

Timing Is Everything: The Role of Interim Use in the Highest and Best Use Conclusion

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Abstract

The purpose of this article is to propose the formal incorporation of the concept of *interim use* into the definition of *highest and best use*. It seems like an unnecessary task, but nowhere in the body of knowledge is the relationship expressed explicitly. This article discusses the reasons in support of the incorporation.

In the valuation of real estate, it is axiomatic that “you can’t get the value right if you get the highest and best use wrong.” This is true because it is the use that is valued. However, as the discussion will reveal, there is a lot more to highest and best use than the use.

Consider the following from an actual court case concerning an older, low-density retail center. The location was quasi-urban, in the path of high-density redevelopment spawned by recently improved rapid rail transportation. It was forecasted that it would be five years before redevelopment of the retail center would be feasible. The issue was the land’s highest and best use. The plaintiff claimed that the land’s highest and best use was its interim use, and the interim use should be the basis of the land’s market value. The defendant’s appraiser concluded that the land’s highest and best use was its use in five years—not the interim use. Who was right?

The answer to that question centers on the relationship of interim use to highest and best use. Is interim use a separate, stand-alone determination, or is it integral to a highest and best use conclusion? The purpose of this article is to explore

the relationship of interim use to a property’s highest and best use and resolve any confusion about that relationship. In addition, two new definitions are proposed with the intent of clarifying the role of interim use in the valuation process.

Relationships of Interim Use and Highest and Best Use

Interim use is only an issue when development or redevelopment of a property is delayed due to legal, physical, or financial reasons. As with the opening anecdote, confusion can occur as to when a property’s highest and best use begins. Is it on the date of value, or is it on a future date when the actual development will occur?

The basic template for the definition of *highest and best use*, developed in the mid-1970s,¹ is as follows:

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 four criteria the highest

1. See discussion in David C. Lennhoff and Richard L. Parli, “A Higher and Better Definition,” *The Appraisal Journal* (Winter 2004): 45–49; and Appraisal Institute, *The Appraisal of Real Estate*, 15th ed. (Chicago: Appraisal Institute, 2020), 306.

and best use must meet are legal permissibility, physical possibility, financial feasibility, and maximum productivity. *Alternatively, the probable use of land or improved property—specific with respect to the user and timing of the use—that is adequately supported and results in the highest present value.*² [Emphasis added.]

The definition requires three conclusions from a highest and best use analysis: the use, the timing of the use, and the most likely users of the property. The three requirements are interwoven and necessary for a clear understanding of the future use of a property. Together, the three conclusions define how a property achieves its maximum productivity. A specific use can be now or in the future and should be targeted to a particular segment of the market. Change one of these elements in a highest and best use conclusion and the productivity of a property necessarily changes. It is the analyst's challenge to determine the combination that results in the highest property value as of the effective date of the appraisal.

Timing Is the Key Ingredient

Of the three highest and best use conclusions, timing of the use is arguably the most critical. No matter how productive a specific use is, if market characteristics dictate an extended delay in implementing that use, the use can become secondary in productivity. As *The Appraisal of Real Estate* states, “The timing of alternative uses is a key consideration in highest and best use analysis because highest and best use is subject to change.”³

The diagram in Exhibit 1 delineates the eight-step process for determining which use is a property's highest and best use.⁴ The first six steps are a recitation of the six-step process of market analysis. Step 1 is a blend of the filtering necessary to determine those uses that qualify to be tested for financial feasibility. It is Steps 2–6 that determine if a use is currently financially feasible or can be forecast to become financially feasible in the predictable future. These uses are candi-

dates for satisfying the maximally productive requirement of the analysis. The alternative use with the highest residual land value is deemed the property's highest and best use.

In the eight-step highest and best use process, it is clear that the highest value of a property can be currently not legally permissible, not physically possible, and not financially feasible. *The Appraisal of Real Estate* notes that “holding a property for future use may produce a higher present value than current development of a different use on the property.”⁵

An example of a physical requirement preventing immediate development is the delayed arrival of public sewer; examples of a legal requirement include an expected change in zoning, subdivision approval, or the expiration of a lease. Once the delay is confirmed, the length of the delay is determined in Step 7 and the residual land value is treated as a reversion, discounted to present value over the holding period at an appropriate rate. This value becomes a candidate for satisfying the maximum productivity requirement. Alternative uses that are not currently ripe can be compared to those that are currently ripe using discounted cash flow analysis. The probable use with the highest present value becomes the highest and best use.

