

Leasing land – calculating a rental

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Introduction

Leasing of privately owned land in Australia is still only carried out on a small proportion of freehold properties. This leasing market is generally based on informal negotiations between the lessor (landholder) and the lessee (often the neighbour). Properties are rarely advertised for lease but increasingly stock and station agents and the rural media are used to attract potential lessees and lessors. Whether negotiations are informal or not, people negotiating a lease often seek help to calculate a fair rental.

Legal implications

The *Agricultural Tenancies Act 1990* applies to agricultural tenancies of land greater than 1 hectare in area and where the agreement is for use of the land wholly or mostly for agricultural purposes. 'Agricultural purposes' are grazing, dairying, pig farming, poultry farming, viticulture, orcharding, beekeeping, horticulture, vegetable growing, the growing of crops of any kind, forestry, or any combination of such purposes. This Act has provisions to protect the interests of both the land lessor and the lessee. The Agricultural Tenancies Act is not difficult to understand and is recommended reading for any party considering a lease. It covers compensation to both owners and tenants for improvements, the rights of owners and tenants, and the arbitration procedure should a dispute arise that cannot be settled by the parties themselves.

The Agricultural Tenancies Act considers a number of tenancy types depending on the lease term.

Table 1 indicates the termination requirements for each tenancy type.

Table 1. Effect of tenancy type on time required to terminate tenancy

Tenancy type	Period of notice required
Fixed term (of any specified length)	None. Terminates at the end of the fixed term.
Periodic tenancy (other than year-to-year)	Equal to at least the length of the term.
Year-to-year tenancy	At least 6 months notice.
Sharefarming agreements	If the sharefarming agreement is for crop growing, the notice must specify at least 1 month after the end of the current annual cropping program.
Other cases	At least 1 month's notice.

Table 1 does not apply for a breach of tenancy or where the lessee and lessor have agreed on a different period of time for notice of termination.

Improvements can be grounds for compensation, and the Act enables the claiming of certain improvements carried out by tenants with or without the owner's consent. If agreement cannot be reached, arbitration can be used to reach a solution. Likewise an owner may claim compensation in certain circumstances for deterioration of the property.

Any claims for compensation are to be lodged with the Director-General of NSW Department of Primary Industries. In most cases a committee of three persons, including a barrister or solicitor as the presiding member, hears disputes.

Calculating a fair rent

The most common question about leasing is how to calculate a fair rent. There is no one correct method that can be used to calculate a fair rental – rather some principles can provide useful information to both the lessee and lessor.



The rental market for leased land operates on the same principle as buying and selling real estate: supply and demand set the price. Most commonly, leasing rates are based on a percentage of the value of the land. When there are boom conditions, land values rise and leasing rates rise. When returns are poor, demand falls and land and lease values also fall. Lease values are generally quite stable at between 5% and 9% of land value. There are exceptions to these percentages, which may be caused by excess demand where rental values could be more than 9%, or where land values are very high and rentals are less than 5%. It is recommended that any party considering the leasing option should check the rate with an alternative method (see below) to ensure that land values in the district reflect the earning potential of the land.

Percentage of market valuation method

If land is valued at \$800 per hectare and the agreed rental value is 5% of the value of the land, then a lease value of \$40 per hectare would be paid by the tenant under the percentage of market valuation method. Land values would be based on an agreed value between the lessee and lessor, which may use recent sales of land that has similar characteristics to those of the negotiated land as a guide. Some lease agreements build in an indexing rate for inflation.

Leasing rates for farming operations

Lease rates currently range from 5% to 9% of the value of land for dryland agriculture. Agreements sometimes have operating restrictions which may vary the lease rate. Operating restrictions are, for example, the maximum area allowance for cereal crops and establishment of pastures following cropping or in the last year of the lease. The greater the restriction on the lease, the less the rental on the proposed lease area.

For irrigated lands, a rental of 10% of the capital value of the developed land is common. As with dryland agriculture, rates vary and the final lease value is usually an agreement by negotiation between the lessee and lessor.

Irrigation land leased attracts a higher rental as there is more certainty in the return on investment for both the lessee and lessor. In some cases, such as irrigated cotton, there may be excess demand resulting in lease rates greater than 10% of land value. The prospect of water shortages should be taken into account in evaluating the value of a lease. Land with a more reliable water outlook is likely to attract a higher lease percentage, but the initial land value should also reflect the water situation.

Leasing rates for livestock production

Leasing land for livestock production is based on the same principles as those for leasing land used for farming. The fair rental value for a lease for livestock production is similar to long-term agistment rates and will generally fall between 5% and 9% of the value of the land.

