FINANCIAL ADVISORY

Identifying Value Through the Highest & Best Use Concept

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For this month's article, I am revisiting my days in commercial real estate appraisal during the late 1990's and discussing an important real estate concept: that of "Highest and Best Use." Most commercial appraisals will include a section with this title. This column will define this term and discuss why it is an important concept for real estate investors to understand.

DEFINITION

According to my old copy of The Appraisal Institute's The Appraisal of Real Estate: "Highest and best use may be defined as the reasonably probable and legal use of vacant land or an improved property, which is physically possible, appropriately supported, financially feasible, and that results in the highest value."

The last few words of that definition, "…and that results in the highest value," is the key to understanding this term. The highest and best use of a property, put simply, is the most profitable development of a site.

Remember when South Coast Plaza in Orange County was surrounded by strawberry farms or when the orange groves that gave the county its name were a common sight? In the case of both the strawberry fields and orange groves; they were replaced by high-rise office buildings, single family homes, apartment complexes and retail centers. In these cases; as the demand for housing and places for new residents to work and shop grew, the value of developable land grew. Eventually, this value reached the point where farming was no longer the highest and best use of these properties, and their use changed to something that would create more value: not only for the landowners, but also these residents who wanted places to shop, eat, work and sleep.

Keeping an eye on the Highest and Best Use values of their properties have made a lot of former farming families very wealthy. As real estate investors, we need to similarly look for such opportunities with our properties.

WHERE YOUR PROPERTIES MAY NOT BE HIGHEST AND BEST USE

Highest and Best Use "mis-matches" are often found in fast-growing or rapidly changing neigh-

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borhoods. Maybe that run-down 4-unit property in a gentrified area can now support a 10-unit condominium complex with prices starting at $700,000. Perhaps an office building or a single-tenant "big box" store can be constructed on land occupied by a decaying and largely vacant retail strip center. Or maybe that restaurant can be replaced by a 5-story parking garage. Identifying opportunities like these can offer financial benefits to owners and amenity gains to the residents and users of a neighborhood.

HOW TO POTENTIALLY GAIN FROM A "HIGHEST AND BEST USE MIS-MATCH"

The "purest" example that I can imagine of this is buying vacant land on the outskirts of a growing town. Once demand for more houses and services heats up, the owner can then construct properties to meet that demand. I personally don't like buying properties that don't create income. Vacant land is even worse than that – it just creates expenses. Rather than experiencing negative cash flow while waiting for something to happen, I'd rather buy something that makes financial sense now and could present a re-development opportunity in the future. Here are some hypothetical examples:

EXAMPLE ONE

Let's say that, in a fast-growing section of town, there is a main street that is lined with retail centers that boast high occupancy. On a large lot along that street is an old and run-down 4-unit apartment property. Perhaps I can buy that apartment property and enjoy the income and growth potential while I wait until retail demand is sufficient to justify another shopping center. This way, my plan has some "insurance" built in: If my new retail center plan never happens, at least I've earned income from the apartments.

EXAMPLE TWO

This is an even simpler example. Let's say that a 10-unit apartment property is for sale in a major city on a very large double lot. In this case, the highest and best use for this property could be as two lots – each with its own apartment property. A potential long-term plan here would be to buy the property with leverage today and, in 20 years when the loan has been paid down and when the property has appreciated, re-leverage the property to fund construction of a second 10-unit building. Afterwards, I can either sell the second property to "cash in," or hold it to enjoy income and appreciation potential from both.

EXAMPLE THREE

Let's say that you don't like real estate development. I understand completely: Early in my real estate career, I was telling a future boss in a job interview how I wanted to get into real estate development. He told me "stick with me, and I'll show you how to make plenty of money without having to take development risk." Now, as a veteran of several major renovation projects, I really understand what he meant. Not only does construction often include expensive "surprises" and time delays, it really takes a lot of time and energy. If I were building a 10-unit apartment complex, my ¾ time job during the process would be "construction manager." I'd rather focus on my business helping investor clients and managing my own portfolio.

As a "development averse" investor, I could still profit from the above scenarios by selling those properties to someone else who wants to take that role on. If my 4 units in example 1 became worth $2 million 10 years from now; maybe a developer would pay me $2.2 million for them. In example 2, maybe I can just sell off the vacant lot in the future for $500,000. I can then 1031 Exchange those proceeds into a property (perhaps one of my partial interest opportunities) to create cash flow potential "out of thin air" where it didn't exist before.

This month, I've talked about ways to create value by finding properties where the highest and best use doesn't match the current use. If you have any questions, call my office toll-free at (877) 313-1868.
