

## Chapter 5

# Fundamental Appraisal Concepts

Appraising is not an exact science. There are no known tables, formulas, or mathematical calculations that will yield an indisputable estimate of market value. The appraiser must base an opinion of value upon the ever-changing relationship between human desires and a commodity. Fundamental appraisal methods enable the appraiser to arrive at an estimate of value that is logical and supportable. Familiarity with fundamental appraisal theory helps the appraiser understand the importance of factors affecting buyers and sellers.

The final product of any appraisal is an estimate of value. There are many definitions of value and types of value. Oregon Revised Statutes, ORS 308.232 and ORS 308.205, provide that the final product of an assessment appraisal is RMV, or market value. For the definition of RMV refer to the glossary at the end of this manual.

### Appraisal Principles

These basic appraisal principles should be considered when valuing property:

**Anticipation**—Value is the present worth of all the anticipated future benefits to be derived from a property.

**Assemblage**—The combining of two or more parcels into one ownership or use.

**Balance**—Maximum value or profit is achieved or sustained when the agents of production, or the surrounding land uses, are complementary and in a state of equilibrium. For example, a residential lot needs complementary land uses like schools, parks, grocery stores, and medical facilities to protect or maximize its value. Complementary land uses are just as important to commercial property. The principle of balance also applies to the relationship between land and building.

**Change**—The principle of change deals with the transitional nature of property. Today's property conditions evolved from yesterday and are the basis for forecast of tomorrow's conditions. Real property, whether an entire neighborhood or a single property, is constantly changing, at times imperceptibly, from one condition or stage to another. Stages of change within a neighborhood include the development or growth stage, static or stability stage, disintegration or decline stage, and revitalization stage. The principle of change is the law of

cause and effect in the market. Change is reflected in the market as appreciation or depreciation in property value.

**Competition.** Competition is created by the potential for profit that attracts new sellers and buyers to a market. Competition among sellers may lead to an oversupply that reduces prices and profits. Competition among buyers may lead to shortages that increase prices and profits to sellers. Applied to property, competition means an excess of one type of facility will decrease the value of all such facilities.

**Conformity**—Value is created, strengthened, or sustained when reasonable homogeneity or similarity exists. This does not mean monotonous uniformity, but relates to the social and economic forces that create a complementary mix. Pressure for property to conform may be exerted through zoning or through deed restrictions on architectural design or size. Conformity works with the principle of progression and regression. It is also tied to under-improvement and over-improvement concepts.

**Consistent use**—The principle of consistent use states that the entire property must be valued with a single use. It is improper to value a property on the basis of one use for the land and another use for the improvements. This principle is especially important to remember when valuing a property in transition from one use to another.

**Contribution**—The principle of contribution states that the value of a component of property depends upon its contribution to the whole. In other words, the cost of the component does not necessarily equal the value that the component adds to the property. For example, installing a gold faucet in a low quality house will not add as much value to the property as the cost incurred.

**Externalities**—Externalities are influences from outside the property that affect the value. An appraiser should not assume externalities exist. Market analysis is necessary to determine whether external conditions are affecting the property's value. Externalities may refer to the use or physical attributes of properties located near the subject property or to the economic conditions that affect the market in which the subject property competes. For example, construction of a sewage treatment plant near the subject property may have a negative impact on value.

**Increasing and decreasing returns**—Increasing the amount of agents in production produces a greater net return to the property up to a point (point of diminishing returns). Once the point of diminishing returns is reached, successive investment increments will decrease their net benefit

to the property. This principle helps the appraiser compare alternative use patterns and intensities of use to establish the highest and best use of the property.

**Plottage**—An increment of value that results when two or more sites are assembled under a single ownership to produce greater utility.

**Progression**—The concept that the value of an inferior property is enhanced by proximity to a superior property.

**Regression**—The concept that the value of a superior property is adversely affected by its association with an inferior property.

