

SHADES OF GRAY: HIGHEST AND BEST USE

Neighbourhoods in transition are creating grey areas for Canadian Residential Appraisers (CRAs) who try to determine highest and best use as part of their day-to-day work, said Brian Varner, AACI.

Varner, Manager of Policy and Appraisal Services for the City of Toronto, made his comments at the June 2011 Appraisal Institute of Canada (AIC) Conference, *Changing Tides, Brighter Horizons*.

These neighbourhood grey areas are an issue especially for CRAs, who can only appraise, review, or consult on individual, undeveloped residential dwelling sites and dwellings containing not more than four self-contained family housing units. For other properties, their reports must be co-signed by an appraiser with the designation Accredited Appraiser Canadian Institute (AACI).

Varner showed participants three typical examples of neighbourhoods in transition from residential to higher uses. One photo showed an unassuming bungalow that was actually zoned for commercial redevelopment. The second example was a rural, four-bedroom house flanked by agricultural buildings on 66 acres of land.

The third photo showed a two-storey home on a city street, currently being used as a rooming-house with five suites and a shared kitchenette.

In the first situation, as a single-family dwelling, the property may be worth \$240,000, but its commercial land value is much higher. "You or your co-signer might discover that it has a land value of \$1,000 Front Foot, or \$360,000."

In the case of the rural home on 66 acres, Varner said, "I know members face this on a regular basis: a client asks to appraise a house on, let's say, one acre of land. Several questions arise from this situation."

When faced with these situations, Varner said, the *Standards* should be your guide. Along with several hypothetical conditions, land use controls must be identified. There might be agricultural zoning, which would prevent a residential dwelling lot.

"State your existing use and the use reflected in the appraisal – you cannot ignore that," Varner said. "You must tell the client, 'the existing use is this, but the value reflected in the appraisal is something else.'"

In the third case, "you might say, 'this is not a rooming-house,'" Varner said, since each room does not have its own kitchen or bathroom. Sales of four-bedroom homes in the area might

reveal a value of \$400,000. But, if a dining room has been converted to a fifth bedroom, using the gross income multiplier may reveal that the property's highest and best use is as a rooming-house, because it has a higher value than a single-family dwelling.

"We have made it clear in some of our *Canadian Property Valuation* publications that rooming houses are beyond the scope of a CRA designation," Varner said.

In all three situations, a CRA can either refuse the assignment, or arrange for review and co-signature by an AACI, in order to be covered by professional liability insurance. Without a co-signature, a CRA risks being disciplined.

When asked if there is a maximum lot size that can be considered in the appraisal, Varner said there is no single correct answer – sometimes the client will dictate, or Revenue Canada may have input. Ultimately, the appraiser must decide if what the lender asks for is even possible.

John Ingram, AACI, president of ARA Ingram Varner in Halifax, Nova Scotia, said finding highest and best use in vacant land presents a whole array of residential or commercial possibilities. In three scenarios, Ingram showed participants how to decide whether each situation warranted direct comparison analysis or subdivision analysis.

In the first example, a parcel of woodland is surrounded by other parcels of woodland with no road access. Nothing surrounding the land lends itself to recreational use. The zoning is wide open. "In all likelihood," Ingram said, "the highest and best use is sitting on it for a future eventuality."

In a second scenario, woodland that has been partly cut over, with no timber value, is in the middle of a developing residential subdivision. There are a few twists: the undeveloped portion in the middle has industrial zoning, and the serviceable boundary comes in around the undeveloped portion of



the unserviceable areas on the left and right. A purchaser would likely wait for a development agreement that makes changes to the serviceable boundary.

It is unknown whether the zoning or serviceable boundary will change. “Again, you are probably going to use a direct comparison analysis,” Ingram said.

Example three is different. This parcel of woodland is in a developing residential area. There are golf courses to the north and south, as well as an emerging subdivision. The unknowns have all been eliminated. An established market surrounds it, so it is far enough along in the evolution of the property to take a subdivision approach.

“Ideally, you would want to look at a direct comparison approach as well,” Ingram said. “In any situation when you are doing subdivision of houses, you want to use direct as a cross-check. But, in this situation, even if you did not have the approval in place, you would be okay with sub-analysis based on modeling from the existing subdivision.”

Allan Beatty, AACI, of Kent-Macpherson Appraisals in Kelowna, BC, said that finding highest and best use for special-purpose property has created an evolving area of debate between theorists and practitioners.

“People who subscribe to one view say they are *contrary* or anti-cost-approach,” Beatty said. They build their whole analysis and their approach to valuing any property, including special-purpose property, on the basis that they are always going to refer to market or they are going to create an income model that is totally fictional.

Beatty has found, especially in appeal situations, that one side says, “Well, the property is so specialized, it is never going to be suitable for anything else, so I cannot value the property as it exists.” That is valuing the property in use. I am an advocate of cost approach, even though at times you might look



to the market to quantify things.”

If the character, nature or use of the property is not expected to change, that is where a highest and best use conclusion is drawn. It is not until appraisers get to that stage that they consider what approaches might be appropriate.

Beatty’s fundamental premises are that every property has a highest and best use, even though determining it is a difficult process; that every property can be valued; that the most probable future use is closely aligned with highest and best use; and that utility creates value.

When confronted with a challenging property for highest and best use, Beatty advised participants to consider its most probable future use, and whether any impairment is evident in beneficial use. Once this is done, he proposed three principles to help navigate the process:

- **Consider all methods of appraisal.** If they cannot be applied in their entirety, sales and income factors may be used to demonstrate depreciation or obsolescence.
- **Appraise according to market evidence.** Find a way to break sales into their component parts. Use the market evidence for what it is worth. It is not perfect, but it beats the alternative of either pretending that these factors are not evident, or not addressing all the issues that ought to be addressed.
- **Keep your eye on beneficial use.** Do some digging. Researching the industry, how

it operates and its challenges may reveal valuable market evidence.

As illustration, a recent assessment appeal regards a Saskatchewan creamery that produces nearly 100% of the milk in that province. The assessment showed that farmers would lose \$5 million in potential profit by having to ship their product elsewhere, creating incentive for the farmers to form their own creamery cooperative, if the current creamery operator were to leave the province. The investment could be amortized at \$5 million per year over quite a short period of time.

The appellants wanted to apply the principles of a previous appeal by Southam News in BC. They said, “No one can ever use this, and we think it should be valued as a shipping warehouse.” They argued obsolescence, even though it had changed hands at least twice in the history of the facility, but still continued as a creamery.

Our Board agreed with the respondent (the assessor), saying that it should be valued according to what it was built for, with its proven track record of production.

“Opening at the first level of decision, the most probable future use is continued operation,” Beatty said. “So, although we won on every point, we lost. It only demonstrates to my way of thinking that there is never a sure thing. Appraisers themselves may never reach full agreement on this.”