Market Rent and Highest and Best Use: Joined at the Hip?

by Barry A. Diskin, PhD, MAI, AI-GRS, David C. Lennhoff, MAI, SRA, AI-GRS, Richard L. Parli, MAI, and Stephen D. Roach, MAI, SRA, AI-GRS

Abstract

It is well established that market value must be premised on the property's highest and best use. What about market rent? This article investigates the relationships between highest and best use and market value and market rent and presents evidence and the rationale for a conclusion that as with market value, market rent also must be based on the property's highest and best use. As a part of the investigation, three mini case studies are presented to illustrate the importance of carefully labeling and developing the appropriate rent. In conjunction with this investigation, *use value* will be redefined and a new definition of *use rent* proffered as an aid in diminishing confusion among the different types of rent.

Introduction

One of the most important steps in an appraisal is the determination of the type of value to be estimated. This is one of the assignment elements to be determined as part of problem identification, which is the first step in the valuation process.[1] Furthermore, it is well established that market value must be estimated in terms of the property's highest and best use. Although other legitimate value estimates can be made—for example, use value and investment value—for it to be *market value* it must be based on the property's highest and best use. This fact is supported in appraisal texts and standards, including the Uniform Standards of Professional Appraisal Practice (USPAP) and the Uniform Appraisal Standards for Federal Land Acquisitions (UASFLA). This connection to highest and best use is critical because, as noted in *The Appraisal Journal*, "it is axiomatic that 'you can't get the value right if you get the highest and best use wrong.'"[2] But what about market rent? Must the rent be based on the property's highest and best use for it to represent *market rent*? Does it matter? In order to answer these questions, it is necessary to first investigate the relationship that value and market value have with highest and best use. The following discussion includes a clarifying case study and proposes a new definition of *use value*. The discussion then turns to the relationship of rent and market rent to highest and best use. Two additional clarifying case studies are then presented. Finally, a definition is proffered for a new term, *use rent*.

Value, Market Value, and Highest and Best Use

It is well established that market value and highest and best use are connected—the market value of a property is the value of the property at its highest and best use. This is in spite of the fact that there are various definitions of *market value*

1. Appraisal Institute, chapter 6, "Identifying the Type of Value and Its Definition," in *The Appraisal of Real Estate*, 15th ed. (Chicago: Appraisal Institute, 2020), 47–57.

2. David C. Lennhoff and Richard L. Parli, "Timing Is Everything: The Role of Interim Use in the Highest and Best Use Conclusion," *The Appraisal Journal* (Summer 2020): 198.

as well as numerous ways to express highest and best use. The mixing and matching of the description of the two concepts does not change the relationship. *The Appraisal of Real Estate*, fifteenth edition, expresses the relationship succinctly: "Market value opinions are based on the highest and best use of a property."[3]

This relationship is repeated in numerous authoritative texts,[4] as well as in USPAP[5] and UASFLA.[6] Nonetheless, this relationship is not self-evident and is not explicit in any of the numerous definitions of *market value*, including the definition used by government agencies that regulate federally insured financial institutions:

> *Market value* is the most probable price that 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, knowledgeably and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:
> - Buyer and seller are typically motivated;
> - Both parties are well informed or well advised, and acting in what they consider their own best interests;
> - A reasonable time is allowed for exposure in the open market;
> - Payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and
> - The price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.[7]

To appreciate the connection, it is necessary to understand the basic definitions of real estate value.

On the one hand, *value* is a generic term, referring to the power of a good or service to command other goods and services in exchange.[8] Value as a generic term can be applied to anything tangible or intangible. The determination of the value of something is normally quite simple because the something is usually, within its population, both uniform and transportable, and operating in an active market. The simplicity arises from the fact that little analysis is required of the demand and supply for the something because the market is typically universal.

When the market in question is a real estate market, however, *value* is defined as "the monetary relationship between properties and those who buy, sell, or use those properties."[9] Real estate is distinct from other markets in that real estate is neither uniform nor transportable. Consequently, the market is unique for each property. Not only is the market unique for each property, but the valuation of each property can be uniquely tailored to match the value question being asked. For instance, the value of a property can be determined based upon a particular use (use value); based upon particular investment terms or motivation (investment value); and/or based upon a property being a portion of a larger enterprise (value-in-use).[10] In each case, the real estate remains the same but the value is different because the appraisal does not focus on the entire property, but on a particular characteristic of the property. In essence, the focus on each characteristic limits the analysis, which in turn limits the results by restricting the considerations. For use value, the analysis prevents consideration of other, possibly more valuable, uses. For investment value, the analysis prevents specific consideration of market terms (except by coincidence).

