Appendix S: Profitability of funeral directors

Introduction and purpose of this paper

1. In this appendix we set out the specifics of analysing the profitability of funeral directors in this market investigation. This should be read in conjunction with our approach to analysing profitability within this market investigation more widely.

2. In this appendix, we explain the analysis we have undertaken in order to come to our profitability conclusions, and how we have taken into account the various submissions we have received from parties in response to our profitability working papers[1] and the Provisional Decision Report.[2]

3. This appendix is structured as follows:

   (a) First, we set out the scope of our profitability analysis, in terms of our coverage of the market for funeral director services and the time period we have considered;

   (b) Second, we provide an overview of the data we have received from the relevant firms and discuss the adjustments we have made to ensure our analysis is economically meaningful;

   (c) Third, we show the results of our financial and profitability analysis of the Large funeral directors;

   (d) Fourth, we set out the results of our financial analysis of the Smaller funeral directors; and

   (e) Fifth, we set out our interpretation of the results of our analysis.

4. We also present an annex which explains the issues we faced in obtaining information from the smaller funeral director firms in the market.

5. For the Large firms, we have undertaken ROCE analysis and consider ROCE, economic profits per funeral and economic profits as a percentage

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[1] During the course of our investigation we have published two working papers in relation to this profitability analysis. On 24 July 2019, we published a working paper titled 'Approach to profitability and financial analysis' setting out in detail our proposed methodological approach to the financial and profitability analysis. Further, on 20 February 2020, we published a working paper titled 'Funeral Directors profitability analysis' which presented initial profitability results.
[2] Funerals Market Investigation Provisional Decision Report

of cost-plus when interpreting the results of our analysis and when making comparisons across the parties.

6. These metrics require reliable information on the level of capital employed by firms which we have been unable to obtain for the Smaller firms.[3] Thus, in analysing the Smaller firms, we have compared the level of 'EBITDARS' (earnings before interest, taxation, depreciation, amortisation, rent and staff costs) per funeral of firms in order to make comparisons.

7. We also consider the revenues earned from the provision of funeral director services, both inclusive of disbursements and exclusive where the data permits. Further detail on the metrics used is included within the results section, from paragraph 172.

Scope of our analysis

8. Our financial analysis is focused on:

(a) The three largest firms of funeral directors, Co-operative Group Limited ('Co-op'), Dignity Plc ('Dignity') and Funeral Partners Limited ('Funeral Partners') (the 'Largest', and also falling within the 'Large' category).

(b) The next ten largest providers of funeral director services by number of branches (the 'Other Large', and also falling within the 'Large' category) being:

(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; and

[3] More detail on issues in obtaining information from these smaller firms can be found in the Annex.

(x) A W Lymn.

(c) A sample of smaller funeral directors, which comprise small businesses and sole traders that operate from one or a small number of branches, typically within the same region. These firms are referred to, in this appendix, as the 'Smaller' funeral directors'.

9. In terms of the time period for the analysis, we considered the 2014 to 2018 period. We had planned to request 2019 data from all of the Large firms and update our analysis accordingly. However, as a result of the COVID-19 pandemic, we were unable to do so for most of these companies.[4]

10. As the scope of our investigation covers the provision of at-need funeral director services, our analysis does not cover the sale of prepaid plans. We do include prepaid funerals at the point that they are provided, but exclude the revenues and costs associated with the sale of the prepaid plan.

11. We received various submissions from parties in relation to the scope of our analysis, largely around the sufficiency of our market coverage and the methods used in obtaining data from the smaller firms.

12. In selecting the firms to include in our analysis we had to balance market coverage with the practicality of seeking to collect detailed financial information from very small firms.

13. To this end, we originally sent a detailed questionnaire to a representative sample of 100 branches of smaller firms. Based on the low response rate and feedback received, we revised our approach to request information at company-level (as opposed to branch-level) using a simplified questionnaire.

14. We note that this approach has given us profit information that was sufficient for the purpose of analysing the profitability of 46 Smaller firms. We have taken care in how we have analysed and compared this information with that provided by the Large firms, given differences in how costs may have been recorded (eg the recording of salary costs, as discussed in the Annex).

15. In combination with full ROCE analysis for the Large firms, which comprise more than 40% of the market, we consider that this gives us useful insight

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[4] We were able to obtain 2019 financial information for the purposes of profitability analysis from [✄] and [✄] only.

into the impact of the AECs we found on outcomes in the funeral director market more broadly.

16. We consider points raised by parties with regards to market coverage and our analysis of the smaller firms from paragraph 318. We provide more detail on our approach to gathering data from the fragmented market and parties' views on this approach in Annex A: Obtaining information from the fragmented market.

17. Other points raised by parties related to the timeframe of our analysis, the consideration of prepaid funeral plans, and the impact of COVID-19. Each of which, we consider in turn below.

