

HIGHEST AND BEST USE ANALYSIS

The analysis of relevant data to develop a market value opinion requires two important steps in the valuation process before the applicable approaches to value are applied. Market/marketability analysis begins the process of narrowing the focus from a broader macro view to data that is especially pertinent to the appraised property. Highest and best use relies on that analysis to identify the most profitable, competitive use to which the subject property can be put. The highest and best use is shaped by the competitive forces within the market where the property is located and provides the foundation for a thorough investigation of the competitive position of the property in the minds of market participants.

An understanding of market behaviour developed through market analysis is essential to the concept of highest and best use. Market forces create market value, so the interaction of market forces that identifies the highest and best use is of crucial importance.

FUNDAMENTALS OF HIGHEST AND BEST USE

Highest and best use may be defined as follows:

The reasonably probable and legal use of vacant land or an improved property that is physically possible, appropriately supported, and financially feasible and that results in the highest value.

The theoretical focus of highest and best use analysis is on the potential uses of the land as though vacant. In practice, however, the contributory value of the existing improvements and any possible alteration of those improvements are also important in determining highest and best use and, by extension, in developing an opinion of the market value of the property.

In the analysis of highest and best use of land as though vacant, the appraiser seeks the answers to several questions:

- Should the land be developed or left vacant?
- If left vacant, when would future development be financially feasible?
- If developed, what kind of improvement should be built?

In the analysis of the highest and best use of the property as improved, the appraiser must answer additional questions:

- Should the existing improvements on the property be maintained in their current state, should they be altered in some manner to make them more valuable, or should they be demolished to create a vacant site for a different use?
- If renovation or redevelopment is warranted, when should the new improvements be built?

To determine highest and best use, the appraiser must analyze data, not just compile it. As an analogy, in applying the direct comparison approach the appraiser does not just compile a list of comparable sales from the market data; he or she analyzes the relevant sales. It is critical that a careful highest and best use analysis precede the application of the approaches to value. Otherwise, there is a high likelihood that serious errors will be made in the valuation process.

In general, if the value of a property as improved is greater than the value of the land as though vacant, the highest and best use is the use of the property as improved. However, a property's existing use may represent an interim use, which begins with the land value for the new highest and best use and adds the contributory value of the current improvements until the new highest and best use can be achieved. In practice, a property owner who is redeveloping a parcel of land may remove an improvement even when the value of the property as improved exceeds the value of the vacant land. The costs of demolition and any remaining improvement value are taken into consideration in the test of financial feasibility

for redevelopment of the land. Likewise, if an improved property has value but may have greater value if modified in some way, the cost of modifying the improvements and the value gained in that modification are accounted for in the determination of highest and best use.

The Four Tests

As market/marketability analysis progresses to highest and best use analysis, appraisers first consider the reasonably probable uses of a site that can be legally undertaken. In the analysis of pertinent data, four steps are implicit and are applied in the following order to develop adequate support for the appraiser's highest and best use opinion:

1. Legally permissible
2. Physically possible
3. Financially feasible
4. Maximally productive

An appraiser generally considers these criteria sequentially. The tests of physical possibility and legal permissibility can be applied in either order, but they both must be applied before the tests of financial feasibility and maximum productivity.

A use may be financially feasible, but this is irrelevant if it is legally prohibited or physically impossible.

The six-step market analysis process described in Chapter 9 provides the data required for the four test criteria (see Figure 12.1). The initial analysis of the market and land use regulations (i.e., property productivity) usually limits the number of property uses to a few reasonably probable choices. For example, market analysis may suggest that there is demand for a large office building in a community. However, if modern, single-unit residential developments surround the subject site, a large, multi-storey office building would probably not be a reasonably probable use, even if it were legally permitted. Similarly, a housing development for the elderly might be a permissible use for a site, but, if most residents of the area are under 40-years old, this use is most likely not reasonably probable and would not be tested for financial feasibility. Consideration of whether a use is reasonably probable should continue throughout the analysis of highest and best use as the appraiser learns more about the potential use of the property. Reasonable probability is both a tentative starting point and a conclusion for the use or uses that are ultimately deemed probable. Appraisers constantly evaluate and reconcile what develops through competent application of the steps in the valuation process. Many of the considerations and discoveries that are made through their analyses become important points not only for the development of their own value conclusions, but also for inclusion in their reports to clients.

There may be a significant demand for a use in the market area of the subject property and the subject may be suited for this use, but a number of other sites may be equally or more appropriate. The appraiser must test the highest and best use conclusion to ensure that existing and potential competition from other sites has been fully recognized.

An appraiser must also consider the competition among various uses for a specific site. For example, competition for available sites along a commercial strip development may be intense. Developers of community garden uses, retail office uses, and fast food franchises may bid against one another for these sites, and the prices they pay for these sites will reflect this competition. Market demand is not

Highest and best use is the reasonably probable and legal use of vacant land or an improved property that is legally permissible, physically possible, appropriately supported, financially feasible, and that results in the highest value.

