Competition & Markets Authority

Appendix A: Profitability analysis

Introduction

A.1 We have assessed the profitability of the 12 largest housebuilders[1] to understand whether their levels of profitability were consistent with the levels we might expect in a competitive market. If profits are above the levels that we would expect in a competitive market and have been sustained over a sufficiently long period of time, this could indicate that competition may not be working effectively.

A.2 This appendix sets out our methodology for, and results of, assessing the profitability of these housebuilders. We cover:

(a) the scope of our profitability analysis;

(b) our approach to undertaking this analysis; and

(c) the results of our analysis.

A.3 In undertaking the analysis, we consulted with the 12 largest housebuilders on our proposed methodology and how we were planning to use their financial information. We explain throughout the appendix how we have taken their feedback into account.

Methodology for profitability analysis

A.4 In this section, we explain how we have assessed the profitability of the 12 largest housebuilders.

A.5 We cover:

(a) the scope of our profitability analysis; and

(b) our approach to undertaking the analysis.

Scope of our analysis

A.6 We set out below the scope of our profitability analysis, highlighting which business activities we consider to be relevant, the geographical area we have covered, which firms we have analysed and the time period over which we assessed profitability.

[1] In October 2022, one of the large housebuilders in our sample, Vistry, acquired another of the large housebuilders, Countryside. Vistry supplied separate responses in respect of its own historic operations and in relation to Countryside. We therefore have the financial information to analyse the historical profitability of 12 largest housebuilders.

Business activities

A.7 We consider the following activities that the largest housebuilders undertake to be relevant for the purposes of our profitability assessment:

(a) securing land for future development;

(b) obtaining planning permission (and putting in place various agreements with the appropriate authorities);

(c) building the properties; and

(d) selling the properties.

Geographical area

A.8 In line with the scope of our market study, we seek to assess the large housebuilders' GB activities only.

Relevant firms

Introduction

A.9 We sought financial information from the 12 largest housebuilders in GB (based on the revenue they generated in 2021 and 2022):

(a) Barratt;

(b) Bellway;

(c) Berkeley;

(d) Bloor Homes;

(e) Cala Homes;

(f) Countryside;

(g) Crest Nicholson;

(h) Miller Homes;

(i) Persimmon;

(j) Redrow;

(k) Taylor Wimpey; and

(l) Vistry.

A.10 According to our calculations, these 12 largest housebuilders in GB generated combined revenues of over £400 billion in December 2022 prices during the 20-year period to 2022.[2] These housebuilders delivered around 40% of total housing completions in both the year to March 2022 and the year to March 2023.[3]

Parties' views

A.11 One large housebuilder stated that we should extend our analysis beyond the 12 largest housebuilders, as our methodology meant that we could not robustly draw conclusions as to whether there were features of the market that favoured the top 12 housebuilders.

A.12 Another large housebuilder disagreed with our understanding that all of the large housebuilding firms active at the time of the global financial crisis (GFC) survived that crisis and remain operating today. This large housebuilder told us that several large housebuilders[4] required significant financial restructuring to manage their debt due to substantial losses incurred during the GFC. Various banks, this large housebuilder explained, had taken control of these housebuilders, subsequently re-floating or selling them to private equity or new shareholders. Those housebuilders had therefore been at high risk of being liquidated and had only avoided that fate by agreeing to being taken over by their main lenders. Initial investors, this large housebuilder explained, suffered irremediable losses since the equity value of those housebuilders had come close to zero.

A.13 Similarly, a further large housebuilder told us that we were minimising the impact of what happened to housebuilders which suffered financial difficulty during the GFC.

Our view

A.14 The CMA's guidelines for market investigations (CC3 (Revised)),[5] acknowledges that in many cases, our focus will be on the largest 'incumbent' firms in the market.[6] In this case, we are particularly interested in understanding whether features of the market favour large housebuilders[7] and whether they have had

[2] We have inflated figures over the 20-year period to December 2022 prices using CPIH.
[3] Sources: CMA analysis of: various large housebuilders' annual reports and accounts and government statistics; Housing supply: net additional dwellings - GOV.UK; Housing supply: net additional dwellings - GOV.UK; Housing statistics quarterly update: new housebuilding and affordable housing supply (gov.scot); New house building (gov.wales).
[4] This large housebuilder specifically referred to [✂], [✂], [✂], [✂] and [✂].
[5] We consider that these guidelines are relevant to our profitability analysis in this market study.
[6] CC3 (Revised), paragraph 114.
[7] See Statement of Scope, paragraphs 2.23 c) and d) and 2.25.

high levels of profitability relative to their cost of capital[8] which may suggest they have market power.

A.15 We have included within our analysis four of the five large housebuilders to which the other large housebuilder referred. Their financial restructuring often involved multiple changes of the legal entity through which their GB housebuilding activity was conducted. Our view is that, although ownership may have changed hands over the period, and in some cases more than once, these businesses remained solvent throughout the period concerned. The fifth housebuilder that the other large housebuilder referred to[9] is a developer and manager of retirement communities, rather than a pure housebuilder, and therefore is outside the scope of this market study.

A.16 We therefore consider that our analysis has appropriately taken into account the performance of the 12 largest housebuilders across the 20-year period of review.

Time period under consideration

A.17 We aim to examine profitability over a time period that is sufficiently long to provide a representative picture of profitability and that is not unduly distorted by unusual macroeconomic conditions or one-off events. CC3 (Revised) recognises that the appropriate time period may vary depending on the specific market.[10]

A.18 As the housebuilding market is highly cyclical and impacted by external factors such as the wider economic climate, we wanted to understand how the level of profitability changed over a long period. We have therefore analysed the 20-year period from 2003 to 2022 inclusive. For the reasons explained at paragraph A.26 we have analysed profitability for each year within the 20-year period.[11]

Approach to our profitability analysis

Selection of profitability measure

CC3 (Revised)

A.19 The analysis of profitability as a means of understanding competitive conditions in a market is based on the premise that in a competitive market, firms would

[8] See Appendix B Cost of capital
[9] [✂]
[10] CC3 (Revised), paragraph 121.
[11] Furthermore, we calibrate our estimate of the cost of capital for large housebuilders to each period of the 20-year period. See Appendix B Cost of capital, *Our approach to estimating the cost of capital*, *Relevant time period*.

generally earn no more than a 'normal' rate of profit.[12] CC3 (Revised) defines a 'normal' level of profit as:

> 'the minimum level of profits required to keep the factors of production in their current use in the long run, i.e. the rate of return on capital employed for a particular business activity would be equal to the opportunity cost of capital for that activity.'

