

LON/LVT/1815/05

Leasehold Valuation Tribunal for the London Rent Assessment Panel

Decision of the Leasehold Valuation Tribunal on an Application under s.21 of the Leasehold Reform Act 1967.

Applicant:	Earl Cadogan
Respondents:	Stephen L. Pitts and Yue Wong (Tenants)
Premises:	35, Hans Place, SW1X 0VZ
Heard:	14 th , 15 th March 2006
Appearances for Landlord:	Mr Philip Rainey of Counsel instructed by Miss A Booth of Pemberton Greenish, solicitors Mr Keith Gibbs FRICS of Gerald Eve Mr Peter Clokey FCA of PriceWaterhouseCoopers
Appearances for Tenants:	Mr Andrew Walker of Counsel instructed by Mr J Stephenson of Bircham Dyson Bell, solicitors Mr Charles Cronin BSc(Econ)
Members of Leasehold Valuation Tribunal:	Mrs J. McGrandle BSc, MRICS, MRTPI Mr F. James FRICS
Date of Decision:	26 April, 2006

1.0. Introduction

1.1 This is an application made by Earl Cadogan ("Cadogan") as freeholder for the determination of the enfranchisement price at 7th June 2004, the date that the claim for the freehold was received, for the freehold interest under s.9 (1c) of the Leasehold Reform Act 1967 as amended by the Leasehold Reform, Housing and Urban Development Act 1993 in respect of the house and premises at 35 Hans Place, SW1 ("the property").

1.2. The respondents, who acquired their interest in May 2002, hold the property under a lease dated 14th December 1979 for a term of 65 years less 3 days from 29th September 1976 until 26th September 2041. The unexpired term at the date of the valuation is 37.3 years. There are no intermediate interests. The rent payable under this lease is £500 per annum rising to £1000 per annum in September 2010 and £2000 per annum in September 2026.

2.0 The Property

2.1. Hans Place is located on the west side of Sloane Street and just south of Harrods in one of Central London's prime residential areas. There is a communal garden. The property is a late Victorian red brick terraced house on six floors (basement, ground and four upper floors) and has a GIA of 5,872 sq.ft.

2.2. The Tribunal were familiar with the location and had before them a description of the property. It was agreed between the parties that there was no need for an inspection.

3.0. Agreed Facts

3.1. It was agreed that the unexpired term should be capitalised at 5.0% and 5.5%, that the unimproved freehold VP value was £4,750,000 and that the unimproved leasehold VP value was £3,000,000. The valuation date was 7 June 2004.

4.0 Issues

4.1. All elements of the valuation were agreed save the deferment rate, Mr Gibbs and Mr Clokey for the applicant contending for 4.5%, alternatively 3.6%, and Mr Cronin for the respondents 6.90%.

4.2. Accordingly Mr Gibbs sought an enfranchisement premium of £1,343,000 whereas the respondents' figure, set out in a valuation attached to their statement of reply dated 7th March, 2006, was £1,080,000.

5.0 Hearing

5.1 By way of background the two financial experts as well as Mr Gibbs were before the Tribunal in the context of the decision in the consolidated appeals known as *Arbib (Arbib v Earl Cadogan LRA/23/2004/2005 et al)* where, on

the question of yield rates the Lands Tribunal stated that in the absence of reliable market evidence the parties should consider providing financial market information in support of yield rates.

5.2. The Lands Tribunal's definition of "deferment rate" is set out in para. 87 of their decision:

"87. The deferment rate is the rate of compound interest that would be needed to be earned on an investment made at the valuation date, in order to produce at the end of the term the capital value which has been determined as being the value as at the valuation date of the interest, which value will however accrue only at the end of the term...."

5.3. While determining in that particular case a deferment rate of 4.5% for a single house the Lands Tribunal cautioned that their decision did not establish a precedent, merely guidance on general principles.

1) The case for the Applicant

5.4. In support of his figure of 4.5% for the deferment rate, Mr Gibbs summarised his evidence thus:

- Continued long-term trend to lower interest rates at the valuation date
- Continued demand for well-located residential property in Central London
- Loss of confidence in equities and perception of residential property as a more attractive option
- Perceived potential for continued growth in residential values in Central London
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5.5. He enlarged upon these points by reference to a number of sources: -

(a) PCL ground rent investments

These showed historically good capital growth, 7.8% per annum over the last 19 years, as witnessed by the Savills Index. In addition there was security of income; minimal outgoings and the potential for early release of capital, by way either of a lease extension or disposal of a freehold.

