

FOCUS ON REAL ESTATE ANALYSIS

Comments on the Probability of Rezoning

BY JOSEPH S. RABIANSKI, Ph.D., CRE

IN THE SPRING 2007 EDITION OF *REAL ESTATE ISSUES*, THE concept and definition of highest and best use was discussed in the article, "Comments on the Concept and Definition of Highest and Best Use," which can be accessed online at www.cre.org/publications. Several conclusions regarding highest and best use (HBU) were discussed, including the definition of market value and legal permissibility's impact on HBUs. The definition of market value is based on the economist's perfectly competitive market in which there are no barriers or obstacles to the entry of new firms or the exit of existing firms. Legal permissibility in the HBU process often is a barrier to entry. Because legal permissibility contains an element of manipulation, it could negatively influence the HBU, thus retarding the highest present value to the land or return on improved property. HBU determination and analysis can be flawed if legal permissibility is contrary to the economics of the property market.

THE PROBABILITY OF REZONING

The "probability of rezoning" rests on the issue of legal permissibility, which can be used as a barrier to entry. The result is a flawed rezoning process. The barrier violates the perfectly competitive conditions in the market. The idea and use of legal permissibility will not disappear from the zoning ordinance or the HBU definition, so its existence must be recognized. We must, however, eliminate legal permissibility's effect on HBU analysis by the market analyst and the appraiser.

The "probability of rezoning" is an educated evaluation (an expert's judgment) about the action that will be taken

by the authorities of a local jurisdiction who have the power in the zoning ordinance to impose restrictions on land use. Local authorities base their decisions on any number of factors, such as the best interests of the property owner, the needs of the community, their personal preferences and biases and, in some instances, personal gain. The analyst or appraiser should not be involved in judging the "probability of rezoning" in this context. The analyst, a market expert, should not have to ponder the possible non-market motives of a set of individuals who



About the Author

Joseph S. Rabianski, Ph.D., CRE, is a professor of real estate at Georgia State University. He teaches graduate and undergraduate courses on topics including market and financial analysis, investment and valuation, housing and regional economics and finance. He also teaches professional courses on behalf of organizations such as the Appraisal Institute, the U.S. government and public and private corporations. Rabianski has more than 40 years of experience in the real estate field and has published numerous articles, books and monographs.

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may have non-market motives. The analyst should not judge and attempt to forecast the results of various underlying motives not expressed in the financial feasibility of a property's use.

The appraiser or the analyst, however, is a vital player in determining the financial feasibility of a property. These market experts have the knowledge to gather, array and interpret the facts to make the evaluation. While their knowledge is property market based, their evaluations should not be recognized as a study of the proclivities of the local authorities who may act counter to the desires of the market and the needs of the community.

The Appraisal Institute's *The Appraisal of Real Estate* (12th edition)¹, on pages 311-312, provides the appraiser with ideas about handling the probability of rezoning. The six statements are easily divided into two categories that represent the Appraisal Institute's interpretation. The appraiser is provided four "must considerations" when evaluating market needs:

- Trends in the market area
- The history of zoning requests
- Uses that are not compatible with the existing land uses in the area
- Land assemblage, removal of structures and new construction in the area

He or she must, in reality, keep in mind that the above four items are generally considered to be market driven but in reality each consideration can be subject to direct manipulation by the local jurisdiction.

Two additional items are presented that are subject to direct manipulation by the local jurisdiction:

- Documents such as the comprehensive or master plan
- Uses for which zoning requests have been denied.

According to *The Appraisal of Real Estate*, an appraiser preparing a "land development forecast" for the area "must fully disclose all pertinent factors relating to a possible zoning change, including the time and expense involved and the risk that the change will not be granted." This statement of disclosure should refer to market conditions and financial feasibility and not the personal

views of individuals (zoning officials) who may or may not consider market conditions and financial feasibility.

The appraiser is instructed to "fully disclose all pertinent factors relating to a possible zoning change . . ." Such reporting of the facts requires expert knowledge about the property market and the financial feasibility of the uses on the property. The appraiser can report the value of the property in a current and legal use, as well as in a future use, be it legal or not. The difference in value gives the owner important information that can be used in the decision to seek a rezoning. The appraiser can report a rate of return on the use of the property in a current and legal use as well as in a future use, be it legal or not. The difference in these yield rates gives the owner important information that can be used in the decision to seek a rezoning.

