February 2014

LEASING AND SHARE FARMING LAND FACT SHEET

GRDC
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SHARE FARMING AND LEASING ADDITIONAL LAND CAN REDUCE COST OF PRODUCTION

A proven strategy to decrease the cost of production is to farm more land. Leasing and share farming additional land offer alternatives to buying land.

KEY POINTS

- Leasing and/or share farming land provide great opportunities for business expansion.
- Good budgeting is critical to successful lease and share farm negotiation.
- Economies of scale achieved via additional leasing and share farming land can reduce the cost of production.
- Always seek legal advice when preparing a lease or share farming agreement.
- *'The faintest ink is better than the fondest memory'*: Always document share farming and leasing agreements.

PHOTO: P2PAgri

Leasing rather than buying more land may provide efficiencies to your business.

The desire to increase profitability tends to drive thoughts around business expansion; however, many farmers are unsure of the most appropriate way to expand their business. The three most common options for expansion include:

1) Purchase additional land;

2) Lease additional land, or

3) Enter a share-farming agreement.

Before entering an agreement to lease or share farm land, farmers need to consider the benefits of each of these options.

Leasing land has historically come with significant risks for both the lessee (tenant) and the lessor (landowner). Land which has been leased for extended periods and to a variety of lessees, can become run down, with poor soil fertility, weeds, and poorly maintained infrastructure due to lack of investment by the lessee in someone else's land. Despite the risks, leasing can and should be a positive experience for both parties if appropriate measures are taken. Leasing can provide a steady income to the landowner from land they no longer wish to farm, and offers greater scale for the lessee without the capital cost/debt of purchasing land.

Similarly, **share farming** provides opportunity for land expansion, but with a different risk profile depending on the agreed share farming arrangement. By definition, share farming means that both the share farmer and the land owner share in the risks of farming. Whoever has the greater share of costs takes the greater risk and thereby takes a greater share of income. As with leasing land, a formal share farming agreement is recommended to manage the operations of the share farming, where all parties understand what has been agreed to and have their interests protected. An essential element of share farming agreements is the detail of responsibilities for management and costs.

The arguments for and against

Table 1 outlines many of the advantages and the potential downside risks of entering a land leasing agreement for both the lessor and the lessee.

Table 1 Advantages and Disadvantages of Leasing Land

	Advantages	Risks/Disadvantages
Lessor (landowner)	No climate/production risk	Maintenance risk (soil health, weeds, infrastructure)
	Reliable income/cash flow	Little/no say in decision making
	Opportunity for capital gain	Reliant on financial viability of lessee
	No working capital required	May be more difficult to sell land
	Little/no labour input required	Dispute with lessee
	No market risk	
	May continue living on the farm	
	Opportunity to do other things	
Lessee (tenant)	Viable means for business expansion without debt/land purchase	No exposure to capital gain
	Economies of scale in operations	Uncertainty of continuing access to land
	Reduced cost of production	Machinery may not be adequate to cover increased area
	Justifies purchase of more efficient equipment	May not gain long term benefits of investment in land productivity (e.g. weed control, soil amelioration such as liming)
	Increased profitability	Exposed to full production & market risk
	More attractive to contractors	Dispute with owner

Source: *Hudson Facilitation*

Table 1 can also be read as being similar for share farming, except the first point, as both land owner and share farmer share the risks of climate and markets. Otherwise, the majority of the agreement is very similar.

Economies of scale

The key driver behind a decision to increase farm area is usually the desire to improve profitability. The key to any improvement in profitability is gaining economies of scale. This refers to a reduction in costs per hectare by defraying costs - particularly overhead costs - over a greater number of hectares, so that although total overhead costs may increase when taking on a lease, the overhead cost per hectare should be lower, resulting in a lower cost of production. This can be well illustrated when we consider machinery costs, which include depreciation, finance costs and insurance – costs which relate to the machine itself, rather than the number of hours it works. This assumes that there is surplus capacity of machinery, so farming additional land allows for more of the machinery capacity to be used.

Owners /managers of smaller scale operations tend to find it difficult to justify the purchase of large scale and technologically advanced equipment as they may risk becoming overcapitalised. While using less efficient machinery has the benefit of lower machinery costs, it may also have an adverse effect on yield. Increasing scale through leasing or purchasing additional land can justify the decision to purchase larger, more reliable, efficient, and technologically advanced equipment which may result in improved yields or cost efficiencies.

