PREISKEL & CO

London Cremation Company

Submission in response to CMA's Market Investigation Working Paper

on Cost of Capital Analysis published 20 February 2020

1. Executive Summary

1.1. This submission is made by the London Cremation Company ("LCC") in response to the CMA's working paper on Cost of Capital Analysis (the "Working Paper").

1.2. The submission is intended to highlight key areas where the CMA's analysis raises concerns for the LCC. In particular, aspects of the return on capital employed analysis ("ROCE") and its calibration raise concerns, especially regarding land valuation and the proposed approach to depreciation. There are also concerns about the proposed approach to weighted average cost of capital analysis ("WACC"), which may inadvertently entrench larger players whose capital costs are different. There are also concerns about inconsistencies in the treatment of the cost of capital as between funeral directors and crematoria.

1.3. We note that the CMA has requested further submission and reasoning on p.17 of the Working Paper. In particular, "we consider in principle that funeral directors and crematoria may have different costs of capital but the data that we have been able to collect does not provide us with a good basis for estimating specific figures."

1.4. We would observe that it does not provide a good basis for price capping and regulating an entire industry.

1.5. We consider that it is highly important when assessing WACC for the cremation segment that the structure of the industry be taken into account. When measuring WACC against a multi-site operator, risk facing that business will be proportionately lower because single site risks are diversified by the breadth of activity. By contrast single sites or small multi-site operators (the great majority) face much higher risks if one crematorium has to close. This needs to be taken into account in calculating WACC.

1.6. To the extent that the capital costs of larger players may be lower, there is a risk of encouraging inefficient entry from larger players, and harming entry by efficient smaller operators, because of assumptions allowing the averaging of capital costs which will tend to favour the incumbent. These and other concerns are set out below with suggested potential approaches to address the concerns.

1.7. In effect, the current approach to WACC applies very large company methodology or that which is suitable to utility regulation to small, independent single-site crematorium operators and smaller businesses to which it is entirely inappropriate.

1.8. In taking these points further, we suggest that WACC is calculated in relation to major corporates with access to public company markets differently from medium and smaller players and that the CMA obtains evidence of actual realistic in-market capital returns for similarly situated businesses from specialist corporate finance advisors who operate in the market for small business finance.[1] This avoids the well-known fallacy of applying irrelevant capital costs applicable to other businesses or capital costs than those relevant to in-scope activities.

1.9. These comments should be read with the LCC's comments on the Working Paper on Crematoria Profitability, which raise closely related points (e.g. depreciation; land values).

2. Overview of comments on CMA's Working Paper

2.1. The CMA cites the approach to assessing profitability set out in its guidelines:

> "is to compare the profits earned with an appropriate cost of capital."[2]

2.2. However, profitability analysis with relation to cost is not an end in itself but rather a part of the overall picture of an investigation concerned with promoting competition and good consumer outcomes. The CMA's investigation must address adverse effects on competition ("AECs"). The purpose of the return on capital exercise needs to be set in this context: whether the business concerned is making excessive returns. We have major concerns that the specification and application of the ROCE model in this case is overly theoretical and does not reflect the realities of the cremation segment in particular, because of its unusual composition of a large listed player (Dignity) and the predominance of much smaller players whose cost of capital in the real world bears no resemblance to what Dignity, a much bigger company, can achieve. To the extent that the CMA has adopted a theoretical construct that is not geared to the realities faced by these smaller players, concerns arise that entry and expansion by the smaller players who are most likely to exert competitive pressure may be impeded or even impaired.

2.3. One of the potential consequences is that a price cap based on a return on capital figure which is unrelated to reality for most industry providers could create the following outcomes for some crematoria operators:

- Inability to invest and expand;
- Inability to service existing debt;
- Inability to maintain properties;
- Difficulty in meeting increasing and pending environmental standards;
- An incentive towards vertical integration and horizontal consolidation;
- In this market, the reduction of existing competition among proximate crematoria could be impacted.

2.4. It is important to remember that 82% choose the crematoria first, so the important competition is horizontal competition between crematoria. This should be promoted.

2.5. The question of the appropriateness of ROCE is explored in more detail below, followed by comments on the CMA's approach to WACC, which, as noted by the CMA, "*does not provide*

[1] We understand that the CMA might approach Baker Tilley, Grant Thornton, BDO, or other specialist niche corporate finance advisors active at the small company end of the corporate finance market.
[2] Paragraph 1, *Working Paper*

us with a good basis for estimating specific figures"[3] in the particular context of the cremation segment. We note that by the same token this would not form an adequate basis for price control.