The exact "probability of rezoning" is the concern of the property owner, not the analyst or the appraiser. The analyst and the appraiser provide facts about the financial feasibility of the project in the form of property market value, residual values to the land and/or rates of return. The property owner evaluates these facts (with or without the advice and assistance of the analyst or appraiser) and makes the judgment about the "probability of rezoning."

However, if the market analyst or the appraiser has to step into the issue of the "probability of rezoning" (an educated guess about the action of the entity with powers of manipulation), a standard practice, or "well documented technique" is needed for making the determination. This is the discussion of a subsequent section. But first, a short discussion of the zoning ordinance and the rezoning request seem to be in order.

THE ZONING ORDINANCE AND THE COMPREHENSIVE LAND USE MAP

The zoning ordinance and the comprehensive land use map are developed with the best of intentions. As a police power of the local jurisdiction, the zoning ordinance serves the public interest by eliminating incompatible land uses that would reduce the property values of the citizens of the local jurisdiction. The key word is "incompatible" and the connotation of the word, which economists term "negative externalities," is a land use that has a reducing effect on the market values of adjacent and proximate properties. Often the intent of a zoning ordinance is interpreted as a deliberate act to separate

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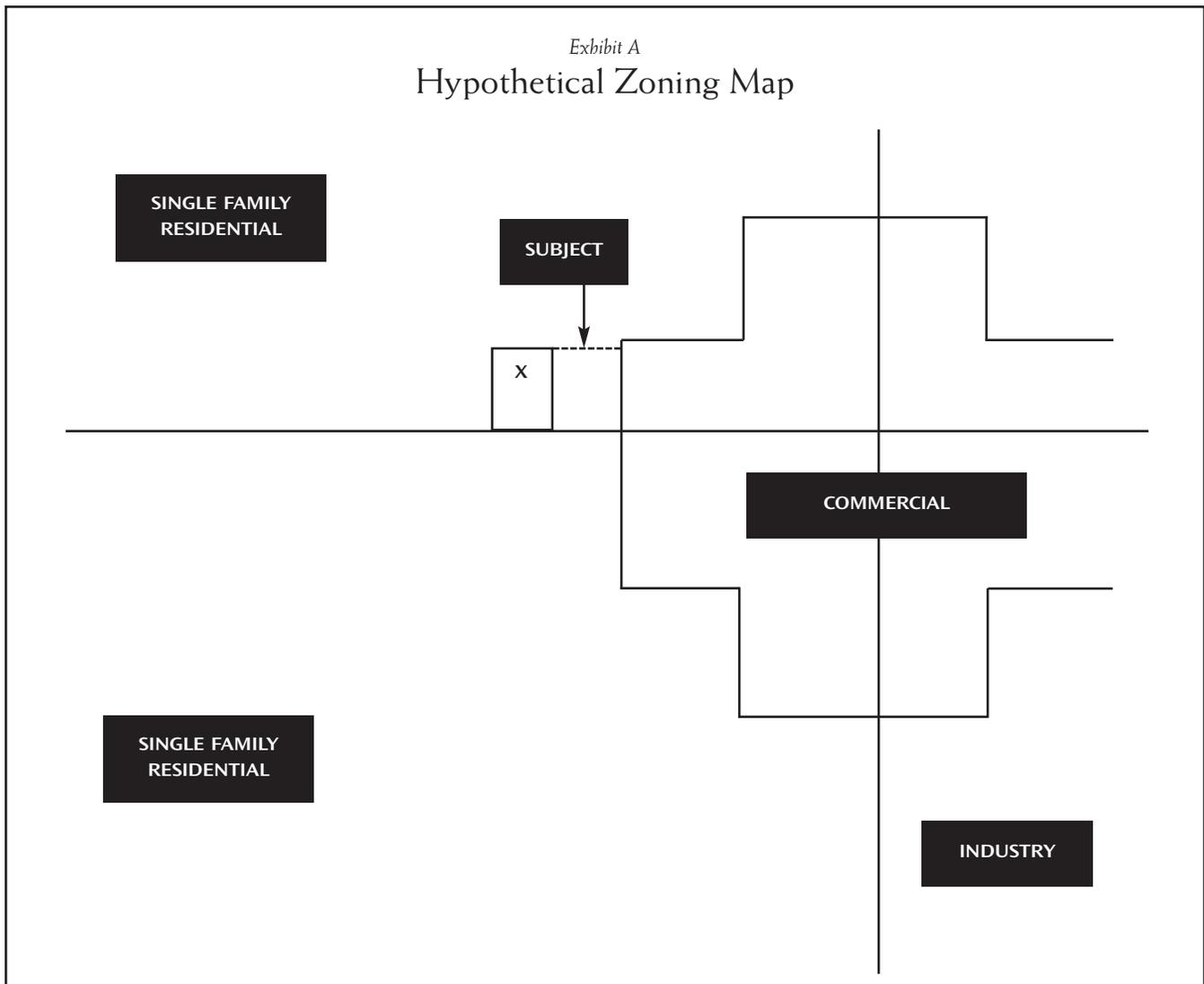
different land uses from each other. Residential land use here, commercial land use there. As a matter of fact, this is the underlying premise when the zoning map is drawn. But economic sense must be applied to the boundaries between land uses. Property value is not singularly affected by the land use on the adjacent property. It also is affected by the land uses in close proximity as well.²

