

Beef Cattle Management Update

BEEF COW LEASING

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Leasing or rental agreements are common between owners and operators of farm land and equipment. Such arrangements are beginning to be more common for beef cow herds as well. However, for leasing to be successful it must offer advantages to both parties. This is possible because the parties involved often have different resources and/or different personal and business objectives. Leasing is one way to meet those objectives. Although the types of beef cow leases available and the particular needs of the parties involved are endless, the mechanics for evaluating a lease and its terms are fairly simple. Like any contract, the lease needs to be in writing, read, understood, and signed by both parties and returned to if problems arise. In general, the terms of the lease should incorporate all costs of production and divide the revenue proportionately to each party's contribution of the inputs.

This "Beef Management Update" will discuss beef cow leasing and is organized as follows. First, some of the advantages and disadvantages of beef cow leasing for each party are examined. Second is a brief list of important provisions that should be included in the written lease. Third, a method for estimating "fair" terms of a beef cow lease is described and an example is given. Finally, while the standard lease discussed in this paper is a share lease agreement, alternative lease types do exist and will be discussed.

Why lease beef cows?

Lease agreements are a form of borrowing capital, but rather than borrowing dollars from a bank, the operator is borrowing the use of the asset from another individual. Beef cow leases are no different, the operator borrows the use of the cows for a period of time. The owner is paid a cash rent, or more commonly, paid in kind with a share of the calf crop. The reasons an individual enters into a lease with another party are varied, but in order for a leasing arrangement to be successful, it must offer advantages to both parties.

For the operator, advantages to leasing may include: (1) increased business volume and access to working capital without going in debt for breeding stock, (2) reduced exposure to production, price, and financial risk because it is shared with the owner, (3) young operators short on collateral can get started in the beef business and better utilize labor if currently underemployed, and (4) the cost of capital to the operator may be at a lower than market rate.

The owner must also benefit from the lease arrangement for it to be successful. Advantages to the owner may include: (1) maintain the breeding herd when labor and/or feed supply are unavailable, (2) provides a source of rental income, (3) reduces exposure to production and price risks, (4) allows for transfer of cow herd ownership over a period of time, and (5) may have income tax and social security tax advantages.

There are also disadvantages to beef cow leasing that must be considered before entering into a lease agreement. Leases may not be preferred in times of rising markets when low cost cows produce high priced calves in the following years. Out right ownership of the cows yields profits that do not have to be shared with the other party. However, such events are typically only seen with hindsight when the unforeseen future is the appropriate decision environment. Obviously, disagreements about the care and management of the herd may arise. These problems are often compounded by the personalities involved. Be sure that the two parties can communicate with one another or have carefully planned for possible points of contention. Many disadvantages to leasing arise from a misunderstanding about what the lease says, or doesn't say. That is why it is essential that the lease be in writing and carefully read, understood, and signed by both parties.

Important lease provisions.

The lease agreement is a written document that spells out the responsibilities of each party. If any questions or controversies arise, the lease should be re-examined to determine a solution to the problem. Each party should read and interpret the lease for himself or herself and not rely on the other's explanation. Should problems arise, and courts are asked to settle the dispute, the written lease is what will be considered, not conversations or unwritten promises. As a party reads the lease, remember that he or she may be looking for what is not in the lease rather than checking what is written. Make a list of factors that are important and use it as a checklist when the lease is read. For example, the owner may not want the heifers implanted if he or she is contemplating keeping replacements. Also, raise any concerns or questions in writing, date the letter and keep a copy on file. State the concern, the individual's understanding and give the other party time to respond. If changes in the lease result, they must be noted on the original document, dated, and signed by both parties.

Remember that a lease or contract does not force the other party to comply with the agreement. It only provides an avenue to prosecute the other should they violate the lease. Also, unless it is clearly stated that the loser pays the winner's costs, each party pays their own legal expenses. There is no substitute for working with reputable people.

Find out about the other party. Ask for references and talk to people that have dealt with them before. Consider including an arbitration clause in the lease that outlines the procedure for handling disputes. This route is often preferred to court cases. However, clearly describe how the arbitrators are selected.

