

## Funerals Market Investigation

### Westerleigh Group's response to the CMA's working papers on profitability and cost of capital analysis

#### 1. INTRODUCTION

1. In the Profitability Working Papers, ("**Profitability WPs**"),<sup>1</sup> the CMA [X].
2. [X]. There are several areas of concern, most prominent amongst which are the CMA's approach to valuing land, its inclusion of profits relating to burials, and its assessment of the cost of capital for crematoria operators.
3. [X].
4. The CMA must also recognise that the sector is at an inflection point, with a clear trend for declining profitability, which is reflective of increased competition and indicative of a well-functioning market. This means that the CMA should take particular caution in drawing conclusions from historic data, which are unlikely to be reflective of how the market will evolve in the coming years. [X]. The impact of the COVID-19 pandemic on the sector has only increased this uncertainty.<sup>2</sup>

#### 2. EXECUTIVE SUMMARY

##### *Recognising the importance of Westerleigh's investment [X]*

5. Westerleigh has invested around £[X] in the sector in the 10 years to 2019, opening 18 new facilities and increasing capacity by over 35,000 funerals per annum.<sup>3</sup> Consumer welfare has increased significantly as a result of this enhanced capacity, choice and competition in local areas.<sup>4</sup> The additional capacity has also proved critical during the COVID-19 pandemic, helping to ensure that the needs of the bereaved have been accommodated despite unprecedented levels of demand. Westerleigh has plans to continue its investment and expansion, further increasing the options available to consumers in many areas. However, these plans are

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<sup>1</sup> Crematoria: Profitability Analysis ("**Profitability WP**") and Cost of capital analysis ("**Cost of Capital WP**") working papers.

<sup>2</sup> Given the short period of time provided for Westerleigh to finalise its response to the Profitability WPs, Westerleigh has not been able to make detailed submissions regarding the impact of the COVID-19 outbreak on the sector and its relevance for the CMA's profitability analysis.

<sup>3</sup> [X].

<sup>4</sup> This is supported by a range of evidence, including the CMA's own econometric evidence (which shows entry has a large impact on incumbent volumes), Westerleigh new sites catchment areas significantly overlapping with those of existing sites, [X], Westerleigh's customer survey showing the importance of this investment to customers, and Westerleigh's investment in facilities specifically aimed to win business from competing crematoria.

currently put at risk by the uncertainty around the COVID-19 pandemic and the CMA's market investigation.

6. Westerleigh's facilities are of notably higher quality than typical incumbent sites.<sup>5</sup> This reflects Westerleigh's business model – it competes by providing a high quality service and better experience for mourners. Private sector crematoria offer a differentiated service to compete with local authority facilities which, due to chronic underinvestment, are often increasingly dilapidated. The poor condition and historical lack of capacity of local authority crematoria is well-known. Westerleigh's investment has therefore provided much needed capacity and choice to the sector. Westerleigh's customer survey shows that the higher quality services it provides reflect the needs and preferences of many customers.<sup>6</sup>
7. The CMA's approach must not unduly discriminate against the specific nature of Westerleigh's business model when assessing sector profitability. As explained below, there are several instances where the CMA's current approach does precisely that, most notably when valuing Westerleigh's land and assessing the relevant cost of capital. This results in a significant overestimate of Westerleigh's return on capital employed ("ROCE") and an underestimate of its WACC.
8. [REDACTED].

***The CMA's approach to valuing land is inconsistent with standard industry practice and biased against Westerleigh***

9. The results of the CMA's analysis are driven, to a significant extent, by the value it has assessed for crematoria land. The CMA initially set out its intentions to appoint an expert to value land. It failed to do so. As a result, it has had to rely on its own analysis which does not meet basic standards of valuation and does not reflect the costs incurred to acquire a modern equivalent asset ("MEA"). Such is the lack of robustness of the CMA's analysis in this critical area, Westerleigh considers that only limited weight can be placed on the results of its profitability analysis. The analysis fails to reflect the nature of the market and how crematoria sites are acquired and will be skewed in various ways for different operators depending on their specific circumstances.
10. The CMA has materially undervalued Westerleigh's land as a result of several clear errors of assessment. This includes, most notably:
  - (a) ***The CMA dismisses [REDACTED] of Westerleigh's freehold site land:*** The CMA has capped the size of a replacement site at [REDACTED]. Westerleigh has consistently explained to the CMA that the quality of its land (large grounds, peaceful setting, good access) is a key part of its business model and is important to customers. This is confirmed by

<sup>5</sup> See, for example, Westerleigh's response to the working papers setting out the CMA's competitive assessment of crematoria services in the UK, dated 2 March 2020 ("**Main WP Response**").

<sup>6</sup> See summary of the results of Westerleigh's customer survey submitted on 16 June 2020. Westerleigh intends to provide a more detailed explanation of its customer survey and the results in a separate submission shortly.

Westerleigh's customer survey. The CMA's analysis fails to reflect the reality that additional land improves the quality of a site and customer experience, and implicitly assumes that Westerleigh has made irrational commercial decisions to acquire more land than it requires.

- (b) ***The CMA fails to assign any value to leasehold sites:*** The CMA erroneously assigns zero value to any land held on a leasehold basis. This is based on arbitrary accounting rules, and unfairly discriminates against operators such as Westerleigh [§]. Westerleigh's leaseholds are long-term, involve transfer of risk, and Westerleigh invests significantly in these sites. There is no good reason not to assign value to these assets in the same way as freehold sites, i.e. to assess and include the MEAV for each leasehold site. [§].
  - (c) ***The CMA assesses land costs rather than replacement value:*** The basis of valuation used by the CMA focuses on costs (which are poorly defined) rather than land value. These are very different, with the cost of acquiring a parcel of land representing only a starting point for assessing value. The CMA's overly simplistic approach falls a long way short of the standards and rigour typically applied to valuations by a professionally qualified expert.
  - (d) ***The CMA assumes a very low cost to acquire land:*** The land acquisition costs assumed by the CMA are significantly below the current market value of land for crematoria use, as evidenced by Westerleigh's recent transactional experience.
  - (e) ***The CMA fails to take account of site-specific variations in land value:*** The CMA uses a uniform assumption for the cost of land per acre across the whole UK based on very limited market data, rather than a proper area- and site-specific valuation (as the CMA initially set out to do through the appointment of an expert). This obviously is not correct and leads to perverse results [§].
11. In this response Westerleigh provides evidence drawn from its significant recent experience in acquiring land for crematoria use to explain how these and other errors in the CMA's land valuation exercise result in a significant underestimate of Westerleigh's capital employed. Alongside this, Westerleigh provides updated insured replacement values for its buildings and explains additional errors in the way in which the CMA has assessed the value of its buildings, in particular in terms of the depreciation methodology employed by the CMA.

***The CMA's cost of capital does not reflect Westerleigh's sources of funding***

12. The cost of capital used for Westerleigh is based on a comparator set of companies that bears limited resemblance to Westerleigh: large, publicly listed, vertically integrated companies. Each will have better and cheaper access to sources of funding through liquid equity and corporate bond markets that Westerleigh has no access to and which market those listed companies (including through reducing information asymmetries). The comparators are all significantly larger than Westerleigh with average revenues of c. £570m, compared with

Westerleigh at £[REDACTED], while Westerleigh also has a significantly greater risk profile than the comparator set given the nature of its business model.

13. These factors all have the effect of materially reducing the CMA's estimate of the cost of capital relative to Westerleigh's actual funding costs, and require a reasonable adjustment to be made when assessing Westerleigh's profitability, at the very least as a sensitivity. Alternatively, the CMA must recognise the fact that its approach to assessing the cost of capital is biased towards understating Westerleigh's WACC when interpreting the results of its analysis.

***The CMA inappropriately includes profits related to burials***

14. The CMA has included Westerleigh's revenues from burials in its profitability analysis. This is inappropriate. Burial services are explicitly excluded from the CMA's definition of 'crematoria services' and are therefore clearly irrelevant.<sup>7,8</sup> The CMA should not draw conclusions on competitive dynamics in the crematoria sector from profits earned from such services. The inclusion of these non-core services significantly inflates Westerleigh's profits associated with the provision of cremation services.<sup>9</sup> In this response Westerleigh therefore calculates profitability excluding both revenues and costs associated with burials.

[REDACTED]

15. [REDACTED].

**Table 1:** [REDACTED]

***Limited conclusions can be drawn from the CMA's profitability analysis***

16. As set out in the CMA's guidance, no firm conclusions can be drawn from profitability analysis. Rather, evidence that returns have exceeded the cost of capital can only provide, at best (when not subject to significant error and uncertainty) an indication of limitations in the competitive process. However, this will only be the case where the CMA can show that the profitability of firms representing a "substantial part of the market" to be significantly and persistently excessive. Moreover, the profitability figures must be considered in the overall context of the market. In Westerleigh's view, the CMA's profitability analysis provides limited evidence of a lack of competition in the crematoria sector. On the contrary, the trend of declining profitability in recent years (alongside other changes and trends) is a clear indication

<sup>7</sup> Profitability WP, paragraph 7.

