

Rebuilding the housebuilder*

Operational restructuring of the housebuilding sector is well underway. Management teams are mothballing sites and reducing overheads. Faced with a continued decline in sales, will these actions stem the need for new funds?

- Financial restructuring may be inevitable
- Value is uncertain
- Rebuilding the housebuilder requires a long term approach

Cash today or value tomorrow?

The value of a housebuilder sits on its balance sheet. In today's market conditions, maximising the value of those assets requires a careful decision on whether to hold or sell. For housebuilders the trade-off between preservation of value and generation of short term cash flow is difficult given the uncertainty of future asset values.

We consider this dilemma across the main asset components of Land, Work In Progress and Stock.

Land

Key issues

- Holding land to develop for future sale of completed sites once the market has recovered
- Postponing site development and minimising the level of cash investment (and associated cost of capital)
- Generating short term cash flow from land bank sales or build an alternative product
- Ensuring the balance sheet accurately reflects the value of land

Strategic considerations

- Extend the available window to develop land by slowing planning applications on optioned land
- Use risk sharing schemes with landowners on optioned land to reduce cash investment
- Social/affordable housing/shared ownership schemes remain a development market. This offers build volumes but at lower margins and lower returns on land investment. Key issues are:
 - Quality of relationships with Local Authorities/Housing Associations

- Suitability of sites, e.g. public transport connections, key worker areas
- Level of funding the housebuilder is expected to commit during the development cycle
- Level of ownership housebuilder can retain in finished stock
- Current land prices make disposals to generate cash unattractive. But selective sales should be considered for sites that do not fit with a refocused geographic presence or different building/ASP focus.

- Deferring payment terms on land purchases

- De-risking exposure on big sites through land swaps

Accounting perspective

- Land banks are held as current assets, at the lower of cost and net realisable value (NRV). With current realisable values falling, most housebuilders will now be looking at potential impairments to their land banks. The Royal Institution of Chartered Surveyors has suggested that land write downs may need to be circa 30%. The level of impairment will depend upon the

ageing profile of the land bank which will require site by site analysis

- Land bank cost is measured on a residual value basis. The price a housebuilder paid for a piece of land will have taken into account the build cost, margin and ultimate sale price
- The impairment charge should be writing down land to a residual value. If there is no change in the valuation this will result in land being traded out at zero margin

For example:

Expected sale price £100k
Margin £15k
Build cost £55k
Land price £30k

- If expected sale prices have fallen by £10k to £90k the housebuilder may have to:

1. reduce future margins from £15k to £5k and hold land values
2. reduce land value now by £10k equivalent to an impairment of 33% and hold future margins or;
3. a mixture of the above

- Some may be taking a more aggressive approach to provisioning to ensure they will achieve positive margins

- Other matters to consider in connection with impairment:

- Any company that has made acquisitions will have revalued any land bank to its fair value as at the date of acquisition – effectively re-ageing the land. Those housebuilders who have been involved in a recent transaction are likely to have larger impairment charges

- Any impairment reduces taxable profits giving a tax savings. If the company suffers losses in the year they can also be carried back one year to reduce the previous year's taxable profits

- Impairment charges to land value will have an impact on housebuilders' LTV covenants, resulting in potential breaches

- Methodology adopted in calculating the writedowns can vary – plot by plot, site by site or region by region and will impact on the quantum. The more detailed the analysis the more likely the writedown

- There may also be a need to assess the value of land being carried under option

Work in progress



Key issues

- Ensure there is a market for the sites already commenced
- Minimise cash expenditure by slowing down or stopping activity
- Managing sub-contractor costs and risks
- Reducing the cost base and overhead to match the reduced activity levels

Strategic considerations

- Mothballing sites to reduce cash outflow requires a site-by-site review of suitability