Let us consider a hypothetical illustration (Exhibit A below) to explain how zoning ordinances can separate different land uses. In our hypothetical situation, residential and commercial land uses are economically compatible. Households need retail and retail needs customers.

A subject site, let's call it "Commercial Site S," is being considered for rezoning from residential to commercial.

Will the rezoning of the subject property negatively affect the property values in the residential area? Not if the commercial use is needed by the community and is generally in line with the existing retail and other commercial uses in the commercial district. Will the rezoning of the subject property to commercial negatively affect the property value of property "X"? No more so than if the subject was affected by its location adjacent to the commercial district. If any negative effect occurs, it would be minor because the property is already located in close proximity to the commercial land users.

If the commercial district does pose a negative impact on the residential area, the property values should increase with distance away from the commercial land use. This



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consequence can be investigated in the market area. Observation will generally show that value change will be gradual with small differences among the properties in close proximity to the commercial land uses. At a certain distance, say 1,000 feet, the negative effect should dissipate.

Should the subject property be rezoned? Yes, as long as the proposed commercial use is compatible with both the residential area and the existing commercial district, and the market demands the use to which the subject will be put.

The point of this example? The zoning ordinance is an economic tool. It is driven by the desire to maintain and protect property values and it affects property values. It is supposed to take the market into consideration when the zoning map is drawn and when rezoning requests are being considered. If the local economy and the local property market are dynamic and the changes are for the better and compatible and conform to the existing conditions, the zoning ordinance should be able to change to reflect the economic changes in the geographic market area.

EXPERT DETERMINATION OF THE 'PROBABILITY OF REZONING'

Author J.D. Eaton stated in his book *Real Estate Valuation in Litigation* that the "probability of rezoning is fertile ground for the unscrupulous, the naive and the dreamer."³ This statement can reflect the motivation of both parties to a rezoning situation. The property owner and the rezoning decision authority, in addition to being biased, can both be guilty of these traits. Under current thinking, the probability of rezoning needs to be determined by an unbiased and knowledgeable third party to the process with documented support for the conclusion. This third party is the appraiser and/or the market analyst. It should not be the owner of the property. It should not be an official of the local jurisdiction who could be protecting the status quo of the comprehensive plan when it does not make economic sense to do so. The judgment about the probability of rezoning should come from a market analysis of the immediate economic and physical environment of the subject property.

The current legal land use restrictions on the subject property and the immediate environment are considerations in the analysis. The more important considerations are the existing land uses and financial feasibility of improved neighboring properties and the financial feasi-

bility of neighboring vacant land. In the end, however, the probability of rezoning is an estimate of the local jurisdiction's willingness to allow the land use change. This willingness to change may not reflect current or future market conditions, and it allows the local jurisdiction to manipulate the HBU decision.

The determination of the market analyst or appraiser of the probability of rezoning should not be determined by the judgment of what the zoning authority might or might not allow. Pragmatism currently forces market analysts and appraisers to make such a judgment to assess the probability of rezoning. Their task is to judge the actions of individuals but not the actions of the property market. The economist will say that the market impediment, the zoning authority, dictates the conclusion instead of the free and unobstructed operation of the real property market. The economist will say that the zoning authority is a barrier to entry. Such barriers are an important element in a monopolistic market situation. It is not the perfectly competitive market situation discussed in Part I of this article, "Comments on the Concept and Definition of Highest and Best Use" that is the underlying economic theory for the definition of market value. The zoning authority through the operation of the zoning ordinance can impede the operation of the competitive market and thereby affect HBU and market value of the property.

