

## The Quest for the Holy Grail Part IV



"A paradox,  
That most ingenious paradox!  
We've quips, and quibbles heard in flocks,  
But none to beat that paradox!"

Gilbert and Sullivan words could be describing the "Paradox" facing the Law Commission's Terms of Reference which seeks to satisfy opposing interests:

*"set out the options for reducing the premium payable by existing and future leaseholders to enfranchise, whilst ensuring sufficient compensation is paid to landlords to reflect their legitimate property interests;"*

in addition, they have been asked to

*"produce options for a simpler, clearer and consistent valuation methodology; and make enfranchisement easier, quicker and more cost effective (by reducing the professional costs), particularly for leaseholders, including by introducing a clear prescribed methodology for calculating the premium."*

This follows on from the Lord Justice Lewinson's plea that hopefully *"The Holy Grail will one day be found"* in the Court of Appeal case of [Adrian Howard v The Trustees of The Sloane Stanley Estate \[2018\] EWCA Civ 35](#) .  
*" which will hopefully satisfy both Leaseholders and Freeholders"* as discussed in, ["The Quest for The Holy Grail Part I"](#).

## The Leasehold Reform Bill

One solution, which has been put forward by Justin Madders MP (Ellesmere Port and Neston) as a Private Member's Bill which seeks to limit premiums to just 10 X ground rent and removing the requirement for lessees to pay Landlords "reasonable fees" (Section 33 and section 60 costs). Based on the [DCLG Research](#) there are 4.2 million leasehold properties (only 53% of which are made up of owner occupiers, the remainder are mainly private landlords).

On the assumption that these leases had an/a

1. average of 81 years unexpired
2. average value of £200,000
3. ground rent of £150

The premium under the existing system would be approx £5000 and Landlords Fees approx. £1500. The Madders formula would limit this just £1500.

Therefore, the savings under the Madders formula be £3500 plus for the premium and £1500 in fees. The total package based upon these figures would cost Landlords a staggering £22 billion approx!

There is a strong possibility these Landlords could successfully seek compensation for these losses from the Government under Article 1 of the First Protocol to the European Convention of Human Rights ("A1P1").

Although there probably isn't much sympathy for the dispossessed private Landlords, surprisingly the biggest Landlords include organisations that generally need as much support as possible:

- Local Councils
- Housing Associations
- Pension Funds

Whilst there may be some justification for assisting owner occupiers with these costs, at a rather conservative potential price tag of £12 billion, I'm not sure that will be a spending priority.

I certainly don't believe there is an appetite for subsidising the other 1.8 million private landlords who own leasehold flats at a cost of £10 billion.

These figures are just an estimate in-order to get an idea of the total costs. There is a huge variation in premium depending upon the value of the flat and the unexpired term of the lease.

The other problem with the Bill is that it is "a one size fits all" and it creates a premium based only upon the arbitrary ground rent, which is likely to lead to greater unfairness in the future, with the biggest beneficiaries being private landlords who own expensive flats with short leases, in Prime Central London.

## Current Valuation Practice

The current valuation practise for establishing the premium for flats can appear to be quite complex to the non-practitioner, but by using modern methods of valuation, such as spreadsheets which have the formulae pre-loaded, it is generally quite straightforward.

- The Premium is effectively the Compensation to the Landlord who will lose the ground rental income and the right to take possession of the flat at the end of the Term (Reversion) either for a further 90 years (the new lease extension term which is added to the existing term) or indefinitely in the case of Collective Enfranchisement. It is calculated by adding together the
  - I. The Capitalised Ground Rent
  - II. The Value of the Reversion
  - III. Marriage Value (If the flat has 80 years or less unexpired)
  - IV. Occasionally there is also Development Value
- The valuation logic for both I. and II. is that the future value of an income or an asset is worth less than it would be if you had the same income or the asset today. This discount depends upon the risk associated with waiting for income or the asset to mature. Therefore, in times of high inflation, the risk increases, so one might expect the discount rate would increase and vice versa. There are other factors that influence this risk such as the general level of interest rates. If interest rates rise, then the opportunity cost of holding money in that income or asset also rise, so the discount would increase and vice versa.