**Substitution**—A property's value is typically based on the value of an equally desirable substitute property. People tend to pay no more for a property than they would pay to acquire substitute property of equivalent utility, assuming there are no costly delays. The principle also recognizes that the substitute property with the lowest price will attract the greatest demand and widest distribution in the market. The principle of substitution is fundamental to all approaches to value. The cost approach is influenced by this principle, in that a purchaser may acquire a similar site and construct a building of like utility. The sales comparison approach relates by substituting one property for a comparable property. The income approach specifically relates to the option of substituting one income stream for another. Income-producing properties can be substituted for different investments as they relate to risk and return.

**Supply and demand**—The utility of real property creates demand, which is desire for possession. Demand is effective when supported by purchasing power. Value increases if supply of real property is reduced by demand, resulting in scarcity. The value of property depends upon the demand for that type of property and varies directly, but not necessarily proportionally, to the supply available within the limits of the available purchasing power.

**Surplus productivity**—The net income that remains after the cost of capital, labor, and management has been paid.

## Highest and Best Use

Highest and best use is the basic premise of RMV. Highest and best use analysis is an integral part of the appraisal process. It is based on the accepted economic assumption that people involved in the real estate market want to receive the maximum benefit of either the land or the improved property, whichever produces the greatest overall investment return.

**Highest and best use defined:** 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 as of the date of the appraisal.

To reconcile a property's highest and best use, the appraiser must answer these four questions; is the use:

- **Physically possible**—suited to the size, shape, and terrain of the parcel?
- **Legally permissible**—conforming to zoning, building codes, private restrictions, environmental regulations, and other governmental controls?
- **Financially feasible**—resulting in a positive net return to the property?
- **Maximally productive**—producing the highest rate of return or highest value for the property?

The proposed use that answers all of these questions positively is the subject property's highest and best use.

Land value is always based on the land's highest and best use as though vacant, even if the site is improved. This long-accepted rule of basic real estate economic theory is based on the principle of surplus productivity and is related to the principles of balance, contribution, and increasing and decreasing returns.

The purpose of determining the highest and best use of the land as though vacant is to evaluate the land's potential uses and select the single use that is the most competitive and profitable. This use is the foundation for the RMV opinion. The highest and best use of land as though vacant must be established when a separate land value is required, and when comparable vacant land sales must be found.

The principle of consistent use states that a property, both land and improvements, must be valued with the same highest and best use. It is improper to value a property on the basis of one use for the land and another use for the improvements. This principle is of special importance when valuing properties in transition. Land is always valued as if it were vacant and available to be put to its highest and best use.

Land has value while improvements contribute to value. The value that existing improvements contribute to the whole property is determined by subtracting the value of the land, as if vacant, from the value of the total property. If the improvements do not contribute economically to the

total property value, they should be renovated, expanded, or demolished.

Restated, improvements contribute value only when the income returned by the property, either from rent or sale, exceeds what the land alone is worth. If the property is improved, but does not return a value greater than the land value as though vacant, then the principle of highest and best use assumes that land will be made available for its most economically beneficial use.

These basic concepts of the economic principle of highest and best use are the basis for the opinion of RMV.

When property owners consider the economic feasibility of remodeling or enlarging existing improvements, they evaluate the costs that will be incurred by deducting the net costs associated with the change from the anticipated RMV of the “new” property. When demolition is considered, the “new” site value is the RMV of the land as though vacant, less the net cost of creating the vacant and available site.

When a developed property is not improved to its highest and best use and the deficiency is not attributed to physical deterioration or an adverse external factor, the deficiency must be some form of functional obsolescence. A misplaced improvement or an outdated building design are examples. Any related loss in property value is always attributed to the improvements because the land value is based on its highest and best use as though vacant.

When appraising legal nonconforming uses, the site may be developed to either a higher or lower use than allowed by current zoning. Land value must always be based on the legal use as if vacant and available to be put to its highest and best use. Any bonus value due to a higher nonconforming use should not be attributed to the land. It is value contributed by the improvements. The contributory value of the improvement is determined by subtracting the land value at its highest and best use (as though vacant) from the total property value. The residual is the contributory value of the improvements.

