Ag Decision Maker

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Computing a Livestock Building Cash Rental Rate

Livestock buildings represent a major investment on most farms. However, in some cases, buildings sit idle while owners continue to pay real estate taxes and insurance premiums on them. On the other hand, some livestock farmers wanting to expand production are hesitant to invest in more buildings or commit funds to modernize present facilities. Both parties may find that renting existing buildings is advantageous. But establishing a rental rate that is fair to both parties is not easy.

What Methods Can Be Used?

Several methods that can be used for establishing building rental rates. These methods help the parties establish a rental rate based on the specific facts of the building in question. The bargaining skills of the parties involved are also important in this process.

Estimating a fair rental rate for livestock buildings can be based on:

- current market rates
- owner's cost of ownership
- tenant's residual income

Current Market Rates

The easiest method is to use rental rates similar to those used by others. *Information File* Farm Building Rental Rate Survey, provides current information about rental rates for several types of buildings and storage facilities. For each structure, the range of rents and the average is specified. There are several different methods used for setting a payment rate, such as a fixed rate per year, a fixed rate per unit of capacity, or a rate per animal housed.

Owner's Cost of Ownership

Another method is to compute a rental rate based on the owner's cost of owning the building. Some of these costs involve an actual cash payment every year, while others do not.

The costs involved in owning a building include:

- depreciation
- return on investment
- real estate taxes and insurance
- repairs
- utilities

Depreciation

Depreciation is the portion of the cost of the building that is counted as an expense each year. It is a way of spreading the initial cost of the building over its expected useful life. For example, the annual depreciation (percent) of a livestock building with a remaining useful life of 13 years is 7.7 percent (100 percent divided by 13 years equals 7.7 percent per year). For a livestock building with a current value of $152,750, annual depreciation is $11,762 (7.7 percent x $152,750 = $11,762).

Return on Investment

Return on the investment in a facility is calculated by multiplying the rate of return on investment (annual interest rate) by the current value of the building. For example, multiplying the current building value of $152,750 by 6 percent results in a return on investment of $9,165 ($152,750 x 6 percent = $9,165). The interest rate can be based on the rate at which money is borrowed, the rate at which money can be invested, or an average of the two.

Taxes and Insurance

Tax rates can be obtained from the county assessor's office. The insurance premium cost can be obtained from the insurance policy. As an alternative, taxes and insurance can be estimated by multiplying one and one-half percent times the current value of the building.

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Repairs
Repairs are needed to maintain the building in a usable condition. To estimate repair costs use past years' repair bills and adjust them for any expected repair needs during the coming year. As an alternative, use a rate of 2 to 4 percent of the replacement value (not current value) of the building.

Utilities
Utilities are usually paid by the renter.

Calculating Rent

An example of calculating the cost of owning a hog finishing building is shown in Table 1. The building is a 1,100 head swine finishing building that is seven years old and has a replacement cost of $235,000.

Table 1. What are the owner's costs?

Current building value	Item		Total Cost	Cash Cost
Replacement cost	$235,000			
Total useful life (years)	20			
Age (years)	7			
Remaining life (years) (total life - age):	13			
Remaining percentage (remaining life / total life)	65%			
Current value (replacement cost x remaining percentage)	$152,750			
Annual ownership costs (based on current value):				
Depreciation		7.7%	$11,762	—
Return on investment		6.0%	9,165	—
Taxes & insurance		1.5%	2,291	2,291
Total ownership			$23,218	$2,291
Annual operating costs (if paid by owner) (based on replacement cost of $235,000):				
Repairs		4%	$9,400	$9,400
Total operating			$9,400	$9,400
Total costs				
Total building costs			$32,618	$11,691
Pigs finished per year *			3,018	3,018
Cost per pig finished			$10.81	$3.87

*1,100 head capacity x 2.8 turns x .98 (2% death loss)

The building owner would like to cover all ownership costs plus generate a profit. In the example, a rental rate of $32,618 ($10.81 per pig finished) will cover ownership costs, and a rental rate above this will generate a profit.

At a minimum, the owner wants to cover cash or out-of-pocket expenditures. This would consist of taxes, insurance and repairs. In the example, this is a rental rate of $11,691 ($3.87 per pig finished). If the owner cannot receive enough rental income to cover cash expenditures, he/she should consider demolishing the building.

Tenant's Residual

Another method is to calculate how much income the tenant has available for rent payments after subtracting the tenant's costs associated with raising the livestock. By subtracting all costs except the cost of the building from the projected income, the renter knows the maximum rent that can be paid to break even.

The costs should include labor and fixed costs on machinery and other buildings. Machinery fixed costs include depreciation, return on investment, housing, and insurance. Any costs paid by the owner should not be included.

At a minimum, the renter wants to breakeven by covering all costs. If the rent is too high, the renter still could decide to rent it and receive less for labor or not completely cover other fixed costs. This may generate cash in the short term but would not be profitable in the long term.

An example of estimating how much rent the tenant can afford to pay is shown in Table 2. The same 1,100 head hog finishing building is used.

Table 2. How much can the renter afford?

Projected income	Per Head
Market hog (260 lb. x $.70)*	$182.00
Projected expenses (less building ownership)	
Feeder pig (50 lb.)	$70.00
Interest on feeder pig (5 mo. @ 7%)	2.04
Feed	73.00
Veterinary and medical	4.00
Marketing and miscellaneous	4.00
Fuel, utilities, misc.	6.50
Interest on feed and other costs (2 mo. @ 7%)	1.30
Labor ($14.00 per hr.)	2.80
Fixed costs of machinery ownership	4.00
Total	$167.64
Residual left for rent (per pig)	$14.36
Pigs finished per year **	3,018
Residual left for rent (building)	$43,338

*Assumes 2 percent death loss.
**1,100 head capacity x 2.8 turns x .98 (2% death loss)

What Other Factors Should Be Considered?

There are several other factors that influence building rental rates. Livestock facilities differ in many respects.

Size – Prospective tenants want facilities that are the right size for their livestock production process. If the building is too small, the renter must find additional facilities somewhere else. If the building is too large, the facilities may be underutilized.

Obsolescence – Many older livestock facilities represent outdated technology that may increase operating costs or reduce livestock performance.

Condition – Damaged insulation or drafts affect livestock performance and increase utility costs.

Needs – Does the livestock building fit the renter's needs? A large open-front pole building may be in good condition, but not serve any useful purpose.

Location – If several farmers want to rent the building, the rent may be higher than if only one farmer wants to rent the building. Also, the distance from the renter's headquarters is important, because extra travel involves additional cost and time.

Conclusion

Both parties should be prepared when negotiating rents. Building owners should have a clear understanding of their costs and prospective renters should have production records that will allow them to compute their income potential under various rental rates to determine how much they can afford to pay. A written lease contract should be used whenever possible. See the AgLease101 website for a sample farm building lease form.

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