(b) The "Arbib" Decision

The subject property compared favourably with the last of the Cadogan cases, 9 Astell Street, where a deferment rate of 4.5% was determined.

(c) Property yield rates

Having explained the rationale for distinguishing the yield rate to be applied to capitalisation of the ground rental income from the deferment rate, Mr Gibbs concluded that there was no longer any uncorrupted open market evidence of yields for long

leasehold single houses and he therefore needed to examine the returns available from other investments.

(d) Short-term residential tenancies

The long-term reduction in yield rates as shown in the Savills PCL gross and net yields index demonstrated investors' confidence in the sustained long-term growth potential of PCL residential property. Capital growth had outstripped rental growth, hence driving down yields.

(e) Trends in interest rates

By reference to the annual rate of inflation, Mr Gibbs stated that there was now a much more benign background than when the conventional 6% deferment rate was adopted 30 years ago.

(f) Other investment markets

The London office market, the Freehold Income Trust, long-dated gilt stocks and long-dated index-linked gilts all showed a continuing trend to lower rates.

5.6. Conceding that it was extremely difficult to decide upon the correct deferment rate to adopt for PCL residential investments Mr Gibbs concluded that a deferment yield as accepted in the "Arbib" case could not be too low.

5.7. Mr Clokey, a chartered accountant and partner in PWC was then called on behalf of the applicant to give financial evidence on the deferment rate. He advised the Tribunal that he gave advice to clients on the merits of different types of investments, including the property market, but not on different types of investments within the property market.

5.8. In support of his deferment rate of 3.6%, Mr Clokey stated that there were two elements involved: -

- a) The risk-free rate on the assumption that the capital value of the investment on reversion will have risen at least in line with inflation and
- b) The risk premium, reflecting the risk borne by the freeholder in committing to the investment during the period until the lease expires.

5.9. Mr Clokey assessed the risk-free rate by reference to the redemption yield on the most appropriate dated UK index-linked government bond. The annual yield as at the valuation date was 1.770% for a bond maturing in 2035.

5.10. Mr Clokey considered the risk of a residential freehold reversion to lie somewhere between government bonds and equities in general. This was because residential property values were less volatile than equities and had a low correlation with equities. Using an equity risk premium of 4.5%, a figure adopted by his firm after extensive research, and applying a "beta" (a measure of systematic risk) of 0.4 produced a figure of 1.8% which when added to the risk free rate of 1.770% gave a deferment rate of 3.57%, say, 3.6%.

5.11. In support of his "beta" of 0.4 Mr Clokey referred to the betas of quoted UK property companies and in particular the Grainger Trust which held long-term residential property investments, albeit spread nationally rather than concentrated in PCL.

5.12. Mr Cronin for the respondents was a self-employed financial analyst who had had a broad experience in financial consultancy. He conceded, however, that he had never advised clients on investment in the property market or a purchaser on how to value a freehold reversion. He was unaware of any purchaser using his method to value a freehold reversion. In support of his deferment rate of 6.9%, he approached the matter from the point of view of an occupier rather than an investor.

5.13. Mr Cronin contended that the material difference between a freehold in possession and a reversion was the possession of the property and that this possession could be implicitly valued by comparison with the explicit costs of occupation, using as a check gross rental yields for short term residential tenancies.

5.14. Mr Cronin assessed the costs of owner-occupation by reference to mortgage interest payments, depreciation, repairs and maintenance, insurance, supported by well known statistical sources. He showed that trends in Greater London were equally applicable to PCL.

5.15. As a check, he then looked at the explicit cost derived from gross rental yields. Analysing Savills' gross rental yields index and stating that rental yields shadowed movements in the cost of occupation, he concluded that his deferment rate of 6.9% was supported.

6.0 Submissions

6.1. On behalf of the respondents, it was Mr Walker's case that the Tribunal was in a new situation of having to assess financial evidence following *Arbib* and therefore new theories as put forward by Mr Cronin were to be welcomed. While Mr Gibbs for the applicant concluded on a general picture of falling interest rates he was unable to link this trend to the precise task in hand, the settling of a deferment rate for the subject property. Mr Clokey was not commenting on how a property investor would value a freehold reversion; his approach was too theoretical. Further, he was unable to say what proportion of the residential property market his quoted property companies represented. There was no direct link between gilts and the property market. The minimum figure for the risk free rate should be 2%. Mr Clokey's overall figure of 1.8% for the risk free premium involved a compounding of weaknesses. In particular, his use of stock market, quoted property stocks and asset betas was unreliable as a source for finding the property risk premium. Mr Cronin's evidence, including his deferment rate of 6.9%, should be accepted.