- Mothballed sites still incur running costs and reactivation costs when the site is completed
- Some of the costs of investment up to the point of finishing the foundation or making a property watertight may not be recoverable
- Some sites will be suitable to be reconfigured so that they can be completed and marketed without all planned properties developed
- Local market conditions may reveal a buyer for partially developed sites

- Ability to convert sites currently in development to meet public sector/affordable housing demand depends upon;
 - Location of site
 - Type of buildings – houses are typically more in demand than apartments
 - Ability to comply with Code Level 3 (sustainability building standards higher in public than private sector)

- Local Authority appetite and ability to fundRegional office closures reflect market conditions: back-office functions can be centralised; functions that require local market presence are in lower demand, e.g. site management, land buying, sales

Accounting perspective

- Impairment issue equally applicable to WIP as it includes the historic cost of the land being built on

Stock



Key issues

- Finding a market for completed properties
- Cash vs. value implications of sales incentives
- Options for holding completed stock off balance sheet
- Shared equity debtors

Strategic considerations

- Promote sales techniques that lock in buyers such as non-refundable reservation deposits

- Sales incentives currently observed in the market attempt to address cash flow but generate deferred consideration
 - Buyer deposit loans of up to 25% of the property value are being offered. These turn stock but result in financing liabilities
 - Part exchange offers appear less prevalent than in the last downturn as lack of market liquidity offers housebuilders low sell-on recoveries or results in older assets being held on the balance sheet

- Identifying and targeting potential purchasers
- Offering discounts and incentives and finding a balance between generating cash and getting full value
- Identifying ideal structure/approach to holding completed houses at minimal cost
- Renting unsold properties generates cash flow but is a last resort for preserving value in the longer-term. This reduces the resale value of properties, can make them harder to sell and retains the asset for the housebuilder

- Recoverability of any shared equity debtors – when will you realise it and at what level if you only have a second charge after the mortgage company?

Accounting perspective

- Again lower of cost versus NRV. With current prices falling and levels of stock held increasing this will increase the level of impairment
- Recoverability of part – exchange and shared equity debtors – how do you value these on the balance sheet? These may have to be discounted

Refinancing or restructuring?



So far, for some players we are seeing a cautious first round with a presumed “equity story” – equity raising and bank waivers leaving the capital structure largely unchanged.

But how bad will it get? Despite operational restructuring, cash needs will arise as housebuilders come out of the seasonal peak (April-June) and sales levels continue to underperform. Refinancing will no longer be an option and the inevitable second round of balance sheet restructuring is likely to focus on reducing debt to a sustainable, performing level whilst maintaining a longer term holding strategy for the remainder with an appropriate level of upside.

Restructuring proposals will need consensual stakeholder agreement – if this is not achievable, then restructuring through insolvency may be the only alternative.

Key issues

- Assessing the revised trading outlook and funding need
- Determining the current and future value of the business
- Seeking consensual outcome from a complex stakeholder group

Key components of financial restructuring will include:

- Understanding of current trading and operational restructuring – seasonal peak sales period, geographical exposure, product specific trends, sales incentives
- Revision of management forecasts – how bad will it get? Impact of site by site mothballing/other management actions and latest industry view of recovery
- Right sizing the business – adjusting the cost base to reflect the new size and shape of the business as a result of weakened market conditions
- Liquidity requirements – management of short term funding needs, including land creditors and subcontractors

- Valuation of land bank/company – land bank impairment policy needs to be considered together with revised forecast trading margins to estimate current value of the business
- Revision of financial covenants – consider a more cash based approach rather than reliance upon subjectivity of land bank valuations or interest cover
- Regular information flow – rapidly changing circumstances require a close watch of KPIs to assess timing of recovery and any change to funding requirements
- Assessment and development of restructuring proposals – evaluation and negotiation of proposals to seek a consensual outcome
- Contingency planning – if a consensual outcome is difficult to achieve, then contingency planning may be required to implement a restructuring solution

Our experience

We have extensive experience in providing strategic, financial and operational advice to the house building sector to assist our clients with the challenges they face. We draw upon our firm wide skills such as financial restructuring, strategy consulting, due diligence, corporate finance and tax combined with our sector understanding to best support your requirements.