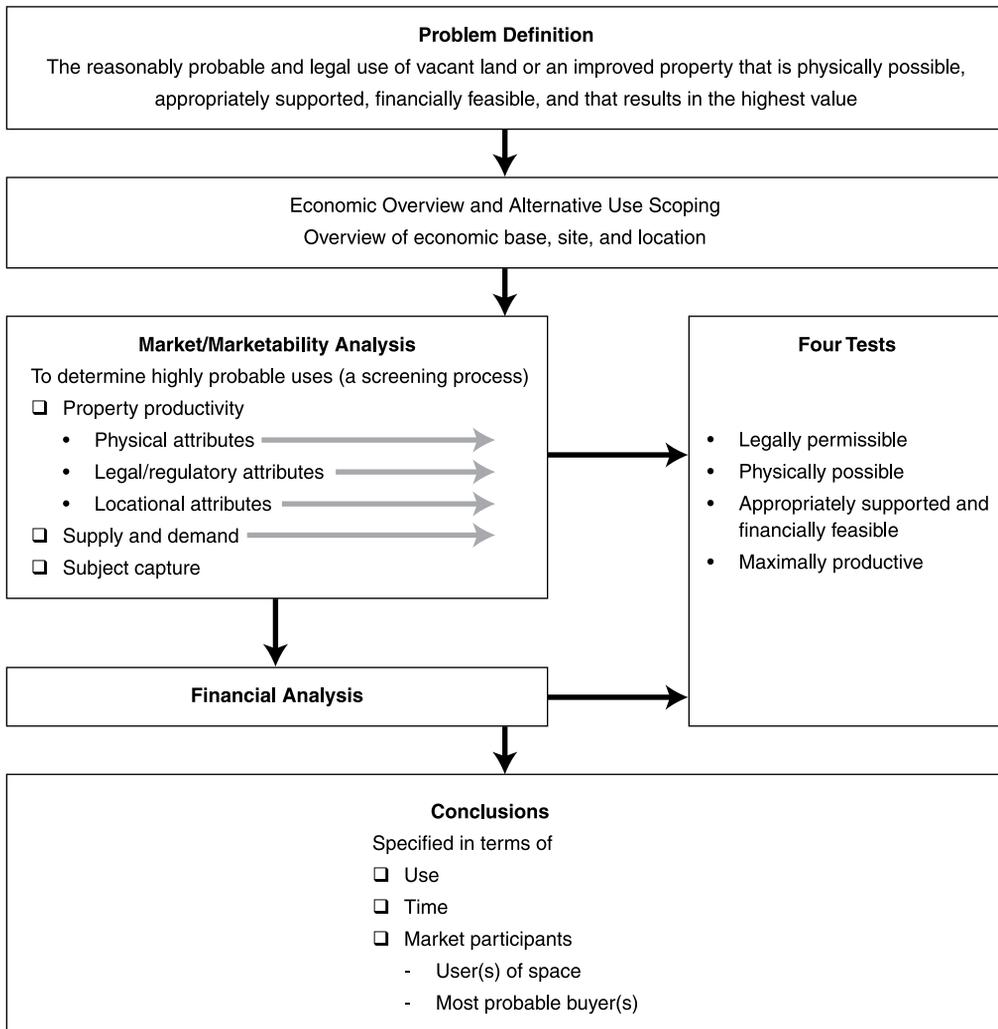
LAND AS THOUGH VACANT AND THE PROPERTY AS IMPROVED

The highest and best use of land as though vacant and the highest and best use of the property as improved are connected but distinctly different concepts. To clarify the distinction, consider a single-unit residential property located in an area zoned for commercial use. If there is market demand for a commercial use, the maximum productivity of the land as though vacant will most likely be for a commercial use. In this case, the residential improvements may contribute little, if any, to the value of the property as a whole except as an interim use during the transition between land uses. If, however, the market value for residential use is greater than the market value for the permitted commercial use less costs to demolish the residential improvements, then the highest and best use of the property as improved will be for continued residential use.

infinite. Even though the subject may be physically and locationally suited for that use, better-located sites may satisfy the market demand completely before the subject property can realize its development potential.

The same observation may be applied to central business districts (CBDs). The market may define the highest and best use of land in the CBD simply as high-rise development, which often includes a mix of uses such as office, retail, hotel,

Figure 12.1: The Market Analysis Process and Four Parallel Tests



Source: Stephen F. Fanning, *Market Analysis for Real Estate: Concepts and Applications in Valuation and Highest and Best Use* (Chicago: Appraisal Institute, 2005), 382.

and residential apartment or condominium use. At times the highest and best use conclusion for a CBD site does not indicate a specific highest and best use, but rather a class of uses that is supported by market area trends and reflects a consistent density of development.

APPLICATION OF HIGHEST AND BEST USE ANALYSIS

Highest and best use analysis builds on the conclusions of market/marketability analysis. The analysis of land as though vacant focuses on alternative uses, with the appraiser testing each reasonably probable use for legal permissibility, physical possibility, financial feasibility, and maximum productivity. In contrast, the appraiser applies the four tests in the analysis of the property as improved, but the focus is not on alternative uses but on three possibilities: continuation of the existing use, modification of the existing use, or demolition and redevelopment of the land.

Highest and Best Use of Land as though Vacant

Land is generally valued as though vacant. When land is already vacant, the appraiser values the land as it exists. However, when land is not vacant its contribution to the value of the property as improved depends on how it can be put to use. Therefore, the highest and best use of land as though vacant must be considered in relation to its existing use and all potential uses. A conclusion of the highest and best use of land as though vacant is required in nearly all appraisal assignments. However, the level of study will be significantly greater when a larger proportion of the total property value is in the land. The level of study will be significantly less when only a small proportion of the total property value is in the land. Appraisers explain in the appraisal report why a lower level of study may have been applied so that others can understand the justifications and the data on which they are based.

