Cash Rent Reset - 1

Something's Gotta Give

Marcia Zarley Taylor , DTN Executive Editor
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Farm tenants are cautioning Iowa realtor and farm manager Steve Bruere they need serious rent concessions in 2016. (DTN photo by Elizabeth Williams)

HADDONFIELD, N.J. (DTN) -- In the Dakotas, managers at one farm operation have rehearsed how to break the news to landlords they plan to terminate their least-profitable rental properties this fall. In central Ohio, another 5,000-plus-acre operator has eyed his bottom 10% leases for possible culls. Farms without drainage, subpar yields or fields too far from home base may get the axe or require steep rent discounts to continue.

In areas of Indiana and Ohio inundated with rain this season, university economists predict a high cash rent "churn" rate for 2016 if current operators can't get some kind of rent relief. Some operators are making a pre-emptive strike, but some "alpha" farmers who expanded on high rent and borrowed money may have little choice if they want credit next season. Young and beginning farmers without family backing also are vulnerable.

Firing the landlord hasn't occurred much since operators' fortunes collapsed in the 1980s. Back then, Midwest cash rents tumbled a cumulative 35% between 1983 and 1987, then marched mostly upward for the next three decades, Chicago Federal Reserve data shows. But season-average corn and soybean prices slid 48% and 35% respectively in the last two years. Next year's corn and soybean futures don't look any brighter.

That grim outlook leaves many of today's cash renters with a string of back-to-back losses and a wide gap in their projected 2016 budgets. Cash rents are a prime target for cuts since they can represent a third or more in Corn Belt expenses.

"Corn prices didn't top $4 for the 2014 crop, and it doesn't look like they'll do it for 2015 and at least 2016," cautioned University of Illinois economist Gary Schnitkey. It's an unpopular message, but "if operators don't do something [to cut costs], they could wipe out all they made between 2010 and 2012," he told DTN.

Even solid operators with money in the bank might not want to fritter away those hard-earned gains. "I know there's a risk that someone in the neighborhood will offer to pay a higher price [if they ask for a rent adjustment]," Schnitkey said. "But if someone isn't factoring lower rents into their equations for 2016, maybe they don't realize the extent of what they risk losing with three years of $3.65 to $3.75 corn."

LANDLORDS ON NOTICE

In Iowa, farmers are getting the message. "The conundrum is do I terminate or do I not terminate," observed Steve Bruere, president of the farm realty firm Peoples Company, in West Des Moines, Iowa. State law requires either the owner or the renter to notify their intention to terminate a lease Sept. 1 for the following crop year. If that ever happens, it's almost always the owner's initiative, not the tenant's, Bruere said.

"This is a really different scenario. It's the first time in my lifetime -- maybe since the 1980s -- where renters are serious about walking away from their leases unless they get some concessions," Bruere added. About two weeks ago, operators started calling his office, saying they'd like to continue renting, but definitely not on the same terms and prices as 2015.

"We said fine, send the owner a lease termination. They won't be offended. We can continue price negotiations later," he said. To soften the blow, Bruere suggests lowering base rents, but building a flex formula that rewards owners with a cash bonus at year-end should actual yields and/or an average market price at the local elevator improve revenue prospects.

Bruere likes to show owners a one-page, color-coded profit map using the operator's financials. When an owner sees a page of red ink, "he may say, 'Gosh,' I better work with this guy on rent because I don't want to bankrupt him,'" Bruere said. "Nobody comes out ahead putting their operator out of business."

What adjustment happens this fall will depend largely on the level of current rents, Bruere added: "Four-hundred dollars was too high, even when things were good, so this will take the froth out of that plus an adjustment for the current economy." Other Iowa farm managers doubt even $300 rents are sustainable in this market.

THE $100 SHAVE

In fact, Schnitkey thinks a typical corn and soybean cash renter who pays a modest $236-per-acre rent on 184-bushel corn ground will need to shave an unprecedented $100 per acre off his cost of production to break even in 2016, assuming a grower can average $4 corn and $9.25 soybeans on normal yields. (If current 2016-crop futures prices hold, growers would need to trim costs about $150 per acre, he warned.)

Cash rents might need to shoulder about half of that cut, just because they are the biggest single line item in most corn budgets, although Schnitkey sees nothing immune from budget tightening -- including family living, depreciation, seed costs, cutbacks in maintenance P and K applications and hopefully some further reductions in fertilizer prices.

"It's not just the $500 cash rents that need an adjustment. It's the cash rents closer to $270 per acre that can result in challenges," agreed Purdue University economist Mike Boehlje, author of a soon-to-be-published stress test on Illinois farmers enrolled in the state's business records system. The study simulates what happens down the road two or three years if growers don't take pre-emptive strikes now.

By Purdue's analysis, operators who rent 85% of their land won't necessarily hit the wall in 2016, but nearly 100% would in 2017 unless they make drastic changes to their cost structure -- or markets unexpectedly rebound, Boehlje said.

"The real problem isn't with debt-to-asset levels in agriculture. The real problem is cash flow and income. If this downturn stretches over three years as we now suspect, many renters will run out of cash, see their working capital depleted and run into debt service problems, not solvency problems," Boehlje said. At that stage, bank regulators, not friendly local loan officers, will call the shots on their credit. It won't be as easy to reamortize land mortgages to finance carryover debts, as it is to do so with a clean credit record today.

"No farmer wants to give land up voluntarily, because he may not get it back when margins recover. It can also saddle someone with excess farm equipment and overhead," said Boehlje. "The question is how much of a premium do you want to pay until prices rebound. If prices don't recover quickly, you could just be throwing money away."

Chicago Federal Reserve surveys stretching back to the 1980s show it's been decades since any meaningful reversals in cash rent occurred, although its seven-state Midwest average slipped 2% in 2014 and 8% in 2015.

"That shows we're beginning the process, but obviously we've got a lot further to go if we have commodity prices where they are today," said Chicago Federal Reserve Economist David Oppedahl.

(To read Schnitkey's essay on the necessity of cash rent cuts, go to http://bit.ly/...)