12 June 2020

Funeral directors and crematoria services market investigation
Dignity response to CMA *Funeral Directors: Profitability Analysis* working paper

1. Introduction

1.1 Dignity plc ("**Dignity**") welcomes the opportunity to comment on the CMA's working papers as part of its market investigation. This submission addresses the *Funeral Directors: Profitability Analysis* working paper published on 20 February 2020. On 2 March 2020 Dignity was also given access to the spreadsheet model of the CMA's analysis of Dignity's profitability.

1.2 There are three crucial points the CMA should note:

(A) Dignity's ability to comment fully on the analyses in this working paper, in particular those covering the wider market, is substantially constrained by the extent of confidentiality redactions and lack of access to the underlying data. As a result, these are Dignity's preliminary comments and will be updated following access to the underlying market data.

(B) The CMA should update its profitability analyses to capture the potentially long-lasting effects of the Covid-19 pandemic on the sector. The CMA's current profitability analysis captures the five years from 2014 to 2018. Even before the pandemic, this market view was outdated. [✂]. Dignity expects smaller funeral directors will have seen similar pressures. Dignity expects that the pandemic has accelerated the growth of alternative funeral options as consumers will be more familiar with alternative options following the pandemic. These impacts are likely to have lasting negative effects on revenues and profitability in the market.

(C) The CMA needs more comprehensive data from smaller funeral directors. Independents comprise over 60% of the market (by funeral volumes), but the working paper currently looks only at 32 independents. This is less than 1% of the market. Even for these 32, data quality problems are visible. This is not a representative sample and the results are not reliable.

1.3 This paper is structured as follows:

(A) Part 2 provides some high-level comments on the analyses in the working paper.

(B) Part 3 examines the CMA's analysis of small funeral directors.

(C) Part 4 examines the CMA's analysis of larger funeral directors.

(D) Part 5 notes some modelling issues found in the CMA's Dignity spreadsheet.

2. Overview of the CMA's analysis

2.1 Dignity welcomes that:

(A) The CMA sought to cover a greater proportion of the market by sending information requests to the ten largest firms (by branch numbers) after the three largest firms. The CMA says that the analysis now covers 42% of branches in the market and around 37% by number of funerals.[1] This improves the coverage, but at well under half the market, there are still concerns that the results are not representative.

The CMA presents information from only 32 of the over 3,500 independents in the market.[2] Further, the CMA notes that data quality concerns exist because *"… some of the smaller funeral directors were unable to provide meaningful financial information, despite the relatively simple nature of the updated request we sent them…. While our request was initially sent to a representative sample, the limited number of responses received means that the sample is no longer considered representative …".*[3]

(B) The CMA says it will collect and analyse data for 2019.[4] Dignity strongly agrees with the importance of accounting for more recent trends, including the impacts of the pandemic in 2020. Dignity has updated the CMA's P&L and Balance Sheets information to include 2019 actuals and 2020 forecasts (see **Annex 3.1** submitted alongside this response and **Annex 2.4** submitted alongside Dignity's response to the *Crematoria: Profitability* working paper).[5] Updated information must also be collected from smaller independents. [✂]. Dignity used the CMA's methodology and found that its estimated economic profits per funeral had more than halved since 2017. Analysing 2019 and 2020 will, in Dignity's view, change the CMA's early views on market profitability trends.

(C) The CMA notes the importance of accounting for leases under IFRS 16. The new standard has changed how Dignity, and other providers, capitalise operating leases. As Dignity leases [✂] assets employed in its funeral services division, [✂]. Further, it is important that the CMA accounts for this change to recognising leased assets across all providers (and in particular Funeral Partners as it has said it leases almost all its assets). Dignity disagrees with the CMA that the capitalising operating leases adjustment should be for Dignity and Co-op only.[6] The principle behind IFRS 16 – that the balance sheet should properly reflect all

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1 *Funeral Directors: Profitability Analysis* working paper, paragraph 29. In Footnote 4, the CMA estimates that the thirteen larger funeral directors had a 37% share by volume of funerals, below the 42% share by branches.

2 CMA's Approach to profitability and financial analysis, footnote 64.

3 Working paper, Appendix A, paragraphs 20 and 22, emphasis added. The issues with collecting reliable financial data were present for the smaller funeral directors as well as for two of the larger funeral FDs (Appendix A, para. 3 and 7). The CMA should take these difficulties into account when considering price control remedies – i.e. proposing feasible remedies which might be implemented by funeral directors that were not able to identify meaningful P&L and balance sheet data.

4 Working Paper, paragraph 31.

5 Dignity also submits an updated version of Annex A-1(a)-1.2 which comprises the reconciliation of Dignity's statutory accounts with the Crematoria and Funeral Services P&L. Please refer to **Annex 3.2**.

6 Working Paper, paragraph 61.

assets employed in the business to increase transparency and comparability – applies to all funeral directors choosing to lease their assets.