The highest and best use of land as though vacant is concluded after the four criteria have been applied and various alternative uses have been eliminated. The remaining use that fulfills all four criteria is the highest and best use.

Testing the Legal Permissibility of Land as though Vacant

Private restrictions, zoning, building codes, historic district controls, and environmental regulations may preclude many potential uses. The appraiser must also consider whether there is a reasonable probability that the zoning or other restrictions could be changed in order for the highest and best use of the property to be realized.

In applying the test of legal permissibility, the appraiser determines which uses are permitted by current zoning, which uses could be permitted if a zoning change were granted, and which uses are restricted by private restrictions on the site. Private restrictions, title or deed restrictions, and long-term leases may prohibit certain uses or specify building setbacks, heights, and types of materials. If deed restrictions conflict with zoning laws or building codes, the more restrictive guidelines usually prevail, but this may pose a legal question that the appraiser cannot answer without

assistance from a professional with the appropriate legal expertise. A long-term lease may affect the highest and best use because lease provisions may limit use over the remaining term of the lease. For example, if a property is subject to a land lease that has twelve years to run, it may not be economically feasible for the tenant to construct and move to a new building with a longer remaining economic life. In such a case, the appraisal report should state that the determination of highest and best use as leased is influenced by the lease's impact on utility over the remaining lease term.

In addition to analyzing zoning and private restrictions, testing the legal permissibility of a land use also requires the appraisers to investigate other applicable codes and ordinances, including building codes, historical district ordinances, and environmental regulations.

Building codes can prevent land from being developed to what would otherwise be its highest and best use by imposing burdensome restrictions that increase the cost of construction. For example, the additional cost of a water retention pond with excess capacity that is required by local ordinance could impact the size of a proposed community shopping centre. Less restrictive codes typically result in lower development costs, which attract developers; more restrictive codes tend to discourage development. In some areas, more restrictive building codes are used to slow new construction and limit growth. Historical ordinances, such as historic facade easements, and overlay districts may be so restrictive that they preclude development.

Concerns over the long-range effects of certain land uses sometimes result in increased environmental regulation and stricter development controls. Appraisers must be familiar with environmental regulations pertaining to clean air, clean water, and wetlands, and they should be sensitive to the public's reaction to proposed development projects. When resistance from local residents and the general public occurs, it can pressure public officials to stop or limit certain real estate developments or change the density or character of a specific plan.

As with zoning ordinances, if there are any limitations inherent in other applicable codes, ordinances, and regulations, the appraiser should investigate whether there is a reasonable probability of a change relative to the subject property.

Testing the Physical Possibility of Land as though Vacant

The test of physical possibility addresses the physical characteristics associated with the site that might affect its highest and best use. The size, shape, terrain, and accessibility of land and the risk of natural disasters such as floods or earthquakes affect the uses to which land can be put. The utility of a parcel may also depend on its frontage and depth. Irregularly shaped parcels can cost more to develop and, after development, may have less utility than regularly shaped parcels of the same size.

Ease of access enhances the utility of a site. For certain property types, visibility is an important feature. For other property types, the privacy provided by the lack of a view is a benefit. It is also important for the appraiser to consider the capacity and availability of public utilities. If a sewer main located in front of a property cannot be tapped because of a lack of capacity at the sewage disposal plant, the property's use might be limited. When topography or subsoil conditions make development

difficult or costly, the land's utility may be adversely affected. If the cost of grading or constructing a foundation on the subject site is higher than is typical for sites in the area competing for the same use, the subject site may be economically infeasible for the highest and best use that would otherwise be indicated.

PROBABILITY OF A ZONING CHANGE

In investigating the reasonable probability of a zoning change, the appraiser must consider trends and the history of zoning requests in the market area as well as documents such as the community's comprehensive or master plan. Uses that are not compatible with the existing land uses in the area (such as a gas station in the middle of an exclusive single-family residential subdivision) and uses for which zoning changes have been requested but denied in the past (such as an industrial use where several industrial zoning changes have been turned down in the past two years) can usually be eliminated from consideration as potential highest and best uses. On the other hand, a zoning change from residential to commercial may be reasonable if other properties in the market area have received a similar zoning change recently or if a community's comprehensive plan designates the property for a use other than its current use. For example, consider a site zoned single-family residential in a transitional neighborhood where the zoning on several similar sites has been changed recently to commercial. Also, the city's comprehensive plan designates the property as lying within a future commercial corridor. Both of these factors may support an appraiser's conclusion that there is a reasonable probability of rezoning the subject site for commercial use.

Additional evidence of the possibility of new zoning includes land assemblage, removal of structures, and new construction in an area. This evidence may be supported by zoning change applications, zoning hearings, actions by municipalities, and interviews with planning and zoning officials. Even if there is no current market evidence of a zoning change, documented interviews with officials and discussion of zoning practices and histories can be helpful in evaluating the possibility of a zoning change. However, these interviews may not be a "proof" of a change or the denial of a change. Elected officials make decisions on zoning ordinances, and the processes are often heavily contested, with the outcomes not known until official actions are taken.

