Appendix Q: Profitability Methodology

Introduction and purpose of this appendix

1. The purpose of this appendix is to set out our approach to financial and profitability analysis of funeral director services and crematoria services, which has informed our assessment of profitability.

2. This appendix is structured as follows:

   (a) First, we discuss the role of profitability and financial analysis;

   (b) Next, we detail the scope of our analysis, both for funeral directors and crematoria; and

   (c) Then, we consider the approach to profitability analysis.

   (d) Finally, we comment on any additional analysis.

3. This appendix does not comment on representations made by parties with regards to our approach to profitability and financial analysis. Rather, detailed discussion of the representations made by parties, and our response, with regards to our profitability methodology is included within the funeral director and crematoria profitability appendices.

Role of profitability and financial analysis

4. The information obtained from our profitability analysis has been used across two main areas:

   (a) *Diagnosis:* as part of our assessment of market outcomes which can help us determine whether there are any adverse effects on competition (AECs); and

   (b) *Detriment*: as part of our assessment of the degree and nature of any detrimental effect on consumers so far as it has resulted from, or may be expected to result from, any AECs.

5. The rest of this section explains each of these two areas in more detail.

Diagnosis

6. When reaching a view concerning the functioning of a market, we consider the outcomes of the competitive process in that market, including: prices and profitability; product quality and range; and levels of innovation.[1]

7. The aim of profitability analysis is to understand competitive conditions within a market, by examining the outcomes of that market in terms of the financial performance of the participating firms. The CMA guidelines state that:

> 'Firms in a competitive market would generally earn no more than a 'normal' rate of profit – 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.'[2]

8. The purpose of conducting profitability analysis, therefore, is to understand whether the levels of profitability (and therefore prices) achieved by the firms in the reference markets are consistent with the levels we might expect in a competitive market. If excess profits (i.e. profits above the levels that we would expect in a competitive market) have been sustained over a sufficiently long period of time,[3] this could indicate limitations in the competitive process.

9. On the other hand, the CMA guidelines highlight that a finding of low profitability does not necessarily signify that competition is working well, since low profitability may be concealing ineffective competition. For example, incumbent firms, despite being protected from new entry, may not earn high profits because they are inefficient and operate with higher costs than would be sustainable with stronger competition in the market.[4]

10. We are also be interested in:

    (a) Potential insights from our profitability analysis into the extent to which price differentials between providers reflect differences in quality.[5] This is because we might expect higher quality to be associated with a higher cost base and therefore a higher price but not necessarily higher profitability.

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[1] CC3 Revised, paragraph 103.
[2] CC3 Revised, paragraph 116.
[3] See paragraphs 27 to 31 for a discussion of the relevant time period.
[4] CC3 Revised, paragraph 125.
[5] Issues Statement, paragraph 8(g).

(b) The trend in profits over the period of review as an indicator of improvements or deteriorations in the competitive environment. For example, where profitability has increased over a number of years, this may indicate a worsening of the competitive situation or weakening of competitive pressures in the reference markets.[6]

11. We interpret the results from our profitability assessment in the wider context of our market investigation. In reaching a view about the functioning of the reference markets and identifying any market features that may have an adverse effect on competition, profitability is one of the outcomes of the competitive process we take into account, alongside evidence on product pricing and quality (and/or innovation).

Detriment

12. Profitability analysis can also be used as an indicator of the degree and nature of consumer detriment arising from any AECs.[7] Should we find profits to be above the 'normal level' (as defined at paragraph 12), we plan to use these excess profits to inform our understanding of the extent of consumer detriment.

13. We do not comment further on our empirical approach to estimating detriment using the profitability analysis, as the assumptions and judgments used in the analyses for quantifying detriment will be the same as those used in the diagnosis phase.

Scope of our analysis

14. In this section we set out the scope of our profitability assessment and the relationship with our terms of reference, highlighting which business activities we consider to be relevant, which firms we have analysed and the time over which we have assessed profitability.

