HIGHEST AND BEST USE

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What it is and how it relates to profit potential

As right of way professionals, we are familiar with the term highest and best use (HBU) when it is used in an appraisal, but what does it really mean? What does it tell us about the subject property?

The HBU of a property is not necessarily the highest price it could sell for, but the sale price that achieves the greatest profit for the property today. Boiled down, the HBU is the reasonable and probable use that supports the highest present market value as of the date of the appraisal.

The HBU analysis provides the blueprint for comparable selection, and helps all parties in determining the eventual conclusion of value. According to the 13th Edition of the Appraisal of Real Estate, market value is to be determined with reference to the property's highest and best use. In other words, the highest and most profitable use for which the property is adaptable and needed, or likely to be needed, in the reasonably near future.

WHOLE VERSUS PARTIAL

Consider the HBU analysis as a funnel with progressively smaller sieves. Each sieve screens out less desirable uses from the subject's entire universe of uses, leaving the most feasible and profitable use allowed by the property's physical and legal constraints. Depending on the appraisal's scope of work, the determination of the subject's HBU could be very specific (continuation of existing use or residential duplex or restaurant) or more general (hold for future commercial use).

In a whole acquisition appraisal, there is usually one opinion of the HBU and one opinion of value. There can be no disconnect between the conclusion of the HBU analysis and the final valuation of the subject property. For every opinion of the subject property HBU, there needs to be a corresponding conclusion of value.

In a partial acquisition appraisal, there will be one HBU analysis before the acquisition and one after the acquisition, and therefore two opinions of value. The before conclusion might be similar to the after conclusion or drastically different, depending on the reasons for the acquisition, the proposed project, zoning changes and other factors. Regardless, each before and after analysis must be self-supporting.

MEETING THE CRITERIA

There are four basic criteria that the HBU must meet. These include legal permissibility, physical possibility, financial feasibility and maximum profitability. This same criteria applies to the land as if vacant, and the whole property as presently improved, both in the before condition and the after condition.

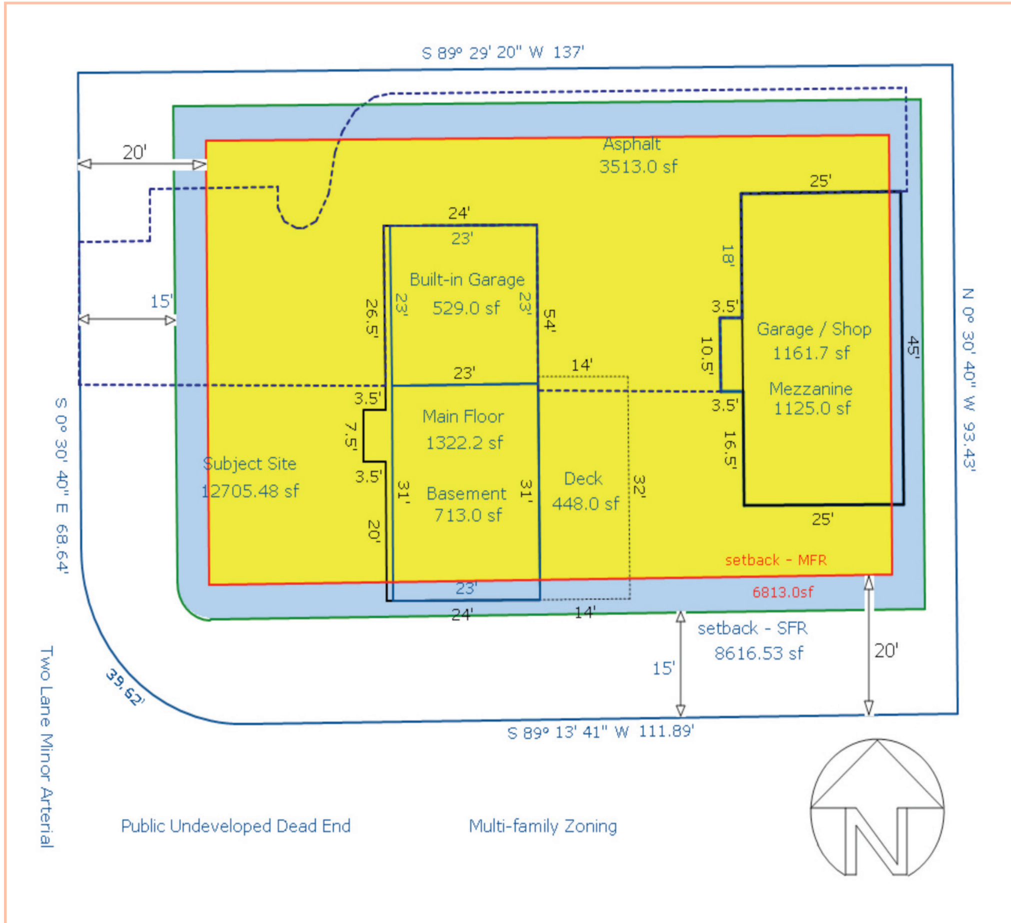
Legal Permissibility

When conducting an HBU analysis, we start with a review of the subject property's title to look for easements, covenants, conditions, restrictions and reservations of record. The site inspection and owner interview should identify possible easements or encroachments not identified in the title.

Figure 1: Buildable Site Area

Multi-family

Single-family or duplex



For example, a conservation easement might restrict use and access to a portion of the property and limit or restrict use of fertilizers affecting the type and maintenance of landscaping around a future office building. An avigation easement may restrict the types of crops to deter birds or limit the height of buildings. A covenant might specify minimum or maximum building sizes on a lot. Reservations of mineral or subterranean rights may restrict use of the site to a certain depth, affecting underground parking, basements or geothermal.