Timeframe

Parties' views

18. NAFD raised concerns that 'looking at a time period of only 5 years could mean that current estimates of ROCE do not capture the full-life returns and may result in a finding that ROCE is greater than the WACC which is due to these life cycle effects rather than problems with competition.'

19. Dignity told us that it recommends 'that the CMA requests more complete actual data for 2019 in January 2020, together with relevant 2020 forecasts' as 'this will allow the CMA a longer time period of analysis and, as the markets continue to change rapidly, it is critical that the CMA's analysis is up-to-date in any remedies design stage.'

20. Co-op said that 'profitability of the Co-op Funeralcare business has reduced significantly over the period' and that this 'suggests that future profitability may be significantly lower than historical profitability and the conclusions from historic profitability may not be indicative of current market conditions.'

21. Further, Co-op explained that its 'profitability has declined significantly in recent years, predominantly due to (1) an increase in the proportions of Simple funerals and Cremation(s) Without Ceremony (CWC) sold, and (2) declining volumes and market share.'

22. It noted that 'even if the CMA extends the period under consideration to 2020, the average level of profitability would still be heavily weighted towards the period where profits were significantly higher than today, which risks drawing conclusions that do not reflect the current market conditions.'

23. Co-op argued that 'the CMA's conclusions are based on the analysis of 2014 to 2018 data' but that 'the market has moved since then and is likely to keep developing rapidly, not least as a consequence of the Covid-19 pandemic.' Co-op continued that 'therefore, the conclusions drawn based on 2014 to 2018 average levels are unlikely to be representative of the market's profitability going forward.'[5]

24. Funeral Partners responded to our profitability approach paper by explaining that its 'strategy of investment in quality means that profitability is deferred, resulting in low profitability in the shorter term.' It 'therefore consider[s] that given [its] 'buy-and-build' investment strategy, coupled with investment in [its] existing funeral homes, the return has not yet realised and can therefore neither be captured by an analysis of historical data, nor be estimated with sufficient accuracy through forecasts.'

25. Funeral Partners therefore asked that we 'consider Funeral Partners' current position – two years into a five-year investment plan – when interpreting the results from the profitability analysis.'

Our approach

26. We consider that five years is a sufficient period over which to understand the profitability of funeral directors. While we agree that it may have been helpful to have more complete information on the most recent performance of the firms in the industry by obtaining 2019 data and future forecasts for the firms analysed, this has not been practicable given the current climate and restrictions placed on data gathering as a result of COVID-19.

27. We have, as noted above, obtained 2019 information from [✂] and [✂]. The results of our financial analysis of these firms based on 2019 data has been included in the relevant tables in the results section below. However, as a result of having the information for these two firms only, our ability to provide detailed narrative on any potential trends in the industry across 2019 is limited.

28. We consider movements in profitability over the 2014 to 2018/19 period in paragraphs 294 to 317 where we discuss the conclusions that we draw from the results of our analysis.

[5] Co-op response to Provisional Decision Report, para 6.29 (a).

Pre-paid plans

Parties' views

29. NAFD raised concerns that 'the role of pre-paid plans could affect the implications of ROCE estimates.' It said that 'it may be possible that the estimated ROCE will be sensitive to how these plans are accounted for in the calculations.'

30. Co-op suggested that the inability to distinguish at-need funerals from pre-need redemptions might confound results due to at-need funerals and pre-need redemptions having different price levels and growth rates. It suggested that since it normally takes an average of around 13 years for a pre-need plan to come to redemption, the price charged for redemptions today at least partially reflects pricing decisions taken many years ago.[6]

Our approach

31. With regards to prepaid funeral plans, the profit and loss information we collected excludes revenues and costs associated with the sale of pre-paid funeral plans but includes the revenues and costs associated with carrying out funerals that were prepaid at the point of need. In addition, in calculating capital employed for ROCE purposes, we have excluded any assets or liabilities noted as being related to pre-paid funeral plans.

32. Pre-paid funeral plans are generally less expensive than at-need for two broad reasons:

    (a) They have often been sold a long time ago when prices were lower in real terms (as funeral inflation has exceeded general inflation in the economy); and

    (b) The provider may hold and earn a return on the monies from pre-paid plans in the time between when the funeral plan was taken out, and when the funeral is provided, meaning that an additional return over and above the amount received from the customer may be earned.

33. To the extent that (a) is the case, there is the potential that profitability analysis could understate the extent of market power today, because it is reduced by these historic lower prices. Similarly, to the extent that (b) is

[6] Co-op response to Provisional Decision Report, para 3.2(b)

the case, either the analysis would miss this additional return, or that return would be added to the revenue figure when the funeral is provided.