A.20 The opportunity cost of capital is measured by the weighted average return on capital[13] which investors expect for providing capital to firms undertaking the in-scope activities. This can be thought of as a market-based return on investment to compensate investors for providing money to firms in the market.

A.21 The rationale for comparing return on capital with the opportunity cost of capital is that in a competitive market, if firms persistently earned in excess of the return required to compensate investors for the risks taken, we would expect entry and/or expansion. This entry/expansion would serve to compete away profits[14] in excess of the cost of capital up until the point where firms cover their total costs, including a market-based cost of capital and no more. Where firms persistently earn in excess of a normal return, this signals that there may be limitations in the competitive process.

A.22 CC3 (Revised), therefore, refers to the rate of return on capital as a means of measuring profitability. Return on capital can be based on profits (return on capital employed (ROCE)) or cash flows (internal rate of return (IRR)). The appropriateness of a given measure will depend on the nature of the industry and the pattern of investment.[15]

A.23 It is our usual practice to measure profitability on an operating basis, thereby excluding the impact of interest and tax. This means that profitability can be assessed independently of the choice of capital structure of individual firms.

Parties' view

A.24 Some large housebuilders told us that IRR or net present value (NPV) metrics would be preferrable over ROCE when assessing economic profitability, as economic profitability assessments should account for the time value of money, and given that significant upfront capital was often required in the housebuilding sector, the timing of cashflows was particularly relevant and this timing aspect was

[12] CC3 (Revised), paragraph 116.
[13] Specifically, the mean ex ante expected return on capital of debt and equity holders, weighted by gearing.
[14] The time period over which this process may take place may differ between different sectors due to the time taken for entry and/or expansion of capacity.
[15] CC3 (Revised), Annex A, Market characteristics and outcomes, Measuring profitability, paragraph 10.

not necessarily reflected within a straight comparison of the outturn ROCE to the cost of capital.

Our view

A.25 We understand that housebuilders, once permission for development has been granted, generally seek to quickly convert subsequent investment in their housing developments into cash wherever possible, and that ROCE is a key metric that they use to evaluate firm-wide performance and inform investment decisions.

A.26 We are seeking to assess profitability at the firm-level, which means analysing the profitability of each firm's portfolio of developments, rather than focusing on the profitability of any individual development. We consider that ROCE is more relevant to assessing the profitability of a sector which operates on such a portfolio basis. That is because it enables us to observe trends in profitability over time and to seek to interpret those trends in the light of the evolving context and events occurring over that time. Period-by-period analysis also lends itself to identifying the incidence over the period of any windfall gains and losses, which are a feature of this market.

A.27 We are also seeking to assess profitability from a common start period (2003) to a common end period (2022) regardless of the start and end dates of individual developments, something which the ROCE approach to analysing profitability easily accommodates.

A.28 When we use cash flows rather than accounting information for the purposes of profitability analysis we use truncated IRR. The IRR calculation is truncated in that it covers a defined period of time which is shorter than the lifetime of the business or spans several ventures (such as individual housing developments), necessitating the need to place a value on opening and closing values for capital employed for each individual development. Truncated IRR provides a single result for the whole time period analysed rather than a separate result for each reporting period within the overall time period.

A.29 There are a number of other reasons why ROCE is a valid way to assess the profitability of the 12 largest housebuilders in GB:

(a) Capital employed, the denominator in the calculation of ROCE, reflects the extent to which housebuilders use external finance to support their operating activities.

(b) The ROCE approach seeks to take account of the time value of money by seeking to place appropriate values on capital employed.

(c) We align the capital employed in the business across the year with the costs reported in the profit and loss account in that year, an approach that is also

reflected in all the computations of ROCE that large housebuilders report in their annual reports.[16]

(d) ROCE (based on the large housebuilders' accounting information) reflects all of the operational costs incurred by these housebuilders. Therefore, ROCE in this case provides a fully inclusive measure of profitability.

Economic versus accounting profitability

A.30 CC3 (Revised) sets out that our approach will often be to start with reported numbers in line with UK Generally Accepted Accounting Principles (GAAP) and then to make adjustments to arrive at an economically meaningful measure of profitability, usually in terms of rates of return on capital.[17] Deriving an economically meaningful measure of profitability from accounting data, in practice, may require adjustments to accounting information provided to us prepared on the basis of which firms report externally.

A.31 Below we discuss those areas where we may need to make adjustments to the accounting information we have received from the large housebuilders to derive an economically meaningful measure of profitability.

Intangible assets

A.32 When attempting to calculate the appropriate value of intangible assets for assessing profitability for competition purposes, there is a risk of creating a circularity: a return on assets (ie either ROCE or truncated IRR), when those assets are valued in a way that would capitalize any future excess profits accruing from the exercise of market power, is not a useful indicator of whether or not there are any such excess profits, and, hence, whether market power exists. Given the reason for our examination of profitability, we were conscious that any approach to measuring intangible assets needed, as far as possible, to avoid capturing any 'excess profits' or value attributable to the possession of market power in the future.

A.33 For this reason, CC3 (Revised) states that we may consider the inclusion of certain intangible assets where the following criteria are met:

(a) it must comprise a cost that has been incurred primarily to obtain earnings in the future;

(b) this cost must be additional to costs necessarily incurred at the time in running the business; and

[16] We achieve this by averaging opening and closing operating capital employed for the reporting period.
[17] CC3 (Revised), Annex A, Market characteristics and outcomes, Measuring profitability, paragraph 9.

