An Analysis Of Valuing Freeholds

1 Executive Summary

Principally the value of a property freehold, subject a long lease is the sum of (i) the present value of the reversion of the property back to the freeholder and (ii) the present value of the stream of ground rents until the time of reversion. and this document contains an analysis of the current methods used to value freeholds.

The information provided in this document is believed to be correct at the time of writing, but the author accepts no liability for errors or omissions in this document. The views expressed in this document are the author's alone and are not meant as advice, legal, financial or otherwise.

Although this document is centred on the valuation of freeholds, additional background and explanatory information with regards to the UK system of leaseholds and freeholds is also provided, mainly through a series of links which the author found insightful when researching the subject, but for the avoidance of doubt, this is neither meant to be comprehensive nor complete.

Contents

1 Executive Summary 1
2 Overview 2
3 Enfranchisement: current law and case law 2
3.1 The Sportelli deferment rate formula 3
3.2 The Court's Directive 4
3.3 Are there acceptable alternatives to the Sportelli formula? 5
4 Enfranchisement: the necessity to value leaseholds 5
5 Tribunal Freehold and leasehold extension valuation 7
6 A note on Online Freehold Calculators 8
7 The calculation of the value of ground rents 8
8 Thoughts on the Leasehold Reform (Ground Rent) Act 2022 9
9 A selection of the author's views 9
9.1 Enfranchisement Fees 9
9.2 Marriage Value 10
9.3 Enfranchisement and Potential Development Value 10
10 Final Comment 11

2 Overview

An in depth overview of the system of leaseholds and freeholds in the UK can be found at:

- https://www.gov.uk/leasehold-property and;
- https://www.lease-advice.org/

As explained in the links above, qualifying leaseholders have the right to extend their lease by 50 years for houses and by 90 years for flats and in some cases also have the right to purchase the freehold. These rights are commonly referred to as property enfranchisement or simply enfranchisement. If freeholder and leaseholder cannot agree upon the price then the leaseholder can turn to the specialist property Tribunal (the "Tribunal")) who will calculate the price which is binding for the freeholder.

It is common in many articles about this subject to refer to the freeholder as "Landlord" and both terms mean the same. In this paper the term Landlord is used in cases where most reference materials also refer to the freeholder as "Landlord".

The remainder of this document is built up as follows:

- Since the value of a freehold, as calculated by the Tribunal, is the value the freeholder *must* accept in case of property enfranchisement, the next four chapters deals with the method the Tribunal currently uses to price freeholds, its rationale for doing so, how this might change going forward and concluded by a note on online Tribunal pricing calculators;
- Chapter 7 contains analysis of pricing ground rents;
- Chapter 8 contains some thoughts on the latest Leasehold Reform (Ground Rent) Act of 2022.
- Chapter 9 contains the author's views on (i) enfranchisement fees, (ii) the concept of marriage value and (iii) a suggested method to account for unrealised development value in enfranchisement; and
- Chapter 10 contains a final comment

3 Enfranchisement: current law and case law

There exists a significant amount of case law with regards to pricing lease extensions and freeholds by the Tribunal and we have not reached the end of legal proceedings. It is fair to say that it is not even the beginning of the end of the ongoing legal battle and some doubt if it is even the end of the beginning…

This chapter provides an overview and analysis of the current acts and case law in so far as they apply to valuations of ground rents and reversions.

The benchmark case to price reversions by the Tribunal is still Cadogan & Anor vs Sportelli ("**Sportelli**") from 2007.

See https://www.bailii.org/ew/cases/EWLands/2005/LRA_23_2004.html

Sportelli itself is an appeal of an earlier appeal at the LEASEHOLD VALUATION Tribunal of the LONDON RENT ASSESSMENT PANEL.

See https://www.bailii.org/ew/cases/EWLands/2005/LRA_23_2004.html

This appeal, Arib v Cadogan (“**Arib**”), provides calculations of the 6 enfranchisement cases dealt with in both this appeal and the subsequent Sportelli appeal in the Court of Appeal.