The probability of a zoning change may not be 100%, and the challenge is to determine whether market participants will pay a premium over the property's current value as zoned in anticipation of a potential zoning change and to document the conclusion. Because developers are frequently risk-averse, most buy "subject to" rezoning approval rather than "as is". Many sales never close because they are subject to rezoning that could not be obtained or could not be obtained within the developer's desired time frame. Appraisals involving a projected or assumed zoning change are subject to an extraordinary assumption or hypothetical condition, depending on the situation, and must be addressed as such. If, for the purposes of the appraisal, the appraiser concludes from research that the probability of a zoning change is likely, the appraisal is subject to an extraordinary assumption because although the appraiser believes the statement to be true, if it is not, the value opinion would be affected significantly.

Testing the Financial Feasibility of Land as though Vacant

In determining which uses are legally permissible and physically possible, an appraiser eliminates some uses from consideration. Only those uses that meet the first two criteria are analyzed further. As long as a potential use has value commensurate with its cost and conforms to the first two tests, the use is financially feasible. Some

economic uses of land such as housing may not be income-producing in the sense of a commercial property, and economic feasibility is weighed by considering prices and price trends. For income-producing properties, the income analysis for financial feasibility must be supported with the six-step market/marketability study. The level of analysis may vary with assignments, but the economic demand for the subject is a prerequisite to the financial testing of alternatives.

If the physically possible and legally permissible uses are income-producing, the analysis of financial feasibility will often focus on which potential uses are likely to produce an income (or return) equal to or greater than the amount needed to satisfy operating expenses, financial obligations, and capital amortization of the investment. If the uses are not income-producing, the analysis will determine which uses are likely to create a value or result in a profit equal to or greater than the amount needed to develop and market the property under those uses. Appraiser's need to do analyses of supply and demand in order to identify those uses that are financially feasible and, ultimately, the use that is maximally productive.

A crucial element in highest and best use analysis is the timing for a specific use. Timing refers to when the improvements would be built as well as the future expectations of occupancy and rent levels. Land and location may suggest a parcel is a prime retail corner at some point in time, but if the retail potential is some years in the future, another use – for example, apartments – that can be developed immediately would make the land more valuable today.

To determine the financial feasibility of an income-producing use, the appraiser estimates the future gross income that can be expected from each use. Vacancy and collection losses and operating expenses are then subtracted from each gross income to obtain the likely net operating income (NOI) from each use. A rate of return on the invested capital can then be calculated for each use. If the net revenue capable of being generated from a use is sufficient to satisfy the required market rate of return on the investment, the use is said to be financially feasible.

To determine the financial feasibility of a use that will not generate income, the appraiser performs an economic analysis by comparing the value benefits that accrue from the use against the costs involved. If the value benefits exceed the costs, the use is considered feasible. If the value benefits fall below the costs or exceed costs by only a marginal amount, the use may not be financially feasible.

Successful application of the financial feasibility test to land as though vacant relies on interpretation of relevant and credible market evidence collected and analyzed in the market area and in the subject property's competitive market. Risk is an important consideration and must be weighed along with other feasibility factors. Any external obsolescence related to a specific use should be incorporated into the test of financial feasibility.¹

¹ For more information on financial feasibility and maximum productivity, see also Stephen F. Fanning, *Market Analysis for Real Estate: Concepts and Applications in Valuation and Highest and Best Use* (Chicago: Appraisal Institute, 2005), 389; and Richard Parli, "What's Financial Feasibility Got to Do With It?" *The Appraisal Journal* (October 2001): 419-423.

Testing the Maximum Productivity of Land as though Vacant

The test of maximum productivity is applied to the uses that have passed the first three tests. Of the financially feasible uses, the highest and best use is the use that produces the highest residual land value consistent with the market's acceptance of risk and with the rate of return warranted by the market for that use given the associated risk. To determine the highest and best use of land as though vacant, rates of return that reflect the associated risks are often used to capitalize income from different uses into their respective values. These are developed from previous research and reflect the rates that market participants apply to the range of uses being considered. Alternatively, land sales to users can be used to test which alternative is maximally productive. For example, if the subject site has current demand for apartments and demand for retail is estimated at five years in the future, the highest and best use can be tested by applying user sales data. Suppose apartment land is selling for \$3.50 per square foot today to users and retail land is selling for \$7.50 per square foot to users. If the land is held for five years at a discount rate of 20%, the present value of the retail land is \$3.00 per square foot, which suggests that the highest and best use today is to develop apartments on the site. The use that produces the highest residual land value is the highest and best use.

An appraiser can find the residual land value by estimating the value of the proposed use (land and improvements) and subtracting the cost of the labour, capital, and entrepreneurial coordination expended to create the improvements. Alternatively, an appraiser can estimate the land value by capitalizing the residual income to the land. The land income that is capitalized into value is the residual income remaining after operating expenses and the return attributable to the improvements have been deducted from the income to the total property.² In testing alternate uses with the land residual technique, the process of capitalization magnifies any differences in the residual income attributable to the land. Therefore, the appraiser should take special care in considering the conclusions or data input into the highest and best use analysis. While the land residual technique can be used in the development of one indication of land value, it is more useful in highest and best use analysis because the relative residual land values of alternate uses can be compared to determine the use that yields the highest value. Chapter 22 discusses the land residual technique and other types of residual techniques in more detail.

The Conclusion of Highest and Best Use as though Vacant

The conclusion of highest and best use should be clearly stated in terms of the following:

1. Use(s)
2. Timing for use(s), i.e., absorption, rents, occupancy, and other considerations
3. Market participants
 - a. Users
 - b. Most probable buyers/tenants

² According to traditional economic theory, income attributable to the three other agents of production (labour, capital, and entrepreneurial coordination) is paid, and then the remaining income – i.e., the residual – is attributable to the land.

