

Practical Highest and Best Use

Prepared for
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Good Morning



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I only have a 45-minute time slot, so
we're going to jump right in and talk
about ↓

Highest & Best Use

Slide 2

Let's Pretend



Sit back, relax, have some
juice or coffee, then **pretend**.

Slide 3

Objective



In a USPAP class, a reviewer for a state-licensing agency commented the **most frequent error** in many appraisals is failure to properly identify and adequately support highest and best use. This step precedes the three approaches. If the highest and best use is flawed, the entire appraisal is **flawed**.

The objective of this seminar is to give you an **overview** of a **proper** highest and best use.



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Today's Seminar

Problematic H&B Use Situations; Detailed Examples

1. Handicap-accessible home
2. A new fire station in residential zoning district surrounded by 40-year-old homes.
3. No supportable market value for four (4) single-unit residential sites (*time permitting*)



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Importance of H&B Use

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Overview

An Appraisal Values the Use

In an appraisal, the value conclusion expresses the worth of the **highest and best use** of the physical real estate.

- The market determines the use,
- and the use determines the value.

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Overview – The Market



Market

- ← Gov't, Zoning Boards
- ← Owners, Buyers, Users

The market determines the use, and the use determines the value.



Value of H&B Use

Use



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The Use Creates the Value

Residential Street

All lots in this row zoned single-family	 A
All lots in this row zoned commercial	 B

Commercial Street

The building ages, building sizes, and lot sizes are the same. Property "B" is worth more because the legal use is different.

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Importance of Highest & Best use

Why is Highest & Best Use So Important?

Comparables are used to support the value conclusion(s). H&B use is important to the appraisal process because it is the **primary determinate** in the selection of appropriate comparables.

If the H&B use is not properly identified, the approaches and value conclusion(s) will not be **credible**.

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It's Important



All sales and leases are transactions. However, all sales and leases are not **comparable** transactions.

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What is a comparable?



Pyramid House in Wadsworth, IL.
About 55 miles north of downtown Chicago..

If the subject and a potential comparable were simultaneously available for sale (or for rent), a prospective buyer (or tenant) would consider both properties similarly desirable alternatives.

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What is comparable?



55' tall, 17,000 sq.ft. on 6 acres. Built between 1977-1982.
Eventually surrounded by a moat.

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THE APPRAISAL FOUNDATION
*Authorized by Congress as the Source of Appraisal
Standards and Appraiser Qualifications*

USPAP

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USPAP, v2020-21

Standard Rule 1-3 "When necessary, for credible assignment results in developing a market value opinion, an appraiser **must**:

- (b) "develop an opinion of the highest and best use of the real estate."

Standard Rule 2-2(a)

- (xii) "When an opinion of highest and best use was developed by the appraiser, summarize the **support** and rationale for that opinion" in the report.

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URAR Forms

- **Residential appraisers:** Most state licensing law requires compliance with USPAP. On the **URAR 1004** form, Fannie Mae specifically declares the form to be a **summary** appraisal report; not a restricted report. Therefore, Standard Rules 1-3(b) and 2-2(a)(xii) both **must** be fulfilled as part of a URAR appraisal report.
- Appraisers **must** develop an opinion of H&B use for the URAR form. Furthermore, the appraiser **must** summarize the rationale for the opinion in the **addendum** because there isn't adequate space on the URAR form.

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Real Life Example 1

Handicap Accessible Home

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Real Life Example 1

Handicap Accessible Home

In a 2014 appraisal of a custom-built, handicap accessible home, the appraisal report penalized the property 15% and stated:

"15% downward functional utility adjustment due to an unusually lengthy marketing time".

How many of the four cited sales were handicap-accessible?

None

On July 25, 2012, a U.S Census Bureau report indicated 56.7 million people or 19% of the population have some type of handicap. More than half had a disability categorized as "severe".

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Real Life Example 1

Handicap Accessible Home *(continued)*

On Feb 5, 2017, the Chicago Tribune newspaper reported:

- Fewer than 4% of all U.S. homes have features that ease visits by a person in a wheelchair - an entry without stairs, wider hallways and doors, and first floor, wheelchair-accessible bathrooms.
- By 2035, about 17 million households are expected to include someone who has a mobility problem.