(c) it must be identifiable as creating such an asset separate from any arising from the general running of the business.[18]

Goodwill

Introduction

A.34 Goodwill is the difference between the price paid by one firm for another firm above the sum of the values ascribed to the individual assets and liabilities acquired on the date of acquisition. In essence, it can normally be thought of as the premium paid to acquire an up and running business as opposed to simply seeking to purchase the separable assets of the business from a number of potentially different sources.

Parties' views

A.35 One large housebuilder told us that any acquisition of one housebuilder by another housebuilder was, in essence, a land deal. In other words, the acquiring housebuilder would simply be seeking to acquire the land held by the other housebuilder. Any premium on acquisition should, in its view, therefore, not be recognised as goodwill but instead should be reflected within the value for land so acquired. This large housebuilder, it explained, did not itself recognise goodwill on its balance sheet in such circumstances.

A.36 This large housebuilder also told us that accounting practice varied across the large housebuilders, with some of them recognising goodwill balances when acquiring other housebuilding firms and some not. If housebuilders adopted the former approach of recognising goodwill on their balance sheets, then, as and when they subsequently developed the land so acquired, they did not get to expensing the cost of that land through their profit and loss, as they would have had to have done with land they had directly acquired themselves.[19] That treatment, this large housebuilder explained, increased their profits, and therefore their reported profitability, by omitting the cost of land.

A.37 Two further large housebuilders told us that they did not recognise goodwill on their balance sheets.

A.38 A fourth large housebuilder told us that within its goodwill balance were amounts relating to options relating to strategic land that it had acquired when buying other housebuilding firms. These options had had to be classified as goodwill rather than

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[18] CC3 (Revised), Annex A, Market characteristics and outcomes, Measuring profitability, paragraph 14.
[19] This is because goodwill recognised on acquisition is considered to be an asset with indefinite life. A firm would only be able to subsequently write down the value of goodwill, if the cash generating unit (CGU) to which it was associated was expected not to earn an economic return ie that the CGU would not be able to earn its cost of capital on that goodwill.

included within land as, at the point when it acquired them, it had not known which particular options it would subsequently want to exercise. This large housebuilder requested that we include these assets within its capital employed.

Our view

A.39 We understand that many housebuilders consider goodwill to represent the intangible value of their past acquisitions which contribute significantly to the returns they are able to generate subsequently. We, however, do not typically include goodwill within operating capital employed as it reflects the premium paid for assets acquired which could be an indication that they are expected to generate returns above the cost of capital. As explained in paragraph A.32, we wish to avoid introducing circularity into our analysis.

A.40 The costs of operating a well-regarded, successful housebuilding business include the cost of actively marketing developments once built and building relationships with key stakeholders, such as local authorities, landowners and selling agents. We would therefore include the costs associated with these activities in our analysis in the period in which they are incurred and not seek to recognise this sort of expenditure as creating an asset.

A.41 As described in paragraphs A.35 to A.37 above, we have learnt from three large housebuilders that there is a good case for viewing 'goodwill' as part of the value of the landbank acquired, the gaining of which is invariably a major driving force for such acquisitions. Given the way this market operates and how land is valued (residual valuation methodology[20]), this logic appears to have considerable merit. This logic is also consistent with why the large housebuilder we refer to in paragraph A.38 wanted us to include within its operating assets that part of its goodwill relating to strategic landbank options.

A.42 However, including goodwill within our measure of operating capital employed on the grounds that it really represents an increment to the value of the land being acquired, would lead to the situation of capital employed of the housebuilders affected being permanently inflated under most circumstances. This is because this capitalised value would not be reduced (by means of a transfer to the profit and loss account) as and when the homes subsequently built on these parcels of land are sold off.[21]

A.43 Due to the divergence in accounting practice across the large housebuilders as to whether the 'premium' paid on acquisition of another housebuilding firm is rolled

[20] See Section 7 of the supporting evidence document, *The role of land for housebuilders*.
[21] The exceptions to 'most circumstances' would be where either a) following a deterioration of house prices in the relevant local market, the goodwill became impaired or b) as in the case of the large housebuilder referred to in paragraph A.38, an accounting workaround has been devised, to reduce the value of the 'goodwill' in line with the build out, often over several years, of the relevant parcels of land.

up into the value of land acquired or, instead, recognised as goodwill, measures of profitability for individual large housebuilders will not be fully comparable across the 20-year period of review.

A.44 To reflect the different accounting practices of the large housebuilders, we have developed two profitability measures, one which excludes goodwill as an element of capital employed, and any related write-downs within operating profit, and one which includes both of these components.

Brands and contract assets

A.45 We understand that many housebuilders consider:

(a) the reputation of their brands to be a key factor in marketing and selling their houses; and

(b) that there is value associated with their reputation and relationships with key stakeholders, which is not reflected in its asset base.

A.46 Some of the large housebuilders recognise a brand asset on their balance sheet when they purchase another brand. This situation is typically the result of one housebuilder acquiring another and then deciding to keep the brand name of the acquired firm going in order to present to its prospective customers two distinct retail offerings, typically one more upmarket than the other.

A.47 One large housebuilder which has brand assets described in its most recent annual report and accounts its accounting policy regarding these assets as follows:

> 'Internally generated brands are not held on the balance sheet. The group carries assets on the balance sheet only for brands that have been acquired. Acquired brand values are calculated based on discounted cash flows. … The acquired brands are tested annually for impairment by performing a value in use calculation, using a discount factor based on the group's pre-tax weighted average cost of capital, on the branded revenue stream.'

A.48 Two of the large housebuilders also recognised contract assets on their balances sheet, thereby recognising the value of specific contracts acquired when purchasing another firm on their balance sheets.

A.49 We do not include brand assets or contract assets in our calculation of ROCE, as we do not consider these assets to be identifiable as an asset separate from any arising from the general running of the business. The rational for this approach is that these type of 'assets' represent, as explained by this large housebuilder's accounting policy for recognising and valuing its brand assets, the capitalisation of

expected future profits beyond a normal return (ie the cost of capital). So if they were to be included in our analysis, they would obscure whether firms were in fact earning excess returns.