There are other special considerations such as surplus and excess land, interim, multiple, special purpose, and speculative uses that will occur during highest and best use evaluations. For a complete discussion of these special situations see a generally accepted authoritative reference source such as the current edition of the Appraisal Institute's, *The Appraisal of Real Estate*.

## Summary

The economic principle of highest and best use is the real estate market participant's basis for anticipating the benefits of real property ownership and the appraiser's basis for valuing that ownership right.

- Highest and best use is the reasonably probable and legal use of vacant land or an improved property that is physically possible, legally permitted, economically feasible, and results in the highest value. A potential use that fulfills these requirements is the highest and best use.
- Land is always valued as vacant and available to be put to its highest and best use.
- If property improvements do not contribute value to the property they should be renovated, expanded, demolished, or a combination of these alternatives.
- It is improper to value a property on the basis of one use for the land and another use for the improvements.

Examples of highest and best use analysis follow.

## Example No. 1. Multiple Full Size Lots

|                 |  |
|-----------------|--|
| SITE            | One tax lot comprised of two 60 by 100 foot platted interior lots. A two-lane, paved and curbed street; sidewalk; and sewer and water system serve the site. |
| IMPROVEMENTS    | None.  |
| LOCATION        | Homogeneous subdivision of similar residential properties, approximately 95 percent built up.  |
| ZONING          | Residential medium density. Minimum lot size: 6,000 square feet.   |
| TRENDS          | Slow and steady increase due to desirable location. Remaining vacant lots are being purchased and improved with comparable houses.                           |
| COMPARABLE DATA | Remaining interior 6,000 square foot lots are supporting selling prices of \$35,000.   |

**Exercise:** Estimate the value of the land using highest and best use procedures.

The subject consists of one tax lot. However, under current zoning and the way the subdivision is platted, two buildable lots exist. Therefore, highest and best use would recognize two separate buildable lots.

The tax lot should be valued as two buildable lots at  $\$35,000 \times 2 = \$70,000$ .

## Example No. 2. Multiple Undersize Lots

|                 |   |
|-----------------|---|
| SITE            | One tax lot comprised of three 30 by 100 foot platted interior lots. A two-lane, paved and curbed street; sidewalk; and sewer and water serve the site. |
| IMPROVEMENTS    | None.   |
| LOCATION        | Homogeneous subdivision of similar residential properties, approximately 95 percent built up.   |
| ZONING          | Residential medium density. Minimum lot size: 6,000 square feet.  |
| TRENDS          | Slow and steady increase due to desirable location. Remaining vacant lots are being purchased and improved with comparable houses.                      |
| COMPARABLE DATA | Minimum-sized, buildable interior lots are supporting selling prices of \$35,000. Oversized interior lots are selling for \$10,000 more.                |

**Exercise:** Estimate the value of the land using highest and best use procedures.

The subject consists of one tax lot. Under current zoning and the way the subdivision is platted, only one buildable lot exists. Therefore, highest and best use would recognize one oversized building lot.

The tax lot should be valued as one oversized building lot at \$45,000 (\$35,000 + \$10,000).

### Example No. 3. Zoning

|                 |  |
|-----------------|--|
| SITE            | One tax lot comprised of one 50 by 100 foot platted interior lot. The site is served with a two-lane, paved and curbed street; sidewalk; and sewer and water system.                               |
| IMPROVEMENTS    | None.  |
| LOCATION        | Street of older single-family residential properties, approximately 95 percent built up. Rear property lines abut strip commercial zoned and improved properties.                                  |
| ZONING          | Residential medium density. Minimum lot size: 5,000 square feet.   |
| TRENDS          | This side of the street has begun the transition to commercial use. Some strip commercial properties have obtained special use permits and have expanded their commercial use to those properties. |
| COMPARABLE DATA | Minimum-sized residential interior lots are supporting selling prices of \$32,000. Vacant lots with special use permits support sales prices of \$45,000.  |

**Exercise:** Estimate the value of the land using highest and best use procedures.

Highest and best use is based upon legal use. In this instance, zoning limits probable uses to residential, so the subject must be valued as vacant residential.

