

ENFRANCHISEMENT TOOLBOX FOR PROPERTY MANAGERS



Property managers are frequently asked by clients and leaseholders for advice on specialist topics. By trying to be helpful they also frequently become unstuck. Although as in most professions, practitioners tend to specialise, clients often expect us to have in-depth knowledge of a wide spectrum of specialist areas. The key to success is to have a good understanding of the basics, understand the limits of our knowledge (and PI insurance) and know where to direct clients for expert advice and excellent service.

One such area is the leasehold enfranchisement of flats. Whilst a relatively simple concept, landlords and leaseholders are still keeping tribunals and courts busy 25 years after the Leasehold Reform, Housing and Urban Development Act was passed in 1993. (Houses can, of course, also be enfranchised but I will deal with that here).

LEASE EXTENSIONS

In simple terms, a lease extension is the right for a leaseholder who has owned a flat for more than two years to obtain a 90-year extension

to their existing lease, with the rent being reduced to a peppercorn ground rent (a peppercorn being historically the lowest form of consideration).

The process involves the leaseholder issuing a notice of claim to the landlords and parties to the lease setting out the property, the terms of the lease, a quoted premium and a counter notice date (two months after the notice). The landlord has two months to serve a counter notice accepting the validity of the notice and proposing a higher premium or refuting the notice. The leaseholder must then make their application to the tribunal between two and six months from the counter notice. This mandatory timetable must be followed, or rights can be lost for either party.

COLLECTIVE ENFRANCHISEMENT

Collective enfranchisement is more complicated. It is the collective right of more than 50% of leaseholders in a building to buy the freehold of the building and either the freehold or perpetual rights over other areas. The building

must qualify for collective enfranchisement by being structurally detached and having no more than 25% non-residential (i.e. commercial) space.

The building qualifications are the same for a collective and a 'right to manage'. Some leaseholders choose RTM first to gain control more quickly, following up with a collective. Whilst the notices differ from those of a lease extension, the process is broadly similar. A lease extension is more straightforward in that it is continuation of the existing lease regarding the extent of the flat and the terms (save for updating permitted terms). A collective is more complicated in that it acquires the freehold and extended rights. These include the whole building, including non-demised elements such as roof spaces and basements, all of which can lead to issues over development values.

In terms of valuation the mechanics are broadly similar.

LANDLORDS AND LEASEHOLDERS ARE STILL KEEPING TRIBUNALS AND COURTS BUSY 25 YEARS AFTER THE LEASEHOLD REFORM

Due to the critical timetable for counter notices, remember always to pass notices received onto clients and their legal advisers immediately!

The leaseholder(s) are also responsible for their own and the landlord's reasonable valuation and legal costs.

LANDLORD'S VALUE

This consists of the landlord's investment value and has three parts:

1. The term/capitalisation rate

Ground rents are capitalised by valuing them at a yield (the capitalisation rate). Until lately they have been the least contentious element but are now being challenged before tribunals. The recent so-called 'ground rent scandal' involved cases in which ground rents had been maximised to the landlord's advantage at review, in some instances doubling every 10 years and escalating to large sums of money. As ground rents have historically been low they made for relatively dull, low-value investments. Now, they are potentially much more dynamic and of far greater value.

There is a further twist currently unravelling. Some pension funds have been acquiring ground rent investments from developers who argue that they 'seek to protect their reputation' by selling to approved investors at low yields and high prices. This evidence is then used to justify higher revaluations of their

retained investments. This has made the argument over capitalisation rates extremely pertinent to freeholders and some critical decisions are awaited which will no doubt be appealed due to the sums involved.

There is also an anomaly in respect of lease extensions and intermediate leases. Only the ground rent on the leaseholder's lease is reduced and not the ground rent on any intermediate leases. This can



leave a head leaseholder with a negative rent, although they are compensated for.

2. Reversion/deferment rate

This is the current value of the landlord's right to repossess the flat when the lease expires, although there can be rights to retain occupation as an assured tenant at market rent – a fact many leaseholders are shocked to discover!

It is valued by deferring the existing freehold value of the flat by an investment yield known as the deferment rate. In the same way that capitalisation rates are now being challenged, this was a fiercely contested issue which culminated in a fixed yield of 5% for flats being determined ('Sportelli'). However, this can be adjusted if the evidence shows that long term growth is lower or capital values are low resulting in the increased risk of obsolescence such that the cost of long term repair outweighs the property value.

The prolonged period of low interest rates is resulting on pressure for this to be challenged again.

3. Marriage value/relativity

Marriage value is the net gain in value from extending a lease – also the reason for the collective as the new resident's company will grant the extension to the participants. It

is divided equally between the landlord(s) and leaseholders. In simple(ish) terms it is the extended lease value (whether it be the original term plus the 90-year extension or a 999 lease for collectives) less the sum of the existing interests i.e. the landlords' and the existing leasehold interests.

Where leases have less than 80 years unexpired, marriage value is payable (but only in full for participants in a collective). The price of the lease extension is likely to be significantly higher if the unexpired term drops below 80 years with marriage value payable.

To calculate the price, the existing lease value must be assessed. The problem here is that we must assume that the flat or building in itself does not have the right to a lease extension or collective i.e. the 'no-act flat/building' and so market evidence cannot be directly applied since it includes the ability to extend or enfranchise within the price.

We therefore look at market evidence adjusted for Act rights or relativity graphs of which there are several. Attempts to find a common graph have failed and recent arguments over alternative methods have now failed ('Mundy'). Relativities change dependent on locations and market dynamics. For example, south coast retirement locations

which are less mortgage dependent tend to have higher relativities.

The introduction of a prescribed relativity may well be on the cards. However, the Court of Appeal recently described this as the Holy Grail of enfranchisement.

DEVELOPMENT VALUE/HOPE OF MARRIAGE VALUE

With a collective, the landlord's value includes other elements of development value such as non-demised flats, roof spaces, air spaces and basements. The issue of development value is a complicated one, taking into account what is possible in terms of existing leases, rights, planning and risks.

Investors may pay a slug of this potential in a collective known as 'hope of marriage value'.

If there are non-participants with leases of less than 80 years (marriage value is not payable above 80 years), the leaseholders would pay marriage value on future lease extensions. The investment market also pays a slug of this for the 'hope' of it being released in the future.

The above rolls up into the value of the landlord's interest.

NON-PARTICIPATORS

Where participation is less than 100%, as is generally the case except for small blocks, the value of the non-participants' element must be funded by the participants, a group of them as an 'investment club' or an external investor known as a 'white knight' – although beware not all of them are gallant!

CONCLUSION

As can be seen from the above, despite 25 years since the Act, enfranchisement is still a complex process. The Government is working with the Law Commission to simplify it with a 'simple prescribed formula'. It is also considering making ground rents on new leases nominal.

My view is that whilst the

lease extension valuation can be simplified mainly through prescribed yields and relativity, this will be less effective for collectives due to the additional complexities of hope/development values, etc. However, by simplifying lease extensions leaseholders will be able to extend their leases more easily to protect their element of value and follow this with a collective.

Getting the right professional team together, whereby the solicitor, valuer and in some cases a barrister are all pulling in the same direction is critical.

Equally critical but even harder is getting a group of leaseholders to do the same. In my experience the key to a successful enfranchisement is binding them altogether and having early open meetings from the outset.

To find the right professionals, check out the ARMA Partners webpage (you can search this by industry to select e.g. solicitors, etc) or the members of the Association of Leasehold Enfranchisement Practitioners (ALEP): www.alep.org.uk.



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