

# Highest and Best Use

## and Partial Acquisitions

BY TODD PICKETT

Appraising for partial acquisitions can often present many challenges to an appraiser and two of the more common of such challenges are the determination of highest and best use (HBU) and the larger parcel. As such, this article will focus on the application of highest and best use and the necessary points that have to be considered in order to determine the larger parcel being appraised and whether the concluded larger parcel has more than one zone (band) of value.

Every appraisal that is completed for a partial acquisition has to include adequate discussion and examination of the foregoing. To elaborate, let's suppose that you have been asked to appraise a 35-acre parcel of land that has a property requirement located within a 5-acre portion of the site and it cannot sustain any form of development. How should compensation be determined?

Generally, the first consideration is the impact the requirement will have on the property as a whole. In order to do this, the HBU of a property must be considered, as the highest and best use analysis of a real property is fundamental to the estimate of its market value. Typically, the four headings under which this analysis is completed are: legally permissible, physically possible, financially feasible and maximally productive. A detailed discussion on each is found in *The Appraisal of Real Estate, Canadian Edition*, published by the Appraisal Institute of Canada.

Two criteria — financially feasible and maximally productive — are very similar in that they analyze the economic determinants of highest and best use. This is why they are often discussed under the one heading of economic.

During negotiations for a partial acquisition, I have found that the general public more easily understands the concept of HBU when it

is addressed in this manner. It paints a clearer picture for them when it is explained that, before a proposed use is considered, it must be physically possible, legally permissible and economically viable.

The application of the concept of HBU can be relatively easy if the property is a new office building in the middle of a business district of a city or if it is a vacant piece of land in the middle of a residential subdivision. But, what if the property is a vacant piece of land located on the fringe of a town, on a major traffic route and zoned for future development? In this situation, the adage that vacant land can be the most difficult property to appraise often proves true. In similar circumstances, appraising for a partial acquisition can present a further challenge for appraisers.

The term partial acquisition refers to a partial requirement for the 1) fee simple ownership; 2) easement or covenant; and 3) an easement for a specified period (temporary easement) of a property. It can also refer to any combination of the three items listed.

Often, when estimating the market value of a property for a partial acquisition, as part of an HBU analysis, an appraiser will have to determine which is the larger parcel and possibly if there is more than one zone (band) of value. Basically, zones of value refer to the amount of value that each individual portion contributes to the overall value of the property.

Consider the following example (please refer to Figure 1):

John and Jane Doe are the fee simple owners of a 35-acre property located on the corner of a major four-lane divided highway and a busy secondary highway. The Highway Authority has plans to improve the intersection where it is located and, therefore, requires property along both its major highway frontage and

secondary highway frontage. Zoning for the property is highway commercial (because of its relatively level and dry terrain) and environmental protection (because of its low, wet terrain and organic soil composition). The environmental assessment report has cleared the project.

This example poses questions as to what is the larger parcel and whether or not there is more than one zone of value.

There are three recognized tests for determining the larger parcel: unity of ownership, contiguity and unity of use. As discussed in *Real Estate Valuation in Litigation*, by J. D. Eaton, not all three determinants for the larger parcel have to be present. However, Eaton goes on to explain that the courts have been more flexible with the requirement for physical contiguity, but have been consistently unanimous when ruling that the prerequisites for the larger parcel are unity of ownership and unity of use.

In order to determine this, we must first consider the physical, legal and economic (financially feasible, maximally productive) components of HBU.

### Physical

An in-depth analysis of the physical makeup of the property is essential to determine the HBU, as well as whether or not it has more than one zone (band) of value. Based on the sketch and the description of the subject property, it can be concluded that the portion zoned for highway commercial use is generally flat and dry land. Conversely, the portion zoned for environmental protection is low and wetland, located in a flood plain that is composed of mostly organic soils. Such vital physical information is typically determined by a good site inspection and a review of the topography and soil maps for the property.