For example, consider justifying the purchase of a larger tractor. The variable running costs, which include fuel, oil, tyres, labour and most servicing requirements, are per hour costs and do not vary with increased machinery use. Therefore we need only consider overhead and finance costs when assessing the impact of scale on hourly cost.

Table 2 (based on figures from the NSW DPI, 2012), shows the estimated overhead costs for a 225HP tractor, valued at $202,674, and costing the farmer $111,470 after trade-in of old tractor and financed at 10% over its working life of 5 years. (In this example, the constant hourly cost of $46.25 does not alter with increased scale and is therefore not included in this calculation).

Given the data presented in Table 2, it becomes clear that a farmer cropping an area which requires 500 hours of tractor use is at a distinct disadvantage to one who requires 2,000 hours' work out of the same machine. If the various implements being towed average 4ha/hour, the farmer using the tractor for 1,000 hours per year (averaging about 19 hours per week year round) is $9.66/ha better off – a significant decrease in Cost of Production. Scale has its rewards!

Duration of the lease or share farming agreement

A longer lease or share farming agreement is often more suitable for the lessee or share farmer, as it provides surety of access to the land for a number of years and therefore ensures a greater interest in maintaining its productive capacity. Similarly for the landowner, a longer term provides security and avoids the inconvenience of regularly seeking a new tenant or share

Table 2 The Impact of Scale on Machinery Costs

ANNUAL COSTS		SCALE	
Overhead costs	**Total**	**÷ Annual hours' work**	**= Cost per hour**
Depreciation: $22,294	**$38,457**	500 hours	$77.09
Interest expense: $14,694		1,000 hours	$38.46
Insurance: $1,469		1,500 hours	$25.63
		2,000 hours	$19.23

Source: *Hudson Facilitation*

farmer. However, it may come at the risk of missing an opportunity to increase leasing costs if land values or markets increase significantly. This can be overcome by including a provision for an annual review of leasing or share farming costs in the written agreement. What is important is that both parties have adequate opportunity to benefit from the arrangement.

Budgeting for leasing or share farming

Before discussing lease prices, you should always do some research on past leasing prices or share farming agreements in the area. This should be accompanied by some detailed budgeting prior to entering any negotiation. Preparing a budget will enable you to establish the maximum price you are prepared to pay for the lease or the minimum share of income and cash costs, and ensure your thinking is clear when negotiations begin. Budgeting will also establish the additional working capital required to farm the additional area.

Consider the following example:

- Lease of 500ha at $200/ha payable in advance: $100,000
- All sown to wheat at a cost of $300/ha: $150,000
- Minimum working capital required: $250,000

Will your bank extend your overdraft by $250,000 to support this venture?

It is important to ensure you can access sufficient working capital to run your desired enterprise mix *before* entering a lease agreement!

It is also important to establish any capital requirements prior to negotiating a lease or share farming agreement. This should include an assessment of the capacity of existing machinery to cover the additional cropping area. If grazing, can the required livestock be provided from existing numbers, or will purchasing be required? If borrowing is necessary to fund the purchase of machinery, livestock or other assets, this must be taken into account when assessing the economics of the lease or share farming agreement.

Valuing the Lease

Historically, the cost of leasing land has been between 4-6% of the value of the land, sometimes higher for cropping land. In some areas, this still holds true. However, a number of factors, including recent increasing land values, means this may no longer be economical for the lessee in many areas.


PHOTO: P2PAgri

Big is beautiful, but … smaller may be smarter! Purchase should be driven by your cost of production.

An alternative means of calculating an appropriate leasing rate is the **Percentage of Gross Margin** (GM). Any negotiations using this method will require budgeting to be completed.

In the following examples, a rate of 30% of GM has been used, as this tends to be economically viable for many farmers and provides adequate incentive to the landowner.

Consider the following example:

Wheat: GM of $600/ha, leased at 30%: $180/ha

Sheep: GM of $30/dse, leased at 30%: $9/dse

Tax Implications

When considering lease costs, it is important to remember that leasing payments are fully tax deductible for the tenant. For the lessor, lease payments are not considered primary production income for the purpose of income tax averaging. It is important for the landowner to establish how leasing may affect their tax position.