Leasing with a purchase option

Another type of lease is available for persons who wish to sell their rural property. The lease with the option to buy attracts a higher rate of initial lease, often from 10% to 15% for the term of the lease. At the end of the lease the property may be purchased by the lessee at a predetermined price. Some leases allow for the difference between the fair rate of lease (5–9%) and the actual lease rate to be taken off the purchase price, but this would need to be clearly stated in the agreement. If the option to purchase is declined by the lessee at the end of the lease period, the lessee has paid a premium for the option to buy. This provides the lessor wishing to sell their land with some insurance against a lessee not taking the option to buy.

The budgeting method

The budgeting method can be used to verify that lease values are appropriate. It uses the principle that a fair rental would be based on a percentage of the potential returns for the enterprises carried out on the leased land. Suggested percentages could be based on 25% of the expected gross margin (GM) income from cropping and a long-term agistment rate of \$0.20 per week for dry sheep and \$2.00 per week for cattle.

Example

The two methods can be compared using information from the 1997 Australian Bureau of Agriculture and Resource Economics Farm Survey Report for an average 'mixed livestock – crop' farm in NSW for the averaged years 1994/95 and 1995/96. The farm details were:

Total farm area	1284 ha
Wheat sown	127 ha
Barley	27 ha
Grain legumes	10 ha
Other crops	68 ha
Sheep	1870 head
Cattle	169 head

The average farm capital of the property was \$1 089 110. It is assumed that 25% of this capital is machinery and is not leased, reducing the value of the capital asset for lease to \$816 832, or \$636/ha. Using the 5–9% of capital value method, a fair lease rental for this property would be between

\$40 841 and \$73 515 per annum, that is, between \$31.81 and \$57.25 per hectare per annum.

At 5% of land value:

$$\$816\,832 \times 0.05 = \$40\,841 \text{ pa}$$

or \$31.81/ha pa

At 9% of land value:

$$\$816\,832 \times 0.09 = \$73\,515 \text{ pa}$$

or \$57.25/ha pa

Using a budgeting approach, the result lies at the lower end of the estimated rental as calculated by the percentage valuation method.

	Value per annum (\$)
Crops: (25% of GM)	
Wheat: \$150/ha (GM) × 25% × 127 ha	4 763
Barley: \$116/ha (GM) × 25% × 27 ha	783
Grain legumes: \$80/ha (GM) × 25% × 10 ha	200
Other crops: \$100/ha (GM) × 25% × 68 ha	1 700
Sheep: \$0.20 per head per week	
1870 head @ \$0.20/hd/wk	19 448
Cattle: \$2 per head per week	
169 head @ \$2/hd/wk	17 576
Total	\$44 470

Rentals other than leasing

Sharefarming is an alternative to leasing, where the landholder takes on some of the risk and receives a predetermined percentage share of the income. Sharefarming is covered by the same Act and is common for cropping enterprises.

The future for leasing

New technology and world markets are forcing agricultural enterprises to become more efficient users of labour, land and capital. Leasing is a way of obtaining the use of more land to make more efficient use of available labour, and other capital.

Leasing agricultural land can also have its advantages for the lessor. It is a way for people who want to retire from farming or for individuals who would prefer a fixed or stable income from their land asset. In many situations the retiring generation may wish to hold onto land, expecting

that members of the next generation will eventually take over the running of the property. The lessor retains ownership of the land, still earns an income from the asset, holds an asset that potentially could appreciate in capital value, and has freed up their labour.

Factors to consider in a lease

- Maximum proportion of area that can be cropped.
- Minimum proportion of legumes/oilseeds in the rotation.
- Maintaining nutrient balance. (Your local advisers should be able to indicate quantities required.)
- Preventing acidity. In many situations liming will be required to prevent further acidification. Visit www.agric.nsw.gov.au/reader/soil-acid for guidelines for the amount of liming required to neutralise acidification and other general information regarding soil acidity.
- Pasture establishment. Agreement may be required on pasture establishment, especially following or during the last crop of the pasture phase.
- Maximum stocking rates.
- Stocking policy during droughts.

Note: As conditions are applied, the percentage return to the lessor for the lease is reduced.

References

- *Agricultural Tenancies Act 1990*
- *Agricultural Tenancies Regulation 2001*
- Kincaid, Diana (1991), *Ick-Hewins Law Notes for the Man on the Land, A handbook for rural users*, Butterworth-Heinemann in conjunction with NSW Farmers' Association, Sydney.
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