3.1 The Sportelli deferment rate formula

The price of a reversion, as per the decision of the court, was to take the value of the Freehold Vacant Possession (“**FHVP**”) and discount this value with a deferment rate, this rate being defined as ***DR = RFR – RGR + RP*** where***:***

i. *RFR: (real) Risk Free Rate: set at 2.25%; less*

ii. *RGR: Real Growth Rate: set at 2%; plus*

iii. *RP: Risk Premium: (for houses) set at 4.5%; (for houses) and 4.75% (for flats); resulting in*

iv. *DR: deferment rate: 4.75% (for houses) and 5% (for flats). (The higher rate for flats was intended to reflect "the greater management problems associated with flats" (para 95).)*

RGR: Real Growth Rate

The figure of 2%, being the inflation adjusted property value growth (RGR), in Sportelli seems to have been simply “picked” in a previous case. See yellow text below

Par. 147

The analysis which we made in para 130 of the reasonableness of an assumption that investment in the residential property market in this part of London will be a successful hedge against inflation makes that figure of say 2% a reasonable starting point for assessing a deferment rate generally applicable, subject to the circumstances of each property, to the Cadogan Estate. There is then needed an adjustment for risk net of growth measured in real terms. From that resultant figure it will be further necessary to make adjustments for any particular advantage or disadvantage of the particular case, which justifies a departure from such rate.

RP: Risk Premium

The 4.5% risk premium is justified as per the below:

Par. 72

In considering these factors, the Tribunal preferred the evidence of Professor Lizieri (for Grandeden) to that of the landlords' witnesses, which they thought "substantially

underestimated the risks". They had earlier summarised Professor Lizieri's evidence, in which he had explained his approach to assessing the risk premium and concluded that – "… offsetting the extra volatility of equities against property's relative illiquidity and some additional allowance for the possibility of physical and functional depreciation,… an appropriate risk premium would fall in a range of 4% to 5%, and that 4.5% was appropriate." (paras 21-2)

RFR: (Real) Risk Free Rate

The (real) Risk Free Rate is observable and yield curves of this rate are available at any time.

In summary both RGR and RP are neither observable nor agreed upon by independent experts and this makes it impossible in practice to apply this formula to calculate the deferment rate over time. The courts themselves have never used this formula to set the deferment rate subsequent to Sportelli and despite the fact that the observable RFR fell by more than 4% , the courts have kept DR equal to 4.75% for houses and 5% for flats.

In the author's opinion the court in Sportelli and Arib before then, was faced with so much conflicting evidence from the experts that they were forced to make a judgement call:

Par 66

Not surprisingly, in such circumstances, the methods adopted by the experts varied considerably, as did their proposed deferment rates (ranging from 3.2% to 7%: decision paras 17, 31).

So (again strictly in the author's opinion) the court simply made a judgement call of 4.75% for houses and 5% for flats and adopted the most applicable calculation method which would lead to these rates.

3.2 The Court's Directive

The directive of the courts in arriving at an acceptable compensation payable to the Landlord been described by the Law Commission in their report published 21 July 2020

See https://www.lawcom.gov.uk/project/leasehold-enfranchisement/

For human rights purposes, the acquisition of the landlord's interest in a building is considered a deprivation of property under Article 1 Protocol 1 to the European Convention on Human Rights ("A1P1") whereas the acquisition of the right to manage a building is considered a control of the landlord's use of property only. As a result, a landlord in an enfranchisement claim must receive adequate compensation for the loss of its interest in the building. For this purpose, the premium payable on enfranchisement, together with non-litigation costs, form the compensation 'package' payable to the landlord.

The reason the law commission is quoted in this case is because of the law commission's term of reference:

> *Government asked us to review the enfranchisement process to make it easier, quicker and more cost effective, and to examine the options to reduce the price payable by leaseholders to enfranchise.*

Therefore despite the fact that the purpose of the commission is to find ways to make enfranchisement more favourable to leaseholders, they themselves state that enfranchisement must include adequate compensation for landlords and the consequence of this statement, in the author's opinion, is that if an alternative to Sportelli would be presented to courts, which in the opinion of the court, would result in a "fairer" price for the landlord, then the courts will have no alternative but to adopt this alternative, even if this new price would make the landlord substantially better off to the detriment of the leaseholder.

