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Highest and Best Use: *What Real Estate Professionals Need to Know*



The next time you pull into a surface parking lot, after you de-stress about finding a vacant spot that isn't bounded by two SUVs, think about what you see.

Real estate professionals see beyond the current use and are constantly thinking about possibilities and opportunities—what is the most profitable use?



Surface Parking Lot—Victoria Downtown fringe

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Since the foundation of contemporary real estate valuation in the 1930s, the underlying principles of valuation practice have evolved from the field of economics.

The valuation principle of highest and best use is based on the economic premise that investors and owners will generally seek the greatest return for capital invested in real estate; hence they will choose the **type and level** of use that provides the greatest return (measured by dollars) for land. The application of highest and best use theory can be found throughout the real estate industry in the daily decision-making processes of buyers, sellers, developers, local government zoning authorities, and others.

While this principle may seem simply common sense, highest and best use theory helps explain why some parking lots are still parking lots and others are being transformed into high-rise residential strata projects.

Appraisers apply four main criteria or tests to determine which use or level of use represents the highest and best use (HBU) for property.

1. What alternative uses are physically possible, given constraints of property size, terrain, soils, drainage, etc.?
2. Which uses are legally permissible, usually defined by local zoning and land use controls such as the Agricultural Land Reserve?
3. Of the uses physically possible and legally permissible, which uses are financially feasible or return a net profit to the investor-owner?
4. Of all the uses that are financially feasible, which use(s) will be the most profitable? That will be the highest and best use.

Appraisers test the HBU for improved property, as if vacant or improved. You may wonder why anyone would want information on a hypothetical vacant land scenario when a property is already improved. It is crucial, however, to evaluate whether the existing improvements (with or without modification) represent the most profitable use of the land or if different improvements and/or uses would be more profitable.

The photo below (Homer Street in Vancouver) illustrates why the existing improvements do not likely improve the property to its highest and best use. This property is located on lower Homer Street in the Yaletown precinct of Vancouver, a neighbourhood that is rapidly changing from a long history of light industry—service commercial uses—to high density residential and retail. The development district zoning in this area allows a density of 3+2 or, in other words, it is possible to develop up to a 5-storey building on the property if the building extended from lot line to lot line.

Important HBU considerations in this example are legal and financial feasibility. While it might be technically possible to develop a 5-storey building

on one or two 30 ft. lots, a larger assembly of adjacent lots would likely be required before a project could be designed that would meet development-permit minimum site area requirements to achieve maximum density and also generate a positive return.

HBU analysis is a multi-step process of investigation. Usually, the best approach is to start by looking for uses that are both physically possible and legally permissible. Legal constraints, such as zoning, will likely be more constraining than technical feasibility because time and money can solve a lot of site problems.

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External factors that require investigation to identify *probable uses* include development trends and potential barriers such as difficulty in financing, building code restrictions, local government initiatives, and the strength of neighbourhood influence groups.

For example, a vacant corner lot in a mixed-use residential neighbourhood is designated as future service commercial in the latest Official Community Plan and the property is large enough to support a small node of service commercial, for example, convenience store, video store, dry cleaners, etc. The current zoning permits only single-family residential use and proposals for re-zoning have failed in the past due, to local resident objections.

The question the appraiser must answer is whether there is a probability of achieving the commercial use or, in other words, is there is a greater than 50 percent likelihood of successful rezoning to commercial? Since the track-record of the local city council is to only rezone with local resident support, commercial use may be eliminated from further consideration. It is important to consider that probability forecasts are dynamic and the probability of achieving rezoning may change in the future with changes in neighbourhood growth patterns, property economics, and resident and city council perspectives.

Assuming that all probable and legal alternative uses have been identified, several uses may be financially feasible. A comparative analysis of the costs, benefits, and risks associated with each use will generally yield the optimal use that is the most profitable and likely to be achieved in the local market.

There are four distinct outcomes for any HBU analysis.

1. The existing improvements represent development of the site to its highest and best use—the most common scenario for residential property.
2. The existing improvements should be demolished and the site redeveloped to a different use or same use at a higher density or better functionality. This scenario occurs when the improvements have reached the end of their economic life and no longer contribute to land value.
3. The existing improvements represent an underimprovement of the site but do not warrant demolition because they continue to contribute to the



Homer Street, Yaletown: Note new highrise in background

land value—a common scenario for older residential and commercial property.

4. The existing improvement represents an overimprovement of the site—not common and usually associated with changes in land-use controls over time that limit permitted uses and/or reduce density.

Does the real world actually behave according to the principle of HBU? Yes, with one major influence—owners have different expectations of risk and reward.

Remember the surface parking with the big SUVs and parking ticket dispenser that seems to eat credit cards? If you were asked to conduct an HBU analysis for this property, your investigation would likely include the following areas of research.

Site Characteristics and Land Use Policies

Your review of the history of the property and discussion with developers and the City Planning Department reveal that the site is large enough to support a more intensive land-use such as a high-density commercial or residential development—for example, condos or office space—with no physical liabilities such as site contamination. The City has adopted a new Neighbourhood Community Plan (NCP) that proposes revitalization of the general area and encourages development of more intensive residential-commercial land use.

