Valuing the freeholder's interest

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James Wilson examines the development of case precedent at the Upper Tribunal on the appropriate deferment rate to be applied in leasehold reform cases

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The deferment rate is a constituent part to value either the freeholder?s or landlord?s interest (referred to in this article as the freeholder?s interest) and is required in all circumstances, i.e. for both house and flat enfranchisement and new lease claims. Accordingly, it is paramount that all valuers are aware of and understand the leading cases. This is by no means a definitive list, but covers the background and a sample of subsequent departures from what is known as the ?generic? rate.

In leasehold reform the three components, where applicable, which when aggregated give the value of the freeholder?s interest are:

- the term
- the reversion
- hope value.

In this article we are only concerned with the value of the ?reversion?, which is calculated by taking the freehold vacant possession value (or share of freehold/999-year lease value as applicable), then discounting it at an appropriate rate of interest, the ?deferment rate?.

What is the deferment rate?

For the valuer to enter any analysis or discussion on the deferment rate it is essential to understand both what it is and its component parts. ?The deferment rate is an annual discount of a future receipt, the vacant possession value of the house or flat at term?, Earl Cadogan v Sportelli [2007] 1 EGLR 153 (referred to as *Sportelli*).

In Sportelli, (one new lease, one house and three collective enfranchisement claims in Prime Central London (PCL), all with unexpired terms over 20 years) the Upper Tribunal (UT) sets out how the deferment rate can be calculated, being ?the addition of an appropriate risk-free rate and an appropriate risk free premium, with a deduction for capital growth?. As a formula, it is represented as follows: DR = RFR ? RGR + RP where DR is the deferment rate; RFR is the risk-free rate; RGR is the real growth rate and RP is the risk premium.

All valuers need to be aware of the provisions of current leasehold reform legislation

The risk-free rate is defined as ?the return demanded by investors for holding an asset with no risk, often proxied by the return on a government security held to redemption?, the UT determined 2.25%; the real growth rate is the growth in house and flats? prices (values) above the rate of inflation, the UT determined 2%; and the risk premium is ?the additional return required by investors to compensate for the risk of not receiving a guaranteed return?, the UT determined 4.5%.

All the above leads to what is known as the ?generic? deferment rate for houses:

DR = RFR ? RGR + RP
DR = 2.25% - 2% + 4.5%
DR = 4.75%.

For flats, 0.25% is added to the risk premium because of the ?prospect of management problems arising during the course of the tenancy? hence the formula becomes:

DR = 2.25% - 2% + 4.75%
DR = 5%.

To establish the risk premium the UT considered the market for the type of asset being valued. The risk of investment in long reversions involved those of:

- volatility
- illiquidity
- deterioration
- obsolescence.

In addition the UT considered ?specific factors? that might affect the appropriateness of using a generic rate, being:

- length of unexpired term
- location
- obsolescence and condition
- flats v houses
- transaction costs.

We now examine a sample of cases where the generic deferment rate has been challenged, having in mind the component parts of the formula.

Leases below 20 years

In Sportelli, the UT had determined that the deferment rate is constant beyond 20 years. For terms of less than 20 years the rate would need to have regard to the property cycle at the valuation date.

In Cadogan Square Properties Ltd (and others) v The Earl Cadogan (and others) [2010] UKUT 427 (LC) (referred to as *Erkman*), five collective enfranchisement claims in PCL, the unexpired terms ranged from 17.8 years down to 15.6, i.e. less than 20 years.

Following its approach in Sportelli, the UT considered and concluded that the formula can be adjusted to reflect the fact that at the valuation dates, the residential property market was above its long-term trend of real growth rate of 2%.

In three of the cases the valuation dates were in 2005. The UT concluded that whereas the hitherto growth rate in PCL was above the long-term trend, future growth would in any event be expected, albeit below the Sportelli rate of 2%. The UT concluded 1.75% for RGR, being 0.25% below 2%. The formula is adjusted to:

DR = 2.25% - 1.75% + 4.75% = 5.25%.

