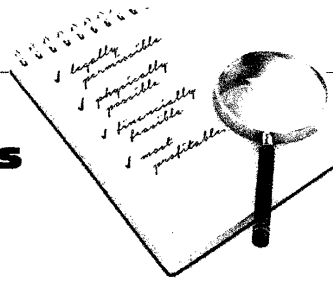


# Highest and Best Use Analysis

by Philip G. Spool, ASA



In any appraisal assignment the importance of identifying the appraisal problem will determine the Scope of Work. The highest and best use of the property is determined afterwards. Why is the highest and best use so important in the appraisal process? It is because the highest and best use determines the most profitable use of the site, whether the subject is vacant land or an improved property on the site.

This article applies to both residential and commercial appraisers. The highest and best use usually requires less analysis when appraising an existing property rather than a proposed property. However, an improved structure is not always its highest and best use.

The fifth Edition of *The Dictionary of Real Estate Appraisal* by 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 value.* Most textbooks don't mention "appropriately supported" as part of the highest and best use definition. The Uniform Standards of Professional Appraisal Practice (USPAP) does not have a definition for highest and best use. However, if an appraisal report is prepared, it requires the appraiser to summarize the support and rationale for that opinion.

An essential element in the preparation of highest and best use is to understand the market forces that affect the subject property. What are the

surrounding properties? Are they similar to your subject property? This is most important when appraising a proposed structure, whether it is a residential or commercial property.

Most residential appraisers use the Fannie Mae form and are content with checking the box "yes" indicating that the highest and best use of the subject as improved is its present use. But the appraiser who does not think beyond checking that box "yes," is doing a disservice to their client by not understanding what highest and best use is all about.

## Four Tests of Highest and Best Use

The four tests of highest and best use are: (1) legally permissible (2) physically possible (3) financially feasible and (4) most profitable. The first two tests are interchangeable in order and, in many circumstances, the last two are combined. Steps three and four (financially feasible/most profitable) cannot be determined until the first two steps are analyzed.

### Legally Permissible

*Legally permissible* primarily pertains to the zoning of the property and its restrictions, such as a deed restriction. For the most part, residential appraisers center their analysis on the various zoning aspects, such as minimum lot size and maximum building size. Waterfront properties may have a maintenance easement that affects the existing or proposed

structure. Therefore, be sure to obtain a current survey of the property. For commercial appraisers, zoning becomes more of an issue with the building height and size. If appraising an apartment complex, it is important to consider the density or number of units per acre of a property that is zoned multifamily. A boundary survey is necessary to indicate if there are any easements or encroachments.

Another consideration is whether the existing structure is a legal non-conforming use. A legal non-conforming use may be "grandfathered," meaning that the structure is okay to remain as is but would not be allowed to be built today under current zoning requirements. But it was considered legal when it was built. An example of a legal, non-conforming use would be a duplex, in a site zoned for a single family or multifamily residence, with a higher density than would be allowable today.

### Physically Possible

The appraiser must take into consideration the size, shape, topography and accessibility of the site when determining what is *physically possible*. Is the size of the site adequate to construct an improvement? What if the site is much larger than the surrounding lots? Can the site be split physically into additional sites? Is the site level or sloping, requiring additional fill to level it or is that typical for the properties in that area? Is the property easily accessible? Is it on a one-way street, divided road or a main thoroughfare? All these situations have to be taken into consideration and mentioned in the report if necessary. Even if there is an existing improvement on the property, you must explain this in your appraisal report so that your client



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will fully understand the property you are appraising.

An analysis of “physically possible” also may examine current improvements. An existing property that underutilizes the site, such as a small structure on a large lot, should have this issue addressed in the appraisal report. This is an example of a non-conforming use that is not necessarily a legal non-conforming use. It may also be considered an interim use or valued for just the site.

### **Financially Feasible**

*Financially feasible* may also consider whether the property is economically feasible. This pertains to the highest and best use as if vacant. Again, it is important to know the surrounding properties. If the proposed property would be an average single family residence, more than likely, it would not be financially feasible to have a house that plans on including many high-end extras, in comparison to the surrounding houses, because that would create an over-improvement.

The same applies to a proposed large two-story house with twice the gross living area of the one story houses in its surrounding neighborhood. The appraiser needs to mention in the report that the cost to construct the improvements is well beyond the cost to construct a typical house for the area. No one wants to pay dollar for dollar for a large house if it is the only one like it on the block. The value by the cost approach would be greater than the sales comparison approach unless you deduct for functional obsolescence, which would be difficult to quantify.

Another consideration is the design of the property. There are many unusually designed houses that only the property owner would want. There is one house in the Florida Keys that is shaped like the bow of a fishing vessel with a two-story lighthouse attached to its side. I have also seen commercial properties where the design of the building is unique to the area. The cost of these structures is not

financially feasible and would be greater than the financial return.