For the subject, a value of \$32,000 is warranted.

## Example No. 4. Residence Not Built to Highest and Best Use

|                 |  |
|-----------------|--|
| SITE            | Two 50 by 120 foot platted lots located in a homogeneous residential subdivision. The lots are level. A two-lane, curbed street; sidewalk; and underground utilities serve the subdivision.  |
| IMPROVEMENTS    | The single-family, class 4 quality dwelling was built in 1968. It contains 1,400 square feet on a single level. It has 1 _ baths, three bedrooms, living room, kitchen, utility room, and an attached double garage. Comparable homes in the area have a RMV of \$125,000 to \$130,000. The dwelling straddles the lot line between Lot 1 and Lot 2. |
| ZONING          | Single-family residential, medium density with a minimum lot size of 6000 square feet required. Setback is: front at 20 feet, sides at 5 feet, and back at 20 feet.  |
| TRENDS          | Middle-class, detached, single-family houses predominate in the homogeneous neighborhood. The area is generally developed with only an occasional vacant lot. Houses show pride in ownership.  |
| COMPARABLE DATA | The market supports a value for each lot, as though vacant, of \$35,000. The on-site development (OSD) is determined to be average and contributes to the value of the site at \$5,000.  |

Continued . . .

**Exercise:** Estimate the value of the property using highest and best use procedures.

**Vacant land value**

|                  |                 |
|------------------|-----------------|
| Lot 1 (50 × 120) | \$35,000        |
| Lot 2 (50 × 120) | 35,000          |
| OSD              | <u>+ 5,000</u>  |
|                  | <u>\$75,000</u> |

**Dwelling**

|                                 |                        |
|---------------------------------|------------------------|
| Value of property               | \$127,500              |
| Less land value                 | <u>- 75,000</u>        |
| Indicated value of improvements | <u><u>\$52,500</u></u> |

The value of the land is estimated, as though vacant, for its highest and best use as two separate buildable lots. Land is said to have value and the improvements contribute to the value of the property.

The contribution of the improvements is estimated by subtracting the value of the land from the overall value of the property. The overall value of the property was determined by direct comparison to comparable sales. Land values are not penalized so long as the existing structures have economic value.

The property, as improved, is not developed to its highest and best use due to the misplacement of the improvements. The misplacement of the improvements creates incurable functional obsolescence. Obsolescence is always attributed to the improvements, not the land.

## **Example No. 5. Residence Built to Highest and Best Use with Excess Land**

|                 |   |
|-----------------|---|
| SITE            | Two 50 by 120 foot platted lots located in a homogeneous residential subdivision. The lots are level. A two-lane, curbed street; sidewalk; and underground utilities serve the subdivision.   |
| IMPROVEMENTS    | The single-family, class 4 quality dwelling was built in 1968. It contains 1,400 square feet on a single level. It has 1 _ baths, three bedrooms, living room, kitchen, utility room, and an attached double garage. The improvements are all located on Lot 1. Lot 2 is currently vacant except for landscaping. |
| ZONING          | Single-family residential, medium density with minimum lot size of 6,000 square feet required. Set back on the front is 20 feet, the sides at 5 feet.   |
| TRENDS          | Middle-class detached single-family houses predominate in the homogeneous neighborhood. The area is generally developed with only an occasional vacant lot. Houses show pride in ownership.   |
| COMPARABLE DATA | The market supports a value for the site, as though vacant, of \$35,000. The on-site development (OSD) is determined to be average and contributes to the value of the site at \$5,000. Comparable houses on single lots in this area have a market value of \$125,000 to \$130,000.                              |

Continued . . .