3. Appraisal Institute, *The Appraisal of Real Estate*, 15th ed., 52.
4. See, for example, J. D. Eaton, *Real Estate Valuation in Litigation*, 2nd ed. (Chicago: Appraisal Institute, 1995), 18; Appraisal Institute, *Real Property Value in Condemnation* (Chicago: Appraisal Institute, 2018), 75; James H. Boykin, *Land Valuation: Adjustments Procedures and Assignments* (Chicago: Appraisal Institute, 2000), 39.
5. Appraisal Standards Board, Standards Rule 1-3 (a) and (b) in *Uniform Standards for Professional Appraisal Practice* (Washington, DC: The Appraisal Foundation, 2020–2021).
6. Interagency Land Acquisition Conference, Section 4.3, "Highest and Best Use" in *Uniform Appraisal Standards for Federal Land Acquisition*s (UASFLA), 2016 ed. (Washington, DC: US Government Printing Office, 2016), http://bit.ly/UASFLA.
7. Appraisal Institute, *The Dictionary of Real Estate Appraisal*, 7th ed. (Chicago: Appraisal Institute, 2022), s.v. "market value."
8. Arthur A. May, *The Valuation of Residential Real Estate*, 2nd ed. (New Jersey: Prentice-Hall, 1953), 12.
9. Appraisal Institute, *The Dictionary of Real Estate Appraisal*, 7th ed., s.v. "value."
10. See discussion in *The Appraisal of Real Estate*, 15th ed., 52–54.

For value-in-use, the analysis prevents the consideration of all but its value in contribution to a greater enterprise.

Market value, on the other hand, is not a generic term; it refers to a value that has no artificial conditions or limits imposed.[11] Because of this, market value is not subjective. It is the value that is strictly market-determined; that is, the value is the outcome of the competitive and open interactions of buyers, sellers, and users, who combine to create market value. These three component interactions are unique to market value. Users interact to identify the most-productive use of the property; buyers interact with other market participants to identify demand characteristics and affordability; and sellers interact to identify the availability of similar property types. Combined, this interaction indicates the most productive use of the property (i.e., the highest and best use) and the value of the property for that use.

The market, in this sense, includes all components expected in a competitive, open market. *Open* means that all relevant market participants can engage equally. *Competitive* indicates that there is a critical level of supply and demand so as to assure that the market participants have choices. Out of the choices, the market participant who offers the highest price for a property will become the buyer. In short, market value implies that the owner of the property (the hypothetical seller) should be able to maximize profit by marketing the property to the highest bidder (the hypothetical buyer).

Only a competitive and open market allows transactions that are not artificially limited. This recognition is embedded in the definition of *market value* quoted earlier. Like all *market value* definitions, there is no "use" referenced; it is implied that the "competitive and open market" will determine the use. This is the case no matter whether the property is land that is vacant or land that is improved. It is the market that determines the use (and, in turn, it is the use that determines value). And the market-determined use is the use that is valued to arrive at market value.

The market-determined use for a particular property is the property's highest and best use. The product of a highest and best use analysis is identification of the most probable use of the property that results in the highest value—in other words, the use that will attract the buyer willing to pay the highest price for the property. After all, if the

If the use is the highest and best use, then the value will be market value; however, if the use is a specified use, then the value will be use value. There can be no mixing of market value and use value.

hypothetical seller wants to maximize its return, that can only be accomplished by selling to the highest bidder. A bidder will pay the highest price because its use is the most productive use after consideration of all reasonable alternatives. Any limitation on use is market dictated—whether it be a legal, physical, or financial limitation. Whatever the limitation is, it is not an artificial limitation. This distinguishes market value from other values and prevents it from being a generic term and a subjective conclusion. Consequently, any reference to market value unambiguously refers to the value of the use that is the property's highest and best use. In addition, market value unambiguously must be determined by a competitive and open market. These two conditions produce a result that is market driven and void of hypothetical conditions.

Ignoring these two conditions can result in an erroneous value. This is shown in the following case study, which introduces the fundamental relationship between the type of use and the type of value. If the use is the highest and best use, then the value will be market value; however, if the use is a specified use, then the value will be use value. There can be no mixing of market value and use value.

11. For a good discussion on the history of issues surrounding *market value*, see Michael V. Sanders, "Market Value: What Does It Really Mean?" *The Appraisal Journal* (Summer 2018): 206–218.