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Real Life Example 1

Handicap Accessible Home *(continued)*

There are numerous federal and state laws that legislate against discrimination based on a handicap.

Next let's consider USPAP. In the Ethics Rule, Lines 198-200 in the 2020-21 version, it states: "An appraiser . . .

***must not** use or rely on **unsupported** conclusions relating to characteristics such as race, color, religion, national origin, gender, marital status, familial status, age, receipt of public assistance income, **handicap**, or an **unsupported** conclusion that homogeneity of such characteristics is necessary to maximize value."*

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Real Life Example 1

Handicap Accessible Home *(continued)*

Is the market exposure time for a \$3 million home the same length as a \$300,000 home?

Usually \$3 million homes have a longer exposure time due to a smaller pool of qualified buyers.

Are \$3 million homes typically applied a downward functional utility adjustments for their longer exposure time?

Usually **No**.

If \$3 million dollar homes are not typically penalized for their longer exposure time, why should a handicap-accessible home be penalized for a lengthy marketing period, **IF** marketing truly is longer?

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Real Life Example 1

Handicap Accessible Home *(continued)*

The flaw in the appraisal of the handicap-accessible home **began** in highest and best use. The ramification of the flawed H&B use caused the sales comparison approach and value opinion to be flawed as well.

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Real Life Example 1

Handicap Accessible Home *(continued)*

The appraiser could have avoided this flaw if the following questions were answered.

- ❖ Who is the most likely buyer type for a handicap-accessible home?
- ❖ Would the features of a handicap-accessible home be considered positive or negative attributes by the most likely buyer type?
- ❖ Would the most likely buyer pay a premium or penalize the property for the home's special physical features?

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Real Life Example 1

Handicap Accessible Home *(continued)*

Even if there were no sales of handicap-accessible homes in the subject's market area, comparisons could have been made in other market areas to support a percentage adjustment.

To prove other market areas are similar, consider:

1. mean home price.
2. median household income, and
3. mean marketing time.

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Real Life Example 1

Handicap Accessible Home *(continued)*

Would an appraisal of a handicap accessible home require more research time and analysis than a typical home?

The answer is likely: **yes**.

Any negative adjustment for handicapped accessibility **must** be properly supported, or the ramifications could be very **severe**.

- Prosecution by the state's attorney for discrimination
- Civil litigation for damages
- Prosecution by the state appraisal-licensing board for a violation of the USPAP's Ethics Rule and likely flawed value opinion

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Real Life Example 1

Handicap Accessible Home *(continued)*

The appraiser should have asked himself:

- Is there adequate demand for handicap-accessible homes?
Yes - No
- Is there an oversupply of handicap-accessible homes?
Yes - No
- Is functional obsolescence supportable with market evidence?
Yes - No

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Real Life Example 1

Handicap Accessible Home *(continued)*

Here are two major issues the appraiser **failed** to recognize.

1. USPAP's Ethics Rule regarding **unsupported** conclusions
2. A **proper** highest and best use analysis

Sounds like a bad headache for that appraiser.



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Real Life Example 1

Handicap Accessible Home *(continued)*

An example of a **proper** H&B use analysis & conclusions.

Physical use: If the land were vacant, what is the ideal or perfect building?

Highest & Best Use As Though Vacant Land

1. Physical use	The ideal use is an average quality, 2, 3, or 4-BR single-unit residence between 2,000 and 2,500 sq.ft. Any other physical attributes like basement, bathrooms, garage, etc.
2. Timing of the use Interim Use	Now <i>(assumes market conditions are suitable)</i> Not applicable
3. Most likely buyer	A developer who would erect the physical use
4. Most likely user	As vacant land, the buyer

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Real Life Example 1

Handicap Accessible Home *(continued)*

If a building exists, the same 4 questions / conclusions must be answered.

Highest & Best Use As Though Now Improved

1. Physical use	Continued use as a handicap-accessible home.
2. Timing of the use Interim Use	Now Not applicable
3. Most likely buyer	A person needing the subject's special physical features; an owner-user
4. Most likely user	The most likely buyer

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Three Key Concepts

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Key Concepts

Three Key Concepts

These main concepts are must be considered in this order:

1. Market analysis
2. Highest & best use
3. Market value

Market analysis, H&B use, and market value are three **intertwined**, fundamental concepts.



