

Highest and Best Use and Property Rights—Does It Make a Difference?

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Abstract

Fee simple property rights application in tax appraisal is a continuing debate in the courts and taxing jurisdictions and among appraisers. The debate centers on the valuation assumption of fee simple interest in the appraisal of single-tenant properties like big-box retail. One side of this debate is that the property should be appraised considering its current use, while the other viewpoint is that the property should be appraised with the assumption that it is vacant and available for a secondary use. This article addresses the question of how highest and best use fits in this definitional debate and suggests that a supported and reasoned highest and best use analysis should dictate the methods and approaches applied in the valuation analysis—and not just definitional interpretation that assumes the property is vacant and available for a use. Big-box retail property is used as the example for this article, but other property types, such as drug stores, manufacturing facilities, or any property type that was built for use by the owner-operator, will have similar issues in tax court disputes.

Introduction

The application of fee simple property rights in tax appraisal is a continuing debate among courts, taxing jurisdictions, and appraisers.¹ The debate centers on the valuation assumption of fee simple interest in the appraisal of single-tenant properties like big-box retail.² A big-box retail property will be used as the example for this article, but other property types, such as drug stores, manufacturing facilities, or nearly any property type that was built for use by the owner-operator, have similar arguments in tax court disputes.³ One side of this debate is that such properties should be appraised considering their current use, while the other viewpoint is that such properties should be assumed vacant and

available for a secondary use. This article addresses the question of how highest and best use fits in this definitional debate. Whether in tax appraisals or in any market value assignment, this article proposes that a supported and reasoned highest and best use analysis should dictate the methods and approaches applied in the valuation analysis, and not just a definitional interpretation that assumes the property is vacant and available for a use, “because in any appraisal, it is the use that is being valued.”⁴ This is not an estimate of the value of a going concern, but the going concern use, and like any commercial use appraisal, it is analyzed to see if the market is supporting its type of operation in order to determine if the cost of creating the real estate component is justified and supported by the market.

1. Tax appraisals seem to be the main context where the divergent views play out as lenders and lending regulators, banks, and condemnation courts seem to be less concerned about this issue.

2. There is similar debate regarding how to assess built-to-suit leased facilities.

3. Two case opinions, one regarding a big-box store in Michigan and one regarding a GM auto plant in New Jersey, show the courts' concern about how highest and best use is applied in market value appraisals. See *Menards Inc. v. City of Escanaba* 315 Mich. App. 512 (May 26, 2016) and *General Motors Corp. v. Linden City*, 22 N.J. Tax 95 (February 2, 2005).

4. *General Appraiser Market Analysis and Highest and Best Use* course (Appraisal Institute, 2016) Part 13, 353.

There are two general schools of thought on the application of fee simple market value.⁵ One school of thought, the traditional way of handling an assignment of fee simple market value of a leased or owner-operated property, adjusts any below- or above-market leases to market-based rents⁶ for the valuation. For “owner-occupied properties, market rent estimates are used in the income capitalization approach.”⁷ For the traditional method, sales of leased properties can be included with adjustments to market rent and market rent capitalization rates. The cost approach indicates the value of the fee simple interest of the property based on land values from current land sales and costs for similar type buildings adjusted for physical deterioration and functional and external obsolescence, if any.

The second school of thought is sometimes called the “dark store theory.” Under this method, to estimate the fee simple market value of a property, such as a big-box retail property, the property is appraised assuming it is vacant and available for a secondary use. This “assumed vacant and available” fee simple theory involves a series of appraisal definitional interpretations. Examples of the definitional interpretations under the dark store theory include:

- The definition of market value precludes using sales of leased properties since they are not fee simple sales.
- Fee simple precludes using any sale lease-back transactions because they are considered a form of 100% financing and not speculative sales meaning they are not market value-in-exchange sales.

- Only generic properties can be used as market value-in-exchange sales, because custom-built properties do not meet the market value-in-exchange test.
- The current use⁸ of the property (i.e., build-to-suit) cannot be considered because it is value-in-use and not value-in-exchange. This thought maintained by some is also used to justify not utilizing the cost approach.

The results of these definitional interpretations by some leads to the determination that an appraisal for fee simple market value assumed vacant must be based on three principles:

1. The only comparable sales will be those representing vacant buildings that are similar physically to the subject and sold for second-generation use.
2. The income approach is based on the market rent of buildings for a secondary use.
3. The cost approach is not applicable because the building suffers from functional obsolescence that is difficult to estimate since it was built for an owner-user.

The definitional interpretations under the dark store theory disregard the existence of the current property use and its user or similar users;⁹ the market demand to support the current use, and the market activity of acquisition of land and construction of improvements for the use. These market realities are disregarded on the basis that no fee simple sale transaction for that use is found in the marketplace.¹⁰

5. A discussion of the pros and cons of each school of thought is not the purpose of this article, but both schools of thought, as we understand them, are included to contrast how each viewpoint might impact the context of highest and best use.

6. Market-based rent includes other properties with similar economic potential, industry affordable occupancy cost ratio to sales, and such techniques as equilibrium rent. See Kerry M. Jorgenson and Stephen F. Fanning, “One Step Further—Implementing the Recommendations of Guide Note 12,” *The Appraisal Journal* (Summer 2013): 218.

7. Appraisal Institute, *The Appraisal of Real Estate*, 14th ed. (Chicago: Appraisal Institute, 2013), 467.

8. Within this school of thought, most consider “current use” to mean the brand store like The Home Depot, whereas in this article the term “current use” means the retail category—in this case home improvement retail—and does not consider the store brand.

9. Note the term “use” means the use of property, like the retail home improvement center in this case, and the term “user” in market analysis refers to the user of the space, i.e., the retail customers, which in this case study are residents, home builders, and contractors within about 3 to 5 miles of the subject property.

10. It is our view that highest and best use does not depend on whether the property is built to suit for one user or many users. It can be a custom-built property if the improvement needs to be designed for a specific user. An owner-occupied, custom-built improvement can be the highest and best use and will be the highest and best use if that owner-occupant uses it. All real estate improvements are build-to-suit improvements to some degree.

The purpose of this article is not to resolve the debate of the two competing interpretations of fee simple but to show how the interpretations may not matter that much, if at all, in highest and best use analysis. Highest and best use is used to define the standard for the real property, disregarding any personal intangible property that may affect the value of the property but not the highest and best use of the property. The premise of this article is definitions do not determine highest and best use; instead, economic principles—such as the principles of anticipation, substitution, supply and demand, and contribution—are the basis of highest and best use.

Accordingly, the key question is, in any assignment, including property tax valuation¹¹ assignments, is highest and best use the basis of a market value or is the basis the assumption of property rights being appraised? Do the interpretations of the assumption applied to property rights and related definitions set the criteria for valuation methods, such as the selection criteria of comparable sales—or does highest and best use set the criteria for the valuation methods?