Other intangible assets

A.50 Following the logic set out in paragraphs A.32 to A.33, other intangible assets which satisfy the criteria, whether internally generated or externally purchased, such as IT software, have been recognised as a valid operating asset within our analysis.

Amounts owed to landowners

Introduction

A.51 When negotiating with landowners to purchase land, large housebuilders sometimes seek to settle payment of the agreed purchase price in a number of instalments. Where housebuilders and landowners agree terms which include deferred payment, housebuilders are required to recognise as liabilities on their balance sheets any amounts due for payment in the future. These liabilities, which we call ‘amounts owed to landowners’, are usually referred to as ‘land creditors’ or ‘land payables’ in the accounts of the large housebuilders.

Parties’ views

A.52 Several large housebuilders told us that they regarded the amounts owed to landowners as representing a source of finance, thereby increasing the value of their operating capital employed. One of these large housebuilders noted that the purchase price agreed included a premium to compensate for the opportunity cost to the landowner of not obtaining payment earlier.

A.53 Another large housebuilder, however, told us that it did not agree with this approach as landowners were not equivalent to banks or other firms whose purpose was to supply external finance to businesses such as housebuilders. This large housebuilder also favoured the following of standard accounting practice within this analysis, rather than the picking and choosing of particular accounting policies that produced a particular outcome, as would be the case here. However, because the lending banks included land creditors in their calculations of gearing for covenant testing purposes, we should, this large housebuilder advised, take account of this feature qualitatively.

Our view

A.54 We understand that housebuilders can treat amounts owed to landowners internally as a source of finance to avoid their staff being incentivised unduly to

use delayed payment to landowners over cash or bank debt to fund land purchases.

A.55 We, however, have not made this adjustment to the large housebuilders' reported capital employed, as we consider delayed payment to landowners to represent (temporary) funding by suppliers rather than a source of finance from investors. Credit extended by landowners, as is the case by other suppliers to the business, serves to reduce overall operating capital employed, thereby reducing the need for funding by investors.

A.56 We, however, have identified separately amounts owed to landowners within our analysis as these amounts are almost invariably disclosed in the large housebuilders' annual report and accounts. From this we can see the relative importance of 'amounts to owed to landowners' had increased somewhat. In 2003, this amounted to under £2 billion of circa £13 billion operating capital employed, but by 2022, this had increased to over £4 billion of circa £23 billion operating capital employed.[22]

A.57 These amounts would equate to funding roughly 15% of capital employed, were one to treat these amounts as a source of finance. Notwithstanding the increasing significance of amounts owed to landowners, we are of the view that these amounts relate to working capital rather than a source of finance like debt or equity.

Interest-free loan / equity stake secured on sold property

A.58 Many large housebuilders hold equity loan assets in their balance sheets that were the result of help they had in the past given to prospective purchasers to secure a sufficient deposit to enable them to purchase a new home.[23] As these loans represent one of many possible incentives that large housebuilders provide to prospective purchasers, we have included them as an operating asset within our analysis.

Cash

A.59 Cash is typically not considered to be an operating asset and is, therefore, not included within the capital employed in profitability analysis. Following the GFC, many large housebuilders have held significant cash balances. This may indicate that cash is now seen as needed to successfully operate in this sector. However, in the absence of detailed information on how the cash balances are used, we have applied the more typical approach of excluding cash from the capital

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[22] All amounts quoted are in December 2022 prices.

[23] Before the advent of HTB there were a number of other government-led mortgage deposit support schemes which required housebuilders to co-fund the contributions to a deposit on a home. In addition, some large housebuilders ran their own mortgage deposit support schemes.

employed. This approach is consistent with the way in which we have estimated our range for the cost of capital.[24]

Exceptional items

A.60 There is no statutory definition of what comprises an exceptional item. Typically, they are seen to be material items reported within the profit and loss account related to the ordinary activities of the firm but which are not expected to occur regularly. Exceptional items are disclosed separately within the accounts but how they are disclosed can vary significantly across the large housebuilders.

A.61 Whilst agreeing that we should include exceptional items within our analysis, some large housebuilders told us that we should disregard the related provisions they had reflected in their balance sheets. These provisions, they explained, were to cover the costs of fire safety improvements in the wake of the Grenfell fire.

A.62 We include exceptional items,[25] such as the remediation costs in the wake of the Grenfell fire in 2017, in our profitability analysis across the 20-year period to ensure that our analysis provides a holistic representation of profitability over the period.

A.63 We have not excluded the related provisions (if any), as these provisions relate to actual obligations of housebuilders at the balance sheet date. Such treatment also maintains consistency between entries reflected within the profit and loss account and the balance sheet.

Leased assets

A.64 We include within fixed assets both assets that are owned outright by the large housebuilders and those leased assets that are reported in the large housebuilders' financial statements as 'right of use' assets. As such, the providers of leasing finance for these 'right of use' assets are treated as providing finance to the business akin to debt finance.

Asset valuation

Introduction

A.65 Housebuilders record the costs invested in their developments on a site-by-site basis and then transfer a proportion of the accumulated total to cost of sales when newly constructed homes are accounted for as sold. Sales of homes are included

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[24] See Appendix B Cost of capital, *Our estimate of the cost of capital*, *Treatment of cash*.
[25] Except those relating to the write down of intangible assets such brands and contract assets, which we, as explained in paragraph A.49 above, exclude on principle.

within revenue on legal completion. That means that for any reporting period, revenues are typically at current (sales) prices[26] and cost of sales reflects a historical expenditure incurred at various points in time, albeit to a significant extent incurred near to the point of sale (as housebuilders seek to keep working capital exposure for each site to a minimum).

A.66 The reported cost of land for a prospective development reflects in the first instance its acquisition cost or, if the land is held under option (which is generally the case for housebuilder interests in strategic land before outline planning permission is obtained), the cost of that investment in that option. Alternatively, land can be purchased with the benefit of planning permission.

