the business. If an operation is highly leveraged and has a significant amount of acres of high-rent land, the tough decision will have to be made sooner than in an operation with low debt and only a few acres of high cash rents. It's also going to be easier for an operator with plenty of net worth built up to continue in this situation rather than a young/beginning farmer who doesn't have years of profits to fall back on. In any case, high cash leases shouldn't be given up as a knee-jerk reaction to tight margins, but only after consideration of net return, overall financial health, and long-term outlook of the operation.

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