6.2. On behalf of the applicant, it was Mr Rainey's case that Mr Gibbs, in proposing a deferment rate of 4.5%, was putting forward the same evidence that was accepted by the Lands Tribunal in *Arbib*. There was therefore no reason to divert from that evidence. Mr

Gibbs had assessed a risk-free rate and a risk premium derived by a property valuer: Mr Clokey had taken a similar approach with an adjustment based on the capital market: Mr Cronin, on the other hand, had approached the deferment rate by deriving it from the cost of occupation.

6.3. The problem with Mr Cronin's theory was that the loss of possession to the investor could not be valued by the cost of occupation to the occupier. The value to the investor and the cost to the occupier were different concepts. Mr Clokey's approach might be novel to the assessment of the deferment rate but it was not novel in other contexts whereas Mr Cronin's approach was unique to him and not supported by peer groups.

7.0. Decision

7.1. The Tribunal in arriving at their decision took into account the views expressed in the Lands Tribunal appeals known as *Arbib* which were that each case should be considered individually and determined on its own merits and not on a standard LVT rate.

7.2. The deferment rate as defined by *Arbib* is the rate of compound interest that would be needed to be earned on an investment made at the valuation date, in order to produce at the end of the term the capital value. This latter value has been determined as being the value as at the valuation date, which value will however accrue only at the end of the term.

7.3. To assess the deferment rate the Tribunal had to assess the individual characteristics of the subject property, described in an earlier paragraph, and the place where that property sits in the open market. In this particular case, the market is the property market and in particular the residential market for PCL properties and the subject property a single house in a prime area of Central London.

7.4. Comparisons were made in the evidence of Mr Gibbs and Mr Clokey with many differing types of asset. The Tribunal is of the view that their evidence still overlooks the fact that property, by its nature, perhaps because of its high acquisition costs, has a tendency to be slow moving and, unlike gilts, not traded freely. Institutions may be increasing their investments in property but generally the proportion invested in property is small and the institutions are selective in their approach. Changes in the deferment rate, while affected by changes in the overall investment, do so only slowly and over a relatively long period of time and certainly not in the period of months between the *Arbib* Astell Street valuation date, for example, and the valuation date in this case.

7.5. The valuers for the parties, of whom only Mr Gibbs appeared, agreed a capitalization rate of 5% and 5.5% which does show that rates have fallen, though only marginally, since LVTs were adopting a conventional 6% rate. The Tribunal are not convinced by Mr Gibbs' argument that long term interest rates will fall. Capital values are hardening and there is not a clear case for saying that they will increase sufficiently quickly to make up the difference in yields when investors consider the return on their overall portfolio of investments.

7.6. Mr Clokey, in speaking to a figure of 3.6%, was reliant on returns in the stock market. These are known to be volatile and the Tribunal could not attach too much weight to this evidence. The figures are too low and it would need substantial capital growth in the property market to meet investors' yield expectations which in the present case had not been proved.

7.7. Mr Cronin relied on an approach which is novel and which has not been adopted by property professionals. It relies on the cost of occupation, a large proportion of which is the mortgage interest rate. Property owners in this part of Central London tend to be less reliant on mortgages. The mortgage rate is subject to fluctuations in bank rate which while affected by the housing market to some extent is not property based. Further, an investor does not look at the cost of occupation; that is the concern of the tenant.

8.0 Conclusion

8.1. Having taken all the evidence into account, and in particular the prime location of the property, a single house, the Tribunal determines the deferment rate @ 4.5%. The Tribunal's valuation, giving an enfranchisement price of £1,342,895, is attached as Appendix 1.

CHAIRMAN..... *J. McCrandall* .

DATE..... *26th April 2006* .

7460

Ground Rent from 2026 2000.00

YP for 15 Years @ 5.5% 10.04

PV of £1 in 22/3 Years @ 5.5% 0.303 3.04

6080

Revn to Freehold 4750000

PV of £1 in 37.3 Years @ 4.5% 0.1936

919600

Lessors Interest 935790

Marriage Value

Freehold Value 4750000

Less

Value Lessors interest 953790

Value Lessees interest 3000000

3935790

Gain 814210

Lessors Share 50% 407105

Enfranchisement Price 1342895

Compensation

Nil

Other Losses

Nil