As such, a use that is delayed many years in the future can be a property's highest and best use even though an alternative use is currently ripe for development. If this is the case—i.e., the maximally productive use is a delayed use—there is necessarily an interim use of the property, although that “use” may be simply to wait. *Interim use* is defined as “the temporary use to which a site or improved property is put until a different use becomes maximally productive.”⁶ An interim use always influences property value. That influence is not necessarily positive, however, as there can be carrying expenses associated with the property that may not be offset by actual income.

2. See discussion in *The Appraisal of Real Estate*, 15th ed., 306. The emphasized portion of the definition was added in 2004.

3. *The Appraisal of Real Estate*, 15th ed., 322.

4. *The Appraisal of Real Estate*, 15th ed., 318. The eight-step process has long been taught in Appraisal Institute courses, but it has been clarified and emphasized in the fifteenth edition of *The Appraisal of Real Estate*.

5. *The Appraisal of Real Estate*, 15th ed., 323.

6. Appraisal Institute, *The Dictionary of Real Estate Appraisal*, 6th ed. (Chicago: Appraisal Institute, 2015), s.v. “interim use.”

Exhibit 1 Eight Steps of the Highest and Best Use Analysis Process

Step 1. Property productivity analysis	Analyze property productivity attributes (site, legal, and location) to eliminate uses and determine most probable uses	<ul style="list-style-type: none"> • Physical possibility • Legal permissibility
Step 2. Delineate the market Step 3. Demand analysis Step 4. Supply analysis Step 5. Residual demand analysis Step 6. Subject capture analysis	Perform market studies to determine the economic demand and timing for probable alternative uses Perform marketability analysis	Data required for analysis of financial feasibility
Step 7. Financial analysis of alternative uses	Complete a financial analysis of alternative land uses to determine which use has the highest residual land value	Financial feasibility
Step 8. Highest and best use conclusions	Perform highest and best use reconciliation and draw conclusions: <ul style="list-style-type: none"> • Use • Timing • Market participants <ul style="list-style-type: none"> • Users of space • Most probable buyer type 	Maximum productivity

Source: Appraisal Institute, "Eight Steps of the Highest and Best Use Analysis Process," Exhibit 18.1 in *The Appraisal of Real Estate*, 15th ed. (Chicago: Appraisal Institute, 2020).

Application of the Current Methodology

In a highest and best use analysis there is usually at least one use that is not subject to an unusual delay in development. If there is also a competitive, reasonably probable use that is forecasted to be delayed, its net income (income less expenses) would be discounted to present value. Again, the use that produces the highest value, regardless of timing, wins the honor of being the highest and best use. A simple example, paraphrased from the Appraisal Institute's *Advanced Market Analysis and Highest and Best Use* course, is helpful in illustrating this concept. Suppose a site has two possible uses that meet the physically possible and legally permissible requirements. The first, a single-family parcel, is currently feasible and has a value to an end user of \$3.50 per square foot.⁷ The second use, townhouses, is not yet financially feasible but is forecast to be in three years, at which time it will

have an end-user value of \$6.00 per square foot. If the discount rate that properly reflects the speculative investor's perception of risk and reward is 13%, what is the highest and best use? The answer is townhouses...even though they are not currently financially feasible. This is because the present value of waiting three years for the \$6.00 price, at 13%, is still higher than the currently feasible single-family unit price at \$3.50. To reiterate, this conclusion holds regardless of the cause of the delay.

A highest and best use determination is nearly always a math problem—implicit for non-income-producing properties and explicit for income-producing properties (simply by the nature of comparison of relative values). If a use is delayed, the problems become more mathematical since it necessarily includes discounted cash flow analysis. *The Appraisal of Real Estate* states, "Alternative uses that are

7. An end-user sale is differentiated from a sale to a speculative investor in that the former involves a buyer who intends to occupy and use the land for his or her own purposes, while the latter involves the purchase of the real property as an investment to be held with the hope of selling it at a profit in the future; see Appraisal Institute course *Advanced Market Analysis and Highest and Best Use*, Part 2-50.

currently financially feasible and those that are forecast to be financially feasible can be compared with discounted cash flow analysis.”⁸ The discounted cash flow process applied in the highest and best use analysis is similar to that applied in the valuation of a property whose development is delayed.

