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Deferring to landlords

Kerry Glanville reports on five appeal cases that have seen the Lands Tribunal depart from existing convention on valuation principles

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In an attempt to reduce the number of appeals from the Leasehold Valuation Tribunal (LVT), the Lands Tribunal has handed down a composite decision in five cases heard together in July and August of this year that concerned the rate at which freehold reversions are deferred for leasehold enfranchisement valuations. The lead case, *Arbib v Cadogan* [2004], and three others concerned houses and flats on the Cadogan Estate, while the fifth concerned a house converted into flats on the Brompton Estate – all of the properties are in central London.

Background

To enfranchise, the tenant must pay a sum that represents the value of the landlord's interest plus one half of any marriage value arising as a result of the 'marriage' of the freehold and leasehold interests. For the purposes of acquiring the freehold interest in a high-value house under the Leasehold Reform Act 1967 or the freehold interest in premises under the Leasehold Reform, Housing and Urban Development Act 1993, marriage value represents the difference between the value of the landlord's interest plus the tenant's interest in the premises before the acquisition and the value of the tenant's interest after it. In the case of a lease extension, the premium payable by the tenant is the difference between the value of both interests before and after acquisition.

The value of the landlord's interest in the premises (excluding marriage value) is made up of two components. The first is the right to receive the rent payable under the lease over the remainder of the term, which is valued by capitalising the rent over the number of years unexpired. The second is the value of the right to vacant possession of the premises at the end of the term. This is determined by assessing the capital value of the premises at the valuation date on the basis that no lease has been granted, and applying a deferment rate to reflect the fact that the right to vacant possession arises at a future date coinciding with the date on which the lease is due to expire. The deferment rate, sometimes referred to as the yield, is the rate of compound interest that would need to be earned on an investment made at the valuation date to produce at the end of the term the capital value that has been determined as being the open-market value of the interest. The Lands Tribunal was concerned in these appeals with determining the appropriate deferment rate.

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Assessing the deferment rate

The particular difficulty that valuers face in ascertaining the correct deferment rate is the lack of reliable evidence in the property market. This lack of market evidence, in turn, arises as a result of some of the assumptions that must be made in carrying out the statutory valuation. It is to be assumed that: the landlord's interest is sold in the open market by a willing seller; neither the tenant nor anyone else with a special interest is seeking to buy; and there is no right to acquire the freehold or an extended lease as provided by the 1967 and 1993 Acts (or the prospect of such legislation being enacted) – the 'no-Act world'.

The problem arises from the fact that the majority of the London landed estates have not traditionally been willing sellers for a variety of reasons. Their initial opposition to the 1967 and 1993 Acts is well documented. On the rare occasions when they have ventured into the market to sell part of their holdings, much of the interest has been from

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tenants, and in many cases tenants have been the successful bidders. The Lands Tribunal had no hesitation in rejecting evidence of the sale at auction of the freehold reversions of seven blocks by Cadogan as being of no assistance, because the tenants were the successful bidders in five cases and the main value in the sales was in the rental stream, which is capitalised separately. Perhaps the biggest difficulty, however, is finding market evidence that is untainted by the effect of the enfranchisement legislation.

The approach to date

Between 1967 and 1989 there were 334 documented settlements of enfranchisement claims on the Cadogan and Grosvenor estates at a deferment rate of 6%. On the Cadogan estate 6% has been applied since 1989. In *Cadogan v Hows* [1989] the Lands Tribunal adopted 6%, accepting this evidence as good evidence of 'the land market'. Once the 1993 Act came into force, rights to enfranchise and to obtain a lease extension were greatly extended with the result that open-market evidence dwindled. For this reason settlements were increasingly relied on for ascertaining the appropriate deferment rate and, although inflation and interest rates changed, the deferment rate at which parties settled remained static.

The Lands Tribunal's most recent decision

The Lands Tribunal acknowledged that 'the no-Act world has disappeared' and stated that the valuers responsible for settlements can:

> ... no longer claim familiarity with a relevant land market to give their settlements the evidential value accorded to them when the settled figure of 6% was accepted.

It found that little guidance can be derived from settlements because often they are only evidence of the figure that has been agreed and not of the various components of the valuation (of which the deferment rate is but one). In reaching a particular figure the parties are often influenced by a desire to avoid tribunal proceedings (so the figure is not comparable with one arrived at in the open market – the so-called 'Delaforce' effect); they become 'self-perpetuating and a substitute for proper consideration and valuation in the particular case'.

The last of these criticisms has also been made of LVT determinations. A deferment rate of 6% was so widely applied by it in relation to claims made on the Cadogan and Grosvenor estates that this came to be regarded as a 'convention'. The LVT has been castigated for failing in its statutory function by treating a deferment rate of 6% as 'established' rather than considering the evidence adduced and arriving at a determination that can be justified on the basis of the circumstances prevailing at the valuation date and that is in accordance with the relevant statutory provisions.

The decision seeks to draw a distinction between reliance on a conventional rate, which is rejected, and adopting a conventional method of valuation for each component, which can be supported by evidence.

Having concluded that no reliable assistance could be gained from the sale of freehold reversions in the open market and that settlement evidence and LVT decisions are flawed, the Tribunal considered evidence put before it that compared changes in yields from residential property in central London with equities, gilts, interest rates and the Retail Price Index between 1988 and 2004. All showed a fall over this period. The yield rates used reflected actual rental income and anticipated capital growth. As the statutory valuation assumes no rental income over the remainder of the term of the lease, the Tribunal was not persuaded that such evidence could be relied on to arrive at a deferment rate, although it was able to conclude from this information that over the medium term such an investment provides a safeguard against inflation – there being real capital growth for both houses and flats, with houses performing better. Also rejected as reliable evidence was the prospectus of the Freehold Income Trust, sponsored by Close Brothers, because it is based on ground rents and reflects the potential for income to be generated in the form of premiums for granting consents, insurance commissions and disposals to sitting tenants.

