

# Deferment rates in the spotlight... again

*Natasha Rees reviews a decision of the Upper Tribunal concerning the correct rate to be applied to leases under 20 years*



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**'The Upper Tribunal decided that there should be a departure from the rate fixed by *Sportelli*. In doing so, they adopted the formula laid down by *Sportelli* but accepted that adjustments had to be made to the real growth rate in accordance with the position in the property cycle at the valuation date.'**

On 3 December 2010, the newly formed Upper Tribunal gave judgment on eight conjoined appeals concerning the correct deferment rate to be applied when calculating the premium payable on enfranchisement where the leases in question have less than 20 years to run. The appeals, known as *Cadogan Square Properties Ltd v Earl Cadogan* [2010], arose because the guidance given in the well-known case of *Sportelli* only relates to cases where the leases are in excess of 20 years.

The Upper Tribunal decided that there should be a departure from the rate fixed by *Sportelli*. In doing so, they adopted the formula laid down by *Sportelli* but accepted that adjustments had to be made to the real growth rate in accordance with the position in the property cycle at the valuation date. In making these adjustments they rejected a mathematical approach that they felt was not economically viable and adopted an approach that required 'valuation judgment'. As a result of the decision, tenants can now contend for a higher deferment rate where their leases have less than 20 years unexpired.

## Background

The valuation process is complex but can be broken down into a number of elements. As part of the process it is necessary to determine the future value of the freehold once the lease, or leases, have expired, and to then give a discount for the accelerated receipt. This is done by applying an interest rate to the present freehold value or a 'deferment rate'. The level of the

deferment rate can have a significant effect on the price of the freehold or lease extension, with lower rates resulting in a higher price. It is for this reason that the issue of the deferment rate has been the subject of much dispute between landlords and tenants.

The Lands Tribunal first ruled on the issue of the deferment rate in a group of appeals known as *Arbib v Earl Cadogan* [2005] when they rejected the traditionally adopted rate of 6%, which was based on settlement evidence, and decided to rely on the evidence of financial experts to determine the appropriate rate despite a significant lack of such evidence. In doing so they concluded that the new measure should be based on index-linked gilts that they adjusted to take account of inflation. The resulting yields were 4.5% for houses and 4.75% for flats. The decision itself advised against reliance on convention or precedents and left many issues open.

It was soon followed by a further group of appeals that came to be known as the *Sportelli* appeals. The preliminary issues in these appeals were heard by the Tribunal in August 2006 and their determination was later approved by the Court of Appeal in 2007. The Lands Tribunal had determined a rate that was based on a mathematical model using financial market evidence. The model used a basic formula that was a risk-free rate of return (based on gilts) of 2.25% minus a real growth rate of 2% plus a risk premium of 4.5% for houses and 4.75% for flats (due to greater management problems). This led to a deferment rate of 4.75% for houses and 5% for flats.

More recently, in a case known as *Cadogan v Erkman* [2009], the Tribunal were asked to rule on the ability of the landlord to call evidence that challenged the guidance in *Sportelli*. They concluded that evidence designed to show that the guidance in *Sportelli* was wrong should generally be excluded unless there were exceptional circumstances that would justify its admission. It was against this detailed history that the Tribunal were asked to consider what the correct deferment rate was for these sub-20-year leases.

## Issues

All of the properties that were the subject of these appeals were located

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in prime central London (PCL) and as a result they were clearly subject to the guidance given in *Sportelli*. The key difference in these appeals was the length of the unexpired term of the leases, which was less than 20 years in every case. In *Sportelli* the leases were all over 20 years unexpired. In that decision the Tribunal said that where the unexpired term was less than 20 years, regard would need to be had to the property cycle at the valuation date. It was therefore open to the tenants to challenge the rates set by *Sportelli*.

