By John Otte

Is a flex lease for you?

IF YOU'RE ABOUT TO RENEGOTIATE WITH LANDOWNERS AND WANT TO MINIMIZE CASH OUTFLOW FOR RENT IN POOR INCOME YEARS, CONSIDER A FLEXIBLE CASH LEASE AS ONE OPTION

Ten of Mike Brelsford's 25 landowners expressed interest in a flexible cash lease going into the 2008 cropping season. That was enough for Brelsford to make the leap into a business arrangement he had never tried before.

In theory, a flexible lease is appealing, especially in times of extreme volatility. Landowners get more income in good years, and operators pay less rent in poor income years. And because risks are higher in farming today, a flex lease may be the best solution in many landlord-tenant agreements.

But theory isn't always enough to provoke real change. As discussions progressed, nine of those 10 landowners backed off, choosing to stay with cash leases at fixed rates. Some feared they wouldn't get enough in return for what they were giving up; others viewed the calculations as too cumbersome.

"I'll be able to provide a better assessment on how the one flexible cash lease is working out when we've settled up after harvest," says Brelsford, of Perry, Iowa.

NUMEROUS TYPES

Owners and operators can set up flexible leases in several ways. Some flexible cash leases provide for the landowner to get a fixed percentage of the crop. Others provide for a base cash rent with some sort of rent escalator or bonus. The rent would rise if yield or price tops a preset level. Some flexible leases vary the rent with both yield and price.

If you're about

to renegotiate with landowners and want to minimize downside profit risk in poor income years, consider the flex as one option. Both sides need to see benefit for this to work.

Suppose owner and operator are negotiating on a lease that will have a base cash rent with an escalator. Agreeing on the base rent and escalator is challenging.

"The landowner's downside risk in event of a poor year is limited to the amount the base cash rent is below the going fixed-rate cash rent in the area," explains Brelsford. "The operator's upside risk is the amount the rent escalators could push the rent above the going fixed cash rent for the area in a good income year. That may be almost unlimited."

RISK COULD RISE

Brelsford believes downside risk protection for the operator from leases with base rents and escalators may not outweigh upside potential given to the landowner. "Triple-stack genetics and variable-rate technology to precision apply inputs are extra costs the operator incurs to boost gross income," he says. "The landowner makes no investment in those technologies, but in a good year, they benefit handsomely from the operator's investments."

William Edwards, Iowa State University economist, notes that one approach to compensate the operator for rising input costs is to first establish the base cash rent, then set a base revenue level. The bonus rent or cash rent escalator would only apply to revenue above the base revenue.

Each year the owner and operator could negotiate a higher base revenue to reflect the operator's higher input costs. "This approach would pay the operator for his nonland costs before he starts to share revenue," explains Edwards.

LANDOWNERS LIKE IT SIMPLE

Some landowners have been entrepreneurs all their lives. They can realistically evaluate the risks and rewards associated with a flexible cash lease. These owners may see a base rent below the going cash rent as a good trade-off for the opportunity to capture more income in good years.

About 55% of Iowa farmland is owned by people 65 years of age and older. About half of that land is owned by people 74 and older, according to surveys by Iowa State University economist Mike Duffy.

"Many, but not all, aging landowners don't want the uncertainty of not knowing how much cash rent they have coming and when they'll get it," says Terry Jones, Russell Consulting Group, Panora, Iowa. "Fixed cash leases, which specify payment dates and amounts, keep it simple for such landowners.

"If calculations in a flexible cash lease start getting too complicated, why not work out the crop percentage and do a crop share lease," suggests Jones.

Bill Holstine, Hertz Farm Management, Nevada, Iowa, sees both owners and operators being concerned that they might miss something one year, so they back away from the flexible lease. "Both sides are quite aware of risk," he says. "Ample concern exists about cost inflation, and what would happen if corn prices dropped $2 per bushel. Who takes the risk?"

KNOW USDA RULES

USDA's Farm Service Agency requires owners and operators to share farm program payments under share leases.

"Suppose the flexible rent payment above the base rent reflects the yield and/or price from a specific farm," says Steven Johnson, farm management specialist with ISU Extension. "FSA will likely determine this lease is a share lease, so the operator would need to share a part of the government farm program payments with the landowner.

"To avoid additional FSA and specific farm recordkeeping, lease participants may choose to use the final county yields for each crop times the posted county prices to determine the county average revenue for that crop year in order to finalize the size of the flex payment," says Johnson. "In such a case, that payment won't be made until at least March following harvest, when USDA's National Ag Statistics Service determines final county yields."

For a flexible cash lease to work, both parties need to see something in it that benefits them, concludes Brelsford. "What they stand to gain must outweigh what they give up in exchange."

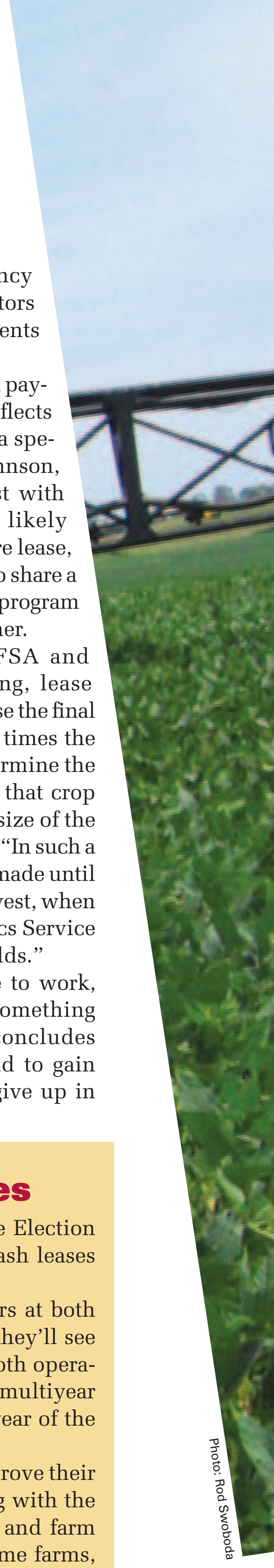

Photo: Rod Swoboda

ACRE throws a wrinkle into flex leases

Iowa State's Steve Johnson expects the new Average Crop Revenue Election program in the 2008 Farm Bill to draw more interest in flexible cash leases in 2009.

"Once operators and landowners understand that revenue triggers at both the state and farm levels are a major portion of the ACRE payment, they'll see that leases could be structured in a similar fashion," he explains. "Both operators and landowners will incorporate these revenue concepts to write multiyear leases that benefit both parties through the 2012 crop year, the last year of the ACRE program."

Johnson expects farmers who enroll in ACRE in 2009 will need to prove their actual farm yields by a Farm Service Agency farm number beginning with the 2004 crop year. That's because ACRE requires the use of both state and farm yields using a five-year Olympic average for planted acreage. For some farms, the easiest year to prove yields will be 2008 when farmers can segregate scale tickets, settlement sheets, grain bin measurements and yield monitor data by FSA farm number during and immediately following harvest.

However, the FSA regulations pertinent to ACRE and farm yields have yet to be written. They likely will not be completed prior to the 2008 harvest.