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The challenges of land valuation for appraisers

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In conversations about appraising, many people consider land to be the simplest property type to value. In my professional experience, land can be the most difficult of properties to appraise. The degree of difficulty is dependent on a myriad of factors including but by no means limited to size, zoning, available utilities, topography, and supply and demand.

At the crux of any appraisal assignment is the concept of highest and best use. In appraisal speak, highest and best use is defined as "the reasonably probable and legal use of vacant land or an improved property, which is physically possible, appropriately supported, financially feasible, and that results in the highest value." This definition is contained within the Dictionary of Real Estate Appraisal, Fourth Edition published by the Appraisal Institute.

When determining the highest and best use of a land parcel, the appraiser needs to ask four basic questions. The first question is what uses are physically possible? In other words, given the physical characteristics of the parcel, what use or uses can the property support. To present an extreme example, a five acre parcel is not suitable for an 18-hole golf course. The second question is what uses are legally permissible? The answer to this question requires a thorough analysis of existing zoning and any other regulations that could impact the use of the property.

The third question is what use or uses are feasible based on supply and demand? A particular use may be physically possible and legally permissible, but if no demand exists for that use, it is not financially feasible. The fourth question is of all the uses that are physically possible, legally permissible and financially feasible which use or uses generate the highest value?

In order to accurately determine the highest and best use, the appraiser may need to value the land parcel under multiple scenarios such as a commercial development, a residential development, or a mixed-use development. This process can be very time consuming but is sometimes quite necessary. Typically, the larger a land parcel and the more zones in which it is located, the greater the complexity of the assignment.

In valuing a complex land parcel, it may be necessary to divide the property into several economic units, determine separate values for each of these and then determine a value for the entirety. The Uniform Standards of Professional Appraisal Practice clarifies that the value of the whole is not the merely the summation of the value of the parts. In most circumstances the whole is less than the sum of the parts based on the theory of economies of scale and is discounted. However, in some situations, the whole may be greater than the sum of the parts and a premium attached. In either event, the appraiser is required to clearly explain why and how the final value conclusion was determined.

For a land parcel with subdivision potential a method termed the development approach may be employed. This approach is an alternative method of estimating the value of projects anticipated to be sold off in incremental units such as building lots created by the subdivision of land or

condominiums. In the application of this approach, the appraiser estimates the gross revenues to be generated by the sale of the units, the expenses of the project including brokers' fees, taxes, development costs, and a period in which development and sale of units are anticipated to occur. From these estimates, an estimate of the developer's cash flow over the course of the projected sell-out is made. The cash flow is converted to a net present value utilizing a discount rate reflective of the risk and nature of the development. This net present value is the value of the project prior to development such as raw land suitable for subdivision. The appraiser must use this approach with caution as it is very speculative and based on assumptions that have the potential to greatly impact value.

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