2.2 Dignity has significant concerns about the robustness of the CMA's conclusions for the tiny number of smaller funeral directors because of the unreliable data and metrics used. The CMA has examined less than 1% of the independents active in the UK, and there are evident issues in the quality of the financial data of these independents. The very basic margin metrics calculated for these independents do not consider capital employed, are volatile, and, most importantly, do not provide evidence of excessive economic profits.[7]

2.3 For the CMA's analysis of larger firms, including Dignity, Dignity submits that there are a number of improvements to be made to the measurement of capital employed that will have the effect of reducing estimated ROCEs.

2.4 Please note also that Dignity's response to the *Crematoria: Profitability* working paper explains why the WACC benchmark applied to the funeral services market should be higher than the 8% currently used. For example, in a market in which over 60% of the operators are 'small' or, in fact, 'micro' businesses, a 'small company premium' should be included. Small and micro businesses do not have the same risk profile as the six listed companies in the CMA's WACC calculation, nor can they access finance on the same terms. The CMA deciding not to include a small company premium in benchmark in the context of this market structure would, in effect, be a policy decision never to include one (which is at odds with other regulatory decisions).

2.5 Dignity accordingly does not believe that the CMA has robust evidence of excess profitability across a substantial part of the market. There is no reliable evidence of customer detriment. This is consistent with the evidence from the pricing working papers.

3. The CMA's examination of the smaller funeral directors

3.1 Even using its Section 174 powers, the CMA could collect meaningful financial information from only a tiny number of the smaller funeral directors. Smaller funeral directors account for approximately 58% of the market by branch and over 60% by funeral volumes. Therefore, incomplete and unrepresentative data is a significant concern, as it means there is little insight into the majority of the market.

7 The CMA noted in the *Approach to Profitability and Financial Analysis* working paper (July 2019) that *"… we recognise that margins are directly linked to the capital employed, so higher levels of investment require higher margins.*" (paragraph 137) and: "*As a matter of principle, we consider that ROCE is the theoretically correct method for analysing profitability*" (paragraph 145). The Competition Commission Guidelines for Market Investigations, 2013 (para 112), note: *"… the CC interprets price-cost margins with caution: margins may be a misleading indicator in some industries and in many circumstances a gap between price and marginal cost can be consistent with robust competition. A fuller analysis of profitability may be required to establish whether prices are on average above the competitive level …*".

3.2 Further, there is a significant risk that there is bias in the CMA's sample of smaller funeral directors. It is based only on firms that responded to the information request (a selection bias). The CMA then excludes several responses due to data issues. Finally, Dignity remains concerned that there is a survival bias in the respondents – indeed, the lack of response from firms could be consistent with this.[8]

3.3 Faced with data limitations, the CMA bases its analysis of smaller funeral directors' profitability on just two metrics: (i) average total revenue per funeral, <u>including disbursements</u> (ARF or ATR); and, (ii) the very basic EBITDARS margin. Neither are reliable metrics on which to examine the trends in economic profitability of funeral directors.

<u>Average Revenue per Funeral (ARF)</u>

3.4 Dignity's response to the *Funeral Directors Pricing* working papers (submitted on 12 June 2020) explained three important points about the ARF metric (see paragraphs 3.10 – 3.15):

(A) By including disbursements, ARF is a less meaningful metric to assess funeral director performance because the disbursements create significant noise in the data and metric.[9] As cremation and burial disbursement costs rise over time, these increase the funeral directors' ARFs. This leads to the incorrect conclusion that funeral director fees are rising when, in fact, a material part of the inflation is coming from disbursements (see, for example, the Royal London survey results). In the Pricing working papers, the CMA's own evidence shows that in recent years funeral director fees have not been rising in real terms (see Dignity's response to the *Funeral Directors Pricing* working papers).

(B) There are significant differences in ARF in different regions of the UK, reflecting different underlying costs and market conditions at the regional level. This makes it extremely difficult to compare ARF between two smaller funeral directors without first understanding the location of these two funeral directors. We do not see the CMA accounting for these regional differences in the analyses in this working paper.

(C) Smaller funeral directors are vulnerable to significant variation in ARFs over time as the funeral mix changes – e.g. if, by chance, more burial funerals than normal occur in a year the funeral director's ARF will rise, unrelated to changes in their own performance or profitability.

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8 Dignity notes the CMA's statement at Appendix A, paragraph 37, that it is not convinced of the relevance of any survivorship bias. But given the CMA's tiny (and unrepresentative) sample, Dignity does not consider the CMA can make this conclusion soundly without further research and evidence.

9 There will be variation caused by the larger disbursements (e.g. differences between burial fees and cremation fees) and how they vary across the UK, but also customer needs and funeral director preferences (e.g. some funeral directors might show an item as a disbursement where others include it within the same funeral director's fee – an organist, for example, could be employed by the funeral director directly (internal payment) or be a third party where the customer pays the fee as a disbursement).