Problems with Current Methodology

The current methodology is clear in two main areas: highest and best use is based on market analysis, and market value is based on highest and best use. An interim use is just one of many uses considered in the eight steps. The resulting highest and best use could be an interim use for a certain number of years, and it could change to a higher use at the end of that period.⁹

The concept of interim use rests on the definition of *temporary*. An interim use is often referred to as a *transitional use*,¹⁰ but the meaning is the same—a use that will eventually be supplanted by a higher and better use. When this change will occur is left for the analyst to discern—almost always by using marketability analysis (recommended but not required). The problem with this is the arbitrary nature of the decision; the future highest and best use must “be predictable with a reasonable degree of reliability.”¹¹ This has persisted as a bone of contention in the concept of interim use for many years. For example, in 1973, Sando opined that “transitional use has a foreseeable termination, usually in from one to five years, and certainly not more than 10 years. A highest and best use concept deferred beyond that period might bring too speculative and remote uses into consideration.”¹² Eaton, to a certain extent, agreed. He states,

to estimate an interim use period longer than five years can be considered speculation and conjecture...If the amount of time between the effective date of the

appraisal and the time when the property is expected to reach its ultimate highest and best use is too great, the appraiser’s conclusion of highest and best use becomes remote and speculative and will be rejected by the courts.”¹³

The obvious question then is, what is magical about five years and where does that length of time come from?

The definition of *interim use* provides no guidance in determining whether an existing use is interim or the actual highest and best use. For example, one classic interim use of vacant land is as a surface parking lot within a central business district. This use can provide significant income and is typically seen as a placeholder or “taxpayer” until the land can be put to a more productive use. In fact, a well-managed central business district parking lot is an income-producing property that provides a return to the land that can be greater than any other use at that time.

The problem is in determining the “if and when” a more productive use will become available. If that time is forecast to be ten years, is a parking lot really an interim use? What about fifteen years? What about an uncertain time period caused by a national financial collapse or an economic collapse caused by a pandemic? The point is that any of those situations can cause a use to qualify for an interim or a highest and best use. The answer is found in market expectations. Would the typical market participant purchase a property with a ten-year hold based on its current condition, or would that purchaser base a purchase decision on the value of the property ten years in the future? Stated differently, if the buyer is willing to pay more for the property than its current use alone can support because of its upside potential, then the current use is best classified as interim.

8. *The Appraisal of Real Estate*, 15th ed., 333–334.

9. Appraisal Institute course *Advanced Market Analysis and Highest and Best Use*.

10. See, for example, Dean G. Chapman and Michelle Patton, “Transitional Use TCE,” *Right of Way* (March/April 2019): 41–44; and Laurence Sando, “Transitional Use Valuations,” *The Appraisal Journal* (April 1973): 222–233.

11. Mark Gallegher, “Evaluating Interim Uses,” *The Appraisal Journal* (January 1994): 53.

12. Sando, “Transitional Use Valuations,” 227.

13. J. D. Eaton, *Real Estate Valuation in Litigation*, 2nd ed. (Chicago: Appraisal Institute, 1995), 118.

Complicating acceptance of the current definition is the fact that virtually all uses are temporary. All land that legally and physically can be developed may eventually be developed; nearly all improved property is destined to be redeveloped. The question essentially comes down to how to determine the demarcation between an interim use and a highest and best use. In other words, when does an interim use become the highest and best use, and when is the current use simply interim? The questions go to the heart of the timing issue, and the answers are found in market data and market analysis. Financial feasibility of an alternative use can be sensitive to market acceptance of the alternative use. *The Appraisal of Real Estate* notes that “the timing of alternative uses is a consideration in the conclusion of highest and best use because highest and best use is subject to change.”¹⁴

An interim use “may have value to the property user” because the interim use generates income that covers costs related to the property.¹⁵ This value to the property user is *investment value* and must be distinguished from the property’s *market value*.¹⁶ Would a typical market participant credit the benefits/expenses to the real estate, and would those market participants limit the benefits to only offsetting carrying costs and demolition expenses? This may be a point of price negotiation, but it seems unlikely that a typical seller would discount such a benefit, no matter how much involvement is required of the user.

