www.lease-advice.org

Valuation for Leasehold Extension

Valuation Issues for Lease Extension 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 lease extension, 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 lease extension 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 landlord'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 lease extension. You should always seek proper professional advice at the earliest possible stage.

The Legislative Basis

The premium to be paid for the new lease, according to Schedule 13, Part II of the Leasehold Reform, Housing and Urban Development Act 1993 as amended by the Commonhold and Leasehold Reform Act 2002, shall be the total of:

- **the diminution in the value of the landlord's interest in the flat;** that is, the difference between the value of his interest now with the present lease and the value of his interest after the grant of the new lease with the extra 90 years.
- **the landlord's share of the marriage value**
- **compensation for loss arising from the grant of the new lease.**

The diminution in the value of the landlord's interest is, effectively,

- the loss of the income from the ground rent for the remainder of the original term (as the whole term of the new lease will be at peppercorn rent)
- the loss due to the additional 90 years wait for the reversion (the surrender of the flat at the expiry of the term)

The marriage value is taken as the potential for increase in the value of the flat arising from the grant of the new lease and the Act requires that this "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 landlord and leaseholder. In the calculation of the Marriage Value the leaseholders' and landlord's valuers will rely on local knowledge and experience to assess the increase in value in the flat arising from the new lease.

The compensation is to provide remedy to the landlord for any other diminution in the value of his interest in other property (other flats in the building or the building itself) and any loss or damage arising from the grant of the new lease. It is difficult to find examples of where a landlord could claim compensation since he will, in most cases, retain the freehold. Probably the only possibilities could be a claim for loss of opportunity for redevelopment potential or for a reconversion of a house in flats back to a single dwelling house.

The Act 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 leaseholder's offer to the landlord contained in the leaseholder's Notice. The offer does not need to be the same as the valuation, and there is no legal obligation to reveal the details of the valuation.

The landlord may accept the leaseholder'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 premium. 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 premium:

- the diminution in the value of the landlord's interest
- the amount of the marriage value
- the proportional split of the premium where there is an intermediate landlord
- the amount of compensation (if any)

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 leaseholder or the landlord.

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 leaseholder but adequately to compensate the landlord for the loss or diminution in value 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 leaseholder's 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 flat or flats, the likely improvement in that value following the grant of the new lease 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. In that the freehold interest has no intrinsic value other than

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

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 a rate of interest, and/or to achieve such a capital value deferred for so many years.

In a valuation for a lease extension what is calculated is the diminution in the landlord's interest arising from the extension of the term at a peppercorn rent. This is represented by the loss of the ground rent for the remaining period of the existing lease and the extra 90 years delay in achieving the reversion.

This is best illustrated by example:

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

i) calculating the term

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 (see below). 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% - 12.433

Ground rent £50 x 12.433 = **£621**

The calculation produces a figure which it is estimated that a property investor would be prepared to pay today for a fixed income of £50 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 leaseholder's and landlord's valuers.

The yield rate used in this note is for purposes of example only and does not purport to represent actual market rates. The effect on the valuation of differing yield rates is demonstrated in the Appendix.

ii) calculating the reversion

Current value of the flat = £150,000 *(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 lease extension it can generally be assumed that the action will achieve some improvement in the value of the flat. 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 flat representing what it could be sold for when the current term expires. For this purpose it must be assumed that the most favourable lease will then be granted to maximise value, e.g. 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 often 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 improvement could produce an increase in the market value of the flat of around 10%, representing a future value of £165,000:

Again a multiplier is taken from the tables to provide an investment value - what is the promise of the future £165,000 worth today? The multiplier, the Present Value of £1 is taken at the same yield rate, 8%, as previously:

Present value £1 deferred 68 years @ 8% - 0.00534

So, £165,000 x 0.00534 = **£881**

Aggregating the diminution in the landlord's interest

The diminution in the interest is calculated as the value of the present term and reversion, ***less*** the value of the reversion at the end of the new term. This is usually so small as to be disregarded:

Reversion to capital value after the grant of the extension

PV £1 deferred 158 years (68 + 90) is 0.000000069

So, £165,000 x 0.000000069 = nil

Therefore the diminution in the landlord's interest is:

term	£621
plus: reversion at 68 years	£881
less: reversion at 158 years	£nil
	= £1,502, say £1500

The Marriage Value

As described on page 2, marriage value is the increase in the value of the property following the completion of the lease extension, reflecting the additional market value of the longer lease. In that this potential "profit" only arises from the landlord's obligation to grant the new lease, the legislation requires that it be shared equally between the parties.

The calculation of the marriage value, according to Schedule 13, is the difference between two aggregate amounts, which are:

i)	the value of the leaseholder's interest under the present lease
plus	the value of the landlord's interest prior to the grant of the new lease
plus	the value of any intermediate interests
ii)	the value of the leaseholders interest with the new lease
plus	the value of the landlord's interest once the new lease is granted
plus	the value of any intermediate interests (if remaining)

The legislation stipulates that where the unexpired term of the lease exceeds 80 years the marriage value shall be taken to be nil.

Taking the figures from the example the calculation will be:

i) leaseholder's present interest	= £150,000
plus landlord's present interest	= £1,500
	= **£151,500**
ii) leaseholder's new interest	= £165,000
plus landlord's new interest	= £nil
	= **£165,000**

The Marriage value is therefore £165,000 minus £151,500 = **£13,500**

Taking the 50:50 split between the landlord and the leaseholder, the leaseholder would have to pay half this figure - **£6,750** - in addition to the diminution in the landlord's interest.

In this example it can be seen that Marriage Value can considerably exceed the value of the landlord's interest. Its calculation is dependent upon the estimated increase in value of the flat 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.

