London Cremation Company

Submission in response to CMA's Market Investigation Working Paper

on Funeral Directors: Profitability 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 Funeral Directors: Profitability 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, the LCC is concerned by the CMA's treatment of property costs, and that the CMA lacks sufficient evidence to impose a price cap remedy.

2. Initial Points to Note

2.1. The CMA Working paper builds on the previous paper "*Approach to profitability and financial analysis of 24 July 2019*." The CMA's basic premise is that in a competitive market firms would generally earn no more than a 'normal' rate of profit. We understand the theory and have considered carefully how it can be applied to the relevant Funeral Markets. In summary we are concerned that:

2.1.1. The approach taken to the benchmarking available finance and costs of capital favours bigger players whose can raise money more cheaply than smaller businesses. The major players in both funerals and cremation have access to capital markets and hence have a lower cost of capital than the smaller players. Smaller players have higher risk premiums attaching to their ability to raise money.

2.1.2. Those that have increased their prices the most – such as Dignity- have led the price increases in the market historically. They are making higher profits than others. However, the methodology taken by the CMA suggests that their profits are high – but the CMA has taken the wrong basis for the valuation of land and buildings and in doings so has created a situation where the true level of profitability is higher than the CMA's calculations suggest.

2.1.3. The approach toward Funeral Directors and crematoria profitability needs to be consistent in principle- some funeral directors- such as Dignity – are vertically integrated with crematoria. As such those players have, in principle the ability to eliminate double marginalisation art each level in the supply chain and the ability to earn increased profits – both at retail and at component level. At present the CMA appears to be taking a different approach toward the valuation of property when looking at Funeral Director profitability then when looking at crematoria profitability. Again, this inconsistency is probably masking the true level of profitability of a vertically integrated supplier such as Dignity.

2.2. CMA approach to measuring normal and supra normal profitability

2.2.1. The CMA guidelines define a 'normal' level of profit as:

'*the minimum level of profits required to keep the factors of production in their current use in the long run, i.e. the rate of return on capital employed for a particular business activity would be equal to the opportunity cost of capital for that activity*.'[1]

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

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

2.4. The CMA guidelines primarily refer to the rate of return on capital as a means of measuring profitability. Return on capital can be based on cash flows (truncated internal rate of return ("TIRR")) or profits (return on capital employed ("ROCE")). ROCE is often used as this can be computed annually and thus provides greater insights into trends over time and the drivers of profits above the 'normal' level. The ROCE is then benchmarked against the weighted average cost of capital ("WACC"), over the Relevant Period. The WACC is the return on investment that providers of capital – both debt and equity – expect, given the risks associated with the relevant activity. Where the ROCE of firms representing a substantial part of the market has exceeded the WACC over a sustained period the CMA will use that as a factor indicating excessive return and lack of competition. The CMA note that ROCE has limitations, notably where firms lease assets that are classified as operating leases and not capex, or where capital items are otherwise not recorded as such in the accounts.

3. Key Capital Assets

3.1. The CMA identifies buildings and vehicles as the main asset classes. Dignity and Co-op refer to long asset lives on buildings, meaning that the Net Book Value would be inappropriate to use as it would not reflect the current or replacement cost of buildings, and instead flatter reported profitability. Carrying value of assets in the accounts are also unlikely to reflect the MEAV. Since property costs in funeral parlours and the value of land and buildings are the single biggest factor, inaccurate valuation of property would materially distort reported profitability and misrepresent the true nature of the problem to be addressed.

The importance of repeat business, reputation and heritage value for the LCC.

3.2. The issue of marketing costs has been raised in the CMA assessment. The Ipsos Mori survey results shows the value of ongoing relationships in generating business and in generating the use of crematoria with recommendations being relevant to reputation, which is at the heart of the reason that businesses market their attributes (and which bear on their" brand value"). The Ipsos Mori evidence indicates that word of mouth is a highly important source of new business, and the experience is a critical factor in the feedback from end

[1] See paragraph 13 of "Approach to Profitability and financial analysis" dated 24 July 2019 https://assets.publishing.service.gov.uk/media/5d382b7f40f0b604db9e7ce4/Funerals_market_investigation_working_paper.pdf

users regarding whether they would make a recommendation for the use of a crematoria on a future occasion.[2]

3.3. Furthermore, the CMA has accepted Dignity's argument that marketing costs can be used as the basis of trade name or brand asset in the account. However, put another way, formal spend on marketing is likely to be less important than the less formal word of mouth and reputation and heritage value associated with its iconic land and buildings that has been garnered over many years, and which is actually generating business for LCC crematoria. Both type of 'marketing' generate sales, but the CMA appears to be willing to only include the value of that identified by Dignity where it has numbers, ignoring the more important elements that should be attributed to the LCC because calculation may be more of a challenge. This is conceptually inconsistent, and unreasonable.

