

Valuing the Probability of Rezoning

In this article, the problem of valuing the probability of rezoning is discussed. The discussion is based on an actual appraisal problem. The probability that rezoning will occur is not an assumption that can be easily made, and the reasonableness of such a conclusion is more often than not the subject of considerable debate.

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A unique appraisal problem exists when valuing a property that has a reasonable probability of being rezoned. Under circumstances such as eminent domain, the value estimate must be based on a specific date, reflect the value of the property as currently zoned, and consider the probability of rezoning. The value estimate must also consider the cost, delays, and time involved in obtaining a rezoning, while allowing for the uncertainty of rezoning based on the market's perspective. A potential pitfall awaits the appraiser who might try to solve this problem by making the value estimate "subject to" rezoning taking place, or who makes the speculative assumption that a reasonable probability exists for the rezoning to occur and, thus, values the property as if rezoning were an established fact. In this article, it is asserted that such an assumption is a serious mistake and one that might be difficult to justify in a court of law under cross-examination. To illustrate

the complexities of this problem, an actual appraisal will be discussed.

The Appraisal Problem

The subject property, located in the municipality of Anchorage, Alaska, was the focal point of a major highway project that was completed in the fall of 1985. The appraisal problem begins with a retrospective valuation date—the effective date of the declaration of the right of way taking under eminent domain. In this instance, the actual data of the appraisal report was three years after the effective date of the right of way taking (1 year after the actual completion of the highway project), making the circumstances relative to the impact of the right of way project on the subject property quite obvious. Consequently, the "after" valuation problem was more readily understood and analyzed than it may have been before completion of the highway project; while the "before" valuation problem was less discernible and required the appraiser to view the property as if the highway project did not exist. Great care must be exercised throughout the appraisal process in the "before" condition so that market data are not affected by project enhancement. This is sometimes difficult, as in the case of the subject; the project had been under consideration by the state for a

10-year period prior to the effective date of the taking and, therefore, sales affected by market speculation in anticipation of the project had to be avoided.

The appraisal problem stems from the subject property's residential zoning having been designated commercial in the municipality's overall development plan.

The crux of the appraisal problem centered on the subject property's multifamily residential zoning at the time of the right of way taking, notwithstanding the fact that it was designated as commercial property within the municipality's comprehensive development plan. But most important, the highest and best use was clearly commercial as of the date of taking. After analyzing all of the pertinent data, it was concluded that a reasonable probability existed prior to the date of taking for a zoning change in the near future to a more intense commercial utilization of the land.

Description of the Property

In the before conditions, the subject property consisted of an undeveloped rectangular-shaped 7.16-acre parcel. The state of Alaska, under the power of eminent domain, acquired approximately 42.7% of this property for the A-C Couplet Highway Project, which left a remainder of four separate and distinct parcels of varying size and shape.

The C Street corridor, a major commercial district arterial, fronted the subject property along its western boundary. Although the subject property did not have direct access to this arterial, it had good exposure and indirect access from developed and undeveloped rights of way. Overall, access and exposure were considered to have been adequate to feasibly support a commercial development.

Properties along the C Street corridor for one half mile on either side of the subject parcel were commercially zoned before the taking, with the exception of a mobile

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home park directly across the corridor that was zoned multifamily residential. Consequently, neighborhood development was primarily commercial, especially along the

Significant rezoning had already occurred in close proximity to the subject.

major traffic arterials. Furthermore, significant rezoning had taken place in close proximity to the subject property both before and after the effective date of taking. To the north and adjoining the subject property was a recently completed 14-story glass and steel office tower; a small business park developed with primarily two- to eight-story office structures buffered the property to the south. To the east and adjoining the subject prior to the date of taking was a large tract of undeveloped land-zoned multifamily residential. This tract was clearly at the center of commer-

cial development with no major road frontage or exposure. Its existence, however, increased the risk of rezoning the subject parcel to commercial because of its immediate proximity to the subject. The municipal planning staff had previously expressed the opinion that high density residentially zoned land in close proximity to a commercial district was in keeping with the goals of the community. In addition, there were several tracts of undeveloped commercially zoned land in the district that had attributes equally desirable as those of the subject site. Therefore, although significant data and support existed in favor of the rezoning effort contemplated, an element of uncertainty and risk would have been perceived by the market.

Highest and Best Use Before the Taking

The appraisal reasonably established that a rezoning effort to commercial utilization would be successful and, therefore, the legal limitations of zoning were not considered to be significant in the development planning process.