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Key Concepts

Market Analysis

Market analysis is a process of examining **supply** and **demand**. Market analysis must precede H&B use. Then, H&B use must precede market value.



Market analysis **must** prove a market now exists or is expected to exist.

It's not possible to form credible opinions about H&B use or market value without considering supply and demand.

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Key Concepts

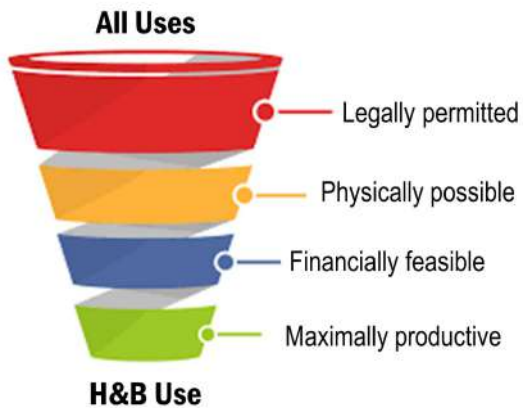
Highest & Best Use – A Definition

“The **reasonably probable** and legal use of vacant land or improved property that is physically possible, **appropriately supported**, financially feasible, and that results in the highest value. The four criteria are

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Key Concepts

Highest & Best Use - A Funneling Process



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Key Concepts

Highest & Best Use – An Alternate Definition

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.”¹

Two Types of Highest & Best Use

1. As though vacant land
2. As though now improved

1. *The Appraisal of Real Estate, 15th Edition*, © 2020 by the Appraisal Institute, page 306

Key Concepts

Market Value – Defined by the U.S. Congress so It’s a Law

The following definition is the one required by the FIRREA - the Financial Institutions Reform, Recovery, and Enforcement Act, a federal law enacted in 1989, effective in 1991.

*“the **most probable** price which a property should bring in a **competitive** and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition are the **consummation of a sale** as of a specified date, and **passing of title** from seller to buyer under conditions whereby:*

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Key Concepts

Market Value - Crucial Criteria

The definition of market value assumes the subject is exposed in an open and **competitive** market and a sale is **consummated** (closed) and **title is passed**. In order to support a market exists, there must be consummated sales of comparable properties.



- A conveyance of title is a sale of ownership rights; a title is passed.
- A lease grants occupancy, but there is no passing of title.

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Key Concepts

Market Value - Crucial Criteria

What if there are there no sales of comparable properties?

Then, there is no supportable market value for **that use**. So, the property must be valued under an **alternate use** scenario.

Ask yourself:

- What else could the property be used for?
- Will the property require modifications for the alternate use?
- What will be the modification costs?
- Consider demolition if a bldg exists and alteration costs are too expensive.



Key Concepts

Market Value - Alternate Uses

Old or special purpose properties often must be valued for an alternate use. Examples:

- Decommissioned military base
- Antiqued branch bank
- Old post office
- Old fire station



Key Concepts

Who is the Likely Buyer Type & Motivation for Buying

Since the definition of market value imagines there is a sale of the subject, the H&B best use **must** consider buyer's perspective.

- ❖ Who is the most likely buyer type?
- ❖ Why is the buyer acquiring the subject? (*the motivation*)
- ❖ What is the buyer going to do with the property?
 - Keep it as is?
 - Change it? *Renovate, repair, demolish, build*
- ❖ When is the change expected to occur, if any?

These questions must be answered to properly identify H&B use.

Answering these questions gives insight and framework to the valuation process.

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Real Life Example 2

Alternate Use of a New Fire Station

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Real Life Example 2 – Fire Station

Alternate Use of a Fire Station

Situation The subject property was in a small suburban village of a Chicago. It was improved with a **new** 12,000 sq.ft., 2-story, brick, fire station erected on five lots. Construction costs were \$2.75 million. Each lot was buildable and measured 35' x 125, so the land comprised a total of 21,875 sq.ft. Surrounding uses were solely single-unit, detached residences.



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Real Life Example 2 – Fire Station

Alternate Use of a Fire Station

Each lot was zoned "R-1" Single-Family". This zoning district only permits single-unit detached residences, religious facilities, public schools, and public works buildings. For a single-unit residential use, each lot was worth \$37,500, so the land "as though vacant" had a \$187,500 market value.