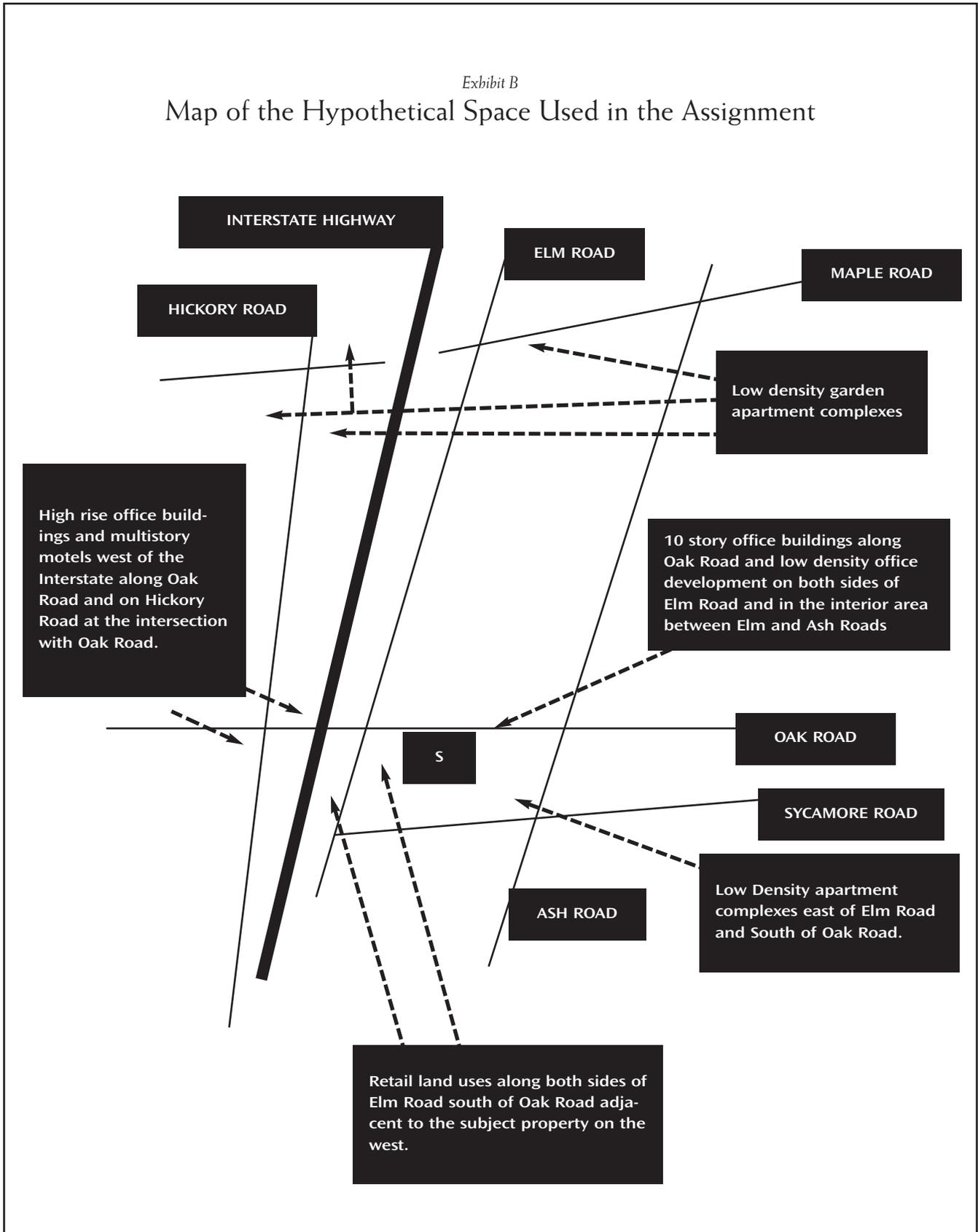
REZONING JUSTIFICATION ANALYSIS

What is needed is a new phrase to identify the role of the market analyst or appraiser and to replace "the probability of rezoning." "Rezoning justification analysis" is a term that would meet this requirement. There are no probabilities; there are no judgments about the actions of specific local officials. It is an evaluation of the facts drawn from the property market. Is it financially feasible to use a currently illegal use at some point in time – now or in the future? The financial feasibility of the illegal use is estimated and compared to the financial feasibility of the current legal use. If the illegal use is "maximally productive," then a rezoning request could be warranted. The financial return from the rezoning should exceed the cost of the rezoning process.

