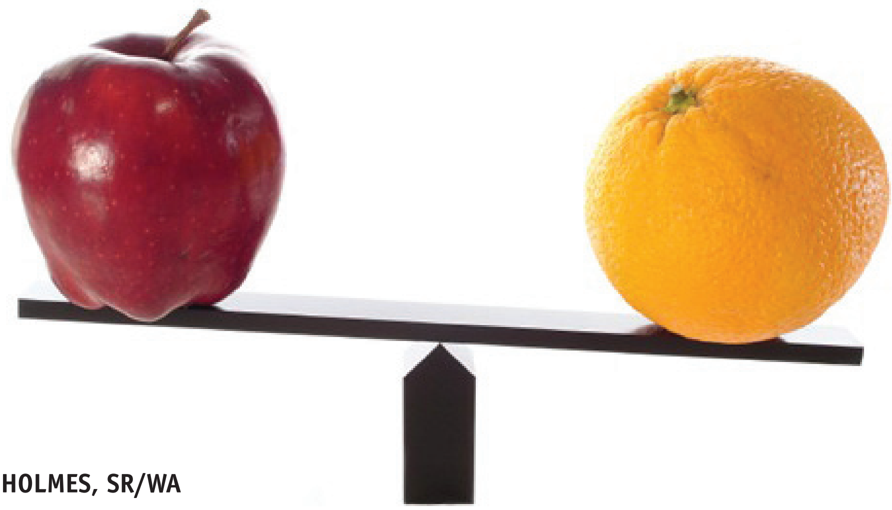
A TALE OF TWO THEORIES

An appraiser's insight on economic units and larger parcels



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For any given appraisal, there are some fundamental appraisal principles and practices that come into play. Identifying the problem, determining highest and best use, and valuing the property are consistently integral requirements.

On a single-owned land tract, properties along major roadways often have more than one distinct use. When eminent domain is involved, valuation of this property type presents some unique appraisal challenges, particularly when only a partial acquisition or taking is proposed. These challenges include consideration of the property to be appraised, the parts and rights to be acquired and the valuation of the remainder, including any potential impact to value.

Defining the Terms

There are some basic similarities and differences between appraising the original subject property as an economic unit of a single parent tract versus treating it as an individual larger parcel. The analysis begins with defining the terms.

As defined in The Dictionary of Real Estate Appraisal Fifth Edition (Dictionary), an economic unit is a portion of a larger (parent) parcel, vacant or improved, that can be described and valued as a separate and independent parcel. Physical characteristics such as location, access, size, shape, existing improvements and current use are considered, and the economic unit should reflect marketability characteristics similar to other properties in the market area. While an economic unit can also be a combination of parcels in which land and improvements are used for mutual economic benefit, it may comprise properties that are neither contiguous nor owned by the same owner. However, those units must be managed and operated on a unitary basis and each parcel must make a positive economic contribution.

A larger parcel, as defined by the Dictionary, is the tract or tracts of land that are under the beneficial control of a single individual entity and have the same, or an integrated, highest and best use in governmental land acquisitions. Elements for consideration in making this determination are contiguity or proximity, as it bears on the highest and best use of the property, unity of ownership and unity of highest and best use. In most states, unity of ownership, contiguity, and unity of use are the three conditions that establish the larger parcel for the consideration of severance damages. In federal and some state cases, however, contiguity is sometimes subordinated to unitary use.

Comparing and Contrasting

For discussion purposes, the key characteristics of the economic unit are "described and valued as a separate and independent parcel," and "reflect marketability characteristics similar to other properties in the market area," according to the Dictionary. The crucial takeaway is that economic units need not be contiguous or under single entity control, but can be managed and operated in unity, while each unit makes a positive economic contribution to the whole.

Critical elements of the larger parcel definition include the "unity of title or single entity beneficial control, unity of highest and best use, and physical unity or contiguity." The definition notes that sometimes, physical contiguity is less relevant than unity of use.

Although these two definitions focus on different components, they are, in fact, interrelated. The references to a larger parcel are included in the definition of an economic unit. The similarity in the definitions stems from the description of the property as a parcel or combination of parcels having a single or integrated highest and best use. The differences include economic units as having "marketability characteristics similar to other properties in the market area…," and making "a positive economic contribution to the operation of the unit." In most states, the three unities of ownership, proximity and use are required to establish the larger parcel for severance damages. Economic units are not necessarily contiguous, nor do they exhibit unity of ownership.