Our offerings to clients includes:

- Assessing and recommending strategic options and land bank considerations
- Managing stakeholder relationships
- Restructuring / refinancing options and implementation
- Short-term cash flow management
- Tax saving strategies

Our recent experiences include

Barratt Homes –

PwC provided financial and operational due diligence on Barratt's acquisition of Wilson Bowden. Post acquisition we provided advice to Barratt on the integration of Wilson Bowden into their existing business.

Project Uncle –

A regional housebuilder had materially underperformed against its business plan and key senior management had exited

the business. We provided an options review and monitored site workout to give the lender confidence in forecasts, justifying the further funding required to allow work out of sites.

Project Magpie –

PwC worked with a residential property developer facing financial exposure due to the size and diversity of their portfolio. We advised the directors on potential refinancing options for negotiations with the lender and on improving the business model for site selection and development.

Project Saint –

Builder involved in the purchase and on-sell of Affordable Housing units experiencing cash flow pressures and a breach of covenants after attempting their own residential developments. PwC helped the business to stabilise through implementation of a site completion plan, reduction of overhead and creditor management.

Rydon Group –

We provided an extensive strategic review examining a number of options to maximise shareholder value, ending in a sale process. We supported shareholders through the sales process, which extracted maximum value and ensured continuity of the business.

Project Chevy –

PE-backed house builder based in London that was active in social and private housing in the SE of England. We assisted the company and PE house in negotiations with the company's bank, as it restructured its capital structure and debt terms, in response to a depressed housing market.

Tax experience –

PwC has worked with various clients within the housebuilding sector utilising tax strategies to make cash savings. This includes pre-sale site reorganisation to gain tax savings and creative deal structuring to take advantage of rollover relief giving tax savings through price mechanics.

Implementation experience –

We have additional practical skills reflecting our considerable building and development experience, including in-house chartered surveyor input to negotiating the sale of property assets, managing the build-out completion of part developed sites and implementing creative property solutions to maximise value.

Other stakeholders to consider

Land creditors –

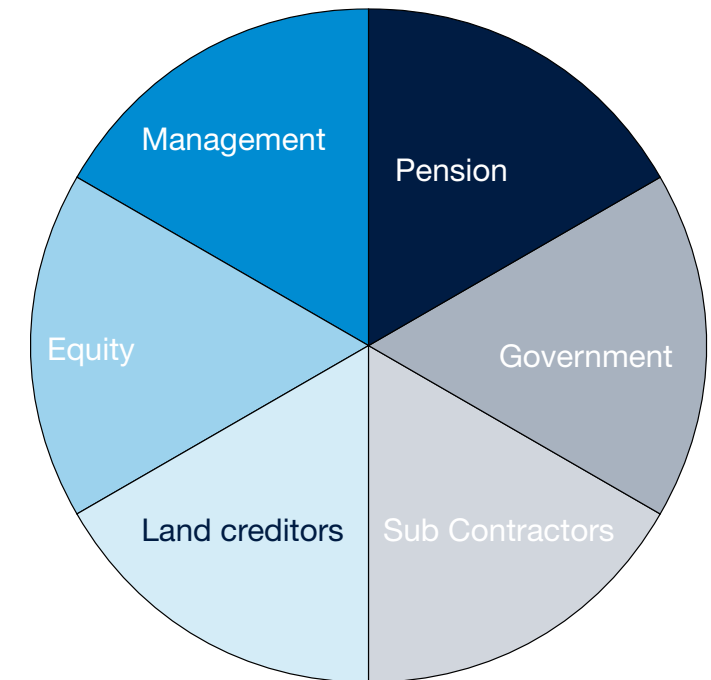
scope to renegotiate payment schedule and option payments

