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# The Quest for the Holy Grail Part III.

*"Come senators, congressmen*
*Please heed the call*
*Don't stand in the doorway*
*Don't block up the hall*
*For he that gets hurt*
*Will be he who has stalled*
*The battle outside ragin'*
*Will soon shake your windows*
*and rattle your walls*
*For the times they are a-changin"*

Words by Bob Dylan but could this sentiment be also attributed to the radical proposals laid out by The Rt Hon Lord Justice Bean, Professor Nicholas Hopkins, Stephen Lewis, Professor David Ormerod QC and Nicholas Paines QC, **the Law Commissioners**, who have recently published two consultation papers on Leasehold Reform:

1. Leasehold enfranchisement: A summary of proposed solutions for leaseholders of houses
2. Leasehold home ownership: buying your freehold or extending your lease ?

Could we now be closer to helping Lord Justice Lewinson achieve his dream that *"The Holy Grail will one day be found"* as he called for in the Court of Appeal case of **Adrian Howard Mundy v Trustees of the Sloane Stanley Estate [2018] EWCA Civ 35?**

It certainly appears as though a path to reform has been laid out since **"Mundy"** and the whole Taylor Wimpey saga concerning Leasehold houses and the 10-year doubling Ground Rent scandals of 2016-2017. Reform that in some cases, is well overdue. However, there does appear to be a level of hysteria and as result, there is a danger of "throwing the baby out with the bath water".

As a contribution to this debate and as practising valuer, I would like to discuss two areas of reform that go to essence of the valuation problem, which are the **Capitalisation Rate** and the **Relativity**. In this paper I will concentrate on:

**<u>Capitalisation Rate</u>**

This concerns the compensation to the freeholder or intermediate landlord for the loss of Ground Rent when either a lease is extended or there is a freehold enfranchisement. This value is ascertained by adding future ground rental income but discounting this future income flow at an appropriate discount Rate i.e. **the Capitalisation Rate.**

The leading Lands Tribunal case on capitalisation rates is, **Nicholson v Goff [2007] 1 EGLR 153** which states:
"*the factors relevant to the capitalisation rate: (i) the length of the lease term; (ii) the security of recovery; (iii), the size of the ground rent (a larger ground rent being more attractive); (iv) whether there was provision for review of the ground rent; and (v) if there were such provision, the nature of it*."

Most cases are resolved without recourse to the Tribunal, as the capitalised ground rent generally only represents a small part of the premium, regardless of the rate adopted. In my experience the range of settlements is between 6% and 7%. The more attractive ground rents, that have regular reviews, with reasonable levels of ground rent, achieve a lower capitalisation rate, resulting in a higher premium. The low fixed ground rents only achieve higher Capitalisation Rates, resulting in lower premiums.

However , that was until the most recent high profile FtT case *of <u>St Emmanuel House (Freehold) Ltd and others v Berkeley Seventy-Six Ltd and others – FTT CHI/21UC/OCE/2017/0025</u> (***also known as the All Saints Case),** where the Capitalised Ground Rent was the "only show in town".
The headline grabbing rate was **3.35%!**
Ever since valuers representing Freeholders have enjoyed pushing premiums up. The case involved the collective enfranchisement of 3 separate blocks containing 52 flats with a rental income of £13,000 per annum increasing by RPI every 15 years. We were informed that this income was attractive to small Pensions Funds as yields on Government Stocks had fallen dramatically. The case for the freeholders filled " 5 large lever arch files ", whereas the Leaseholder's case was largely based upon the valuer's lengthy experience. There was some anecdotal evidence concerning the valuer's mother's flat. The freeholders' case was preferred.

However, the headline grabbing Capitalisation Rate adopted by the Tribunal of 3.35% is not what it seems. To get this rate the Tribunal adopted the **<u>Equated Yield</u>** of the **<u>Current</u>** rent known as the "**EYC**", which took no account of any future rent increases. This method seriously underestimates the future income.

**<u>An extract of the All Saints Decision valuation for St Emmanuel's Court is shown below:</u>**

| | | | | | | |
|---|---|---|---|---|---|---|
| **VALUE OF HEADLESSEE'S INTEREST** | | | | | | |
| **Capitalise ground rents** | | | | | | |
| | **AGREED Ground Rent 2016 to 2022** | | | | £4,000 | |
| CR | 3.35% | 5.61 years | | | 5.03808 | £20,152 |
| Increase to | **AGREED Ground Rent 2022 to 2132** | | | | £5,152.84 | |
| CR | 3.35% | 110 years | 29.05495 | | | |
| **x** Pv | 3.35% | 5.61 years | 0.83122 | **x** | 24.15118 | £124,447 |
| **Plus Headlessee's reversion** | | | | | | |
| | | | | | **AGREED Reversion Value** | £21,417 |
| | | | | | **Value of headlessees's existing interest** | £166,016 |

