LEASE

THE LEASEHOLD ADVISORY SERVICE

COMMONHOLD AND LEASEHOLD REFORM ACT 2002

VALUATION FOR COLLECTIVE ENFRANCHISEMENT

Valuation issues for flats

Introduction

This leaflet is not meant to describe or give a full interpretation of the law; only the courts can do that. Nor does it cover every case. If you are in any doubt about your rights and duties then seek specific advice.

In any action of enfranchisement, collective or individual, one of the first questions to be asked is "How much will it cost?" Because of the uncertainties of the valuation process required by the legislation it is often very difficult to form a clear view at the beginning of exactly what the costs of the freehold will amount to.

This advice note sets out to describe:

- *how the legislation requires the price to be made up*
- *the general principles and methods of valuing a freeholder's interest*
- *the role of the professional adviser in the process*

This note is not intended as a '*do-it-yourself*' guide to valuing your own freehold. You should always seek proper professional advice at the earliest possible stage.

The legislative basis

The price to be paid for the freehold, according to Schedule 6, Part II of the Leasehold Reform, Housing and Urban Development Act 1993 (as amended), shall include:

- **income received from ground rents *(the term)*;**
- **reversionary value of the freehold on expiry of the leases *(the reversion)*;**
- **the marriage value;**
- **value of other interests, eg Rent Act tenancies, commercial properties, garages;**
- **injurious affection (compensation for other losses).**

The marriage value is taken as the latent increase in value arising from the joining of the freehold and leasehold interests and the Act requires that this potential profit shall be shared between the parties.

The proportion of the split of marriage value is fixed by the legislation at a 50:50 division between the landlord(s) and the RTE company. In the calculation of the marriage value the leaseholders' and freeholder's valuers will rely on local knowledge and experience to assess the increase in value in the flats arising from the potential ability for the enfranchising leaseholders to grant themselves 999 year leases without paying a premium.

Injurious affection is to compensate the freeholder for any diminution in value of another property as a result of the forced sale – for example, loss of access to a adjoining site or the removal of a future opportunity for development of a joint site. It may also include compensation for the loss of possible development value of the property subject to the action – for example, the opportunity to build on the roof of a block of flats.

The legislation does not require a formal valuation to be carried out but it would be prudent to obtain one. The valuation will provide the basis for the RTE company's offer to the freeholder contained in their Initial Notice. The offer does not need to be the same as the valuation, as there is no legal obligation to reveal it.

The freeholder may accept the RTE company's offer or respond, in his Counter-Notice, with his own asking price. It is to be hoped that the parties will then enter into negotiation and settle the price. If this cannot be achieved then either party may make application to the

Leasehold Valuation Tribunal, in accordance with the set timescales.

The Leasehold Valuation Tribunal will, after hearing the submissions of both parties, determine all outstanding issues relating to the price:

- the value of the freeholder's interest;
- the value of other interests or appurtenant land;
- the amount of the marriage value;
- the proportional split of the price between the freeholder and any intermediate landlords;
- the amount of any compensation.

The LVT's role is not to decide in favour of either party's valuation but to determine the issues independently; the Tribunal's determination may not, therefore, necessarily reflect the prices proposed by either the leaseholders or the freeholder.

More information on LVT procedures is contained in our leaflet 'Application to the LVT'.

The legislation requires that the value of the interest to be acquired should be determined in accordance with general market values – assuming a willing vendor and a willing purchaser. The principles of the Act are not to provide a forced bargain for the RTE company but to compensate the freeholder adequately for the loss of his property – a fair price based as closely as practicable on open market values. The essential difficulty is the assessment of an 'open market value' in the artificial situation created by the imposition of the lease-holders' rights.

Principles and methods

Valuation is an imprecise science, based as it is on the application of methodical calculation to a combination of known and assumed information. Certain facts are known – the outstanding term of the lease and the amount of ground rent payable; to this the valuer has to provide the current market value of the flats, the likely improvement in that value following enfranchisement and estimate a yield rate for calculation.