City council's track-record (by review of council minutes) is to support implementation of the new "results-based" NCP; the result has been a number of new developments in the neighbourhood. Consequently, you've concluded there is a greater than 50 percent probability that the property could be redeveloped for residential condos and/or office-retail with a density similar to nearby projects.

Market Information

- The owners have been receiving \$7 per sq. ft. rent absolute net for the 29,000 sq. ft. lot—in other words, the parking company tenant pays all

expenses and the associated vacancy rate is minimal: about 5 percent.

- There is a shortage of parking only during peak periods of the year and the amount of parking required to support downtown commercial uses is expected to remain in equilibrium in the foreseeable future.

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- At the present time, concrete high-rise residential condos are selling for an average of \$500+ per sq. ft. while construction costs are rising rapidly and approaching \$300 per sq. ft.
- Land purchased for redevelopment in the downtown core has been selling for about \$30 per buildable foot (sq. ft. of finished construction).

- There is a strong demand for quality residential condos in the downtown core area and it is likely that condos would sell out within a year of availability.
- It appears that lenders are available to finance this type of project, provided a minimum of 50 percent pre-sales can be achieved.
- No new parkades have been constructed in the downtown core for a number of years. City planning staff, however, indicate that the Advisory Planning Committee is attempting to encourage alternative transportation; the development of large parking structures would be out of sync with the Neighbourhood Plan. Therefore, a multi-storey parkade is discounted as a probable alternative use.

Possible Scenarios

As a result of your initial screening of uses, two options are physically possible and legally probable: maintaining the current parking use or redevelopment as a residential strata or mixed-use residential-office-retail project. After testing the financial feasibility of the alternative uses, the projections of total



Homer Street, Yaletown district Vancouver: Before

return for each use are presented to the owner for discussion.

The value of the property based on its income from surface parking is estimated at \$3 million, while the value of property, assuming a certain residential density could be achieved in redevelopment, would be about \$5 million to \$7 million. The value range represents the possibility of different development scenarios, developer's profit, and risk associated with a number of development variables such as costs, prices, and market absorption rates.

The initial analysis and the visibly active construction market seem to indicate that redevelopment of the property is the highest and best use. HBU theory, however, doesn't always explain human behaviour. In this case, the owners confirm they are not looking for a development partner or won't be offering the property for sale as a development site. It appears the owners have decided to continue with the surface parking use since the property continues to yield an acceptable return, management requirements and risk are minimal, and there is an expectation of continued equity appreciation. Since

the owners have held the property for a considerable time, sale or redevelopment would trigger a large capital gain and income tax liability.

There is also the possibility that the ownership group cannot agree on a course of action. Real estate experts should be aware that there can be many other cases where the presence of vacant or underutilized properties does not reflect the overall health or status of the real estate market. Personal or corporate investment decisions can run counter to traditional theories of highest and best use.

Some local government planning policies may prohibit the demolition of buildings to make way for more profitable and easier to manage surface parking lots.

In the parking example described above, the property appears ripe for redevelopment, regardless of the owners' intentions. The existing parking rental use is described in HBU jargon as an

"interim" use. In some cases, the interim use period reflects time required to seek rezoning and development approvals for the new use.

In other situations, such as the above case study, owners have purposely traded greatly reduced potential income for a lower yet predictable income stream or do not have easy access to capital or development expertise.

The "before and after" photos illustrate a scenario where an old automotive repair facility in Yaletown was first converted to a commercial entertainment use (club) and subsequently redeveloped as an office building, to the maximum density allowed. In this case, the commercial use was an interim use of a property that was ripe for redevelopment to a more profitable use.

As the previous parking example illustrates, an HBU analysis may not result in a clear "winner" but options with different degrees of risk and reward. Owners of older commercial properties, where the buildings are approaching the end of their economic life, face the problem of rising expenses and vacancies.

An HBU analysis will provide information on whether it makes more sense to rehabilitate the property to lower vacancy (retain or gain new tenants) and increase rents, demolish, and rebuild or convert to an alternative use. Some local government planning policies may prohibit the demolition of buildings to make way for more profitable and easier to manage surface parking lots.

In recent years, some older office buildings have lost tenants to newer facilities with better parking, faster elevators, larger floor-plates, lower utility costs, and generally nicer premises. Where these older buildings have heritage character, opportunities may arise for rehabilitation of former office space to residential and/or retail use.

As a result, additional factors in an HBU analysis must be examined, such as local government heritage



Same property: After recent redevelopment



Former Victoria Office Building: Conversion to Retail and Residential



Conversion underway

policies, council support for conversion of commercial properties to residential use, tax incentives, seismic standards, technical feasibility, design issues, residential parking requirements, etc. In the examples on this page, the feasibility of a project to convert an older downtown 3-storey office building to a mixed-use retail and strata residential project changed when the City agreed to a 10-year municipal tax exemption bylaw under a heritage revitalization agreement.¹

The rectangular shape of the building, strong demand for condos, and ability of the developer to secure a large retail tenant in a prime downtown location were major factors in creating an opportunity for this mixed-use development project.

Conclusion

As the case studies in this article illustrate, the process of highest and best use analysis is more than application of common sense; it is a systematic process that can explain the nature of many real estate decisions. Current developments are not often an indication of the overall status of the real estate industry but may be a reflection of private investment decisions and the direction of local municipal development objectives. ▲

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¹ Sections 225 and 226 of the *Community Charter* [SBC 2003] Chapter 26.