3. Concerns regarding the CMA's application of ROCE

3.1. The starting points for formulating theories of harm are the terms of reference and the Market Investigation Report.[4] Remedies are then assessed with relation to the potential harms identified.

3.2. The potential issues that have been identified in the case of the Funerals enquiry[5] are:(i) a lack of effective competition on pricing and quality subject to some recognition of prices and profitability varying by geography; and (ii) recent price increases implemented by the major suppliers that have directly boosted their profit margins for a persistent period of time.[6] In simple terms, the investigation is whether there are "excessive profits" – and if so, which operators have had the incentive to charge them, and why.

3.3. In the Final Report on Market Investigation Reference (the "Final Report"), the CMA stated that:

> *"We therefore consider that there are reasonable grounds for suspecting that the markets for funeral director services and crematoria services are not functioning well and as a result there are effects adverse to the interests of consumers, as illustrated by the long-term pricing policies of the larger suppliers and the associated high profit margins."*[7]

3.4. The CMA also found that:

> "*In particular, in relation to geographic market definition, the evidence we have set out in the above sections indicates that the funeral industry operates at a local level and that demand is essentially local*."[8]

3.5. In summary, the issue to be addressed is one of potentially excessive pricing, the prevalence of features identified by location, and the similarities and differences of excessive prices by location.

3.6. Against this benchmark, concerns arise relating to (i) whether ROCE is appropriate; (ii) inconsistency between the approach taken to funeral director and crematoria analysis as regards both ROCE and WACC; (iii) the actual cost of capital, especially for smaller crematoria operators.

Limitations of a ROCE approach

3.7. The CMA's own guidance requires caution in seeking an economically meaningful profitability analysis. CMA Guidance makes it clear that the task for the CMA is to remedy, mitigate, or prevent the AEC and its detrimental effects on customers.[9] The CMA should

[3] Paragraph 58, *Working Paper*
[4] See CC3 at 165.
[5] See Final Report Decision on a Market Investigation Reference 28 March 2019 part 6 "Effects adverse to the interests of consumers."
[6] See CC3 at 6115 & 6116.
[7] Paragraph 7.13, *Final Report.* Profitability in the MI was assessed on an EBITDA basis
[8] Paragraph 7.13, *Final Report*
[9] Paragraph 330, CC3

"*deal comprehensively with the cause or causes of AECs wherever possible, and by this means significantly increase competitive pressures in a market within a reasonable period of time*."[10] Price-capping based on ROCE or any other basis is not a priority remedy. Moreover, as an indicator of the existence, level, or nature of excessive profits it has its limitations.

3.8. In deciding on a measure of profitability, accounting profit produced in line with UK Generally Accepted Accounting Principles ("GAAP") is often used with "*adjustments to arrive at an economically meaningful measure of profitability, usually in terms of rates of return on capital*."[11] However, it is recognised that the CMA "*will often inform its judgement on what is an 'economically meaningful measure of profitability' by examining the management accounting records of the firms in question*."[12]

3.9. The CMA accepts that "*whatever measure of profitability is used, the calculation of profitability for the purposes of competition analysis is often not straightforward because of the need to obtain an appropriate value for capital employed.*"[13] It is also recognised that in service and knowledge-based industries, "*the book value of capital employed may bear little relationship to the economic value because of the presence of significant intangibles*",[14] for example those businesses that generate goodwill or reputational value as is the case with crematoria and funeral businesses generally.[15] It also recognises that the replacement cost of assets may be different from historical costs due to the length of time elapsed, changes in asset prices, and efficient technologies over time.

4. <u>The CMA's use of WACC</u>

4.1. We have considered the CMA's estimates of the industry WACC which has arrived at a proposed 8% WACC which is applied to all industry participants.

4.2. This estimate is probably in the right sort of ballpark for very large, listed (or substantial privately owned) businesses. However, it bears no resemblance to a realistic WACC for the vast majority of crematoria operators beyond the two largest private companies.

4.3. There are a number of aspects of the CMA's calculation of its 8% WACC that raise concerns. However, by far the most important and material ones are its assumed Beta and the level of appropriate equity risk premium, and the applicability of these to the majority of very small businesses active in the cremation sector.

4.4. The appropriate WACC for a large company (e.g. Dignity; Co-op, etc.) is not relevant and unreasonable if applied to small crematoria operators. We are confident that any experienced corporate finance advisor operating in the small business segment will confirm.