Case Study 1—Market Value

For at least a decade, an argument has continued about the value of nationally or regionally known drugstores. The crux of the dispute centers on whether assessors should use sale-leaseback and build-to-suit transactions (without adjustment) as indications of market value.

As previously pointed out, understanding the connection between market value and highest and best use is critical. To illustrate, the following case study presents a common circumstance that accompanies the mislabeling of market value.

In some areas, there are but two major drugstore retailers—for this example assume CVS and Walgreens. Furthermore, assume, by law, the property assessor must come to an estimate of the market value of the real estate used by a CVS store. How is that to be accomplished?

The assessor will find, for instance, that if a CVS store is sold without the typical CVS lease in place, the likely purchaser is not Walgreens. There are two reasons for this. First, even a cursory observation will show that the two firms (for example, CVS and Walgreens) typically locate their stores near each other. A CVS store is often on an opposite corner or in the same or next block. This phenomenon is an example of the principles of cumulative attraction, retail agglomeration, and Hotelling's law.[12]

Second, even if the two retailers are not located near each other, most top-tier retailers have their own building prototype and will not want to be associated with the competitor's image. Walgreens will not choose to be in a building once used by CVS.

So, who is the probable purchaser in an open and competitive market? We know that there has to be a probable purchaser, because by definition *market value* presumes a transaction—the owner transfers title to a purchaser. Generally, the transfer of the real estate with a lease to CVS in place most likely would be to another investor interested in buying the bond-like arrangement.[13] This is true even if the store is vacant since the real estate is of secondary importance. Determining the market value of the fee simple interest in such a property requires first looking to the highest and best use of the property, which requires a determination of the most likely purchaser assuming that the property would be exposed to a competitive and open market. Market observation reveals that most sales of property developed under build-to-suit arrangements are purchased for a secondary use, such as a non–brand-name retailer, or modified for an adaptive reuse.[14]

The crux of the dispute centers on whether assessors should use sale-leaseback and build-to-suit transactions (without adjustment) as indications of market value.

Buildings for some businesses, especially retail and restaurants, have design features and improvements that are valuable only to a single business/user, because they are part of the business's branding. Examples of this are common and include fast-food franchises (e.g., McDonald's with their golden arches), and dine-in restaurants (e.g., Cracker Barrel); the building design is so immediately recognizable that it does not even require a sign.[15] Although these special components contribute to the business, they rarely have value in the marketplace. Instead, these items are segments of the going concern of the business.[16]

As noted, Walgreens and other similar retailers often enter into long-term leases; they choose not to tie up their capital in real estate. A common agreement between the lessor and lessee for CVS or Walgreens includes a sale-leaseback agreement whereby the retailer owns a finished store that meets their needs, sells the property, and then leases the store back on a net basis.

The concern with this arrangement from a valuation perspective is clearly expressed in *The Appraisal of Real Estate*, fifteenth edition:

> Sale-leaseback transactions must be used with caution because the lease is usually negotiated as part of the

12. According to Hotelling's law, there is an "undue tendency for competitors to imitate each other in quality of goods, in location, and in other essential ways." "Hotelling's Law," in *The Palgrave Encyclopedia of Strategic Management*, 2018 ed., https://bit.ly/3PLxbEF.
13. The analogy of a national brand lease to a corporate bond is common. Discussions with brokers who specialize in the sale of these arrangements confirm that typical buyers view the transactions as having strong similarities to bonds. Interviews with investors/buyers corroborate the broker information.
14. In fact, when CVS absorbed Eckerd's, the majority of the closed stores quickly found lessees, including car dealerships, grocery stores, and other specialty retailers.
15. Barry A. Diskin and Jack P. Friedman, "Taxation of 'Branding' Leasehold Improvements," *Property Tax Alert* 4, no. 1 (March 2006).
16. See Douglas D. Lovell, "Does Your Client Really Need a Market Value Estimate?" *The Real Estate Appraiser* (May 1991): 11.

> sale rather than as an independent, market-based lease negotiation. Sale-leasebacks that are negotiated as financing vehicles may reflect motivations of the tenant and landlord that are not typical of the market.[17]

Some assessors assert that drugstores with national recognition create their own highest and best use category. There is a viewpoint that the real estate needs for users like major drug retailers are profoundly different from other retail users. That argument holds that market value for CVS and Walgreens should be higher because these stores tend to locate at high-traffic corners at traffic-controlled intersections. The evidence indicates otherwise, however. Other retail users also need a specific-size building at high-traffic intersections. Examples include fast-food restaurants, banks, convenience stores with gasoline pumps, and shopping centers. Many businesses operate with a particular prototype building on a preferred site size. The concept is not unique to nationally known drugstores, and the relationship of their initial sale price to market value also is not unique.