After identifying the title and site-specific limitations, it's important to understand what the zoning permit allows. Are there conditional uses, and if so, what uses are restricted? Conditional uses might have various hierarchies for administrative review or hearing examiner decisions that could delay a proposed use or reconstruction of an existing use, items that the HBU will need to address.

The analysis should investigate the jurisdiction's comprehensive plan, which might specify a change to the subject's future land use. If the change were substantial, like rural residential to commercial retail, it might necessitate an interim use of existing improvements. Alternatively, the transportation policy of a jurisdiction may require dedications or setbacks for future road expansions depending on the redeveloped use of the subject, which could limit the net buildable site area.

The HBU analysis should also list possible uses of the subject property and if needed, include a site plan showing all restrictions and setbacks, and gives a visual representation of the buildable area, possibly including existing improvements. For example, consider a subject property (Figure 1) where zoning allows a minimum site size of 7,200 square feet. The larger parcel property at 12,680 square feet is greater than the minimum, but still too small to be subdivided. The subject site is constrained by frontage setbacks from a minor arterial and a residential street, in addition to the side and rear yard setbacks. The buildable area for single-family and duplex uses (in blue) is estimated to be 7,877 square feet. The buildable area (in yellow) for multi-family uses is estimated to be 6,168 square feet. The subject's size, setbacks and buildable area would preclude some commercial uses, but not all. All residential uses are viable. Potential issues for the remaining uses could involve on-site parking and internal driveways.

Physical Possibility

Physically possible uses consider the topography, soils and general terrain of the subject site itself, as well as the surrounding terrain that influences the utility of the property. The HBU analysis of physical conditions should follow the earlier more detailed site discussion in the appraisal. This is when questions often arise, and one question will likely be followed by more questions. For example, let's say the subject site is level. If the site is above or below the surrounding road access grade, is a portion of the property needed for internal access? If so, does the jurisdiction dictate maximum driveway slopes? Is the soil and terrain amenable to a septic system or on-site storm water detention? Will there be additional or extraordinary costs for these systems above those for substitute properties?

Although the property may have been used for one purpose in the past, there's always the question of whether or not it can be used for the same purpose now or in the foreseeable future. There may be new contamination or emergent wetlands or drainage issues. Any analysis should include an explanation of the options, as well as the limitations of these issues. Later, in the site valuation, the cost of mitigating physical issues should be considered.

As part of the site valuation, it's essential to know whether mitigation will require some additional non-productive use of the site, further limiting useable or buildable area. It's important to establish whether a smaller buildable area limits the number of units, lots or commercial ground floor area. It's possible that smaller lots or units might not compete well in that particular market, and smaller commercial ground floor areas could limit lessees who require certain amounts of square footage. Parking, landscaping, or open space requirements might be allowed within setback areas, but their consumption of available square footage could preclude certain uses, especially on a small site. Addressing these questions will help determine what is physically possible.

Financial Feasibility

To be financially feasible, the property either needs to generate sufficient net income to support the proposed/existing use, like through continuous periodic income generated by strip malls or land leases, or the property's proposed present value must exceed (re)development costs by at least the expected entrepreneurial profit. This occurs when it is expected to have a one-time profit, like a single-family residence. Each remaining legally permissible and physically possible alternative use of the subject property should be examined in this manner.

Figure 2: Profitability Potential

Property Use	Single-Family	Duplex
Sale Price	**$170,000**	**$215,000**
Land Cost	$50,000	$50,000
Development Costs	$100,000	$150,000
Total Costs	**$150,000**	**$200,000**
Profit	$30,000	$15,000
Profit (as % of costs)	13.3%	7.5%

Although it may not be necessary to value each alternative use of the subject property, the HBU analysis should provide sufficient reasoning that leads to the conclusion made in the analysis. For instance, imagine an 8,000 square foot residential building lot that allows either one single-family dwelling or one duplex dwelling. To compare the profit potential, establish the sale price and subtract your land and cost for constructing, marketing and selling the residence (development costs). In this example (Figure 2), the question of whether it's financially feasible to construct a single-family or duplex dwelling is an easy one. It is apparent that both uses are financially feasible because profit exceeds cost in both cases.

Costs, retail sale prices and rents used in analyzing the feasible and profitable uses must come from current trends within the competitive subject market, otherwise the analysis will be flawed. If the subject is an arterial frontage property where development along the arterial is only duplexes, there may be no buyer demand for single-family residences on the arterial. And even though the profit might be higher for a single-family residence, it might not be a feasible use.

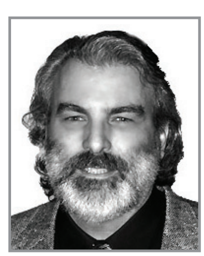
Maximum Profitability

To maximize profitability or productivity, the selected land use must yield the highest value of the remaining possible uses. Maximum profitability is found by determining the residual land value by estimating the various feasible uses (land and improvements) and subtracting labor, capital and entrepreneurial coordination, and picking the highest dollar amount. Using the previous example, single-family development of the subject property maximizes profitability at 13.3% and is the HBU versus the duplex at 7.5% profitability.

The opinion of HBU needs to be adequately explained and supported so that the opinion of market value in the appraisal conclusion is clearly based on the conclusion of the highest and best use of the subject property. Since profit can only be analyzed in terms of the private sector, public uses, such as public works and parks, must be valued accordingly.

CONCLUSION

The highest and best use analysis serves as an essential tool in estimating real property value. The analysis reveals what type of development would result in the highest market value from among the most financially feasible uses that have the physical ability to adapt within the legal limitations. While it may not necessarily reflect the highest price that a property could sell for, it should estimate a use for the property that achieves its greatest profit on the date of value.



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