3.3 Are there acceptable alternatives to the Sportelli formula?

The courts themselves have admitted that there is no evidence to suggest that the deferment rate should remain constant over time, instead of changing from time to time as a result of different market conditions. Despite this they have indicated that they will keep instructing the Tribunal's to keep using the same deferment rates as established in the 2007 Sportelli case "*unless compelling evidence to the contrary is adduced"*

E.g. See Llangewydd *https://www.bailii.org/uk/cases/UKUT/LC/2021/251.html* .

In the author's opinion, the courts are simply waiting for an acceptable update of the methodology to calculate the deferment rate and the author believes that this new methodology must comply with both of the following two requirements to be considered to be adopted by the courts:

A. The calculation methodology must have been accepted as correct by a substantial majority of independent experts; and
B. The calculation of the actual deferment rate must be entirely based on observable parameters.

Eureka Capital has developed a method which in principle complies with both of the above requirements. Following ongoing due diligence this method will be published in due course.

4 Enfranchisement: the necessity to value leaseholds

With enfranchisement, if the remaining leasehold has a maturity of less than 80 years then the value of the existing leasehold must be taken into account by the Tribunal when calculating the cost of buying the freehold or extending the lease and therefore this chapter briefly describes how valuing leaseholds is done by professional valuers.

Leases are priced by market participants using relativity tables. These tables (containing percentages) express the value of the lease relative to the value of the FHVP. E.g. as per the Gerald Eve 1996 table (see the table in Link 2.), which seems to be used by most professional valuers, a leasehold with a remaining value of 40 years is worth 66.00% of the value of the property where this value refers to the value of that property being a freehold property and with vacant possession. Guidance how to use these tables in practice is provided in the next paragraph.

Below are four links to relativity table links plus some comments provided below the links:

1. A comparison of relativity tables of different professional valuers using figures from between 1974 - 2007

   https://www.graphsofrelativity.co.uk/inputs/3/valDate/2022-11-14/unexpTerm/79/hiddens/null/checkeds/null

2. Gerald Eve's relativity table compiled in 1996 using figures from the period between 1974 – 1996:

   https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=&cad=rja&uact=8&ved=2ahUKEwi18obi7a77AhUMiFwKHRhtDXAQFnoECBMQAQ&url=https%3A%2F%2Fwww.geraldeve.com%2Fwp-content%2Fuploads%2F2019%2F11%2FRelativities-1996.pdf&usg=AOvVaw1Zhwsrgz5PC3bXoL3H34z6

3. Adjusted Gerald Eve's relativity table from 1996 containing relativity values under the assumption that the client does **not** have the right of enfranchisement. This as a result of updated case law (see par. 13 in the link below):

   https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=&ved=2ahUKEwi18obi7a77AhUMiFwKHRhtDXAQFnoECBIQAQ&url=https%3A%2F%2Fwww.geraldeve.com%2Fwp-content%2Fuploads%2F2020%2F10%2FLeasehold-Enfranchisement-Briefing-Note_2020_final.pdf&usg=AOvVaw1uCC_EplK9HJiq-FAuZUZS

4. Savills 2016 relativity tables, fairly similar to the Gerald Eve tables and showing relativities with- and without the right of enfranchisement side by side.

   https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=&ved=2ahUKEwiVl9zF8a77AhUKRsAKHSRhDEQQFnoECBcQAQ&url=https%3A%2F%2Fpdf.euro.savills.co.uk%2Fuk%2Fresidential---other%2Fleasehold-enfranchisement-june-2016.pdf&usg=AOvVaw327AKnV-xe7-wrGvmKtdjB

The following comments can be made:

- The author has found no indication that relativity tables are linked to interest rates in any way and is proceeding under the assumption that they are not. Whether this is justified and the reasons why it might be justified, will be left to others to argue.
- The Gerald Eve and Savills tables are compiled using (mostly) data from the London property market. There are indications that leasehold relativities for properties outside London are higher than stated in these tables, but this falls outside the scope of this document.