4.5. The CMA's estimate of Beta is based on a selection of six large (and some are VERY large) vertically integrated listed companies in the funeral space. All of these companies are large, and all have very significant diversification of commercial and operational risk within them through the overall scale of their activities.

[10] Paragraph 330, CC3
[11] CC3 Annex A paragraph 9 fn 1
[12] CC3 Annex A paragraph 9
[13] CC3 Annex A paragraph 12
[14] CC3 Annex A paragraph 12
[15] See for example the Ipsos Mori Survey results concerning the importance of reputation, in particular in generating volume, and similar evidence from Funeral Partners internal documents as referred to by the CMA in its Working Paper on Funeral Directors Pricing Levels and Trends

4.6. LCC [✂]. Of these "comparable companies", two have revenues of c£1-200m, three have revenues of £600-750m, and one (SCI) has revenues of c£9bn. These companies are simply not comparable or relevant to LCC or indeed to any of the other small operators in the cremation sector whether privately or LA owned and comprise the majority of the cremation sector.

4.7. We appreciate that there is a dearth of listed comparable companies to underpin the CMA's analysis. However, that does not negate the fact that none of these companies can be reasonably regarded as in any way comparable to a business like LCC or to the many other smaller operators in our sector. The lack of appropriate comparables does not mean that inappropriate comparables should be used.

4.8. The resulting Beta is consequently not a reasonable estimate that can be applied to LCC or indeed to any cremation provider other than Dignity and perhaps Westerleigh.

4.9. [✂]We do not believe that any accounting and finance expert with experience in fundraising for small businesses would advise the CMA any differently on this point.

4.10. Part of the difficulty arises from the fact that the CMA seeks to apply the same WACC to all cremation providers irrespective of their size. Should it wish to do so, then the CMA will require to validate that its assumed WACC can be reasonably and fairly applied to the many small businesses in our sector.

4.11. The alternative would be to recognise that smaller operators require to pay a substantial equity return premium as a result of their small size, their reduced ability to spread operational and financial risk across a large number of sites, their reduced management depth, etc. This could be done by incorporating some form of small company equity risk premium in the CMA's calculations of WACC, possibly on a sliding scale relative to some measure of size and "investability".

4.12. It might be considered efficiency enhancing for vertical integration and scale to benefit the ultimate consumer. This has not been the experience with existing vertically integrated providers. In this market, the rivalry between small crematoria providers is one of the few features of the market which needs to be promoted in accordance with the CMA's duties.

4.13. We are aware that the CMA has rejected the inclusion of a small company premium in the WACC calculation by Co-op on the basis that (para 58, Cost of Capital paper) "we do not consider that there is good theoretical or empirical evidence to support the inclusion of a small company premium on equity". We respectfully submit that there is a good theoretical and empirical basis for the inclusion of a small company premium on equity, as the majority of businesses in the industry are small. That is not to say that we disagree with the CMA's position on this particular point in relation to the Co-op.

4.14. By way of illustration, we would direct the CMA's attention to a document entitled "Practitioner's guide to the cost of capital and WACC calculation" which is described as "EY Switzerland valuation best practice" (document available at https://www.eycom.ch/en/Publications/20200227-Practitioners-guide-to-cost-of-capital-And-WACC-calculation/download).

4.15. The EY Best Practice document (p17) states: "empirically on average smaller companies achieve higher risk adjusted returns. In the long run, higher returns are related with higher risk. The additional return of smaller companies is not fully reflected in the CAPM (ie beta is underestimated). To reflect the additional risk of smaller companies more adequately, the cost of equity derived from the CAPM is adjusted with a size premium,…..EY Switzerland applies the size premium……The smaller a company's market capitalization the higher the size premium."

4.16. The CMA's position that smaller businesses do not require an equity risk premium to be included in their cost of capital is therefore unsustainable, unreasonable and unfair to the many smaller cremation businesses in operation.

4.17. The effect of using this single level of WACC in the design of any CMA remedies will be to make it impossible for any crematorium service providers other than just the very largest to raise equity funding for expansion. This will actively reduce long term competition in cremation services, and will lead to considerably increased concentration.