34. With regards to our analysis, we do not consider that we are missing any returns, as our analysis reflects the actual profitability from providing these services over the relevant period. However, if returns had been missed in our analysis, we consider that profitability would be under- rather than over-estimated.

ROCE analysis

Approach to ROCE analysis

35. Here we consider ROCE in the context of our analysis of funeral director firms.

36. ROCE is calculated as earnings before interest and tax ('EBIT') as a percentage of the capital employed by funeral directors to provide funeral director services.

37. We are guided by the following key principles in carrying out our analysis:

(a) Return on capital employed compared with the weighted average cost of capital ('WACC') is our primary means of measuring profitability.[7]

(b) We determine the ROCE using operating profits and net operating capital employed. 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 (ie the provision of funeral director services) should be included. We exclude financing costs, and taxation on income and any associated corporation tax or deferred tax.

(c) We start with accounting profits and the balance sheets for the operating units of the firms that undertake the relevant activities, and then make adjustments to arrive at an economically meaningful measure of profitability.

[7] We use return on capital employed (ROCE), where data permits, as this can be computed annually and thus provides greater insights into trends over time and the drivers of profits above the 'normal' level. In addition to using the ROCE framework, we also consider it relevant to calculate economic profits and economic profits/cost-plus as alternative points of comparison across firms which may have different capital structures. Fundamentally, these represent the same approach but allow data to be presented in different ways.

(d) We also require common cost and asset allocations where a firm undertakes other business activities in addition to those which we are reviewing in the market investigation.

38. The value of assets in the capital employed input should reflect their current value to the business (VTB). Modern equivalent asset value (MEAV) is the most common outcome of a VTB assessment. This is the replacement cost of the asset in its current condition today.

39. We have assessed the financial information provided by the funeral director businesses that are within the scope of our analysis and considered the submissions we have received (predominantly from the three largest funeral information to reflect replacement cost.

Identification and valuation of capital employed

40. This section sets out our approach to: (1) identification of the operating capital employed required to provide funeral director services and (2) valuation of those assets.

41. The main categories of assets recorded on the balance sheets of the funeral director businesses are:

(a) tangible fixed assets, such as properties, refurbishment/fit-outs, mortuaries, refrigerators, and vehicles;

(b) intangible fixed assets, such as goodwill, brand/trade names, and software;

(c) working capital, which comprises operating current assets such as inventory, trade debtors, other debtors and VAT, and operating current liabilities such as trade creditors and other creditors;

(d) other current assets such as cash; and

(e) other current liabilities such as intercompany balances.

42. In this section, we consider each of these categories of assets in turn and set out the approach that we have taken in recognition and valuation of these assets in our analysis.

Tangible fixed assets

43. The tangible fixed assets related to the provision of funeral director services are typically properties, refurbishments/fit-outs, mortuaries, refrigerators and vehicles.

44. These assets tend to be valued on the balance sheet at historic cost less any depreciation charged against the asset over its useful life. We asked the three largest firms questions to inform our understanding of the cost of replacing these assets. In particular, we asked them whether:

(a) net book value (NBV) was a good approximation for the cost of replacing (owned) material assets in the Historical Period;

(b) rental payments on material assets in the Historical Period were in line with market rates.

45. In response, the parties identified the asset categories that they deemed to be material, and then went on to provide views on the appropriateness of NBVs, rental payments etc, as proxies for replacement cost.

46. All three of the largest funeral director firms noted two material asset categories: buildings and vehicles. We first consider these two fixed asset categories, which the parties consider to be material, and then turn to the remaining fixed asset categories.

Properties – owned

47. The first asset category we consider is that of those properties which are deemed as owned. These properties are either owned or held under a long-term ('finance') lease.

48. Co-op told us that properties are measured at cost less accumulated depreciation or impairment losses. It said that given that freehold buildings have relatively long, useful economic asset lives, many of them are likely to have been purchased a long time ago when property prices were different from what the market offers today. Co-op therefore considered that NBV was unlikely to be an appropriate approximation of the cost of replacing the property today.[8]

49. Similarly, Dignity stated that NBV would 'not be sufficient to allow [it] to replace the network of funeral homes and supporting infrastructure to the standard of the existing portfolio.' Dignity noted that it accounts for its physical assets at historic acquisition costs, and inflation in the costs of physical assets – land, buildings, and fleet – means that the depreciated

[8] Co-op explained that they compared gross book values of a number of properties with the estimates of costs of replacing them based on insurance valuations to consider this point. Their results showed insurance values ranging from 1.8 to 5.1 times higher than gross book value.

historic cost values in the fixed asset register (FAR) would not cover the cost of replacing the assets today.