What is the length of the lease and when may it be terminated? The lease term should correspond to the calf crop and end either at weaning, when the calves are sold, or another appropriate time. Some leases run for a set amount of time, for example, five years, while others run until they are terminated. If it is a multiple year lease, are some terms negotiable or adjusted each year to reflect changes in input costs since the original lease was signed? A crop share lease must be terminated by September first effective the following March. It may be desirable to have a cow herd lease terminated before hay is put up or before breeding begins and have it end at weaning.

Why may a lease be terminated and what are the procedures for terminating and ending the agreement? Can the lease be broken at other than previously stated dates, for example, due to poor management? Typically, leases may be terminated because one party is not acting in good faith or not following standard animal husbandry practices. The lease should contain such a clause as well as state who can make such a call, i.e., a veterinarian, and not the damaged party. Also, list how the lease is ended. Are jointly owned animals (replacement heifers or bulls) sold? If not, who has the right to keep them? Are cows weighed and the operator paid or charged for any net weight change?

The lease should clearly state who holds title to the animals, including the calf crop on the cow. State whether any of the animals can be used a collateral. That is, can a debtor collecting on the

operators feed bill sell the entire calf crop? Who is responsible for insurance, both for animal loss and animal liability? (e.g., damage to the neighbor's crop or an accident caused by a cow on the road).

The lease should specify what inputs will be provided by each party. As shown in the attached "Beef Cow Leasing Planning Guide," the starting point for negotiating a fair lease is to divide the revenue between the parties according to the share of the inputs that each contributed. However, it is also important to outline the quality and quantity of inputs used. For example, the type of diet, parasite control, vaccinations, herd health program, and genetics may need to be spelled out or at least stated who will decide. How are replacement heifers handled, who owns them (the cow owner or jointly), who feeds them and who chooses them? When and where are the calves sold? The marketing year (tax year) may be a particularly important question if the owner has been selling in January but the operator needs the cash flow in November. Are all calves to be sold or can heifers be selected from the calf crop before selling? If so, at what price?

The lease should address these issues as well as other factors important to either party. Because it is impossible to anticipate every conceivable problem, a good lease should provide a way to find a solution that is acceptable to both parties.

Establishing a "fair" lease agreement.

The "fairness" of a lease is obviously in the eyes of the beholder, and therefore, must be acceptable to both parties. In general, rental agreements are thought to be fair if the share of revenue received by each party is approximately the same as the share of the inputs they contributed. Negotiation will have to determine the value placed on each contribution. That is, not all cows are worth \$1,000 and swamp hay shouldn't be priced as if it were alfalfa. The planning guide below will help identify production costs and the contributions of each party, and provide an outline for determining a fair division of the calf crop. However, the planning guide is a tool for negotiating a lease; it was not meant to be the final word on cow leasing. It is the first step in finding an acceptable lease agreement for both parties.

There are two basic types of costs to consider, ownership costs (also known as fixed costs) and operating costs (variable costs). Ownership costs are those associated with owning an asset: cattle, land, buildings or equipment. These are often referred to as the DIRT five expenses: depreciation, interest, repairs, taxes, and insurance. Operating costs are the day- to-day expenses of running a cow herd: pasture, winter feed, labor, fuel and utilities, veterinary and medical, and marketing.

Cow depreciation and death loss are a contribution of the owner if the owner is responsible for raising replacements. Depreciation is the annual change in value of the cow while she is in the herd. If the cow is worth \$900 when placed in the herd, has a \$600 salvage value as a cull and is in the herd five years, the depreciation is \$60 per year $((900-600)/5)$. Death loss is estimated as an annual percent, for example, two percent times the average value of the cow. Depreciation and death loss for bulls is calculated the same way except that it is divided by the number of cows per bull to arrive at a per cow cost.

