Brexit and Enfranchisement Premiums: Where are we headed?

The vote on 23rd June which saw the UK vote to leave the European Union has left us with more questions than answers in relation to property and enfranchisement:

- Should landlords be seeking to settle and complete current lease extension and collective freehold claims for fear that tenant flat owners may withdraw their claims and achieve a lower premium via claims made in the future?
- Should flat owners consider withdrawing current claims for the same reason?
- Should flat owners defer making intended claims?

These are just some of the questions landlords and tenants, freeholders and flat owners need to consider. Unfortunately there is not much to go on when seeking answers.

The short, medium and/or long term effects Brexit will have on residential property values is uncertain and may play out in unexpected ways. In addition there are other factors to consider that may have an effect on property values

Brexit

HM The Treasury had warned before the Brexit vote house prices could fall by 10-18% by 2018, compared to where they might otherwise be (they were forecast to be circa 10% higher than current levels netting out around an 8% decline). There is some anecdotal evidence that significant price reductions have been achieved post Brexit. The attempted withdrawal of capital from commercial property funds that have now locked their doors may affect sentiment in the residential sector. Inflation is predicted to reach 4% by the end of 2017. Interest rates may increase either as a consequence or due to the effects of our credit status being downgraded to AA by the credit rating agencies. Buy to let investors may sell perceiving that they have achieved as much capital appreciation as is likely and in anticipation of the changes to income tax treatment. If passporting rights for financial services are not secured as part of the Brexit negotiations personal incomes, tax revenues and demand for residential and commercial property may fall and there may be forced sellers.

On the other hand, currency depreciation coupled with any such falls in value should attract dollar buyers. Investors are piling into bonds so driving down the cost of borrowing. The Bank of England has engaged counter cyclical relaxation of the capital requirements of banks which should increase lending, assuming borrowers are prepared to pick up the cheap debt, and seems likely to engage in further quantitative easing which has increased asset values in the past. The Government demonstrated that it would do what was necessary to support the housing market and the construction sector in response to the 2007 recession, for example with the Help to Buy scheme. Now it may lend further support by reducing stamp duty for first time buyers. Buy to let investors may stay their hand in view of interest rate expectations, likely tax hit and the lack of satisfactory alternative investments.

The net effect may be low transaction levels and little change in values in the short term. It is too early to know what the actual outcome will be. It will take quite some time for the comparable evidence required for a valuation to come through.

In the meantime tenant flat owners and their landlords need to decide how to proceed. They will have to make a judgment as to where values might be in a year's time and to gauge the effect of that on the premium payable.

As an example *(It is worth noting there are various factors that affect the premium payable such as ground rent which mean you cannot rely on this as a valuation tool and instead must obtain advice from a suitably qualified surveyor):*

A flat in Kensington & Chelsea worth £1m on an extended lease with approximately 62 years currently left to run the existing lease term stands to save say £7,000 if they re-start in 12 months and values have fallen by 10% by that point - or £18,000 if values drop by 20%. This takes into account the shortening of the lease. If values hold level then they will pay £4,000 more in premium and this will of course be magnified if values move up (say £15,500 more with a 10% increase and £27,000 more with a 20% increase).

In addition withdrawing their claim and re-starting will incur costs including those of the landlord of say £5,000. So re-starting will be expensive if values hold level, a marginal saving would be achieved if there is a 10% drop, a more interesting saving will be achieved with a 20% drop and a very painful increase in premium will be suffered if values move up.

Other factors

What about other changes that may affect the premium? What is known as the 'deferment rate' may change and if it does this may have a big effect on the premium payable.

So where does it come in? The premium payable for a new lease comprises the reduction in value of the landlord's interest that it suffers as a consequence of the lease being extended and (where the lease terms is less than 80 years) their share of the marriage value.

The reduction in value is the difference between the value of the landlord's interest before and after the grant of the new lease based on certain statutory assumptions i.e. that the statutory right to claim a new lease or enfranchise doesn't exist in respect of this flat and that any increase in value of it attributable to improvements carried out at the tenant's own expense is ignored so that they don't pay twice.

It is made up of two elements. Firstly the value of the right to receive rental income going forwards and secondly the reversion to the existing lease so the freehold value of the flat when the lease falls in. A 'capitalisation rate' is used to calculate the value now of rental income in future. A 'deferment rate' is used to value the right to possession in time; so you defer the current value of a freehold flat using this rate – the lower the rate the greater the premium you arrive at from your starting point of current value.

What level is it set at currently? In 2007 deferment rate was fixed at 5% in Prime Central London (PCL) for flats with more than 20 years of their lease term left to run. It has limitations as a consequence; it isn't binding outside PCL so tenants there may seek a higher rate; for remaining lease terms of below 20 years either an adjustment or a different valuation method is required).

How is it set? The deferment rate is derived from a formula being the risk free rate (RFR) plus a risk premium for this type of asset minus the real growth rate. The risk free rate might be challenged in a way that benefits landlords rather than tenants. A reduction in the RFR would drag down the deferment rate and so increase the premium payable for a new lease or the freehold. It is based on expert evidence from 2007 as to the average index linked to yields on a 5 year rolling basis over the decade prior to that. The current figure for the RFR is 2.25%. Since then those yields have moved down significantly perhaps to 0 or below, so what would the effect be of a reduction of say 2%? Take an example of a flat with a lease term having 85 years unexpired - worth £1m on an extended lease the reduction in value of the landlord's interest at a deferment rate of 5% would be around £16,000. If the deferment rate is reduced to 3%, this figure increases to around £82,000.

An estate landlord would have sufficient incentive and depth of pocket to take this on.

So flat owners for example may hold off claiming a new lease or the freehold in the hope of achieving a lower premium as a result of Brexit but be hit by a surprise upturn in values or another change that operates against them such as an adverse adjustment in the deferment rate.

For further information, please contact:

Mark Vinall | Partner
T: 020 7593 5163
E: mvinall@wslaw.co.uk