5 Tribunal Freehold and leasehold extension valuation

For the avoidance of doubt:

- This chapter applies to leaseholds where the landlord built the dwelling before granting the lease and does not apply to leaseholds where the dwelling was built by the original leaseholder after the lease was granted.
- Nowhere in any act is there a prescribed or statutory method which explicitly outlines how the Tribunal should calculate the price of freeholds or leasehold extensions. This chapter merely describes, *in the opinion of the author*, the *likely* calculating method which, at the time of writing this document, the Tribunal is likely to adopt in order to determine the price.

When calculating the price the freeholder needs to receive for selling his reversion to the leaseholder, the Tribunal will likely:

1. Firstly determine the current value of the reversion by discounting the value of the FHVP with the deferment rate set by Sportelli, being 4.75% for houses and 5% for flats. An illustrative example is included further down.
2. Secondly the Tribunal will calculate the value of the lease as percentage of the value of the FHVP by using a relativity table possibly supplemented by considering additional evidence provided by experts and under the assumption that the lease to be valued does not include the right to buy the freehold. This requirement is stipulated in Section 9a of the Leasehold Reform Act 1967.
3. Thirdly the Tribunal will add both percentages determined under 1. And 2. above and if these percentages add up to less than 100%, then the leaseholder would end up with a windfall when buying the reversion from the freeholder, since combining leasehold and reversion is by definition worth 100% of the value of the FHVP. This windfall, i.e. 100% - (percentage calculated under 1. + percentage calculated under 2.) is referred to as the marriage value, i.e. the increase of the combined value of freehold and leasehold when bringing them in the same ownership. If the remaining value of the lease is less than 80 years then this marriage value is split between leaseholder and freeholder, otherwise it is ignored.
4. The Tribunal then adds (a) the value calculated under 1 , plus (b) half the marriage if applicable plus (c) the present value of any cancelled ground rents and this is the price the leaseholder must pay the freeholder for the reversion.
5. For leasehold extensions, the process is the almost same, other than that the amount calculated under 4. Is adjusted downwards with the value of the reversion 90 years after the expiration of the existing lease using the method under 1.

Illustrative example.

A leaseholder of a flat has 50 years left on the lease and pays a ground rent equal to £500 pa. The value of the FHVP equals £1,000,000.

1. The "Sportelli" determination of the current value of the reversion as percentage of the value of the FHVP equals $\frac{1}{(1+5\%)^{50}}$ = 8.720%.
2. The value of the leasehold as a percentage of the value of the FHVP is taken from the Gerald Eve 2016 table and equals 70.493%.

3. Adding both percentages gives (8.720% + 70.493%) = 79.231%. The difference of this percentage and 100% equals 100% - 79.231% = 20.787%, being the marriage value.
4. Assuming that the present value of the ground rents equals £10,093 (more about calculating the present value of ground rents in chapter 7) and because the remaining term of the leasehold is less than 80 years, the price the leaseholder will need to pay to the freeholder equals £10,093 + (8.720% + 20.787%/2) * £1,000,000 = £201,228.
5. If instead of buying the freehold, the leaseholder only wants to extend the freehold to 50 + 90 = 140 years, then the freehold retains a reversion in 140 years' time and as per 1. above that would be worth $\frac{1}{(1+5\%)^{140}}$ = 0.108% of the value of the FHVP, thus equal to £1,080 and thus the price for the 90 years extension would be equal to £201,228 - £1,080 = £200,148.

An obvious comment might be: why bother the extend the lease for 90 years if you can purchase the freehold for an extra £1,080? Sometimes the leaseholder does qualify to extend the lease but does not qualify to buy the freehold or it could be that a freehold needs to be created at substantial costs which are to be incurred by the leaseholder and prohibitive when considering buying the freehold.

