HIGHEST AND BEST USE

A new look into the future

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The Appraisal Institute defines highest and best use as "the reasonably probable and legal use of vacant land or an improved property that is physically possible, appropriately supported, financially feasible and that results in the highest use."

Traditionally, highest and best use was limited to the four criteria including legal permissibility, physical possibility, financial feasibility and maximum productivity. Often, a funnel will be used whereby the five basic real estate markets (residential, commercial, industrial, agricultural and special use) are poured into the funnel, thus narrowing down the use by process of elimination. For example, assume one is valuing a 3.5-acre vacant tract of land located along a major highway at the edge of town, and the site is zoned "C" for Commercial. In this case, the legal constraints of zoning would eliminate residential and industrial uses while its size would limit agricultural uses. The appraiser next looks at the site and concludes that the highest and best use is for commercial use. This, of course, assumes that market demand exists and that supply is in balance. This simplest analysis falls short of what is required within USPAP and often fails to properly identify alternative uses or simply glosses over market-driven trends.

Appraisers are taught that highest and best use is the cornerstone of the appraisal process. Additionally, highest and best use is often the source of divergences of value between two appraisers. The purpose of this article is to inform appraisers and users of appraisal services of new teachings in highest and best use analysis.

Highest and Best Use and USPAP

According to the 2020-2021 Uniform Standards of Professional Appraisal Practice (USPAP), Standard Rule 1-3, "when necessary for creditable assignment results in developing a market value opinion, an appraiser must (a) identity and analyze the effect on use and value of (i) existing land use regulations; (ii) reasonably probable modifications of such land use regulations; (iii) economic supply and demand; (iv) the physical adaptability of the real estate; and, (v) market area trends; and (b) develop an opinion of the highest and best use of the real estate."

It should be noted that a more detailed highest and best may not be necessary in all circumstances. For example, if the subject is a single-family dwelling in an existing single family development with strong market activity, it is likely that an exhaustive analysis of highest and best use is not necessary. However in right of way projects, often the nature of the acquisition may require more analysis, particularly in partial acquisitions.

The Eight-Step Process of Highest and Best Use

In the 2020 "The Appraisal of Real Estate," 15th Edition, Appraisal Institute, Chapter 18 expands upon the concept of highest and best use. Whereas many appraisers and users of appraisal services are aware of the basic concepts (such as the four criteria test), additional market data and marketability analysis may be warranted to produce a creditable opinion of value. The following chart, taken from the Appraisal of Real Estate, can assist the appraiser in better supporting their opinion.

Dividing the analysis of highest and best use into eight parts provides a new framework to better analyze this important concept.

Under the traditional method, Step One analyzes the property's physical and legal constraints. This is the part of the analysis most appraisers grasp. In Step One, one should be delving into the property's potential productivity. This includes a study of its ease of access, location, visibility, proximity to utilities, physical characteristics of the site and zoning/deed restrictions. However, moving into the remaining steps is often ignored or glossed over.

Under Steps Two through Six, the appraiser should delineate and analyze the market. In the example of the vacant 3.5-acre site, one must determine the market for the tract of land. Under the zoning, what uses are permitted? Can the zoning be modified or changed? What is the level of competition?

Using this example, assume that the 3.5-acre site is physically possible and legally permissible to develop a hotel, an office or a strip shopping center. Under the eight-step process, one would need to explore the potential demand for each use, analyze the supply of sites competing for this use and determine if there are pending projects that would compete with the subject. In our example of the 3.5-acre site, if we determine that the demand for office space (for example if the vacancy factor is 20 percent), we might question if new development is likely to occur. In the case of hotel use, we should explore if occupancy (demand) is sufficient to warrant new construction. Basically, one is determining if the existing supply satisfies the current market demand and if anticipated demand is sufficient to warrant new construction.

EIGHT STEPS OF THE HIGHEST AND BEST USE ANALYSIS PROCESS

Step 1.	Property Productivity analysis	Analyze property productivity attributes (site, legal, and location) to eliminate uses and determine most probable uses	Physical possibility Legal permissibility
Step 2. **Step 3.** **Step 4.** **Step 5.** **Step 6.**	Delineate the market Demand analysis Supply analysis Residual demand analysis Subject capture analysis	Perform market studies to determine the economic demand and timing for probable alternative uses Perform marketability analysis	Data required for analysis of financial feasibility
Step 7.	Financial analysis of alternative uses	Complete a financial analysis of alternative land uses to determine which use has the highest residual land value	Financial feasibility
Step 8.	Highest and best use conclusions	Perform highest and best use reconciliation and draw conclusions: · Use · Timing · Market participants - Users of space - Most probable buyer type	Maximum productivity

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Under Step Seven, construction costs and the availability of financing will play a role in the analysis. The use which produces the highest financial reward will be the highest and best use.

In our example site, we have found that office demand was flat and construction costs render new development as unfeasible. Thus, this use can be eliminated. However, we noted that within the neighborhood (or market area), several new hotels have been constructed. Also, the local retail market appears strong with new development and strong occupancy. In our research, we

find that sales of retail sites are averaging $7.50/SF whereas hotel sites are averaging $10.00/SF. However, while hotel sites are costing more, the subject site's ability to secure an anchor tenant (such as a grocery store, which is an economic draw) may create a competitive advantage over the use as a hotel site.

In Step Eight, the conclusion of highest and best use must consider the timing of development and availability of market participants. Ultimately, who is going to purchase and use the site? The comparable sales selected in the valuation should match the timing, use and user conclusions.

Conclusion

For condemnation projects, it is important to recognize that the valuation of the remainder after may (and often does) change the highest and best use. For example, a proposed partial acquisition may alter access into the property. Other potential problems that should be considered include creation of easements that limit the use and utility of the remainder, additional development costs created by the acquisition, irregular shape and/or size configuration, problematic interior site circulation, limitations as a result of new governmental restrictions, etc. Another issue might arise by the creation or elimination of surplus or excess land, the creation of non-conforming uses, and/or the creation of an interim use.

In conclusion, the concept of highest and best use has become more complex and requires more diligence by appraisers, especially in right of way appraisals. ✪

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