The valuer will have to rely on his experience and close monitoring of the local property market to produce meaningful figures, but it must always be appreciated that property valuation cannot produce definitive values, no matter how skilled or experienced the valuer. The valuation will always be the best estimate based on market forces – what a purchaser will be prepared to pay – and it is almost inevitable in valuations for 1993 Act procedures that the leaseholders' valuation and the landlord's valuation will be some way apart. A good valuer will be able to anticipate the likely variations and to advise his client at an early stage, whilst being able to support his own valuation.

Freehold property

Freehold property subject to long lease is normally valued on an investment basis. The freehold interest has no intrinsic value other than:

- **the rental income (*the term*)**

and

- **the eventual repossession of the property at the end of the term (*the reversion*)**

so its value at a given moment is based on a calculated present value of the future income.

This is comparable to an investment – what sum should be put down today to achieve such an income for so many years at such a rate of interest, and/or to achieve such a capital value deferred for so many years.

This achieves a 'snapshot' figure of what value this promised income and/or capital value has today, and is the figure likely to be achieved in an open market sale to an investor in long-term securities.

This is best illustrated by example:

Assume: a block of 10 flats with 68 years unexpired leases. The ground rent of each flat is £50 per annum and the individual market value of each flat with its existing lease is taken as £150,000.

(i) calculating the term

Total ground rent of £50 x 10 flats = £500 pa for the block

This ground rent figure is multiplied by the Years Purchase, a multiplier calculated by the valuer or, more usually, taken from valuation tables. To obtain the Years Purchase multiplier, the valuer must make an assumption of a Yield Rate. In this example the yield is taken as 8%; the Years Purchase figure is then looked up in the tables.

Years Purchase for 68 years @ 8% is 12.433

So, £500 x 12.433 = <u>£6,216</u>

The calculation produces a figure which it is estimated that a property investor would be prepared to pay today for a fixed income of £500 per annum for the next 68 years to produce a yield of 8%. The critical factor in the calculation is the assumed yield percentage, which the valuer will estimate from a close scrutiny of local freehold auction prices, calculating back the yield from evidence of what freehold investments have achieved in the open market. In effect, the valuer, being able to see from the particulars of auctioned properties the unexpired terms and the ground rents and knowing the prices actually paid, will be able to do the above calculation in reverse producing an indicator of the yield percentage being achieved. It is important in analysing these transactions for the valuer to know the individual circumstances of the sale, as the base information obtainable from the auction results may not always provide completely accurate evidence on which to base other calculations. This can lead to disagreement in estimates of yield percentage by opposing valuers working from the same local market information. The yield is a most important element in valuation and one likely to be the subject of difference between the leaseholders' and landlord's valuers.

(ii) calculating the reversion

Current value of the flats = £150,000 x 10 flats
= <u>£1,500,000</u> *(the leaseholders' present interest).*

It is in the nature of a leasehold tenancy for the value to diminish as the lease expires and a long lease is generally worth more on the open market than a short lease. In cases of enfranchisement, when the enfranchising leaseholders have the opportunity to grant themselves lease extensions, it can generally be assumed that the action will achieve some improvement in the value of the individual flats. The amount of this improvement will be heavily dependent upon the length of the unexpired term before extension and there are no hard and fast rules as to how much the value will increase. It is this that the valuer will have to estimate, based on his research into local comparables.

Where the leaseholder has made improvements to the flat which could affect its value these must be disregarded for the purposes of the valuation. If the improvements are substantial the valuer will have to calculate the additional value they give to the flat (not what they cost) and then discount this from the estimated present value of the flat; in effect the valuer has to assess the *unimproved* value of the flat.

For the purpose of the calculation of the reversion a value must be ascribed to the flats representing what they could be sold for when the current term expires. For this purpose it must be assumed that the most favourable leases will then be granted to maximise value, eg a 999 year term.

(Most long leaseholders have statutory protection to revert to assured tenancies on the expiry of their existing leases. In the valuation of leasehold interests subject to protected occupancy, the improved value is sometimes discounted by a percentage to reflect that the landlord will not receive a vacant flat on expiry but a tenant paying a full weekly rent. This is disregarded for the purposes of the example.)