Application of Highest and Best Use Principles

The Appraisal of Real Estate, fourteenth edition, states, “The analysis of highest and best use is at the heart of appraisals of the market value of real property.”¹² It seems logical, therefore, that highest and best use must be the first step in a market value appraisal regardless of how property rights are interpreted. Almost every state’s definition of market value for property tax and eminent domain purposes includes a reference that highest and best use is to be considered in valuing real property.¹³ Highest and best use and market value are tied to “use” since value is created through the use of the property.

The conclusion of a highest and best use study could very well be that the highest and best use of the property is to change the property’s current use to a new use, but this article suggests this conclusion should be determined by the highest and best use study and not definitions. To demonstrate this view, the following discussion will present a case study of the highest and best use process for a big-box retail property to see what changes to highest and best use, if any, result from different interpretations of fee simple estate.

The Appraisal of Real Estate, fourteenth edition, suggests that “the analysis of highest and best use can be thought of as the logical end of a spectrum of market analysis procedures, running from the macroeconomic overview of a general market study, through the more detailed marketability studies and analyses of financial feasibility, to the formal analysis of highest and best use.”¹⁴

Market value of a property rests on the foundation of determining “the present value of all of the future benefits it brings to the owner.”¹⁵ The analyst, in measuring the market support for a property use, examines the current and future demand and competitive supply in the subject market.¹⁶ Therefore, the purpose of a highest and best use study is to forecast what is the most probable alternative use of the property that will produce the highest present value of future benefits that can be realized by the owner of the property.

No matter which property rights are appraised, the future benefits are forecast from the results of the six-step market and marketability study. The market and marketability study is based on economic (fundamental) demand over time by users of the real estate space under study.

The market and marketability six-step study is the process that highest and best use analysis uses. It is applied to each reasonably probable alternative market segment that the property is most likely to serve. The highest and best use study of a currently operating big-box retail

11. Some state laws require value in use and thus highest and best use is not applicable, but the market analysis for that use is still applicable.

12. *The Appraisal of Real Estate*, 14th ed., 332.

13. Some states have by law specified that the current use is to be valued; therefore, highest and best use would not be applicable in those situations.

14. *The Appraisal of Real Estate*, 14th ed., 331.

15. “Introduction” in Appraisal Institute Guide Note 12, *Analyzing Market Trends* (Chicago: Appraisal Institute, 2012).

16. *The Appraisal of Real Estate*, 14th ed., 300.

would include the “assumed vacant alternative” for a second-generation use as well as the continuation of the current use of the property, and any other reasonably probable alternatives.

Each alternative use from the market and marketability six-step process then goes into a seventh step—the financial analysis of the alternatives—to determine which alternative provides the highest present value. The eighth and final step in highest and best use analysis is the study conclusion, sometimes called the maximally productive analysis. This step could also be called reconciliation. In appraisal, highest and best use reconciliation is the final analytical step in determining which alternative produces the highest value at the least risk. Risk determination is based on the reliability and confidence in all the data points used in the analysis.¹⁷ The results of the eighth step are then reported in the three-part highest and best use(s) conclusion on:

- Use
- Timing (economic demand/timing)
- Market Participants:
 - Most probable users of real estate space
 - Most probable buyer type (owner-operator, investor, developer, etc.)

Although appraisers traditionally have emphasized the physical use in the conclusion of highest and best use, all three of the above considerations are necessary to identify the highest and best use.¹⁸ Highest and best use determines who would be the most probable users of the space and over what time period. The second part of a market value appraisal measures the most probable market value of the subject’s highest and best use. The different interpretations of the property rights’ market value being sought might change some of the valuation techniques used, but it will not change the property’s highest and best use.

Case Study: Highest and Best Use in Market Value Appraisals

To demonstrate the highest and best use analysis process, a simplified case study is presented next. The case study looks at a big-box home improvement center and will go through each step in the highest and best use analysis process to see if any differences result when the property is appraised as fee simple or leased fee. The case study will parallel the same six-step market and marketability study process shown in *The Appraisal of Real Estate*, fourteenth edition. This same six-step process is used for an existing multitenant shopping center case study model found in the Appraisal Institute’s *Advanced Highest and Best Use and Market Analysis* course and detailed in the book *Market Analysis for Real Estate*, second edition.¹⁹ Exhibit 1 outlines the major steps that will be described in the case study. A glossary of terms and definitions is located in the Appendix at the end of this article to aid the reader.

Case Study Property Description

The case study examines an actual property and uses data based on its location. Some data is modified for brevity, confidentiality, and to simplify the case study for article purposes.

- Type: Home improvement center (retail sales include, building material, appliances, hardware, paint, etc.)
- Age: Seven years; built specifically for current owner
- Building size: 130,000 sq. ft., enclosed, plus partially covered lawn and garden center²⁰
- Garden center: 27,000 sq. ft., canopy area
- Ceiling height: 22 feet
- Building condition: Good
- Parking: One space per 200 square feet of building

17. Space constraints prevent an in-depth discussion of all the details of the highest and best use analysis process. The term *risk* in maximally productive is described in the *Market Analysis for Real Estate*, 2nd ed., which states, “The test of maximum productivity could also be called *reconciliation*, another word for the final analytical step to assess the data to determine the risk or reliability and confidence in all the data points used in the analysis. If all the data and analysis techniques are considered equally reliable, then the highest and best use that is maximally productive is the alternative that yields the highest value to the land.” Stephen F. Fanning, *Market Analysis for Real Estate: Concepts and Applications in Valuation and Highest and Best Use*, 2nd ed. (Chicago: Appraisal Institute, 2014), 496.

18. *The Appraisal of Real Estate*, 14th ed., 356.

19. Fanning, *Market Analysis for Real Estate*, 2nd ed. See especially, the retail shopping center example in chapter 13 and the eight-step outline of concepts on page 483.

20. This size is the actual gross area of the building, but it is recognized this is above the average store size reported for most home improvement centers in their annual reports. The annual reports typically state only what is considered the average of the gross sales area of the buildings and do not include auxiliary space such as offices, storage, etc. Most do not include outside sales areas, such as their garden centers.

- Owner-occupied
- Subject site is a separately owned super pad as part of a larger retail cluster of adjacent discount department stores, fast food pads, and small strip centers.
- Legal encumbrances: The subject property has numerous cross access easements, joint curb cut permits, joint and site-specific utility and drainage easements. There also are numerous joint operating agreements with adjacent retail, such as common area maintenance (CAM).
- Site size: 17 acres
- Zoning: Heavy commercial, which allows some outside storage. This zoning also allows multiple retail, service, and office uses. Alternative rezoning to apartment is also highly probable.
- Location: Suburban location in a major metropolitan area near a freeway with significant community retail and regional retail in close proximity

Case Study Highest and Best Use—Alternative Use Scoping

The foundation of an appraisal is the documented evidence that there is an appropriate level of market support for the existing use of the site or for alternative uses. This case study presents methods to establish the basis of market support for a highest and best use of the real property and whether the differing interpretations of the property rights theories change the highest and best use process or conclusions for an improved property.