**Exercise:** Estimate the value of the property using highest and best use procedures.

**Vacant land value**

|   |                 |
|---|-----------------|
| Lot 1 (50 × 120)                                      | \$35,000        |
| OSD   | + 5,000         |
|   | <u>\$40,000</u> |
| Lot 2 (50 × 120)                                      | \$35,000        |
| (Excess land—highest and best use as a building site) |                 |

**Dwelling**

|                                 |                 |
|---------------------------------|-----------------|
| Value of property (Lot 1)       | \$127,500       |
| Less land value                 | <u>- 40,000</u> |
| Indicated value of improvements | \$87,500        |
| Value of property (Lot 1)       | + 40,000        |
| Value of property (Lot 2)       | <u>+ 35,000</u> |
| Total property value            | \$162,500       |

The value of the land is estimated, as though vacant, for its highest and best use as two separate buildable lots.

Lot 1 is improved to its highest and best use as a single-family dwelling. Comparable sales are used to determine the total value of Lot 1 and the improvements sited upon it.

Lot 2 is considered excess land that is not needed to accommodate the primary highest and best use located on Lot 1. The appraiser appropriately identified Lot 2 as excess land and indicated its unit value separately.

## Example No. 6. Misplaced Residential Improvement

|                 |  |
|-----------------|--|
| SITE            | The five-acre rural residential site is approximately 1,000 feet deep with 218 feet of frontage adjacent to a paved county road. It is served by public utilities that include electricity and telephone. Water is provided by a well. A septic system provides sanitation. The site has a view of the valley to the north from the north portion of the parcel.   |
| IMPROVEMENTS    | The site is improved with a 20-year-old, class 5, residential structure. The house contains approximately 2,000 square feet, which includes three bedrooms, two baths, a living room, dining room, kitchen, utility, and family room. There is also an attached double garage of approximately 600 square feet. The house is in average-plus condition for its age. The house is at the south end of the parcel adjacent to the county road and has not taken advantage of the view. |
| LOCATION        | A rural location outside of a community of 40,000. The area is slowly changing from commercial farming to rural residential.   |
| ZONING          | Rural residential with minimum lot size of five acres. Conditional uses include golf courses, schools, and churches.   |
| TRENDS          | Rural land values steadily increase as upper middle class families continue to purchase small acreage for serenity, view, pasture for horses, etc.   |
| COMPARABLE DATA | The market supports a value for view sites, if vacant, of \$90,000. The contributory value for on-site development (OSD) is estimated to be an additional \$15,000. Comparable improved properties, where the improvements have taken advantage of the view, are selling for \$250,000 to \$275,000. Comparable properties with misplaced improvements are selling for \$220,000 to \$240,000.   |

Continued . . .

**Exercise:** Estimate the extent of incurable functional obsolescence in the improvement that has resulted from placing it away from the available view.

**Land value**

|                     |                 |
|---------------------|-----------------|
| 5.0 acres with view | \$90,000        |
| OSD                 | <u>+ 15,000</u> |
|                     | \$105,000       |

|   |                  |
|---|------------------|
| <b>Subject value by direct comparison to sale properties not using view</b> | \$235,000        |
| Value of improved land  | <u>- 105,000</u> |
| Contributory value of improvements not taking advantage of view             | \$130,000        |

|   |                  |
|---|------------------|
| <b>Value of like properties using view by direct comparison</b>       | \$265,000        |
| Value of improved land  | <u>- 105,000</u> |
| Contributory value of improvements using view                         | \$160,000        |
| Less contributory value of improvements not taking advantage of view  | <u>- 130,000</u> |
| Incurable functional obsolescence due to misplacement of improvements | \$ 30,000        |

The subject property has not been improved to its highest and best use because the improvements have been misplaced away from the available view. Misplacement of a dwelling is a form of incurable functional obsolescence that remains with the improvements for the duration of their useful lives. In all cases, land value is estimated as though vacant and available for development to its highest and best use. In this case, the land value is established as if to take full advantage of the available view.