In this example we assume that the acquisition of the freehold would produce an increase in the market value of the flats equivalent to 10%, representing a future value of £165,000:-

Improved value: £165,000 x 10 = <u>£1,650,000</u>

Again a multiplier is taken from the tables to provide an investment value – what is the promise of the future £1.65m worth today? The multiplier, the Present Value of £1, is taken at the same yield rate, 8%, as previously.

Present Value of £1 deferred 68 years @ 8% is 0.00534

So, £1,650,000 x 0.00534 = <u>£ 8,811</u>

(iii) the investment value of the freehold

The investment value of the freehold – *the freeholder's interest* – is therefore represented by the sum of the values of the term and the reversion:

£6,216 + £8,811 = <u>£15,027</u>

that is, the sum that the interest is likely to achieve in an open market sale.

The marriage value

As described on page 1, *marriage value* represents the increase in the value of the flats following the completion of the enfranchisement; their additional market value arising from the ability of the enfranchising leaseholders to grant themselves longer leases. In that this potential 'profit' only arises from the freeholder's obligation to sell, the legislation requires that it be shared equally between the parties.

The legislation stipulates that for any flat held by a participating member, where the unexpired term of the lease exceeds 80 years, any marriage value is to be ignored.

Taking the figures from the previous example above:

the improved value of the property is	£1,650,000
From this is subtracted:	
the leaseholders' present interest	£1,500,000
and the freeholder's interest	£15,027
In this case the marriage value is	<u>£134,973</u>

Taking the 50:50 split between the freeholder and the enfranchising leaseholders, the leaseholders would have to pay half this figure – £67,486 – in addition to the freeholder's interest.

In this example it can be seen that marriage value can considerably exceed the value of the freeholder's interest. Its calculation is dependent upon the estimated increase in value of the flats and, clearly, the lower that increase, the lower will be the marriage value. This is an area where the input of a valuer with local knowledge is of paramount importance to both parties in order to provide substantive comparable evidence of the local market and how, if at all, flat values will be affected.

The longer the current lease, the lower the latent marriage value may be, until eventually it becomes negligible.

In a collective enfranchisement action, marriage value is only chargeable in respect of the flats of the participating leaseholders. The example above assumes all leaseholders participating for the sake of simplicity.

The flats of those leaseholders not participating in the action are not included in the calculation in that there will be no improvement in the value of those flats arising from the enfranchisement. (The non-participating leaseholders will not benefit from the purchase in that they will not be able to extend their leases other than by the payment of a premium to their new freeholder at a later date). The effect of this is illustrated by example in the Appendix *(see page 8)*.

Completing the valuation

Using the examples above, the potential valuation of the building, assuming no extra costs arising from additional freeholder's interests, or injurious affection, would be the sum of

Freeholder's interest	£15,027
Marriage value x 50%	£67,486
Possible purchase price	£82,513
	or £8,250 per flat

This example assumes all leaseholders are both qualifying and participating. The example is provided solely to demonstrate general working practice in valuation and should not, of course, be applied in any individual circumstances.

The areas for differences between the parties will be obvious from the examples, valuing from their different perspectives, notably:

- the yield rate;
- the increase in the value of the flats.

These differences are illustrated by further examples in the Appendix.

Financial implications for the leaseholder

As can be seen, the share of the cost of the freehold to be paid by the leaseholder is directly in relation to the potential for increase in the value of the flat. In the above example, the value of the leaseholder's flat was taken to increase by £15,000 arising from the payment by the leaseholder of an individual contribution to the purchase price of £8,250. Therefore the leaseholder has a 'profit' from the transaction of £6,750 (less his own and the landlord's costs).

This element of 'profit' will, of course, decrease in proportion to the shortness of the lease, eventually disappearing altogether. It is a matter for the leaseholder to assess the relative value of proceeding by setting the likely amount he will have to pay against the resulting increase in the value of the flat. Clearly a leaseholder would be unwise in negotiating a price in excess of the expected rise in the value of the flat.

