4323

FIRST-TIER TRIBUNAL
PROPERTY CHAMBER
(RESIDENTIAL PROPERTY)

Case Reference	:	**LON/00AN/OLR/2016/0927**
Address	:	**Flats 1A, 15, 23, 24, 51, 61, 62, 70, 128, 129, 143, 165, 166, 169, 177, 178, 180, 181, 187 Kings Court, Hamlet Gardens W6 ORN**
Applicants	:	**The various leaseholders of the above flats**
Representative	:	**Mr Loveday (Counsel) instructed by Bishop & Sewell LLP solicitors**
Respondents	:	**Peak Holdings Limited (First Respondent)** **Kings Court (London) Association Limited (Second Respondents)**
Representative	:	**Mr Fieldsend (Counsel) instructed by Bolt Burdon solicitors**
Type of Application	:	**Grant of new lease (Section 48 Leasehold Reform, Housing and Urban Development Act 1993)**
Tribunal Members	:	**Mr M Martyński (Tribunal Judge)** **Mr L Jarero BSc FRICS**
Date and venue of Hearing	:	**4 October 2016** **10 Alfred Place, London WC1E 7LR**
Date of Decision	:	**11 October 2016**

DECISION

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Decision summary

1. The tribunal adopts the Second Respondent's valuation[1] prepared by Miss Jennifer Ellis FRICS.

Background

2. The subject flats are contained within Kings Court ('the Block') which is a purpose-built block of flats. There are 193 flats in total. All those flats are let on long leases.

3. The freehold interest in the Block is held by the First Respondent.

4. The Second Respondent has a headlease ('the Headlease') of the residential and common parts of the Block. The Headlease is dated 12 December 1990 running from that date to 28 March 2101.

5. Flat number 193 was created from a former tank room at the top of the Block in or about March 2001 and a long lease of that new flat was granted by the Second Respondent at that time. The Second Respondent then acquired that (under) leasehold interest in October 2004.

6. The registered proprietor of the long lease of flat 193 as matters stand therefore, is the Second Respondent.

7. By Deeds of Variation made in November 1990, the rent review dates for the payment of Ground Rent in the various underleases at the Block were varied so as to align with the Headlease.

8. The total rents payable by the underlesses of the 192 flats as from 1990 mirrored the total rent payable by the Second Respondent under the Headlease. As from the creation of Flat 193, the ground rent payable under the lease for that flat created a very small surplus of rent for the Second Respondent.

9. The membership of the Second Respondent is made up of some, but not all, of the long leaseholders in the Block.

10. From 2014 some 35 lease extensions for flats in the Block have been granted at a peppercorn rent. The result of this is to create a negative rent-flow for the Headlease.

11. The Applicants served their Notices of Claim to exercise the rights for the grant of new leases on two different dates, those being 12 & 16 November 2015.

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[1] £11,221 for 12 November notices and £11,460 for 16 November notices as opposed to the Applicant's valuer's figures of £3,916 and £3,917 respectively.

12. The First Respondent is the 'competent landlord' for the purposes of each claim. The terms of each new lease have been agreed and the First Respondent took no part in the proceedings.

13. The Second Respondent holds the intermediate leasehold interest in respect of each of the flats in question in this application. The application therefore concerns the amount payable to the Second Respondent pursuant to Part III of Schedule 13 Leasehold Reform, Housing and Urban Development Act 1993 ('the Act').

The valuations

14. Valuation reports were produced for each party by; Stephen R Jones BA (HONS) MRICS for the Applicants and Miss Jennifer Ellis FRICS for the Second Respondent.

The issues

15. The issues in the application were finely honed by the parties and accordingly the brevity of this decision reflects the careful and considered preparation carried out by the parties' Valuers and legal representatives.

16. The issue between the parties is summarised in the skeleton argument provided by Mr Fieldsend for the Second Respondent as; *what capitalisation rate is to be applied to the lost ground rent for each flat following the grant of each new lease?.*

The valuation approaches

17. Mr Jones for the Applicants argued that the Capitalisation Rate should be a dual rate of 6% with a 2.25% sinking fund

18. For the Second Respondent, Miss Ellis argued that the Capitalisation Rate should be a single rate of 2.84% or 2.78% (depending, in accordance with each flat, as to when the Claim Notice was served).

19. According to Mr Jones' valuation report:

> Ordinarily I may accept (in accordance with the *Nailrile*[2]decision) where there is a negative rent flow both before and after a statutory lease extension, 'before' and 'after' valuation of the rent flow should incorporate a single capitalisation rate. However, the situation at Kings Court appears to be quite unique for the following reasons:-
>
> i.) There should be no question a purchaser of the head lessee's interest in any of the subject flats would not pay a sum to acquire that interest, on the basis the Head Lessee's interests include an under lease (and therefore the leasehold reversion) of a seemingly valuable part of the block it previously acquired (flat 193).