An example can demonstrate the dilemma. Suppose two uses for an urban parcel of land have been determined to be reasonably probable and both are legally permissible and physically possible. Market analysis has determined that apartment development is currently financially feasible; office development is forecast not to be financially feasible for five years. The current use of the property is for surface commercial parking.¹⁷ The following table shows the various inputs in the use analysis.

Category	Apartment Use	Office Use
Property land size (sf)	100,000	100,000
Most recent user price per sq. ft.	\$20	\$45
Indicated user value	\$2,000,000	\$4,500,000
Holding period (yrs)	0	5
Discount rate	—	20%
Indicated value disregarding interim use	\$2,000,000	\$1,808,449
Interim use NOI/Yr	0	\$100,000
Present value of interim use	0	\$299,061
Indicated value including interim use	\$2,000,000	\$2,107,510

Without consideration of the present value of the interim use (\$299,061), the analyst would conclude the land’s highest and best use to be apartment use: \$2,000,000 compared to \$1,808,449 for future office use. But with consideration of the contributory value of the interim use, the highest and best use is office use (\$2,107,510). This would indicate that the land should be valued as office land with a five-year delay in development, with a future value of \$4,500,000. Limiting the contribution of the interim use would yield an erroneous result. That is, by restricting the utility of the interim use, the current value of the property would be \$1,808,449, which is less than the current value of the land as an apartment site. The use in highest and best use is the use that creates the highest land value. The principle of consistency dictates that land cannot be valued for one use while the improvements are valued for another. By extension, it is inconsistent to identify interim use as a contribution to property value in one section of an appraisal and dismiss it in another.

14. *The Appraisal of Real Estate*, 15th ed., 333.

15. *The Appraisal of Real Estate*, 15th ed., 333. Emphasis added.

16. There are numerous references in the literature related to defray-the-costs conditions, but these predate the publication of the 15th edition of *The Appraisal of Real Estate*. See, for example, David M. Champagne, “Interim Highest and Best Use: Condemnation Appraising,” *The Appraisal Journal* (January 2001): 19–25; and Galeshaw, “Evaluating Interim Uses.”

17. Parking lots can present issues relative to business versus real estate income. See, for example, Barry A. Diskin and David C. Lennhoff, “They Paved Paradise: Appraising a Parking Lot,” *The Appraisal Journal* (Spring 2020): 126–139.

Solutions to the Current Methodology

In the example, the confusion extends to the application of the methodology. Who would be the knowledgeable buyer of this land, and how would the land be priced? If the land is marketed to an office user, then a prudent and knowledgeable seller would demand compensation for the potential income of the interim use. The interim use should be integral to both the determination of the land's highest and best use and to the determination of the land's value. This would rectify any consistency problem as well as recognize that what is being concluded and what is being valued is a property with mixed uses.

There is no controversy regarding a highest and best use conclusion that is mixed-use. "Highest and best use often comprises more than one use for a parcel of land or an improved property."¹⁸ There also is no controversy on how to value a mixed-use property. "If the highest and best use of a property is for more than one use on the same parcel or in the same building, the appraiser must analyze the *contributory value* of each use."¹⁹ (emphasis added)

Continuing with the apartment/office example, if it is accepted that the highest and best use of the land is for future office development, which requires the consideration of the interim use, the interim use value is de facto *contributory value*. Consequently, interim use converts a single-use conclusion to a mixed-use highest and best use conclusion—one that is based entirely on the timing of the mixed uses.

Most mixed-use conclusions are not only a mix of uses but also a mix of timing for the uses. Although not occupying the same space, the uses often occupy different points in time. For example, a mixed-use highest and best use conclusion might be expressed as follows: the front two acres developed immediately with retail, the rear two acres with office sometime in the identifiable future. In this example, there could be a third use, an interim use, associated with the land identified for future office development. Highest

and best use is one conclusion, but that conclusion can incorporate more than one use and more than one timing. This is not a novel viewpoint. Eaton noted that "one property may, in effect, have two highest and best uses—one for a relatively short period and one as a deferred highest and best use."²⁰ Eaton's position is consistent with an earlier understanding of interim use, which held that "interim uses are current highest and best uses that are likely to change in a relatively short time."²¹ The Appraisal Institute text *Real Property Valuation in Condemnation* takes another view. It states, "A complete highest and best use conclusion must include an opinion as to the proper timing of the use. There are not two highest and best use conclusions. An interim use is not itself a highest and best use. Rather, an interim use is part of a highest and best use."²² No explanation is given on how an interim use is integrated into a property's highest and best use. However, this article proposes that the integration is so complete that interim use is equivalent to any other use identified in a highest and best use conclusion.