6 A note on Online Freehold Calculators

Online calculators to price freeholds or leasehold extensions are mostly provided by companies who either are in the business of buying freeholds or are advising leaseholders and these calculators therefore can be expected to produce pricing which is lower than the pricing produced by applying chapter 5. Freeholders who intend to sell their freehold or provide leasehold extensions should keep this in mind, when presented with these calculators, and should at least ask how these calculators arrive at their pricing if this pricing is significantly different from chapter 5.

7 The calculation of the value of ground rents

The substantial majority of ground rents will consist of either fixed or index linked cash flows and yield curves exist for both these cash flows. Reversions however depend on the value of the FHVP and so far no "FHVP yield curve" is either used or even agreed upon by market professionals.

Discounting cashflows is common practice in every part of the financial industry and is principally done by taking the risk free yield curve for that cash flow and applying an appropriate spread. This spread, in this case, consists of three elements:

i. Expected loss due to default of the borrower
ii. Liquidity (or lack thereof) of the cashflows or the asset producing the cashflows
iii. Cost or effort of collecting the cash flows. Colloquially referred to as a "hassle" factor

If a leaseholder would default on paying ground rents then ultimately the freeholder can go to court and apply to forfeit the lease. Given the fact that the market value of a leasehold generally far exceeds the market value of a series of ground rents and thus would amply compensate the landlord for any loss of ground rents, the occurrence of a default will not result in any loss and thus the credit quality of ground rents is considered to be of the highest quality and comparable with sovereign credit risk.

Ground rents are not liquid, however in the case of pension funds there is an added benefit which compensates for this lack of liquidity. An analysis of this ground rent liquidity feature will be published in due course.

Last but not least is the “hassle” factor. Institutional investors are not set up to deal with collecting ground rents and thus assets secured on ground rents normally leave the collection of the ground rents with the freeholder. A common finance structure is that an institutional investor provides funding on the first [50] years of ground rents and will take a charge on the remainder of the ground rents and the reversion to ensure that the freeholder will collect the ground rents in full and pass them on.

8 Thoughts on the Leasehold Reform (Ground Rent) Act 2022

Principally, the author has no issue with the rationale of this Act. Practices of saddling hapless leaseholders with doubling ground rents every 10 years (sometimes even 5 years..) were unacceptable and the fact that the government finally stopped this can only be a good thing.

However freeholders still have the obligation to insure the building. Normally conscious freeholders will collect several insurance quotes and will choose the best value for money, but no one will continue doing so for the next 999 years for free, so it is the author’s expectation that a considerable peppercorn freeholds will end up with entrepreneurs who will simply select insurance companies based on commission paid back to them, subject to future government regulation. It is worth noting that the extra costs for the leaseholder in this scenario might outweigh any perceived benefit from having only a peppercorn rent.

One application of ground rents which the author believes has so far untapped potential, is to use ground rents to pay for significant upgrades of a building especially environmental upgrades. There exist a great many apartment blocks which would significantly benefit from improved insulation, hot water generation through heat exchange, solar panels etc, but often (at least some) leaseholders don’t have the cash available to execute this upgrade despite the fact it would pretty much pay for itself through lower energy bills. Being able to negotiate an increase of the ground rent for the next 25-40 years would be a (cheap) way to finance such upgrade, but the overriding negative attitude regarding ground rents, culminating in the 2022 Act, has made this opportunity much less feasible. At least for now….

9 A selection of the author’s views

9.1 Enfranchisement Fees

If a leaseholder wants to enfranchise, then in principle the leaseholder should be liable for any associated fees. It is the view of the author that these fees should be capped at levels known in advance to the leaseholder and reflecting a reasonable compensation for the landlord’s minimum anticipated costs. Any of the parties’ costs to appear in front of the Tribunal should be borne by the

parties themselves, although the courts should have the ability to award costs in cases where one of the parties acted frivolously or vexatiously or if one of the parties rejected a price from the other party and the Tribunal ultimately calculated a price less generous to the rejecting party.