<u>Inconsistency of approach between crematoria and funeral director analysis</u>

4.18. As regards the use of a single WACC across crematoria and funeral directors, the LCC considers that:

(a) crematoria-specific asset betas or gearing levels are different and represent a different business from Funeral Director businesses;

(b) the two activities have different risk profiles and hence different asset betas and sustainable gearing levels;

(c) the CMA notes that crematoria "*appear to share a number of characteristics of infrastructure or utility assets, such as relatively large fixed asset bases and stable volumes/revenues.*"[16] The LCC submits that this is incorrect; indeed, if it were true, then the return on capital modelling should also be the same for both crematoria and funeral directors. But in fact, crematoria cannot be compared with multi-location high fixed cost businesses such as other utilities (e.g. gas pipelines, telecoms infrastructure, water or energy businesses) which have pricing and costs that can, reasonably, be averaged. Land and depreciation functions differ by operator location, in systematically different ways, unlike utilities (e.g. a London operator's costs may be higher). Crematoria, may, by contrast with the above, be regarded as having similar characteristics to supermarkets, with local costs and local catchment areas, but with prices that are set locally or regionally (unlike supermarkets). Importantly, this implies that an unmodified utilities approach is not sensible: ROCE would not be applied to the diverse estate of a supermarket, because differences in localities, depreciation, and land would make this inaccurate.

(d) Moreover, the CMA's own record of firms' documents, notably those of the Co-op, show regional and local pricing indicating a greater level of geographic difference supporting the fact that there are local geographic markets whose costs of capital will differ, as noted above in relation to the small firm cost of capital; and

(e) In contrast to crematoria, funeral directors are relatively asset light, which is likely to result in lower operational gearing.

4.19. We consider that taking a ROCE referenced against WACC is inappropriate as described above, particularly so when an unrepresentative single WACC based on both funeral directors and crematoria is taken as the comparison baseline. It is also important to recognise for the record that the CMA has admitted that it has "limited availability of data

[16] Paragraph 2, *Working Paper*

from comparable companies",[17] indicating that it has taken inappropriate and irrelevant comparator companies because "most of our comparators undertake both activities."[18]

5. **The CMA's factual references**

5.1. Factually, there are certain basic pieces of evidence that the CMA has ignored in asserting that funeral directors and crematoria are the same such that a single WACC is merited. In terms of the wider market:

(a) There are hundreds, if not thousands, of funeral directors in the UK that are not vertically integrated;[19]

(b) there are approximately 300 crematoria in the UK;

(c) 70% of crematoria are local authority crematoria that are not vertically integrated;

(d) at most, less than 30% of the market may be vertically integrated.[20] In a market where 70-80% of the players are not vertically integrated the idea that "*most of our comparators undertake both activities*"[21] suggests that the CMA has taken the wrong comparators, because the effect of vertical integration will be overstated by a WACC that reads so heavily on vertically integrated players.

As regards the LCC specifically:

(e) the LCC is not vertically integrated;

(f) we note that the LCC was one of the four firms taken for the purposes of the profitability analysis, but that the four firms taken for the WACC were Dignity, Memoria, Co-op, and Funeral Partners. This is inconsistent. Comparing the profitability of LCC against any one of these organisations is not improved by increasing the numbers of non-comparable alternatives taken; and

(g) the CMA's assessment of international comparisons is similarly flawed as it refers to entities that pursue integrated and hence different activities to those of the LCC.[22]

5.2. The use of a WACC, with reference as it has to a mix of debt and equity, would be appropriate for an assessment of firms that raise capital via a mixture of debt and equity. It would be reasonable for a firm that is accessing capital markets or is publicly quoted. As noted above, this is not possible for smaller players. The LCC does not raise capital on this basis; the approach is not relevant and is an inappropriate and unreasonable basis on which to judge the profitability of smaller players.

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[17] Paragraph 2, *Working Paper*
[18] Paragraph 2, *Working Paper*
[19] UK Funerals.co.uk estimate four thousand funeral directors but precise numbers are difficult to pinpoint.
[20] See CMA Crematoria Profitability at paragraph 6 where 31% of share of supply was taken for 4 firms including LCC, without LCC we estimate that the 3 other firms would represent less than 30% of the share of supply and less than 26% on volume of cremations.
[21] Paragraph 2, *Working Paper*
[22] Paragraph 24 *et seq.*, *Working Paper*

5.3. Moreover, the use of a WACC based on benchmarks which are necessarily theoretical, with reference to beta values and costs of gearing that assume a business structure and a business model that does not exist and is, in consequence, based on no relevant evidence.

5.4. We note that the CMA states:

> "*As discussed above, we consider in principle that funeral directors and crematoria may have different costs of capital but the data that we have been able to collect does not provide us with a good basis for estimating specific figures*."[23]

5.5. Regarding to the effectiveness, reasonableness, and proportionality of the CMA's decision-making we consider that the WACC analysis as currently constituted provides no useful material with which to assess or compare profitability.

[23] Paragraph 58, *Working Paper*