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Real Life Example 2 – Fire Station

Alternate Use of a Fire Station

Situation A small lender in the same village as the fire station requested an opinion of "market value". Based on construction costs, they initially believed the property had a market value near \$3 million.

The mayor, who also headed the zoning board, was asked:

"If the village no longer needed the fire station, would the village allow the property to be sold for use as a contractor's yard, an auto body shop, an auto repair shop, or some other similar use?"

The mayor replied: **"No; it is zoned residential so the village would not permit those commercial uses in that zoning district"**.

In essence, the mayor's reply precluded "sale" of the property for any non-residential use except potentially a religious facility.

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Real Life Example 2 – Fire Station

Alternate Use of a Fire Station

Situation The design of this special-purpose building was very institutional. For an auto-related use, the tall first-floor ceilings and large overhead doors were ideal. But the village would **not** allow these uses in a residential zoning district.

It would be cost prohibitive to convert the building to a religious use. Moreover, the land size was insufficient to provide adequate parking for this use.

Lastly, there were no sales of new fire stations to indicate how much the property might be worth in an open, competitive market for any alternate use. So, the following were the highest and best use conclusions.

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Real Life Example 2 – Fire Station

Alternate Use of a Fire Station

Highest & Best Use As Though Vacant Land

1. Physical use	The subject consists of 5 lots; each is suitable and zoned to permit a detached single-unit residence. As consistent with nearby homes, the ideal use for each lot is a brick-constructed, 1,400 to 1,800 sq.ft home with 3 BRs, 1 or 2 baths erected on a full bsmt with a 2-car garage.
2. Timing of the use Interim Use	Now; demand is adequate for 5 new homes Not applicable
3. Most likely buyer	A developer
4. Most likely user	As vacant land, the buyer

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Real Life Example 2 – Fire Station

Alternate Use of a Fire Station

Highest & Best Use As Though Now Improved

1. Physical use	No other municipality would buy the property for use as a fire station. The existing building cannot be sold in an open, competitive market for an alternate use. If the property is not used by the current user, it would likely sit dormant for several years, then be demolished.
2. Timing of the use Interim Use	To achieve market value, the building must be razed now. Not applicable
3. Most likely buyer	A developer who would raze the building.
4. Most likely user	The developer

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Real Life Example 2 – Fire Station

Alternate Use of a Fire Station

Valuation The appraisal report included the following conclusions with appropriate definitions:

Market value of the land as though vacant	
5 buildable sites @ \$37,500	= \$187,500
Less demolition costs: 12,000 sq.ft. @ \$10	- 120,000
Market Value "As Is"	<u>\$67,500</u>

A "value in use" was also included in the report with a value estimate near the \$3 million total cost.

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Four Conclusions

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Final H&B Use Conclusions

Four (4) Final Questions / Conclusions

Overview

There are four final questions / conclusions that **must** be answered to properly identify and support the H&B use.

1. What is the physical use?
2. What is the timing of the use?

Who are the market participants?

3. Most likely buyer type(s) *(gives insight to motivations)*
4. Most likely user type(s) *(gives insight to preferences e.g. seniors vs young families)*

These 4 questions **must** be answered for the land as though vacant.

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Final H&B Use Conclusions

Four (4) Final Questions / Conclusions

Overview

- If the land has one or more buildings, then the same 4 questions **must** be answered again for the improved real estate.
- The H&B use of the land as though vacant may or may not be the same as the H&B use as though now improved. If the two uses are not the same or very similar, then the building has functional obsolescence,
- The **physical use** must be identified because the associated property rights are what is valued in the three approaches.

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Final H&B Use Conclusions

Four (4) Final Questions / Conclusions

Overview

- Yes, there can be more than one buyer type.
- The most likely user type must be identified to ascertain what characteristics of the property are important to the **user type**, and what rents that user type has paid in the past.

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Ideal Improvement

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Final H&B Use Conclusions

Ideal Improvement

The ideal improvement represents the H&B use of the land as though vacant, so it **must** be identified. When identifying, be as specific as the data will allow.

Why the Ideal Improvement is Important

1. The ideal improvement is new and functionally efficient, so it has no physical deterioration and no functional obsolescence. Whether the ideal should be built now or delayed is a **timing** issue.