### **Most Profitable**

The *most profitable* use generally pertains to commercial properties. The bottom line is what would be the highest net income for a proposed structure. Determining the most profitable use might require a market analysis or a feasibility study. Prior to accepting the assignment and quoting a fee, communicate with your client what your Scope of Work will be.

A commercial appraiser valuing a vacant commercial lot on a corner of a busy intersection needs to consider what type of commercial property should be built and its most profitable use. For a commercial appraiser, the highest and best use conclusion is more specific as to the type of improvement that should be built (retail, office, fast food restaurant, service station, etc.). Again, this would require an analysis of the net operating income for each potential building that can be legally and physically constructed on the site.

For residential appraisers, the financially feasible use generally goes hand-in-hand with the most profitable use and can be combined. The residential appraiser need not be as specific to the exact type of house to be constructed. There is some truth to the statement “a house is a house,” even though the size of a proposed house may be based on the typical land-to-building ratio in the immediate area, as well as what type of house should be built—based on the demand at the time of appraisal (size, design/style, amenities, etc.). But the residential appraiser does not make that specific conclusion. That is up to the owner or buyer of the property.

### **“As Improved” Analysis**

What if the appraisal assignment is for a house that is zoned for a single family residence and the existing structure is very old, with the market activity in

the area reflecting demand for custom homes? Older homes are being purchased and demolished to make way to build custom homes.

You need to determine if the existing house is an *interim use* with some contributory value. Your highest and best use conclusion would indicate that you utilize the sales comparison approach with other, older single family residences. However, if the existing house has zero remaining economic life, it still may have a useful life to the homeowner even though the improvements don’t contribute to the overall value of the property.

Your highest and best use conclusion would indicate that you utilize the sales comparison approach for vacant lots or other houses with no contributory value. In either case, the best way to determine if the improvements have any contribution to the overall value is by valuing the land. For those residential appraisers who do the cost approach in their appraisal report, an accurate valuation of the site is important for an older house. Find land sales or do a proper land extraction (abstraction) analysis. Don’t just put a boilerplate statement in your report that the site value was based on land sales and/or land extraction.

### **Commercial Appraisers**

What happens when the appraisal assignment is a house originally zoned as a single family residence but the zoning has changed to commercial use? An example would be a vacant house located on a busy street and surrounded by other houses. The properties along this street were previously zoned for single family residences but now are rezoned for small office usage. Many were converted into small medical offices. Across the street are single family residences with a similar building and lot size that remained zoned for single family residence.

Part of the highest and best use analysis would be to determine if the value of the house zoned for office usage is greater than the houses across the street zoned

for single family residences. In this case, the appraiser must not only find sales of other former houses that were converted into an office but more than likely will have to use the income approach to determine whether the value indicated by the income approach is greater than that of the sales comparison approach. If the highest and best use conclusion is office usage, then it would require a state certified General Real Estate Appraiser, due to its commercial zoning and potential use as an office building. Scenarios like this are important to understand before taking on the assignment.

#### USPAP Requirements

Appraisers who think it is sufficient to state the highest and best use of the subject "as improved," are wrong. Even though the URAR 1004 form asks the

residential appraiser to check the box if the highest and best use of the subject property is its present use, this is not sufficient to satisfy USPAP's requirement to indicate why. Standards Rule 2-2 (a) (ix) indicates: "state the use of the real estate existing as of the date of value and the use of the real estate reflected in the appraisal." But Standards Rule 2-2 (a) (x) goes further by stating: "when an opinion of highest and best use was developed by the appraiser, summarize the support and rationale for that opinion." This requirement is for commercial appraisers as well.

A simple paragraph is sufficient to cover all four parts of highest and best use. The following is an example for a residential appraisal report that can be used and modified if necessary:

"The subject is a legally permissible use based on its current zoning. Also, the

lot size, shape and land-to-building ratio allow the present structure and indicate a good utilization of the improvements. Based on current market conditions, the existing structure as a single family residence is its financially feasible and maximally productive use. The highest and best use, as if vacant, would be to construct a single family residence."

For a commercial appraiser, determining a property's maximally productive use, and ultimately the highest and best use, can be more complex. A more detailed explanation is necessary. **WRE**

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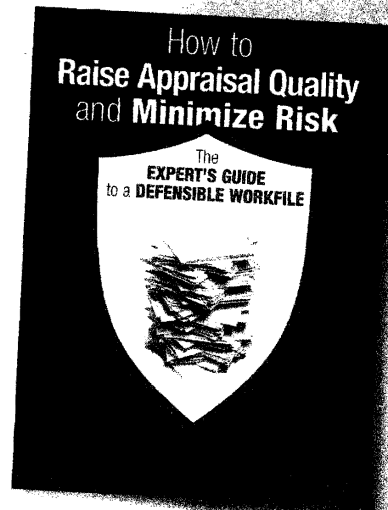
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