The overall value of the property is determined by direct comparison with sales of like properties having misplaced improvements. The contributory value of the misplaced improvements is estimated by subtracting the value of the improved view site from the property's overall value. The extent of depreciation in the dwelling from functional obsolescence is found by direct comparison with the value of comparable dwellings situated to take advantage of the view, as shown above.

Again, any loss in value due to the misplacement of the improvements is always attributed to the improvements, never to the land.

## Example No. 7. Residence in Transitional Area

|                 |   |
|-----------------|---|
| SITE            | 100 by 100 foot inside level lot. A two-lane, curbed street; sidewalk; and sewer and water system serve the site.   |
| IMPROVEMENTS    | Residence built in 1920 contains 870 square feet on the first floor and 770 square feet on the second floor with one bath, three bedrooms, and a detached single garage. Front yard setback is 20 feet. A comparable house in a residential location has a market value of \$135,000.   |
| LOCATION        | Commercial location on major arterial in a community of 50,000. Arterial serves middle-class residential area.  |
| ZONING          | Commercial/service. Zoning permits commercial retail, commercial office, fast foods, auto repair, etc. Conditional uses include selected light industrial. Front setback on new construction is 5 feet.   |
| TRENDS          | Commercial land values are increasing and are supported by average quality development. Some houses with good structural characteristics have been renovated and converted to office use. Traffic count and location support additional development of fast food restaurants, convenience grocery stores, offices, and repair shops.  |
| COMPARABLE DATA | The market supports a value for the site, as though vacant, of \$50,000. If renovated, the house would rent as commercial office, travel agency, insurance agency, or real estate sales for \$675 per month; operating cost, including management, is 20 percent after vacancy. Vacancy is projected at 10 percent. The market supports a 10 percent overall rate for this quality property. Conversion cost is estimated at \$6,500. If the structures are razed, net razing cost is estimated at \$4,000. |

**Exercise:** Estimate the value of the property using highest and best use procedures.

**Dwelling Razed**

|                            |                |
|----------------------------|----------------|
| Vacant land value (market) | \$50,000       |
| Razing cost                | <u>– 4,000</u> |
| Net site value             | \$46,000       |

**Dwelling Renovated**

|                                 |                 |
|---------------------------------|-----------------|
| Gross income                    | \$8,100         |
| Less vacancy (10%)              | <u>– 810</u>    |
| Effective gross income          | \$7,290         |
| Less operating expenses (20%)   | <u>– 1,458</u>  |
| Net operating income            | \$5,832         |
| Capitalized at 10%              | \$58,320        |
| Less cost of renovation         | <u>– 6,500</u>  |
| Present improved property value | \$51,820        |
| Less vacant land value (market) | <u>– 50,000</u> |
| Value of improvements           | \$1,820         |

The value of the land is estimated as though vacant, for its highest and best use as commercial land. Because the improvements do not contribute to the highest and best use of the land as though vacant, the value of the site is estimated by subtracting the cost of razing the improvements from the estimated value of the land. Although the value of the renovated property slightly exceeds the net value of the site as though vacant, the renovated dwelling would have obvious functional obsolescence, and the improvement value would be marginal. Land values are not penalized so long as the existing buildings have economic value. The recent increases in land value suggest demolition and rebuilding as the better use. Furthermore, by examining the land-to-building ratio, the marginal nature of the renovated buildings becomes evident.