3.5 Chart 9 of the working paper underlines the "*significant noise across the smaller funeral director firms' ARF*", and that the "*ARFs of smaller firms vary widely both within each party across the time period and across the parties*".[10]

3.6 The data issues are also clear. Table 14 of the working paper shows, for example, that:

(A) FD21 saw the same average revenue per funeral during the whole period (i.e. £3,500), which is highly unlikely and appears to be a misreporting issue.

(B) FD22 experienced an increase in average revenue per funeral of £823 in just one year (i.e. £3,342 in 2017 vs. £4,165 in 2018), which suggests a mix effect.

(C) FD32 starts at £4,314 in 2014, rises by £921 to £5,235 in 2015, before falling again to end below its 2014 level by 2018 (i.e. £4,262).

3.7 The small sample distortions within a small funeral director and high volatility over time point to several concerns:

(A) The data collected by the CMA for this tiny sample may not be sufficiently reliable to base any conclusions on.

(B) Even if the data were correct, the noise introduced by disbursements, regional variation, and mix effects would make conclusions based on this data vulnerable.

(C) A remedy with a cap on average revenue per funeral is not feasible as it would be impossible to set a cap given the significant variability across and within funeral directors over time – for example, the cap would need to be reviewed every year.

3.8 The CMA then concludes that *"[i]n practice, this means we are not seeing a market-wide change in ARF*". Dignity does not see how this conclusion can be robust given (i) the issues in the smaller firms' data; (ii) the evidence that ARF was lower for 2 of the 3 largest firms, which dwarfs the tiny sample of smaller firms;[11] and, the findings in the *Funeral Directors Pricing* papers. Any rise in ARF could be driven by inflation in disbursements or customer preferences, rather than by dynamics of funeral director performance or profitability. Funeral director fee growth appears to be below inflation for most firms – falling in real terms.

<u>EBITDARS</u>

3.9 Dignity is concerned that the costs of smaller independents are under-reported. Dignity noted that many of the independent providers are owner-operated and that the CMA

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10 Working Paper, paragraph 227 and Chart 9 notes.

11 Any combination of two of the three largest firms will account for more branches and funeral volumes than all the smaller firms considered by the CMA combined.

should consider information on the owner's personal earnings, dividends and assets used in the business so that these are to be incorporated fully into the analysis, and on a comparable basis to the larger firms.[12]

3.10 The CMA found evidence that corroborated Dignity's concerns:

(A) "*We observed that the majority of the smaller funeral directors recorded very low salary costs, which we considered was likely to reflect only the costs of employing external staff, while the profits of these businesses reflected both salary for the owner-managers and an element of return on the capital employed in the business*".[13]

(B) "…*[evidence] demonstrated that when Dignity acquired an independent business, staff costs increased significantly"* and the CMA concluded that *"at least part of this difference is likely to be the result of recording the salaries of all employees in P&L expenses (whereas independents may reflect such 'costs' in their profits)."* [14]

3.11 The CMA therefore sought to calculate the EBITDARS for the firms – earnings before interest, tax, depreciation, amortisation, rent and staff costs. The CMA uses this as the main metric of comparison across the smaller and larger funeral directors.[15]

3.12 Similar to ARFs, Chart 4 of the working paper shows a very wide distribution in EBITDARS across the smaller funeral directors and across time. <u>The CMA notes that there is no apparent trend</u>.

3.13 Dignity considers that there are further issues with the analysis that make the results unreliable:[16]

(A) First, the CMA does not explain how it adjusted for rental costs where the owner-manager owns the premises (e.g. uses their own personal home as the branch). This would create a distortion in comparison between those funeral directors owning their properties and those leasing a separate property. Issues may also arise where the funeral director uses their own vehicle rather than having it leased or owned as part of the company. Different approaches by different funeral directors would create distortions in the measured EBITDARS. Given the crucial

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12 Working Paper, Appendix A, paragraph 29.