50. Dignity noted that significant investment would be needed to replace the physical infrastructure supporting over 840 funeral homes, the mortuaries and the coffin factory. Dignity said that, in its experience, fitting out a satellite branch typically incurs expenditure of c.£[✂]. It said that 'for a full-service branch, the fit out alone would be significantly higher in addition to the losses incurred during the ramp-up phase of the branch. Assuming the lower bound of around £[✂] per branch, the costs of replacing the portfolio of over 840 funeral homes would exceed £[✂] million.'

51. We note that Co-op and Dignity have pointed out that where assets are long-lived and have been recorded at historic cost in accounting records, the carrying value of the assets is unlikely to reflect MEAV. Furthermore, we note that properties are the single largest tangible asset category for these firms, such that inaccurate valuation of these assets could materially distort our analysis. Therefore, we agree that the most accurate approach is to revalue owned properties.

52. In contrast, 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.

53. Funeral Partners noted that when these transactions occur, 'the values are broadly in line with the values of the assets as held on the balance sheet.'

54. We requested data from Funeral Partners to identify individual owned property assets. We noted that the number of properties owned by Funeral Partners at the year-end date in the Historical Period ranges from 0 to 9. These owned properties tend to be disposed of within 1 to 3 years.

55. As such, where a firm leases its properties, or owned properties have recently been acquired, we do not believe that revaluation of the property portfolio is required.

56. We have detailed our approach to revaluing the property portfolio of the firms below.

- *Approach to property revaluation: asset value and capital employed*

57. We consider 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, ie the current market values of

the properties.[9] However, we have not been able to obtain this information given the large number of properties employed by the parties and the fact that market prices of the properties are not information that the firms would hold.

58. We therefore considered two alternative potential approaches to valuation: insurance values and indexed historic costs.

59. Dignity suggested that we use the insurance value of properties in valuing the property portfolio of funeral directors.[10]

60. However, we do not believe that insurance values are an appropriate method of valuation for funeral director properties. Values for the purposes of insurance are generally based on the rebuild cost of a building, which can differ materially from its "replacement cost" to the business, which we consider is likely to be well approximated by the market value in this case.

61. Funeral directors generally purchase a retail or commercial property at market value and refit for the purposes of providing funeral director services.[11] We note that the type of properties used in funeral directing have a reasonably clear market value which is unlikely to be distorted by the use to which they are put, as may be the case for crematoria (which have a single use). As such, we have not used insurance values to revalue the property portfolio of funeral director firms.

62. Next, we considered using historic costs, ie what the parties actually paid but, as noted above, where assets were purchased a long time ago, these may differ considerably from current replacement costs. As a result, it is necessary to adjust historic purchase costs to reflect the change in the value of property over time.

63. We considered using the House Price Index (HPI) to uplift historic purchase costs however we thought this would be likely to over-value properties purchased historically due to significant growth in UK house prices over the last 50 years. As such, we have chosen not to use this index.

64. Our analysis is therefore based on the use of the general level of inflation (CPI) to revalue properties. This assumption maintains the real value of firms' properties over time. We note that a commercial or retail property

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[9] As these are generally standard high street units, we would not be worried about profitability of the particular firms affecting purchase prices.
[10] Dignity response to funeral director profitability working paper, para 4.8(b)
[11] This differs from crematoria where operators tend to purchase a plot of land and construct the building, which then has no alternative use and hence a market value which is determined by the profitability of the operation of the crematorium.

price index would be likely to be more accurate. However, we have not been able to identify a suitable such index.

65. Dignity raised a concern with the use of CPI, noting that using CPI as opposed to HPI lowers the capital employed (thereby increasing economic profits) and does not consider regional variation, a particular concern for Dignity which told us that its branch portfolio is more exposed to higher inflation rates due to being largely based in London.[12]

66. As stated at paragraph 63, we consider that the HPI would be likely to over-value properties purchased historically due to the very significant growth in real UK house prices over the last 50 years. Funeral director properties are generally (off) high-street retail units, with distinct market dynamics from residential property. As such, we consider that the HPI would incorrectly value the funeral director property assets. Therefore, as noted at paragraph 64 we consider that a commercial or retail property index would be more appropriate, but we have not been able to identify one.

67. While CPI itself does not take into account regional variations in the property portfolios of the firms, it ensures that the real value of property is maintained over time, with firms' original costs reflecting the locations of their properties across the UK.

68. We have included all property assets, including capital expenditure on capitalised building assets incurred at the time of the property acquisition, for instance professional fees, agent fees and stamp duties, as well as other property-related assets such as refurbishment costs. However, we note that there is potential that some property assets which are not directly related to the acquisition or improvement of the fabric of the property may have been included, thus overvaluing the capital employed. Our method is detailed below.

69. To revalue properties, first we identified the property assets relevant to the provision of funeral director services within the parties' property portfolio, and the original book value (being the purchase price paid). Then, we used CPI to uplift the property value for each year of the Historical Period.