[2] *Nailrile Limited v Earl Cadogan and another* and similar appeals [2009] 2 EGLR

ii.) The sole reason the existing rent flow is negative is due to previously statutory lease extensions. On which basis, a 'money pot' built up by those claims should cover the portion of the fixed outgoing annual ground rent of the respective flats held on extended leases with a peppercorn ground rent. Accordingly, there should be no need for the Head Lessee to pay any 'reverse premium' to any hypothetical purchaser (for example), because the Head Lessee's interest should include a fund to cover the shortfall in the negative rent flow, based upon the fixed ground rents of the under leases (prior to being extended).

iii.) Shareholders of the Head Lessee's company include under lessees of the subject flats (as well as other flats within the block). Accordingly, any future sale of the head lease to a third party is highly unlikely.

20. We quote the following from Miss Ellis' report as follows:

> 4.3 **Dual Rates**
>
> 4.3.1 An investor expects to receive a return in his investment and also to see the repayment of the investment. For example, someone who deposits £100 in a bank at 2% interest, expects to receive £2 pa and to get his £100 back on demand. Similarly an investor who buys a property producing a rent, expects to receive a return in his investment by way of the annual rent payable and also to be able to re-sell the investment to recoup the capital invested.
>
> 4.3.2 The purchase price invested in a freehold interest, is safely covered by the perpetual nature of the freehold. A valuer can assess how much and investor should pay so that the rent received produces a return on the price paid at a given rates (the remunerative rate).
>
> 4.3.3 However the investor who buys a leasehold interest without a reversion does not have "safe coverage" because the lease is a wasting asset which has no value at the end of the lease. To 'protect' the original investment, a valuer assumes that the owner of a leasehold will set aside part of the rental income to create a sinking fund. By the end of the lease, we valuers say, the monies accumulated in the sinking fund will repay the original investment....
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> 4.3.4 This approach results in the application of dual-rates to capitalise the rent. The remunerative rate provides the owner with a return on his investment, whilst the sinking fund rate, re-provides the investment.......
>
> 4.3.5 By common consensus, the sinking fund must be invested very securely, which results in the [accumulative sinking fund] being below the remunerative rate.
>
> 4.3.6 However where an interest with a negative rent flow is being 'sold', the vendor has to pay a sum of money to the hypothetical purchaser (commonly known as a reverse premium) to take the obligation (to pay more than he receives) off his hands. The hypothetical purchaser does not make a monetary investment but receives a sum of money to invest to cover the shortfall in income. In these circumstances, as there is no 'original investment' to be replaced, there is no need to provide for a sinking fund.
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> 4.3.7 .... in valuing each [Intermediate Leasehold Interest] as a component of the whole intermediate lease, the vendor will be paying the hypothetical purchaser to relieve him of the obligation to pay more than he receives. With no investment by the hypothetical purchaser, it is not appropriate to allow for a sinking fund and I adopt a single rate approach.

21. Miss Ellis goes on to consider the sort of investment needed by the hypothetical purchaser on a negative rent flow. She referred to Nailrile where it was concluded that, as in this case, the head rent increases by fixed amounts, the remunerative rate should be derived from the yield from 2.5% Consolidated Stock ('Consols'). She noted that Consols were

redeemed by the Government in July 2015 leaving a lacuna. She produced a Technical Discussion Paper published in October 2015 by the DCLG. That paper stated that it was proposed to replace Consols in legislation with the Constant Maturity 30-30.5 year National Loans Fund ('NLF') rate. She understood that Statutory Instruments were being drafted to effect the change in rate.

22. She went on to conclude that NLF rate should be adopted to fill the void left by Consols as a comparator rate and therefore adopted that.

Nailrile

23. It is useful at this point to deal with the *Nailrile* decision in more detail. Nailrile is a decision of the Lands Tribunal dating from December 2008. It dealt with five separate applications that had been made to the, then, Leasehold Valuation Tribunal, regarding the terms of acquisition of new leases granted pursuant to section 48 of the Act.

24. The Tribunal set out by way of introduction the following:-

> [6] In the course of 2006 and 2007 the LT received a number of appeals in which the valuation of [Intermediate Landlord Interests] under Chapter II of part I of the 1993 Act was in issue, and it was thought appropriate to attempt to group these for hearing together, thus enabling a representative variety of cases to be considered with the objective of producing a decision that would have general application. In the event , we were able to hear together five appeals.