13 Working Paper, paragraph 179.

14 Appendix A, paragraph 47.

15 Working Paper, paragraph 209.

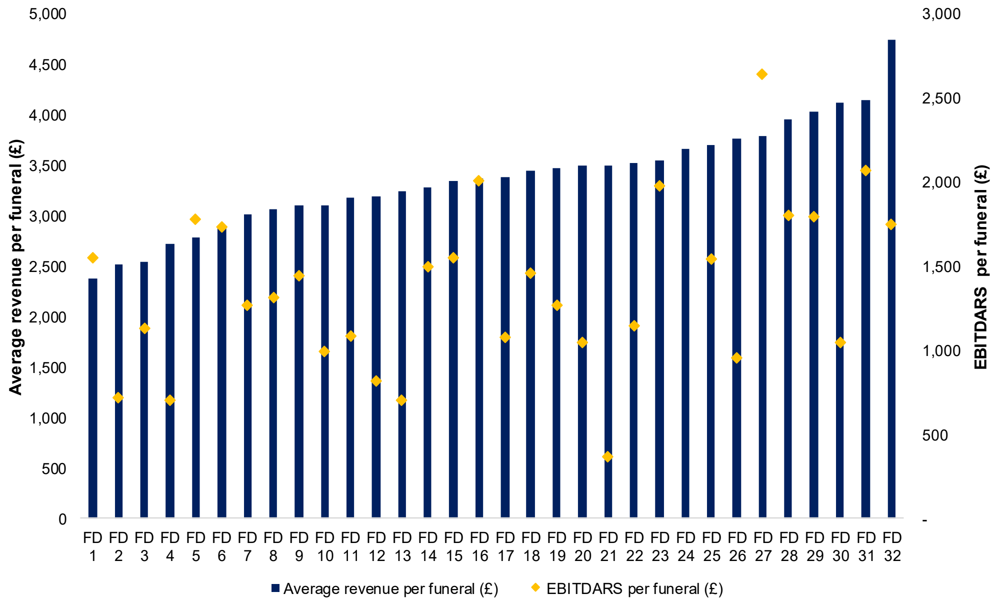
16 There also appear to be issues in the completeness of the data. While the average EBITDARS per funeral (£) is reported to be missing for FD4 in Table 15, the CMA reports an EBITDARS margin (%) for the same funeral director in Table 17.

importance of the physical property in the capital employed of a funeral director, more explanation and adjustment are required for these smaller operators.[17]

(B) Second, the CMA does not explain how it adjusted for the leasing costs of assets or facilities that are not the main property. For example, at Footnote 15, the CMA refers to a small operator that used shared mortuary facilities in the absence of having their own premises. The CMA would need to consider whether these differences in business model have been adjusted for in the EBITDARS metric (without seeing the underlying data, Dignity cannot comment further).

(C) Third, there appears to be significant inconsistency for the smaller funeral directors when looking at the CMA's two metrics alongside each other. Figure 1 below shows a very mixed picture. The pattern also changes year-to-year. This makes drawing conclusions on the basis of either metric extremely difficult.

Figure 1: Comparing smaller funeral director ARF and EBITDARS per funeral (£)



Note: The figure combines data in Table 14 and Table 15 of the working paper. EBITDARS per funeral is not displayed for FD24 as it is reported to be 'n/a' in Table 15.

3.14 Finally, Figure 2 shows that when comparing the average EBITDARS margins (for 2014 to 2018) between larger and smaller funeral directors, many smaller providers have EBITDARS margins well below the larger funeral directors (shown in Figure 2 as ranges as these are redacted in the working paper). This suggests that a significant proportion of the market may operate on lower margins than the firms surveyed by the CMA.

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17 Issues of comparability between funeral directors are underlined by the CMA's experience in collecting balance sheet information from smaller funeral directors. Appendix A, paragraphs 11 and 12, show that many smaller funeral directors could not properly identify or segment their capital employed, and even where balance sheet data could be provided, the CMA's cross-checks found inaccuracies that could not be addressed.

Figure 2: [✂]

[✂]

Note: [✂].

<u>Concluding comments on smaller funeral directors</u>

3.15 For the reasons above, it is Dignity's view that the CMA's analysis of smaller funeral directors is not sufficiently reliable or representative to make robust conclusions about the majority of the sector. There are clear and significant data quality issues. Further analysis of this majority of the sector must be done before remedies can be considered.

3.16 There is a huge level of differentiation in outcomes even within this tiny sample – across parties and across time. Even within individual funeral directors, the CMA evidence points to wide differentiation in outcomes.

3.17 The metrics and outcomes do <u>not</u> provide sufficient evidence to conclude that excess economic profits are being made by smaller funeral directors.

3.18 Further, the difficulties experienced by the CMA in seeking to analyse this important part of the market also underlines the complexity that any price control remedy will face in design and implementation across the industry.

4. The CMA's examination of the larger funeral directors

4.1 The working paper explains that the CMA analysed ROCE for thirteen larger firms. These firms comprised under 40% of the market by volume of funerals delivered. There is substantial variation in performance, even within this group of firms. The CMA, for example, found that "*there are significant differences in ARF and cost-plus across these larger firms*".[18]

4.2 For the period 2014-2018, the CMA reports that ten of the thirteen earned ROCE in excess of the WACC.[19] Due to the extent of confidentiality redactions it is not possible to assess what proportion of the market these firms covered or what the trends in economic profits were over time. This restricts our ability to comment effectively on the CMA's analysis. However, in any event, Dignity considers that the view on profitability from 2014-2018 is now outdated.

4.3 Figure 3 below presents the CMA's findings for Dignity the 2014-2018 period and adds 2019 using the CMA's approach. [✂]. Using the CMA's approach (which understates capital employed), ROCE in 2019 [✂].

Figure 3: [✂]

[✂]

4.4 [✂].

4.5 However, Dignity is further concerned that the CMA's current approach substantially overstates the economic profitability of its funeral services division:

(A) Dignity agrees that it is appropriate to revalue owned property assets to reflect MEAV.[20] However, the approach and index applied by the CMA understates the true values of Dignity's property.