70. Next, we considered what UEL to assume for the revalued properties in our analysis. In the information given to us by Co-op, the asset life of all buildings (excluding fixtures and fittings) was shown as 50 years. Dignity provided us with their fixed asset register which showed useful lives for

[12] Dignity plc response to the CMA's Provisional Decision Report, Annex 1: Critical observations on the CMA's profitability analyses and customer detriment figures, para 2.7 and 2.8

property assets ranging from 0.04 to 60 years. We calculated that approximately [✂]% of the relevant portfolio had a useful life of 50 years.[13] On the basis of this information and observing that a UEL of 50 years is standard for properties, we used this in all instances.

71. We used the revised purchase cost, UEL and asset age to calculate the revised accumulated depreciation. Removing revised accumulated depreciation from the revised purchase price results in the depreciated replacement cost.

72. The original net book value of the revalued properties was removed from calculated capital employed and replaced with the depreciated replacement cost.[14]

73. This resulted in an updated capital employed figure which reflected the revalued core property asset. We explain below the consequent adjustments made to depreciation in order to ensure consistency between balance sheet and P&L (ie full articulation of the accounts).

- *Approach to property revaluation: depreciation and EBIT*

74. Having revalued owned properties using the consumer price index, it is also necessary to take into account the corresponding impact on EBIT. There are two elements to this:

(a) As the value of their firms' properties has increased, the depreciation charge thereon will also increase; and

(b) as the properties employed by the firm change in value over the relevant period, the firms make holding gains / losses on these properties.

75. The holding gain (or loss) is calculated as the movement in the depreciated replacement cost of the property from one year to the next. The holding gain (or loss) is therefore the increase (or decrease) in the replacement cost of the asset during a given period. This is the result of holding the asset only ie not the result of improvements/refurbishments/fit-outs etc.

[13] CMA calculation

[14] Dignity is the only firm for which we performed property revaluation which undertakes both Funeral Director and Crematoria services. Head office properties are shared across these two workstreams, thus we undertook an exercise to allocate revalued Head Office properties to the funerals business. We separately identified property assets relating to Head Office and followed the process as laid out at paragraphs 69 to 73 above to identify the original net book value of said properties, and their revalued depreciated replacement cost. We calculated the percentage of total properties that funeral services properties made up, based on Dignity's balance sheet, and used this to allocate the revalued depreciated replacement cost of Head Office properties to the funeral services capital employed.

76. For the results of our analysis to be economically meaningful, all changes in the value of capital employed over the period must be recognised in EBIT, including holding gains and losses. Therefore, we have removed the depreciation that the firms charged against their property portfolios over the relevant period and replaced this with a total holding gain or loss, which reflects both changes in the CPI and the depreciation of property assets as they age.

77. To ensure that annual trends in financial performance of the funeral director business are not distorted by trends in holding gains or losses, we have calculated the total holding gain (or loss) over the five-year period and allocated this equally to each year.[15]

Properties – rented

78. Not all properties used by the parties are owned or treated as owned (ie held under a finance lease). The parties rent many of their properties under short-term (ie ‘operating’) leases. Rented properties held under operating leases are not currently recorded on the balance sheet, and therefore are not included within capital employed. While capital employed is therefore lower than it would be if the leased properties were held on the balance sheet, EBIT is also lower due to rental payments.

79. Our consideration of rented properties is twofold: firstly, we consider the appropriateness of rental costs in reflecting the value of the asset, and secondly, we consider the capitalisation of property-related operating leases.

80. First, we asked the parties whether rental payments in the Historical Period were in line with market rates. Co-op stated that leasing arrangements are structured such that premises are leased from individual landlords in the open market, with three levels of rent review at the start, during, and at the end of the lease term. Co-op therefore regards rental payments to be in line with market rates.

81. Dignity noted that property rentals are from third-party landlords and their rates would reflect market conditions in each location. Dignity also stated

[15] In its response to the profitability working paper, (para 3.13) Co-op queried how we calculated the holding gains or losses for the first year of the 2014 – 2018 period, ie 2014. Co-op noted that ‘it should be calculated as the difference between the revalued ending balance and the revalued beginning balance of property assets in 2014.’ Co-op continued that ‘this is because the adjustment should be applied to all years including years prior to 2014, to ensure the consistency of financial data across time.’ We have calculated holding gains or losses as the difference between the revalued ending balance and the revalued beginning balance of property assets in 2014 (using estimated 2013 data based on 2014 data with those properties purchased in 2014 removed).

that it conducts regular rent reviews and negotiations. Therefore, Dignity consider rental payments to be in line with market rates.