- For those who have an enthusiasm for mathematical formulae
  - I. The Capitalised Ground Rent is found by multiplying the ground rent by the Present Value of £1 per annum also known as **Years Purchase**.  $YP = 1 - PV/i$  (see below for the **Present Value** formula)
  - II. The Reversion is found by multiplying the Freehold Value by Present Value.  $PV = 1/(1 + i)^n$
- These valuations can be tedious but there are many web sites that have these calculators included and I tend to use [www.toolbar.co.uk](http://www.toolbar.co.uk)

### Capitalised Ground Rent

This value is ascertained by adding future ground rental income but discounting this future income flow at an appropriate discount Rate i.e. **the Capitalisation Rate**. I discussed the main issues that surrounding this part to the valuation in [The Quest for the Holy Grail Part III](#).

My conclusion was as follows:

*"I suggest the following rates would be a good starting position:*

- 1) *Small fixed incomes should be at approx 7.00%*
- 2) *Ground Rents that double every 25/33 years should be at 6.50 %*
- 3) *Ground rents that increase every 15 years by RPI should be at 5.85%" (using EYF)*

Using these Capitalisation Rates, I have carried out many calculations on each rent profile between 25 and 125 years which reveals the following average **Years Purchase** which can be a simple substitute for capitalising the ground rent. There is very little variation in these figures until the unexpired term fell below 25 years, when the **Years Purchase** started to fall significantly. Therefore, if it is felt there is a need to apply a simple calculator for establishing the Capitalised Ground Rent then the table below could be used for leases with a greater unexpired term of 25 years.

For terms below this level a straight-line deduction could be used from the 25-year YP at the figures shown below to a Zero YP at the end of the lease:

Ground Rent Profile	Ground Rent Multiplier (YP)
Fixed Ground Rent (No rent reviews)	14
Ground Rent with 33 Year Reviews: increase by £50 increments	16
Ground Rent with 25 Year Rent Reviews: Double at each review	19
Ground Rent with 15 Year Rent Reviews: increase by RPI	27

### Onerous Ground Rents such as 10 Year Doublers

I have been unable to find any market evidence and there is little consensus on valuing them. However, I have calculated the **Years Purchase** adopting a Capitalisation Rate of 6%. The results are an "eye watering" **190 YP** at 125 Years unexpired; **127 YP** at 100 Years; **83 YP** at 75 Years **46 YP** at 50 Years and **25 YP** at 21 Years. This approach was supported in [Ground Floor & First Floor Flats 13 St. Martins Avenue LON/00BB/OC9/2015/0277](#).

## The Value of the Reversion

This is the most straightforward calculation and it involves carrying out a valuation of the flat, on the assumption it had a share of Freehold and unencumbered by a lease. Effectively it has been accepted by valuers and tribunals that this is the same as the Long Lease Value with a 1% addition. Since the Sportelli Case determined that Flats should use a 5% Deferment Rate, apart from in the Midlands, this rate is universally applied.

The valuation merely applies a discount rate of 5% (Deferment Rate) to the Share of Freehold Value for the unexpired term.

## Marriage Value

Marriage Value only applies to Leases of 80 years or less and is defined as the additional value brought about by “marrying” two interest together, the freehold and the short lease. In Lease Extensions, the Landlord retains the Freehold, but effectively this is usually only of nominal value after the lease is extended. To calculate this sum, it is necessary to carry out a “**Before and After Valuation**”. The additional value is “marriage value” and the Landlord is entitled to 50%.

When calculating the marriage value, it can be difficult to assess the value of a short lease as there is a scarcity of evidence. To assist this process, most surveyors rely on Graphs of Relativity, a summary of which are contained the [RICS Research Report 2009](#).