Leasing and Share Farming Checklist

When entering an agreement, if you ensure you have covered the following points, you will be more likely to ensure a successful arrangement for both parties:

- **Always** have a written agreement signed by both parties. Table 3 outlines what your written agreement should include.
- Seek guidance from your solicitor to ensure any agreement is legally binding on both parties.

FAQs

Will my farm's profitability improve if I take on additional land?

Without assessing the options through an analysis of different farm management scenarios, it is difficult to determine if business profitability will improve. Unfortunately in some cases, farm business efficiency doesn't improve! In taking on additional land, it is important to consider the following:

- Do you have the management capacity to operate the larger business?
- Do you have the necessary machinery and livestock capacity?
- Do you have the financial capacity?
- Do you have the labour capacity?
- Do you have the passion and goals needed to manage the larger business?
- If the additional land is more than 100km away, have you considered the added logistics of management and machinery efficiencies?

It is only in considering each of these areas and looking at strategies needed to increase the business's capacities, that improvement in profitability can be properly assessed.

Table 3 Checklist for Leasing and Share Farming Agreement

Land Details	➨ Clear definition of the area of land being leased/share farmed. ➨ Any inclusions/exclusions beyond the land, particularly water and machinery. ➨ Agreement on the condition of soils, pastures, weeds and infrastructure prior to commencement of lease. ➨ Responsibility for repairs and maintenance of infrastructure. ➨ Requirements of the tenant to maintain soil health, fertiliser applications and weed management. ➨ Any restrictions, such as stocking rate, type of livestock, chemical use, crop exclusions. ➨ Agreement on whether pasture areas are to be sown back to pasture at the end of the lease.
Timing	➨ Start and end date of the lease.
Finances	➨ Requirements for payment - amount, timing and method of payment. ➨ In the case of a share farming agreement, the percentage of the income and cash costs to be shared by both parties. ➨ If for longer than one year, include provision to adjust the leasing rate annually, at least in line with CPI. In the case of a share farming agreement, you may wish to revisit the proportions being shared every few years. ➨ The bond to be paid, if any. ➨ Agreement on ownership of capital improvements at the end of the lease or share farming, if any is undertaken. ➨ Responsibility for payment of rates, insurance, utilities and so on (normally landowner).
Legal Processes	➨ Agreement on circumstances under which the lease or share farming agreement may be terminated early, or renewed/extended. ➨ Penalties/actions should any of the following occur: • late payment of lease rental or shared income; • late payment of shared cash expenses; • failure to vacate land on agreed date; • failure to pay utility bills; • failure to adequately maintain infrastructure/soils/weeds, and • breaching any other agreed terms. ➨ First right of refusal to purchase the property is typically offered to the lessee or share farmer if the property is placed on the market. ➨ Procedure to resolve conflict should it arise.

Source: *Hudson Facilitation*

FAQs

What is the main difference between a lease and a share farming agreement?

In a share farming agreement, the risks are shared between the two parties. In a lease agreement, the lessee shoulders all the risks associated with climate unpredictability and grain market price fluctuations. Also, in the case of the land owner, the Australian Taxation Office views income from share farming as primary production, but income from leased land is not. So from a tax perspective, the use of land is differentiated.

USEFUL RESOURCES

Ashby, R & Ashby, D (2011), "*Successful Land Leasing in Australia – A Guide for Farmers and their Advisers*" 2nd Edition, Rural Industries Research and Development Corporation, Electronically Published, May 2011 by RIRDC. (This provides an excellent and highly detailed guide to land leasing)

NSW Department of Primary Industries (2012), *"Guide to Tractor and Implement Costs"* published electronically in June 2012. http://www.dpi.nsw.gov.au/__data/assets/pdf_file/0003/175494/135-kw-to-166-kw-tractor.pdf,. Accessed 26th June 2013.

Related GRDC Fact Sheets
Other related fact sheets in this Farm Business Management series are: Marketing and Selling (Order Code: GRDC932), Leasing and Share-Farming Land (Order Code: GRDC933) and Valuing Family Drawings and Your Management (Order Code: GRDC936).

Copies of all the above fact sheets are FREE plus P&H and available from:

Ground Cover Direct Freephone: 1800 11 00 44 or email: ground-cover-direct@canprint.com.au

These can also be downloaded from www.grdc.com.au/fbm

Plan to Profit (P2P), a whole-farm financial management program that can help calculate a farm's financial budgets: www.P2PAgri.com.au

MORE INFORMATION

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AES00006