Property

3.4. The CMA recognises that:

> "*the most accurate approach would have been to obtain values relating to the current purchase cost of the properties employed by firms in providing funeral director services*."[3]

3.5. However, the CMA has not obtained this information "*given the large number of properties employed by the parties and the fact that market prices of the properties is not information that the firms would hold*."[4]

3.6. Market prices for properties in the past 5 years does not appear to be an insuperable evidentiary hurdle. It could presumably have been obtained from surveyors or estate agents.

3.7. Historic costs, being original book value, have been used and uplifted by the House Price Index to reflect current values. Adjustments have then been made to create an updated capital employed figure. This is problematic.

3.8. It is also inconsistent for the CMA to take a different approach to the issue of property when considering Crematoria, where a similar issue with relation to the valuation of property arises, but the CMA uses a different methodology to assess profitability.

4. Larger Funeral Director Profitability Results

4.1. The CMA has estimated average revenues and average cost-plus per funeral including all disbursements in order to more easily compare funeral director profitability. As averages are taken individual profitability may vary considerably.

4.2. As one of the main costs is property, which by its nature varies by location, the CMA's approach does not sufficiently take into account regional or local variations in profitability.

4.3. The CMA has found that the "*financial performance of the three largest firms exhibits significant similarities, with their average revenues per funeral being within [%]% of each other, and their total cost plus per funeral being within [%]% of each other*."[5] What this is telling us is only that an outcome of averaging when comparing similarly placed firms is similar. The nature of the exercise and the choice of firms is likely to have had significant

[2] See Tables 61,62, and 63 of the Ipsos Mori Research.
[3] Paragraph 114, *Working Paper*
[4] Paragraph 114, *Working Paper*
[5] Paragraph 153, *Working Paper*

impact on the outcomes. Given the averaging exercise the outcomes pertain more to methodology than reality. True profitability of certain players is likely to be higher than is currently visible in the CMA's calculations.

4.4. The CMA also finds that all other firms in the set of those chosen "*have earned returns significantly in excess of their cost of capital, demonstrated by their significant economic profits per funeral.*"[6]

5. The CMA's Commentary on its Analysis of Large Funeral Directors

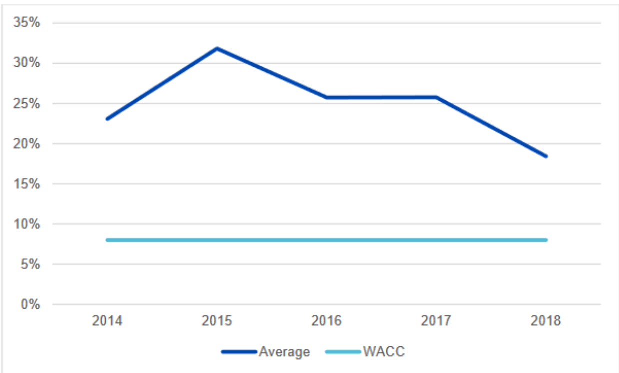
5.1. The CMA concludes that, overall, the firms chosen "*demonstrate that the larger firms, as a group, are making high returns. With a few exceptions, the firms are making strong economic profits and demonstrate substantial returns on capital employed*."[7]

5.2. This may not fully explain the reality there are considerable differences between the firms that are in the chosen set, and it is a matter of concern if the chosen set are to be used as a basis for regulating an entire industry. As a statistical matter, they represent a small percentage of funeral directors, and the wide variations in differing returns on capital should be thought of not as the average but as a sample; and that certain players should be regulated but from the basis of a conclusion that the entirety of the industry is making excessive returns.

6. Smaller Funeral Director Profitability Results

The CMA initially sought to collect both profit and loss, and balance sheet information from the smaller funeral directors in order to carry out ROCE analysis. However, the CMA found that the smaller funeral directors were largely unable to provide robust balance sheet information. In the circumstances, it is not surprising that smaller firms have smaller revenue per funeral than larger firms. However, the wide range cited by the CMA indicates there may be different approaches being taken by the different funeral directors toward their business and their profitability; in all events this is not a reason for market intervention.[8]

Chart 1: Average ROCE of the larger funeral directors from 2014 to 2018, including WACC comparison (%)