Before the right of way taking, the subject

Although significant data supported a rezoning, a certain amount of risk could be perceived by the market due to particular community goals.

property was physically capable of being developed for a variety of uses. No particular physical limitations were apparent with respect to any of the feasible uses. After completing a thorough analysis, market dynamics indicated only two feasible uses as of the date of taking. The alternatives were a retail mall type of development or a subdivision into a small-lot commercial business park similar to the adjoining property to the south. A hypothetical subdivision analysis was performed which included a comparative sales analysis of similarly sized, commercially zoned subdivision lots to form a residual value estimate for the land. The indicated land value developed from this analysis was \$6.50 per square foot, which was nearly equal to the value as currently zoned.

A land residual analysis using current market data was performed on a hypothetical retail mall development. This was supported with cost data obtained from a similarly sized retail mall project and other relevant market data. This analysis revealed a substantial difference as compared with the hypothetical subdivision analysis, indicating a residual value to the land of \$11.50 per square foot.

The Valuation Problem

With the highest and best use of the property established, the task of valuing the property before the right of way taking became the next step in the valuation process. The best comparisons to the subject property would have been properties with similar characteristics that had sold prior to rezoning and were in transition from multifamily residential to commercial zoning. Market investigation, however, revealed that no truly comparable properties with similar characteristics had sold under these circumstances.

Typically, buyers are averse to closing at a price reflecting a value as rezoned when



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the rezoning is speculative. It is difficult, however, to "prove" what the actual discount would be for this risk without tangible market evidence. This is not to say that

After establishing highest and best use, the property had to be valued "before" the right of way taking.

there have never been instances in the market in which a buyer takes the risk of closing a sale prior to achieving a zone change; but in most instances in which this occurs, informed buyers will usually offer no more for the property than the market value of its then current zoning. This eliminates the risk if the buyer is unsuccessful in achieving the more valuable zone, because he or she has paid no more for the property than it was worth in the less valuable zoning classification. Concurrently, sellers of properties that have a reasonable probability of becoming rezoned will not typically offer to sell at the market value of the property as currently zoned. An informed seller would certainly contend that the property

Generally, informed buyers of property that is likely to be rezoned will offer no more than the market value under its current zoning classification. Sellers, however, will not sell at that value.

had such a probability and would be irrational to sell at a market price for properties with similar zoning but no probability of being rezoned. In such situations, the parties can be expected to bargain toward a price that can be viewed as the value of the property with the more valuable zoning classification, discounted by some amount.

Absent sales of similar properties that sold prior to rezoning and were in transition from multifamily to commercial classification, it was reasoned that the next best comparison to develop a market-abstracted discount rate are sales with similar characteristics that have sold subject to a rezoning effort. However, this situation eliminates most, if not all, of the risk for the buyer of the property. Nonetheless, it was hoped that if sales of this nature could be located and if any properties had immediately been resold after becoming rezoned, then these transactions would reveal what the market recognized as the discount for the costs, delays, and time involved in obtaining a zoning change. The discount developed from this situation would be minimal because the buyer does not take any significant amount of risk. Based on anticipated action from a prudent buyer, it was hypothesized that the minimum amount a buyer would pay for a property with a reasonable probability of being rezoned would be the upper end of the value range for similarly zoned properties (in this case, multifamily residential). Conversely the maximum amount a buyer might reason-

ably pay would be the price as zoned commercial, but discounted to reflect the cost, delays, and time involved in achieving such a rezoning. The value difference between

When purchasing property that has a rezoning probability, there is an element of risk involved that is difficult to calculate.

multifamily residential-zoned property and commercial-zoned property, less any discount to reflect these costs, would be the theoretical difference attributable to the inherent risk perceived by the market. The value scale shown in Figure 1 presents this graphically.

The difference between \$7 per square foot on the upper end of the value scale for

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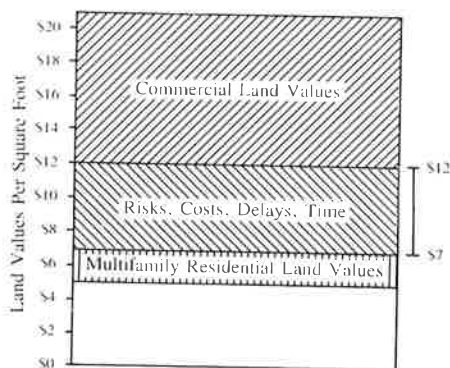
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multifamily residential-zoned property and \$12 per square foot on the low end of the value scale for commercial-zoned property values is the corresponding range in terms of dollars representing not only the costs, delays, and time required to rezone a property, but also the risk a buyer theoretically takes when purchasing a property with a reasonable probability of being rezoned. Correspondingly, the argument can also be made that the maximum discount or adjustment a buyer would apply to a property with the probability of being rezoned would be the difference between the value anticipated after being rezoned and the upper end of the value range as currently zoned. Using the parameters set forth on the chart above as an example, the following maximum discount can be developed:

\$12.00 per square foot	Anticipated value as rezoned
- 7.00 per square foot	Current value as presently zoned
\$5.00/12.00 = 41.7%	Potential maximum discount

The maximum discount developed

above sets the parameters for establishing an adjustment from sales that were made subject to rezoning. However, the actual adjustment theoretically would be less than the maximum potential developed (41.7%); otherwise, the price would be based on the upper end of the value range as currently zoned.