Valuing an intermediate interest

In some cases the leaseholders' immediate landlord may not be the freeholder but a head lessee. The Initial Notice must be served on the head lessee, as well as the freeholder, and he is entitled to a role in the valuation and negotiation process. In that the freeholder must deliver an unencumbered freehold title to the RTE company on completion of the collective enfranchisement, the head lessee's title will be wound up and he is entitled to compensation. The overall sum for leaseholders to pay for the freehold will be the same but it will need to be divided between the two landlords, the freeholder and the head lessee, in proportion to the value of their relative interests. This may be agreed between the parties or may be determined by a Leasehold Valuation Tribunal.

Further information on the valuation process is set out in Schedule 6 to the Leasehold Reform, Housing and Urban Development Act 1993, as amended by the Commonhold and Leasehold Reform Act 2002.

The role of the valuation surveyor

The importance of good professional advice has been referred to already but is worth recapping on the role of the valuer in the procedure:

- to carry out the valuation in accordance with the legislative guidelines;
- to advise on the possible purchase price, based on experience and preparation of 'best and worst case' valuations;
- to advise on the offer to be made to the freeholder in the Initial Notice;
- to advise on the response to the freeholder's Counter-Notice;
- to conduct negotiations with the freeholder on behalf of the RTE company;
- to provide expert evidence at the Leasehold Valuation Tribunal;
- to provide technical advice on repair and maintenance and cost implications of future leaseholder management.

Leaseholders would be most unwise to attempt any enfranchisement action without early advice from a valuation surveyor, competent in the legislation and with a good knowledge of the local property market. Once the procedures are commenced, with the service of the Initial Notice, the participating leaseholders are committed to proceed and to pay the freeholder's reasonable costs; it is best not to enter this cycle without the fullest professional advice as to the likely cost and outcome.

Not all surveying practices specialise in this kind of work and leaseholders should make careful enquiries relating to the practice's experience of the legislation before proceeding. Advice on local practices can be obtained from the Royal Institution of Chartered Surveyors, or from us.

Appendix

The calculated valuation is dependent upon certain variable factors:

- the unexpired term;
- the ground rent;
- the current and improved values of the flats;
- numbers of participating leaseholders;
- the yield rate.

The following examples will illustrate the potential for change in calculated values arising from changes in these variables.

The examples are based on the same situation used in the text *(see page 3)*, and the variations can be compared.

Variations – effects on valuation

To recap on the original valuation:

a block of 10 flats, 68 years unexpired, ground rent £50 pa, current value £150k, improved value £165k, with all 24 leaseholders participating.

Freeholder's interest: term £6,216 + reversion £8,811 = £15,027

Marriage value £134,973 x 50% = £67,486 = £82,513

Effect of a shorter lease

Assume same situation but with leases of only 35 years unexpired

i) Valuing the term

Ground rent x YP 35 years @ 8%*

£500 x 11.65 = £5,825

ii) Valuing the reversion

With an unexpired term this short, the increase in value arising will be much greater.

Assume the improved value of each flat remaining at £165,000 but the current value as much less – say £66,000, or around 40% of freehold value.

Current value 10 x £66,000	£660,000
Improved value 10 x £165,000	£1,650,000
x PV £1 deferred 35 years @ 8% = 0.0676	
= £111,540	
Freeholder's interest	**£117,365**

iii) Marriage value

Improved value	£1,650,000
less: leaseholders' interest	£660,000 –
less: freeholder's interest	£117,365 –
= £872,635	

Assume split 50:50 = £436,317

Possible purchase price £553,682, or £55,368 per flat

In this case the value of the term is less, with a shorter period of rental income expected but the reversionary value is very much more – the freeholder has a shorter time to wait for the property. The increased margin between the current value of a flat with a short, virtually unsaleable lease and the improved value has the effect of greatly increasing the marriage value.