Exhibit 1 Highest and Best Use Analysis Process

Alternative Use Scoping—Determine reasonably probable alternative uses for study

Market and Marketability Analysis—Analysis of most probable alternative uses

Property Analysis

Step 1: Property Productivity Analysis—Define the product

- 1.1 Legal determinants of use
- 1.2 Site and improvements determinants of use
- 1.3 Location determinants of use and timing

Market Analysis

Step 2: Delineate the Market—Identify demand sources of property users

Step 3: Demand Analysis—Current and forecasted user demand

Step 4: Supply Analysis—Measure current and forecasted competition for demand

Step 5: Market Condition Analysis—Market cycle analysis

Marketability Analysis

Step 6: Subject Marketability Analysis—Determine market capture

Testing Highest and Best Use Alternatives

Step 7: Financial Analysis of Alternative Uses—Present value of future benefits

Reconciliation and Conclusions

Step 8: Highest and Best Use Conclusions—Most profitable alternative at least risk; conclusion specific as to

- Use
- Timing (occupancy, etc.)
- Market participants

Highest and Best Use as if Vacant. For article brevity, the site-as-if-vacant is not covered in detail here. However, this does not suggest it is of less importance, as a site-as-if-vacant highest and best use can be a critical input into the highest and best use of the site-as-improved. For example, the site-as-if-vacant highest and best use includes the analysis of the site's ideal improvement. The ideal improvement specifies things like size of building and use. As *The Appraisal of Real Estate*, fourteenth edition, notes, "an appraiser's conclusion of the ideal improvement should be as specific as the market suggests."²¹ The ideal improvement is a gauge to help determine an improved property's obsolescence, if any, and comparable properties that might be analyzed in the sales comparison approach.

The case study concluded the site use was community retail as evidenced by the site's physical features and the adjacent uses, which are all community retail uses like the subject as part of a community retail node at a major intersection. The site-as-if-vacant three-part conclusion is:

- **Use:** Big-box community retail
- **Timing for Use:** Current to three years in the future
- **Market Participants:** Users (customers) are moderate-income residents and businesses within 3 to 5 miles of the subject site. The most probable buyer of the land assumed vacant is a developer or owner-operator.

Highest and Best Use as Improved and Alternatives to Consider. *The Appraisal of Real Estate*, fourteenth edition, states that "highest and best use of property as improved pertains to the use that should be made of an improved property in light of the existing improvements and the ideal improvements described." In appraisal of the market value of improved properties, appraisers consider alternative uses of the existing improvements. The alternatives considered may include:

- Demolish the existing improvements and redevelop the site.
- Convert, renovate, or alter the existing improvements to enhance or change the current use to a more productive use.
- Retain the existing improvements and continue the current use.²²

While many alternatives might be considered, when the property being appraised is improved an appraiser could first complete a market and marketability study of the property at its current use and then a preliminary general analysis of the most optimistic value of the subject property at reasonable alternative uses. If the property at its current use is forecast to continue to be occupied in a manner that ensures an indicated value at or above the values of the other optimistic alternatives, then the current use could comfortably be selected as the highest and best use and other alternatives would likely not need to be analyzed further.

Market and Marketability Study of Current Use of Property

The market and marketability study of the current use of the property is part of the highest and best use analysis that determines the fundamental economic demand for the current use, which will be used as the base alternative to compare to other uses of the property.

Step 1: Property Productivity Analysis

Property productivity analysis is the "analysis of the capacity of a property to house economic activities, supply services, and provide amenities to meet human needs."²³ The property productivity analysis consists of looking at the subject building and site improvements, the subject's legal constraints and opportunities, and the location in order to determine what use the property is designed to serve. Part of this analysis is to determine if the property is the latest design for that use or if the latest market trends have made the improvements obsolete. In other words, is the building designed to best serve and attract customers for the property's intended use.

Property Analysis—Case Study Example. Exhibit 2 shows the case study's property rating as a home improvement center, which is the current use of the property. The market standard is based on the newest home improvement store designs in the property's metro area and outside its metro area or anticipated new property criteria in the industry. In other words, it is the analysis to

21. *The Appraisal of Real Estate*, 14th ed., 345.

22. *The Appraisal of Real Estate*, 14th ed., 345.

23. Fanning, *Market Analysis for Real Estate*, 2nd ed., 33.

determine what is the market segment the property is designed to serve (site, improvements, legal, and location). The property productivity analysis is a comparison to the ideal improvement for this industry and what are the current industry trends in this market. The details of the criteria are beyond the scope of this article, but the illustration shows that if the store is designed to house the economic activity it was intended to serve, then the building does not have any functional obsolescence for this use;²⁴ therefore, the building is experiencing only the normal physical depreciation for a seven-year-old building. Changing the building's design is always a functional problem to deal with for any type of retail improvement and that is what property productivity is all about.

It should be noted that property productivity analysis in a market value appraisal is not a study of a specific brand but of a retail type. Different brands will often have different building designs to some extent, as that is a function of the cost generally applicable to any retail improvement. The property productivity analysis determines what is typical for this economic use in this market setting compared to the ideal improvement and the market demand for that use. (Demand is covered later, in Step 3 of the analysis process.) The property productivity analysis in Step 1 is used to assess whether the existing property and location can meet the economic expectations of the market segment that the property was designed to serve.²⁵ The results of Step 1 analysis of property, analysis of site, and analysis of location provide the basis for physical depreciation and potential functional obsolescence.

The property productivity analysis does not change whether the subject is a home improvement center, like the subject case study, or a multitenant community shopping center or some other type of big-box discount center. The specific features of each building type or location that serves the retail market segment might change but not the analysis method of property productivity impact on property use. The prop-

erty productivity analysis in most cases would recognize if the subject has any obsolescence whether it is caused by building design, site, legal, or location issues.

The potential economic obsolescence, if any, is covered in the demand section of the next steps. The highest and best use process determines the economic demand for the use not the brand. The example case here is a big-box home improvement center, but the same principle would be used for a market value appraisal of a grocery-anchored shopping center. Part of that highest and best use analysis would be to determine the current and forecasted demand for grocery-anchored shopping centers and not the grocery brand that is currently in the center.

Legal Analysis Impact on Use. Another aspect of property productivity analysis involves looking at all legal implications that impact (positively or negatively) any use, including the impact on current use. The impact of zoning, easements, and deed restrictions on the property are studied. Legal constraints can alter uses of the property. In the subject case, the property is owner-operated so its use can continue or the owner can change the use as long as it is consistent with the site's zoning, deed restrictions, easements, etc. The property has curb cut permits, many cross access and utility easements, drainage easements, and a common area maintenance agreement so any alternative use would have to accommodate those restrictions. A big-box retail property, as part of a planned shopping center, also many times will have deed restrictions on alternative uses. In this case study, there are no restrictions that would prohibit continuing current use as a home improvement center or a change to an alternative use except for a department store use. Legal use also has to be compared to market demand. For example, if current leases are considered²⁶ and the subject has a lease with twenty-three years remaining but the economic demand for the subject use is deteriorating over time, then the lease would

24. This does not mean there would not be some functional obsolescence issues to address in the valuation. Nearly any commercial property will have some functional issues when a new owner occupies or leases out a property. Almost every new owner or occupant wants to make changes to meet its specific needs.