<sup>8</sup> In addition, the CMA has included profits from memorial services, which are included in the CMA's definition of products "associated" with cremations. However, memorials are subject to different competitive dynamics (including a much wider pool of competitors), which the CMA has not assessed as part of its investigation.

<sup>9</sup> The CMA's calculations include burials revenue, while excluding the direct cost of burials, further inflating profitability. This approach is also incompatible with the CMA's approach to valuing land, as cemeteries require significant space which the CMA has largely excluded by capping site sizes at 10 acres.

that market forces are working well.<sup>10</sup> Indeed, despite the CMA's focus on the private sector, three of the four largest private sector operators do not exhibit excess profits.<sup>11</sup>

17. While the CMA's analysis of public sector operators shows excess profitability, as Westerleigh has highlighted previously, profitability analysis is not well-suited to organisations whose objective function is not to make a profit.<sup>12</sup> Westerleigh has no visibility of the analysis undertaken for local authority sites but continues to urge significant caution in interpreting the results for this reason. For example, the CMA has provided no supporting material to indicate whether the limited sample of local authority sites were generating a surplus in order to fund bereavement services, public health funerals, or maintain closed cemeteries. Moreover, Westerleigh is concerned that the errors it has identified in the CMA's analysis of its own profitability are replicated with the local authority sites and that there is a likelihood of potentially counterintuitive results given the age of those sites and significant depreciation of assets (yet in need of significant investment), and the small sample of sites the CMA has analysed (only 10%).
18. Finally, to the extent the CMA has concerns regarding any individual firm's behaviour and profits, this clearly does not represent a "*substantial part of the market*" and does not permit the CMA to draw any wider conclusions across the sector.

#### ***Structure of response***

19. The rest of this paper is structured as follows: (i) **Section 3** details our concerns with the CMA's valuation of Westerleigh's asset base, in particular of land and buildings; (ii) **Section 4** details concerns with the CMA's assessment of profitability; (iii) **Section 5** examines the CMA's treatment of the cost of capital; and (iv) **Section 6** concludes.

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<sup>10</sup> CC3 (revised), paragraphs 118 to 126.

<sup>11</sup> Alongside Westerleigh's limited returns, our understanding is that Memoria and LCC make a return below their cost of capital.

<sup>12</sup> The public sector is able to access capital at significantly lower rates than the private sector, as well as access capital budgets for the provision of essential public services. In this way, local authority providers have different drivers such that "profitability" analysis and/or the ROCE may not be relevant. Moreover, in this context comparisons between the private and public sectors are likely to be largely meaningless.

### 3. CAPITAL EMPLOYED

20. The results of the CMA's profitability are driven, to a significant extent, by its valuation of crematoria land: as the CMA has correctly recognised: "*For crematoria, land is one of the most significant assets employed and hence must be valued appropriately*".<sup>13</sup> Unfortunately, however, while the CMA correctly sought to appoint an independent expert to value crematoria land, it failed to do so and instead adopted an approach to valuation that is far from appropriate and significantly undervalues Westerleigh's assets.

#### 3.1 Valuation of land

21. Westerleigh has identified a number of significant errors in the CMA's approach to valuing crematoria land, as follows:
- (a) Having failed to identify an independent expert to value crematoria land, the CMA has adopted an over-simplified land valuation methodology which inappropriately focuses on costs and fails to accurately reflect market value. See sections 3.1.1 and 3.1.2.
  - (b) The CMA unfairly and systematically undervalues Westerleigh's freehold sites by adopting an assumption that only 10 acres of land is required for a MEA, which means that it only assigns value to [X]. See section 3.1.3.
  - (c) The CMA erroneously places no value on land operated under leasehold assets. This approach reflects arbitrary accounting rules rather than the economic value of the assets, and unfairly discriminates against operators such as Westerleigh [X]. Westerleigh also has freehold land at some of its leasehold sites that must be taken into account in any valuation exercise. See section 3.1.4.
  - (d) The CMA significantly underestimates the current market value of land for crematoria use. Evidence from Westerleigh's own, significant, recent experience of transacting for land demonstrates that the average cost per acre is substantially higher than the £89.5K (outside London) assumed by the CMA. See section 3.1.5.
  - (e) The CMA assumes that land values are uniform across the UK, irrespective of location (other than London). This is manifestly incorrect. Land values will vary according to a range of factors which need to be properly assessed in determining the MEAV of any given site. See section 3.1.6.
  - (f) The CMA assumes that land values have not changed over a five year period. This is not consistent with Westerleigh's experience which shows that land values have increased over time and must be reflected in the CMA's analysis. See section 3.1.7.

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<sup>13</sup> Approach to Valuation of Crematoria Land, 5 December 2019 ("**Land Value WP**"), paragraph 8.

22. In the sections that follow, Westerleigh explains each of these errors and provides indicative figures to illustrate the extent to which each results in an overestimation of Westerleigh's ROCE in the CMA's analysis as part of the Westerleigh Adjustments.

### 3.1.1 Failure to appoint an expert

23. The CMA decided in December 2019 to commission an independent, expert report to value crematoria land and published a detailed methodology working paper on land valuation. In its response to the Land Value WP, Westerleigh set out its concerns about the proposed methodology to be used for land valuation and made recommendations on the scope of the valuation and selection of the appropriate expert. However, Westerleigh broadly welcomed the use of an expert, with professional qualifications and experience of the crematoria sector, to carry out valuations in line with well-established methodologies and appropriate rigour:

*"It is essential that the expert appointed has close and direct experience as to how land is transacted specifically for crematorium development, and has experience of past transactions in the market (including recent leasehold transactions). This is essential in appropriately identifying sites and assessing market values."*

**Westerleigh response to Land Value WP, para. 3.2**

24. The decision to hire an expert was taken eight months after the CMA started the second phase of its investigation and 18 months after beginning its review of the sector. The 'tender' process therefore allowed very little time for experts to respond, and as a result, the CMA's tender failed on two occasions. At this stage, Westerleigh would have expected the CMA to be transparent and approach the sector to obtain views on how best to obtain an objective valuation of the land. Given its recent investment in the sector, having developed close to 20 sites over the last 10 years (and having assessed many more potential sites over that time), carrying out extensive land acquisition work, Westerleigh has more expertise on crematoria land values than anyone else in the UK. Westerleigh could have assisted the CMA to find an appropriate means to value the land.
25. The CMA chose instead to undertake the land valuation itself via a rudimentary desktop exercise that makes little sense to Westerleigh. Westerleigh goes on in this section to highlight some of the main concerns with the CMA's approach to land valuation and how these affect the profitability assessment.

### 3.1.2 The CMA's over-simplified land valuation methodology

26. In the first instance, **the CMA's land valuation is based on determining costs not on assessing value**. These are very different. Valuation attempts to assess the 'real world' value that a site



would be exchanged for (the exercise which the CMA initially set out to commission). 'Market Value' is defined as:<sup>14</sup>

*"The estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer<sup>15</sup> and a willing seller<sup>16</sup> in an arm's length transaction after proper marketing where the parties had each acted knowledgeably, prudently and without compulsion"*

27. There are very detailed guidelines and standards for professional valuers to follow in valuing land, in particular prepared in accordance with the appropriate sections of the RICS Professional Standards ("PS"), RICS Global Valuation Practice Statements ("VPS"), RICS Global Valuation Practice Guidance – Applications ("VPGAs") and United Kingdom Valuation Standards ("UKVS") contained within the RICS Valuation - Professional Standards 2014, (the "Red Book"). Such valuations are compliant with International Valuation Standards ("IVS").
28. Understanding the nature of the market and how crematoria sites are transacted is key to assessing value. For example, Westerleigh carries out sequential site searching, identifying several sites which may be feasible for crematoria development (taking account of s.5 constraints and other planning and commercial issues). Westerleigh is particularly sensitive to site location and setting as a key part of its business model is to provide a peaceful, spacious setting with good road access (see also section 3.1.3). Proposed terms with landlords will typically be on a 'subject to planning' basis for use as a crematorium.
29. The cost of acquiring the parcel of land represents only a starting point for the value of land. For example, as explained further below:
  - (a) Costs do not reflect the potential value creation in gaining planning permission. Land with existing planning permission for a crematorium will attract a significant premium compared to land without, over and above the planning costs themselves, given the significant risks associated with the planning process (see section 3.1.5).
  - (b) The land will require significant works, in addition to buildings, to turn it into a viable site, which increases its value (see section 3.2.1).
  - (c) Costs do not reflect the de-risking of the site (see section 3.1.5).