* *This yield rate is used for purpose of comparison with the other examples; a valuer would not necessarily apply this rate to such a short unexpired term.*

Effect of a longer lease

Assume same situation but with leases of 95 years unexpired

i) Valuing the term

Ground rent x YP 95 years @ 8%

£500 x 12.49 = £6,245

ii) Valuing the reversion

With a long unexpired term of 95 years the value of the flats will already be higher and it is unlikely that there would be any further increase in market value arising from the enfranchisement. Therefore the value will be calculated from their current market value, (taken as £165k) with no improved value applicable.

Current value 10 x £165,000 = £1,650,000

x PV £1 deferred 95 years @ 8% = 0.00067

= £1,105

Freeholder's interest = £7,350

iii) Marriage value

With the statutory limit on marriage value at 80 years, there will be no marriage value to calculate.

In this case the longer term produces a marginally higher value for the term but the reversion is almost without value. Similarly there is no marriage value calculable.

Effect on the marriage value of different numbers of participating leaseholders

Assume the same situation but only the statutory minimum of participating leaseholders (half of the total number of flats in the building – assume 5 out of 10)

i) Freeholder's interest – as original example = £15,027

ii) Marriage value – the value of the property will be improved by the assumed increase in market value of the flats of the participating leaseholders only:

5 flats at the assumed improved value of £165,000
= £825,000

plus 5 flats at the current value of £150,000 = £ 750,000

= £1,575,000

Therefore to calculate the marriage value as before:

improved value	£1,575,000
less: leaseholders' current interest	£1,500,000
less: freeholder's interest	£15,027
	£59,973

Split 50:50 = £29,986

Possible purchase price £45,013
or £9,000 per participating leaseholder

It can be seen that a lower number of participating leaseholders will reduce the amount of marriage value and, thereby, the overall purchase price, albeit to be shared between a lesser number of participants.

Effect of differing yield rates

The yield rate assumed by the valuer directly affects the multipliers used in the calculations and different yield rates will result in differing valuations. It is likely that the relative perspectives of the landlord's and leaseholders' interests will lead their valuers to differing conclusions on the appropriate rate.

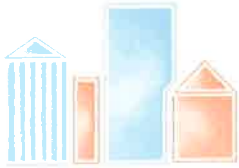
For the purpose of example, the freeholder's interest (excluding the marriage value) is recalculated from the original example at rates from 6% to 11%.

Original calculation using 8%	term	£6,216
	reversion	£8,811
		<u>£15,027</u>
Variations using 6%	term	£8,175
	reversion	£31,350
		<u>£39,525</u>
using 7%	term	£7,071
	reversion	£16,500
		<u>£23,571</u>
using 9%	term	£5,539
	reversion	£4,702
		<u>£10,241</u>
using 10%	term	£4,992
	reversion	£2,475
		<u>£7,467</u>
using 11%	term	£4,541
	reversion	£1,369
		<u>£5,910</u>

That is, if comparable rates of return, or yields, in the market are low, a purchaser of the freehold would expect to pay a higher price for the investment, and vice versa.

***Note:** the yield rates used above and throughout this booklet are for example only and do not purport to represent current levels applying in the market.*

Useful addresses



Leasehold Valuation Tribunals

London
Whittington House, 19-30 Alfred Place, London WC1E 7LR
0207 446 7700

Eastern
Great Eastern House, Tenison Road, Cambridge CB1 2TR
0845 100 2616

Midlands
2nd Floor, East Wing, Ladywood House, 45-46 Stephenson Street,
Birmingham B2 4DH
0845 100 2615

Northern
Sunley Tower, Piccadilly Plaza, Manchester M1 4BE
0845 100 2614

Southern
1st Floor, 1 Market Avenue, Chichester PO19 1JU
0845 100 2617

Wales
1st Floor, West Wing, Southgate House, Wood Street,
Cardiff CE1 1EW
029 2023 1687

Other useful addresses

The Royal Institution of Chartered Surveyors
12 Great George Street, Parliament Square, London SW1P 3AD
0207 222 7000

LEASE

THE LEASEHOLD ADVISORY SERVICE

70-74 City Road, London EC1Y 2BJ
Telephone: 0207 490 9580 or local rate on 0845 345 1993 Fax: 0207 253 2043
Email: info@lease-advice.org Website: www.lease-advice.org