82. Funeral Partners told us that it considers rental payments to be in line with market rates ‘in the main’. It noted that operating leases are undertaken on an arm’s-length basis with rental payments reflective of underlying market conditions. Additionally, rent reviews are in place and it is noted that ‘many of the lease terms have been renegotiated after initially being acquired as part [of] business acquisitions.’

83. With rental payments considered by the three largest funeral director firms to be in line with market rates, we concluded that it was not necessary to adjust rental costs when carrying out our analysis.

84. Next, we noted that as of 1 January 2019, IFRS 16 came into effect, changing the methods used to record operating leases.[16] The impact of these changes will be reflected in the annual accounts published by Dignity and Co-op for periods commencing on or after 1 January 2019. We do not expect this to have an impact on the reported financial statements of any of the other parties included in our analysis, as we believe Dignity and Co-op to be the only parties reporting under IFRS.

85. Dignity highlighted the change in accounting standard in response to our profitability approach paper and said that ‘approximately [✂]% of the Group’s properties are on lease terms that are currently accounted for as operating leases, but which will result in the recognition of both assets and liabilities under the IFRS 16 standard. [✂].

86. Dignity told us that as it leases ‘[✂] assets employed in its funeral services division, capitalising these leases under IFRS 16 [✂] its capital employed by over £[✂] and so [✂] ROCE materially.’ Dignity noted that the capitalisation of operating leases should be applied to all providers.[17]

87. Dignity argued that other firms that use long-term operating leases should have said leases capitalised. Dignity refer to [✂] largely leased asset base arguing that [✂].[18]

88. Dignity responded to our profitability approach paper by saying that ‘Dignity agrees with the need to capitalise leases, and to do so across the relevant

[16] IFRS 16: Leases is the International Financial Reporting Standard used by companies reporting under International Financial Reporting Standards (IFRS) to account for leases. Both Dignity and Co-op report under IFRS therefore will be required to follow the methodology set out in this standard as of 1 January 2019. We understand that all other firms in our analysis report under UK GAAP, where requirements differ.
[17] Dignity response to funeral director profitability working paper, para 2.1 (c)
[18] Dignity response to funeral director profitability working paper, paras 4.17 and 4.18.

period and the providers in the CMA's analysis.' It said that 'as the CMA is, in particular, seeking to understand forward-looking profitability, where capitalisation of leases under IFRS 16 is required, it is necessary to conduct the analysis in the relevant period on a consistent basis.'

89. Further, Dignity told us that IFRS 16 is factually a part of the market now and going forward. It said that capitalising leases would, more likely than not, reduce the estimated ROCEs, potentially materially for those firms with a large proportion of leasing (eg Funeral Partners and Dignity). It argued that in not capitalising leases for the Large firms, ROCE is incorrectly estimated and a poor reflection of forward-looking levels.[19]

90. In addition to the points raised by Dignity, Co-op also told us that operating leases should be capitalised as part of our analysis.[20]

91. We considered whether it was appropriate to capitalise leased assets in our profitability analysis as required under IFRS 16. First, we noted that we did not have information to undertake this exercise. Only Dignity and Co-op will have prepared workings to capitalise operating leases under the new accounting standard and only for 2019/2020 onwards, thus the data would not be relevant to the Historic Period. In this context, we were concerned that replacing actual, known rental costs with CMA estimates of the capital value of leases risked reducing the comparability and robustness of our analysis.

92. Second, having reviewed IFRS 16, we are not convinced that the capitalisation of leases as required under this accounting standard is appropriate for the purposes of our economic profitability analysis. For example, we note that the value of a leased asset under IFRS 16 depends on the creditworthiness of the business leasing the asset, ie the same asset may have a different value if leased by a larger firm than a smaller firm even where the terms of the lease are identical. Such an approach is at odds with the basic benchmark of our analysis which seeks to identify the arms-length market price of all inputs required to provide a good or service. In this context, we find that it is preferable to use rents agreed by firms in the open market, rather than seeking to capitalise such costs as per IFRS 16.

93. Finally, we observed that capitalising leases more generally (ie whether we followed IFRS 16 or an alternative approach) would have two (at least

[19] Dignity plc response to the CMA's Provisional Decision Report, dated 17 September 2020, Annex 1: Critical observations on the CMA's profitability analyses and customer detriment figures, para 2.9
[20] Co-op response to Provisional Decision Report, para 6.40

partially) offsetting effects: increasing both capital employed and EBIT, with the latter effect resulting from the removal of rental payments from the P&L, and their replacement by depreciation (which is reflected in EBIT) and financing costs (which are not). While we recognise that this type of adjustment may be expected to have an impact on measures of ROCE, it is not clear that, if correctly applied, it would or should have a material impact on any estimates of economic profits, particularly in light of parties' submissions that rental payments are expected to be in line with market rates.[21]

94. Considering that our conclusions of profitability are based on a number of metrics (ie not ROCE specific), and with consideration of the complexity of making these adjustments, lack of comparability across firms, and the limited information that we have available in this area, we have not made adjustments to capitalise leases to any parties' financial information.