The conclusion of the highest and best use of a parcel of land should be as specific as the appraiser's research allows and the assignment requires. Available data might only support general conclusions as to use. General categories such as "an office building", "a commercial building", or "a one-unit residence" may be adequate in some situations, but in others the particular use demanded by market participants must be specified, such as "a suburban office building with 10 or more floors" or "a three-bedroom residence with at least 2,500 square feet." Sometimes there is ample sales evidence available on highly similar sites, so it is unnecessary to refine the highest and best use conclusion. In any case, the appraiser should provide market evidence that leads to an understanding of the use or uses, the timing for those uses, and the probable users and buyers.

The intensity of a use is an important consideration in highest and best use analysis. The present use of a site may not be its highest and best use. The land may be suitable for a much higher, or more intense, use. For instance, the highest and best use of a parcel of land as though vacant may be for a 10-storey office building, while the office building that currently occupies the site has only three floors. Conversely, it is possible the highest and best use could be less dense than the current use, perhaps due to a downturn in demand.

The timing of a specified use is another important consideration. In many instances, a property's highest and best use may change in the foreseeable future. For example, the highest and best use of a farm in the path of urban growth could be for interim use as a farm, with a future highest and best use as a residential subdivision. If the land is ripe for development at the time of the appraisal, there is no interim use. If the land has no subdivision potential, its highest and best use would be for continued agricultural use. In such situations, the immediate development of the land or conversion of the improved property to its future highest and best use is usually not financially feasible.

Another important consideration is who among the market participants would be attracted to the highest and best use. In the market delineation step of the market

THE IDEAL IMPROVEMENT

If the appraiser concludes that a building improvement is the highest and best use of a parcel of vacant land, the appraiser then determines and describes the type and characteristics of the ideal improvement to be constructed. The ideal improvement should meet the following criteria:

- Takes maximum advantage of the site's potential market demand
- Conforms to current market standards and the character of the market area
- Contains the most suitably priced components

If a new improvement is considered to be the highest and best use of the land as though vacant, it presumably will have no physical deterioration or functional obsolescence – i.e., it would be neither an underimprovement nor an overimprovement. Thus, any difference in value between the existing improvement and the ideal improvement would be attributable to these forms of depreciation. The appraiser must still consider external obsolescence, which may affect both the existing improvement and the ideal improvement.

analysis process (Step 2), the appraiser determines the probable users for the specified use as well as probable buyers. The development of those conclusions in market analysis is integral to highest and best use analysis.

Highest and Best Use of Property as Improved

Highest and best use of a property as improved pertains to the use that should be made of an improved property in light of the existing improvements and the ideal improvement described at the conclusion of the analysis of highest and best use as though vacant. With any improved property, there are three possibilities that must be considered:

1. Demolish the existing improvements and redevelop the site
2. Continue the existing use
3. Modify the existing use

The analysis of highest and best use as improved also applies when proposed improvements are being valued. For example, consider an assignment in which the land is vacant at the time the appraisal is prepared, and the appraiser develops a market value opinion that is either:

1. Subject to the hypothetical condition that the improvements are built as of the current date
or
2. Subject to the extraordinary assumption that the improvement will be built as of a future date.

In such a case, the appraiser must analyze the highest and best use of the property as if *improved as proposed*.

If an extraordinary assumption such as this is made, the appraiser bases the assumption on a conclusion developed from the appraiser's research and data. Because readers of the appraisal report may confuse the appraiser's opinion that the construction is likely with the fact that the improvements do not factually exist at present, appraisers must take care to distinguish these differences and the effect of differences in time frames between the effective date of the value opinion and the date that improvements are forecast to exist.

The highest and best use of a property as improved may be continuation of the existing use, renovation or rehabilitation, expansion, adaptation or conversion to another use, partial or total demolition, or some combination of these alternatives.

Testing Continuation of the Existing Use of the Property as Improved

The existing use of the property as improved is often implicitly legally permissible and physically possible. If the existing use will remain financially feasible and is more profitable than modification or redevelopment, the existing use will remain the highest and best use of the property as improved.

An appraiser may need to address deferred maintenance in the analysis of the financial feasibility of the existing use. The property may require repairs for the existing improvements to achieve the best competitive position in the marketplace. The costs of curing physical deterioration or functional obsolescence, redesigning a building, or converting the existing improvements into an alternative use (including a provision for profit) must be analyzed in light of the value created in the market. The effect of the changes on value is more important than simply how much the changes will cost. If the changes will not be economically feasible, the expenditures would not be made – a point that the appraiser would be wise to incorporate into the highest and best use analysis.

Testing Modification of the Existing Use of the Property as Improved

Modification of the existing improvements must meet all four tests of highest and best use. The study of property productivity in the market analysis process is likely to show what changes to the existing use are physically possible and legally permissible. Determining the financially feasible modification that is more profitable than either the existing use or any other modifications is a matter of weighing the costs of modification and the benefit to the property, e.g., an adequate increase in rent as a result of the modification. Failing to adequately test for the possibility of modification of the existing use can be a serious flaw in an appraisal.