AN ASSIGNMENT

A recent evaluation assignment of a partial taking brings this issue to the forefront. Let us take a look at another

Exhibit B
Map of the Hypothetical Space Used in the Assignment



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example of rezoning. Exhibit B (on page 29) provides a map of the immediate area next to the subject property. The subject property is a seven-acre site serving as a single family residence but is zoned as multifamily residential. It has substantial frontage on Oak Road, just east of the intersection with the Interstate. The local jurisdiction has taken in excess of one acre of the site by taking a 120-foot wide strip of land from the entire front of the site along the 360 feet of frontage the site has along Oak Road. Adjacent to the west of the subject site are two recently developed retail outparcels along Oak Road: a new neighborhood shopping center and a power center are under construction along the east side of Elm Road heading south. Across Elm Street are free-standing retail establishments. Across Oak Road from the subject property are recent high-rise office buildings facing Oak Road with mid-rise office buildings in the area behind the high-rise office buildings. East of the subject property are the entrances to two low density garden apartment complexes that are 10 to 15 years old. Further east along both sides of Oak Road is a mixture of free-standing retail establishments, motels, unanchored strip centers and more garden apartment complexes. Apartment complexes also exist further north of Oak Road, on both Elm Road and Hickory Road. The subject site is the high ground in the neighborhood. The land slopes down east of the subject property along Oak Road and southeast through the low rise apartment complexes. This topological feature provides the subject property with a scenic view of two high-rise office nodes to the north, one to the south, and one office node to the east.

Without the benefit of financial analysis, what is your judgment about the process of determining the HBU of the subject property based on a qualitative analysis of the economic and physical environment in which the subject property exists?

Here is my opinion about the HBU process based on the development of compatible and complimentary adjacent and proximate properties: The subject site should be tested for high-rise office use and high-rise, high-density apartment use. Also, it should be tested for general retail use. These three property types are financially feasible in the immediate area of the subject property and these three uses for the subject property have a high probability of being financially feasible in this market. One of them

could be the maximally productive use for the site, but this will not be known without the analysis.

The representatives of the local jurisdiction (planning director and county attorney) insist that the comprehensive plan will not change with regard to this site. This decision was made without any formal financial analysis; there was no HBU consideration and their opinion of value was based solely on continuation of the existing zoning and thus the development of the site as a low density apartment complex. These local representatives determined that this would be consistent with the existing apartment developments on that side of the road and behind the subject site. All three land use prospects for the HBU that appear to be good prospects for a financial feasibility test are eliminated by the power of the local jurisdiction. Moreover, by dictating the ultimate use, the local jurisdiction controls the price for the land by stating that only low-rise, low density apartment-comparable properties are permitted in the sales-comparable method. The value of land for garden apartment development was approximately \$200,000 per acre, while the value of commercial land was in the range of \$600,000 to \$900,000 per acre.

The county appraiser's HBU analysis was limited to low-rise apartment development, not by the market but by administrative fiat. This is not HBU analysis in a free and competitive market. The authorities of the local jurisdiction imposed a substantial barrier to the value of the land analysis in order to control the price they had to pay for the taking.

The market analyst or the appraiser cannot change the authority of a local jurisdiction to impose a zoning ordinance or to allow a rezoning. But, the appraisal and market analysis professional can change the way it defines the market potential of a property in our free market economy. Consider the following suggestions for the HBU as vacant and HBU as improved definitions. They are the same definitions offered in Part I of this article, "Comments on the Concept and Definition of Highest and Best Use," but they contain new clauses, which are underlined:

The HBU of a vacant land is the most financially feasible use from all uses that can be supported by freely competitive and (legally and physically) unobstructed current and future property market conditions, that is compatible with

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existing adjacent and proximate land uses, that serves the economic needs of the local community, and that generates the highest present value to the land.

The HBU of an improved property is the most financially feasible use from all uses supported by freely competitive and (legally and physically) unobstructed current and future property market conditions that is compatible with existing adjacent and proximate land uses, that serves the economic needs of the local community, and that generates the highest financial return to the property.