### Legal

The legal aspects of HBU are essentially determined by the property's zoning, but may include environmental regulations and other legal interest such as long-term leases. Concern over the impact that development can have on the environment has prompted considerable changes to environmental regulations as

**“Before a proposed use is considered, it must be physically possible, legally permissible and economically viable.”**

they relate to land use. For example, in some jurisdictions, a change in use from significant wetland or primary agriculture to urban is strictly prohibited. As well, if the property has a long-term lease, it can affect its HBU because the terms of the lease may limit or prevent future development. A partial acquisition appraisal must identify all interest in the land, such as a lease, because, if the property being appraised has a leased interest that is affected by the acquisition, then the portion of the lease affected is compensable.

In this example, the subject property is held with fee simple interest and has two areas with separate zoning – environmental protection and highway commercial. Consequently, this means that, based on its zoning, there are two permitted uses on the property.

### Economic (financially feasible, maximally productive)

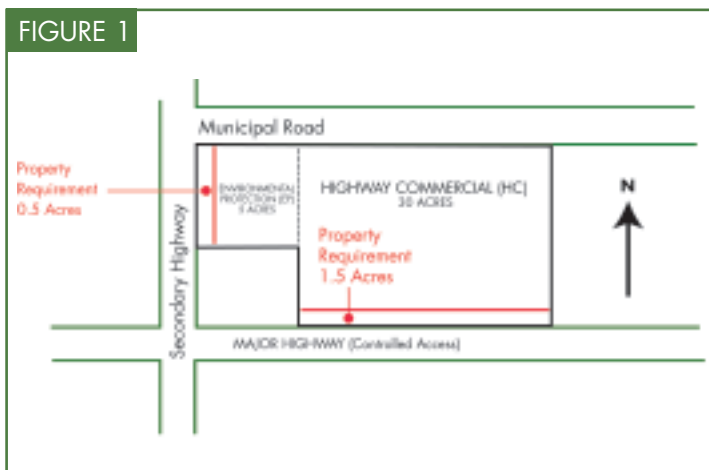
This involves a wide range of factors from the cost to produce or replace a property, to the supply and demand, and the price of competitive properties. Intrinsic in these factors is market activity.

With consideration to market activity, let us suppose the property in this example is in a commercial neighborhood that includes several vacant highway commercial properties of similar size (35 acres) and that there is modest growth expected in the foreseeable future. Furthermore, let us assume that these properties do not have an area zoned for environmental protection. Essentially, this means that there are several properties of similar size, with a slightly better overall possible and permitted use than the subject property, available for sale in a somewhat sluggish market.

The following conclusions can be made:

- ▶ The property is 35 acres in size
- ▶ There are two separate zonings (five acres zoned environmental protection and 30 acres zoned highway commercial)
- ▶ The property is owned by Jane and John Doe
- ▶ It is located in a market with several similar properties listed for sale
- ▶ It has frontage on a controlled access highway, a county road and a municipal road

FIGURE 1



Therefore, based on the three tests for the larger parcel, i.e., unity of ownership, contiguity and unity of use (remember that all three do not have to be present in each case), the property is considered to have a larger parcel of 35 acres.

Furthermore, based on the property's zoning, use (current or anticipated), natural topography, soil quality and depth, it is considered to have two zones (bands) of value. Basically, zones of value indicate the contributory value of each zone to the overall value of the property. This is accomplished by dividing the larger parcel into its physical, legal and economic makeup. The *Principles of Right of Way*, published by the International Right of Way Association, states: "Whenever the larger parcel consists of lands with different uses or potentials, or where the site topography, soil bearing quality, or other characteristics are different in various areas of the larger parcel, the right of way appraiser will generally estimate the contributory value of each zone. Generally, he does this by using a different 'price per acre' or 'price per square foot' (unit price) for each zone."