## Relativity<sup>1</sup>

In “[The Quest for the Holy Grail II](#)”, I discussed the difficulty in finding reliable short lease evidence and I questioned:

- *Why would anyone sell a short lease, when they could sell a long lease without having to find the costs before embarking on the process?*
- *If evidence is found, is it an arm’s length transaction? Why was the flat sold? Could it have been a forced sale? Were both sides professionally advised?*
- *With such few sales, can there really be a true “Market”?*
- **Is it time for a Statutory Graph?”**

In the following recent cases the Tribunal rejected so called “market evidence” and all “Auction evidence”, which would have resulted in a much higher Premiums:

- In [Flat A, 431 New Cross Road, New Cross, London, SE4 6TA \(LON/IR/LON/00AZ/OLF/2017/1393\)](#)

the Judge questioned “market evidence” concerning the sale of 3 flats in the subject building and stated:

*“There was no clear evidence as to the marketing method employed in relation to the three flats’ No agents’ sales particulars were included in the trial bundle, the Estate Agent was based in Northampton, and this raises a question as to the marketing of the flats., and whether they were fully exposed to the market.”*

- In [Flat 2a St George’s Road, Leyton, London, E10 5RH \(IR/LON/00BH/OLR/2018/0145\)](#) the Judge criticised the short lease comparables:

*“The tribunal also finds that the sales at Grosvenor Court, do not provide good comparable evidence, as the photographs provided to the tribunal showed a purpose-built block of flats on 4 floors with the interiors providing significantly lighter and more spacious accommodation than the subject property. Further, the tribunal considers that Grosvenor Court is located too far from the subject property and in a more upmarket area and the sales relied upon too far from the valuation date”*

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<sup>1</sup> The percentage a Short Lease flat is worth when compared to the Freehold Value (the bigger the differential as shown by a lower percentage, the higher the Premium as this increases the amount of Marriage Value)

- In [21 Clementina Road, Leyton, London, E10 7PD \(LON/00BH/OLR/2017/0976\)](#) the Judge stated that:

*“the tribunal was firmly of the view” that an “auction sale gave rise to a very restricted market for investors and possibly cash buyers only. Therefore, this form of sale does not in the opinion of the tribunal produce a reliable market value”.*

In [“The Quest for The Holy Grail Part I”](#), I produced a table which shows that if there has been a fall in **Relativity** since the RICS Research Report 2009, this can be quantified by the difference in **Relativity** between the Savills Enfranchiseable Graph of 2002 and 2015, as both graphs straddle the period before and after the Research Paper. This approach was suggested in the Mundy Case. The advantage of using these graphs is that they don’t require adjustment for “no act rights”, which can be a rather subjective exercise. See Table below:

Unexpired Term	Savills 2002	Savills 2015	% difference
80	92.4	90.5	2.06
75	90.8	89.1	1.87
70	89.1	87.4	1.91
65	87.2	85.5	1.95
60	85.2	83.4	2.11
55	83.1	80.9	2.65
50	80.7	78	3.35
45	78.1	74.7	4.35
40	75.2	70.9	5.72
35	71.9	66.5	7.51
30	68.1	61.4	9.84

In [Flat A, 431 New Cross Road, New Cross, London, SE4 6TA \(LON/IR/LON/00AZ/OLF/2017/1393\)](#) and [Flat 2a St George’s Road, Leyton, London, E10 5RH \(IR/LON/00BH/OLR/2018/0145\)](#) the tribunal found the best method for working out the Relativity was to adopt the Average of the [RICS Graphs for Greater London and the Rest of England \(Section 2 of the Research Report 2009\)](#) but adjusting them downwards by the Savills Discount as shown in the above table.

We deal with approximately 300 lease extensions per year and have done for several years and the vast majority are agreed with other surveyors within this range.

In my previous [First-tier Tribunal cases where there’s been no reliable market evidence](#), the Tribunals have adopted the average of what it felt were the most relevant graphs.

Therefore, as a broad spectrum, I believe there is a strong argument for setting the Relativity, **Outside Prime Central London** at between the Average of the RICS Graphs and Average discounted by the reduction in the Savills 2002 and 2015 Enfranchiseable Graphs.

In **Prime Central London**, the "Industry Standard" has been Gerald Eve for many years. This was re-enforced by the Mundy decision. To provide a spectrum of valuations I have applied the Savills Discount to Gerald Eve.