New Definitions Proposed

The relationship of interim use to highest and best use needs to be clarified. To help improve understanding of the relationship, the following definitions are proposed for *interim use* and *mixed-use development*.

Interim Use. A temporary use to which a property or portion of a property is put until a more intense future use of the same property is identified and supported by market data and market analysis. Interim uses contribute to highest and best use decisions as well as property value for a finite period of time.

The proposed definition is more flexible in describing what really constitutes an interim use. It retains the concept of the temporary nature of the use but also requires the timing of the use to be supported with a reasonable degree of certainty.

18. *The Appraisal of Real Estate*, 15th ed., 334.

19. *The Appraisal of Real Estate*, 15th ed., 334.

20. Eaton, *Real Estate Valuation in Litigation*, 2nd ed., 115.

21. *The Appraisal of Real Estate*, 10th ed. (Chicago: Appraisal Institute, 1992), 290.

22. Appraisal Institute, *Real Property Valuation in Condemnation* (Chicago: Appraisal Institute, 2018), 83–84.

The acceptance of the above definition of *interim use* would not be that radical. The definition would simply dismiss the possibility that a highest and best use determination is fluid. If the uses of a site change over time, then the highest and best use is a mixture of uses, not a complete change of use. This recognition requires a new definition of *mixed-use development*.

Mixed-Use Development. A property that comprises multiple uses within a single site, characterized by the physical, function, and timing integration of its components.

Interim use should be treated the same as any other part of a mixed-use conclusion is treated—a different use with a different timing. The determination of the balance and contribution of the various uses in a project can be discovered through discounted cash flow analysis.²³ The only twist is that there is a limited life to an interim use. But this is no different from the conclusion of a residential subdivision, which also has a limited life.

Conclusions

In practice, how would the new definitions be applied? Let's revisit the introductory courtroom drama. Although this case was settled with both sides claiming "satisfaction," the issue would never have materialized had it not been for the ambiguity of the methodology. If the methodology had employed the two proposed definitions, the land rent at issue would be based on the total property value since the highest and best use would be a mixed-use development. The interim

use would just be one of the two uses that combined to create a mixed-use project. Land value should not be based on the interim use alone nor the ultimate use alone. It is the combination of those uses that results in the property's highest and best use and the basis of value.

Under the two proposed definitions, the highest and best use conclusion of the introductory property could be expressed as follows:

Based on the marketability study conclusions, in our opinion, the highest and best use of the site is for development of a Class A, mid-rise apartment building by an end user, with development in five years following the operation and then demolition of the existing shopping center improvements.

A statement of this nature accepts that highest and best use can be dependent on the passage of time and the change of use over time. All appropriate uses are integrated into the conclusion, leaving no use as secondary and leaving no use as incidental.

When any use of a property is delayed, interim use becomes an issue. Interim use is a property characteristic that must be considered directly in a highest and best use conclusion when a use is delayed. Incorporating interim use into a highest and best use conclusion is no different than arriving at any other mixed-use conclusion. Consistency dictates that interim use be treated the same in the highest and best use analysis and the valuation of a property. Recognizing that interim use is a component of a mixed-use development would result in such consistency.

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23. The process is demonstrated in the Appraisal Institute course *Advanced Market Analysis and Highest and Best Use*, Section 7.

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Additional Resources

Suggested by the Y. T. and Louise Lee Lum Library

Appraisal Institute

- **Education**
<http://www.appraisalinstitute.org/assets/1/7/aiedcat.pdf>
- **Guide Notes to the Standards of Professional Appraisal Practice**
https://www.appraisalinstitute.org/assets/1/7/AI_Guide_Notes.pdf
- **Lum Library, Knowledge Base [Login required]**
Information Files—Value
- **Property Rights Symposium Discussion Paper**
<http://bit.ly/SymposiumPaper>