Pension deficit –

restructuring impact and negotiation with pension trustees

Government –

encouragement of responsible approach to restructuring



PwC UK Housebuilding specialists

Jonathan Hook	Construction & Housebuilding Industry Leader	020 7804 4753	jonathan.hook@uk.pwc.com
Chris Temple	Building Products Industry Leader	020 7213 4601	christopher.j.temple@uk.pwc.com
Barry Gilbertson	Real Estate, House Building and Construction Specialist	0207 212 3511	barry.gilbertson@uk.pwc.com
Michael Berkowitch	Restructuring Partner	020 7213 1429	michael.berkowitch@uk.pwc.com
Zelf Hussain	Restructuring Director	020 7804 6796	zelf.hussain@uk.pwc.com
Peter Spratt	Restructuring Partner	020 7212 6032	peter.spratt@uk.pwc.com

BRS Real Estate specialists

Barry Gilbertson	Partner	0207 212 3511	barry.gilbertson@uk.pwc.com
London & South			
Ed Cook	Senior Manager	0207 804 5057	ed.b.cook@uk.pwc.com
Nigel Darlington	Senior Manager	0207 804 5943	nigel.darlington@uk.pwc.com
Deborah Parker	Senior Manager	0207 804 392	deborah.k.parker@uk.pwc.com
North, Midlands & South West			
Richard Crompton	Senior Manager	0161 247 4598	richard.g.crompton@uk.pwc.com
Neil Reader	Manager	0113 289 4393	neil.w.reader@uk.pwc.com
David Sparke	Senior Manager	0113 289 4441	david.sparke@uk.pwc.com
Scotland			
John Macpherson	Senior Manager	0131 524 2245	john.macpherson@uk.pwc.com

Local BRS Housebuilding contacts

Scotland				
Bruce Cartwright	Partner	0131 260 4087	bruce.cartwright@uk.pwc.com	
North				
Steve Ellis	Partner	0113 289 4340	steve.a.ellis@uk.pwc.com	
Ian Green	Partner	0113 289 4274	ian.d.green@uk.pwc.com	
Matthew Wilde	Partner	0161 245 2214	matthew.j.wilde@uk.pwc.com	
Midlands				
Matthew Hammond	Partner	0121 265 6670	matthew.hammond@uk.pwc.com	
Rob Hunt	Partner	0121 265 5660	rob.hunt@uk.pwc.com	
Stuart Maddison	Partner	0150 960 4306	stuart.maddison@uk.pwc.com	
Wales and West				
Derek Howell	Partner	0292 064 3240	derek.a.howell@uk.pwc.com	
Rob Lewis	Partner	0292 064 3236	rob.n.lewis@uk.pwc.com	
South East				
Stephen Oldfield	Partner	0160 388 3214	stephen.m.oldfield@uk.pwc.com	
David Bennett	Director	0118 938 3049	david.j.bennett@uk.pwc.com	
Karen Dukes	Director	0129 356 6996	karen.dukes@uk.pwc.com	

managinginadownturn.com

This publication has been prepared for general guidance on matters of interest only, and does not constitute professional advice. You should not act upon the information contained in this publication without obtaining specific professional advice. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication, and, to the extent permitted by law, PricewaterhouseCoopers LLP, its members, employees and agents do not accept or assume any liability, responsibility or duty of care for any consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it.

The member firms of the PricewaterhouseCoopers network provide industry-focused assurance, tax and advisory services to build public trust and enhance value for its clients and their stakeholders. More than 146,000 people in 150 countries across our network share their thinking, experience and solutions to develop fresh perspectives and practical advice.

© 2008 PricewaterhouseCoopers LLP. All rights reserved. 'PricewaterhouseCoopers' refers to PricewaterhouseCoopers LLP (a limited liability partnership in the United Kingdom) or, as the context requires, the PricewaterhouseCoopers global network or other member firms of the network, each of which is a separate and independent legal entity. Design Services. Ref 2008LDS22090.