<sup>14</sup> See RICS: Valuation and sale price – March 2019 (<https://www.rics.org/globalassets/rics-website/media/knowledge/research/insights/valuation-and-sale-price-march-2019-rics.pdf>). Definitions from the International Valuation Standards Council (IVSC).

<sup>15</sup> *"Willing buyer: motivated but not compelled to buy...neither over-eager nor determined to buy at any price... purchases in accordance with realities of the current market and with current market expectations rather than in relation to an imaginary or hypothetical market that cannot be demonstrated or anticipated to exist".*

<sup>16</sup> *"Willing seller - neither an over-eager nor a forced seller prepared to sell at any price, nor one prepared to hold out for a price not considered reasonable in the current market and motivated to sell the asset at market terms for the best price attainable in the open market after proper marketing".*



30. Furthermore, the CMA has made significant subjective judgements, going against evidence from professional valuers with experience of the sector. Specifically, the CMA dismisses the Cushman & Wakefield report submitted by Dignity on the basis that "*a number of sites [are] valued on the basis of residential or long-term residential alternative use... and this approach is likely to over value the land.*" This interpretation goes against the judgement of the expert, is incorrect and shows a poor understanding of the circumstances in which crematoria land transactions occur, as Westerleigh outlined in detail in its response to the Land Value WP in December, and the importance of using valuation experts with experience and knowledge of the sector. See section 3.1.5.
31. Ultimately the methodology which the CMA has adopted, without an appropriately qualified expert and without reference to accepted practice or professional standards for valuation, is inappropriate and Westerleigh believes will lead to an incorrect assessment of profitability. This is a serious flaw in the CMA's analysis which significantly limits the weight which can be placed on the CMA's profitability calculations.

### 3.1.3 Systematic undervaluation of Westerleigh land by excluding most of it

32. The CMA has capped the size of replacement sites at 10 acres under all scenarios on the basis of "*evidence... that this is the typical size of site needed to operate a crematorium*".<sup>17</sup> Westerleigh recognises that not every modern equivalent site will be the exact same size as the Westerleigh site being valued. However, the replacement site must be a fair reflection of the value. In particular:<sup>18</sup>
- (a) **Westerleigh's freehold sites are on average** [X].<sup>19</sup>
  - (b) In total, **the CMA fails to value** [X]. To only value [X] of Westerleigh's land is entirely unreasonable and significantly biases the CMA's analysis [X].
  - (c) Westerleigh also has freehold land at some of its leasehold sites that must be taken into account in any valuation of freehold land (see next section).
33. The CMA does not take into consideration the commercial decisions taken by Westerleigh on land purchase and, without any expertise in this area or reasoning, assumes that Westerleigh could operate its current sites on an equivalent basis with [X]. It is unclear how the CMA expects Westerleigh to 'replace' its current sites ([X]) with a 10 acre site and suffer no impact

<sup>17</sup> Profitability WP, paragraph 72.

<sup>18</sup> Note that during the process of responding to the CMA's working papers, Westerleigh has noticed errors in the way the CMA has classified certain sites as freehold or leasehold. [X]. The effect of this update is to increase the ROCE in the CMA's calculations. [X].

<sup>19</sup> This differential is not driven by burial grounds as, even excluding those sites with burial grounds, Westerleigh's average site is close to [X]. Westerleigh has only three freehold sites with burial grounds: New Southgate, Westerleigh, and West Suffolk.

on its business. If such sites were 'equivalent' (i.e. MEAV), why would Westerleigh have invested significantly more to acquire sites with "excess" land?

34. A core part of Westerleigh's business model is site selection. It spends considerable time and investment selecting sites with large grounds that guarantee a peaceful setting free from noise and pollution, far from traffic to minimize road noise, isolated from neighbouring residential or commercial buildings, and of sufficient size to allow for a range of current and facilities and future developments, including car parking, hospitality and second chapels. This enables Westerleigh to differentiate itself from incumbent crematoria (typically older local authority sites in urban centres) and is an important aspect of the 'qualitative pull' of Westerleigh's sites (which is supported by its customer survey).<sup>20</sup>
35. Furthermore, not all sites operate as a single chapel crematorium. For Westerleigh sites which have a second chapel and other facilities like hospitality, these are clearly not comparable with the "average" crematorium. Such additional facilities require separate circulation and car parking which could not physically be accommodated within a 10-acre site.
36. Importantly, Westerleigh has acquired additional land adjacent to existing sites over the last few years, even when its existing site was greater than 10 acres, demonstrating that additional land has value for enhancement to the quality of the site or to facilitate future improvements (such as expansion of circulation space, car parking, development of hospitality or second chapel facilities) or to provide land for memorials. These acquisitions have included land at [REDACTED].
37. A 10-acre site would offer a very limited amount of capacity to undertake memorials, which would be exhausted very quickly having regard to the long-life cycle of a crematorium. Significantly larger sites are therefore required for long term memorial capacity. In Westerleigh's view, capacity to provide memorials is critical to the long term success and sustainability of a successful crematoria and this is one of the reasons why [REDACTED].
38. For the CMA to establish that 10 acres is a sufficient size for a modern asset equivalent, it would need to be able to identify vacant land and confirm that this vacant land is surplus, including through assessing current defined service requirements that takes account of different business models and differentiation between providers. No such process has been undertaken.<sup>21</sup> Indeed, the CMA's approach implicitly assumes that Westerleigh has made irrational commercial decisions to acquire more land than it needs. It is not open to the CMA to make assumptions of this nature.

<sup>20</sup> Note that Westerleigh also bears the cost of owning and maintaining the whole of each of its sites, not just the 10 acres allowed by the CMA. The CMA's methodology therefore results in a mismatch of costs and capital employed in its profitability analysis.

<sup>21</sup> If the CMA deems such land to be surplus and not contributing to the site, then arguably Westerleigh would have the ability to divest of such land at an appropriate valuation.

39. In summary, the CMA's approach systematically undervalues the land at Westerleigh sites. Given Westerleigh has typically significantly larger sites than other providers,<sup>22</sup> the CMA's approach is discriminatory, disproportionately inflating Westerleigh's profitability relative to other operators and penalising its investment to create a higher quality offering. In doing so, it reaches conclusions that discourage investment and encourage uniform provision of site size and settings. Westerleigh believes that its sites are the appropriate size for the operation of the crematorium, proportionate with the business of each site and therefore should be accounted for in the assessment of land value and capital employed.
40. The effect of excluding this freehold land from the analysis significantly inflates the ROCE. While Westerleigh believes the total site size should be included as this will reflect the business case for that particular site, for illustrative purposes and following the CMA's assumption that MEAs have homogenous site size requirements, Westerleigh Adjustments shows the effect on the CMA's scenarios including each freehold site at the average freehold Westerleigh site size.<sup>23</sup> This Westerleigh Adjustment:
- Reduces the CMA Base case by [REDACTED] ppts.
  - Reduces CMA Sensitivity 1 by [REDACTED] ppts.
  - Reduces CMA Sensitivity 2 by [REDACTED] ppts.

### 3.1.4 Capitalisation [REDACTED]

41. The majority ([REDACTED], [REDACTED]%) of Westerleigh's current operational sites are long-term leaseholds typically with terms of [REDACTED]. For many of these leasehold sites, Westerleigh is [REDACTED].
42. However, the CMA places no value on the land operated under these leasehold assets. This is inappropriate. The CMA's approach to valuing land is to determine the MEAV, i.e. "*the current market price of the lowest cost, suitable site that an operator could purchase to serve the relevant local market*".<sup>24</sup> Regardless of whether crematoria land is currently held on a freehold or leasehold basis, it could not be replaced at zero cost.
43. Moreover, whether a property is leasehold or freehold simply reflects a property financing decision (which should not affect the measure of profit for the purposes of a competition assessment). The CMA's approach, which is based on arbitrary accounting rules with no connection to economic value, will result in different outputs solely as a result of the structure of the land holding. The CMA's approach also treats Westerleigh unfairly compared to other

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<sup>22</sup> [REDACTED].

<sup>23</sup> The changes reported here solely relate to the [REDACTED]. The same approach is applied to all Westerleigh Adjustments, a summary of which is provided in the conclusion to this submission. [REDACTED].

<sup>24</sup> Land Valuation WP, paragraph 15.

operators, producing a significantly higher ROCE than would have been the case if Westerleigh had a greater proportion of freehold sites.