A.67 As further costs are incurred by housebuilders to promote 'strategic' sites, these costs are added to the cost of the investment. When planning permission is obtained, the housebuilder will be required to exercise its option to buy the land on terms agreed at the signing of the option agreement or become committed to pay the price it has contractually agreed to pay the landowner. Either way this means that by the time that the site has acquired full planning permission and is ready to be developed, the investment in it can comprise a mix of expenditure on land incurred at differing points during the planning cycle.

Conceptual approach to asset valuation

A.68 Our normal practice is that assets included under capital employed should reflect their value to the business (VTB).[27] The VTB approach aims to value assets in such a way that the assets included in our analysis allows for:

(a) existing firms in the market to recover the opportunity cost of using the assets to supply the in-scope activities; and

(b) a hypothetical entrant to recover the costs of the assets required to supply the relevant activities.

A.69 A valuation based on the replacement cost of the modern equivalent asset (MEA)[28] is the most common outcome of a VTB assessment. This approach is consistent with CC3 (Revised), which states that the CMA considers MEA values

[26] Many large housebuilders sell a proportion of their homes in advance of constructing them. In those cases, the sales price will reflect the current market price at the time of exchanging contracts, which may differ from prevailing market prices at the time of legal completion, especially if there is a significant gap between the two.
[27] Also referred to as the deprival value, or value to the owner principle.
[28] The MEA value is the cost of replacing an old asset with a new one with the same service capability allowing for any differences both in the quality of output and in operating costs.

to be the most economically meaningful measure for the purpose of measuring profitability in most cases.[29]

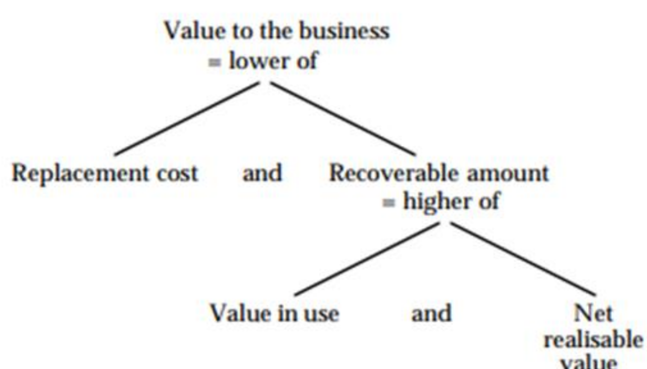
A.70 However, in some circumstances, the recoverable amount may be lower than the replacement cost. An asset will not be replaced if the cost of replacing it exceeds its recoverable amount. In such circumstances, the asset's current value is determined as follows:

(a) When the most profitable use of an asset is to sell it, the asset's recoverable amount will be the amount that can be obtained by selling it, net of expenses; in other words, its net realisable value (NRV).

(b) When the most profitable use of an asset is to consume it - for example, by continuing to operate it - its recoverable amount will be the net present value of the future cash flows; in other words, its value in use.

A.71 This can be portrayed diagrammatically as shown in Figure A.1.

Figure A.1: Hierarchy of valuation bases for value to the business (VTB)



Source: Statement-of-Principles-for-Financial-Reporting (ASB) (1999), Chapter 6 Measurement in Financial statements, Alternative measures of current value, paragraph 6.8.

A.72 Also relevant to an economic approach to asset valuation is the time taken to construct an asset. That is because the cost of financing that construction will be one factor influencing asset values. When development and/or construction of an asset, such as housing, takes some time, the cost of financing during this phase can be a significant part of the total costs of creating that asset. Capitalising interest incurred during this phase is not an unusual accounting practice.[30] What is more unusual when placing a value on assets is to use an estimate of the opportunity cost of capital instead of the financial interest cost of borrowing in the calculation. It is important that the opportunity cost of capital employed rather than the debt interest cost is used in such cases. This is because the value to a

[29] CC3 (Revised), Annex A, paragraph 114.
[30] See, for example, Financial Reporting Standard 102 (January 2022), Section 25 Borrowing costs, permits a policy of capitalising interest.

business of an asset once it is constructed is not dependent on the method of financing it during its period of construction.[31]

A.73 In the following paragraphs we discuss the valuation of large housebuilders' land assets separately from all other assets and liabilities.[32]

Land

Parties' views

A.74 One large housebuilder told us that timescales were highly variable, short-term land would typically be purchased around three years ahead of the first sale and with further sales spread across the following years. In the case of long-term land, promoting a site for local plan allocation and outline planning consent could typically take up to three to ten years, during which significant costs and efforts are incurred to obtain land allocation and planning consent.

A.75 Another large housebuilder told us that the lag between expenditure on land and the sale of new houses had grown in recent years as intense competition between housebuilders had meant that commitment to site purchases was taking place at an earlier stage of the planning timeline. It told us that it worked on the basis that it took on average between 4 to 5 years to develop a site acquired with planning permission to the sale of the final property completed.

A.76 A third large housebuilder told us there could be a significant time lag between land purchase and the start of construction and that it was rarely the case that sites were purchased and paid for when all requisite approvals were in place and construction could start immediately.

A.77 A fourth large housebuilder noted that currently its business was currently worth less (in terms of the value of its shares) than the cost it had incurred (as reflected on its balance sheet) and that was also true of all but one of the quoted housebuilders. The market value of its shares had reduced over the years as the time taken to recirculate capital had increased as a result of the ongoing deterioration in the planning system.

A.78 Several large housebuilders thought that we should revalue land on a current basis and reflect the change in land values from year to year through the operating

[31] Accounting for Economic Costs (1986), Volume II, Principles of Fixed Asset Valuation, Interest During Construction, page 17. Although this text refers to the valuation of fixed assets, this is also relevant to current assets, such as residential housing, that takes a while to create.
[32] Other assets and liabilities principally comprise construction work-in-progress, other working capital other than inventory (ie debtors and creditors). It also includes tangible fixed assets and provisions.

profit and loss. Other large housebuilders thought that we should follow the treatment adopted in their annual report and accounts.