It is noteworthy that the definition of *market value* quoted earlier not only describes market value but also provides the rules (components) for determining market value. No other type of value is defined in this way. For instance, *use value* is described as follows:

> *Use value* is "the value of a property based on a specific use, which may or may not be the property's highest and best use. If the specified use is the property's highest and best use, use value will be equivalent to market value. If the specified use is not the property's highest and best use, use value will be equivalent to the property's market value based on the hypothetical condition that the only possible use is the specified use.[18]

This definition is silent regarding the rules for applying the definition. No mention is made requiring a competitive and open market, no mention is made of conditions requisite to a fair sale, no mention is made of dictating actions by the buyer and seller. In short, the *use value* definition places no restrictions on the details of the transaction. For these reasons—and in order to distinguish and standardize the application of *use value*—the following definition is proposed:

> *Use value* is the most probable price that a property put to a specified use should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller, each acting prudently, knowledgeably and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:
>
> - buyer and seller are typically motivated;
> - both parties are well informed or well advised, and each acting in what it considers its own best interest;
> - a reasonable time is allowed for exposure in the open market;
> - payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and
> - the price represents the normal consideration for the property sold, unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

Note that the specified use is the only difference from market value. A competitive and open market is required, and the actions of the buyer and seller are defined, but the use is presumed to be limited to less than the property's highest and best use.

Rent, Market Rent, and Highest and Best Use

If highest and best use determines market value, what determines highest and best use? In large part, it is market rent. It is axiomatic that a property's highest and best use will have the highest rent of the alternative uses, all else being equal. But, market rent can be determined as an independent calculation. Is it also tied to highest and best use similar to market value? The discipline associated with the application of *market value* should be duplicated with *market rent*. The current definition of *market rent* is as follows:

> The most probable rent that a property should bring in a competitive and open market under all conditions requisite to a fair lease transaction, the lessee and lessor each acting prudently and knowledgeably, and assum-

17. Appraisal Institute, *The Appraisal of Real Estate*, 15th ed., 438.

18. Appraisal Institute, *The Dictionary of Real Estate Appraisal*, 7th ed., s.v. "use value."

ing the rent is not affected by undue stimulus. Implicit in this definition is the execution of a lease as of a specified date under conditions whereby

- Lessee and lessor are typically motivated;
- Both parties are well informed or well advised, and acting in what they consider their best interests;
- Payment is made in terms of cash or in terms of financial arrangements comparable thereto; and
- The rent reflects specified terms and conditions typically found in that market, such as permitted uses, use restrictions, expense obligations, duration, concessions, rental adjustments and revaluations, renewal and purchase options, frequency of payments (annual, monthly, etc.), and tenant improvements (TIs).[19]

This definition is modeled like the definition of *market value*. Both assume *knowledgeable participants*, which is a key component of the market in both market value and market rent. For the same reasons that market value is tied to highest and best use, market rent is tied to highest and best use. In addition, market rent unambiguously must be determined by a *competitive and open market*. These two conditions produce a result that is market driven and void of hypothetical conditions imposed on the market. As with market value, ignoring these two conditions can result in an erroneous rental rate. This is shown in the following case study.

Case Study 2—Market Rent

This second case study looks at determination of market rent, with an emphasis on the build-to-suit market and the related rents.

As with sale-leaseback arrangements, national retailers including CVS, Walgreens, and others often enter into build-to-suit agreements whereby a developer is retained to produce the finished store, and upon completion, the retailer leases the property at an agreed upon rate of return from the developer. Retailers enter into these agreements to avoid tying up their capital in real estate development when it would be better deployed within the business. These build-to-suit arrangements are rarely, if ever, exposed to the market and, therefore, do not meet the criteria for market rent. The rent is simply a function of cost to construct and may include non-realty components.

In his *Appraisal Journal* article Robert W. Hartmann states, "Sale-leaseback and build-to-suit transactions are, in essence, financing vehicles and not necessarily market-derived transactions."[20] The income streams associated with build-to-suit and sale-leaseback arrangements, by default, contain the effect of financing. *The Appraisal of Real Estate* and the Appraisal Foundation include language supportive of this contention.[21]

For CVS and Walgreens, there is a great likelihood the rent figures are based on the cost of a turnkey finished property, include a component for financing, and are influenced by the intangible of a lease that is guaranteed by a nationally known retail firm. If any of these elements are present, the rental rate includes non-realty components.[22] For this reason, such rents are not market rent and, therefore, should not be used to estimate the market rent of the fee simple interest. The results of doing so can be dramatic. Consider the following build-to-suit example.

