FUNERAL MARKET INVESTIGATION

WORKING PAPER ON COST OF CAPITAL

CO-OP RESPONSE

Executive Summary

1. While the CMA has withdrawn its deadline for submission of comments on its latest batch of working papers, it has asked Co-op if it is in a position to provide comments. We have previously shared that we are willing to do this, however, the comments are being finalised by the Legal team without significant involvement by our Funeralcare business colleagues, who are currently focussed on adapting to the significantly changing environment resulting from the coronavirus pandemic and ensuring we continue to support families at this very difficult time. We, therefore, may have additional comments we want to add at a later date.

2. This note sets out Co-op's response to the UK Competition and Markets Authority's (CMA's) cost of capital analysis working paper published on 20 February 2020.[1] This response was largely drafted prior to the COVID-19 pandemic and does not therefore fully take account of its implications for our customers, our business and the sector as a whole. However, as we have indicated elsewhere, it is already clear that these will be very serious.

3. In its cost of capital analysis working paper, the CMA discussed the approach taken in estimating the nominal pre-tax weighted average cost of capital (WACC) for funeral directors and crematoria. We welcome the overall approach adopted by the CMA for cost of capital estimation. We note, however, that the CMA has not engaged with the comments we raised in our response to the working paper on the approach to cost of capital analysis. Therefore, we do not agree that the CMA's analysis and WACC estimates are robust.

4. First, we do not agree with the CMA's exclusion of a small company premium. In its paper prepared on behalf of Co-op, Oxera explained that the vast majority of the funeral directors in the market are small, and therefore, a small company premium should be added to their WACC estimate.[2] Oxera outlined the three main aspects which contribute to higher cost of capital for small companies: illiquidity of small companies' shares, lack of diversification of company-specific risks, and constraints on debt financing.

5. Second, we have serious concerns that the CMA's standard and industry-level WACC may have significantly understated Co-op's true cost of capital. We have previously explained that Co-op does not routinely use WACC specific to the Funeralcare business for the purpose of decision making.

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[1] CMA (2020), 'Funeral Market Investigation–Funeral Directors – Cost of Capital Analysis', 20 February.

[2] Oxera (2019), 'Funerals market investigation: approach to profitability analysis. Prepared for Co-operative Group Ltd', 9 August, section 3.

Instead, it uses a hurdle rate based on an estimate of the corporate level WACC, which is more consistent with the Co-operative ownership structure.[3] This hurdle rate [✄].[4]

6. Finally, we completely disagree with the CMA's assumption that Co-op has similar asset beta to the 6 listed comparators identified by the CMA.[5] Given that Co-op has significantly higher operational gearing than these comparators[6] and that the CMA has historically awarded uplifts to regulated companies with high operational gearing,[7] we believe that an uplift to the CMA's estimated asset beta is warranted for Co-op.

7. Overall, CMA working papers setting out its evidence base so far (consumer survey, firm-level analysis, take-up of simple, price dispersion analysis, profitability analysis) show a disconcerting picture emerging. On the one hand, the evidence strongly indicates that intrusive remedies, such as price controls or local authority tendering, would be wholly disproportionate to the current and expected future level of competition in this market. On the other, despite the level of robustness and overall quality of the CMA's analysis being poor, the CMA appears minded to draw misguided conclusions on the extent of consumer detriment in this market, by directly attributing any gaps, distortions and ambiguities in the analysis towards consumer harm. As the CMA is still consulting on a wide range of remedies, some of which are extremely intrusive, we are seriously concerned that the CMA is on course to greatly overstate the magnitude of the AEC (if any) in this market, and that it risks applying damaging and disproportionate remedies as a result.

8. As mentioned above, this response was prepared before the COVID-19 outbreak and therefore, does not reflect the latest available evidence. Although the outbreak is unlikely to affect Co-op's position in relation to the issues outlined below and CMA's estimates of the cost of capital are based on historical data from 2014 to 2018,[8] the structural change in investors' perception of risk may have long-lasting implications for the industry WACC in the future.