For nonconforming properties or properties with improvements that differ significantly from the ideal improvement, the appraiser must determine whether the codes, ordinances, or private restrictions allow modification of the improvements that would bring them into conformity. This may involve analysis of the reasonable probability of a change in zoning as was conducted in testing the highest and best use of the land as though vacant. Again, the appraiser should report any evidence supporting a reasonable probability that a change could be made to bring the improvements into conformity with a particular code, ordinance, or restriction. Such evidence could include trends in the market area, historical changes to codes or ordinances in the area, or a community's master plan. The appraiser should incorporate the costs of obtaining the changes, the time necessary to achieve the changes, and the risk of achieving the changes into the analysis of financial feasibility of modification of the existing use of the property as improved.

Testing Demolition of the Property as Improved and Redevelopment

Demolition can be considered the most extreme form of modification of the existing use of the property as improved. When an alternative use of the site is legally permissible, physically possible, financially feasible, and more profitable (less the cost of demolition and redevelopment of the site) than the continuing use of the existing improvements, then the alternative use will be the highest and best use of the property as improved. Many buildings are torn down and their sites left vacant or devoted to an interim use for a variety of reasons: property taxes, liabilities, avoidance of criticism about an "eyesore", and others.

SPECIAL SITUATIONS IN HIGHEST AND BEST USE ANALYSIS

In identifying and testing highest and best use, special considerations are required to address the following situations:

- Single uses
- Legally nonconforming uses
- Interim uses (including land held for investment purposes)
- Uses that are not the highest and best use
- Multiple uses
- Special-purpose uses

Single Uses

The highest and best uses of land as though vacant and property as improved are often consistent with surrounding uses. For example, in an industrial district, a single-unit home would usually stand out as an inconsistent – and inappropriate – land use. Sometimes, however, a property's highest and best use may be unusual or even unique. For example, market demand may be adequate to support one large, multi-storey office building in a community, but the market may not support more than one. As another example, a limited-market or special-use property such as a specialized industrial facility may be unique and highly beneficial to its site, but it might

not be supported by surrounding land uses or comparable properties. Regardless of what improvement is currently on a site, the highest and best use of the site as though vacant should be the land use that meets all four tests. Therefore, the ideal improvement might be significantly different than the existing improvements, and the highest and best use of the site as though vacant for a single-use property might be to develop it differently than it is currently developed.

If an existing single-use property is being appraised, the appraiser should perform some level of market analysis to determine whether the single use should be continued or discontinued. If the analysis reveals that the single use should be discontinued, the appraiser should then ask what, if anything, should be done with the improvements? If the improvements do not contribute to value and the assignment involves an opinion of market value, then the highest and best use would probably be something other than maintaining the existing use. Also, the improvements might contribute to value but still not qualify as the highest and best use because modification of the existing improvements would create a higher value. For a proposed single-use property, the appraiser should carefully analyze the market to determine whether any other such properties already exist and, if so, if the market demand is strong enough to support another.

Single uses, interim uses, legally nonconforming uses, uses that are not the highest and best use, multiple uses, and special-purpose uses all require special consideration.

single use

A special case of highest and best use; a unique or special-purpose land use that may not be consistent with surrounding uses.

Legally Nonconforming Uses

A legally nonconforming use is a use that was lawfully established and maintained but no longer conforms to the land use regulations of the zone in which it is located. Some legal nonconformities can be created by governmental action such as a partial taking in an expropriation proceeding. Consider a gas station property with 20,000 square feet of land, which is the minimum amount of land area required by zoning for gas station use. If the city acquired 1,000 square feet of the land for an intersection

legally nonconforming use

A use that was lawfully established and maintained, but no longer conforms to the use regulations of the current zoning in the zone where it is located; also known as a *grandfathered use*.

improvement, the site would then contain 19,000 square feet and would no longer conform to the zoning requirements for site size. Other legally nonconforming use situations can be created when codes and ordinances are changed. For example, a single-unit residence on a 7,500 square foot site in the core residential district of a community zoned R-1 requires at least 7,500 square feet of land area. If the city adopts a new zoning ordinance in which the minimum site size for a lot zoned R-1 is increased to 10,000 square feet, the existing property will no longer conform. In both instances, the nonconforming use situations are considered legal nonconformances because they were caused by an action of a governmental body. Some communities also differentiate between legally nonconforming uses and properties that are legal but do not conform to development standards. In the former, the use is nonconforming, but in the latter the property is still used in accordance with the zoning but the site (or the house) may be too small. Most zoning ordinances have special sections that deal with nonconforming use situations; appraisers must be familiar with these sections when appraising legally nonconforming uses.

Zoning changes may create underimproved or overimproved properties. A one-unit residence located in an area that is subsequently zoned for commercial use may be an underimproved property. In this case, the residence will most likely be removed so that the site can be improved to its highest and best use, or the residence will be considered an interim use until conversion to commercial use is financially feasible. A legally nonconforming property can become overimproved when zoning changes reduce the permitted intensity of property use. For example, the site of an older apartment building with eight units in a fully built-up neighbourhood might be downzoned to a less intense use. That is, if the vacant site were developed now, the new zoning restrictions would only allow six units to be built. Nonconforming uses may also result from changes in development standards that affect features such as landscaping, parking, setbacks, and access.

Zoning ordinances vary with the jurisdiction. They usually permit a pre-existing, or grandfathered, use to continue but prohibit expansion or major alterations that support the nonconforming use. Some jurisdictions specify a time period for phasing out legally nonconforming uses. In many jurisdictions when a nonconforming use is discontinued, it usually cannot be reestablished. In most jurisdictions, a nonconforming use must be eliminated if the property suffers major damage or if the property is abandoned for a statutory period of time. In some instances, a nonconforming use can

be rebuilt to the same intensity of use that it had prior to its destruction, provided it has no more impact on the market area than it did before.