25. This process is similar to the one that many retail market users employ. See, for example, Lowe's 2016 Annual Report, describing its evaluation of "Long-Lived Asset Impairment," 28, <http://bit.ly/Lowes2016>.

26. If the fee simple assumption assumes no lease, then this analysis would not be required.

have to be analyzed in more detail to give a probability opinion as to whether it would be honored for twenty-three more years.

The table in Exhibit 2 shows the conclusions of the subject property rating for continued use as a home improvement center.

Location Determinants of Use. Real estate location attributes determine the type and location of land uses most expected in an area. In the next step of this study, the economic demand analysis will tell how much growth might be expected over time.

Exhibit 2 Community Retail Home Improvement Center Property Rating

Factors (Rate factors by inserting "X")	Inferior			Industry Standard	Superior		
	High	Moderate	Slight		Slight	Moderate	High
Site							
Size					X		
Land-to-building ratio				X			
Parking							
Number					X		
Location				X			
Interior circulation				X			
Site Improvements							
Topography impact on access				X			
Drainage				X			
Exterior access (curb cuts, cross access easements)				X			
Landscaping				X			
Building Improvements							
Condition of building				X			
Construction quality				X			
Layout (design, customer appeal)				X			
Layout (storage ability, ceiling heights, etc.)				X			
Building (delivery configuration and access)				X			
Marketing Features							
Signage appearance				X			
Street visibility				X			
Adjacent retail (cumulative attraction)				X			
Building exterior and interior appearance				X			
Legal							
Zoning/easements/CAM/deed, etc.				X			
Rating Conclusions							
Number of items rated	0	0	0	17	2	0	0
Times category score	0	2	4	5	6	8	10
Category score	0	0	0	85	12	0	0
Total subject score	97						
Percentage above or below standard	2%						

Note, the industry standard score would be 95 and the bottom line is percentage above or below this standard.

Location determinants of growth consist of static and dynamic features. Static features include linkages and land use associations. *Linkages* refer to the movement of people, goods, services, or communication to and from the property site. Common linkages include roads and utilities. Land use association refers to the current types of development in the area and how they relate or support each other. Current land uses in an area set a pattern that is typically expected in the future.

Because location characteristics change over time, the dynamic aspects of location also need to be addressed. Dynamic location features are the land use growth patterns and the direction and rate of this growth.

Exhibit 3 shows the conclusion of the location analysis of the case study subject property by comparing other northeast metro area’s community retail nodes to the subject retail node.²⁷ The

subject property’s “Area A” is rated as one of the best locations in the city (city in northeast part of metro area). Of note for this article’s purposes is that the rating factors and method do not change because of the property rights appraised. The rating is of an overall area cluster (node) of land use and not the subject itself.

Conclusion of Property Productivity Analysis.

The property productivity analysis shows no property rights impact. The property productivity analysis does not change, whether the subject is a home improvement center, like the case study subject, or a multitenent community shopping center or some other type of big-box discount center. The specific features of each building type or location that serves the retail market segment might change but not the analysis method of property productivity impact on

Exhibit 3 Community Retail Location Rating

Factor	Rating Criteria	Area A (Subj)	Area B	Area C	Area D	Area E	Rank by Importance
1	Proximity to households in 3 miles	1	1	1	1	1	6
2	Proximity to new retail	3	1	1	1	2	5
3	Location in path of new residential growth	3	2	1	1	2	5
4	Median household income in 3 miles	3	2	1	1	3	6
5	Proximity to existing or approved major roads—access and visibility	3	2	2	1	3	4
6	Traffic count through node	3	2	2	1	3	6
7	Proximity to demand generators, such as hotels, offices, hospitals, etc.	3	1	1	1	2	3
8	Size and drawing appeal of anchors in the node	3	2	1	1	2	7
9	Tenant mix and compatibility in area	3	2	1	1	1	3
10	Effective age of centers	3	2	2	1	2	1
Total (Individual score times weighting)		126	78	57	46	99	
Percentage of Total Scores		31%	19%	14%	11%	24%	

For a more detailed explanation of location rating, see *Market Analysis for Real Estate*, 2nd. ed., 263–267 or Appraisal Institute course *Advanced Market Analysis and Highest and Best Use*, Exhibit 11.11.

27. A *node* is “a cluster of properties with the same or complementary uses.” Appraisal Institute, *The Dictionary of Real Estate Appraisal*, 6th ed. (Chicago: Appraisal Institute, 2015). Here the node is retail and service land use that is community oriented. In this study, most nodes served a 3- to 5-mile submarket area.

property use. The property productivity analysis in most cases would recognize if the subject has any obsolescence caused by building design, site, legal, or location considerations.

Step 2: Delineate the Market

Several factors are involved in identifying the market area. In brief, this part of the study determines the area where most of the customers originate and where most of the competition is located.²⁸ In general for community retail in a metro area, the market area is defined as the average halfway point between the subject community retail shopping node and the next major competitive retail node. In this case this was determined to be about 3 to 5 miles in an irregular shape.

Step 3: Demand Analysis

The Appraisal of Real Estate, fourteenth edition, explains that “for each particular type of property, demand analysis focuses on the end product or service that the real estate provides.” For retail space, the appraiser would “attempt to determine the demand for retail services generated by potential customers in the market area.”²⁹ Consequently, this part of the highest and best use analysis regarding the continuation of the current use alternative is a demand study for home improvement retail.

Inferred Demand Studies. Various methods can be used to infer future fundamental demand³⁰ for the subject home improvement retail property’s future needs. The following are some inferred demand data found for the subject retail market type in the subject’s delineated market area.³¹

- **Subject Historical Performance**—*The Appraisal of Real Estate* observes that “the performance of the subject property is likely to be the most reliable indicator of current demand for existing properties in the market.”³² In this case study, the subject has been 100% occupied for the last seven years as a home

improvement center. Based on general observations of operations and review of historical aerials of subject parking lot, the subject seems to have an ample flow of customers for its current use.

- **Location Historical Trends**—Comparing the subject location to the location of new community retail found the subject is located in one of the better new retail development areas.
- **Population Growth Trends**—The property’s submarket area is one of the fastest-growing sectors in the city, with an ample stock of existing homes and new residential development.
- **Rent and Occupancy Trends**—The property’s submarket is compared to other community-type retail submarkets, and the results show the property’s submarket has rents and occupancy that are some of the best in the city.
- **Home Improvement Retail Sales Trends**—Retail sales in the property’s submarket area are stronger than the sales for the metro area as a whole. The table in Exhibit 4 shows the market area has net in-migration of sales to the subject market area since the subject market area sales are higher than metro area sales.

Exhibit 4 Per Capita Retail Sales for Subject-Type Retail

Industry Group	NAICS*	Sales Per Capita	
		Metro Area (\$)	Subject Market Area (\$)
Building Material and Supplies Dealers	4441	657	725

*North American Industry Classification System

28. For more detail see “General Procedures for Defining the Trade Area” in Fanning, *Market Analysis for Real Estate*, 2nd ed., 270.