Funeral director services definition

15. For the purpose of this investigation 'services by funeral directors at the point of need', The supply of services by funeral directors at the point of need (referred to as 'funeral director services') is described as follows in the terms of reference:

[6] Market Investigation Guidelines, (CC3 Revised), paragraph 124.
[7] Market Investigation Guidelines, (CC3 Revised), paragraph 104.

services provided by a funeral director in connection with the arrangements for a funeral, and including, but without limitation:

- *guidance and support to the family and/or persons arranging the funeral;*
- *collection, storage and care of the deceased;*
- *organisation and services carried out on the day of the funeral;*
- *the supply of goods and services to facilitate the arrangements, including, for example, the coffin, hearse and limousine(s);*
- *intermediary services between the customer and third parties, such as the crematorium or burial site, a doctor or medical practitioner, a minister or celebrant;*
- *discretionary services that are provided by the funeral director directly or as an intermediary between the customer and third parties, such as memorials, death notices, venue hire and catering, flowers, Order of Service etc.;*
- *the provision of services by funeral directors in connection with the redemption of a pre-paid funeral plan,*

but excluding:

- *the provision of pre-paid funeral plans.*

Crematoria services definition

16. Crematoria services are defined as follows in the terms of reference:

the services provided by a crematorium in connection with the cremation of the deceased, including the provision of a chapel or specific place for attended cremations, the committal and the associated sales of additional products and services, such as memorials, audio-visual support and hospitality.

Identifying the relevant firms providing funeral director services

17. Our market-wide profitability assessment for funeral director services has focused on two groups of firms:

(a) The Large providers of funeral director services in the UK. These firms have an estimated combined market share of approximately 42%, based on number of branches.[8]

(b) A sample of branches in the remaining 58% of the market, which is composed of smaller providers.

Identifying the relevant firms providing crematoria services

18. Our market-wide profitability assessment for crematoria services has focused on two groups of firms:

(a) The four largest providers of crematoria services in the UK, namely Dignity, Westerleigh Group Limited (Westerleigh), Memoria Limited (Memoria) and London Cremation Company PLC (LCC). In the UK, these firms have an estimated combined market share of approximately 31%,[9] based on number of crematoria.

(b) A random sample of crematoria in the remaining 69% of the market, which is predominantly composed of local authority operated crematoria.[10]

Time period under consideration

19. We aim to examine trends in profitability over a time period that is sufficiently long to provide a representative picture of profitability that is not unduly distorted by unusual macroeconomic conditions or one-off events. Our Guidelines recognise that the appropriate time period may vary depending on the specific market.[11]

20. Having discussed the availability of data with the largest providers of funeral director services and crematoria services, and considered the nature of demand in the sector, we collected data over a five-year historical period from 2014 to 2018, for both funeral director services and crematoria services (referred to as the "Relevant Period" in the rest of this working paper).

21. We planned to collect 2019 financial information for all of the crematoria for which we have undertaken profitability analysis, and all of The Large funeral

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[8] CMA analysis
[9] In June 2018, there were 293 Crematoria in the UK. Dignity owns 46 = 16% (46/293); Westerleigh owns 29 = 10% (29/293); Memoria owns 9 = 3% (9/293) and LCC owns 6 = 2% (6/293). 16%+10%+3%+2% = 31%. See Final Report from Phase 1, paragraphs 2.37, 2.38 and 2.39.
[10] 110 crematoria are operated by private companies – our largest providers collectively operate 90 of these (46+29+9+6). Of the remaining 203, 183 are operated by local authorities (90%), with the remaining individually owned by private operators. See Final Report from Phase 1, paragraphs 2.37, 2.38 and 2.39.
[11] Market investigation Guidelines (CC3 Revised), paragraph 121.

director firms. However, restrictions on our data gathering capabilities as a result of the Covid-19 pandemic meant that we were unable to collect 2019 financial data for all firms.

22. We obtained 2019 data from [✂], the results of which are reflected in our financial analysis, however due to the fact that the information was obtained only from this firm, we do not use this information to comment on any trends in the industry more broadly.[12]

Approach to profitability analysis

Overarching conceptual approach

Return on capital employed versus cost of capital

23. The analysis of profitability as a means of understanding competitive conditions in a market is based on the premise that in a competitive market firms would generally earn no more than a 'normal' rate of profit.[13] Our 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.'

24. The opportunity cost of capital is the weighted average return on capital,[14] 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.

25. The rationale for benchmarking return on capital with the opportunity cost of capital is that in a competitive market, if firms persistently earned in excess of the return required to compensate investors for the risks taken, we would expect entry and/or expansion. This entry/expansion would serve to compete away profits[15] 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.