These definitions can be modified to specify the need for compatibility and conformity among property types by adding the following phrases to the definitions: “compatible with existing adjacent and proximate land uses, and serving the economic needs of the local community.”

Under these definitions, the HBU is the use of the property, based on free market factors, judged by the appraiser to be the most financially feasible, compatible and economically desired use in the various current and prospective property markets.

What if the HBU is not a “legally permissible use” but an “illegal” use that the market will support? In terms compatible with the above definition, what if the HBU is not a current use that conforms to the zoning ordinance but its use is financially feasible but does not conform to the existing zoning ordinance? The appraiser’s responsibility to the client, the property owner in this situation, is to report the HBU. If the HBU is not a legal use, then the appraiser’s analysis can be used in the public hearing to request (appeal, beg or plead) to have the local zoning authority convert the illegal use to legal. On the other hand, if the local jurisdiction is the client, the appraiser’s responsibility to the client is also to report the HBU. To do otherwise would be unethical.

REZONING JUSTIFICATION ANALYSIS REVISITED

This article calls for the appraiser to move away from attempting to judge the “probability of rezoning” because it is a judgment about an impediment in the free market that is subject to manipulation and monopolistic control by the local government. The market analyst and the appraiser are well qualified to judge the financial feasibility of a vacant or improved property use. The judgment is well grounded in market factors rather than in the powers of government that can be easily manipulated.

In order to eliminate confusion, “rezoning justification analysis” should replace the “probability of rezoning” in the appraisal literature. Consider the following definition for “rezoning justification analysis:”

Rezoning justification analysis is the application of financial feasibility as determined by the market analyst’s or appraiser’s expert judgment. The rezoning justification is high if the proposed use for the subject property is financially feasible whether it is permitted or not by the current zoning for the subject property.

Under this concept of “rezoning justification analysis,” the appraiser can test financial feasibility of any and all “illegal” uses and show the extent of the effects of the rezoning on the subject property and the market area. The rezoning itself is beyond the scope of the market analyst’s or appraiser’s assignment. The market expert provides the evidence to evaluate the rezoning request. The financial feasibility can be tested. The compatibility and conformity can be evaluated. The rezoning justification is a matter that the market expert can research, evaluate and report.

The actual rezoning decision is a different matter. The probability for rezoning is a situation faced by the owner of the property and the decision rests in the hands of others. The rezoning justification rests on the facts provided by the market expert. The decision to rezone can pass or fail for other reasons not covered in the market expert’s analysis.

Consider the following simple cases as an example of rezoning justification analysis.

Case I: The value of the land in apartment use in the current market is \$400,000 per acre for high density apartment development. Land value is \$350,000 per acre in office use, which is not legal for the site and not prevalent in the area. A rezoning request is not financially appropriate in this case because the land value in the illegal case is less than the current legal use.

Case II: The value of the land in apartment use in the current market is \$340,000 per acre for high density apartment development. Land value is \$380,000 per acre in office use, which is not legal for the site but does exist in close proximity. A rezoning request is financially appropriate but only if the cost to obtain the rezoning is less than \$40,000 per acre.

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In these cases, the market expert reports what is obtained from market evidence. The property owner can determine if the benefits from rezoning will cover the costs of obtaining the rezoning.

CONCLUSION AND SUMMARY

The judgment about the "probability" of rezoning relies, in part, on market information. Zoning officials can affect the outcome of a rezoning request for a variety of reasons. Some of these reasons are based on market considerations and sometimes community concerns. Personal bias also can play a part. When personal bias comes into play, the zoning process is manipulated and thereby a violation of the perfectly competitive market situation. The analyst or appraiser should not have to make this judgment about probability. He or she should provide evidence concerning a rezoning. Is it financially feasible for the landowner? This form of the analysis is

rezoning justification analysis; it considers only the market information to judge the HBU of the land or the improved property. ■

ENDNOTES

- ¹ The Appraisal of Real Estate, 12th edition. (Chicago: Appraisal Institute)
- ² The Principles of Conformity and Externalities come into consideration here. "Conformity holds that the real property value is created and sustained when the characteristics of the property conform to the demands of the market (*Appraisal of Real Estate*, p. 41) "The principle of externalities states that factors external to a property can have positive or negative effect on its value". (*Appraisal of Real Estate*, p. 42)
- ³ J.D. Eaton. *Real Estate Valuation in Litigation*, 2nd edition (Chicago: Appraisal Institute, 1995, p. 143)