Small company premium is warranted for the vast majority of funeral directors

9. In its profitability analysis working paper, the CMA uses WACC directly only for benchmarking the return on capital employed (ROCE) of the 13 largest funeral directors in the market.[9] We note that the majority of the 13 largest funeral directors can still be considered small companies and therefore, require a small company premium.

10. In particular, Duff & Phelps, a financial advisory firm, uses a cut-off market capitalisation of €500m to identify small firms in its analysis of the small company premium.[10] In comparison, Dignity, the

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[3] Co-op (2019), Schedule 1 to Annex B to 'Response to CMA's Request for Information dated 10 May 2019', 10 June, para. 4.2.

[4] Co-op (2019), Annex A1.4.1 to Schedule 1 to Annex B to 'Response to CMA's Request for Information dated 10 May 2019', 10 June, p. 24.

[5] CMA (2020), 'Funeral Market Investigation–Funeral Directors: Cost of Capital Analysis', Table 5.

[6] See Table 1 of this response.

[7] CMA (2015), 'Bristol Water plc. A reference under section 12(3)(a) of the Water Industry Act 1991. Report', para. 10.152.

[8] CMA (2020), 'Funeral Market Investigation–Funeral Directors: Cost of Capital Analysis', para. 1.

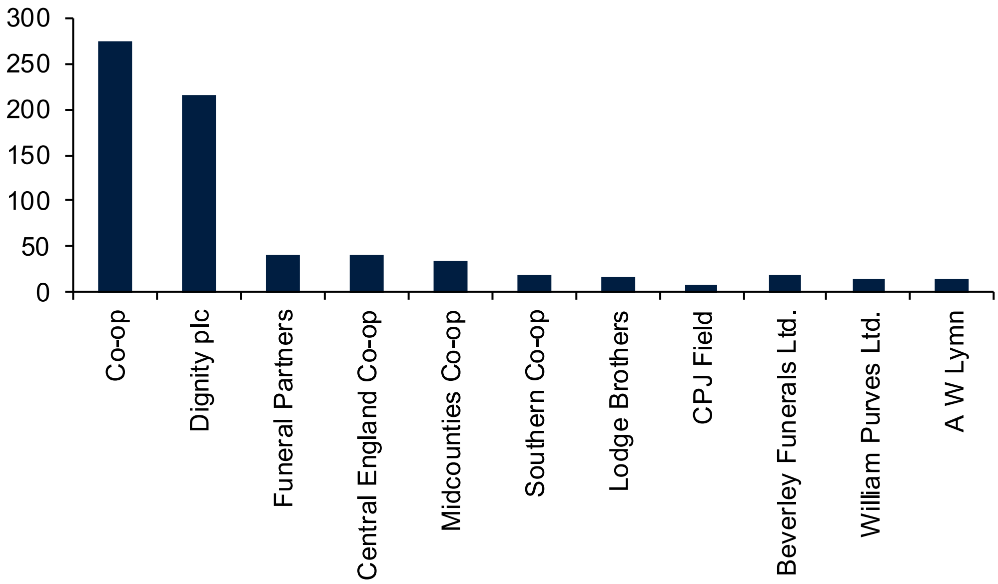
[9] In addition to Co-op, Dignity and Funeral Partners, these include, in decreasing order of size, as proxied by the number of branches: (i) Central England Co-op, (ii) Midcounties Co-op, (iii) East of England Co-op, (iv) Southern Co-op, (v) Lodge Brothers, (vi) CPJ Field, (vii) Beverley Funerals, (viii) William Purves, (ix) Alan Greenwood and Sons, (x) A W Lymn. See CMA (2020), 'Funerals Market Investigation. Funeral Directors: Profitability Analysis', 20 February, para. 4.

[10] Duff & Phelps (2019), '2019 Valuation Handbook. International Guide to Cost of Capital. Market Results Through December 2018 and March 2019'. Exhibit B-1. €500m is approximately equivalent to £435m as of 2 March 2020.

only listed UK funeral services provider, has a market capitalisation of just under £300m,[11] and therefore, in Duff & Phelps' terms would classify as a small company.