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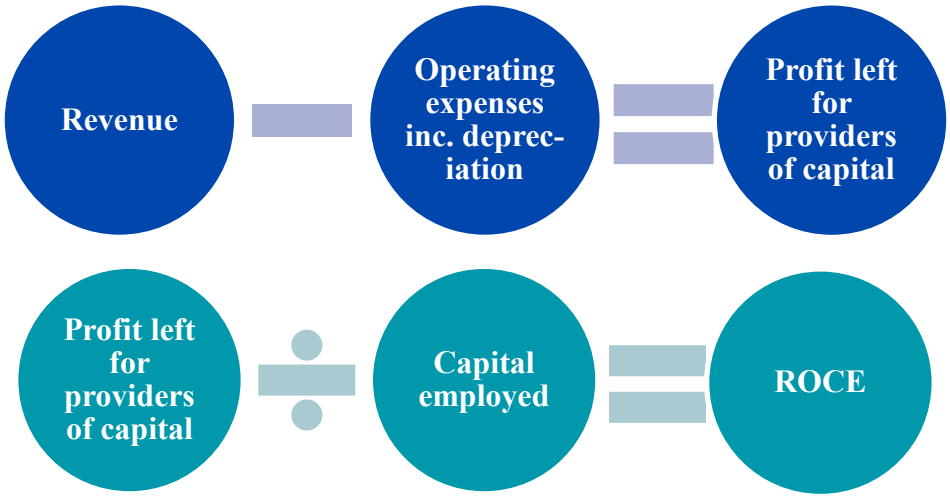
[12] We obtained some 2019 financial data from [✂] however this lacked key information to allow us to undertake profitability analysis therefore we have not done so for [✂] for 2019.
[13] Market investigation Guidelines, (CC3 Revised), paragraph 116.
[14] Specifically, the mean ex ante expected return on capital of debt and equity holders, weighted by gearing.
[15] The time period over which this process may take place may differ between different sectors due to the time taken for entry and/or expansion of capacity.

Where firms persistently earn in excess of a normal return, this therefore signals that there may be limitations in the competitive process.

26. The CMA's guidelines, therefore, 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)). Ordinarily, where data permits, we use ROCE, as this can be computed annually and thus provides greater insights into trends over time and the drivers of profits above the 'normal' level.

27. Figure 1 below illustrates how ROCE is calculated.

Figure 1: The components of ROCE



Source: CMA analysis. Note, profit left for providers of capital can be distributed or reinvested in the business.

28. 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.[16]

29. In practice, we might expect the profitability of some firms to exceed a 'normal' level from time to time.[17] However, a situation where the ROCE of firms representing a substantial part of the market has exceeded the WACC over a sustained period could be an indication of limitations in the competitive process.[18]

[16] WACC is therefore expected return on equity and expected return on debt, weighted by gearing – the relative proportions of debt and equity.
[17] Market investigation Guidelines (CC3 Revised), paragraph 117.
[18] Market investigation Guidelines (CC3 Revised), paragraph 118.

30. However, we note the following considerations when applying the ROCE versus WACC framework:

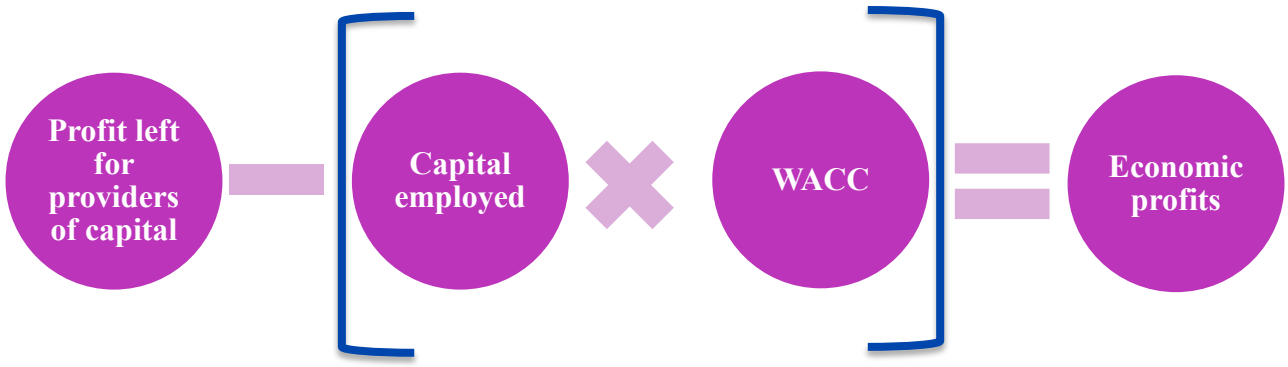
(a) ROCE percentages can sometimes be distorted, for example where firms choose to lease a material portion of their assets, and these leases are classified as operating leases for the purposes of financial reporting or where investment in intangibles[19] is expensed, rather than capitalised;