The principal question that had to be answered was whether the generic rate, in relation to flats of 5%, should be increased if the property market was at or near the top of the property cycle at the relevant valuation dates. There was also a second issue on two of the properties. On these two properties the landlord was contending that they should be valued as houses rather than flats since they had the potential to be reconverted from flats into a single house. As a result, the landlord was contending for the house rate of 4.75% rather than the flat rate of 5%. The Tribunal had to decide which rate was appropriate.

## Facts

The appeals related to five properties all situated on Cadogan Square. In each case, the property comprised a Grade II listed building divided into flats, and in each case the tenants had made a collective claim pursuant to s13 of the 1993 Act. The main difference between each case was the valuation date (the date when the notice of claim was served) and the length of the lease remaining as at the valuation date (see box below).

## LVT decisions

On 23, 38 and 42 Cadogan Square the landlords had argued in the LVT that the deferment rate should be 5% based

on the generic *Sportelli* rate for flats. Gavin Buchanan, the surveyor acting for the tenants of these properties, argued that the rate adopted should be 5.5%. His reasons were that if the property cycle was near its peak and the unexpired term was less than 20 years then the deferment rate should be higher because there was a greater prospect of a downturn. In all three cases the LVT adopted a rate of 5% as set by *Sportelli* although it was only in one of the decisions that they gave clear reasons for this.

On 31 and 37 Cadogan Square the tenants were originally contending for a rate of 5% based on the *Sportelli* rate for flats, but the landlords argued that the rate for houses of 4.75% should apply since the basis of the valuation was as a house. The LVT accepted this and determined a rate of 4.75%.

## Appeals

In the appeals the tenants contended for a rate of 5.8% on all of the properties except for 42 Cadogan Square where they were limited by the earlier decision of Earl Cadogan to the rate they had contended for in their statement of case of 5.5%. They relied on the evidence of a surveyor, Gavin Buchanan, and also that of a financial expert, Prof Colin Lizzieri. The landlords continued to argue that the rate on the three properties 23, 38 and 42 Cadogan Square should be based on the *Sportelli* flat rate of 5% and for 31 and 37 Cadogan Square it should be based on the rate for houses of 4.75%. They relied on the evidence of a surveyor, Julian Clark, and a financial expert, Mark Bezzant.

## Tenant's case

Professor Lizzieri, on behalf of the tenants, argued that the valuation dates in question were at the top of the property cycle and that consequently a downward adjustment was likely. Investors would be aware that prices had peaked and would, therefore, at best rise slowly and at worst fall sharply. He felt that this would reduce the real growth rate: one factor of the *Sportelli* formula. By way of example, on 38 Cadogan Square he calculated that the real growth rate would be reduced from the generic *Sportelli* rate of 2% to 1.2%. If this figure was then substituted into the *Sportelli* formula it resulted in a deferment rate of 5.8% rather than 5%. The figure of 5.8% was endorsed by Gavin Buchanan.

## Landlord's case

The landlord's expert, Mr Bezzant, originally prepared a report in relation to 42 Cadogan Square where he claimed that the guidance in *Sportelli* was wrong and that the deferment rates were too high. Following the decision of the Lands Tribunal in Earl Cadogan, where they ruled that the landlords could not challenge the guidance in

## Lease lengths and valuation dates

1. 23 Cadogan Square: 17.5 years. Valuation date 3 October 2005.
2. 31 Cadogan Square: 15.6 years. Valuation date 29 August 2007.
3. 37 Cadogan Square: 16.1 years. Valuation date 19 February 2007.
4. 38 Cadogan Square: 17.8 years. Valuation date 22 June 2005.
5. 42 Cadogan Square: 17.3 years. Valuation date 29 November 2005.

*Sportelli*, he revised his report and contended for a rate that was no higher than the generic rate set by *Sportelli*.

Mr Bezzant felt that two of the factors in the *Sportelli* formula, the risk premium and the real growth rate, were interrelated. He felt that if the market was at a peak, and future growth expectations were going to be reduced, then this would impact on the risk premium as well because there would be a risk that the expected growth would not be achieved. He felt that as a result of this, any change in the real growth rate would be cancelled out by a change in the risk premium. He concluded that where the unexpired term was less than 20 years the deferment rate should only be adjusted if there was a change in the risk-free rate; this remained the same as the *Sportelli* rate, so the deferment rate he contended for remained at 5%.