Completing the Valuation

Using the examples above the potential valuation of the new lease, assuming no extra costs arising from intermediate interests, or compensation, would be the sum of

Diminution in the Landlord's interest = £1,500

marriage value x 50% = £6,750

possible premium = **£8,250**

This example is provided solely to demonstrate general working practice in valuation and should not, of course, be applied in any individual circumstances.

It will be obvious from the example the areas for differences between the parties, valuing from their different perspectives, notably

- the yield rate
- the increase in the value of the flat

These differences are illustrated by further examples in the Appendix.

Financial implications for the leaseholder

As can be seen, the amount of the premium 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 a premium 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 premium he will have to pay against the resulting increase in the value of the flat. Clearly a leaseholder would be unwise in negotiating a premium in excess of the expected rise in the value of the flat.

Intermediate interests

In some cases the leaseholder's immediate landlord will not be the competent landlord for the purposes of the application, only having a headlease. Therefore the calculation of the premium payable by the leaseholder will have to take into account the effect of the grant of the new lease on both landlords' interests, the immediate landlord and the freeholder. The overall sum for the leaseholder to pay will be the same but it will need to be divided between the two landlords.

Valuing the interests

It is quite common for the intermediate landlord's lease to be only a few days superior to that of the leaseholder's, that is it comes to an end shortly afterward. In this situation the only diminution in the intermediate landlord's interest comes from the loss of the rental income for the remainder of the term. The intermediate landlord has no reversionary value, or so little as to be disregarded and so the value of the reversion will represent the diminution in the freeholder's interest. Applying this to the original example (and disregarding any ground rent paid by the intermediate landlord to the freeholder), the diminution in the two interests would be: (figures rounded down)

the intermediate landlord (the loss of the rent)	£620
the freeholder (the delayed reversion)	£880

The overall diminution in the value of the landlord's interests would be the same from the leaseholder's point of view but the £1,500 total would be divided between the two of them.

Where there is a marriage value it must also be split between the two landlords. This must be in proportion to the amounts by which their individual interests are diminished, in this case apportioned to a ratio of 620 to 880: Using the example, where the landlords' share of the marriage value was calculated at £6,750 the distribution would be:

the intermediate landlord : $£6,750 \times \frac{620}{1500} = £2,790$

the freeholder : $£6,750 \times \frac{880}{1500} = £3,960$

Therefore the division of the leaseholder's premium between the landlords is:

Intermediate landlord

Diminution in interest	= £620
Share of marriage value	= £2,790
	= £3,410

Freeholder

Diminution in interest	= £880

Share of marriage value	= £3,960
	= **£4,840**
Total premium	= **£8,250**

Further information on the valuation process is set out in Schedule 13 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 a valuation to assess the premium in accordance with Schedule 13**
- **to advise on the offer to be made to the landlord in the leaseholder's Notice**
- **to advise on the response to the landlord's Counter-Notice**
- **to conduct negotiations with the landlord on behalf of the leaseholder**
- **to provide expert evidence at the Leasehold Valuation Tribunal, if necessary**

A leaseholder would be unwise in attempting any lease extension 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 leaseholder is committed to proceed and to pay the landlord's reasonable costs; it is best not to enter this cycle without 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 our list.

Appendix

As stated previously the calculated valuation is dependent upon certain variable factors:

- **the unexpired term**
- **the ground rent**
- **the current and improved values of the flat**
- **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 and the variations can be compared.

Variations - effects on valuation

To recap on the original valuation:

a flat with 68 years unexpired, ground rent £50 pa, current value £150k, improved value £165k

Landlord's interest: Term £620 + Reversion £880

= £1,500

Marriage Value £13,500 x 50% = £6,750

= £8,250

Effect of shorter lease

Assume same situation but with a lease of only 35 years unexpired

i) Valuing the Term

Ground rent x YP 35 years @ 8%*

£50 x 11.65 = <u>£582</u>

ii) Valuing the Reversion

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

Assume the improved value remaining at £165,000 but the current value as much less - say £66,000 or around 40% of long-lease value

Improved value = £165,000

x PV £1 deferred 35 years @ 8% = 0.0676

= £11,154

Landlord's interest = £11,736

iii) Marriage Value

Improved value = £165,000

less: Leaseholders' interest £66,000

less: landlord's interest £11,736

= £87,264

Assume split 50:50 = £43,632

Possible premium £55,368

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 landlord 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 purposes 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 a lease of 95 years unexpired

i) Valuing the term

Ground rent x YP 95 years @ 8%

£50 x 12.49 = £624

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 the current market value, (taken as £165k) with no improved value applicable.

Current value x £165,000

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

= £110

Landlord's interest = £734

iii) Marriage Value

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

Possible premium = £734

In this case the longer lease may produce a marginally higher value for the term but the reversion is almost without value.

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	£620
	reversion	£880
		£1,500
Variations		
using 6%	term	£817
	reversion	£3,135
		£3,952
using 7%	term	£707
	reversion	£1,657
		£2,364
using 9%	term	£554
	reversion	£470
		£1,024
using 10%	term	£499
	reversion	£253
		£752
using 11%	term	£454
	reversion	£137
		£591

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.

Addendum

Changes to Yield Rates

- The examples in this advice note are worked from a Yield Rate of 8%, which was relevant at the time of drafting; yields vary from time to time and this yield may not be necessarily be appropriate today.
- Sportelli rate - In September 2006 The Lands Tribunal issued a determination in Cadogan v Sportelli in which the Tribunal sought to impose a nation-wide deferment rate (the yield used for calculation of the value of the reversion) of 5%. In most cases, the Leasehold Valuation Tribunals are following this ruling.

  The effect of the reduced deferment rate has been to increase the value of the landlord's interest.

  There is a further note on Sportelli on the website.