On this basis, I have produced 2 tables where I have calculated the premium from 30 to 95 years unexpired. I have established a short-cut method which applies a **Percentage of Market Value** to calculate **The Premium**.

I have also calculated the premium for flats with a value of **£400,000 to £1,000,000** in Prime Central London and **£200,000 to £500,000** outside Prime Central London. The tables are quite useful as they do provide “ballpark” figures at a glance as to the likely cost of a lease extension.

They also show that the increase per year in the premium is approx. 5-6% on the assumption that prices do not increase. However, if prices increase that needs to be added to the cost. On average in London where prices have increased by approx. 7% per annum that would suggest an annual increase in premium of approx 13%!

There surely can't be a better incentive than that for leaseholders for extending their leases as soon as possible.

1. In Prime Central London between the Gerald Eve Graph and the Gerald Eve Graph with the Savills Discount

Prime Central London			Premium range for:		Premium range for:		Premium range for:		Premium range for:	
Years remaining	% of Flat Value		£400,000		£500,000		£750,000		£1,000,000	
95	1.05	1.23	£4,700	£4,900	£5,700	£5,900	£8,100	£8,300	£10,500	£10,700
90	1.38	1.40	£5,800	£6,000	£7,100	£7,300	£10,100	£10,300	£13,200	£13,400
85	1.74	1.78	£7,300	£7,500	£8,800	£9,100	£12,800	£13,000	£16,700	£16,900
80.01	2.20	2.30	£9,100	£9,300	£11,100	£11,300	£16,100	£16,400	£21,200	£21,400
79.99	4.35	5.42	£17,700	£21,700	£22,000	£26,900	£32,800	£40,100	£43,500	£53,300
75	5.90	6.88	£24,000	£27,500	£29,800	£34,200	£44,400	£51,000	£59,000	£67,700
70	7.79	8.70	£31,600	£34,800	£39,300	£43,400	£59,600	£64,600	£77,900	£85,900
65	9.77	10.75	£39,600	£43,000	£49,300	£53,500	£73,500	£79,800	£97,700	£106,200
60	11.88	12.90	£48,000	£51,600	£59,800	£64,200	£89,300	£95,900	£118,800	£127,500
55	14.14	15.35	£57,100	£61,400	£71,100	£76,500	£106,300	£114,200	£141,400	£152,000
50	17.12	18.55	£69,000	£74,200	£86,000	£92,500	£128,600	£138,200	£171,200	£183,900
45	20.36	22.10	£82,000	£88,400	£102,300	£110,200	£153,000	£164,700	£203,600	£219,200
40	23.95	26.05	£96,400	£104,200	£120,300	£129,900	£179,900	£194,300	£239,500	£258,700
35	28.47	31.00	£114,600	£124,000	£142,900	£154,700	£213,800	£231,300	£284,700	£308,000
30	33.53	36.13	£134,900	£144,500	£168,300	£180,300	£251,800	£269,700	£335,300	£359,100

1. Assumed Nominal Ground Rent of £50 doubling every 33 years. A higher ground rent and more frequent reviews will increase premiums
2. This guide should only be used to arrive at a 'Ballpark' figure, we recommend a full inspected valuation should be carried out prior to purchase or serving Notice on the Freeholder/Head Lessee
3. This guide assumes there is no short lease evidence available. However, you should note that the purchase price of this short lease property and others may increase the premium significantly

2. In Greater London and the rest of England between the average of the RICS Graphs and the average of the RICS Graph with the Savills Discount