I have looked at the same information and agreed facts and re-analyzed the figures but adopting a conventional calculation using an assumption that inflation will rise by 3% per annum. This approach was called the "**EYF**" at the Tribunal (although this calculation is not shown in the decision) and is the **<u>Equated Yield</u>** adopting **<u>Future</u>** income growth. The resulting capitalisation rate is much higher at **5.84%.**

**<u>The All Saints Decision based upon a 3% RPI</u>**

| | | Right to receive ground rent | | | 5.84% | Years Purchase | | Value | |
|---|---|---|---|---|---|---|---|---|---|
| Period 1 | £4,000 | for | 5.60 | Years defered | 0.00 | Years | 4.66243 | £ | 18,649.72 |
| Period 2 | £6,232 | for | 15 | Years defered | 5.6 | Years | 7.14222 | £ | 44,509.38 |
| Period 3 | £9,709 | for | 15 | Years defered | 20.6 | Years | 3.0485 | £ | 29,598.04 |
| Period 4 | £15,126 | for | 15 | Years defered | 35.6 | Years | 1.30118 | £ | 19,682.15 |
| Period 5 | £23,566 | for | 15 | Years defered | 50.6 | Years | 0.55538 | £ | 13,088.31 |
| Period 6 | £36,716 | for | 15 | Years defered | 65.6 | Years | 0.23705 | £ | 8,703.46 |
| Period 7 | £57,202 | for | 15 | Years defered | 80.6 | Years | 0.10118 | £ | 5,787.69 |
| Period 8 | £89,119 | for | 15 | Years defered | 95.6 | Years | 0.04319 | £ | 3,849.03 |
| Period 9 | £138,844 | for | 5 | Years defered | 110.6 | Years | 0.00795 | £ | 1,103.81 |
| | | | | | | | | | |
| | Reversion | | | | | £6,030,000 | | | |
| | | PV £1 in | 115.60 | yrs @ | 5% | 0.003552 | = | £21,418.56 | |
| | | | | | | TOTAL VALUE | | £ | 166,390.15 |
| | | | | | **All Saints Decision** | | | **£166,020** | |

I also reviewed the other 2 blocks, St Gabriel's and St Saviour's, which had capitalisation rates of **5.88%** and **5.85%** respectively.

Therefore, the **All Saints Decision** wasn't the radical departure from conventional wisdom that we were led to believe. In fact, it's just a fraction below 6%, which is what the lessee's surveyor "headline" rate was. It was just applied to the current ground rent **(EYC)** when it should have been applied to the future ground rent **(EYF).**

This also fits in with the analysis we have carried out on sales of similar freehold ground rents investments.

On this basis, capitalisation rates should continue to vary in line with the sound advice given in the **Nicholson v Goff**. The rate should depend upon the rent profile. I suggest the following rates would be a good starting position:

1. Small fixed incomes should be at approx 7.00%
2. Ground Rents that double every 25/33 years should be at 6.50 %
3. Ground rents that increase every 15 years by RPI should be at 5.85%

I don't feel there is a need to prescribe capitalisation rates as they are almost always readily agreed by surveyors. If it was felt that prescription was necessary then I think most freeholders and leaseholders would agree to the above, provided there was a mechanism for re-evaluating the prescribed rate at regular intervals, possibly every 5th year.

**Onerous Ground Rents**

These include 10-year doublers, or those that increase in line with the value of the property. These are rarely sold in the open market and so there's very little evidence. They carry with them the advantage of regular inflation busting increases. They also carry with them the stigma that very often purchasers have bought them without being aware of the of the dramatic rent increases. When I have been asked to value/negotiate these, I generally reach agreement at around 6% and have an FtT decision at this level

LON/00BB/OC9/2015/0277 Ground Floor & First Floor Flats 13 St. Martins Avenue

**Should the creation of new ground rents be banned?**

I personally don't feel there should a ban on ground rents in the future. That would be a serious restriction on consumer choice.

Many of my clients want the opportunity to extend their lease at a lower premium and are willing to pay a higher ground rent to achieve this.

There is however a good argument that the ground rents should be prominently advertised in sales literature with future ground rents specified even if that involves using an estimated RPI of say 3%. They should carry adequate health warning, so the consumer is made aware of the full facts. I have seen too many with very limited information regarding the future ground rent.

However, I do believe there is an argument to ban the creation of new onerous ground rents that double every 10 years or less or rise in line with property values and are reviewed every 10 years or less. These are generally designed to catch unwitting solicitors or conveyancers out and most people regard them as unfair.

I would be interested to hear any other views on this problem.

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