## Example 8. Residence Located in a Commercial Zone as an Interim Use

|                 |   |
|-----------------|---|
| SITE            | 50 by 100 foot inside level lot. Two-lane, curbed street; sidewalk; and sewer and water system serve the site. All other utilities are overhead.  |
| IMPROVEMENTS    | Residence built in 1940 contains 1,100 square feet on the first floor and an unfinished concrete basement of the same size. The house has three bedrooms, one bath, living room, and kitchen/dining rooms. There is also a detached single garage. Front yard set back is 20 feet. Occasionally, several adjacent properties are purchased to create a large enough parcel to utilize commercially. The existing houses are razed and the land is redeveloped with a commercial structure. These sales indicate a commercial land value of \$8 per square foot. |
| ZONING          | The area is zoned service-commercial. The zoning permits a variety of commercial businesses such as fast food restaurants, offices, convenience grocery stores, auto repair, etc. Front set back on new commercial construction is 5 feet.  |
| TRENDS          | The area is a mix of older residential construction and commercial establishments. Existing houses are still being purchased for affordable housing. When an investor can assemble enough of these properties, the houses are razed and new commercial structures, such as fast food restaurants, convenience grocery stores, or insurance offices are built.   |
| COMPARABLE DATA | The market supports a value for the site, as though vacant, of \$40,000. If renovated, a comparable house would rent as a commercial office (real estate, insurance, etc.) for \$1,200 per month, with operating cost of 20 percent after vacancy. Vacancy is projected at 10 percent. If the house were to be used as a single-family rental, it would rent for \$750 per month with vacancy projected at 5 percent and expenses at 20 percent after vacancy. The market for purchase as a single-family owned residence is fairly                             |

strong with comparables indicating a value range of \$105,000 to \$110,000.

**Exercise:** Estimate the value of the property using highest and best use procedures.

**Land value**

|                            |                |
|----------------------------|----------------|
| Vacant land value (market) | \$ 40,000      |
| Razing cost                | <u>– 4,000</u> |
| Net site value             | \$36,000       |

**Dwelling renovated (office)**

|                                 |                |                 |
|---------------------------------|----------------|-----------------|
| Gross income                    | \$14,400       |                 |
| Less vacancy (10%)              | <u>– 1,440</u> |                 |
| Effective gross income          | \$12,960       |                 |
| Less operating expenses (20%)   | <u>– 2,592</u> |                 |
| Net operating income            | \$10,368       |                 |
| Capitalized at 10%              |                | \$103,680       |
| Less cost of renovation         |                | <u>– 15,000</u> |
| Present improved property value |                | \$88,680        |
| Less land value                 |                | <u>– 40,000</u> |
| Value of improvements           |                | \$ 48,680       |

**Dwelling as a Single-Family Rental**

|                                 |                 |
|---------------------------------|-----------------|
| Gross income                    | \$ 9,000        |
| Less vacancy (5%)               | <u>– 450</u>    |
| Effective gross income          | \$ 8,550        |
| Less operating expenses (20%)   | <u>– 1,710</u>  |
| Net operating income            | \$ 6,840        |
| Capitalized at 10%              | \$ 68,400       |
| Present improved property value | \$ 68,400       |
| Less land value                 | <u>– 40,000</u> |
| Value of improvements           | \$ 28,400       |

**Dwelling as a Single-Family Residence**

|   |                 |
|---|-----------------|
| Value of property from comparable sales | \$107,500       |
| Less land value                         | <u>– 40,000</u> |
| Value of improvements                   | \$ 67,500       |

The value of the land is estimated, as though vacant, for its highest and best use as commercial land. This is its highest legal use. Various situations must be examined to determine the highest and best use of the property as improved. As the transition continues from residential to

commercial, supply and demand will force the land value upward. At some point, the value of the land as though vacant will force redevelopment of the subject property from an interim use to its highest legal use.

Four situations were examined to determine the reasonable and probable use that supports the highest present value of vacant land or improved property as of the date of the appraisal.

Analysis of these situations indicates the market for commercially zoned property in this area is not sufficient to warrant redevelopment. Furthermore, there is adequate competition to retain the residence as an interim use.