Suppose the valuation assignment involves real estate with the following characteristics:

- Freestanding retail pharmacy on 1.7 acres of land
- Parking for 78 cars
- Highly visible site with easy access and traffic control
- Single-story facility with gross building area of 13,000 square feet
- Cost of construction was $2,300,000, including numerous business-specific custom features
- Site cost was $1,250,000. (The high land-to-total cost ratio is not unusual. Frequently freestanding pharmacies buy improved sites and raze the improvement, as business value more than covers the above-market cost.)
- All-in cost was $3,550,000
- Annual rent is based on 8% of all-in cost—$284,000 or $21.85 per square foot

Current rental comparables in the immediate area for freestanding retail properties range from $15–$18. These are all second-generation store uses, but with similar freestanding retail highest and best uses.

A few years after construction the property owner sold the leased fee to a group of dentists at a 6% capi-

19. Appraisal Institute, *The Dictionary of Real Estate Appraisal*, 7th ed., s.v. "market rent."
20. Robert W. Hartmann, "Valuation for Loans on Restaurants," *The Appraisal Journa*l (October 1996): 411.
21. Appraisal Institute, *The Appraisal of Real Estate*, 15th ed., 438; and Appraisal Practices Board, *APB Valuation Advisory 2: Adjusting Comparable Sales for Seller Concessions* (Washington, DC: The Appraisal Foundation, March 7, 2012), 15, https://bit.ly/3cxhtii.
22. Moreover, accurately segregating these non-realty elements from the total lease payment is difficult because the lack of data prevents any systematic method to segregate the elements.

talization rate, or $4,733,333. The successfully operated store is reassessed, in fee simple (meaning, *available* to be leased at market), for real estate tax purposes at $5,000,000, based mostly on capitalization of the build-to-suit rent. In this example, substituting build-to-suit rent for market rent results in a value obviously well above market value of the fee simple interest.

Case Study 3—Market Rent

The third case study involves a condemnation action in California that presented several interesting issues related to market rent. It concerns the determination of the market rent for a project that is mixed use by timing.[23]

The property is a 50,000-square-foot parcel located along a major street in a major city. The site is improved with a 20,000-square-foot, forty-year-old retail building occupied by a discount retailer that is the original tenant in the building. The balance of the site is devoted to surface parking. The business conducted on the property has been highly successful and profitable; the sales per square foot are among the highest in the forty-store chain.

The land use regulations permit a wide variety of commercial and residential uses, and the height and density regulations would permit a building up to about twenty stories. Several similar nearby properties had recently been redeveloped with condominium towers having residential units over ground-floor retail space. Analysis of these properties, nearby sales, and other market metrics led to a conclusion that the highest and best use would be redevelopment with a twenty-story mixed-use commercial/residential tower. Although the development would have been physically possible and economically feasible, the timing of development could not have been "now" because the site was not entitled for that use. An entitlement expert who had processed entitlements for a number of properties in the immediate area opined that it would take about six years to process environmental approvals and building plans, and to obtain actionable entitlements to build the project.

In the condemnation action, the property was valued by appraisers retained by both the public agency and the property owner. Although there was disagreement over the value of the property, the appraisers reached very similar highest and best use conclusions, including conclusions regarding the height, bulk, and mixed-use nature of the building, and conclusions regarding the timing of the use. In other words, both appraisers concluded that the highest and best use of the property was redevelopment of the property in about six years when entitlements could be obtained and retention of the retail interim use until that time. Consistent with their conclusions regarding the timing of the highest and best use, both appraisers relied solely on the sales comparison approach to appraise the property. However, the appraisers were also requested to provide an opinion of the market rent for the property, which was a required input into business goodwill valuations that were being conducted by forensic accountants (loss of business goodwill is a compensable element of compensation in condemnation cases in California).

The third case study involves a condemnation action in California that presented several interesting issues related to market rent.

Keeping these facts in mind, what is the market rent for the property on the date of appraisal for the period of time during which the retail use would remain pending redevelopment? The issue can be illuminated by examining the positions of the two parties:

The appraiser for the public agency concluded that the market rent for the property was $2,400,000 per year,[24] or $120 per square foot of building area per year. The appraiser reached this conclusion by applying a 6% rate of return (extracted from the market) to the $40,000,000 value conclusion for the property. The conclusion was silent regarding additional terms of the market rent.

