

The principle of change and ‘highest and best use’

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What’s the Deal By Daniel Lesser

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(The views and opinions expressed in this blog are strictly those of the author.)

Real property is in a constant state of flux and change, affecting individual assets, neighborhoods and cities. Economic, environmental, government and social forces affect all markets, particularly real estate. Highest and best use often is identified as the key concept supporting real estate use and value decisions.

The highest and best use of a specific parcel of land is shaped by the competitive forces within the market where a property is located. The market value of real estate, predicated on highest and best use, represents a photograph at a certain point in time within its constantly changing environment.

With the global COVID-19 pandemic spreading to and across the U.S., coupled with governmental stay-at-home orders locking down major urban markets, thousands of lodging facilities throughout the nation have temporarily, and in many cases, permanently ceased operations. In hard-hit New York City, dozens of hotels have shut down as demand from all segments has declined substantially.

The Hotel Pennsylvania, which closed its doors on April 1, has furloughed more than 400 employees. For nearly 25 years, Vornado Realty Trust, owner of the 1,700-room hotel, has wanted to redevelop the site at 401 Seventh Avenue, across from Penn Station and Madison Square Garden. The notion of the hotel’s demolition was introduced in 1997 when VNO acquired the property. VNO announced again in 2007 the hotel would be demolished to make way for 15 Penn Plaza, a new office building with Merrill Lynch & Co. as anchor tenant.



Preservation activists rallied to save the nearly century-old hotel, but the Great Recession that began in December 2007 and concerns regarding Merrill Lynch’s solvency that resulted in that firm’s September 2008 sale to Bank of America at the height of the financial crisis. The proposal to erect the planned 2.5-million square-foot tower collapsed. While in 2007 the highest and best use of the Hotel Pennsylvania site appeared to be razing the structure and constructing a new office tower, just one year later the global financial crisis rendered the economic feasibility of that proposed development untenable.

A 2010 vote by the New York City Council approving construction of 15 Penn Plaza as a more than 2.0 million-square-foot office building on the site of the Hotel Pennsylvania, was perceived at the time as most likely the final chapter of this storied hotel’s economic life. But in late 2011, weak market conditions delayed the structure’s demolition, and by 2013 the plan was abandoned. Although VNO announced a renovation of the hotel in 2018, its special permits regarding the proposed redevelopment with the NYC Planning Commission were renewed. During a Q1 2020 earnings call, Steven Roth, VNO’s founder and chairman, referred to the Hotel Pennsylvania as “a parking lot for a development site” and further stated, “We have thought internally about using this and just never reopening it.” Many perceive the reference to “this” meant the opportunity of using the recent closure to revisit VNO’s long-term goal to redevelop the prime site.

During 2008, the interim highest and best use of the property evolved to the continued use of the site as a functionally and physically obsolete hotel until such time when a proposed redevelopment of the site again became financially viable. It now appears the economic

feasibility of tearing down the Hotel Pennsylvania and developing a major office building on the site will once again turn positive in the near term.

What does highest and best use involve?

Highest and best use often is identified as the key concept supporting real estate use and value decisions. The highest and best use of a specific parcel of land is not determined through subjective analysis but rather by the competitive forces within its market.

The exact definition of “highest and best use” varies, but it generally is the most probable use of land or improved property that is legally physically possible, financially feasible (and appropriately supportable) from the market and which results in maximum profitability.

An analysis of highest and best use involves two considerations:

1. The most likely and profitable use of the site "as if vacant" under the requirements set forth above.
2. If a property is "already improved," “highest and best use” is the use that should be made of the property to maximize value for non-income-producing properties or, maximize net operating income on a long-range basis for investment properties. In cases where capital expenditure is necessary to renovate or improve an income producing property, these costs must provide a sufficient rate of return (to the owner) for the total amount invested in the site and building improvements.

The highest and best use as vacant land may be the same or different as the highest and best use as improved.

If a property is situated in an area zoned for commercial use, the maximum productivity of the land as though vacant will likely be based on commercial use. If, however, the competitive level of demand is greater for say, residential or multi-family use, then the highest and best use of the property as improved would be for residential use. If market preference conflicts with zoning, and consequently violates the legal permissibility test, a developer will consider if there is sufficient profit incentive to justify the added legal costs, extended time frame, and potential neighborhood opposition before obtaining a zoning change and developing the site.

So long as the value of a property "as improved" is greater than the value of the site as "if vacant," the highest and best use is typically the "improved" property. Once the value of the vacant land exceeds the value of the improved property (including demolition costs), highest and best use usually dictates that the improvements be demolished.

Like the Great Recession, the COVID-19 pandemic is causing a dramatic resetting of commercial real estate values, as well as new development and redevelopment construction costs. This phenomenon, along with a bottoming out of the market, has investors now looking to deploy the tremendous amounts of stockpiled equity capital that has recently been raised, to effectuate the highest and best use of a variety of commercial real estate assets throughout the nation.

As debt becomes more readily available, all types of real estate transaction activity will continue to increase. Such deals will include the development of myriad new real estate projects, as well as the re-development of older assets that are ripe for investment of capital expenditures to extend the economic life of existing improvements.

Like perceived value of an asset, the highest and best use of property is dynamic and changes and evolves over time, sometimes overnight. Clearly, the highest and best use of a proposed hotel site situated in lower Manhattan was dramatically different on September 10, 2001, when compared with 24 hours later.

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