Vehicles

95. As noted in paragraph 46 the other asset category considered by the firms to be material was vehicles. The parties therefore considered whether the NBV of their vehicle assets was reflective of replacement cost in their current condition.

96. Co-op told us that it assessed the NBV and market value of vehicles in 2018 and concluded that on average the NBV of its fleet is a fair approximation of the cost of replacing it. It said that since there have been no changes in depreciation methodology or significant changes in the market values over the historical period, it has assessed the value of its fleet only in 2018.

97. Co-op explained that the market value estimates used to consider whether NBV is appropriate were based on either:

(a) Known sales values from their history of sales; or

(b) market research of auction and online sale prices, for vehicles of those types and ages that they do not typically sell.

98. From its research, Co-op told us that it found that NBV is higher for vehicles from 1 to 3 years old and lower for older vehicles. Therefore, on

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[21] 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. It is calculated as EBIT less WACC x Capital Employed.

average, it considers that the NBV of its fleet is a fair approximation for the cost of replacing it.

99. In contrast, Dignity told us that its fleet of hearses typically comprises new, bespoke-built vehicles. It said that it would be difficult to replace this specification of hearse on the second-hand market. Dignity also said that it tends to purchase batches of hearses to achieve volume-related discounts, which may not be possible to achieve in the more fragmented second-hand market. As such, it told us that it thinks the true replacement cost of the hearses would be significantly higher than the amount recorded on the fixed asset register.

100. Dignity told us that the NBV for the limousine fleet would likely be a more reasonable estimate as there is a more liquid second-hand market in limousines. It told us that a second-hand fleet would not align with Dignity's desired positioning as a quality operator.

101. Funeral Partners told us that the business looks to have "matched" fleets within local operational areas, and thus sourcing used vehicles in the second-hand market is generally not particularly viable in terms of reaching this goal.

102. However, Funeral Partners told us that where ceremonial vehicles have been placed or sourced in the second-hand market, the values arising on such vehicles have not been out of line with NBV for vehicles of a similar age and condition held by Funeral Partners.

103. We do not agree with Dignity that potential difficulties with replacing an asset (in particular, a bespoke-built hearse) on the second-hand market necessarily makes NBV a poor proxy for depreciated replacement cost, or that discounts for purchasing large volumes should not be reflected in the depreciated replacement cost of its fleet. First, we note that any discounts achieved for bulk purchases can be expected to be generally available in the market and hence reflect the market price of replacing assets. Second, we note that the value of hearses (including bespoke-built hearses), like all vehicles, will decline over time to the point where they no longer have any value. We would expect funeral directors to select an appropriate 'useful economic life' for their assets when applying depreciation to them. Therefore, although the NBV of any given hearse may differ from the value that such a hearse would achieve in an (illiquid) second-hand market, on average across a fleet of hearses, we would expect NBV to proxy the depreciated replacement cost.

104. In addition, we note that both Co-op and Funeral Partners consider that NBV is a reasonable approximation of replacement cost, at least over the whole portfolio of vehicles. Therefore, we do not consider it necessary to revalue the vehicle portfolios of the firms.

Intangible fixed assets

105. In this section we consider intangible fixed assets. First, we consider which types of intangible asset should be recognised in the capital employed of the firms for the purposes of our profitability analysis. Then, we consider how the relevant intangible assets should be valued in the context of the value to the business framework as set out in Appendix Q.

106. We note that the Large funeral directors tend to have the following intangible assets recorded on their balance sheets: goodwill, reputation/trade name and software. In addition, the parties put forward several other potential intangible assets that they believed should be recognised in their capital employed.

- *Parties' views*

107. Dignity put forward the view that additional intangible assets necessary for the running of the funeral services business are not reflected on its Fixed Asset Register ('FAR'). These include:

(a) The customer relationships and trusted reputation of the funeral homes reflected, in part, in the goodwill and trading name assets on the balance sheet; and

(b) the IT software, systems and know-how that supports the funeral director business, internally developed over time.

108. Funeral Partners emphasised the value of its intangible assets, including brand names and goodwill, to the business. It said that Funeral Partners invests heavily in terms of the businesses and brands which it acquires. It told us that it works to maintain these values as they are a fundamental part of each acquired business and that recognition of intangible assets (in terms of their value, and therefore their inclusion as part of the capital employed in the business) is an important matter.