44. Regardless of the financing and legal structure of land ownership, Westerleigh develops the site and puts the asset to use to generate revenues from the site. The long-term nature of the leaseholds (typically between [X] and [X] years) means the risk and reward of ownership is transferred to Westerleigh. [X].
45. Supporting this, Westerleigh makes significant capital expenditure to invest in its leasehold land:<sup>25</sup>
- (a) Westerleigh's invests in constructing a crematorium on the site (which, once completed, has no alternative use on a leasehold site – i.e. the asset cannot be moved) and incurs the same level of acquisition costs, planning costs, other land development costs and construction costs as for freehold sites.
  - (b) As noted above, [X] of Westerleigh's leasehold sites include purchase of freehold land at or adjacent to the leasehold site, including:
    - (i) [X].
    - (ii) [X].
    - (iii) [X].
  - (c) [X].
46. The leaseholds are therefore simply a financing choice and the leasing costs are financing costs equivalent to the financing used to fund purchase of a freehold. The ROCE should reflect the economic value of the assets and not be driven by the property financing decisions of Westerleigh. By treating the two differently, the CMA's methodology favours a particular ownership structure over another, which will also unfairly treat operators with different access to finance differently. [X].
47. [X]. Indeed, under new accounting rules (IFRS 16), leaseholds are required to be included in balance sheets as right of use assets, with the rentals being treated as a financing cost. Westerleigh could choose to adopt IFRS and apply the relevant policy for leasehold capitalisation. The CMA's approach should be determined by the appropriate economic value, not by an arbitrary choice of accounting standards.
48. An illustration of the impact of this is [X]. If the CMA's calculations were amended to reflect the current legal and financing structure of the property, then the ROCE calculation would be reduced, as it would be if Westerleigh had chosen to contract on a freehold rather than leasehold basis initially.

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<sup>25</sup> [X].

49. Under the CMA's approach, the ROCE is almost always likely to be higher as a result of leasing the land rather than acquiring it.<sup>26</sup> In its *Approach to profitability and financial analysis working paper*, the CMA states that leases "can to some extent be alleviated by calculating economic profits in absolute terms." Westerleigh disagrees this is the case, and believes that to avoid a discriminatory approach to operators the value of all leasehold land should be capitalised and treated as part of the asset base in the same way freehold land is. At the very least, the CMA should be including such a scenario in its sensitivity analysis to assess the extent that its approach is adversely affecting operators with leasehold property structures.
50. In summary, the effect of excluding this leasehold land from the analysis significantly inflates the ROCE. As noted above, Westerleigh believes the total site size should be included as this will reflect the business case for that particular site. In the context of capitalized leaseholds, these should be treated on the same basis as freehold assets and depreciated over their useful economic life.<sup>27</sup> For illustrative purposes and following the CMA's assumption that MEAs have homogenous site size requirements, Westerleigh Adjustments shows the effect on the CMA's scenarios including each leasehold site at the average leasehold Westerleigh site size.<sup>28</sup> This Westerleigh Adjustment:
- Reduces the CMA Base case by [✂] ppts.
  - Reduces CMA Sensitivity 1 by [✂] ppts.
  - Reduces CMA Sensitivity 2 by [✂] ppts.

### 3.1.5 Significantly higher land acquisitions costs

#### (a) Land market data from market comparators is not representative

51. As the basis of their market value comparators, the CMA has limited its information to the cost of acquisitions of a small sample of only 16 freehold sites over an eight year period (2010 – 2018) – only three of which are Westerleigh sites – in arriving at a base case view of land value across the whole of the UK. This raises a number of concerns:

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<sup>26</sup> Westerleigh's gearing and cost of debt is likely to be artificially lower as well (see further section 5 below) than under an alternative accounting policy.

<sup>27</sup> The CMA has recognised this approach previously when capitalising leaseholds (see Private Healthcare Market Investigation, Annex 6-13, paragraph 60). Westerleigh notes that the leaseholds could also be valued at the NPV of future rental payments. Westerleigh has looked at both approaches and, in the CMA's base case, both lead to very similar valuations.

<sup>28</sup> As a consequence of treating leasehold assets on the same basis as freeholds, rental payments made on these buildings should be removed from operating costs (i.e. no longer subtracted from revenue) and this is factored into the Westerleigh Adjustments. Note that this adjustment is not applied to the rental payments for the [✂], which remain included. The changes presented here are for illustrative purposes. Westerleigh can assist the CMA in providing further details on these points.

- (a) The limited analysis ignores the significant other transactional market data on land acquired for use on a long leasehold basis,<sup>29</sup> which contains useful information on land values (and from which imputed freehold costs can be estimated), is a large part of the market, often the only basis upon which land is available, and, in the case of Westerleigh, represents the [REDACTED] (see section 3.1.4 above).
- (b) [REDACTED].
- (c) The sample is of freehold acquired sites since 2010. It would be appropriate to index these costs up to the relevant period using a representative index (one which reflects the movement in values for these assets). It is not clear whether this has been done already. If not, then clearly acquisition costs from 2010 are not informative of costs and land values in 2018/9, particularly given the trend in crematoria land values.
52. To demonstrate that the CMA's approach does not reflect a realistic estimate of what the acquisition costs of a modern equivalent facility would be, Westerleigh provides below the: (i) costs of its recent freehold transactions, (ii) its recent unsuccessful bids for freehold sites which were acquired by rivals, and (iii) the imputed freehold value from recent leasehold transactions.
- (i) Recent freehold site acquisition costs**
53. For the freehold sites, an analysis of acquisition costs (including transaction costs but excluding planning costs and land development costs), excluding the two outlier transactions noted above shows an average freehold cost of £[REDACTED] per acre using the CMA's 10 acre cap. [REDACTED], both significantly higher than the CMA's assumed cost outside London of £89.5K and much higher than [REDACTED] used by the CMA.
54. It is unclear from the Profitability WP whether the CMA has calculated the average price using the 10 acre cap or the actual site size (as Westerleigh has no visibility over the sites used to calculate the cap). Westerleigh has significant concerns with an approach that caps replacement site sizes at 10 acres (given Westerleigh's average site size is more than double this based on deliberate investment decisions on site size), which are set out in detail in section 3.1.3 above. However, for consistency, the appropriate approach if the CMA continues to use this methodology would be to calculate the cost per acre as the cost of land acquisition divided by the lower of (a) the actual area of the site in question and (b) 10 acres, given the CMA does not recognise any value for sites larger than 10 acres.<sup>30</sup>

<sup>29</sup> See Westerleigh's response to the Land Valuation WP, para 3.2: "It is essential that the expert appointed has close and direct experience as to how land is transacted specifically for crematorium development, and has experience of past transactions in the market (including recent leasehold transactions). This is essential in appropriately identifying sites and assessing market values."

<sup>30</sup> Removing this 10 acre cap, the average freehold cost is between £[REDACTED] and £[REDACTED]. As noted above, these reflect acquisition costs, not the value of the site (all have involved significant investment in land development).

Table 2: [REDACTED]<sup>31</sup>**(ii) Recent unsuccessful freehold site acquisition costs**

55. In addition to the above completed transactions, Westerleigh has been unsuccessful in bids for other sites, that have been secured by other crematoria developers/operators. This competition for sites – which has increased very significantly in recent years – inevitably increases acquisition costs and site valuations, leading to more competitive bids and a lower return on investment following development. These include the following recent transactions on a freehold basis, which show significantly higher acquisition costs than the CMA's assumption. The average based on these plus the transactions set out above is an average freehold cost of £[REDACTED] per acre, significantly higher than the £89.5K per acre value adopted as the base case by the CMA. Removing the 10 acre cap, shows an average freehold cost for the sites below plus those above of between £[REDACTED].

Table 3: [REDACTED]

**(iii) Recent leasehold acquisitions (imputed freehold value)**

56. Recent leasehold acquisitions also provide important supporting market evidence that land costs are significantly higher than the CMA's estimate. The calculations below show the imputed freehold cost for Westerleigh's recent leasehold transactions based upon current rental and a current market yield of circa [REDACTED].
57. The analysis also shows considerably higher equivalent costs than the CMA's approach, averaging £[REDACTED] per acre (using the CMA's methodology of limiting usable site area to 10 acres), rising to £[REDACTED] per acre [REDACTED]. Removing the 10 acre cap, shows an average equivalent freehold cost below of [REDACTED].<sup>32</sup>

Table 4: [REDACTED]<sup>33</sup>

58. In summary, based upon the above analysis, and applying the CMA's 10 acre cap, the average for all transactions detailed above (freehold and leasehold) is a land cost of £[REDACTED] per acre. This increases to a figure of £[REDACTED] if the [REDACTED]. This **objective, more comprehensive and more timely market data suggests an average benchmark cost in the region of circa £[REDACTED] per acre would not be unreasonable (based on the CMA methodology)**. Removing the 10 acre cap, gives an average land cost of £[REDACTED], [REDACTED] that used by the CMA. Note again that this is land cost and not land value with land improvements and planning consent (see further below).