29. *The Appraisal of Real Estate*, 14th ed., 303.

30. Term *inferred* is sometimes confused with fundamental demand, which is calculated demand. However, both are focused on demand for future users of the space. See Fanning, *Market Analysis for Real Estate*, 2nd ed., 17–20 for more discussion on this terminology issue.

31. For article brevity, the full inferred data is not shown in this article.

32. *The Appraisal of Real Estate*, 14th ed., 310.

Demand Analysis Measured by Market Fundamentals Methods—Population. Market fundamentals demand analysis derives specific demand calculations for the market area by analysis of drivers of retail demand—customers. Consequently, population forecasts are important considerations. In the case study of a home improvement center, the major demand generator is the population and growth forecast within 3 to 5 miles of the subject.³³ For this case, a ten-year forecast was developed using five years' data from the CCIM Institute's Site to Do Business (STDB) and the local council of governments' thirty-year Small Area Forecast and then reconciling these numbers.³⁴ The market area was forecast to grow for the next ten years, similar to the STDB trend forecast, and then level off with slower growth for the next twenty years according to the council of governments' forecast.

Demand Analysis Estimated by Per Capita Buying Power Method. The per capita method of demand analysis is a widely used and reliable method, and it adapts well for simplicity presentations like this article.³⁵ The per capita method is based on actual current home improvement sales in the subject market area compared to the population. The per capita sales are then used to calculate current demand and forecast future demand for home improvement sales for the property's market area (also called the primary trade area). The following shows an estimate of the case study property's capture of demand for subject-type retail.

In the case study, the demand estimate is for the current alternative use of the subject property, i.e., continued operation as a home improvement retail store. The subject retail property characteristics are based on the previous property productivity analysis of physical, legal, and location attributes. The determination of the typical sales for the subject property establishes the retail market segment that is the focus of this market analysis. Note that the subject-type retail part of the market and marketability analysis is not a study of

a particular home improvement brand, such as The Home Depot or Lowes, but of the retail segment that is typically accommodated by a property that has certain building, site, and location characteristics described in the property productivity analysis (discussed in Step 1). This is the same as the market and marketability study for a neighborhood shopping center that has a grocery anchor. It is not a study of that grocery store brand but of the grocery store market segment as part of the shopping center the grocery store is associated with.

The procedure to determine the typical retail purchases is the same whether for a multi-occupied retail shopping center or a single-occupant property.³⁶ The focus is on the type of retail that is being sold, or could be sold, at the property; the brand and whether the occupant rents or owns the space is not important. A big-box home improvement center has many product lines arranged in separate departments, including lumber, home appliances, electrical supplies, plumbing supplies, hardware, lighting, etc. This retail format employs the retailing concept of cumulative attraction by combining multiple, complementary retail items in one location for the convenience of different types of customers, from homeowners to professional contractors. This creates the magnetic appeal of a complementary retail collection all in one location, as the subject functions as a single-building shopping center concept.

The table in Exhibit 5 shows the sales per square foot, comparing data for the metro area to the subject's primary market area (also called primary trade area). The previous property productivity analysis found the subject was well suited for a home improvement center use as it is currently operating. This market analysis measures the demand for the retail category utilizing data of actual sales of the Building Material and Supplies Dealers segment in the North American Industry Classification System (NAICS).³⁷ Other retail categories are shown in the table to demonstrate the process and to show that it is the same process for all types of retail including multi-

33. The market area (primary trade area) for the subject is an irregular area that varies from 3 to 5 miles from the property.

34. Forecasts range from low to high. Only the mid-point is shown in this article.

35. Detail of per capita method can be found in Fanning, *Market Analysis for Real Estate*, 2nd ed., 320–322.

36. For more detail description of the procedure referenced, see Fanning, *Market Analysis for Real Estate*, 2nd ed., 393–396.

37. The data utilized is North American Industry Classification System (NAICS) 4441, which is retail primarily engaged in retailing new building material and supplies. This includes Retail Trade Home Centers (NAICS 444110) like the subject as well as stand-alone stores like hardware stores, paint stores, etc.

Exhibit 5 Selected Per Capita Retail Sales for Subject-Type Retail

Industry Group	NAICS	Metro Area (\$)	Subject Market Area (\$)	Amount Utilized for Study (Subject-Type Retail) (\$)
Automobile Dealers	4411	2,047	1,805	
Other Motor Vehicle Dealers	4412	347	168	
Automotive Parts, Accessories & Tire Stores	4413	241	285	
Totals 441 - Motor Vehicle and Parts Dealers		2,635	2,257	0
Furniture Stores	4421	295	394	
Home Furnishing Stores	4422	168	213	
Totals 442 - Furniture and Home Furnishing Stores		463	607	0
Electronics and Appliance Stores	4431	923	1,246	
Totals 443 - Electronics and Appliance Stores		923	1,246	0
Building Material and Supplies Dealers	4441	657	725	725
Lawn & Garden Equipment & Supplies Stores	4442	54	120	
Totals 444 - Bldg Equip & Garden Equip & Supplies Dealers		751	845	0
Grocery Stores	4451	2,211	3,110	
Specialty Food Stores	4452	115	171	
Beer, Wine and Liquor Stores	4453	179	232	
Totals 445 - Food & Beverage Stores		2,505	3,514	0

Data Source: US Census of Retail, which occurs every five years. ESRI updates data and it is distributed in this case through STDB Retail MarketPlace Profile Report. Numbers rounded.

Exhibit 6 Home Improvement Center Sales Potential for Subject

Line	Factor	Year		
		2016	2021*	2026*
1.	Population in primary trade area	162,000	172,500	178,000
2.	Home improvement retail sales per capita (\$)	725	725	725
3.	Home improvement retail sales potential in primary trade area (\$)	117,450,000	125,062,500	129,050,000

*Forecast is in constant dollars.

tenant shopping centers. The only difference is the retail segment chosen for the property's market and marketability study.

In Exhibit 6, the retail market segment data is applied to the market area population forecast to determine the fundamental demand for the next ten years, which is increasing.

Step 4 and Step 5: Supply Analysis (Competition for Demand) and Market Condition Analysis

In the highest and best use analysis, Step 4 measures the current and forecasted competition for demand. In the case study, the subject property is one of two owner-occupied big-box (100,000+ square feet), multi-product home improvement stores in the market area. The market area also has numerous (40+) smaller stores with mostly single or narrow product-line stores like electric and plumbing supplies, paint and wallpaper, hardware, fencing, floor covering, glass, lumber retailing, etc.

Step 5, the next step in the highest and best use analysis, is analysis of the current market cycle. For the subject property, according to the STDB Retail MarketPlace Profile estimate, the subject market area is currently slightly undersupplied.