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Final H&B Use Conclusions

Why the Ideal Improvement is Important

2. If the subject improvement is significantly different than the ideal, the subject has significant depreciation. So, identification of the ideal is necessary to **properly estimate depreciation** for an existing improvement.
3. During unfavorable market conditions, the ideal improvement may not be feasible. If the ideal improvement is constructed during weak market conditions, economic external obsolescence would likely diminish its market value. Consequently, **timing** of the ideal improvement is a crucial, but separate issue

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Physical Use

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Final H&B Use Conclusions

Physical Use Conclusions As Though Now Vacant

The physical use is the ideal use of the land as though vacant. This use **must** be identified because this use must be considered when the land is valued. However, the ideal improvement may not be feasible during weak market conditions. Some brief examples of physical uses are:

- **Build new** Agricultural
- Open space Wilderness
- Easement Park
- Parking Storage
- Row crops Vineyard
- Cattle grazing Many others
- Remain dormant (*unused*) as a permanent use

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Final H&B Use Conclusions

Physical Use Conclusions As Now Improved

- Retain as is
- Repair
- Remodel
- Renovate
- Enlarge / reduce
- Convert to an alternate use
- Demolish & build new

*All change the property
in some fashion*

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Timing of the Use

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Final H&B Use Conclusions

Timing of the Use

- Timing of the physical use is either now or at some semi-determinable point in the future.
- If the physical use is **not** presently feasible, determine whether it will ever be feasible.

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Final H&B Use Conclusions

Timing of the Use

- If demand for a specific use is not expected for a lengthy period, then consider demand and the time frame for **alternate uses**. Again, time is a crucial factor in any present worth calculation.
- "**Hold for future development**" is **not** a proper H&B use conclusion without a time forecast when demand is expected to justify new construction.

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Interim Use

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Final H&B Use Conclusions

Timing of the Use, Interim Use

- **Definition:** An interim use² is:
the temporary use of a site or improved property until a different use becomes the maximally-productive highest and best use.
- Identification of an interim / temporary use is necessary during unfavorable market conditions when the highest and best use is delayed.

2. Seminar specific definition

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Final H&B Use Conclusions

Timing of the Use, Interim Use

- Examples of valid interim uses include but are not limited to:
 - ❖ Agriculture
 - ❖ Parking
 - ❖ Storage
 - ❖ Continued use as is
 - ❖ Golf driving range
 - ❖ Remain dormant (*unused*)
- Remain dormant may also be a permanent use if no demand presently exists and is not expected to evolve for a lengthy period.

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Most Likely Buyer Types

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Final H&B Use Conclusions

Attributes of the Five (5) Most Likely Buyer Types

Overview

There are five most likely buyer types. Each has a different motivation for purchasing real estate. Characteristics of each buyer type are detailed on the next several slides. The five major buyer types are listed below; there are likely sub-categories.

1. Owner-User
2. Secure Income Investor (*mostly interested in the income stream*)
3. Developer
4. Speculator or speculative investor
5. Value Growth Investor (*mostly interested in appreciation of value*)

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Final H&B Use Conclusions

Most Likely Buyer Types - A Common Misstatement

One common **misstatement** is:

“The most likely buyer is an investor”.

This statement communicates nothing meaningful because every buyer is also an investor. There are different types of buyer - investors.

What are the specific characteristics of the most likely buyer type?

Next, we'll describe the attributes of the 5 most likely buyer types.

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Final H&B Use Conclusions

Five (5) Most Likely Buyer Types

1. Owner-user

- ❖ A user who wants to utilize the property or just control the use. Property suitability or use control are the primary purchasing criteria.
- ❖ Does not experience risk of vacancy, so incurs the least risk
- ❖ An end-user who customarily uses the property almost immediately, which may imply financial feasibility.
- ❖ Medium to long-term ownership periods
- ❖ Government / public use is an owner-user

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Final H&B Use Conclusions

Five (5) Most Likely Buyer Types

2. Secure Income Investor

- ❖ Predominantly seeks an established cash flow, **secured** by written leases.
- ❖ In this category, some investors prefer just high-quality tenants with little risk hence accept low yield. Other investors will accept other levels of tenant quality, risk, and return.
- ❖ Value growth is secondary to a secure income stream.
- ❖ Usually does not change the property in any major way.
- ❖ Medium to long-term investment horizons
- ❖ Tenant quality impacts risk and yield