**(b) Reasons for higher acquisition costs**


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<sup>31</sup> These include both [REDACTED].

<sup>32</sup> [REDACTED].

<sup>33</sup> [REDACTED].



59. The evidence outlined above shows that the land acquisition costs faced by Westerleigh are significantly higher than those assumed by the CMA for the purchase of a MEA. The difference reflects both an unrepresentative sample that contains very limited Westerleigh acquisitions (of which, [REDACTED]) and the CMA's failure to take account of the specific nature of Westerleigh's business model which is focused on providing a differentiated offering, including considerable focus on the quality of location and the quality of site, which is supported by a range of evidence that Westerleigh has detailed elsewhere (including the survey of Westerleigh's customers). [REDACTED].
60. Alongside these, Westerleigh wishes to point to two additional factors not taken into account or inappropriately dismissed by the CMA.
- (i) Valuation on basis of possible residential alternative use**
61. The CMA notes that valuation on the basis of residential or long-term residential alternative use is likely to overvalue the land (particularly compared to agricultural land).<sup>34</sup> This misunderstands how Westerleigh commonly acquires land. [REDACTED].
62. A typical Westerleigh target site will be on the edge of large settlements or conurbations, within easy reach of large populations. [REDACTED].
63. [REDACTED]. Further evidence of residential development as a likely use for typical sites includes:
- (a) [REDACTED].
- (b) There are a number of existing sites where Westerleigh is seeing residential development activity around or close to its site, [REDACTED].
- (c) [REDACTED].
64. [REDACTED].
65. In this context, the CMA has downplayed the methodology and valuations of Cushman and Wakefield (professional valuers with significant experience in the sector), noting of the report: "*we were concerned that the approach adopted was likely to result in an over-valuation of the land on an MEAV basis. For example, Cushman & Wakefield valued a number of the sites on the basis of residential or long-term residential alternative use.*"
66. Westerleigh cannot comment fully on the Cushman & Wakefield report as it has not seen it. However, it believes the CMA shows a poor understanding of how land is acquired in the market, which is symptomatic of its approach to valuation. In Westerleigh's view the CMA has therefore failed to adequately justify its decision not to take the Cushman & Wakefield methodology and valuations into account in its own methodology and analysis. Westerleigh addressed this specific point in its response to the Land Value WP in December:

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<sup>34</sup> Profitability WP, paragraph 66.

[REDACTED]

**(ii) Land values with planning consent**

67. Land acquired by Westerleigh and other operators is often on a subject to planning basis and, as purchaser, Westerleigh bears the risks and costs of securing planning consent for use as a crematorium (and constructing the crematorium). This does not appear to be recognised by the CMA, which has simply calculated the average cost of planning permission for a crematorium and then adjusted this for the probability of failing to obtain planning permission to arrive at a uniform planning figure of £428K per site. This has been added to all sites built pre-2010, while for those built in recent years, the CMA has just used actual planning costs. The CMA has not provided any details of its assumed probability of failing to obtain permission and so Westerleigh is unable to comment on this.<sup>35</sup>
68. Planning costs alone understate the value of land with planning consent. The cost and risks of pursuing a planning consent for crematoria use are extensive and, as in all other sectors of the land market, the returns for such planning costs and risk are reflected in a premium on land cost to reflect market value with planning consent. Typically, this could be in the range of [REDACTED]% uplift on land cost and could be higher for sites with a lower prospect and higher risk in securing planning consent such as those within open countryside or the greenbelt (surrounding many of the UK's major conurbations) where the presumption is against any form of development.<sup>36</sup>
69. In summary, the effect of using an artificially low acquisition cost for the land of a replacement facility significantly inflates the ROCE. For illustrative purposes and following the CMA's assumption that MEAs are subject to the same capped 10-acre land cost regardless of specific site or area in the UK and applying the updated cost only to freeholds (both of which Westerleigh strongly disagrees with), Westerleigh Adjustments assume an acquisition cost of [REDACTED]. This is a conservative approach given the acquisition costs outlined above. This Westerleigh Adjustment:
- Reduces the CMA Base case by between [REDACTED] and [REDACTED] ppts.
  - Reduce CMA Sensitivity 1 by between [REDACTED] and [REDACTED] ppts.
  - [REDACTED] is unaffected.

**3.1.6 The CMA has applied uniform land values irrespective of location**

70. In its Land Value WP, the CMA outlined that the modern equivalent site must "*be appropriately located to serve the market served by the existing crematorium*".<sup>37</sup> In response,

<sup>35</sup> Westerleigh requests disclosure of this and the reasoning and evidence supporting it.

<sup>36</sup> A demonstration of the costs and risks involved is [REDACTED].

<sup>37</sup> Land Value WP, paragraph 15(a).

Westerleigh emphasised the importance of specific location choice to its business model and the extensive investment and time taken to identify suitable sites. Westerleigh's site requirements dictate both an advantageous location outside but close to population centres, providing for a peaceful setting with good road access. This limits the availability of sites that meet such requirements. In applying a crude uniform price per acreage, the CMA applies the same geographic criteria to all operators and to all sites in all parts of the country (except London but only as a sensitivity) with no geographic limitation or criteria, no local assessment, and no consideration of whether a site purchased at such a cost in each area would "*have a reasonable prospect of obtaining planning permission for use as a crematorium.*"<sup>38</sup> This departs significantly from the methodology which the CMA set out in the Land Value WP.

71. In the first instance, the CMA should clearly be using Sensitivity 1 as its Base Case as there is no justification for using the same land cost in London as the rest of the UK. However, this does not go nearly far enough. Both regional variations and specific locations within that region are important considerations that will lead to materially different valuations:
- (a) Land, and its value per acre, is not homogeneous across the UK and the CMA's approach of applying the same cost per acre regardless of location, leads to perverse results. For example, Westerleigh's sites located in [X] are all valued exactly the same (£[X]) while its site in Scotland is very similar (£[X]). This is clearly unsound and does not meet even a basic common-sense test. The value of land in these regions is dramatically different.
  - (b) The value of specific parcels of land within regions also vary significantly. The CMA's approach suggests that a crematoria located within the middle of a major conurbation with a large population catchment and addressing demand for say 2,000–3,000 cremations per year as a result would have the same land value as another crematoria site located in a rural location and with a small population catchment with 700–800 cremations per year. Again, this does not reflect reality.
72. The demand for crematoria services is not homogeneous across the UK but varies for each specific site location based upon size of local population and demographics. As such the volume of cremations and hence revenue at any site location depends upon numerous factors such as current and future catchment populations, age structure, religion and competition (current and future) from other crematoria also serving that area.
73. In order to arrive at any meaningful benchmark site value, these specific factors along with the more general attributes of the particular local land market, need to be properly assessed and accounted for by a suitably qualified valuer.
74. Westerleigh shows below land valuations for each of the local authorities in which its freehold sites are located. These figures are produced by the Valuation Office Agency and published by the Ministry of Housing, Communities and Local Government (for 2017 and for English local authorities only). The variation in land between sites is significant and this excludes the

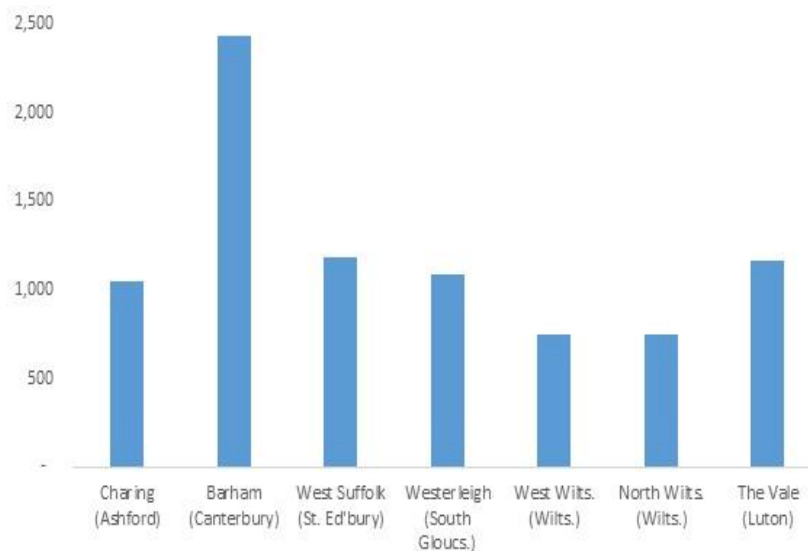
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<sup>38</sup> *Ibid*, paragraph 15(c).

variation for other sites across the country not in Westerleigh's portfolio. Note that Figure 1 excludes Westerleigh's London site, New Southgate. Figure 2 shows the land costs as a proportion of the land costs in Barnet, the local authority in which New Southgate is located. The per acre land value for Barnet local authority area is £10.1 million.<sup>39</sup>