9.2 Marriage Value

For illustrative purposes, as per the Gerald Eve 2016 table, the marriage value of an 80 year reversion of a flat equals 100% - 90.502% - $^{1}/_{(1+5\%)^{80}}$ = 7.48%. If the term of that reversion falls by 1 day then half of that value ends up with the landlord and in the author’s opinion, there exists no argument that this jump in compensation can be seen to be an representation the change in actual market value of the reversion. To be clear, Eureka’s Capital modelling of the value of reversions, to be published in due course, is able to exclude any concept of Marriage Value, therefore avoiding this “jumped” value change alltogether.

9.3 Enfranchisement and Potential Development Value

The general rule is that whoever makes improvements to the dwelling can keep the benefits of those improvements in any subsequent enfranchisements. How this is applied in practice falls outside the scope of this document, other than the author’s advice that when substantial improvements have been made during the existing lease and enfranchisement is considered, it is worth getting expert advice, since the potential impact of improvements on enfranchisement valuation can be substantial.

This chapter deals with recognised but unrealised development value and the author’s opinion of how this should be accounted for in enfranchisement.

- If the proposed development can be done purely at the discretion of the landlord and the landlord is able to keep all the benefits of the development, then, in the author’s opinion, the landlord should be compensated in full for the loss not to be able to execute the development if the leaseholder wants to buy the freehold. E.g. if the landlord would be able to add an extra floor on top of an apartment block and create two extra flats without the leaseholders having to agree to this, then the landlord should receive the estimated market value of the two new flats minus the cost of executing the development. If the leaseholder is unwilling or unable to compensate the landlord as per the above, the leaseholder can always opt to extend the lease, in which case no such compensation is needed, since the development opportunity remains with the landlord.
- If both leaseholder and landlord’s permission is needed for any development then, in the author’s opinion the general rule should be that the benefits of any development during the remainder of the lease should be split between leaseholder and landlord and the benefits of any development after the lease should go to the landlord in full. As an illustrative example assume that the net added value of a development after costs would be £200,000 and the remaining term of the lease would be 50 years then the benefit of this development would be equal to a 50 year lease on £200,000 and, as per the Gerald Eve 1996 table, equal to 74%.

The leaseholder's share of that would be half of that, i.e. £200,000 * 74% * 50% = £74,000 while the landlord's share would be £200,000 - £74,000 = £126,000. Thus the landlord should receive £126,000 as compensation for his loss of the development opportunity. Alternatively the leaseholder can extend the lease for 90 years, assuming the lease is for a flat, and by extending the lease the leaseholder would effectively gain half of a lease on the development value with a term of 90 years, starting 50 years from now. Using the Gerald Eve 1996 table a 140 year lease equals 99%. Subtracting the first 50 years would leave 99% - 74% = 25% and half of that equals 12.5%. The leaseholder would therefore have to compensate the freeholder for 12.5% * £200,000 = £25,000 for the freeholder having to postpone any development for an additional 90 years.

For the avoidance of doubt, the above-mentioned development value should be the amount an independent third party would be willing to pay to execute the development. The amount will most likely be significantly less than the added value of the development minus its costs, since the third party needs to factor in both (i) a profit for himself and (ii) potential costs of leaseholder and/or landlord creating obstacles and delays in the execution of the development.

Alternatively both leaseholder and landlord would most likely be significantly better off if they would find a way to work together and split the benefits of doing so. For example, instead of compensating the leaseholders in cash for being allowed to execute a development, the landlord could compensate the leaseholders by upgrading their apartment block and mitigate the cost of doing so through savings on costly expenditure like scaffolding and the hiring of plant which can be used for both the upgrade and the development but only has to be paid for once.

10 Final Comment

It is a reality that bad landlords make the news while responsible landlords remain anonymous. An example of the former were the doubling ground rent practices mentioned earlier and the author agrees with both public opinion and government measures of putting an end to this.

However there are currently 4.6 million leasehold dwellings in the UK and despite some calls for leaseholders to be "liberated" from landlords, the reality is that the leasehold-freehold system is going to be around for many years to come and instead of pitting leaseholders and landlords against each other, the author believes that there is far more to be gained if leaseholders and landlords find ways to work together, especially when there are ways to add value to the property they both have an interest in.

Milko Ostendorf

On behalf of Eureka Capital Limited

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