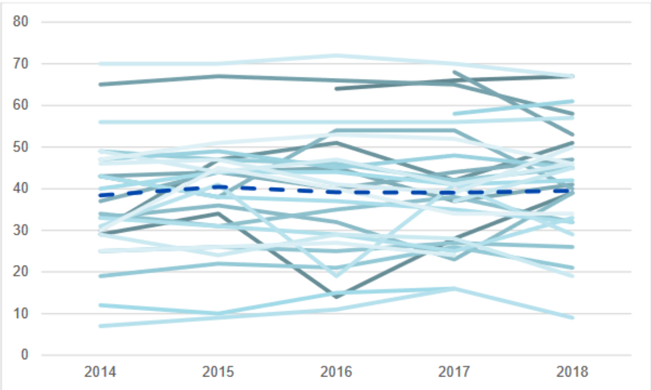
Source: CMA analysis
Notes:
a) Chart 1 is a line chart with two lines, spanning from 2014 to 2018 inclusive. The darker coloured line represents the average ROCE of the larger funeral directors, and the lighter line demonstrates WACC.
b) The results of individual parties have been removed for confidentiality purposes. A consequence of this change is that text in paragraph 197 and related chart, were also excised.
c) The chart demonstrates that in all years the average ROCE is significantly higher than the WACC benchmark, which remains at 8% throughout the period.
d) The average line shows that ROCE starts at around 23% in 2014 before reaching its peak in 2015, at around 32%. Average ROCE drops in 2016, to just above 25% and remains consistent in 2017. There is a drop in ROCE in 2018, as it falls to around 18%.

[6] Paragraph 153, *Working Paper*
[7] Paragraph 173, *Working Paper*
[8] Chart 1, *Working Paper*

7. The CMA's Initial Analysis of Results

7.1. The CMA's results indicate that profit increased at the beginning of the period, and then declined, with no apparent relation the cost of capital.[9] If anything, this may be evidence of a recent level of investment in an investment cycle that is longer than the time period chosen by the CMA and a lumpy and infrequent investment cycle with a low level of profit over time. A reality check suggests that necessary investment in funeral businesses could be taking place on a long-term basis. Moreover, it reflects the fact that interest rates and cost of capital have been low in recent times, but opportunities for expansion in the market are limited. If there is evidence of a longer capital investment cycle, with investment taking place over a longer time period than the five-year snapshot, then the ROCE would be unlikely to be significant and would simply suggest that smaller players invest from their accumulated profits rather than raising external finance, which would be as expected in risk averse small businesses.

[10] **Chart 4: EBITDARS margins of the smaller firms from 2014 to 2018 (%)**[29]



Source: CMA analysis
Notes:
a) This line chart presents the EBITDARS margins of each of the 32 smaller firms analysed across the period from 2014 to 2018 inclusive, including an average benchmark.
b) The solid lines show individual party results, while the broken darker blue line demonstrates the group average.
c) Individual parties have not been identified for confidentiality reasons.
d) The chart demonstrates that EBITDARS margins of smaller firms vary widely both within each party across the time period and also across the parties.
e) The chart shows that the margins range from above 70% to less than 10%.
f) No apparent trend is discernible from the chart.

7.2. Moreover, the CMA's analysis in relation to EBITDARS margins of smaller firms specifically stated that "*no apparent trend is discernible from the chart*."[11] The same conclusion, or lack thereof, is reached in relation to average revenues per funeral.[12]

7.3. In light of the above, the CMA should recognise that there is an insufficient evidentiary basis for intervention. The market should be allowed to operate. The evidence such as it is suggests that the sector is one in which many family firms operate on a non-profit maximising basis, and recognise this in its remedy design. Otherwise intervention risks distorting the market and leading to unintended outcomes, including price rises.

8. The CMA's Conclusions

8.1. Limited conclusions can be drawn from the CMA's analysis in the Working Paper, but to rely on them as the basis for implementing a price cap or other remedies would be unreasonable and may misconstrue the underlying evidence.

[9] Chart 1, *Working Paper*
[10] Chart 4, *Working Paper*
[11] Chart 4, *Working Paper*
[12] Chart 9, *Working Paper*

8.2. To take a select group of 10-13 firms, some of which have seen increasing profits, cannot be taken as indicative that the industry as a whole has seen increasing profits.

8.3. The CMA risks implementing remedies which may undermine the market structure and disregard socially beneficial features of the industry as a whole. This is contrary to the CMA's duty to promote competition and consumer interest. In an effectively competitive market, there should be room for a variety of different business models, with firms permitted to take different approaches

8.4. To impose remedies while ignoring the ways in which consumer welfare is currently being achieved, such as by firms which set out to provide a service to the community, but which have not increased prices or made excessive profits would be counterproductive and contrary to the purposes of the law.