(b) ROCE percentages can sometimes be distorted by the choice of accounting depreciation method; and

(c) the scale of any excess profits, and therefore detriment, is not immediately clear from a percentage gap between ROCE and WACC.

31. The issues set out at paragraph 32, can to some extent[20] be alleviated by calculating economic profits in absolute terms. We have therefore calculated economic profits as well as ROCE. Economic profits are the profits left over, after the providers of capital have been paid a market-based return on their investment, which is equal to the capital employed multiplied by the WACC.

Figure 2: Economic profits



Source: CMA analysis. Note, profit left for providers of capital can be distributed or reinvested in the business.

32. Given that economic profits are revenues less total operating costs including a market-based cost of capital, they can be calculated using the same input data and analysis as ROCE versus WACC.

[19] Assuming the expense is capital in nature, rather than simply an ongoing cost of running the business – see intangible recognition criteria at paragraph 67 of this working paper.
[20] A complete solution to distorted ROCEs also requires annuity depreciation as set out in paragraph 119.

33. We recognise that economic profitability analysis, based on a ROCE versus WACC framework, requires a number of assumptions to be made. The results from economic profitability analysis can be sensitive to ranges around these assumptions, particularly with regards to asset valuations.[21] We have, therefore, considered sensitivities in relation to key asset valuations where appropriate. We have also considered evidence drawn from parties' internal documents in coming to our provisional conclusions on firms' financial performance.

Scope of relevant operating revenues, costs, assets and liabilities

34. We determine the ROCE using operating profits and net operating capital employed and then compare it to the relevant pre-tax WACC. The general principle is that all revenues, costs, assets and liabilities necessarily arising from the operation of the business to supply the in-scope activities should be included.

35. In practice this means that the following items should be excluded:

    (a) Financing costs both of a profit and loss and balance sheet nature, e.g. interest and sources of finance regardless of whether they are short- or long-term.

    (b) Taxation on income and any associated corporation tax or deferred tax.

Economic versus accounting profitability

36. When estimating ROCE, our approach is to start with accounting profits and the balance sheets for the operating units of the firms that undertook the relevant activities, and then to make adjustments to arrive at an economically meaningful measure of profitability.

37. Deriving an economically meaningful measure of profitability from accounting data, in practice, usually requires adjustments to the following areas:

    (a) Value of capital employed in the business: As set out in Figures 1 and 2 above, an assessment of economic profitability requires an estimate of the capital employed in the business. Capital employed is measured by valuing the assets needed to provide the in-scope activities.[22]

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[21] The importance of this issue often depends on the capital intensity of the business and the nature of the assets required to provide the in-scope activities. See for example, paragraph 23 of Appendix 9.9 'Approach to profitability and financial analysis' of the CMA's Energy Market Investigation Final Report, for a discussion of the appropriate approach to profitability for energy generation as compared to retail.
[22] More specifically, the net operating assets.

When undertaking profitability analysis, the assets should, in theory, be valued according to the current opportunity cost of owning the asset or the value to the business (VTB).[23] This ordinarily requires an adjustment to one or more balance sheet values, as explained in paragraphs 47 to 48 below and the Annex.

(b) *Common cost and asset allocations:* where a firm undertakes other business activities, in addition to those which we are reviewing in the market investigation.

Our approach to asset valuation

38. The assets included in the capital employed input to profitability analysis, should reflect their current VTB.[24] The theory behind valuing assets at the VTB is set out in the Annex.

