COMMONHOLD AND LEASEHOLD REFORM ACT 2002

VALUATION FOR LEASE EXTENSION

Valuation issues for lease extension for flats
This booklet 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 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), 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; 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 50:50 division between the landlord and the leaseholder. In the calculation of the marriage value the leaseholder’s 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 Tenant’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 diminution in the 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, 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 leaseholder’s 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.

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 an unexpired term of 68 years, a ground rent of £50 per annum and a present market value (with the existing lease) of £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% is 12.433

So, ground rent £50 x 12.433 = £622

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.*

**ii) calculating the reversion**

Current value of the flat = £150,000

* (the leaseholder’s 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 increase in the value of the flat. The amount of this increase 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, 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 grant of a new lease 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, 5%. Following a case known as Sportelli, the 5% deferment rate was set nationally. Since then there have been several cases that have successfully challenged this. Therefore we adopt 5% only for illustrative purposes.

\[
\text{Present value £1 deferred 68 years @ 5\% is 0.03623}
\]

\[
\text{So, £165,000 x 0.03623 = £5,978}
\]

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 it is often disregarded:

\[
\text{Reversion to capital value after the grant of the extension}
\]

\[
\text{PV £1 deferred 158 years (68 + 90) is 0.0004488}
\]

\[
\text{So, £165,000 x 0.0004488 = £74}
\]

Therefore the diminution in the landlord’s interest is:

\[
\begin{align*}
\text{term} & \quad £622 \\
\text{plus: reversion at 68 years} & \quad £5,978 \\
\text{less: reversion at 158 years} & \quad £74 \\
& \quad = £6,526
\end{align*}
\]

(iii) Aggregating the diminution in the landlord’s interest

The marriage value

As described on page 3, 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 leaseholder’s 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 = £ 6,600

= £156,600

ii) leaseholder’s new interest = £165,000

plus landlord’s new interest = £ 74

= £165,074

The marriage value is therefore £165,074 minus £156,600 = £8,474

Taking the 50:50 split between the landlord and the leaseholder, the
leaseholder would have to pay half this figure – £4,237 – 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.

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 = £6,526
marriage value x 50% = £4,237
possible premium = £10,763

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

Completing the valuation

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

● the yield rate for both the term and the reversion;
● the increase in the value of the flat.

These differences are illustrated by further examples in the Appendix (see page 9).
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 £10,800. Therefore the leaseholder has a ‘profit’ from the transaction of £4,274 (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 comparing 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.

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.

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 Tenant’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 LEASE.
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 (see page 5), and the variations can be compared.

To recap on the original valuation:
- a flat with unexpired term of 68 years, ground rent £50 pa, current value £150k, improved (long lease) value £165k
- Landlord’s interest: term £622
  - plus reversion £5,978
  - less proposed interest £74
  - = £6,526
- Marriage value £8,474 x 50% = £4,237
  - = £10,763
Assume same situation but with a lease of only 50 years unexpired

i) Valuing the term

Ground rent x YP 50 years @ 8%*

\[ £50 \times 12.233 = £612 \]

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 £95,700 or around 58% of long-lease value.

Improved value = £165,000

x PV £1 deferred 50 years @ 5% = 0.0872

= £14,388

Less reversion to capital value after the grant of the extension

PV £1 deferred 140 years (90 + 50) is 0.0011 @ £165,000

= £182

Landlord’s interest = £14,818

iii) Marriage value

Improved value = £165,000

plus proposed interest £182

less: leaseholders’ interest £125,000

less: landlord’s interest £15,000

= £25,182

Assume split 50:50 = £12,591

plus landlord’s interest = 14,818

Possible premium £27,409

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 greater margin between the current value of a flat with a short lease, and its value with the new lease, has the effect of greatly increasing the marriage value.

*These yield rates are used for purposes of comparison with the other examples; a valuer would not necessarily apply these rates.
**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 = £625

ii) Valuing the reversion

With a long unexpired term of 95 years the value of the flat 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 increased value applicable.

Current value x £165,000

x PV £1 deferred 95 years @ 5% = 0.00971

= £1,602

Less reversion to capital after the grant of the extension

PV £1 deferred 185 years (90+95) is 0.0001202

x £165,000 = £20

Landlord’s interest = £2,207

iii) Marriage value

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

Possible premium = £2,207

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

Similarly there is no marriage value.

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**Effect of differing yield rates**

The yield rates 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 leaseholder’s interests will lead their valuers to differing conclusions on the appropriate rate.

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Useful addresses

Leasehold Valuation Tribunals
Residential Property Tribunal Service (RPTS) National Helpline:
Tel: 0845 600 3178  Website: www.justice.gov.uk

Wales
1st Floor, West Wing, Southgate House, Wood Street, Cardiff CF10 1EW
Tel: 029 2092 2777  Fax: 029 2023 6146
Email: rpt@wales.gsi.gov.uk  Website: http://wales.gov.uk

Other useful addresses

Her Majesty’s Stationery Office (HMSO)
Copies of all legislation regulations and other official publications can be downloaded from www.legislation.gov.uk.
Alternatively printed copies can be purchased from:
The Stationery Office Ltd (TSO),
PO Box 29, Norwich, NR3 1GN)
Tel: 0870 600 5522
Online ordering: www.tsoshop.co.uk

Association of Residential Managing Agents (ARMA)
178 Battersea Park Road, SW11 4ND
Tel: 020 7978 2607  Fax: 0207 498 6153
Email: info@arma.org.uk  Website: www.arma.org.uk

Association of Retirement Housing Managers (ARHM)
Southbank House, Black Prince Road, London SE1 7SJ
Tel: 020 7463 0660  Fax: 020 7463 0661
Email: enquirers@arhm.org  Website: www.arhm.org

The Royal Institution of Chartered Surveyors (RICS)
12 Great George Street, Parliament Square, London SW1P 3AD
Tel: 0870 333 1600 Email: contactrics@rics.org  Website: www.rics.org

The Federation of Private Residents’ Associations
PO Box 10271, Epping CM16 9DB
Tel: 0871 200 3324 Email: info@fpra.org.uk  Website: www.fpra.org.uk