11. In the regulated water sector, the CMA granted a higher allowance for both cost of equity and cost of debt to Bristol Water in recognition of its smaller size in comparison to larger water and sewerage companies. Bristol Water's turnover was £124m at the time of the CMA's assessment.[12] Figure 1 below shows that 11 out of 13 funeral providers considered by the CMA as large in its profitability assessment are smaller than Bristol Water at the time of its appeal. Based on the above, we consider that the majority of the largest funeral providers in the UK are eligible for a small company premium.

Figure 1 2018 funeral services revenue of the largest funeral directors in the UK (£m)



Note: The companies are ordered by the number of branches they operate. Although data refers to financial year 2018, the eleven players do not follow the same approach to defining the financial year. East of England Co-op does not provide turnover for the funeral services segment. Alan Greenwood & Sons Ltd was incorporated in 2019, and therefore, does not have financial data to report yet.

Source: Oxera, based on companies' accounts and Co-op's response to the RFI from 10 May 2019.

12. In addition, the CMA compares the profits of the 13 largest providers with the profits of the small independent providers, indirectly assuming that a similar profitability level is appropriate for the two groups. However, we would argue that it is appropriate for the small providers to earn higher profits given the small company premium on their cost of capital.

13. In its paper on the approach to profitability analysis, the CMA recognised that smaller providers may have 'a higher cost of capital because of their ownership structure and lack of access to listed debt markets'.[13] However, the CMA does not engage with this topic in its cost of capital working paper.

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[11] As of 2 March 2020. Market capitalisation information was retrieved from the FT Equity Screener, https://markets.ft.com/data/equities/tearsheet/profile?s=DTY:LSE.

[12] CMA (2015), 'Bristol Water plc. A reference under section 12(3)(a) of the Water Industry Act 1991. Report', paras 10.80, 10.143–10.165. Bristol Water plc (2014), ' Regulatory accounting statements. Year ended 31 March 2014', p. 2.

[13] CMA (2019), 'Funerals Market Investigation – Approach to profitability and financial analysis', 24 July, para. 104.

14. In relation to the cost of debt, the CMA has compared its estimates with the actual cost of debt of the market players, which we consider appropriate. However, in relation to the cost of equity, the CMA states the following:

> *We do not consider that there is good theoretical or empirical evidence to support the inclusion of a small company premium (on equity).*[14]

15. Co-op does not consider this assessment sufficient and would welcome the CMA's response to the previously provided comments.

Standard WACC estimates significantly understate Co-op's true cost of capital

16. In our previous submissions, we have stated that Co-op does not routinely use a WACC specific to the Funeralcare business for the purpose of decision making.[15] This is because, unlike the ownership model of shareholder-controlled corporations, Co-op's ownership model does not offer Members a direct and realisable economic interest in the enterprise value and retained profits of Co-op and, as such, Members, unlike shareholders, may not directly benefit from future economic activity and profitability.[16] Therefore, the cost of equity component of a standard WACC, which is derived from the rate of return that a company expects to compensate its equity investors (shareholders) with, may not be representative of Co-op's true cost of equity.

17. To correctly reflect Co-op's true cost of capital, [✂], which was derived from the corporate level WACC in 2016. A [✂] was applied to the mid-point estimate of the WACC to take account of the increased risk inherent in new projects, the bias for optimistic cash flow estimates, the scarcity of capital and to ensure the creation of value over the minimum level.[17] [✂]. We note that this flat hurdle rate is [✂] than the CMA's point estimate of the standard WACC (8%) for funeral directors and crematoria in the UK.

18. For the reasons set out above, we believe that the CMA's estimate of the standard WACC significantly understates Co-op's true cost of capital.