## Example 9. Legal Nonconforming Use

|                 |  |
|-----------------|--|
| SITE            | A rectangular site with 200 feet of frontage on a main arterial street serving an upper middle-class neighborhood. The lot is 200 feet deep. The site is level and served with all necessary public utilities. It contains 40,000 sq. ft.  |
| IMPROVEMENTS    | Formerly a single-family dwelling built in 1930. The wood frame structure contains approximately 1,400 square feet. The structure is being utilized as a neighborhood convenience grocery store and has been in this use since 1950. Overall, the structure is in above-average condition.   |
| LOCATION        | The property is located in a developing single-family neighborhood where average to above-average quality houses are being built. The neighborhood is on the edge of a community of 50,000, located outside of a major metropolitan area. It is located adjacent to a secondary state highway that serves a popular outdoor recreation area.   |
| ZONING          | The zoning is low density single-family. Primary use is for above average single-family dwellings with conditional use allowances for schools, churches, and open space. The commercial use predates the current zoning and is a nonconforming use. If the use is discontinued for 18 months, or if fire or other natural causes damage the building by over 50 percent, the commercial use cannot be reestablished. Alterations are permitted only if the altered property has no greater adverse impact on the community than it currently presents. |
| HISTORY         | The current business has annual sales of \$225,000 from about 1,000 square feet of sales space. The remainder of the structure is used for storage and a bathroom. Personal property, which is old but in good usable condition, is estimated at \$4,000. With increasing development in the area, sales have been steady with some increase.  |
| COMPARABLE DATA | Analysis of comparable unimproved residential land sales supports a  |

value of \$40,000 or \$1 per square foot. Similarly improved properties without nonconforming use history reflect a contributory improvement value of approximately \$45 per square foot. Analysis of comparable “Mom and Pop” convenience stores indicates the value range of \$90 to \$105 per square foot, including personal property and land. The comparable sales indicate that these types of properties are typically being purchased on the basis of 60 percent of gross annual sales.

**Exercise:** Estimate the value of the property using highest and best use procedures.

**Overall value**

|  |           |
|--|-----------|
| 1,400 sq. ft. at \$90 per sq. ft. overall  | \$126,000 |
| 1,400 sq. ft. at \$105 per sq. ft. overall | \$147,000 |
| \$225,000 annual sales × 60%               | \$135,000 |

**Allocation**

|   |                 |
|---|-----------------|
| Overall value (annual sales)                    | \$135,000       |
| Land (40,000 sq. ft. at \$1 per)                | 40,000          |
| Fixtures  | + 4,000         |
| Improvements (1,400 sq. ft. at \$45 per)        | <u>+ 63,000</u> |
|   | \$107,000       |
| <b>Residual Bonus Value (nonconforming use)</b> | \$ 28,000       |

(\$135,000 - \$107,000)

—or—

|                                 |                |
|---------------------------------|----------------|
| Overall value (annual sales)    | \$135,000      |
| Land (40,000 sq. ft. at \$1.00) | 40,000         |
| Fixtures                        | <u>+ 4,000</u> |
|                                 | \$44,000       |
| <b>Residual to improvements</b> | \$ 91,000      |

(\$135,000 - \$44,000)

\$91,000 = \$65 per sq. ft. (1,400 sq. ft.)

Comparable residences are valued at \$45 per square foot. Therefore, the legal nonconforming use bonus to the residence is \$20 per square foot.

A legal nonconforming use is a use that was lawfully established and maintained, but no longer conforms to the use regulations of the zone in which it is located. The zoning change may create either an under-improvement or over-improvement. A nonconforming over-improved property results when zoning changes reduce the legal permitted use. The legal nonconforming use may also create a bonus value that is always attributed to the existing improvements.

If vacant, the subject land has a highest and best use as a residential site. This is the land's highest legal use. Comparable residences are valued at \$45 per square foot. Therefore, the nonconforming use bonus to the structure is \$20 per square foot. This bonus value is reflected in the value of the improvements because it is dependent upon the continuation of the current nonconforming use. If the use is discontinued, the bonus value ceases to exist.