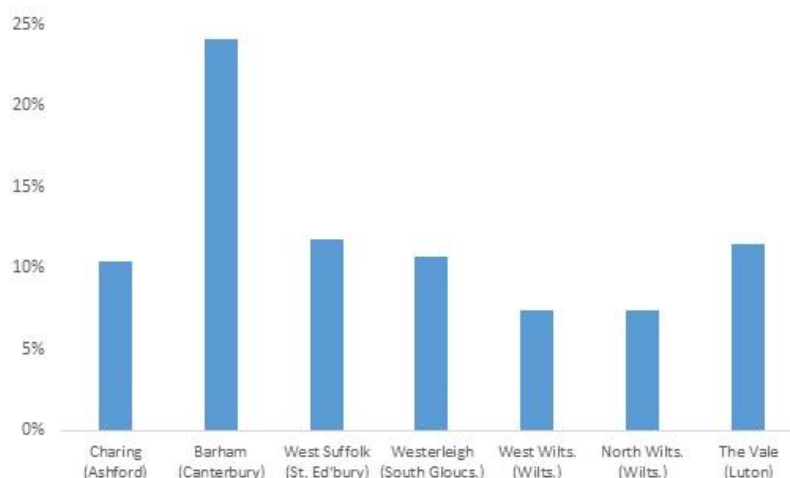
75. Note that Westerleigh cautions against using land value indices and considers them only illustrative due to the wide variation even within a given local authority area. Further, this analysis does not attempt to show the specific values of these sites, but simply to illustrate the variations in land valuations between regions where the relevant sites are located.

**Figure 1: Differential costs across Westerleigh site local authorities (£,000s per acre)**



<sup>39</sup> The dataset provides land value estimates for policy appraisal, providing a 'typical' residential site in each of England's local authorities. While Westerleigh addresses the appropriateness of residential land value below, the purpose of this comparison is to show the significant variation in land value between areas.

**Figure 2: Differential costs across Westerleigh site local authorities  
(% of Barnet LA – New Southgate)**



76. In summary, the effect of using a uniform cost for the land of a replacement facility across sites and UK areas introduces significant uncertainty and risk of error into the CMA's analysis, reducing its probative value. Westerleigh has been unable to make any adjustment on this point specifically because it reflects a fundamental weakness of the CMA's approach and should be taken into account in interpreting the results.

**3.1.7 Land value has not remained constant over the entire period**

77. The CMA assumes that land values remain fixed over the five year period. This is not Westerleigh's experience of land value and prices, which in many cases have increased considerably. The market has changed significantly in recent years as land owners have become aware of the use class and potential demand from crematoria operators and have consequently sought a premium from them.

78. In addition, [REDACTED].

79. Using the market data from Tables 2 to 4 above (summarised in Table 5 below) shows that recent values for land transactions in 2015/16 were on average £[REDACTED] per acre (using the CMA's methodology of limiting usable site area to 10 acres). This increases to an average of £[REDACTED] per acre (CMA methodology) for more recent site acquisitions between 2017 and 2020, pointing to [REDACTED]%.

**Table 5: [REDACTED]**

80. The effect of using a constant land value over the five year period does not therefore reflect reality based on Westerleigh's experience and inflates the ROCE. Westerleigh Adjustments assume land value increases of [REDACTED]% per annum. Westerleigh believes this is very conservative given the land values suggested by the data above. This Westerleigh Adjustment:

- Reduces the CMA Base case by [REDACTED] ppts.

- Reduces CMA Sensitivity 1 by [X] ppts.
- Reduces CMA Sensitivity 2 by [X] ppts.

### 3.2 Valuation of buildings

81. The CMA's profitability analysis also materially undervalues Westerleigh's buildings, as a result of the following issues:

- The CMA uses a 2018 valuation of the insured replacement cost of Westerleigh's buildings, which significantly undervalued those buildings, as shown by a more recent valuation undertaken by a qualified surveyor. See section 3.2.1.
- The CMA's analysis erroneously excludes the value of buildings at certain Westerleigh sites. See section 3.2.2.
- The CMA's depreciation methodology understates the capital employed by inappropriately depreciating assets in year regardless of when the property was built. See section 3.2.3.
- The CMA's depreciation methodology also incorrectly depreciates capital improvements to sites based on the age of the site itself, rather than when the investment in question was undertaken. See section 3.2.4.

82. As with land valuation, Westerleigh provides below indicative figures to illustrate the extent to which each of these issues results in an overestimation of Westerleigh's ROCE in the CMA's analysis as part of the Westerleigh Adjustments.

#### 3.2.1 Updating replacement insurance costs to reflect restatement

##### (a) Restatement of insured values

83. The CMA uses insured replacement cost to value buildings. Westerleigh has recently undertaken a review of its replacement costs by a qualified surveyor for its 2020 insurance renewal. The 2018 valuation, used by the CMA, significantly underestimated re-instatement costs. This has shown an increased insured replacement cost not reflected in the CMA's assessment, of £[X] compared to £[X] in 2018 (on a like for like basis), an increase of £[X], [X]%.

84. Given the previous insurance costs were significantly understated, Westerleigh has updated the values to the 2020 restatement. This Westerleigh Adjustment:

- Reduces the CMA Base case by [X] ppts.
- Reduces CMA Sensitivity 1 by [X] ppts.

- Reduces CMA Sensitivity 2 by [✂] ppts.
85. Note that while insured replacement cost provides a useful starting point, it will not accurately reflect the value of an asset or the true cost of developing an equivalent asset. The replacement cost includes no allowance for (i) transaction costs associated with the development, (ii) the significant inherent risk of developing and constructing a new crematorium (the reinstatement of an existing building following an insurable catastrophe will not face the same risks), and (iii) land development costs (see below).
- (b) Exclusion of land development and transaction costs**
86. The CMA's approach to valuing land (and buildings) also makes no allowance for land development costs associated with initially developing a site for a crematorium. These include extensive site design, enabling and preparation work including the provision of off-site infrastructure and services.
87. This expenditure is neither captured in the land acquisition benchmark cost, the planning benchmark cost or the value of buildings on the site on an insurance replacement cost basis, which seeks to assess the cost to re-build an existing asset following an insurable event (e.g. after a fire). For a typical site this would include *inter alia*:
- (a) Ground stabilisation and site remediation including removal or capping of contamination;
  - (b) Earthworks within the site to provide appropriate development levels on which to build and provide landscape grounds;
  - (c) The formation of suitable new access, and in most cases extensive off-site highway improvement, works to the adjoining highway network under S278 Agreements such as construction of new right turn lane;
  - (d) The provision of all services to the site (water, electricity, gas, drainage and telecoms) and/or the diversion and/or upgrading of existing services and construction of land drainage infrastructure within the site;
  - (e) The construction of roadways, parking areas and pathways within the site;
  - (f) Landscaping – the preparation of the site including importing significant quantities of topsoil and carrying out extensive landscaping works across the site.
88. The replacement cost will not include all the costs necessary to undertake the development of a new site, such as agent, engineer, architect and legal fees.
89. Both individually and collectively these costs are material and, based on recent experience, can commonly be around £[✂] or more per site. These costs are not reflected in the land cost benchmarks used by the CMA which relate to land cost alone, nor are they accounted for in the reinstatement cost of buildings for insurance purposes. By excluding them, the CMA is



assuming a modern equivalent facility is a parcel of undeveloped land. This leads to the CMA underestimating the capital employed.

90. The effect of excluding these necessary development costs for each site unduly inflates the ROCE. Westerleigh has not adjusted the ROCE to take account of these costs but notes the impacts shown are likely to be a conservative understatement of the full reduction in the ROCE.

### 3.2.2 Including replacement building costs for all sites

91. The CMA's analysis erroneously excludes building values associated with a number of Westerleigh's sites, which must be included in the asset base.

#### (a) Long-term operating leases where Westerleigh has made significant investment in buildings

92. [REDACTED].<sup>40</sup> The CMA's methodology has (presumably in error) ignored this investment in its assessment of building values. In its workings, the CMA has commented that "*Westerleigh does not own the building*" and therefore applies zero value to capital employed at these sites. While it is correct that Westerleigh does not own the freehold of the land on which the buildings are situated, (in line with many of the long leasehold sites in Westerleigh's portfolio), it is not correct to ignore the investment which Westerleigh has made, which significantly overstates the return on capital on these sites. The leases and management agreements for these sites have finite and relatively short terms. [REDACTED]. As a result, Westerleigh will need to generate a return on its investment and recover the investment over a short time period, taking account that the investment was into the improvement of the facilities and therefore will [REDACTED].<sup>41</sup>

#### (b) [REDACTED]

93. The capital employed at this site has been excluded from the data despite having been completed during the period.
94. Westerleigh includes the investment in operating lease buildings, depreciating them in line with the terms of the lease (as is the case in Westerleigh's accounts),<sup>42</sup> and the insured replacement cost of the [REDACTED]. These Westerleigh Adjustments:

- Reduce the CMA Base case by [REDACTED] ppts.
- Reduce CMA Sensitivity 1 by [REDACTED] ppts.
- Reduce CMA Sensitivity 2 by [REDACTED] ppts.

