

# FAULTY INTERPRETATIONS OF THE CONSISTENT USE PRINCIPLE



**BY JOHN SCHMICK**

In theory, the concept of consistent use makes perfect sense, and when applied correctly, it supports the appraiser's analysis and opinion of value. The premise of consistent use is simple: the land and its improvements must be valued on the same basis. However, it is not a concept to be used independently of other valuation principles.

Consistent use is defined as: "...the concept that land cannot be valued on the basis of one use while the improvements are valued on the basis of another."<sup>1</sup> Underlying the concept of consistent use is the principle of highest and best use: "The highest and best use of land as vacant and the highest and best use of the property as improved are connected but distinctly different concepts."<sup>2</sup>

## DETERMINING MARKET VALUE

In practice, it is all too common for an appraiser to value the subject's land on the basis of one type of use, while valuing the improvement based on a different use. The resulting analyses and

opinions of value are misleading, at best, and may be invalid as well. It is essential for the appraiser to understand the principle of consistent use and ensure that it is appropriately applied.

Thus, one of the first tasks in employing the principle of consistent use is for the appraiser to determine the highest and best use of the land. This is based on what is physically possible, legally permissible, financially feasible and maximally productive. It is that use or type of use that will result in the greatest market value for the land.

In contrast, a highest and best use analysis of an improved property will consider the existing or proposed improvements in light of the highest and best land use. The highest and best use as improved will help determine if the existing improvements should be continued for that use, modified or demolished. Once the highest and best use of the land is established, the land is valued on that basis. Value, as improved, is compared to the initial land value as vacant (highest and best use). The principle does not allow the appraiser to ignore the original highest and

best use conclusion, nor does it allow the appraiser to value improvements on a basis that is different from the established highest and best use.

If the subject property is in an area that is transitioning from one type of use to another, the improvements may be considered an interim use or, possibly, obsolete. When the appraiser selects comparable sales that force a consistent use over the highest and best use, the resulting opinion of value is misleading. If this method were being used in litigation, the appraiser's error in consistent use application would surely create credibility issues.

## CLEAR SIGNS OF MISUSE

Two recent cases demonstrate what happens when the appraiser values the land under one use and the building under another.

### Case Study 1 – Inconsistent Zoning

The subject is a midsize industrial property with a high land to building ratio (5.7:1). It is located on the west side of a medium-sized city along a street that has grown into a major east-west traffic corridor. The subject property is still used for manufacturing and open storage. Over many years, other industrial properties along the street have been converted to, or replaced with, commercial properties. In fact, the city has indicated that any property owner who requests rezoning from industrial use to commercial use will be granted that zoning change. A street widening project required that the subject property be appraised for a partial taking in eminent domain.

#### Valuation Process

The appraiser opined that the highest and best use of the land was for commercial development. Appropriately, he used commercial land sales to estimate land value (assuming \$6.50 per square foot commercial land). However, to determine the value of the improvement, he used a building residual method.

Through a collection of warehouse and light manufacturing property sales in an industrial area on the north side of the city, the appraiser allocated the sale prices between land (assuming \$2.50 per square foot industrial land) and the gross building area (GBA) components (\$15.50 per square foot for the building). He then added the corresponding amount of industrial improvement value to the subject commercial land value and opined to the resulting market value of the subject property in the before taking condition.

The appraiser's valuation of the after taking condition followed the same process. The only difference was using a reduced size of the subject land after the street was expanded.

342,000 sq. ft. land x \$6.50 per sq. ft.	\$2,223,000
60,000 sq. ft. GBA x \$15.50 per sq. ft.	\$ 930,000
<b>Total Property Value</b>	<b>\$3,153,000</b>
<b>Per Square Foot GBA</b>	<b>\$52.55</b>

#### Application Error

In this situation, the appraiser added an industrial building value to a commercial land value to arrive at the property value. Because the two components were not valued on the same basis, the requirement for consistent use was not met. The resulting value would not be supportable in the market. At \$6.50 per square foot for commercial land and \$15.50 per square foot of industrial building, the indicated value was \$52.55 per square foot of building size. In this case, the highest industrial building sale in the market was \$36.00 per square foot of building.