Conclusion of Market Analysis. Steps 2–5 summarized above are part of the market analysis phase of the highest and best use analysis process. The analysis of Steps 2–5 procedures and the case study conclusion do not change whether the subject of the study is a home improvement center or another retail property, such as multitenant shopping center, discount department store, or even if the subject is vacant. The market delineation, demand methods, supply and market condition analysis procedures remain the same for all retail property types and the analysis is not concerned with the property rights of the properties. There may be different demand factors for each type of retail, but the market analysis procedure does not change.

Step 6: Subject Marketability Analysis (Capture Potential)

Step 6 in the highest and best use analysis process is marketability analysis, which will indicate the market capture. *The Appraisal of Real Estate*, fourteenth edition, states,

An appraiser should also consider the competition among various uses for a specific site.... *Market demand is not infinite.* Even though the subject may be physically and locationally suited for a use, better-located sites may satisfy the market demand for that use completely before the subject can realize its development potential.³⁸

Fundamental analysis in a marketability study looks at the specific property's economic well-being. Fundamental methods can include forecasting subject capture by pro rata share and forecasting subject capture using a competitive rating comparison. On the other hand, "inferred analysis is a starting point for the forecast of subject capture, using methods such as

- historical capture of the subject property
- capture of comparable properties
- secondary data surveys and forecast
- effect of marginal demand on the subject property
- local economic analysis"³⁹

The results of the inferred analysis and fundamental analysis are then reconciled to determine the future occupancy and expected rent levels for the specific property.⁴⁰

In the case study, the market area has two major big-box home improvement stores, the subject being one. As stated previously, there are a large number of other stand-alone single-product and narrow-product home improvement stores. The two major big-box stores dominate the market as of the date of the analysis.

In this study, business locator data for the market area estimated that these two big-box stores' sales account for nearly 90% of the home improve-

38. *The Appraisal of Real Estate*, 14th ed., 336.

39. *The Appraisal of Real Estate*, 14th ed., 329. Note, the term *marginal demand* has been changed to *residual demand* in current Appraisal Institute courses and books.

40. *The Appraisal of Real Estate*, 14th ed., 329.

Exhibit 7 Home Improvement Center Sales Potential for Subject, Mid-Range Forecast

Line	Factor	Year		
		2016	2021	2026
1.	Population in primary trade area	162,000	172,500	178,000
2.	Home improvement retail sales per capita (\$)	725	725	725
3.	Home improvement retail sales potential (\$)	117,450,000	125,062,500	129,050,000
Step 6 Subject Marketability Analysis (Subject Market Capture)				
4.	Subject capture rate (%)	40.0	40.0	40.0
5.	Indicated subject capture	46,980,000	50,025,000	51,620,000
6.	Size of subject enclosed space	130,000	130,000	130,000
7.	Sales per square foot (\$)	361	385	397

ment retail sales in the market area and as low as 65% in other comparison market areas.⁴¹ A competitive property rating of the competitive stores, including the smaller retailers selling home improvement products, concluded the subject should capture in the 40% range of all home improvement sales in this market area. Even if the interpretation of fee simple is to assume the building is vacant on the effective appraisal date, this assumed vacant building in Step 1 was rated good for this use and the location was rated the best in town. With this competitive advantage, and the strong demand found in this market for home improvements sales, the subject building⁴² should probably capture close to its historical share immediately, or at worst, it would take only a few months to get back to the operation volume the subject was generating the day before the effective appraisal date when it is assumed suddenly vacant and available on the effective appraisal date. Exhibit 7 applies the capture conclusion for the subject to estimate its sales potential over time.

Conclusion of Subject Marketability Analysis and Market Capture. Even with an interpretation that fee simple means the subject is assumed vacant and available on the effective date there is no impact on market capture in the appraisal process. There is no impact because the as-if-

vacant assumption does not change the demand in the market, it does not change the competition in the market, and it does not change the capture analysis method. On the effective date of the appraisal there is the same amount of demand in the subject market area, and that must go somewhere.

Step 1 in the market analysis determined the subject building is rated above typical industry standards for a home improvement center. The location analysis determined the subject's location is the best retail location in the city. The subject is rated for capture against the competition based primarily on building design and location factors. There are limited alternatives for where the demand could go on the effective date of the valuation. The demand is determined by the capture rating analysis for the subject property on the effective date, no matter what fee simple interpretation is applied.

Case Study Analysis: Alternative Use of the Property—Second Generation Use (Go Dark)

An alternative use of the subject property would be a use other than as a home improvement center. This is sometimes called a second-generation use. In the highest and best use study, a second-generation use is a different alternative than the alternative of continuation of current use. Any number of

41. Data from STDB utilizing ESRI (<http://bit.ly/ESRIhome>) and Infogroup (<http://www.infogroup.com/>) data sources.

42. This is an economic estimate, as economically it may be the previous occupant or a new business taking advantage of the opportunity to fill a large market void.

reasonably probable alternative uses of the property can be studied and if determined to produce a higher value than the current use after considering cost and time to generate new use of the property, then the secondary use would be the highest and best use. Second-generation uses could be co-highest and best uses if the second-generation use value is virtually the same as the first-generation use.

As shown throughout the previous six-step process, the property rights that are being appraised (fee simple, leased fee, etc.) or alternative use of property is not a factor in reaching the highest and best use conclusion for the subject property. Whether an appraisal assignment is of the fee simple interest or of the leased fee interest does not dictate or influence the highest and best use conclusion. Application of the six-step process can, however, provide conclusions that suggest an alternative use to the original building-designed use or even its current use.

Alternative Conclusions. Consider the result if alternative conclusions were reached in the various steps. For example, suppose there had been the following conclusions:

Step 1: Building is in below-average condition and located in a less desirable retail node due to construction of a new bypass.

Step 3: Subject market area sales are below the levels found in the region.

Step 4: Subject is one of four stores in the market area.

Step 5: Market area is oversupplied with home improvement stores.

Step 6: Subject capture is 15% of the market area.

With these changed findings, the subject's sales would be forecasted at \$136 per square foot. Research indicates that the average sales per square foot should be \$300 for a home improvement center. If this situation is what is found, the subject would not be performing well as a home improvement center use if that is the current use. This would likely indicate a highest and best use other than the current use or that the current use will probably have a short remaining economic life and become an interim use. The enterprise management of this property, either as tenant or owner-occupant, would classify this long-term asset as an impairment and would close it and relocate. Under this changed set of conclusions, application of the six-step process would also lead one to support and conclude a change in

use, or a go-dark conclusion for the subject property. A definition does not lead to this conclusion, however; it is the highest and best use process that leads to the go-dark conclusion.

Step 7: Financial Feasibility Analysis of Alternatives

This part of highest and best use analysis tests the financial rewards of alternatives that are physically possible and legally probable and whether the economic demand for the uses are supported by the factors in the six-step marketability study. In the case study, three alternatives were studied—demolition, continued current use, and remodeling for a second-generation use.

Alternative 1: Demolition. The site is assumed vacant. Analysis of this alternative finds the subject site as-if-vacant value was not remotely close to the value of the property as improved.