25. The five appeals heard concerned:
One case where the lease extensions in question would create a negative rent flow for the first time
Three cases where there was a positive rent flow at all times.
One case where there were negative rent flows before and after lease extensions.

26. In considering negative rent-flows, the tribunal commented as follows:-

> [125] However, the intermediate lease will not always have a positive profit rent after the grant of a new lease......The use of a sinking fund to value a negative income is therefore redundant and the use of any dual-rate yp is wrong in principle.
>
> [140] We conclude, therefore, that where neither the MILI provisions nor a commutation of rent apply, an [Intermediate Landlord Interest] should be valued after the grant of a new lease as follows:
> (a) ....
> (b) Where the leaseholder's profit rent in the whole intermediate interest is negative following the grant of a new lease, the diminution in the value of the [Intermediate Landlord Interest] should be calculated by the single-rate approach. Where the head rent is either fixed or increases by fixed amounts throughout the term of the [Intermediate Landlord Interest], we consider that the discount rate should be that of 2.5% consolidated stock.

27. The Applicants' problem with the single-rate approach using the NLF rate as advocated by Miss Ellis was that this approach, in the

current climate of very low interest rates, meant that the effect on premiums was disproportionate and those premiums were subject to fluctuations depending on the valuation date.

28. Further, argued Mr Loveday for the Applicants, the situation in these applications is significantly different to those in the various appeals considered in *Nailrile*. He identified the following issues:
(a) the funds from the lease extensions that have taken place so far would have enabled the Second Respondent to invest money to offset the negative rent flow. Why then would the Second Respondent pay anyone to take the lease off its hands
(b) the shareholders of the Second Respondent are leaseholders, plainly they would not, in a real world scenario, want to sell thier interest in the Headlease and lose control of the Block
(c) the Second Respondent owns the underlease of flat 193 – a valuable asset which could be used and which the Second Respondent would not want to sell

29. Mr Loveday also relied on the fact that the NLF rates adopted by Miss Ellis (2.84% & 2.78%) were very close to the 'risk-free rate' of 2.25% identified in Sportelli[3], leaving very little headroom and that as of 30 September 2016, the NLF rate was 1.53%, below the risk-free rate.

30. Mr Loveday concluded that the hypothetical purchaser in this case would walk away on the case presented by Miss Ellis.

31. For the Respondent, Mr Fieldsend summarised the Applicants' position as being; the single rate method produces an absurd result, therefore the dual-rate approach must be taken – the tail wagging the dog. He summarised that the simple fact is, that the dual-rate approach *cannot* be used with a negative rent flow.

32. Further, argued Mr Fieldsend, *Nailrile* is not fact specific. The tribunal in that case considered cases covering a variety of factual situations so as to lay down general principle.

33. As to the various unusual aspects of these applications identified by Mr Loveday (para 28 above), Mr Fieldsend argued that these were irrelevant. One has to consider a hypothetical seller and buyer. A transaction will take place, one party cannot walk away. The transaction will take place having regard to market conditions at the time of the transaction. It is not possible to attribute actual 'real life' characteristics to the parties.

Decision

[3] *Earl Cadogan v Sportelli* [2007] 1 E.G.L.R. 153, LT

34. We agree with the Applicant's submission that the statutory exercise to be undertaken in a valuation is the sale of the Intermediate Landlord Interest and that alone. It does not take into account the Intermediate Landlord's wider financial position. The funds derived from previous lease extensions is irrelevant to that sale.

35. The fact that the Second Respondent holds the leasehold interest in Flat 193 is similarly irrelevant. The hypothetical sale is of the interest in the Headlease. The Second Respondent would not be obliged to dispose of its underlease of Flat 193 and the value of that underlease is, as per the funds derived from the previous lease extensions, irrelevant to the sale.

36. Again, following this reasoning, the identity of the shareholders of the Intermediate Landlord must also be irrelevant to the transaction being considered.

37. We do not consider that, because there are difficulties identified in the NLF rates, that the dual-rate can be adopted in the light of the comments in *Nailrile* that such an approach is wrong in principle in negative rent-flow cases.

38. We do not consider that *Nailrile* is fact specific and consider that it lays down principle to be followed by this tribunal – a point specifically made by the Lands Tribunal.

39. As to the difficulties with the NLF rate identified by Mr Loveday, we do not ignore them but they appear to be the result of the prevailing economic climate which is the background against which the hypothetical transaction must take place. We note in passing that, according to Miss Ellis, other flats have made agreements to enfranchise at premiums in the latter part of 2015 that are a little above the rates (£11,221 for 12 November notices and £11,460 for 16 November notices) that she argued for in her report.

40. Accordingly we adopt Miss Ellis' valuations for each flat produced for the tribunal.

Mark Martyński, Tribunal Judge
11 October 2016