Although the sales data used are ultimately up to the judgment of the appraiser, in his book, *Real Estate Valuation in Litigation*, J. D. Eaton suggests how to decide which zoning classification (multifamily or commercial) should be compared to the subject.

If there is little doubt that the property will be rezoned, and the discount applicable to the higher-zoned sales would be comparatively minimal, it may be advisable to use sales of higher-zoned property. On the other hand, if there is only a marginal increment in value attributable to the probability of rezoning, it is generally best to utilize sale properties that have the same zoning as the property being appraised and adjust the values upward.¹

In support of a market-derived discount rate, an extensive search of the immediate market area was undertaken. Two sets of sale data involving zoning transactions were located and analyzed, allowing for a matched-pair relationship mirroring the market. The first matched pair involved a transaction whereby the buyer had negotiated the purchase on two adjoining properties owned by the same seller. Property A was zoned commercial, while property B was split-zoned multifamily residential and commercial. The buyer closed the sale on property A almost immediately for a square

foot price of \$14.79. Sale property B was purchased subject to rezoning to commercial at an average purchase price of \$11.93 per square foot and ultimately closed, approximately 16 months later, after it was rezoned. The two sales were similar in most respects, with the exception of the zoning.

The second matched pair involved a sale that was originally set up as an option to purchase and subject to rezoning from multifamily residential to commercial. On being rezoned (which took approximately 1 year), the parcel was resold and developed. The original sale involved a tract of land that was subdivided into four 1-acre parcels with an option to purchase each parcel separately (each parcel had its individual set of terms and conditions). The original purchase price of this particular parcel was \$13.33 per square foot; the parcel was subsequently resold after being rezoned for \$18.95 per square foot.

The analyses of the two matched pairs indicated an adjustment range of 23.97% to 42.16%. The upper end of this range was supported by a matched pair that involved not only a rezoning effort but also subdivision of the parcel. It was concluded, therefore, that the actual adjustment for rezoning would be below that indicated by these sales and perhaps best supported by the first matched pair analyzed. Discussions with investors and developers in the market confirmed the hypothesis that a discount would certainly be applicable to a property purchased under circumstances similar to those outlined for the subject property. None of those interviewed, however, had ever been involved with a pur-



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chase of property in which they had been forced to close the transaction without knowing whether or not their rezoning effort would be successful. Interestingly, all had agreed that the discount would be at least 25% of the rezoned value.

In conclusion, the discount rate developed and supported from sales made subject to rezoning only compensates for the costs, delays, and time involved in obtaining a zoning change. Therefore, this discount rate is considered the base rate because it does not include any discounting for the risk that would be present in a property being appraised under these circumstances. The total discount, then, is the base discount rate plus an additional discount for risk. The total discount rate can be increased according to the risk perceived by the market for the probability of rezoning, up to the maximum discount as shown on the value scale.

Typically, the market would anticipate less risk with the probability of rezoning after completion of a highway project.

However, the valuation premise concerning the probability of rezoning must remain the same in the after as in the before condition. In the after condition, the remaining parcel is zoned as it was in the before condition and must be valued on the basis of having a reasonable probability of being rezoned. It must be realized, however, that it would not be inconsistent to use a different discount rate in the before condition from the one used in the after condition to reflect the varying degree of risk that the market recognizes for these two potentially different situations.

In the final analysis, the determination of the applicable discount rates for both before and after the right of way taking is based on the appraiser's judgment, having considered all relevant factors.

Conclusion

The probability of rezoning is a difficult assumption to develop and support; however, once established, the problem of esti-

imating value becomes an even greater challenge. Although there may be legitimate circumstances that allow an appraiser to condition the value estimate subject to a zoning change, under the threat of condemnation or other similar conditions, the appraiser is bound by a specific date in which to value the property and the value estimate must reflect the value of the property as then currently zoned. The value estimate must consider the probability of rezoning by reflecting the costs, delays, and time involved in obtaining such rezoning, together with some allowance as seen in the market for the uncertainty of rezoning. (IRMA)

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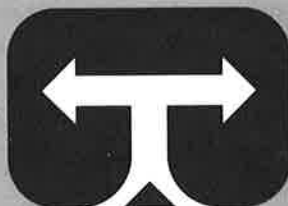
End Note

1. J. D. Eaton. *Real Estate Valuation in Litigation*, Chicago: American Inst. of Real Estate Appraisers, 1982, p. 96.

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