Alternative 2: Continued Current Use. The site continues as a home improvement center. The estimated sales potential as improved is higher than most big-box home improvement centers and is above the national average. The occupancy cost ratio (rental) analysis (Exhibit 8) indicates the subject occupancy affordable rent is above most other rent for comparable stores in the sub-market area, and commands economic rent similar to feasibility rent for new construction.

Feasibility rent is the threshold rent needed for a developer to realize its minimum incentive (profit) for purchasing the location and developing a new building on the site for the use considered. This rent reflects the costs of acquiring the land, building the improvements, and finding a tenant that would use the property to its optimum potential. Feasibility rent can be equal to market rent but is usually less than market rent as it reflects the minimum a developer would accept for the use of the property by a tenant.

Owner-occupants also consider feasibility rent in determining whether they should build their property or rent. Owner-occupants save the rent expense and therefore their occupancy costs are lower, and their business profits can be higher. Feasibility rent would also represent the minimum rent an owner-occupant would save by developing the property for its own use. Owner-occupancy removes control of the property by a landlord, and the owner-occupant has more options in managing the property.

All successful retailers consider the options they have as to whether to rent or build. Publicly traded retailers publish the methods they use in selecting their locations and research the market to identify their customers' characteristics. The method used in this article is very similar to what successful retailers do to determine whether a location will be successful or not, and they periodically evaluate each of their locations as to what current market conditions are and how well those locations are performing to meet their operating standards.⁴³

When a retailer's location is not performing to its standards, the retailer makes a decision to close the store or relocate. In the case of a rental property, the retailer may not have the choice to immediately close or move depending on the terms of the lease. If the location is owner-occupied, then the retailer-owner can move whenever it decides that is to its advantage.

Exhibit 8 Occupancy Affordability Rent

Subject estimated sales per square foot (\$)	361
Occupancy cost ratio NNN (%)	3.0
Indicated NNN rent per square foot (\$)	10.84

National data averages indicate home improvement centers pay about 6.48% gross sales on occupancy cost, which includes CAM, insurance, and taxes but not utilities.

Note the deduction from 6.48% occupancy cost to 3.0% accounts for the CAM + insurance + RET to get to a NNN lease estimate. The 3% is making the data net of taxes, CAM, etc. The source is an industry association like the International Council of Shopping Centers and older publications like the Urban Land Institute's *Dollars and Cents of Shopping Centers 2008*. It has been shown by many that this ratio stays constant over time.

For more discussion on this topic, see Fanning, *Market Analysis for Real Estate*, 2nd ed., 302–304.

Alternative 3: Remodeling for Alternative Use of Property. Other alternative uses, sometimes called “second-generation uses” of the property as improved, require remodeling the store to varying degrees depending on specific use, and

more importantly, remarketing the property for a different use, which requires additional cost and time. As *The Appraisal of Real Estate* notes, “a crucial element in highest and best use analysis is the timing for a specific use.”⁴⁴

When the cost and time is factored into the financial analysis, no other use was found in the case study that could generate the sales volume of the current operation and location. However, if in another case the conclusion were that the store sales would be about \$136 per square foot as discussed previously, the rent that could be paid would be reduced significantly. This would then lead to consideration of the alternative use, and whether higher rents would be paid by an alternative user instead of the current use of the building.

As reflected in this alternative use example, a secondary use of the property could be found if there was a property deficiency found in the Step 1 analysis, an indication that the location features were forecast to deteriorate over time. A secondary use also would be considered if some downward market demand was found for home improvement retail sales in the market in Steps 2–5 or if Step 6 showed the subject capture was low.⁴⁵

Step 8: Highest and Best Use Conclusion of Maximally Productive Use

The Appraisal of Real Estate notes that “if all the alternative uses are eliminated and the current use remains financially feasible without modification of the improvements or redevelopment of the site and retains the highest value of the alternative uses, then the current use will remain the highest and best use of the property as improved.”⁴⁶ The conclusion of the case study in this article was that demand data for both inferred and fundamental calculations found the current use had strong demand at this location. The time, cost, and risk of changing uses to a second-generation use was judged to have more risk without producing a higher return. Consequently, no other use, consistent with the rate of return warranted by the market for the subject property, performs as well as the current use. The highest and best use conclusion for the subject is therefore:

43. The Home Depot, *2016 Annual Report*, “Impairment of Long-Lived Assets,” 27.

44. *The Appraisal of Real Estate*, 14th ed., 341.

45. For an example of Level C analysis of a shopping center for second generation use see chapter 19, “Highest and Best Use of a Vacant Shopping Center” in Fanning, *Market Analysis for Real Estate*, 2nd ed.

46. *The Appraisal of Real Estate*, 14th ed., 347.

- **Use:** Big-box home improvement store
- **Timing:** Current with remaining economic life of twenty to thirty years
- **Market Participants:**
 - *Users:* Moderate to higher income home owners and home builders
 - *Most probable buyers:* Owner-occupant or investor

Property Rights Impact on Highest and Best Use

Conclusion. Regardless of the interpretation of the meaning of fee simple or market value, the highest and best use process is the same and the definitional interpretation does not change the final conclusion of highest and best use. The market data in this case study all supported the conclusion that the use that would produce the highest present value of future benefits to the owner of this property is the continued use of the property as a home improvement retail center. No matter which interpretation of property rights and market value are applied to the appraisal, demand in the market is still demand and competition in the market is still competition, and the alternative use of the subject property that would produce the highest present value of future benefits is as a home improvement center.

Valuation of the Highest and Best Use

Appraisal Institute materials emphasize the importance of highest and best use analysis. It is axiomatic that “whenever a market value opinion is developed, highest and best use analysis is necessary.”⁴⁷ Highest and best use analysis establishes what is being valued and is the foundation of all market value appraisals.⁴⁸ The highest and best use of the property considered in this article was demonstrated to be continued use as a home improvement center with a remaining economic life of twenty to thirty years. In other property

assignments, the highest and best use might be different, such as a second-generation use. Whatever the highest and best use conclusion is determined to be, “the conclusions reported in the highest and best use section of a report should be consistent with conclusions and applications in the other parts of the report. ...and the market analysis and other report sections must support the highest and best use conclusions as well as the sections discussing the application of the approaches to value.”⁴⁹

Consequently, the highest and best use three-part conclusion establishes the basis for the market value opinion, setting the stage for the selection of appropriate comparable sales.⁵⁰ The three-part conclusion of highest and best use also is the basis of the cost approach, since “the cost approach reflects market thinking because market participants relate value to cost.”⁵¹ The three-part highest and best use conclusion is also the basis of the income approach, because “all income capitalization methods, techniques, and procedures forecast anticipated future benefits and estimate their present value.”⁵² Retailers constantly reevaluate their assets in terms of the market. For example, The Home Depot in its annual report, states,

“We evaluate our long-lived assets each quarter for indicators of potential impairment. Indicators of impairment include current period losses combined with a history of losses, management’s decision to relocate or close a store or other location before the end of its previously estimated useful life or when changes in other circumstances indicate the carrying amount of an asset may not be recoverable. ...The assets of a store with indicators of impairment are evaluated by comparing its undiscounted cash flows with its carrying value.... If the carrying value is greater than the undiscounted cash flows, an impairment loss is recognized for the difference between the carrying value and the estimated fair market value.”⁵³

47. *The Appraisal of Real Estate*, 14th ed., 42. Also see USPAP Standards Rule 1-3.

