



# Determining Farm Building Rent

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How do you determine a rental rate for a building? It may be either a building you want to rent or one someone wants to rent from you.

Two parties are involved; the owner and the renter. The **owner** has costs associated with the services the building will provide. These costs (fixed and variable) are relevant in deciding (1) whether to rent the building and (2) whether to continue to own it, but may have little bearing on the actual rent received.

The **renter** who wishes to use the building needs to consider what it will add to returns, or the amount it will reduce costs. For example, he knows that providing housing for a combine will keep it in better condition and enhance its trade-in value compared to leaving it exposed to the weather. He estimates this value to be \$500 per year. This is the maximum rent he would be willing to offer for the building services.

There is no one correct answer to the question, "What is a fair rent for a building?" The amount the renter is willing to offer will usually be different than the amount the owner needs to cover his costs. The rental rate will need to be determined by bargaining. If there is a going rental rate, it can be used as a starting point in bargaining. If a going rate is not available, then the owner must determine an asking price and the user must determine an offering price for the services of the building.

In addition to the building itself, other considerations are accessibility, distance, degree of security (safe from fire, theft, vandalism, etc.), and, for some specialized buildings (confinement livestock buildings, for example), comfort of the operator and level of management skill needed.

The remainder of this circular will deal with a method the owner may use in determining an asking price and the renter may use in determining an offering price.

## Owner's Costs and Considerations

The owner must determine the costs of providing the services of a building. The annual total cost will be of two parts — fixed costs and variable costs.

**Fixed costs** include depreciation, interest on capital investment, repairs and insurance. Once the building is purchased, these costs continue whether the building is used or unused. Two of these costs involve direct cash outlays (repairs and insurance), and two do not involve cash payments (depreciation and interest on investment). (The exception is if there is an outstanding debt to be serviced that would require principal and interest payments.)

**Variable costs** for a building are those that increase with the use of the building and decline as the use declines. They might be added repairs caused by use, or include changes in the use of electricity or water.

Before any fixed cost determinations can be made, the present value of the building must be determined and an estimate made of its remaining useful life.

**Value** — there are several possibilities in arriving at the estimated value of the building:

1. Initial cost less depreciation taken: This is used for income tax purposes but has little relationship to recoverable investment.

2. **Structural value:** This is the reproduction costs less allowance for estimated physical deterioration. (Has little to do with recoverable investment unless the building has historical or architectural significance.)
3. **Contributory value:** An attempt to estimate the recoverable investment as reflected in its potential market value based on the long-run costs of replacement of its services. Because of the estimates needed on replacement cost, physical deterioration, and functional and economic obsolescence, there can be significant differences of opinion on value.
4. **Value in use:** This is the capitalized value of services rendered and is used to determine the value of the building from a rental rate (or potential rental rate). Our objective is to determine a rental rate, so this method is not relevant.
5. **Salvage value:** What it could be sold for if moved or razed.

If it can be moved it may have more recoverable value than with other methods. Of these methods, contributory value and salvage value appear to be the most applicable in determining a rental rate.

**Salvage value** — occasionally a building is sold for use or scrap. Allowing for differences in condition and age, such sales can be used for estimating building value.

**Contributory value** — this is the replacement cost of similar new building adjusted for the age, obsolescence and design peculiarities of the old building. In considering replacement cost of a new building it should be a building that can provide the same function(s) at the least cost.

In addition to replacement cost of a new building, you need to know the estimated life of the new building as well as the estimated remaining life of the old building in terms of performing its functions.

Adjustments to value may also need to be made for obsolescence and/or design peculiarities.

This information can be entered on Worksheet #1, "Estimating the Contributory Value of a Building." Final results are, at best, approximate. More than one estimate may be useful to provide a range — one "most likely," one high and one low, for example.