<sup>40</sup> Westerleigh has [REDACTED], as set out in information provided during the RFI process.

<sup>41</sup> In addition, [REDACTED].

<sup>42</sup> The adjustment adds the depreciated capital employed to the adjusted balance sheet.

### 3.2.3 Depreciation methodology understates capital employed

95. The CMA has depreciated *in year* regardless of when the property was built and opened. This makes no sense and is unreasonable. For example, [REDACTED] was opened in December 2018, less than a month before year-end yet the CMA has applied a fully year depreciation charge for 2018 for the site. This inexplicably assumes [REDACTED] instead opened in January 2018, almost a year before it actually did open. This is not an anomalous example: [REDACTED] the freehold sites were opened by Westerleigh in the second half of the year yet each is subject to a full year depreciation charge in the year of opening.<sup>43</sup>
96. It is standard accounting practice for depreciation of an asset to begin when it is available for use.<sup>44</sup> In the context of Westerleigh site buildings, the site is opened when the building is available for use. The CMA provides no reasoning for its approach, which again overstates the ROCE.
97. While depreciation should be applied at the point of use, for illustrative purposes of the effect on the ROCE, Westerleigh has assumed those sites opened or acquired in the second half of the years are not subject to a depreciation charge in the first year while those opened in the first half of the year are. This Westerleigh Adjustment reduces the *CMA Base* case by [REDACTED] ppts.

### 3.2.4 Depreciation error in treatment of subsequent capital investment in sites

98. The CMA's approach wrongly depreciates capital improvements to sites based on the age of the site. The CMA's calculations use latest replacement cost for insurance purposes, depreciated based on the age of the site, with an assumed total life of 100 years. This methodology means that recent improvements and enhancements to the site are overly depreciated, understating the capital employed in the asset. Westerleigh has a track record of significantly improving the quality of its sites over time, by investing in enhanced facilities, these include:
- (a) [REDACTED].
  - (b) [REDACTED].
  - (c) [REDACTED].
99. [REDACTED]. This is clearly unreasonable. To illustrate the effect on the ROCE, Westerleigh has added the additional capital employed as a result of the different depreciation profiles for the three sites above. This may understate the impact of this error as it is not adjusted to current insurance reinstatement values as per the CMA's methodology. This Westerleigh Adjustment reduces the *CMA Base* case and sensitivities by [REDACTED] ppts.

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<sup>43</sup> [REDACTED].

<sup>44</sup> See IAS16: 55. <https://www.iasplus.com/en/standards/ias/ias16>

#### 4. PROFITABILITY

##### 4.1 Treatment of burial activity

100. The CMA has included revenue from burials in Westerleigh's earnings. However, this unfairly inflates Westerleigh's ROCE for the purposes of assessing competitive dynamics in the crematoria sector for two reasons.

101. First, the CMA must remove costs attributable to burials, which should be afforded the same treatment as revenues. All revenues and costs relating to burials should be removed.<sup>45</sup>

102. Second, and more importantly, burial services are explicitly excluded from the CMA's definition of 'crematoria services'.<sup>46</sup> It is therefore clearly inappropriate to take account of revenues earned from such services in assessing crematoria profitability.

103. Of Westerleigh's freehold sites, only three have burial grounds and only ten of its entire portfolio have burial grounds. At only [X] of its sites does burial activity account for more than [X]%<sup>47</sup> of total funerals.

104. [X]. This means that including revenue from burials materially overstates Westerleigh's ROCE from the provision of cremation services.

105. The CMA's rationale for including burial revenue is that Westerleigh responded that it was [X].

106. Westerleigh has previously provided analysis of revenues and has prepared an estimate of burial costs to provide adjusted revenue and costs related to cremation.<sup>48</sup> The removal of burial revenues *and costs*:

- Reduces the CMA Base case by [X] ppts.
- Reduces CMA Sensitivity 1 by [X] ppts.
- Reduces CMA Sensitivity 2 by [X] ppts.

##### 4.2 Removal of memorial activity

107. The CMA has also included in Westerleigh's earnings revenue from memorials. Westerleigh recognises that it is difficult to distinguish cremation and memorials with memorials an

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<sup>45</sup> It should be noted that, in this context, costs associated with the [X].

<sup>46</sup> Profitability WP, paragraph 7.

<sup>47</sup> Based on the number of interments in proportion to total cremations and interments

<sup>48</sup> Note this adjustment removes burial revenue and overheads while COGS remains unchanged as these were already excluded in the CMA's calculations.

important part of its cremation business and does not suggest separating these in the same way as burials.

108. However, in interpreting the ROCE and its profitability analysis, the CMA must recognise that memorials are subject to a separate competitive assessment. While memorial services are included in the CMA's definition of services 'associated' with cremations, Westerleigh is subject to different competitive dynamics in relation to the provision of memorial services (including a wider pool of competitors), which the CMA has not considered. The inclusion of revenue from such services therefore provides a poor indicator of competitive conditions in relation to cremation services. In addition, memorials require ongoing investment in land, without which memorial revenues would not be sustainable. This is not compatible with the CMA's approach to land valuation capping site sizes at 10 acres.

#### 4.3 Development costs incurred

109. [REDACTED].

110. However, given these costs have been incurred and the uncertainty around planning and development that means these projects may not go ahead, Westerleigh believes that these costs should be recognised as incurred and historic earnings adjusted accordingly. Costs incurred on these projects over the period in question are summarised below.

**Table 6: [REDACTED]**

111. Further, during the period under review, Westerleigh [REDACTED].
112. As the CMA's land valuation is based on land cost rather than value and ignores the value created in leasehold sites, the CMA's approach completely ignores [REDACTED].
113. The CMA should adjust historic earnings to write off these costs incurred. Table 7 below sets out the adjustments to profitability required.

**Table 7: [REDACTED]**

## 5. COST OF CAPITAL

### 5.1 Cost of equity

114. The cost of equity used for Westerleigh is based on a comparator set of companies that bears limited resemblance to Westerleigh: large, publicly listed, vertically integrated companies. These factors all have the effect of materially reducing the CMA's estimate of the cost of capital relative to Westerleigh's actual funding costs, and require a reasonable adjustment to be made when assessing Westerleigh's profitability, at the very least as a sensitivity. Alternatively, the CMA must recognise the fact that its approach to assessing the cost of capital is biased towards understating Westerleigh's WACC when interpreting the results of its analysis.

#### 5.1.1 Westerleigh is different from other industry participants and comparators

115. Westerleigh is a relatively small (by both revenue and balance sheet) private company that focuses almost entirely on crematoria. It therefore faces different risks to those faced by other providers in the sector and the comparator businesses used in the CMA's sample, and, as a result, its costs cost of capital is also therefore likely to differ.

116. Set out below is an analysis of revenue for the businesses sampled in the CMA's cost of capital analysis, alongside Westerleigh:

**Table 8: Comparison of Westerleigh and sample group**

	Service	Invocare	Carriage Services	Dignity	Propel Funeral	Stonemor	Westerleigh
<b>Company type</b>	Listed company	Listed company	Listed company	Listed company	Listed company	Listed company	Private company
<b>Territory</b>	US	Australia	US	UK	Australia	US	UK
<b>Nature of business</b>	Diversified funeral services provider	Diversified funeral services provider	Diversified funeral services provider	Diversified funeral services provider	Diversified funeral services provider	Diversified funeral services provider	Crematoria developer and operator
<b>Revenues</b>	\$3.23bn (USD)	\$494m (AUD)	\$273m (USD)	£301m (GBP)	\$95m (AUD)	\$238m (USD)	£[X]m (GBP)
<b>Employees</b>	16,320	c. 1,800	2,797	3,304	c. 700	2,546	[X]

117. Westerleigh is not a comparable business to the companies used in the cost of capital sample:

- The comparators are all significantly larger than Westerleigh with average revenues of c. £570m, compared with Westerleigh at £[X].
- All are publicly listed are so have far more ready access to capital markets, both equity and corporate bond markets.
- All comparators are vertically integrated and diversified.