Many appraisers may be wondering if the market reacts in this fashion. Well, put yourself in the shoes of a purchaser and say that you are considering the purchase of property as described above. It is fair to say that as a prudent purchaser your offer will be based on the potential uses for the whole site, while keeping in mind that a large portion is unusable. It is therefore reasonable to state that an offer on such a property will be based primarily on the useable portion of the site that provides utility for development.

Hence, the HBU of the property is considered to be a vacant lot that is well suited for highway commercial development, with a larger parcel of 35 acres and two zones of value.

Compensation for John and Jane Doe can now be determined by using the direct comparison approach to value, with two categories of market data. The first category will include the portion of the property zoned for highway commercial use and the second category will include the portion zoned for environmental protection.

Let's assume that, after a thorough analysis of the market data for the highway commercial portion in Category 1, a final estimate of its market value is a unit rate of \$80,000 per acre. As well, for the environmental protection portion in Category 2, a final estimate of its market value is a unit rate of \$1,000 per acre. Therefore, compensation for the owners is detailed as follows:

**Category 1** (highway commercial portion):

$$\begin{aligned} \text{Area of Requirement} \times \text{Rate Per Acre} &= \\ 1.5 \text{ acres} \times \$80,000 \text{ per acre} &= \$120,000 \end{aligned}$$

**Category 2** (environment protection portion):

$$\begin{aligned} \text{Area of Requirement} \times \text{Rate Per Acre} &= \\ 0.5 \text{ acres} \times \$1,000 \text{ per acre} &= \$500 \end{aligned}$$

*Total Compensation:*  $\$120,000 + \$500 = \mathbf{\$120,500}$

It is easy to see the effect of using separate rates for the property requirement. The benefit of this is that it ensures the property owners receive their due compensation and the Highway Authority does not overpay for the property.

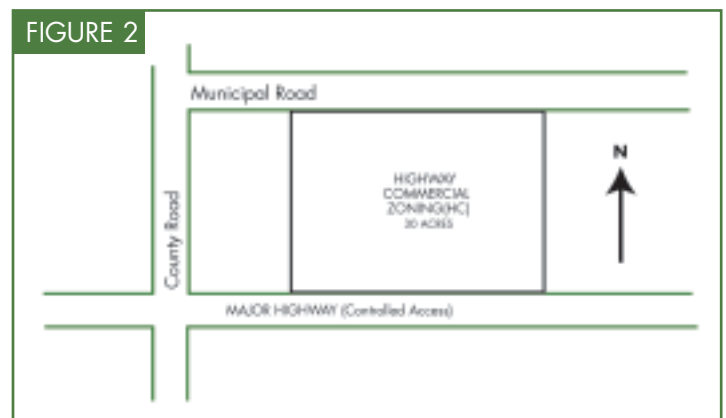
However, it should be noted that this approach does not always apply to each property that has more than one permitted zoning. For instance, it is not very practical when applied to a site developed to its highest and best use, with the entire property complementing this use. As explained in the *Principles of Right of Way*, "it is most useful when applied to rural or development land parcels with different potential when fully developed." A determination as to whether a property has more than one zone of value can only be made after a thorough analysis of all the available data.

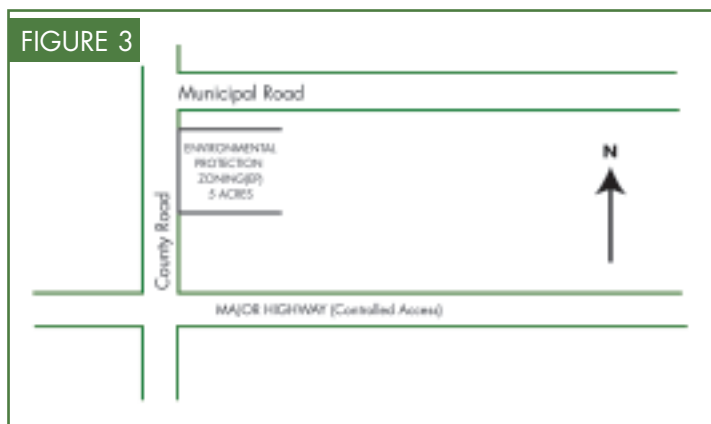
On one occasion, I had to appraise a property with circumstances very similar to the above example. After several meetings, the property owner signed the offer and recognized the merits of using this approach. As one can imagine, expounding the merits of this approach can be quite difficult, but I feel that, by approaching it in the following manner, things were put into perspective for the property owner:

During one of my final visits, I presented the property to the owner on two separate sketches; one showing just the highway commercial portion (Figure 2) and another showing the environmental protection portion (Figure 3).

- 1) I first presented him with the sketch showing the highway commercial portion (see Figure 2) and asked him a question that generally went something like, "if this piece of property was the only portion you owned, what form of development do you feel it could support?" His response was that this is a very good piece of vacant land that could support any number of commercial developments.
- 2) I then presented him with a sketch of the environmental protection portion (see Figure 3) and asked him the same question. His first reaction was laughter, but he then responded that he understood my point.

Sometime after this meeting, the property owner agreed to sign the offer.





This example can be used to outline the principles of determining the larger parcel; however another situation (such as the one shown in Figure 4) may also be encountered.

With this example, the requirement affects the timber land, which is required to successfully operate the saw mill. In this situation both properties would be considered the larger parcel because the saw mill cannot operate without the timber land.

Considering such situations are common practice when appraising for the negotiated purchase of (or the expropriation of) a partial acquisition. It is not only necessary to consider the value of the requirement, but also to consider the impact on a business operation.

Another consideration that is often overlooked is the effect that the requirement has on the property. If there is an adverse effect, then the property owner is entitled to compensation for injurious affection. However, when estimating injurious affection, the appraiser has to consider the possibility of general or special benefits.

- ▶ General benefits are enjoyed by the public in general, or are benefits that accrued to all the property owners affected by a project.
- ▶ Special benefits are enjoyed by a particular property and are a direct result of the project.

Hence, if there is a special benefit to a property that is beyond any general benefit enjoyed by other properties, then the expropriating authority can deduct this benefit from its offer of compensation. This is addressed under section 23 of the Ontario Expropriation Act, which states that any advantage to an owner's land (remaining land) can only be offset against injurious affection. However, it is interesting to note that section 27(g) of the Newfoundland Expropriation Act states that, in all cases, any advantage shall be taken into account in the reduction of the amount of compensation.

Thus, it is important to determine if there has been a change in the HBU of the property, as a result of the partial acquisition, because it can affect the owner's compensation. As an example, assume that the property requirement changed the HBU from commercial to residential. In this situation, the owner is entitled to compensation for any reduction in its market value (i.e., injurious affection).

However, if the reverse happens, then the Highway Authority can offset the increase in value against the amount of damages for injurious affection, as is the case with the *Ontario Expropriation Act*. But, according to the wording of the *Newfoundland Expropriation Act*, "in all cases," such an advantage can be offset against other forms of compensation. Therefore, it is very important for an appraiser to refer to the expropriation act of the province that is applicable to him/her, since the wording around this can vary slightly.

The two primary approaches used to value partial acquisitions are the:

- 1) Before and After Method, where the difference in the value before and after the acquisition is considered; and
- 2) What is commonly referred to as the Summation Method which:
  - separately shows the value of the part acquired;
  - any damages for injurious affection and/or
  - any special benefits.

In conclusion, an appraisal is only as good as the data used. Report the data as it is found and try not to appraise with sympathy for a property owner, as it could cloud judgement about the data on which you are relying. Sticking with the facts will produce a more accurate estimate of a property's market value and thus result in a more accurate estimate of compensation. This will make the encounter fair for both the property owner and the expropriating authority. ■

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