When valuing land with a legally nonconforming use, an appraiser must recognize that the current use may be producing more income, and thus have more value, than the property could produce with a conforming use. The legally nonconforming use may also produce more income and have a higher value than comparable properties that conform to the zoning. Therefore, when the value of the legally nonconforming use of the property is developed by comparing similar, competitive properties to the subject in the direct comparison approach, the appraiser should consider the higher intensity of use allowed for the subject property and also consider the risks and limitations associated with the nonconformity. In the case of the eight-unit apartment building in an area downzoned to six-unit developments, for example, the appraiser will have to determine whether sales of properties with six units are appropriate comparable transactions in applying the direct comparison and income approaches.

Legally nonconforming uses that correspond to the highest and best use of the property as improved are often easy to recognize. However, sometimes it is not clear whether an existing nonconforming use is the site's highest and best use. The question can only be answered by careful analysis of the income or selling price produced by the nonconforming use and the incomes or selling prices that would be produced by alternative uses if the property were brought into conformity with existing regulations.

Interim Uses

The use to which a site or improved property is put until it is ready for its future highest and best use is called an interim use. Thus, interim use is a current highest and best use that is likely to change in a relatively short time, say, five to seven years. Buildings that are nearing the end of their physical lives, farms, parking lots, and temporary buildings may be interim uses. Mining and quarry operations may be considered special cases of interim uses that usually continue until depletion of the resource.

The appraiser must identify the interim uses of the property being appraised and all comparable properties. The appraiser must take into account differences in the interim uses of comparable properties even though their future highest and best uses are identical. Differences in the prices paid for such properties may be due to different return requirements and different anticipated demolition costs.

An interim use may or may not contribute to the value of the land or the improved property. If an old building or other use cannot produce gross revenues that exceed reasonable operating expenses, it does not contribute to property value. If the net return of the improvements is less than the amount that could be earned by the vacant land, the buildings do not have contributory value (although in some markets property owners may prefer to retain a single-unit dwelling on commercial land in transition rather than leave the land vacant). Indeed, the value

interim use

The temporary use to which a site or improved property is put until it is ready to be put to its future highest and best use.

of an improved property may be less than the value of the land as though vacant when demolition costs and real estate taxes are considered. The value of the land is based entirely on its potential highest and best use.

The principle of consistent use, which holds that land cannot be valued based on one use while improvements are valued based on another, must be considered when properties are devoted to temporary, interim uses. The use value of a site under an interim use may differ substantially from the market value of the same site as though vacant and available for development to its long-term highest and best use. Many outmoded improvements clearly do not resemble the ideal improvement, but they do create increments of value over the value of the vacant land. These improvements may appear to violate the principle of consistent use, but in fact, the market simply acknowledges that during the transition to a new use the value contributed by old improvements make the land and the existing improvements worth more than the vacant land.

Land that is held primarily for future sale, with or without an interim use, may be regarded as a *speculative investment*.³ The purchaser or owner may believe that the value of the land will increase, but there is a risk that the expected appreciation will not occur while the investor holds the land. Nevertheless, the current value of the land is a function of its future highest and best use, so the appraiser should discuss its potential highest and best use. The appraiser may not be able to predict the exact future highest and best use, but the general type of future use and the timing for the use can be forecast based on its site, legal, locational, and market demand characteristics compared to competitive vacant tracts. The timing for such a use is usually in a range. The range can be broad in areas of long-term growth and tighter in areas with more current development potential.

Use That Is Not the Highest and Best Use

According to the concept of consistent use, an improvement must be valued based on a use that is consistent with the property's highest and best use (if the value sought is market value). However, many existing buildings and other improvements are inconsistent with the ideal improvements for their sites and are developed differently than they would be if the land were vacant. Nevertheless, the highest and best use may be in the same category as the existing use. For example, the highest and best use of a site improved with a 10-year-old apartment building may be for a new, more functional apartment building. Similarly, the highest and best use of a residential site improved with a 20-year-old house may be for a new, more modern one-unit residence.

For certain sites the general category of highest and best use may have changed, e.g., from apartment to industrial use or from one-unit residential to commercial use. If the improvements on these sites existed prior to the change in the market area, they suffer from external obsolescence and are likely to have less value than similar improvements on more appropriate sites. It would be incorrect to value such

³ In general usage, the term *speculative investment* can carry pejorative implications of high risk or uncertainty. In the language of real estate appraisal, speculation is defined as the purchase or sale of property motivated by the expectation of realizing a profit from a rise in its price.

improvements as if they were located on an appropriate site. The appraiser would need to find comparable sales on similarly inappropriate sites or determine an adjustment for the external obsolescence. Similarly, comparable rental properties ought to reflect or be adjusted to reflect similar deficiencies in location. The cost approach value indication would also be affected by external obsolescence.

Mixed Uses

Highest and best use often comprises more than one use for a parcel of land or an improved property. A large tract of land might be suitable for a planned unit development with a shopping centre in front, condominium units around a golf course, and one-unit residential sites on the remainder of the land. Business parks often have sites for retail stores in front and warehouse or light manufacturing structures in the rear.

mixed use

A combination of compatible land uses in an area or in a single building.