- (d) Just one of the six sampled companies (Dignity) is based and operates in the UK with the other companies listed overseas – so accessing a different pool of investors – and largely focussed on operating in domestic and local markets (none operate in any material way in the UK). Overseas markets and funeral services businesses are sufficiently different to cause concern that the cost of capital estimate is based on a sample of which 83% relate to other territories.
118. Westerleigh has a greater risk profile than a diversified vertically integrated funeral services provider and has less access to, and greater cost of, finance than a listed company. Publicly traded companies have access to a larger pool of investors – equity and corporate bond markets - which they can source funds from due to increased liquidity, visibility and reduced uncertainty in determining value. Westerleigh's investments and assets are relatively illiquid and more difficult for an outsider to value, for which investors require greater returns.
119. Westerleigh also has a different business model to other operators as it has invested significantly in recent years with 18 sites opened in the last 10 years (113% growth in sites over the period) and a further [✂] pending the outcome of the CMA's review. Such investment in new facilities should be encouraged by the CMA but at the same time this level of growth creates additional risks for Westerleigh and investors in Westerleigh.
120. Westerleigh recognises that finding comparators can be challenging and differences in the sample is to be expected given that the sample is of public companies which have available market pricing data. However, where there are differences, using a cost of capital derived from a poorly matched comparator group is likely to lead to significant errors in estimating the cost of capital.
121. Importantly, each of the differences between Westerleigh and the comparator group noted above – greater risk profile, less access to funding sources, and more costly financing – point to Westerleigh's cost of capital being higher than the comparator group and that used by the CMA. Specifically, the CAPM assumes efficient markets and perfect information for investors. There is limited empirical support for the CAPM in the UK in any event. For Westerleigh, which is not listed so has no liquidity in its equity and asymmetric information, its beta is likely to be higher to reflect this.
122. Westerleigh believes it fair that reasonable adjustments are made to reflect these factors, some of which are considered further below.

#### **5.1.2 Westerleigh faces a different risk profile**

123. Unlike the large diversified funeral businesses, (or infrastructure and utility assets) Westerleigh is exposed to significant risk arising from the following attributes of the crematoria market in the UK.

**(a) Greater planning regulatory risk**

124. As noted above, Westerleigh's site acquisition is reliant on planning and Westerleigh bears the risks and costs of securing planning consent for use as a crematorium, which can often be a controversial development.
125. The planning costs for Westerleigh's recent sites (see Table 2 above) have been [X] (ranging from £[X] to £[X]). The time period for obtaining planning permission is also highly variable and more than five years. This means that investment is required without any guarantee of return as the investment is subject to obtaining planning permission and, where planning is eventually obtained (if it is obtained), the time period for realising the return is uncertain. The risks associated with planning permission have also increased considerably as sites to serve major urban centres are often located within the greenbelt. Due to Westerleigh's site selection criteria, these risks are especially high as there is a lower prospect and higher risk in securing planning consent for sites in the open countryside or the greenbelt (surrounding many of the UK's conurbations) where the presumption is against any form of development.
126. For example, the extensive planning process for its [X] and [X] are examples of the complexity and risks involved (including multiple appeals, judicial review, possible referral to the Secretary of State). Similarly, Westerleigh has had [X]. For each of these examples, the investment was made yet the prospect of obtaining a return and the time period for that return were and are highly uncertain.
127. In assessing the ROCE, the CMA assumes a probability of failing to obtain planning permission<sup>49</sup> and so recognises this risk. The risk represents a *systematic non-diversifiable risk* that affects the return required by investors. These risks have a significant negative impact on the business thus investors are concerned by such risks and charge a premium to bear them. This cannot be considered an unsystematic risk as it is clearly not diversifiable by investors. Westerleigh believes this should increase its beta.
128. In not reflecting this risk and difference between land cost and value (by calculating the value of crematoria sites based on the land cost rather than land value), the CMA is unfairly overinflating Westerleigh's ROCE and not taking account of the inevitable impact on cost of capital of higher risk. A business model of acquiring developed or mature assets would show a significantly higher capital employed but would face lower risk and therefore lower cost of capital.

**(b) Westerleigh is not vertically integrated**

129. As noted above, the comparators used by the CMA are all vertically integrated. By basing its assessment of the WACC on these firms, the CMA does not take account of the greater risk

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<sup>49</sup> Although, as noted above, Westerleigh has not had sight of what this assumed probability is or how it has been assessed.



faced by a stand-alone crematoria operator. Westerleigh believes its beta should be higher to reflect this.

**(c) Unpredictable volumes/revenue arising through investment in additional capacity, led by ongoing private sector investment**

130. Westerleigh, other private operators in the market and increasingly local authorities, have collectively a significant ongoing pipeline of new developments and each new crematorium will take volume in competition at the expense of existing sites. Hence all existing crematoria are subject to significant volume risk.

131. This significant demand risk distinguishes crematoria assets from infrastructure and utility assets that do not face such threat of competition and unlike crematoria have predictable and stable volumes and revenues over their full life cycle.

132. This also has implications over the relevant time period, as due to the acknowledged large fixed asset base, this unpredictability of volume, revenue and profitability needs to be considered and reflected in risk adjusted market returns over, and at different points, in the whole life cycle of the asset [X].

133. Westerleigh has recently experienced and been impacted by this volume risk, which has led to reduced volume and profitability in a number of new and existing site locations, including [X].

**(d) Long-term revenue decline: growth in direct cremation**

134. A more recent structural change, which differentiates crematoria from infrastructure and utility assets, is the impact of changing consumer demands on how crematoria assets are used and the revenues they will generate.

135. In the funeral market this is illustrated by changes in market share and service mix arising from the growth in demand for direct cremations, which whilst not impacting on cremation volume, is significantly impacting upon average revenue per cremation and leading to long term revenue decline.

136. The scope and impact of the growth in this trend is material and direct cremation levels in some other territories are significantly higher than the UK. Along with the risk of future competition and the impact on volume, this trend is significantly increasing the risk and volatility of future crematoria revenues.

**5.2 Sensitivity of costs of capital to assumptions (including time period)**

137. The cost of capital calculations used by the CMA are particularly sensitive to the assumptions chosen, including:

(a) The time period used – more recent data may give different results. This is especially the case, for example, with Dignity, the UK company in the comparator group, which has seen significant volatility in equity prices in recent years.

(b) The companies included in the sample.

(c) Gearing ratios.

138. Westerleigh has undertaken a desktop exercise with slightly varied assumptions and companies. This gives a significantly higher average cost of equity than the high estimate prepared by CMA (20% higher than the 8.6% estimated by the CMA).

**Table 9: Comparison of Westerleigh and sample group**

	Dignity	Invocare	Tear	Lungyen	Service	Average
Nominal RFR	1.00%	1.00%	1.00%	1.00%	1.00%	
Market return	5.00%	5.00%	5.00%	5.00%	5.00%	
ERP	5.25%	5.25%	5.25%	5.25%	5.25%	
Asset beta	0.78	1.16	0.55	0.61	0.6	<b>0.74</b>
Equity beta	1.41	1.4	0.61	0.71	0.91	<b>1.01</b>
Nominal CoE	14.5%	14.4%	6.3%	7.3%	9.3%	<b>10.3%</b>
Gearing	39.9%	16.8%	9.5%	14.1%	33.5%	<b>23%</b>

139. In recognition of these points, we believe that a more appropriate equity beta for Westerleigh lies in the range 1.2 to 1.5, giving a higher WACC of between 9 and 11%.

**Table 10: WACC Adjustments**

	WACC
CMA Base	<b>8%</b>
Equity beta @ 1.2	<b>9%</b>
Equity beta @ 1.5	<b>11%</b>

## 6. CONCLUSION

140. Westerleigh does not believe the CMA's calculations point to [REDACTED]. When subject to corrections and reasonable adjustments, including: updating the period to 2019, taking account of Westerleigh's business model in fully valuing the land acquired and necessary for a replacement site, capitalising long-term leaseholds for which Westerleigh makes significant investments and bears the risk of ownership, providing for a more reasonable cost of land, removing activity related to burials, and updating replacement insurance costs for buildings, [REDACTED]. These reasonable, sensible and conservative adjustments are illustrative of the significant margin for error in the CMA's analysis and the significant risks were the CMA to rely on its results.
141. The profitability results reflect Westerleigh's experience in the sector. As Westerleigh has outlined previously, [REDACTED]. Reflecting this, price increases have been significantly lower than in previous years, with prices frozen at a number of sites.
142. Westerleigh summarises below the impact on the CMA's scenarios of each illustrative Westerleigh Adjustment, using the 2015-2019 updated data as a baseline.<sup>50</sup>

**Table 11: [REDACTED]**

143. The update to 2019 data and the adjustments referred to in this submission should take place prior to the provisional findings or else the CMA risks drawing poorly informed conclusions on the sector.

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<sup>50</sup> The figures shown take the [REDACTED].

17 June 2020



APPENDIX A: [✂]