(B) Dignity agrees with the CMA's decision to include leased properties into the capital employed. Dignity's 2019 Annual Report explains the substantial impacts of IFRS16 on Dignity's financial results, adding over £60 million to the funeral services capital employed.

(C) Dignity welcomes recognition of trade names/brand values in the capital employed, although it disagrees with the valuation assumptions used. Dignity's own experience is that marketing and start-up losses are far more significant than

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18 Working Paper, paragraph 176. Dignity is unable to comment on the differences in 'cost-plus' across the larger firms because the CMA has redacted this information – including the Average – from all tables in the working paper.

19 Working Paper, paragraph 175. Dignity refers to its comments on WACC in response to the CMA's *Crematoria: Profitability Analysis* working paper.

20 Working Paper, paragraph 49.

suggested by the CMA. Using actual data on start-up losses, the value of this asset would be [✂] than currently included.

Property revaluation

4.6 Dignity agrees with the importance of revaluing Dignity's funeral property assets. The owned assets are recorded at historical purchase costs in the Fixed Asset Register (FAR) and the depreciated. The NBVs of these properties would understate the cost that an entrant would need to incur to replace equivalent assets.

4.7 The CMA has decided to revalue these assets by using the Land Registry's House Price Index (HPI) to uplift the historical purchase cost of each property. It then depreciates the adjusted values using the straight-line method and assumes a Useful Economic Life (UEL) of 50 years.[21] The CMA acknowledges that '*a commercial or retail property price index would be more accurate*' but it has '*not been able to identify* […] *such an index*'.[22] The CMA notes it may also undertake further sensitivity analysis.

4.8 Dignity has several comments about the CMA's approach in this regard:

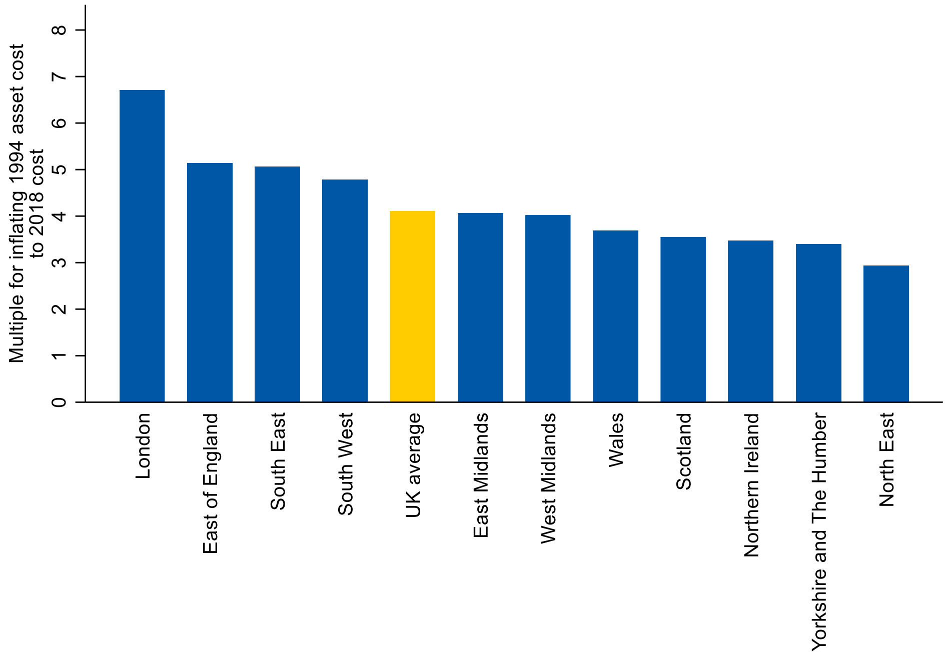
(A) Dignity agrees that the HPI approach is an imperfect index. If it is used, it should be tailored to the region of the funeral provider. The national HPI does not reflect regional differences in property inflation, as shown in Figure 4 below, which illustrates how the multiple for inflating the cost of an asset in 1994 to a 2018 cost (i.e. 2018 HPI / 1994 HPI) varies significantly by region. For example, London properties have increased in value more than six-fold since 1994

21 Working Paper, paragraphs 122-124.

22 Working Paper, paragraph 117.

whereas properties in Northern Ireland and the North East saw more limited growth over the same period.