Co-op is likely to have higher cost of capital than the listed comparators identified by the CMA due to higher operational gearing

19. Notwithstanding the CMA's reliance on a standard WACC estimate that is inherently inconsistent with Co-op's ownership model, we are also concerned by the fact that Co-op has higher operational gearing than the 6 listed comparators identified by the CMA in its cost of capital analysis. In its price control redetermination for Bristol Water (2015), the CMA acknowledged that 'higher operational gearing […] should in theory lead to a higher asset beta.'[18] On this basis, the CMA allowed an uplift in beta estimation due to differences in operational leverage, and proportionately increased the asset beta for Bristol Water by around 13% relative to larger water companies.[19]

20. One measure of operational gearing is the proportion of fixed operating costs to total operating costs. Table 1 shows that Co-op Funeralcare's proportion of fixed operating costs to total operating

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[14] CMA (2020), 'Funerals Market Investigation – Cost of capital analysis', 20 February, para. 57

[15] Co-op (2019), Schedule 1 to Annex B to 'Response to CMA's Request for Information dated 10 May 2019', 10 June, para. 4.2.

[16] Co-op (2019), Annex A1.4.1 to Schedule 1 to Annex B to 'Response to CMA's Request for Information dated 10 May 2019', 10 June, p. 23.

[17] Co-op (2019), Annex A1.4.1 to Schedule 1 to Annex B to 'Response to CMA's Request for Information dated 10 May 2019', 10 June, p. 24.

[18] CMA (2015), 'Bristol Water plc. A reference under section 12(3)(a) of the Water Industry Act 1991. Report', para. 10.151(b).

[19] CMA (2015), 'Bristol Water plc. A reference under section 12(3)(a) of the Water Industry Act 1991. Report', para. 10.152.

costs (61%) is much higher than the average of that across the CMA's 6 comparators (40%). This is primarily driven by Co-op's asset-heavy business model: e.g. it held c. £[✂] mortuary assets as at 2018.[20] Adopting a methodology for asset beta uplift that is similar to the CMA's in its 2015 Bristol Water redetermination, the asset beta of Co-op would have been [✂]% higher than the average asset beta across the CMA's 6 comparators.

Table 1 ***The proportion of fixed operating costs to total operating costs for six comparators identified by the CMA and for Co-op Funeralcare***

	Calculation	**2014**	**2015**	**2016**	**2017**	**2018**	**Average**
Service	A	3%	5%	6%	6%	5%	5%
Invocare	B	n/a	n/a	n/a	n/a	n/a	n/a
Carriage Services	C	16%	15%	15%	13%	15%	15%
Dignity	D	41%	41%	41%	42%	46%	42%
Propel Funeral	E	n/a	n/a	61%	61%	72%	65%
Stonemor	F	85%	84%	86%	87%	84%	85%
Average	G = (A + C + D + E + F) ÷ 5	36%	36%	42%	42%	44%	40%
Co-op Funeralcare	H	61%	59%	61%	61%	63%	61%
Asset beta uplift (for illustration only)	**I = H ÷ G**	**167%**	**163%**	**145%**	**145%**	**142%**	**152%**

Note: Cost of Goods Sold (COGS) is assumed to be the only variable cost. The asset beta uplift (I) is calculated following the CMA's methodology in the CMA's price control redetermination for Bristol Water (2015) and is for illustration only. COGS for Invocare was not available on Bloomberg. No financial data was available for Propel Funeral in 2014 and 2015.

Source: Oxera analysis based on Bloomberg data (comparators) and Co-op's submissions to the CMA. RFI dated 10 May 2019, 10 June, Questions 1, 5b and 11 of Annex A, Schedule 1 and Questions 11 of Annex B, Schedule 1.

21. For the reasons set out above, we believe that, by taking the asset beta of the 6 identified comparators at face value and making no adjustments, the CMA may have significantly underestimated the asset beta (therefore the cost of equity, and WACC) of Co-op. Therefore, we believe that an uplift to CMA's estimated asset beta is warranted for Co-op.

[20] Co-op has c. £4.3m mortuary assets on its balance sheet as at the end of 2018. See Oxera (2019), Annex A.1.1.1 to Annex A to 'Response to CMA's Request for Information dated 10 May 2019', 10 June, tab 'Mortuary'.