

COMMERCIAL

What is the Highest and Best Use?

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Real estate development, whether ground up, value add or adaptive reuse, begins with an entrepreneur envisioning a Higher and Better Use for a property. The concept of Highest and Best Use forms the very foundation of property development, underwriting and valuation. But what does it really mean?

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. The four criteria the highest and best use must meet are legal permissibility, physical possibility, financial feasibility, and maximum productivity.”*¹

Breaking that down, the concept of Highest and Best Use works like a funnel which has four levels or tests.



A potential use must pass all four tests in order to be considered the Highest and Best Use of the property. This is an iterative process that begins with the broadest test, that of Legal Permissibility. Uses that pass the first

test go on to the second test, and if they pass, then they go on to the third test, and so on. If the answer to any of the tests for a proposed use is No, then the potential use fails and is not the Highest and Best Use. Only the one use that passes all four tests can be considered the Highest and Best Use of a property.

TEST #1—IS THE USE LEGALLY PERMISSIBLE?

Suppose a developer wants to convert an older industrial building into a modern creative office use in order to achieve higher rents. While the higher income may look profitable, if the on-site parking does not meet the municipal parking requirement for creative office, then the proposed development cannot legally proceed. Zoning guidelines, specific plans, historical designations, Coastal Commission requirements, CC&R's, et.al. restrict what can be built on a site. Even a “by right” development within the zoning guidelines can stall if an active neighborhood group lobbies the municipality to hold up issuance of a building permit in order to prevent or limit the development. Often a Conditional Use Permit or a Zoning Change must be approved in order for a development to proceed. These approvals are discretionary, which can add risk, time and expense to a potential development.

TEST #2—IS THE USE PHYSICALLY POSSIBLE?

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Developing an industrial building in a steep hillside area with narrow roads would not be possible since cargo trucks could not navigate into and out of such a neighborhood. The second test evaluates which legally permissible uses could practically be built on the property. Questions to consider include: Do the size, shape and topography of the site support the proposed use? What is the surrounding terrain? Is there easy access to the site? What are the neighboring uses? Will the soil support the proposed use? What are subsurface conditions, such as the depth of the water table? Are there any environmental conditions such as potential for earthquakes or floods, which might hinder development? Potential uses must be both Legally Permissible and Physically Possible in order to proceed to the next test.

TEST #3—IS THE USE FINANCIALLY FEASIBLE?

Developers generally intend to make a financial profit on their development by building something that will be worth more than the cost to acquire the land and build the improvements. In order to be financially feasible, a development must yield at least a market rate of return in order to attract investment capital (equity and debt). Considerations in the analysis of financial feasibility include: Is there sufficient market demand for the potential use? What is the existing and proposed supply of competing properties? How much will the construction cost to build? Are costs projected to remain stable

or to increase during the course of the development? How long will it take for the completed project to be absorbed? What will it cost to reach stabilization (e.g. - rent loss, tenant improvements and leasing commissions)? What is the direction of macro-economic trends? What is projected to be the state of the economy when the project is completed and ready for absorption and disposition? A property or site may have multiple potential uses that yield a market rate of return, so there may be more than one financially feasible potential use.

TEST #4—IS THE USE MAXIMALLY PRODUCTIVE?

Out of the potential uses of a property that are Legally Permissible, Physically Possible, and Financially Feasible, which use produces the highest overall return (yield or profit)? This is the most profitable or Maximally Productive use, and is considered to be the Highest and Best Use of the property.

This iterative analysis of Highest and Best Use can be performed on vacant land (or land as though vacant) and on improved properties based on their existing improvements. Comparing the results of both analyses for an improved property will indicate whether the existing improvements add value to the property, or if the improvements are obsolete and all of the value is in the land.

These two concepts are defined by The Appraisal Institute as follows:

Highest and Best Use, As Though Vacant

“Among all reasonable, alternative uses, the use that yields the highest present land value, after payments are made for labor, capital, and coordination. The use of a property based on the assumption that the parcel of land is vacant or can be made vacant by demolishing any improvements.”²

Highest and Best Use, As Improved

“The use that should be made of a property as it exists. An existing improvement should be renovated or retained as is so long as it continues to contribute to the total market value of the property, or until the return from a new improvement would more than offset the cost of demolishing the existing building and constructing a new one.”³

Sometimes special situations occur in the analysis of Highest and Best Use such as:

- Legally Non-Conforming uses that do not meet zoning requirements but were built before adoption of the current zoning code
- Interim Uses which are temporary uses of a property while the Highest and Best Use of the property is changing
- Existing uses that are not the Highest and Best Use of the property
- Mixed uses that combine different property uses within the same property
- Special use properties that are purpose built for one particular use, but will need to be fully renovated in order to

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accommodate more conventional uses in the future

CONCLUSION

The four-tiered analysis of Highest and Best Use can provide important insights about whether a property owner should continue a current property use, modify or renovate existing improvements, or tear down current improvements in order to completely redevelop a property. Highest and Best Use analysis for a potential development will determine if the proposed improvements are Legally Permissible, Physically Possible, Financially Feasible and Maximally Productive. Developers, investors, lenders and appraisers rely on this foundational analysis to make important business decisions related to real property.

- 1 Source: Appraisal Institute, *The Dictionary of Real Estate Appraisal*, 5th ed. (Chicago: Appraisal Institute, 2010).
- 2 Ibid.
- 3 Ibid.