One parcel of land may serve many functions. Timberland or pastureland may also be used for hunting, recreation, and mineral exploration. Land that serves as a right of way for power lines can double as open space or a park. Public streets with railroad sidings are also considered multiple-use land.

A single building can have multiple uses as well. A hotel may include a restaurant, a bar, and retail shops in addition to its guest rooms. A multi-storey building may contain offices, apartments, and retail stores. A "single-family", owner-occupied home may have an apartment upstairs.

If the highest and best use of a property is for more than one use on the same parcel or in the same building, the appraiser must estimate the contributory value of each use. If, for example, the market value of a timber tract that can be leased for hunting is compared on a unit basis with the value of another timber tract that cannot, the difference should be the value of the hunting rights. In the opinion of market value, the appraiser would have to account for both the value of the hunting rights and the value of the timber operation on the site. In oil-producing areas, appraisers are often asked to segregate the value of mineral rights from the value of other land uses; properties with mineral rights value can be compared with properties that do not have such rights. In multiple-use assignments, the sum of the values of the separate uses may be less than, equal to, or greater than the value of the total property.

Special-Use Properties

Since special-use properties are appropriate for only one use or for a very limited number of uses, appraisers may encounter practical problems in specifying highest and best use. The highest and best use of a special-use property as improved is probably the continuation of its current use if that use remains viable. For example, the highest and best use of a plant currently used for heavy manufacturing is probably continued use for heavy manufacturing, and the highest and best use of a grain elevator is probably continued use as a grain elevator, as long as there is sufficient market demand for such use. The highest and best use conclusions in both examples would likely include some forecast of continued economic demand. If the

current use of a special-use property is physically, functionally, or economically obsolete and no alternative uses are feasible, the highest and best use of the land may be realized by demolishing the structure and possibly selling the remains for their scrap or salvage value. This may be true even if the improvements are still relatively new and even if they were costly to build.

Sometimes assignments involving special-use properties require two valuation scenarios to address the appraisal problem:

1. A market value based on the property's highest and best use
2. A use value that presumes the existing use

When this is the case, the appraiser must be careful to develop each value opinion appropriately and to be very clear in reporting the assignment results. An opinion of market value requires there be a market for the property. If there are no buyers for the subject property in its current use, an alternative use must be considered. Using the cost approach to value a special-use property where no market exists will usually overstate the market value of the property.

Table 12.1: Highest and Best Use Statements in Appraisal Reports

| | |
|---|--|
| <i>If . . .</i> | The land is already improved to the highest and best use. |
| <i>Then the report should include . . .</i> | A discussion of this analysis and conclusion. |
| <i>If . . .</i> | The highest and best use of an improved property is different from its existing use. |
| <i>Then the report should include . . .</i> | Justification for this conclusion in a market value appraisal report. |
| <i>If . . .</i> | The property is improved but a separate estimate of land value is presented in the appraisal. |
| <i>Then the report should include . . .</i> | Discussion of the highest and best use of the land as though vacant as well as the highest and best use of the property as improved. |
| <i>If . . .</i> | A separate estimate of land value is not presented, and continued use of the property as improved is an appropriate limiting condition of the appraisal. |
| <i>Then the report should include . . .</i> | Discussion of only the highest and best use of the property as improved, unless the highest and best use of the land as though vacant is relevant to the analysis of highest and best use as improved. |
| <i>If . . .</i> | The highest and best use of the land as though vacant and highest and best use of the property as improved are different. |
| <i>Then the report should include . . .</i> | Discussion of the analysis of each highest and best use separately. |

COMMON ERRORS AND ISSUES IN HIGHEST AND BEST USE

- One misconception is that it is acceptable to simply state the highest and best use conclusion. Appraisals typically require some analysis of highest and best use. Solely providing data is not addressing highest and best use – the data must be analyzed.
- Another misconception is that it is unnecessary to discuss excess land or functional issues relating to highest and best use.
- Sections of appraisal reports are related. The market analysis and other sections of the report must support highest and best use conclusions as well as the valuation sections.
- When the existing use is legal but nonconforming and is obviously the highest and best use, it is appropriate to acknowledge in the report that highest and best use is the current use, which is legal but nonconforming.

REPORTING HIGHEST AND BEST USE CONCLUSIONS

When an appraisal report includes a market value opinion, the report must address highest and best use. Highest and best use as though vacant must be addressed in reports that include a market value opinion for the site as though vacant. Highest and best use as improved must be addressed in reports that include a market value opinion for the property as improved. A logically structured highest and best use study of the four tests forms the foundation for the opinion of value. Certain conditions of an appraisal assignment may alter the information that should appear in the appraisal report regarding highest and best use, as illustrated in Table 12.1.

As illustrated earlier in the chapter, much of the information required to perform highest and best use analysis is developed using the six-step market analysis process. An appraiser may need to include a discussion of or reference to a separate marketability study (either inferred or fundamental) prior to the discussion of the highest and best use determination.

In addition, highest and best use analysis often incorporates techniques and data from the application of all three approaches to value. In many appraisal assignments, the final tests of financial feasibility and maximum productivity require information that is obtained from the application and development of the approaches. Therefore, even though the discussion of highest and best use traditionally precedes the approaches to value in an appraisal report, the conclusion of highest and best use often can be finalized only after a preliminary analysis of alternative land uses has been performed. The conclusions reported in the highest and best use section of a report should be consistent with conclusions and applications in the other parts of the report.