A.79 One large housebuilder told us that rises in the land values were caused by general macroeconomic factors and therefore not attributable to any market power. As a result, the concerns we had expressed about reflecting changes in land values were misplaced. This large housebuilder also told us that we had previously discounted increases in land values occurring within the timeframe of our profitability analysis because they had represented 'non-operating' profit.[33]

A.80 This large housebuilder told us capitalising interest at the cost of capital would help account for the time value of money but that it still preferred that we adopt an IRR or NPV approach to assessing profitability, which it believed was more consistent with the guidance, precedence and academic literature. It thought such an adjustment would be material, pointing out to delays experienced between purchasing land and selling homes. This large housebuilder also told us that in addition to capitalising interest, the carrying value of land should also be revalued to its replacement cost to provide an accurate picture of economic profitability in the sector.

Our view

A.81 We understand that the values for some assets reported in the financial statements of large housebuilders (eg land) are likely to be lower than their current market value. For financial reporting purposes assets are valued at the lower of cost and net realisable value, which generally means that assets, if revalued, are only revalued downwards.

A.82 Land with development potential for housing (or for that matter commercial purposes) is purchased by housebuilders on the basis of the residual valuation methodology (ie worked out backwards from the expected sales value of the envisaged housing less expected costs to build, expected costs of fulfilling planning obligations and expected costs of getting land through the planning process).

A.83 As land for housing development is valued by market participants on the basis of the residual valuation methodology, all three current valuation bases (replacement cost, value in use and net realisable value) as portrayed in Figure A.1 would, in principle, generate the same value for land:

(a) replacement cost: the cost that would be incurred by a new entrant ('entry value');

[33] In the Private Healthcare market investigation.

(b) value in use: the discounted present value of the cash flows expected from continuing use and ultimate sale by the present owner; and

(c) net realisable value: the amount that can be obtained by selling it, net of selling expenses ('exit value').

A.84 We acknowledge that the value of a particular tract of land to housebuilders typically increases as it becomes more likely that planning permission will in fact be granted and that the envisaged development will go ahead. Conversely, if permission is not granted, the cost of the land will be written off as an unsuccessful investment. The market value of land may also go up and down due to general movements in the land market, which will typically be linked to the fortunes of the local economy, which in turn are also likely to reflect changes in the macroeconomic environment.

A.85 Under our asset valuation framework, this would ordinarily mean that we would recognise that change in value during the period it occurred, even though these changes would not be recognised under UK GAAP until potentially much later. Under UK GAAP, the convention normally adopted is to value assets at the lower of historical cost or recoverable amount, meaning gains are not recognised until eventual sale.

A.86 We, however, do not consider that reflecting the change in land values each year would be meaningful. Under the residual land valuation methodology, recognising changes in land market values during the period they occurred would involve recognising profits much earlier on in the development process, with subsequent periods merely earning their cost of capital if all goes to plan. That approach makes asset valuation a circular exercise. It is circular because valuation would be directly linked to the latest expected sales value for the planned output of housebuilders across their sites, the profitability of building which we are trying to assess.[34]

A.87 Furthermore, trends would reflect changes in expectation for the whole portfolio of developments regardless of whether they were being built out or not,[35] rather than the emphasis being on the profitability of the homes being sold in the relevant period. We therefore consider it is more economically meaningful in this case to adopt the normal accounting approach to asset valuation, which is the lower of cost and recoverable amount. For this reason, we disagree with the large housebuilder which suggested – see paragraph A.79 – that adopting a current

[34] Accounting practice is only to adopt such a circular approach to asset valuation where assets are impaired ie the assets are not worth replacing. In that case, the valuation of earning capacity - discounted at the opportunity cost of capital – is needed in order to ensure that assets are not overvalued.
[35] An accounting measure of performance such as ROCE should be giving information about returns to investment decisions that are currently being implemented rather than about changes in expectations regarding planned costs and revenues (here in relation to housing developments) to which a firm is not yet obligated. Source: Edwards, Kay and Meyer (1987), pages 47–48.

valuation basis would only be an issue if changes in current value were attributable to market power.

A.88 It is also the case that housebuilders are primarily developers of housing on land that they acquire rather than traders in developable land, because, ultimately, the most profitable opportunity for them is to build homes for sale on land that they have acquired. This is a further reason why reporting profits when homes are sold is most appropriate here.

A.89 We note that increases in land values following residential development are the central feature of the operation of the new build housing market and any idea of us discounting this increase in value, as one large housebuilder suggested (see paragraph A.79), would make our profitability analysis meaningless.

A.90 We also note that our approach will not take into account the gain in the value of land over acquisition cost held by the housebuilders at the end of the period of analysis (ie 2022) in the same way that any gain in value of land would not be recognised at the beginning of the period (ie 2003).

A.91 Finally, all of the housebuilders report ROCE in their annual reports and to their investors on the basis as described above (ie they do not revalue land until the profit is realised through the sale of homes). Analysts do not look to revalue land in this way either. We further note that all of the large housebuilders measure and reward performance on the basis of ROCE where items included within capital employed are measured using the same basis of preparation as their financial statements. This implies that they believe that basis of preparation to generate relevant information.

Capitalising interest

A.92 In principle we would like to capitalise interest (at the cost of capital) on purchases of land up to the point of deployment, so that, in each period up to that point, housebuilders earned their cost of capital not only on the initial investment but also on any rolled-up interest. However, to undertake this exercise, we would need the carrying value of land (net of any associated amounts owed to landowners) to be analysed by year of acquisition at every balance sheet date across 20 years and this information is not routinely gathered, let alone reported.

A.93 Expenditure on land and construction, unlike for the purchase of fixed assets, is not routinely reported in the housebuilders' financial statements. This is because land is treated as a current asset (ie inventory[36]), rather than a non-current asset[37]

[36] Traditionally referred to in the UK as 'stock'.
[37] Traditionally referred to in the UK as 'fixed assets'.

and information reported on capital expenditure in firms’ financial statements focuses on non-current assets rather than current assets.