39. A valuation based on replacement cost or modern equivalent asset value (MEA) value is the most common outcome of a VTB assessment. This approach is consistent with the CMA guidelines, which state that the CMA considers MEA values to be the economically meaningful measure for the purpose of measuring profitability in most cases.[25]

Allocating common costs and assets

40. We are interested in the profitability of the business activities which are in scope,[26] which in this case is the provision of funeral director services and crematoria services. We have analysed the profitability of these two different services separately.[27,28] This is because pure play firms compete in the market i.e. there are stand-alone providers of crematoria services and/or funeral director services in the market.

41. Where the business activity being investigated is only one part of the firms' activities – for example for Dignity that provides both funeral director services and crematoria services – we have sought to ensure that the financial information has been prepared as if these activities had been undertaken by

[23] In practice this is only necessary where the impact of including assets at book value, rather than VTB has a material impact on the outturn results and conclusions.
[24] Also referred to as the deprival value, or value to the owner principle.
[25] CC3 Revised, Annex A, paragraph 14.
[26] CC3 Revised, paragraph 114.
[27] This is particularly relevant for Dignity – as it provides both funeral director services and crematoria services.
[28] In line with the approach taken on previous inquiries, such as the Energy Market Investigation, where retail and generation profitability were considered separately, on a stand-alone basis. See for example, paragraph 26 of Appendix 9.9 of the Final Report of the Energy Market Investigation, dated 24 June 2016.

the firm on a stand-alone basis, ie common costs and assets have been allocated to the different activities on a reasonable basis.

Assessment of potential inefficiencies

42. As set out at paragraph 11 above, a finding of low profitability would not necessarily signify that competition is working well. Low profitability may be concealing ineffective competition. Reasons for this may include:

    (a) 'Weak competition as a result of customers not responding effectively to competing offers may sometimes result in an inefficient market structure in which operators have higher costs and set higher prices than would be the case in a competitive market.

    (b) Incumbent firms, despite being protected from new entry, are not earning high profits because they are inefficient and operate with higher costs than would be sustainable with stronger competition in the market.'

43. We have sought to assess potential inefficiencies among funeral directors through an analysis of staff and property costs, as well as through a review of parties' internal documents. Our provisional conclusions are set out in detail in Section 7.

Annex: Theoretical approach to asset valuation

1. The assets included in the capital employed input to profitability analysis, should reflect their current value to the business (VTB).[29] The VTB approach aims to value assets in such a way that the cost base included in our economic profitability analysis allows for:

   (a) The existing firms in the market to recover the opportunity cost of using the assets to supply the in-scope activities; and

   (b) a hypothetical entrant to recover the costs of the assets,[30] required to supply the relevant activities.

2. Accounting values for assets may not reflect the VTB. This may be because:

   (a) For reasons of accounting prudence, an asset is not on the balance sheet;

   (b) the firm has paid off most of the upfront cost of the asset and is accounting for the asset at depreciated historical cost e.g. vehicles at zero book value;

   (c) changes in technology over time may mean that asset values in the Relevant Period differ to the balance sheet values; and/or

   (d) the firm is accounting for the asset at market value, but market-based valuations are not reflective of the cost of the assets, because strategic considerations and/or inflated future income expectations due to ineffective competition (i.e. profits above the 'normal' level), impacted value.

3. The VTB methodology, explained in detail below, ensures that the conditions set out at paragraph 1 are met and that the issues set out at paragraph 2 are overcome.

4. The VTB of an asset can be determined by reference to entry value (replacement cost), exit value (net realisable value) or value in use (discounted present value of the cash flows expected from continuing use and ultimate sale by the present owner). For some assets (for example, investments in actively traded securities), these three alternative measures produce very similar amounts, with only small differences due to transaction

[29] Also referred to as the deprival value, or value to the owner principle.
[30] Where the assets yield equivalent services to those currently used by the existing firm/(s) being analysed.

costs. However, for other assets (for example, fixed assets specific to the business), differences between the alternative measures can be material.

5. In most cases, as the entity will be putting the asset to profitable use within its current operations, the asset's value in its most profitable use (in other words, its recoverable amount) will exceed its replacement cost. In such circumstances, the entity will, if deprived of the asset, replace it, and the current value of the asset will be its current replacement cost.