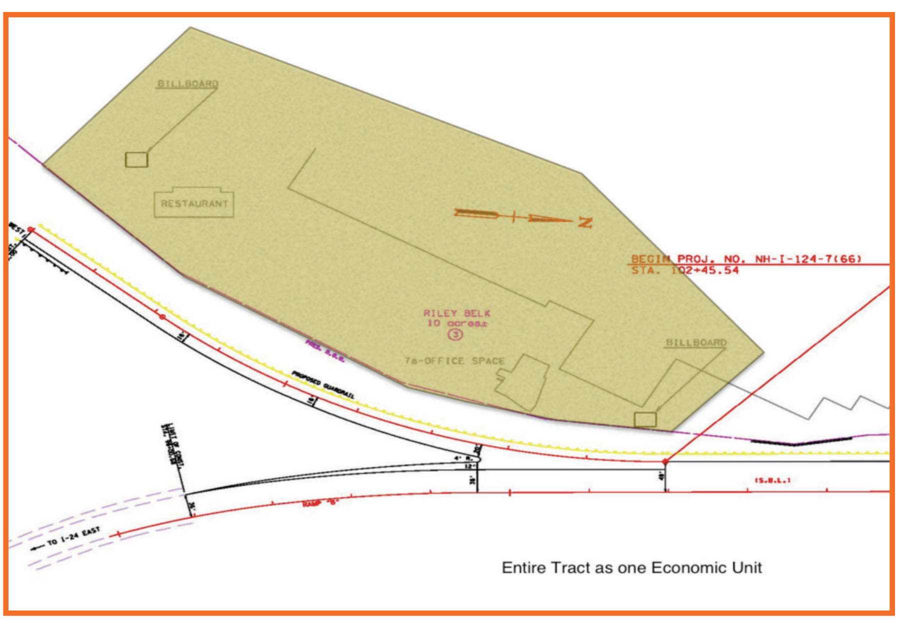
Practical Application

To illustrate these two theories, let's use a multi-use property that I was recently asked to review. While the specific details have been altered for confidentiality purposes, the property was an improved, single owner 10-acre tract that had multiple occupants and uses. These included two highway billboard signs with site leases, two different sign owners, a restaurant commercial use that was land leased, and a multi-story office building owned and operated by the property owner. These uses dovetailed well for two reasons. First, the surplus parking was used by the office and restaurant at opposite times. Secondly, the billboard sites required high visibility and good access, but not much land area.

The restaurant-leased land had an acquisition area, but its remainder did not appear to be affected. There was concern about the right of way's proximity to the office building and the potential for remainder value impact. One of the billboards was part of a regional advertising company's showings, while the other was owned by an adjacent landowner who used it to advertise an off-premise facility. Additionally, the acquisition proposed took fee simple area from both lease defined billboard sites, which reduced their land sizes to below the required legal minimums.

The first step in every partial taking appraisal assignment is to identify the value of the larger parcel, along with its corresponding property rights. This is followed by the remainder valuation to ascertain whether the property has sustained a loss beyond the value of the taking or acquisition. The nature and extent of the taking often determine the larger parcel. Here, I was to ascertain whether the interests should be valued as separate economic units or as individual larger parcels.

In comparing the two possible parcel classifications, I used the appraisal industry's three primary valuation methodologies. These include the Sales Comparison Approach, which compares closed transactions for similar property types; the Income Approach which evaluates the subject property in terms of its investment characteristics including potential rental income, expenses and expected investor return; and the Cost Approach, which considers the reasonable substitute via purchase of a similar site and construction of similar improvements, less any depreciation evident in the subject.