Clearly, failure to conform to the consistent use principle resulted in an unrealistic and misleading indication of property value. More importantly, this methodology creates a situation whereby the building value 'floats' on the land value. As such, this property will not reach the redevelopment stage in its lifecycle until industrial land values reach or exceed industrial building sales prices. Even as the market surrounding the subject transitions into a commercial corridor, the subject will continue to reflect a substantial contributory industrial building value that will unnecessarily delay redevelopment of the subject.

### Case Study 2 – Disregarding Highest and Best Use

The second subject is a midsize industrial property (80,000 square feet gross building area) with a high land to building ratio (6:1). The property was used for manufacturing and storage of decorative concrete blocks. It is located in a first ring suburb of a large Midwestern city along a state highway and a major arterial street. Combined traffic volume exceeded 45,000 vehicles a day.

The city created redevelopment plans for a new commercial gateway district into the city centered on the subject property which is still used for manufacturing and open storage. A major highway expansion project took land and closed streets in the area. Four of eight driveway access points were eliminated and the main access point was relocated so that it faced the subject's brick perimeter security wall. It was necessary to significantly alter interior traffic patterns to accommodate these changes.

## Valuation Process

The appraiser opined that the highest and best use of the land was for commercial development. However, because the improvements were still in use, the appraiser assumed the use was still profitable and opined the improvements should be continued in use. Having established an industrial highest and best use for the improvements, he cited the consistent use theory as requiring that both land and building be valued on the same basis. Subsequently, he disregarded the commercial highest and best use and valued the land as industrial land consistent with the industrial building use.

## Application Error

The concept of consistent use states that the value of the land and the value of the improvement must be on the same basis. However, nowhere in appraisal literature or theory does it state that the current use of the improvement supersedes the highest and best use of the land. Land is valued as vacant and according to its highest and best use.

Having determined that the highest and best use of the land was commercial, it was a violation of the Uniform Standard of Professional Appraisal Practice (USPAP) to value it on some other basis. In this case, the misapplication of consistent use invalidated the final opinion of value in several areas:

- Economic obsolescence was not identified and resulted in an unreliable cost approach conclusion. The higher commercial land value indicated the improvements were an interim use with little to no contributory value.
- Incorrect sales data was used in the sales comparison approach.
- Income approach for the industrial use was insufficient to support commercial land values.

Ultimately, the estimate of damages caused by the road project, as reported by this appraiser, was materially misleading. Rather than identifying the subject as a redevelopment site with an obsolete building, an inappropriate application of consistent use theory indicated a stable industrial property. A simple comparison of land value (as vacant and according to its highest and best use for commercial use) to the improved value as an industrial property would have identified the lack of contributory value for the improvements.

## PREVENTING APPLICATION ERRORS

By employing the following basic concepts, appraisers can avoid the type of errors most often associated with consistent use.

1. Begin the process by valuing land as vacant and available for its highest and best use. This is the starting point for most appraisal assignments. Value as improved is compared to the highest and best use land value to measure total depreciation/

obsolescence and to determine where a property stands in its lifecycle. It also indicates whether or not the improvements have any contributory value.

2. Determine if the existing improvements are consistent with the highest and best use of the land as vacant. If the highest and best use of land is commercial, it is probable that industrial improvements may not support any contributory value. Economic rents for the improvements may not support highest and best use land value, thereby indicating a change in highest and best use of the improvements.
3. Compare the sales of improved properties similar to the subject improvements to the highest and best use land value to determine contributory improvement value. Extraction or residual methods that subtract a type of land different than the subject highest and best use land must be avoided. At a minimum, a test of reasonableness should be conducted after the improvement value is added to the subject's highest and best use land value to determine how the subject value compares to the sales data from which the extraction was made.

## CONCLUSION

Faulty interpretations of the consistent use theory will typically result in misleading appraisal reports and value opinions. Any errors in methodology will reflect poorly on the industry and on the individual appraiser.

At the beginning of each assignment, the appraiser must determine the highest and best use of the subject. If the property is transitioning from one use to another, the appraiser would be wise to review the basic appraisal principles governing highest and best use and, if in doubt, seek guidance from peers in the local chapters of IRWA or the Appraisal Institute.

It is the appraiser's responsibility to understand and correctly apply valuation concepts and methodologies as required by the USPAP.

## Footnotes

<sup>1</sup> Eaton, J.D., *Real Estate Valuation in Litigation*, 2nd Ed., 1995, page 114.

<sup>2</sup> Appraisal Institute, *The Appraisal of Real Estate*, 13th Edition, page 280.



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