Figure 4: UK regional and national HPI inflation multiples

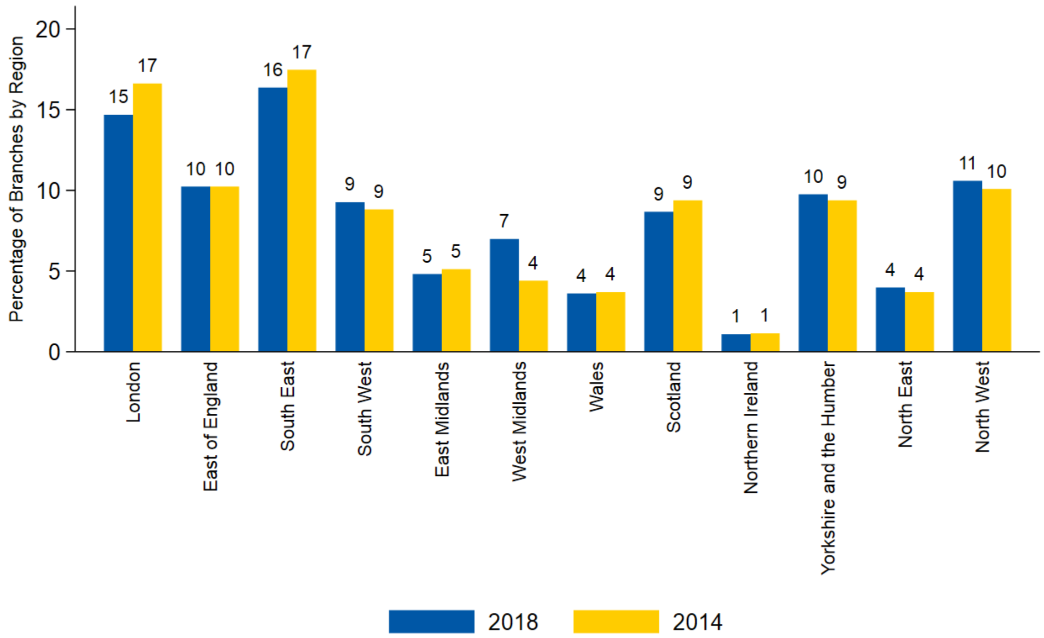


Source: HM Land Registry data available at https://landregistry.data.gov.uk/app/ukhpi
Note: Data for the North West region are only available from 1995 and have thus been excluded from this analysis.

As shown in Figure 5 below, more than half of Dignity's branches are in regions that experienced faster price rises than the national average, with almost a fifth of its portfolio in London. Therefore, the use of the national HPI understates the rise in property values of Dignity's portfolio. Using regional indices would increase Dignity's capital employed [✂] in each year.[23]

[23] The North West HPI time series goes back to 1995; for this region, the 1995 HPI figure is then used for 1994 Dignity's assets. Likewise, the South East HPI time series goes back to 1992; for this region, the 1992 HPI figure is used for pre-1992 Dignity's assets (i.e. one asset in 1989).

Figure 5: Percentage breakdown of Dignity branches by region (2014 and 2018)



Source: Dignity Branch Postcodes
Note: 2014 figures are based on 709 branches active in that year. There were 9 additional branches that were active in 2014 but then closed at some point in 2015-2017 – these are excluded from the chart.

(B) The CMA uses a different approach to revalue property assets in this analysis of funeral directors than it used to revalue crematoria properties in the *Crematoria: Profitability* working paper. Dignity makes the following observations:

(i) In the crematoria analysis, the CMA used the 2019 insurance values and applied straight-line depreciation using a 100-year UEL.

(ii) The total insurance value of Dignity' freehold funeral properties in 2019 amounted to just under £[✂].[24] The average age of freehold funeral property assets recorded in Dignity's 2018 FAR is approximately [✂] years.

(iii) If the CMA's crematoria approach was applied to the funeral director analysis, the depreciated replacement cost (using the 50-year UEL assumption) of these funeral services properties would be around £[✂] in 2018, approximately £[✂] higher than currently estimated by the CMA's (national) HPI approach.[25] This would substantially reduce estimated ROCE.

(iv) Dignity considers that this alternative basis of valuing capital employed for funeral directors should be included as a scenario in the *Funeral Director: Profitability* working paper. This would also likely affect the

24 This is calculated as total buildings insurance values of funeral properties marked as 'Freehold' in Dignity's 2019 Insurance Schedule.

25 Were the 100-year UEL assumption used, as in the crematoria working paper, the resulting estimate would be approximately £[✂] higher than currently estimated by the CMA's (national) HPI approach.

ROCEs of other funeral operators – footnote 8 of the Working Paper, for example, notes that insurance values for Co-op branches ranged from 1.8 to 5.1 times higher than gross book value.

(C) The CMA revalued Dignity's owned funeral properties, but certain assets were omitted which should be included:

(i) Head Office properties allocated to funeral operations[26]: these property assets have been separately identified as 'Head Office Property' in Dignity's FAR. The total NBV of freehold Head Office properties allocated to funeral operations in 2018 is around £[✂].

(ii) Land: the CMA has not revalued the land associated with funeral properties, amounting to around £[✂] in 2018.[27]

(iii) Dignity invested over £[✂] in refurbishments to the properties over time. These are now £[✂] in NBV in the FAR. These refurbishments improved the fabric of the buildings and would also themselves see appreciation in value. These refurbishments should be included in the revaluation.

4.9 Dignity is, therefore, concerned that the capital employed related to the owned properties is very significantly underestimated by the CMA.