A.94 Regarding the point of the large housebuilder summarised at paragraph A.80 rolling up interest on investments in land, as well as revaluing land at each balance sheet date, would result in factoring in twice the influence of the cost of capital on the value to be placed on assets held by housebuilders. This is because one of the factors that influence current values for assets is the cost of capital.[38]

A.95 It is uncertain the effect that capitalising interest would have on our analysis, given our understanding that large housebuilders investment in land in any one development can be comparatively modest up to the point when permission is secured. Even at the point when housebuilders become obliged to pay for the land in full, landowners may have agreed to be paid, at least in part, at a later stage in the process (see paragraphs A.51 to A.57), thereby reducing housebuilders’ net investment in land[39] in the interim. We do, however, acknowledge that housebuilders when developing certain sites, particularly those requiring significant upfront investment in infrastructure, can be waiting extended times between for their return on their investment.

A.96 With this caveat, reporting profits earlier would not, in principle, change the overall profits earned or the measure of economic profitability covering the whole period of individual developments, just reprofile the timing of the recognition of profits.

Conclusion on valuation basis for land

A.97 In summary, in our analysis, we have not revalued land at each successive balance sheet date to reflect market participants’ latest view of the commercial prospects for each site held by housebuilders. Instead, the uplift in the value of the land that results from residential development flows through the profit and loss account as and when homes built on that land are sold.

Valuation of assets other than land

A.98 Based on our understanding of the timing of expenditure incurred in connection with the activity of housebuilding (as set out in paragraphs A.65 to A.67 above), and with the exception of land (which we consider separately above), we consider that using the costs and carrying values for assets and liabilities measured on the lower of historical cost or recoverable amount are likely in most cases to be a reasonable approximation of their value to the business. Other than capital employed tied up in working capital (ie current assets less current liabilities),

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[38] Accounting for Economic Costs (1986), Volume II, Principles of Fixed Asset Valuation, Factors influencing asset values, Real interest costs, page 22.
[39] Net investment in land by the housebuilder at any one point will reflect the sum of payments to date to landowners. It will not include amounts due to be settled sometime in the future.

housebuilders appear to have little capital employed. In particular, there appears to be little capital employed tied up in fixed assets, the category of assets we are normally concerned about revaluing onto a current basis when conducting profitability analysis.

Results

A.99 Table A.1 below shows the results of our analysis.

Table A.1: Profitability results for the 12 largest housebuilders in aggregate: 2003 to 2012 (all in £millions unless otherwise indicated)

	2003	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*
Revenue	17,909	19,419	18,591	20,424	22,621	18,353	12,341	12,154	12,380	13,913
Cost of sales: business as usual	(13,876)	(14,796)	(14,204)	(15,835)	(17,608)	(15,038)	(12,160)	(11,502)	(10,497)	(11,468)
Cost of sales: market-wide downturn inventory impairments	-	-	-	-	-	(3,862)	(1,711)	(154)	(46)	-
Cost of sales: otherwise identified as exceptional	-	-	(22)	-	-	(16)	(10)	20	(1)	-
Cost of sales: legacy property fire safety improvements	-	-	-	-	-	-	-	-	-	-
Administrative expenses: business as usual	(1,081)	(1,158)	(1,123)	(1,142)	(1,235)	(1,200)	(910)	(861)	(789)	(870)
Administrative expenses: otherwise identified as exceptional	(33)	28	20	(24)	(130)	(165)	(99)	(77)	(18)	(3)
Operating profit measure I	2,920	3,493	3,261	3,422	3,648	(1,928)	(2,549)	(420)	1,027	1,572
Administrative expenses: impairment of goodwill	(46)	(54)	(3)	(3)	(3)	(1,717)	-	(2)	(1)	(7)
Operating profit measure II	2,874	3,439	3,258	3,419	3,645	(3,645)	(2,549)	(422)	1,027	1,565
Land	6,441	7,523	11,314	12,874	18,443	15,184	11,975	11,050	11,855	11,951
Other inventory	10,470	11,650	8,654	8,182	11,924	10,736	7,937	7,208	6,783	7,164
Amounts owed to landowners	(1,745)	(1,919)	(1,718)	(2,118)	(3,797)	(2,987)	(2,025)	(2,150)	(2,238)	(2,516)
Legacy property safety improvements provision	-	-	-	-	-	-	-	-	-	-
Other provisions	(67)	(69)	(55)	(54)	(138)	(230)	(224)	(157)	(147)	(144)
Interest-free loan / equity stake secured on sold property	1	2	1	51	76	141	295	482	599	681
Other operating asset / liability	(2,529)	(3,490)	(4,324)	(3,860)	(4,232)	(4,013)	(3,769)	(3,764)	(3,595)	(3,589)
Net operating assets excluding goodwill	12,571	13,697	13,872	15,075	22,276	18,831	14,189	12,668	13,255	13,546
Goodwill	949	889	936	1,248	3,295	1,622	1,436	1,451	1,350	1,305
Net operating assets including goodwill	13,520	14,586	14,808	16,323	25,571	20,453	15,625	14,119	14,605	14,852
Average capital employed: measure I	12,571	13,134	13,784	14,474	18,676	20,554	16,510	13,429	12,962	13,401
Average capital employed: measure II	13,520	14,053	14,697	15,566	20,947	23,012	18,039	14,872	14,362	14,728
ROCE measure I (ie excluding goodwill) (%)	23	27	24	24	20	(9)	(15)	(3)	8	12
ROCE measure II (ie including goodwill) (%)	21	24	22	22	17	(16)	(14)	(3)	7	11

Table A.1 (continued): Profitability results for the 12 largest housebuilders in aggregate: 2013 to 2022 (all in £millions unless otherwise indicated)