Following on for the two cases with valuation dates in 2007, where in the interim the market increased sharply by 15% in 2006 and a further 8% by September 2007, the UT concluded 1.5% for RGR, being a further 0.25% below 2%. The formula is now adjusted to:

DR = 2.25% - 1.5% + 4.75% = 5.5%.

Short unexpired terms

In Trustees of the Sloane Stanley Estate v Charles Carey-Morgan [2011] UKUT 415 (LC) (referred to as *Vale Court*), a collective enfranchisement claim in PCL, the unexpired terms were 4.74 and 70.25 years. Having identified the factors that were different as between a five-year reversion and a 15-year reversion, the UT concluded the Sportelli formula is not to be applied to the valuation of very short-term reversions. Short-term reversions are more akin to freehold interests in possession.

The UT determined that the deferment rate for reversions of less than five years should be the net rental yield that the evidence shows to be appropriate for the property in question; and in addition there should be an end allowance, which in the absence of setting some other percentage should be 5%.

On the facts of the case, the net rental yield of 3.25% with an end allowance of 5% equates to a deferment rate of 4.37%.

Generic rates departures

Other cases where departure from the generic rates has been allowed include Zuckerman v Trustees of the Calthorpe Estates [2009] UKUT 235 (LC) (referred to as *Zuckerman*). For the 11 new lease claims in Kelton Court, Dudley, West Midlands (a block of flats of 1970s construction), the UT determined departure from the generic rate as follows:

- greater risk of deterioration in Kelton Court than PCL, not reflected in vacant possession values, increase in risk premium of 0.25%
- significantly lower long-term growth rate in West Midlands than in PCL, increase in risk premium of 0.5%
- greater risks associated with flats pursuant to the introduction of the Service Charges (Consultation Requirements) (England) Regulations 2003 , increase in the addition for flats to reflect greater management problems from 0.25% to 0.5%.

The formula is now adjusted to: DR = 2.25% - 2% + 5.75% = 6%.

Following on from Zuckerman, in City & Country Properties Ltd v Alexander Christopher Charles Yeats [2012] UKUT 227 (LC) (referred to as *City & Country*), a new lease claim in a block of 54 1930s-built flats in Horsham, West Sussex, the UT, having granted permission to appeal, had limited it to the issues of capital growth and management and their effect on the deferment rate. The LVT had determined an additional 0.25% for obsolescence and that stood. The UT allowed the appeal on the management issues only, as follows:

- added risk of obsolescence (LVT), 0.25% addition to the risk premium
- addition for flats of 0.5% to reflect potential management problems.

The formula is now adjusted to: DR = 2.25% - 2% + 5.25% = 5.50%.

The UT refers to its decision in Daejan Investments Ltd v Benson [2011] 1 WLR 2330 (referred to as *Daejan*) and set out its reasons for the 0.5% uplift in respect of reversions on flats as opposed to those of houses, briefly as follows:

- an addition of 0.25% allowed for in Sportelli to reflect the lack of certainty that the purchaser would not become involved with any management problems
- an addition of a further 0.25% to reflect the potential actual burden of management; however, if clear evidence exists showing that the purchaser of the freehold reversion would realise on the facts of the case it was extremely improbable that, as freeholder, it would become burdened with any responsibility of management, this evidence may be sufficient to displace this extra 0.25%.

The Supreme Court?s majority (3:2) overruling of the decisions of all lower courts and tribunals has arguably appreciably reduced the potential actual burden of management and thus displaced the extra 0.25%, Daejan Investments Ltd v Benson and others [2013] UKSC 14 .

All valuers need to be aware of the provisions of the leasehold reform legislation and for those practising in the field it is paramount to have an understanding of the background, the component parts and case precedent to the formula that gives the generic deferment rate.

If you are an RICS member involved in enfranchisement you may like to join the RICS Leasehold Enfranchisement Community.

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