Operating Leases

4.10 As noted by the CMA in paragraphs 61 to 63 of the working paper, the introduction of IFRS 16 has changed the way firms account for operating leases and this will reduce estimated ROCE.[28]

4.11 As previously explained to the CMA, the Dignity Group leases [✂]% of its properties. Indeed, Dignity leases [✂] property assets employed in the funeral services division. These property assets have not yet been included in the CMA's capital employed.

4.12 Dignity's Annual Report 2019 provides a detailed analysis of the impacts of IFRS 16 on its balance sheet on pages 117 and 118.[29] IFRS 16 results in Dignity recognising £95

26 These property assets have been separately identified as 'Head Office Property' in Dignity's FAR.

27 These consist of funeral property assets containing the description terms 'land', 'fhlnd', 'fhlan', or 'lllnd' in the asset number recorded in Dignity's FAR.

28 The CMA noted in the *Approach to Profitability and Financial Analysis* working paper (July 2019) that "*ROCE percentages can sometimes be distorted, for example where firms choose to lease a material portion of their assets, and these leases are classified as operating leases for the purposes of financial reporting*" (paragraph 34) and "*Where firms lease a significant portion of their assets, we shall consider whether lease capitalisation is necessary to avoid the distortive effect on ROCE*" (paragraph 65).

29 Please refer to **Annex 2.1** submitted alongside Dignity's response to the Crematoria profitability working paper.

million in right-of-use assets for the Group, with around [✂]% of this value relating to property assets employed in the funeral services division.[30]

4.13 Capital employed in the funeral services division, therefore, increases by over £[✂], and [✂].

4.14 IFRS 16 is now in place and will affect estimated ROCEs on a forward-looking basis.

4.15 The CMA states that only Dignity and Co-op report under IFRS and so other firms will be unaffected.[31] Dignity disagrees strongly with this approach.

4.16 The capital employed for all funeral directors should reflect capitalised leases. IFRS 16 aims to increase comparability across firms and increase transparency into a firms' business models by ensuring that assets (and liabilities) involved in delivering the activities of the business are included properly in the financial analysis. The CMA should, therefore, apply the principle of IFRS 16 to all firms to accurately measure economic profitability (rather than distorted accounting profitability). The CMA should take this into account in any assessment of future remedies.

4.17 It is also clear that other firms use long-term operating leases that should be capitalised. Paragraph 50 of the working paper notes that the third largest operator in the market "*Funeral Partners explained that it only periodically holds freehold buildings. The business prefers to use buildings under operating lease. When buildings are acquired through acquisition of another business, these are disposed of through a sale and leaseback agreement*."

4.18 [✂].

<u>Software</u>

4.19 The CMA agrees with Dignity's view about including internally developed software in the capital employed. The CMA notes that Dignity did not provide it with an estimate of the cost of these systems. However, Dignity provided the CMA with information on InvoCare's recent replacement of its ERP system in c.280 branches at a cost of over £4 million.[32] Dignity considers that this can be used by the CMA as a relevant estimate.

30 For more details on IFRS 16, please refer to **Annex 2.2 – 2.3** submitted alongside Dignity's response to the Crematoria profitability working paper.

31 Working Paper, paragraph 61.

32 Dignity's Background Submission to the Financial Request, paragraph 4.16. See also Dignity's response to the *Approach to Profitability and Financial Analysis* working paper (July 2019).

Purchased brand/trade names

4.20 The CMA agrees that purchased brand/trade names should be recognised in the profitability analysis but, in Dignity's view, the CMA significantly understates the value of this asset. As the CMA recognises, Dignity's strategy was to expand its branch network through acquiring established, well-respected branches rather than by opening new branches. In doing so, Dignity gained an asset that it would otherwise have acquired only through significant additional marketing spend and start-up losses.

4.21 The CMA assumes that a marketing spend of only £8,000 across the first three years of a new branch is sufficient for establishing the trade name/reputation of that branch in its local area. Dignity strongly disagrees.

4.22 First, the CMA's estimate is based on data from Co-op and Funeral Partners and their annual marketing spend on new branches.[33] Co-op new branches marketing spend is likely low because a new branch already benefits from Co-op's wider brand investment and name recognition, which also includes multiple non-funeral services e.g. groceries and banking. Dignity cannot comment on the Funeral Partners information without further disclosure.

4.23 Second, Dignity considers that a more accurate representation of the value of the trade name asset can be achieved through estimating the average accumulated start-up losses of a new organically opened branch. These early losses are the investment required by a new funeral business to establish a reputation in its local area and reach a sustainable scale. This approach is also conservative because Dignity's new branches would likely already benefit from the reputation (and wider operating and infrastructure cost savings) of being part of a large national network as well as the reputation established locally by other existing Dignity branches, whereas an independent funeral director would need to incur even greater costs to build a similar reputation and sustainable volume.