Entire Tract as one Economic Unit

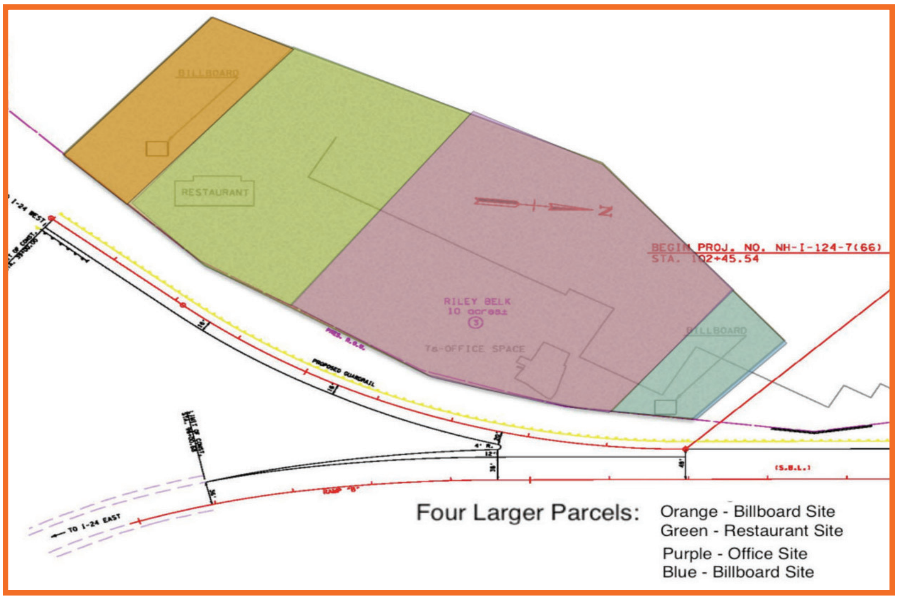
Economic Unit Analysis

In my first analysis of the property, I considered the larger parcel for highest and best use, land valuation, and general treatment of the property as a 10-acre tract with all four improvements and various income streams.

Sales Comparison: For this approach, I needed to obtain improved sales of properties with a combination of office, restaurant, and billboard uses on a five to 20-acre highway frontage site. While a national data search is sometimes needed, in this case, a regional search was sufficient.

Income Approach: Readily available lease comparisons made this approach easier to perform. I used data about the lease rates for other office buildings in the market area, as well as leasing prices of other nearby restaurants or clubs. I researched the investor rates of return for each property type and determined what sign sites were leased for in this market area with current traffic volumes and area demographics.

Cost Approach: This approach was simpler to use because the underlying land could have reasonable substitute parcels in



the subject size range. It was also useful because there were nearby land tracts that had sold in the past 12-24 months along major highways with similar traffic counts. The depreciated replacement cost, based on national and local data, was separate for each type and easily obtained.

Once I completed the three approaches, I reconciled them to analyze the quality and quantity of data for each. I surmised that the Sales Comparison Approach provided limited information, as there was difficulty in obtaining sales of complex, mixed-use properties such as the subject property, and many adjustments for dissimilar features (both physical and economic). In this case, the Income Approach provided a better investor value indication, and could be considered most appropriate for the subject, while the Cost Approach provided support for other indications.

Larger Parcel Analysis

In the second analysis, I considered four separate larger parcels as individual subject tracts. In highest and best use, maximally productive was the final test. It may seem logical that four smaller individual properties could have a wider potential demand, creating a higher maximal productivity than a single larger parcel. Properties that have unities of use, ownership and contiguity are typically identified as the larger parcel. For the case above, this would result in four separate parcels - one for the office building, one for the restaurant improvement, and one for each of the two billboard sign sites.

Sales Comparison: For this approach, I used office, restaurant and billboard sites for the analysis. With these separate property types, there was typically more directly comparable local sale and listing information available.

Income Approach: In both scenarios (economic unit and larger parcel), I used the Income Approach for the identified independent units and provided separate valuations for each type. This is important because different property uses such as office, restaurant, and billboards will likely have differing investor return rate characteristics.

Cost Approach: Using this approach, I evaluated separate, smaller underlying land tracts (versus one larger tract), which resulted in higher unit values. It also required an independent analysis of the site improvement resources for each parcel.

Considering the Options

In both scenarios, I was able to determine the highest and best use for the entire 10 acres with economic units, as well as the individual, smaller larger parcels identified by use. Using the individual tracts provided a clearer and more concise analysis because the highest and best use considered physically possible, legally permissible and financially feasible uses, and then allowed me to evaluate which was maximally productive. Based on the last test of highest and best use, these four tracts had a higher value as individual properties based on a broader market demand, separate higher and best uses and three different use types. Therefore, my recommendation was to appraise the property as individual larger parcels, as this achieved the highest value and accurately determined the potential value impact to the remaining property.

Understanding the goals of the decision maker or investor may be a challenge, but through some market research, one can often obtain an analysis of purchase, lease, and development decisions. Where an existing property enjoys contiguity and unity of ownership but has more than one potential highest and best use, the value of a partial taking may be based on the unit value attributable to that portion of the property from which the taking occurs. In eminent domain valuation assignments, it is essential for the appraiser to consider the larger parcel and evaluate its true highest and best use. ✪

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