Interest on cows and bulls is a contribution of the owner of the animal (bulls may be jointly owned) and should be figured at bank rates. If the average value of the cow is \$750 $((900+600)/2)$ and the interest rate is 12 percent, the annual interest expense per cow is \$90 (750×0.12) . Bull interest is calculate the same but adjusted to a per cow basis. Taxes and insurance on cows and bulls is a contribution of the owner and is easily documented.

The DIRT five expenses also apply to land, buildings, and equipment and is a contribution for whichever party is providing the input. If these inputs are depreciated out and show no value on the

books and if it is not appropriate to value them at their replacement cost, the fair rental market value may be used to calculate the contribution.

Likewise, operating cost such as pasture, hay and grain, should be valued at their market value, net any transportation. Supplemental protein, salt, and mineral are easily documented because they are purchased. These inputs should be provided by the party providing the winter feed so there is no conflict concerning rations. Fuel and utilities used in the care of the cow herd should also be included. There may also be miscellaneous expenses that must be accounted for such as registration fees, ear tags, or the cost of arbitrators or appraisers.

The remaining major operating expense is labor and management. Hired labor is a contribution from the party paying the wage. Labor and management provided by the operator must also be valued as a contribution. Labor required per cow will vary depending on the size of the herd. (It takes the same amount of time to fix fence for 100 cows as it does ten.) For herds of less than 30, it may require 10 to 15 hours per cow per year, while larger herds may require half that amount. The wage rate per hour is obviously a negotiable point, but it should reflect the market value for similar work plus a management fee. The management fee per hour is what sets apart someone to whom the owner can trust his cattle, compared to someone paid just to haul hay.

Some operating expenses may be more easily divided according to each party's contribution than to have one or the other provide the input. For example, herd health and vet bills maybe should be shared so there is no conflict as to when to call the vet. Trucking and marketing expenses are another such expense.

The example shows that major production expenses total \$451 per cow. The owner contributed \$182, or 40 percent, and the operator contributed \$269, or 60 percent, of the total. The minor expenses were shared in the same 40:60 relationship as was the sale of calves. The owner in this example provides cows, bulls, and replacements and receives all the income from the sale of cull livestock. It is important that the two parties work together to fill out this planning guide. Everyone's costs win be a little different, but the estimates need to be realistic and acceptable to both parties to reduce the number of problems later.

While most inputs are listed in the guide, one factor of production that is implicit and cannot be assigned a value is risk. It is important to recognize who stands what types of risks and that it may be necessary to negotiate a larger share of returns to make taking that risk worthwhile. The following section will discuss the different types of risk and how the impact of these is altered by the type of lease.

Alternative leasing agreements.

There are an endless array of leases possible, but this section will focus on three: fixed percent of the calf crop (FPCC), fixed number of calves (FNC) and cash rental (CR). To begin, consider an one hundred cow herd after preg check capable of weaning 97 calves with steers weaning at 550 lbs. and heifers at 520 lbs. with the costs shown in the example in the attached "Beef Cow Leasing Planning Guide." For the FPCC lease, assume that the owner receives 40 percent of the revenue from calf sales and the operator 60 percent in accordance with the contribution of each. Under the FNC lease the owner receives 39 average weight calves (40 percent x 97 calves) at weaning. The cash rental payment is the expected market value of 39 calves, for example, \$95 per cwt. for both steers and heifers, averaging 535 lbs. or \$19,822 per year and the operator keeps all the calves.

The expenses for the owner and operator under the FNC are the same as the FPCC. Under the CR, the owner pays his costs plus vet expenses for the cow herd but not the calves; there are no marketing costs. The owner's expected returns are lower for the FPCC in the example due to

rounding to whole calf units. Note that identical percentage changes in market weight and market price have the same impact on returns and differ only by rounding errors.

Every individual has a different definition of risk and, therefore, will prefer one lease over another depending on their objectives and attitude toward risk. While one lease cannot be declared better than another, it is possible to discuss the variability of returns found in the different leases as well as its source.