4.24 The CMA decided not to include start-up losses because evidence collected from independent entry suggests that *"[..] funeral directors do not necessarily incur operating losses for an extended period when they open, and do not need a high volume of funerals in order to break even"*. [34] Dignity requests the CMA to produce this evidence of the costs of independent entry. Given the limited information received from smaller funeral directors, as discussed above, Dignity has concerns about the reliability of this evidence.

4.25 The CMA mentions <u>a single independent funeral director's anecdotal experience</u> in Footnote 15 as evidence, which says *"it is possible to set up a funeral director business, including fridge and preparation equipment, with less than £10,000"* because they used "*a branded van to both transport the deceased but also to advertise the business*" and "*shared mortuary facilities in the absence of having their own premises*".[35] Very clearly

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33 Working Paper, Footnote 13. As explained in its response to Question 6 of the RFI dated 29 November 2019, Dignity's marketing spend is not recorded at a branch level but at community group level – i.e. cost centre. As such, Dignity does not hold information on the actual marketing spend with respect to individual new branches.

34 Working Paper, paragraph 104.

35 Working Paper, Footnote 15.

this independent is choosing the barest minimum business model, rather than a model built on quality.[36] There is no evidence the staff are appropriately trained or salaried or that this branch could deliver sustainable volumes and capacity.

4.26 Indeed, the CMA specifically notes evidence that the small independents do not accurately record salaries (see paragraph 3.10 above). Dignity employs and pays its staff a fair salary, ensures professional standards, provides appropriate infrastructure and capacity. These are necessary investments in a professional, reputable and sustainable branch. It can take several years of losses before the branch covers its costs, and many never do (and so must close).[37]

4.27 For example, the branch-level financial performance for 69 greenfield branches Dignity opened between 2010 and 2013 is shown in Figure 6.[38] Each row represents a branch, with 0 on the x-axis representing the beginning of the branch's first full calendar year of life. The bar remains red for years in which the branch does not cover its direct and allocated (indirect) central costs. The bar turns green when revenues cover these direct and indirect costs. This does not mean the branch yet earns a sustainable return (it is not earning a return on capital employed), but to be conservative this low threshold of break-even performance is applied.

4.28 [✂].

36 It is a good illustration of what a race to the bottom could look like were the CMA to regulate prices of funeral directors without ensuring minimum quality standards.

37 Dignity's response to Question 26 of the CMA's RFI dated 8 August 2019.

38 Dignity opened 72 branches during this period, but branch-level information was not available for three branches.

Figure 6: Five-year profitability of Dignity greenfield branches opened in 2010-2013

[✂]

Source: Dignity Management Accounts 2010-19.
Notes: [✂].

4.29 Figure 7 shows the development in the total and accumulated economic profit/loss of these 69 branches over time. Overall, losses of over £[✂] were incurred during the first three years of operation. On average this is more than £[✂] per branch in start-up losses over the first 3 years. It does not include recovering the cost of capital.

Figure 7: Economic profit/loss of Dignity greenfield branches opened in 2010-2013

[✂]

Source: Dignity Management Accounts 2010-2019.
See notes under Figure 7.

4.30 If estimated start-up losses of £[✂] per branch are used as a proxy for the costs avoided through acquiring an established branch, rather than the CMA's figure of £8,000 per branch, capital employed increases significantly. It would increase the value of this asset [✂]. This would still be substantially lower than what Dignity in fact recognises in its balance sheet for trade names.

Concluding comments on larger funeral directors

4.31 Dignity's estimated ROCE [✂] driven by changing market circumstances. Further adjustments to capital employed through owned property values, capitalising leases, and including an appropriately valued reputation asset reduce ROCE further.

4.32 [✂].

4.33 Due to the confidentiality redactions, Dignity is not able to comment effectively on the analyses undertaken for other larger firms. Dignity notes however that excess profits were found for only ten of the larger firms. Even when combined, these firms likely cover only around a third of the UK market by funeral volume. Therefore, the CMA's analysis does not suggest that there are significant and sustained excess profits for a substantial part of the market.

5. Small errors in the modelling

5.1 Dignity identified some data issues in the CMA's spreadsheet, in particular:

(A) Dignity replicated the CMA's calculation of the average UK HPI index in the CMA spreadsheet. Dignity obtained slightly different figures for 2016 and 2017 as some monthly HPI index figures in these two years do not reconcile with those available on the Land Registry website. Further, The CMA used an average UK HPI index for 2018 equal to 118.3, which is based on monthly data up to June 2018 and not December 2018. The 2018 index based on the full data is 119.8.

(2) In cell V23225 of the 'Asset Register 2016' tab, the CMA subtracts the cost of the asset (V23218) from the total cost (V23215). However, the cost of the asset is not included in the range of cells being summed over to calculate the total cost (V23215). In essence, the subtraction means that the asset is being removed twice. This affects the 'Cost' column (V) and the NBV column (Z).

(3) In cell AF23215 of the 'Asset Register 2016' tab, the CMA's summation over the 'Depreciated replacement cost' column is not implemented correctly as columns 'Percent' (AG) and 'Code' (AH) are included in the summation when they should not be.