The appraiser for the property owner concluded that the market rent was $840,000 per year, or $42 per square foot per year. The appraiser reached this conclusion by analyzing recent leases of similar retail properties devoted to similar uses, including several leases to the same user. Additional concluded terms included a six-year lease, rent escalation of 3% per year, tenant paying all utilities and minor maintenance, and no landlord concessions.

To help bridge the gap between the valuation conclusions, consider the positions of the respective appraisers in light of the recognition that market rent must be based on the highest and best use of the property for which the market rent is being determined.

23. Lennhoff and Parli, "Timing Is Everything: The Role of Interim Use in the Highest and Best Use Conclusion," *The Appraisal Journa*l.

24. All rental figures used in this example are net.

The agency's appraiser's conclusion does not reflect that the highest and best use of the property has two components—the retention of the retail use for six years, and then redevelopment of the property.[25] This situation is an example of an interim use. In this case, the interim use is due to a delay in legal permissibility. Here, the highest and best use of the property as of the effective date of the appraisal was not solely continued retail use nor was it solely future mixed-use redevelopment—it was both.[26]

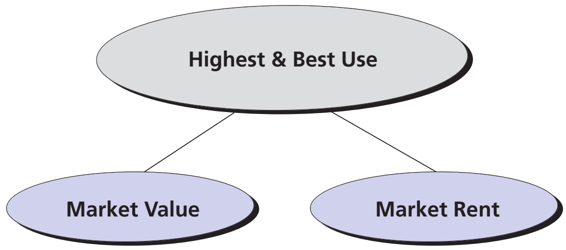
Since the highest and best use of the property for the six years following the effective date of the valuation included retention of the improvements on the property, the only way to harmonize the concepts of market rent and highest and best use is to conclude that the market rent on the date of appraisal was for retail use. Applying a return on the value of the property, as the agency's appraiser did, improperly merged the components of highest and best use and commingled the timing of the interim use and the future use.

Market rent, like market value, is as of a specific date. The highest and best use determination mandated that, in this case, market rent was for retail use consistent with the existing building. The probability that use of the property in the future may change should not influence the conclusion of market rent in the present.

Now suppose some of the facts of the case study are changed to further illustrate the linkage between market rent and highest and best use. Assume the same property and the occupant but no six-year delay to obtain entitlements, the property is fully entitled for redevelopment, and the value of the land for redevelopment far exceeds the value of the property under the current discount retail use. Given that the highest and best use timing is now under this scenario, there is no interim use and the market rent would be based on the development highest and best use.

Case Study 3 demonstrates that all highest and best use conclusions are on a timeline that progress through component uses. This is especially the case with a proposed mixed-use property when one of the uses is an interim use. Even with a "single use" project, the use is "single" only because of the inability to predict far enough in the future. In this sense, all uses are interim uses.

Exhibit 1 Relationship between Highest and Best Use, Market Value, and Market Rent



This recognition mandates that the market rent associated with a highest and best use is the use that is immediately operative. In other words, a highest and best use has a macro level and a micro level. The macro level addresses the three highest and best conclusions (use, timing, market participants), while the micro level addresses the use that is the result of the timing dictated by the macro highest and best use. In this way, both market value and market rent are connected at the hip to highest and best use, with market value based on the macro highest and best use and market rent based on the micro highest and best use, i.e., the immediate use of the property. The flowchart in Exhibit 1 shows that both market value and market rent are equally dependent on a property's highest and best use.

Just as there are many types of value, e.g., use value, insurable value, and investment value, there are a number of types of rent. In fact, *The Appraisal of Real Estate* lists eight different types of rent:[27]

- Market rent
- Contract rent
- Effective rent
- Excess rent
- Deficit rent
- Base rent
- Percentage rent
- Overage rent

The important distinction between *use value* and *market value* is that use value is based on a specific use, which may or may not be the property's highest and best use. "If the specified use is the

25. The purpose of the market rent estimate in this matter was to support a valuation of the business goodwill of the retailer. Since the retailer would have been displaced upon redevelopment, only the referenced six-year period is at issue.

26. "There are not two highest and best use conclusions. An interim use is not in itself a highest and best use. Rather, an interim use is part of a highest and best use." Appraisal Institute, *Real Property Valuation in Condemnation* (Chicago: Appraisal Institute, 2018), 83–84.