Table 1 shows the impact of a three percent increase and decrease in the number of calves weaned, weaning weight, and price. The FPCC reduces the impact of death loss on operator return more than either the FNC or the CR. When the number of calves weaned decreased three percent under the FPCC, returns dropped by \$915 from the expected amount compared to a \$1525 decline under the other two leases. Conversely, the FPCC lease increases variability of owner returns due to calf death loss because the number of calves or cash income is guaranteed under the FNC and CR leases. There is little difference between FPCC and FNC as far as market weight or market price variability is concerned for either the owner or the operator. However, the CR protects the owner from production and market uncertainty but has the highest variability of returns for the operator.

Each individual views production and price risk differently. The three leases examined yield varying impacts on the owner and operator from these risks and should be taken into account when beef cow leasing is considered. Although risk considerations will not likely be the major determinant of a lease, they may be important as the two parties negotiate an agreement that offers advantages to both.

Table 1. Risk Analysis of Three Beef Cow Leases, Assuming 100 Cow Herd¹

	<u>Base</u>		<u>Up 3%</u>		<u>Down 3%</u>	
Calves weaned	97		100		94	
Weaning weight	535		551		519	
Selling price	\$95		\$97.85		\$92.15	
Expected returns:	<u>FPCC</u>		<u>FNC</u>		<u>CR</u>	
Operator	\$1,900		\$1,799		\$1,678	
Owner	1,000		1,102		1,222	
Change in net returns due production and price risk:						
	<u>+3%</u>	<u>-3%</u>	<u>+3%</u>	<u>-3%</u>	<u>+3%</u>	<u>-3%</u>
Change in calves weaned:						
Operator	\$2,815	\$985	\$3,323	\$274	\$3,203	\$154
Owner	1,610	390	1,102	1,102	1,222	1,222
Change in market weight:						
Operator	\$2,785	\$1,016	\$2,680	\$917	\$3,153	\$204
Owner	1,590	410	1,695	509	1,222	1,222
Change in market price:						
Operator	\$2,787	\$1,013	\$2,683	\$914	\$3,157	\$199
Owner	1,592	408	1,699	507	1,222	1,222

¹ FPCC = Fixed percent of calf crop, owner receives 40% in example.
 FNC = Fixed number of calves, owner receives 39 head in example.
 CR = Cash rental, owner receives \$19,822 in example.

BEEF COW LEASING PLANNING GUIDE

Replacement animals ¹ :		Example	Your Herd		
Furnished by owner		X			
Raised jointly					
<u>Contribution²</u>	<u>Expected Cost</u>	<u>Owner</u>	<u>Operator</u>	<u>Owner</u>	<u>Operator</u>
Cows					
Interest	\$750 x 12%	\$ 90	\$ 0		
Depreciation	300 / 5 yr	60	0		
Death loss	750 x 2%	15	0		
Bulls					
Interest	1500 / 25 x 12%	7	0		
Depreciation	100 / 25 / 5 yr	8	0		
Livestock insurance	1 - 3	2	0		
Buildings & equipment					
Repairs	5 - 10	0	7		
Interest & depreciation	25 - 50	0	35		
Insurance & taxes	3 - 5	0	4		
Utilities & fuel	3 - 5	0	4		
Feed cost					
Pasture	30 - 60	0	50		
Stlk field	0 - 12	0	7		
Hay & silage	80 - 120	0	100		
Grain	0 - 12	0	2		
Supp. & mineral	7 - 12	0	10		
Labor & management					
5 to 10 hours	35 - 70	0	50		
Other _____	?	0	0		
Total contribution of major expenses					
Owner + operator =	\$451	\$ 182	\$ 269		
Share of contribution	100%	40%	60%		
Minor expenses shared according to contribution					
Veterinary & medicine	7 - 10	40%	60%		
Trucking & marketing	3 - 7	40%	60%		
Income shares					
Calves		40%	60%		
Cull cows (note ownership)		100%	0%		
Bulls		100%	0%		

¹ Depreciation and death loss are not considered as a contribution when replacements are raised in the operation. If owner buys replacements and bulls, he contributes these costs and receives cull sales income.

² Contributions on a per cow basis. Use average cow and bull values.