48. Appraisal Institute Course Manual, *General Appraiser Market Analysis and Highest and Best Use* (Chicago: Appraisal Institute, 2008), Part 1-4.

49. *The Appraisal of Real Estate*, 14th ed., 358.

50. *The Appraisal of Real Estate*, 14th ed., 381.

51. *The Appraisal of Real Estate*, 14th ed., 561.

52. *The Appraisal of Real Estate*, 14th ed., 440.

53. The Home Depot, *2016 Annual Report*, “Impairment of Long-Lived Assets,” 27.

Market Value Methodology Interpretation and Highest and Best Use. The central point of this article is that highest and best use sets the basis of market value, no matter what the interpretation of property rights, it does not change the highest and best use analysis procedures or conclusions. The highest and best use study does not assume a transaction,⁵⁴ it is only concerned with which one of the alternative uses of a property creates the highest present value of future benefits to the owner. The valuation section then is to measure the market value of that use.

Conclusion

This article's conclusion is that the highest and best use process is the same no matter which property rights school of thought is utilized in an appraisal. The process is the same regardless of whether there is a vacant or occupied assumption. The highest and best use analysis starts with one of the alternatives analyzed being the use to which the property is currently or was formerly used and/or the use(s) that the property was designed to serve. "The performance of the subject property is likely to be the most reliable indicator of current demand for existing properties in the market."⁵⁵ The highest and best use analysis discussed herein is very similar to what an owner or tenant of a big-box retail operation does in assessing whether a store should remain open, be closed, or be relocated.

The case study example for this article demonstrates that an appraisal of a big-box retail property needs a highest and best use analysis just like any other property type. All properties' highest and best use analyses consider alternative uses, including the current (or former use) or second-generation use, to establish the basis of highest and best use to be valued.

The differing opinions of the meaning of fee simple and its application is a debate of different *interpretations* of words and not a debate of the study process needed to determine which alternative use of a property is most likely to provide the highest present value of future benefits to the owner of the property. The dark store theory view is to disregard the current use because it is the result of a lease, or specific business enterprise (property use unique to the business), which in essence disregards the highest and best use conclusion and the existence of a market that supports the use.

The premise of this article is that the interpretation of what the definition of fee simple means does not change a property's highest and best use from its current use to a secondary use, only the fundamental user market can do that.

The case study in this article demonstrated the use that would produce the highest return to the real estate, which is its highest and best use. This confirms the maxim that: "The market determines the use; the use determines the value."⁵⁶

54. There are exceptions like in a bubble market; the speculative sale to a market of hyper-exuberant buyers may produce a higher present value than the fundamental use of the property and in that case the speculative sale maybe the highest and best use. Also, financial analysis of alternative fundamental use of property can sometimes be analyzed by user end sale prices. But sales are not the exclusive method to analyze alternative highest and best use.

55. *The Appraisal of Real Estate*, 14th ed., 310.

56. Appraisal Institute Course Manual, *General Appraiser Market Analysis and Highest and Best Use*, Part 1-7.

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SEE NEXT PAGE FOR APPENDIX >

Appendix Glossary of Terms and Definitions

Big-box store—A single-use store, typically between 10,000 and 100,000 square feet or more, such as a large bookstore, office-supply store, pet store, electronics store, or toy store. Source: International Council of Shopping Centers, *Dictionary of Shopping Center Terms*, 4th ed. (New York: International Council of Shopping Centers, 2012).

Fee simple estate—

- Absolute ownership unencumbered by any other interest or estate, subject only to the limitations imposed by the governmental powers of taxation, eminent domain, police power, and escheat. Source: Appraisal Institute, *The Dictionary of Real Estate Appraisal*, 6th ed. (Chicago: Appraisal Institute, 2015).
- The highest estate allowed by law. An inheritable ownership interest of indefinite duration. Source: Fee Simple Definition Work Group proposed definition, “Symposium on Property Rights” (Appraisal Institute symposium, September 7, 2017), <http://bit.ly/SymposiumPaper>.

Fundamental demand—The quantity of a particular type of real estate product that is desired by and affordable to the space users in a given market at a particular point in time. Source: *The Dictionary of Real Estate Appraisal*, 6th ed.

Go dark—To vacate retail space prior to a lease expiration. The space may remain vacant or “dark” for an extended period of time. Source: *The Dictionary of Real Estate Appraisal*, 6th ed.

Highest and best use—Many definitions of *highest and best use* can be found in *The Dictionary of Real Estate Appraisal*, 6th ed., *The Appraisal of Real Estate*, 14th ed. (see especially page 333), and other literature. All definitions center around determining the alternative use of a property that will create the highest present value to the owner. In *The Appraisal of Real Estate*, 14th ed., the two definitions that best describe the term as used in this article are as follows:

1. “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. “The reasonably probable use that produces the most benefits and highest land value at any given time.”

Intangible property—Nonphysical assets, including but not limited to franchises, trademarks, patents, copyrights, goodwill, equities, securities, and contracts as distinguished from physical assets such as facilities and equipment. Source: The Appraisal Foundation, “Definitions,” in *Uniform Standards of Professional Appraisal Practice*, 2018–2019 ed. (Washington, DC: The Appraisal Foundation, 2018).

Risk—There are numerous types of risk, but for this article the primary risk, but not the only one considered, is market risk, i.e., risk that the forecasted user market conditions of demand or supply and the subject market capture potential will shift outside the forecasted range.

Second-generation space—A building or space used by a tenant other than the original tenant; often functionally obsolete before refurbishment but sometimes containing tenant improvements that can be reused by a new tenant. Also called *relet space*. Source: *The Dictionary of Real Estate Appraisal*, 6th ed. Second-generation use is sometimes called secondary use. In this article, any secondary use or second-generation use is considered a different alternative in the highest and best use study.

Space user market—The fundamental market of the users of the real estate’s physical space; the market for the right to use real estate over time. Source: *The Dictionary of Real Estate Appraisal*, 6th ed.

SEE NEXT PAGE FOR ADDITIONAL RESOURCES >

Additional Resources

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

Appraisal Institute

- **Education**
<http://www.appraisalinstitute.org/assets/1/7/aiedcat.pdf>
- **Lum Library External Information Sources [Login required]**
Information Files—Taxation and assessment
- **Property Rights Symposium Discussion Paper**
https://www.appraisalinstitute.org/file.aspx?Document=Property_Symposium_Exp_12-21-17_-_Final.pdf

CCIM Institute Site to Do Business

<https://www.stdb.com/>

Federal Reserve of St. Louis, FRED Economic Data

<https://fred.stlouisfed.org/>

US Census Bureau Data

<https://www.census.gov/data.html>