Mr Bezzant also considered an alternative approach known as the 'net rental yield' approach where he calculated the value of the reversion by reference to the net rental yield over the term as the deferment rate. This also produced deferment rates for sub-20-year leases that matched the generic *Sportelli* rate, and his counsel submitted that it was this approach that should be adopted. Mr Clark stated that it was impossible to know where you were in the property market at any given time and that the real growth rate of 2% was modest for PCL and not unrealistic even for shorter leases.

### Decision

The Tribunal accepted the tenant's argument that they should adopt the *Sportelli* formula and then consider whether to alter one or any of the components in the formula to reflect the position in the property cycle at the relevant valuation date. They rejected the landlord's primary argument that relied upon evidence from net rental yields.

In looking at the formula they considered first the risk-free rate and concluded that since neither party had produced any evidence to show what the risk-free rate would be for sub-20-year leases they would adopt the *Sportelli* rate of 2.25%. They then considered whether a change in the 'real growth rate' would be matched by a change in the 'risk premium'.

Although they accepted that there was a coupling of these factors for longer leases, they did not accept that such a relationship existed for shorter-term leases.

They concluded that the *Sportelli* formula can be adjusted to reflect the position in the property market cycle and agreed with Prof Lizieri that it should be the real growth rate that is adjusted. Prof Lizzieri had proposed, using a mathematical model based on lease length, to make the necessary adjustment, but the Tribunal felt this would require a formula that smoothed the transition from over 20 years to less than 20 years and that to do so would not be economically justified. They therefore adopted

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a 'valuation approach' suggested by Gavin Buchanan in the LVT.

On this basis they decided that any adjustment to the real growth rate would be a matter of negotiation between the parties and would change according to where the valuation date was in the property cycle. Early on in the cycle the landlord could not sustain an argument that the growth rate would continue at its rate of 2% and the purchaser would not be able to objectively establish that there was no prospect of further growth. On 23, 38 and 42 Cadogan Square, where the valuation dates were between June 2005 and November 2005, the Tribunal said that the parties would have negotiated a growth rate of 1.75% and thus a deferment rate of 5.25%.

On 31 and 37 Cadogan Square, where the valuation dates were February and August 2007 and the market was increasing dramatically, the tenant would be able to argue for a lower future growth rate and they decided that the parties would have agreed a future growth rate of 1.5% and thus the deferment rate would be 5.5%. They refused to adopt a deferment rate for houses

even though the freehold value included an element to reflect the conversion of flats back into a house.

### Conclusion

The decision is a complex one that requires the adoption of the mathematical formula laid down by *Sportelli* together with the application of valuation judgment. The valuer must consider the state of the property market at the valuation date and its prospects over the remainder of the term, and then adjust the real growth rate accordingly. Since the Tribunal agreed that it was impossible to finesse the adjustment to less than a 0.25% it is unlikely that any tribunal will accept an adjustment

that is below this level. The approach is also only suitable for lease lengths of 10-20 years. Where the lease is below ten years it was accepted that the risk-free rate adopted in *Sportelli* might not be appropriate, and there were hints that a deferment rate based on rental yield should be considered.

This is unlikely to be the end of the story as far as deferment rates are concerned. Although the decision has probably set a precedent for valuation dates between 2005-2007, some say that the outlook for 2009-2010 is more fragile and the decision leaves room for argument. Landlords are also continuing to challenge *Sportelli* with a further test case coming up soon on the Wellcome Trust Estate where the leases are all over 20 years but the landlord is contending for a rate of 3%. It is therefore still a case of watch this space. ■

*Arbib v Earl Cadogan*  
[2005] 3 EGLR 139  
*Cadogan Square Properties Ltd v Earl Cadogan*  
[2010] UKUT 427 (LC)  
*Cadogan v Erkman*  
[2009] 1 EGLR 87