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Final H&B Use Conclusions

Five (5) Most Likely Buyer Types

3. Developer

- ❖ Acquires real estate to **change** it in a major physical way hence change its value.
- ❖ Makes a profit via the process of change which is mostly received towards the end of the project or development.
- ❖ Willing to accept huge risk so seeks huge reward
- ❖ Buys land to improve it
- ❖ Buys buildings to renovate, enlarge, or convert to an alternate use
- ❖ Mostly short to medium-term projects

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Final H&B Use Conclusions

Five (5) Most Likely Buyer Types

4. Speculator or Speculative Investor

- ❖ Generally, does not use the real estate
- ❖ Primary goal is to buy low and sell high
- ❖ Incurs the most risk, so typically pays the lowest price
- ❖ May suggest physical use is not presently feasible
- ❖ Medium to long ownership periods
- ❖ Prevalent in market during **weak** market conditions
- ❖ Income generation is secondary to value growth and the time to market recovery.

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Final H&B Use Conclusions

Five (5) Most Likely Buyer Types

5. Value Growth Investor

- ❖ Mostly seeks rapid value growth or appreciation
- ❖ Typically, does not use the property
- ❖ Most ownership reward at investment termination.
- ❖ Short to medium-term ownership periods
- ❖ Prevalent in market during periods of **strong** market conditions when prices are rapidly growing / appreciating.
- ❖ Income generation is secondary to value growth, hopefully over a short ownership period.

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Most Likely User Types

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Most Likely User Types

A Partial List

The most likely user types are numerous and very diverse. Some examples include but are not limited to:

- An owner-user. Government is both an owner and user.
- Local, modest income users
- Local, upper income users
- Nationally recognized big-box retailer, fast-food restaurant, branch bank, convenience store / gas station, or drug store chain
- Local service business
- Auto dealership
- Local funeral home
- No likely user; can't be identified due to no discernible demand
- *Many others*

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Four Tests & Four Conclusions

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Four Tests & Four Conclusions

Remember

The four **tests** of H&B Use are:

- Physically possible
- Legally permissible
- Financially feasible, and
- Maximum productivity

The four **conclusions** of H&B use are

- What is the physical use?
- What is the timing of the use?
- What is the most likely buyer type?
- What is the most likely user type?

Before the conclusions can be formed, the tests **must** be fully explored.

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Real Life Example 3

No Supportable Market Value

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Real Life Example 3 - Residential

No Supportable Market Value During early 2016, four scattered single-unit residential lots in a distressed town were appraised.

Average site size	11,700 sq.ft.
Last asking price	\$12,000 total for all 4 sites
Time on market	1,902 days (5.2 years) over last 6 years
Peak home prices	\$116,441 mean citywide in 2007 \$103,000 median citywide in 2007
Mean home price, citywide	\$53,260 (1st Qtr 2016) \$51,970 (All of 2015)
Median home price, citywide	\$29,000 (1st Qtr 2016) \$30,675 (All of 2015)
Home foreclosure rate	60% citywide

Huge Spreads

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Real Life Example 3 - Residential

Most Likely Buyer Type *(continued)*

The following were the actual H&B use conclusions. The last three of these conclusions may be the norm in an economically depressed area.

Highest & Best Use As Though Vacant Land

1. Physical use	An 1,800 to 2,500 sq.ft. average-quality, single-unit residence on each of the 4 subject sites.
2. Timing of the use	Indeterminate. No discernible demand now or within next decade; likely even longer.
Interim Use	Remain vacant with negative income due to real estate taxes
3. Most likely buyer	No identifiable likely buyer
4. Most likely user	No identifiable likely user

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Real Life Example 3 - Residential

No Supportable Market Value *(continued)*

The appraisal's final value conclusion was:

"No Discernible Demand, So No Supportable Market Value".

There were no consummated sales of similar land to support any numerical value conclusion. It may be plausible some buyer may pay some nominal price like \$10, \$100, or \$1,000, but in 5+ years there was no buyer. So, there is no market evidence (sales) with passing of title to support a nominal price. If there are closed sales at any price, then that data supports market value. Any numerical conclusion of market value including zero should be supported with consummated sales.

The bank's reviewer, an MAI, reluctantly accepted this conclusion.

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Wait!

Any Questions?

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