### **Worksheet 1. Estimating the Contributory Value of a Building**

- |  |           |
|--|-----------|
| 1. Approximate new cost of a replacement building that can provide the same services | \$ _____  |
| 2. Estimated life of the new building  | _____     |
| 3. Calculation of contributory value:  |           |
| a. Estimated remaining years of life (old building)                                  | _____     |
| b. Portion of value remaining Line 3a ÷ Line 2                                       | _____     |
| c. Estimated value adjusted for age Line 3b × Line 1                                 | _____     |
| d. Less adjustment for obsolescence  | -\$ _____ |
| e. Less adjustment for design problems   | -\$ _____ |
| f. Estimated Contributory Value Line 3c—(Line 3d + 3e)                               | \$ _____  |

## Worksheet 2. Rent Determination from Building Costs

- A. Depreciation: Value \$ \_\_\_\_\_<sup>1</sup> ÷ estimated remaining years of life \_\_\_\_\_
- B. Interest: Value \$ \_\_\_\_\_<sup>1</sup> × \_\_\_\_\_ interest rate<sup>2</sup>  
2
- C. Repairs: Value \$ \_\_\_\_\_<sup>3</sup> × .02 (or farm records) \_\_\_\_\_
- D. Insurance: (1) Insured value \_\_\_\_\_ × insured rate \_\_\_\_\_  
(farm records) or (2) Value \_\_\_\_\_<sup>3</sup> × .75/\$100 \_\_\_\_\_
- E. Total Fixed Building Costs (A + B + C + D) \_\_\_\_\_
- F. Variable Costs: Estimate, or use farm records for operating repairs, utilities \_\_\_\_\_
- G. Total Building Ownership Costs (E + F) \_\_\_\_\_
- H. Annual rent required to cover:
- 1) Variable costs only (F) \_\_\_\_\_
- 2) All cash costs (C + D + F) \_\_\_\_\_
- 3) Total Costs (G) \_\_\_\_\_

<sup>1</sup>From Worksheet #1, or other estimate.

<sup>2</sup>Rate you could earn elsewhere — at least passbook savings rate.

<sup>3</sup>If you have farm records data, use it or estimate based on average costs.

Once the value of the building is estimated, Worksheet #2, "Rent Determination from Building Costs," can be used to estimate the rental value from the owner's standpoint. If the building is to be rented for less than a year, divide by 12 and charge a monthly rate based on the months it will be used. If the building has only one use, total costs (line H3) may be a reasonable asking price.

### Renter's Considerations

How much can you afford to pay for building rent? How much should you pay? To answer these questions you need to determine the value of the building services to you.

Consider having versus not having a building. If after all other costs are considered you determine you can gain a certain amount by having the

building, then that amount is the maximum rental you can afford to offer.

As an example, suppose the price of sunflower is \$8.50 per cwt. at harvest and you expect the price to be higher next spring.

#### Example:

Price of sunflower at harvest	\$ 8.50/cwt.
Expected price in 8 months (or less)	10.50/cwt.
Expected gain (gross)	\$ 2.00/cwt.
Estimated cost of storage (interest on grain, shrink, insurance, handling, extra trucking)	1.25/cwt. _____
<b>Balance remaining for risk, management and building rent</b>	<b>\$.75/cwt.</b>

Assuming everything turns out and the price of sunflower does reach \$10.50 per cwt., would you offer 75¢ per cwt. as a rental? No, it is a breakeven proposition leaving nothing for risk and management. But if you could rent the storage for 25¢ per cwt., the expected return to risk and management would be 50¢ per cwt. You must decide whether the possible return is worthwhile.

A general procedure for estimating the value of gaining the use of a building is outlined in Worksheet #3. If the owner of the building(s) has no alternative use for it (them), you might offer less than you determine that you can afford to pay. At this point, bargaining enters in and both parties will try to use their best judgment in arriving at the final rental price.

### **Worksheet 3. Renter's Estimate of the Value of Using a Building**

	Per Unit	Total
1. Expected gain (gross), or increase in gross income from using the building.	\$ _____	\$ _____
2. Expected expenses, or increase in expenses, due to use of the building. <sup>1</sup> (except building rental)	\$ _____	\$ _____
3. Other considerations (distance, security, comfort, management required)	\$ _____	\$ _____
4. Balance available for risk management and building (and facilities) rent.	\$ _____	\$ _____

<sup>1</sup>Extension Service crop or livestock budgets, or AGNET programs may be used in estimating expenses if personal farm records are not available.