6. Where an asset is worth replacing, its VTB will be its current replacement cost, or more precisely the replacement cost of a Modern Equivalent Asset (MEA)[31] determined in a fully competitive market and allowing for the asset's *remaining useful life*.[32] The MEA value is the cost of replacing an old asset with a new one with the same service capability.

7. A valuation based on replacement cost or MEA value is the most common outcome of a VTB assessment. This approach is consistent with our Guidelines, which state that the CMA considers MEA values to be the economically meaningful measure for the purpose of measuring profitability in most cases.[33]

8. However, in some circumstances the recoverable amount may be lower than the replacement cost. An asset will not be replaced if the cost of replacing it exceeds its recoverable amount. In such circumstances, the asset's current value is determined as follows:

   (a) When the most profitable use of an asset is to sell it, the asset's recoverable amount will be the amount that can be obtained by selling it, net of selling expenses; in other words, its net realisable value (NRV).

   (b) When the most profitable use of an asset is to consume it – for example, by continuing to operate it – its recoverable amount will be the net present value of the future cash flows. In other words, its value in use.

9. This can be portrayed diagrammatically as shown in Figure A.1.

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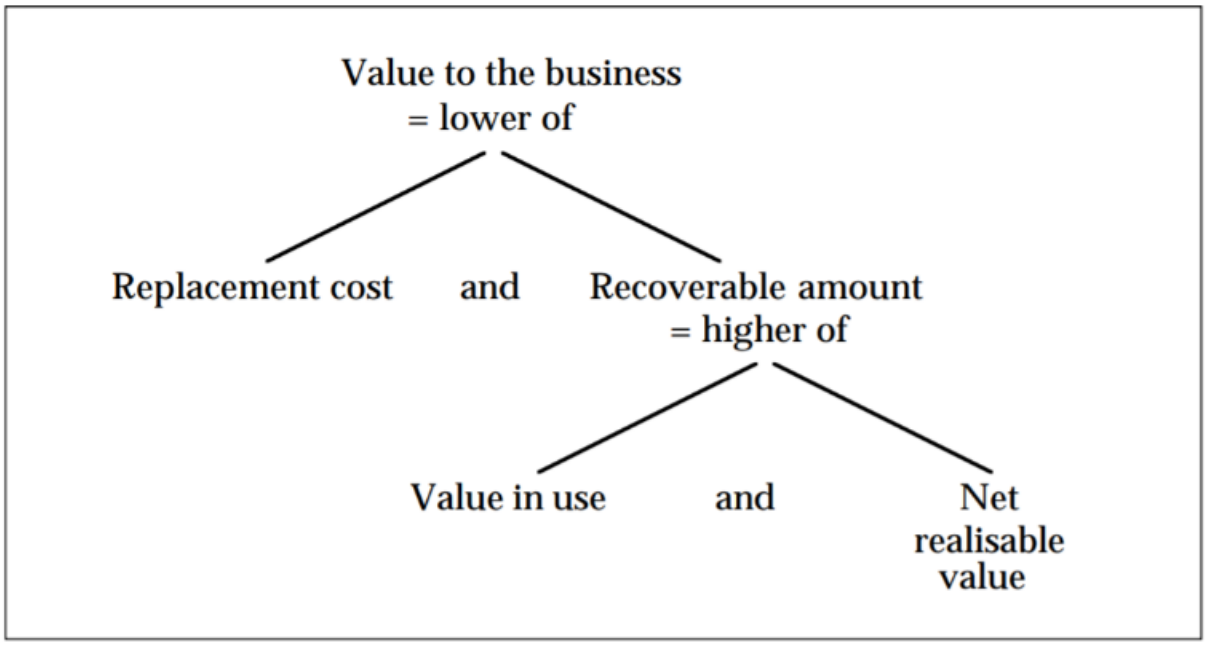
[31] The MEA value is the current cost of acquiring assets that yield equivalent services to those currently used by the firm, based on the most efficient technology and optimal configuration.
[32] Otherwise known as depreciated replacement cost.
[33] Market Investigation Guidelines (CC3 Revised), Annex A, paragraph 14

Figure A.1: Establishing which valuation basis for an asset gives its value to the business



Source: UK Accounting Standards Board, Statement of Principles, 1999 paragraph 6.8.

10. Application of these valuation principles consistently across all assets is also called current cost accounting (CCA).