27. Appraisal Institute, *The Appraisal of Real Estate*, 15th ed., 420.

property's highest and best use, the use value will be equivalent to market value."[28] However, although they are equivalent, they are not synonymous. Just as a capitalization rate and a yield rate might be the same number (as when no change in income or value is projected over the holding period), they are also not synonymous. There is no formal term "use rent," but perhaps there should be, as the issue of market rent is really a labeling issue. Absent the distinction between use rent and market rent, however, appraisers may not consider the difference between the two and end up estimating the use rent when they are supposed to be estimating the market rent.

Under the paragraph heading "Market Rent and Highest and Best Use," UASFLA states as follows:

> [I]n developing an appraisal for a leasehold, the appraiser must use the definition of *market rental value* [in Section 1.5.4.1]. As part of the development of an appraisal for a leasehold acquisition, the appraiser must determine the highest and best use of the property (as improved) that is the subject of the leasehold. This requirement is critical to the selection of comparable rents used in the valuation process."[29]

This indicates that the UASFLA recognizes market rent must be premised on the property's highest and best use. And just as the market value depends on getting the highest and best use right, so does market rent. The market rent cannot be right if the highest and best use conclusion is wrong, or if the highest and best use is ignored and market rent is estimated based on the existing use. This relationship is further confirmed in *The Appraisal of Real Estate*, fifteenth edition, which states "if the current rent and terms of a leased parcel correspond to market rent and terms for comparable leased parcels *with similar highest and best uses* [emphasis added] then only a property rights adjustment would be necessary."[30]

The connection to highest and best use is what distinguishes market rent from other rent types. Consequently, any reference to market value unambiguously refers to the rent of the use that is the property's highest and best use. In addition, market rent unambiguously must be determined by a competitive and open market. These two conditions produce a rent that is market driven and void of hypothetical conditions imposed on the market.

As noted earlier, one way to diminish confusion about what *market rent* means would be to formulate a definition of *use rent* to differentiate it from *market rent*. To achieve that goal, the following *use rent* definition is proposed:

> The most probable rent that a property limited to a specific use would bring in a competitive and open market under all conditions requisite to a fair lease transaction, the lessee and lessor each acting prudently and knowledgeably, and assuming the rent is not affected by undue stimulus. Implicit in this definition is the execution of a lease as of a specified date under conditions whereby
> - Lessee and lessor are typically motivated;
> - Both parties are well informed or well advised, and acting in what they consider their best interests;
> - Payment is made in terms of cash or in terms of financial arrangements comparable thereto; and
> - The rent reflects specified terms and conditions typically found in that market, such as permitted uses, use restrictions, expense obligations, duration, concessions, rental adjustments and revaluations, renewal and purchase options, frequency of payments (annual, monthly, etc.), and tenant improvements (TIs).

To summarize, the key to *market rent* is the "market," which implies the most probable rent the market would pay, which in turn implies the property's highest and best use. This is because the market rent estimate, as with a market value estimate, would be the "highest value reflected by detailed analyses of all logical potential use and development alternatives."[31]

28. Appraisal Institute, *The Dictionary of Real Estate Appraisal*, 7th ed., s.v. "use value."
29. Interagency Land Acquisition Conference, *Uniform Appraisal Standards for Federal Land Acquisitions* (UASFLA), 2016 ed. (Washington, DC: US Government Printing Office, 2016), 39.
30. Appraisal Institute, *The Appraisal of Real Estate*, 15th ed., 345.
31. Harold D. Albritton, *Controversies in Real Property Valuation: A Commentary* (Chicago: American Institute of Real Estate Appraisers of the National Association of Realtors, 1982), 9–10.

Summary and Conclusions

This article demonstrates how both market value and market rent are inextricably tied to the highest and best use of the asset being valued. Although there are other types of value and other types of rent, if the wrong value or the wrong type of rent is estimated, then the result will be the wrong answer to the appraisal problem. As the mini case studies illustrate, that answer could be significantly different than the correct one. Just as there is no concept of "market value in use," there is no such thing as "market rent in use." To clarify this point, a definition of *use rent* has been suggested in this article. Note that use rent might be higher or lower than market rent or equal to market rent—however, it is never synonymous with market rent, although they may at times be the same number. As explained, the type of value sought will influence the type of rent estimated and together they define the appraisal problem to be solved or the question to be answered. Clarifying the distinction among value types and rent types should reduce the likelihood of an appraisal unintentionally answering the wrong question related to market rent.