Notwithstanding the above difficulties, the Tribunal was satisfied that the deferment rate would not be constant over several years when factors influencing the investment market, such as interest rates, inflation and prospects for capital growth, were fluctuating.

In view of the dearth of reliable evidence in the property market for determining a deferment rate, the Tribunal set out to find another investment with similar characteristics, the performance of which could be analysed to arrive at a range of appropriate deferment rates. It found what it was looking for, subject to some adjustments, in the money market.

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A viable comparison

The Tribunal concluded that a deferment rate could best be compared to an index-linked non-interest-bearing gilt to which a risk-premium net of growth could be added. Both represent a yield from a long-term investment, which provides no income until maturity, and are not sensitive to inflation. Comparing yields from various types of investments, including such gilts, the Tribunal noted that these rose from 5.7% in 1986 to 7.6% in 1993 and then fell back gradually to 2.5% in 2003 and less than 2% in 2004. They adopted 2% as representing 'a broadly genuine risk-free yield'. To arrive at a deferment rate for the properties on the Cadogan estate, this yield rate was adjusted by adding 2.5% to allow for general risks that the market might regard as being attached to such an investment – for example, the need for management and the fact that the asset may be destroyed or be expensive to realise at the end of the term.

The Tribunal went on to consider further specific adjustments to the 4.5% rate to reflect any particular advantage or disadvantage of each property. It concluded that no adjustment was necessary to reflect a difference in risk between the reversion in a single flat and a block of flats, because it is assumed under the 1993 Act that the freehold reversion to the flat is to be treated as being sold with the rest of the block. The fact that the tenant of a house under the relevant provisions of the 1967 Act is assumed to have no repairing obligation was found to have no impact on the deferment rate, due to the improbability of such high-value property falling into neglect at the end of the term. The Tribunal did, however, find that the increased level of management and lower capital growth of flats justified an increase in the deferment rate to 4.75%. Although no evidence was put before it in relation to the subject appeals to justify a different rate according to the length of the unexpired term, the Tribunal acknowledged that this might be appropriate. The deferment rate for one of the appeal properties, a very expensive house, was uplifted to 4.75% to reflect the risk of such a large, single investment. No adjustment was made for the different valuation dates in the appeals.

Conclusion

The five appeals were heard together to enable the Tribunal to hear several different valuers address the deferment-rate issue in respect of properties in a similar prime location. This was done in the hope that the general guidance it has given on valuation principles will reduce the number of appeals to it from the LVT.

In view of the disappointment expressed by the Tribunal members at the lack of specialist evidence regarding the financial markets, the relatively small range of investments considered and the lack of expert analysis of the published statistics relied on, it remains to be seen if this will, indeed, be the last word on deferment rates.

In any event, once a continuation or change in the trend of risk-free yields becomes established, deferment rates will change again. In the meantime, tenants will pay higher prices for their freeholds and higher premiums for their extended leases. The ramifications of this decision will be felt far beyond the Cadogan Estate. ■

James Ashley Arbib v Earl Cadogan
re: 40 Chelsea Square
LRA/23/2004

Earl Cadogan and Cadogan Holdings Ltd
re: 9 Astell Street
LRA/18/2005

Earl Cadogan v Dorrit Moussaieff
re: First and Second Floor Flat,
8 Cadogan Square
LRA/8/2005

Earl Cadogan v Hows
[1989] 2 EGLR 209

Earl Cadogan and Cadogan Estates Ltd v
55/57 Cadogan Square Freehold Ltd
re: 55/57 Cadogan Square
LRA/62/2004

Hugo Benjamin Day and Lady Hilary
Maureen Greenslade Day v
32 Rosary Gardens (Freehold) Ltd
re: 32 Rosary Gardens
LRA/87/2004

Dismantling the myths

A number of other columns on which the conventional approach to enfranchisement valuations has been built were dismantled by the Tribunal, which very helpfully set out a summary of its general conclusions. Some of the more important ones were:

1. The *RICS Appraisal and Valuation Manual* (the Red Book) is not usually of any assistance or relevance in the context of a statutory valuation.

2. There is unlikely to be any dependable market evidence that can be applied to the statutory assumptions, given the extent of the influence on the market of the enfranchisement legislation.

3. There is no 'convention' as to what a deferment rate should be; in each case it must be ascertained by evidence. It is unlikely that there could be a constant deferment rate over a period of years when other rates and markets are fluctuating.

4. Decisions of the LVT and the Lands Tribunal on questions of fact or opinion should not be treated as evidence of value in later cases. A decision of the Lands Tribunal setting out general guidance on valuation principles or procedure, however, may be applied or referred to in subsequent cases.

5. If there is no reliable land market evidence, then resort must be had to the financial or money markets to assess the deferment rate.

6. The starting point is a risk-free investment. On the evidence in these appeals this was found to be index-linked gilts.

7. For the Cadogan estate, a deferment yield of 4.5% is the norm to be applied to houses, and a deferment rate of 4.75% is the norm to be applied to flats, subject to the specific qualities and circumstances of each property.

8. It remains an open question as to whether there is a uniform deferment rate, regardless of the length of the unexpired term.

9. Changes in deferment rates will not occur until a change in the trend in risk-free yields has become established, or the continuation of a trend establishes a new level of yields.