Guide to Premiums Outside Prime Central London			Premium range for:		Premium range for:		Premium range for:		Premium range for:	
Years remaining	% of Flat Value		£200,000		£300,000		£400,000		£500,000	
95	1.14	1.50	£2,800	£3,000	£3,700	£3,900	£4,700	£4,900	£5,700	£5,900
90	1.42	1.80	£3,400	£3,600	£4,600	£4,800	£5,800	£6,000	£7,100	£7,300
85	1.76	2.15	£4,100	£4,300	£5,700	£5,900	£7,300	£7,500	£8,800	£9,100
80.01	2.22	2.65	£5,100	£5,300	£7,100	£7,300	£9,100	£9,300	£11,100	£11,300
79.99	2.28	3.50	£5,100	£7,000	£7,100	£10,200	£9,200	£13,300	£11,400	£16,500
75	3.40	4.55	£7,100	£9,100	£10,400	£13,300	£13,700	£17,400	£17,000	£21,600
70	5.06	6.20	£10,500	£12,400	£15,400	£18,200	£20,300	£24,100	£25,300	£29,900
65	7.16	8.35	£14,800	£16,700	£21,800	£24,600	£28,800	£32,400	£35,800	£40,300
60	9.46	10.70	£19,400	£21,400	£28,700	£31,600	£38,000	£41,900	£47,300	£52,100
55	12.52	13.95	£25,600	£27,900	£37,900	£41,300	£50,300	£54,800	£62,600	£68,300
50	16.00	17.65	£32,500	£35,300	£48,300	£52,400	£64,200	£69,500	£80,000	£86,600
45	21.08	22.95	£42,700	£45,900	£63,600	£68,300	£84,500	£90,700	£105,400	£113,100
40	25.56	27.80	£51,800	£55,600	£77,100	£82,700	£102,500	£109,900	£127,800	£137,100
35	29.42	32.10	£59,600	£64,200	£88,700	£95,600	£117,900	£127,100	£147,100	£158,500
30	33.34	36.20	£67,400	£72,400	£100,500	£107,900	£133,600	£143,400	£166,700	£178,900

1. Assumed Nominal Ground Rent of £50 doubling every 33 years. A higher ground rent and more frequent reviews will increase premiums
2. This guide should only be used to arrive at a 'Ballpark' figure, we recommend a full inspected valuation should be carried out prior to purchase or serving Notice on the Freeholder/Head Lessee
3. This guide assumes there is no short lease evidence available. However, you should note that the purchase price of this short lease property and others may increase the premium significantly

This is the last in the 4-part series of Articles written entitled "The Quest for the Holy Grail"  
It began in January 2018 as a result of the Court of Appeal Decision in the Mundy Case.

[Part 1](#) dealt with the issue of falling Relativities discussed in the Upper Tribunal Mundy Decision:

*"Structural changes in interest rates and rates of investment returns, changes in the nature of the market such as an influx of foreign buyers, and changes in the institutional and legal structure of the residential market"* and the possible solution to correct the graphs in the RICS Research Paper 2009 by using the difference in the Savills 2002 and 2015 Graphs which straddle the period prior to and after the Banking Crisis in 2008.

[Part 2](#) discussed the problems in finding short lease evidence and whether once found they could be relied upon. The possibility using a Statutory Relativity Rate was raised.

[Part 3](#) discussed the Capitalisation Rate post the "All Saints" decision and concluded *"it wasn't the radical departure from conventional wisdom that we were led to believe"*. It dealt with Law Commissions Consultation Paper and I suggested the Rates which had been commonly been accepted and could be used in any future Statutory Rate. I also dealt with onerous ground and discussed the problems of valuing them.

Part 4, this Article, brought all these strands together and suggested a simple percentage of the Freehold Value to establish the Premium. I provided 2 "easy to use Lease Extension Ready Reckoner", showing a table of Premiums, all together for the 1<sup>st</sup> time, for varying lease lengths. It also suggested a simple Ground Rent multiplier (YP) that could be used to capitalise different Ground Rent profiles.

I'm not sure what the outcome of the Law Commission's Consultation will be. I've heard from many people that not much will change occur, but I don't believe that will be the case. The "cork is out of the bottle" ever since the "Parthenia Model" was rejected in the Mundy case and the Taylor Wimpey scandal focused attention on Leasehold abuse. I believe the current system has several faults and it is commendable that so many people have come together to try to reform it. However, there's a need for balance and I am hopeful that this ongoing dialog and discussion will bring about a system of land ownership that is built on the best of the past but is fit for the 21<sup>st</sup> Century.

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

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