About the Authors

Barry A. Diskin, PhD, MAI, AI-GRS, is the principal in the firm Diskin Property Research. He is a consulting analyst with Cushman & Wakefield. The focus of his litigation support practice includes eminent domain, property tax, and contamination issues. From the fall of 1980 through the spring of 2015, Diskin was a professor in the College of Business at Florida State University. During his 35 years at FSU, he taught courses in real estate valuation to seniors at the undergraduate level as well as graduate students; he received two university-level teaching awards. Today, his teaching activities continue as a member of the faculty of the Appraisal Institute. Diskin received a master's degree in finance and a PhD in land economics from Georgia State University. Professional designations include the MAI and AI-GRS. He is a member of the Real Estate Counseling Group of America, a group of practitioners and academicians. Diskin has published articles on various topics in such journals as *Real Estate Issues*, *Assessment Journal*, *Journal of Property Valuation and Taxation*, *The Appraisal Journal*, *American Business Law Journal*, *National Tax Journal*, *Journal of Real Estate Research*, *Chartered Property and Casualty Underwriters Journal*, *Right of Way*, *Real Estate Appraiser and Analyst*, *Journal of Real Estate Appraisal and Economics*, *Assessment Digest*, *Real Estate Economics*, and *International Journal of Business Disciplines*. He is a member of *The Appraisal Journal* Academic Review Panel. Diskin has testified in more than forty counties in Florida and in a number of other states, including Maine, Michigan, South Carolina, Arizona, and California. He has appeared before committees of the Florida legislature on several occasions and appeared as a guest expert on national television. **Contact: diskin@diskinproperty.com**

David C. Lennhoff, MAI, SRA, AI-GRS, is a principal with Lennhoff Real Estate Consulting LLC, which is officed in Gaithersburg, Maryland. His practice centers on litigation valuation and expert testimony relating to appraisal methodology, USPAP, and allocating assets of a going concern. He has taught nationally and internationally for the Appraisal Institute. International presentations have been in Tokyo, Japan; Beijing and Shanghai, China; Berlin, Germany; Seoul, South Korea; and Mexico City, Mexico. He has been a development team member for numerous Appraisal Institute courses and seminars and was editor of its *Capitalization Theory and Techniques Study Guide*, third edition. He was the lead developer for the Appraisal Institute's asset allocation course, *Fundamentals of Separating Real and Personal Property from Intangible Business Assets*, and edited the two accompanying business enterprise value anthologies. He also authored the Appraisal Institute's *Small Hotel/Motel Valuation* seminar. Lennhoff is a principal member of the Real Estate Counseling Group of America, a national organization of analysts and academicians founded by the late William N. Kinnard Jr., PhD. He is a past editor-in-chief of and frequent contributor to *The Appraisal Journal*, and a past recipient of the *Journal*'s Armstrong/Kahn Award and a two-time winner of the Swango Award. **Contact: david.lennhoff@gmail.com**

SEE NEXT PAGE FOR ADDITIONAL RESOURCES >

Richard L. Parli, MAI, is president of Parli Appraisal Inc., a full-service appraisal firm located in Warrenton, Virginia. He has been involved in the development of numerous Appraisal Institute courses and seminars, is a coauthor of the Appraisal Institute text *The Valuation of Apartment Properties,* and is a professional faculty member of the Johns Hopkins Carey Graduate School of Business. He has an MBA in finance from the Pennsylvania State University and is a principal member of the Real Estate Counseling Group of America. He is a past recipient of *The Appraisal Journal*'s Swango Award and a three-time winner of the Armstrong/Kahn Award. **Contact: rparli@parliappraisal.com**

Stephen D. Roach, MAI, SRA, AI-GRS, CDEI, has been an appraiser for over forty-two years. His appraisal assignments have included significant and complex assignments throughout the United States. Roach holds a bachelor of science degree in real estate from San Diego State University, and he has extensive deposition and trial testimony experience. Roach is a contributing editor to numerous Appraisal Institute books, courses, and seminars. His Appraisal Institute teaching experience includes basic and advanced courses on income capitalization, litigation courses, and over 200 additional courses and seminars. In addition to teaching courses throughout the United States, Roach has led appraisal courses, seminars, or lectures in Switzerland, Germany, South Korea, Japan, and China. He also has served as a visiting professor of appraisal theory and practice at the International Center for Land Policy Studies and Training in Taipei, Taiwan, since 2004. Roach is a principal member of the Real Estate Counseling Group of America. **Contact: steve@jrcvaluation.com**

Additional Resources

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

Appraisal Institute

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