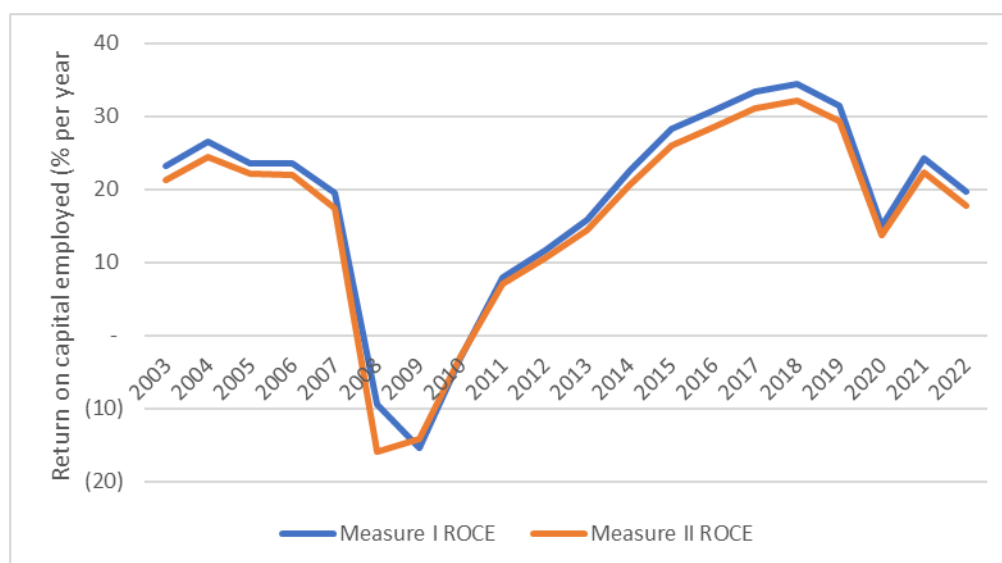
	2013	*2014*	*2015*	*2016*	*2017*	*2018*	*2019*	*2020*	*2021*	*2022*
Revenue	15,855	19,389	23,367	26,549	29,803	31,640	32,035	24,006	31,867	32,651
Cost of sales: business as usual	(12,698)	(15,015)	(17,668)	(20,015)	(22,237)	(23,514)	(24,107)	(19,056)	(24,479)	(24,757)
Cost of sales: market-wide downturn inventory impairments	-	-	-	-	-	-	-	-	-	-
Cost of sales: otherwise identified as exceptional	-	-	7	1	-	(1)	-	(51)	(6)	-
Cost of sales: legacy property fire safety improvements	-	-	-	-	-	(35)	(23)	(212)	(387)	(1,817)
Administrative expenses: business as usual	(948)	(1,053)	(1,237)	(1,289)	(1,333)	(1,373)	(1,387)	(1,340)	(1,489)	(1,611)
Administrative expenses: otherwise identified as exceptional	(6)	(6)	(0)	(4)	(8)	(31)	2	(36)	-	(42)
Operating profit measure I	2,203	3,316	4,469	5,242	6,225	6,686	6,520	3,311	5,506	4,425
Administrative expenses: impairment of goodwill	(4)	-	-	-	-	-	-	(21)	(1)	(77)
Operating profit measure II	2,199	3,316	4,469	5,242	6,225	6,686	6,520	3,290	5,505	4,348
Land	12,611	15,094	16,674	17,888	18,358	19,750	19,973	20,773	21,557	22,806
Other inventory	7,251	8,228	9,851	11,302	12,257	11,898	12,621	13,736	12,802	13,193
Amounts owed to landowners	(2,618)	(3,394)	(4,169)	(4,569)	(4,568)	(4,849)	(4,841)	(4,333)	(4,155)	(4,041)
Legacy property safety improvements provision	-	-	-	-	-	(35)	(44)	(240)	(601)	(2,185)
Other provisions	(103)	(143)	(159)	(179)	(339)	(282)	(230)	(327)	(464)	(459)
Interest-free loan / equity stake secured on sold property	797	736	609	388	274	193	147	112	92	65
Other operating asset / liability	(3,708)	(5,365)	(6,383)	(7,216)	(7,191)	(6,702)	(6,172)	(6,899)	(6,785)	(6,900)
Net operating assets excluding goodwill	14,230	15,156	16,422	17,614	18,791	19,973	21,454	22,823	22,445	22,478
Goodwill	1,299	1,318	1,303	1,326	1,280	1,433	1,416	2,005	1,939	2,013
Net operating assets including goodwill	15,529	16,473	17,724	18,940	20,071	21,405	22,870	24,828	24,384	24,491
Average capital employed: measure I	13,888	14,693	15,789	17,018	18,202	19,382	20,713	22,138	22,634	22,461
Average capital employed: measure II	15,190	16,001	17,099	18,332	19,505	20,738	22,138	23,849	24,606	24,438
ROCE measure I (ie excluding goodwill) (%)	16	23	28	31	34	34	31	15	24	20
ROCE measure II (ie including goodwill) (%)	14	21	26	29	32	32	29	14	22	18

Note 1: All monetary amounts have been inflated into December 2022 £s using CPIH to show 20 years-worth of financial information using a consistent unit of measure.
Note 2: For 2003 alone, average operating capital employed is year-end operating capital employed.
Note 3: The 12 large housebuilders have a variety of different year ends ranging from March to December. The results presented for any one year relates to all year ends falling in that calendar year.
Source: CMA analysis based on large housebuilders' annual report and accounts information.

A.100 As further explained in paragraphs A.41 to A.44, to reflect the different accounting practices of the housebuilders, we have developed two profitability measures, one which excludes goodwill as an element of capital employed ('measure I ROCE') , and any related write-downs within operating profit, and one which includes both ('measure II ROCE').

A.101 In Figure A.2 below we depict both measures of ROCE across the 20-year period of review.

Figure A.2: Return on capital employed: measure I versus measure II



Source: CMA analysis based on large housebuilders' annual report and accounts information.

A.102 As the two measures do not give a materially different picture, we adopt measure I when otherwise presenting and interpreting the results of our analysis, which we do in the Final Report.