109. Similarly, Dignity told us that it has pursued a deliberate strategy of growth through acquiring funeral directors with established, trusted local reputations and books of customers. Dignity argued that had it sought to grow customer volumes without acquisitions, it would have devoted and

incurred substantially higher customer acquisition costs through the P&L (eg marketing costs, and years of losses during the ramp-up phase of new branches), than it did in fact incur while growing the book through acquisition.

110. Dignity stated that these costs of acquiring customers would have weakened operating profits in the period, but instead are, in effect, reflected in the goodwill and trading names intangibles on the balance sheet.'

111. Further, Dignity said that it separately identifies acquired trading names as intangible assets in its accounts (in line with accounting standards). These trading names reflect the value of the reputation of an established funeral director in a local area. Dignity began capitalising acquired trading names in 2004. Therefore, for acquisitions prior to this date, including the management buy-out in 2002, the trading name values would be included in the goodwill figures on the balance sheet.

112. Dignity noted that it considers it would be incorrect, in this case, to exclude goodwill from the capital employed.

113. In terms of software, Dignity told us that it capitalises only some of its software licenses on the balance sheet. Dignity said that its main operating systems were developed internally over several years, and the cost to replace the main IT systems, internally developed software and know-how would be substantially higher than the IT asset reflected on the balance sheet.

114. Dignity told us that it does not yet have an estimate of what it would cost to replace the internally-generated IT infrastructure, but it would be substantial. Dignity provided us with information on the cost incurred by InvoCare[22] in their recent replacement of software. Dignity suggested that this is an appropriate comparable estimate of the cost of replacing its own software system.[23]

115. A response submitted by Co-op highlights the importance of former owners in maintaining funeral homes' volumes and profitability following an acquisition, which Co-op told us was consistent with the presence of intangible assets with significant economic value and with the common erosion of the value of an intangible asset when it is transferred from one owner.

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[22] InvoCare Limited is an Australian public company operating in the funeral home, crematoria and cemetery industries.
[23] Dignity response to funeral director profitability working paper, para 4.19.

- *Our consideration of parties' views*

116. Our Guidelines[24] set the criteria for consideration when determining whether to recognise an intangible asset for the purposes of profitability analysis or not. The Guidelines state that we may consider the inclusion of intangible assets where the following criteria are met:

(a) It must comprise a cost that has been incurred primarily to obtain earnings in the future;

(b) this cost must be additional to costs necessarily incurred at the time in running the business; and

(c) it must be identifiable in creating an asset separate from any assets arising from the general running of the business.

117. We have noted three main categories of intangible assets recorded on the balance sheets of funeral director firms:

(a) Goodwill;

(b) reputation/trade names; and

(c) software.

118. We considered whether the parties' submissions gave us reason to believe that there were any additional categories of intangible assets that should be reflected in the firms' capital employed for the purposes of our profitability assessment. For example, we considered the potential to include 'books of customers'.

119. We noted that funerals are a one-off purchase with no ongoing contract with the customers. Hence, we do not consider that 'customer books' represent a meaningful intangible asset for funeral directors.

120. Next, we consider each of the categories of assets at points *(a)* to *(c)* above in turn with respect to whether such an intangible should be recognised in capital and, if so, how it should be valued.

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[24] CC3 (Revised), Appendix A, paragraph 14

Purchased goodwill

121. Firstly, we consider purchased goodwill. Goodwill arises where a price is paid for a business which exceeds the fair value of tangible assets plus separately identifiable intangible assets.

122. When firms acquire other firms and pay a price in excess of the net assets, they are incurring costs which primarily reflect the value of anticipated future earnings. These costs are additional to those needed to run the business.

123. However, goodwill, by definition, is not an asset that is separable from the running of the business. It is the value of the profits generated from running the business - above those needed to cover costs, including asset costs. Goodwill should not therefore be included in the capital employed because it breaches the third recognition criterion, criterion (c) per paragraph 117.

124. Further, including goodwill is circular when trying to assess whether profits have been above the level needed to cover costs, including asset costs. In extremis, if all future profits were capitalised as goodwill, it would not be possible to find supernormal profits under a ROCE versus WACC framework.[25]

125. Funeral Partners disputed our exclusion of purchased goodwill. It told us that while it recognises the issue of circularity, it does not believe the correct approach is to dismiss the value of goodwill in its entirety. Funeral Partners suggested that its goodwill balance is accurate, telling us that the balance is subject to an impairment review on an annual basis.[26]

126. As per the points stated at paragraphs 121 to 124 we do not consider it appropriate to capitalise any element of the goodwill balance due to the nature of goodwill itself. The impairment review performed of Funeral Partners' goodwill balance is for statutory reporting purposes and not for the analysis of economic profitability, therefore while the balance may be correctly valued for accounting purposes, we do not consider it appropriate for our analysis.

127. We consider the point raised by Dignity at paragraph 109 above with regards to the additional cost that would have been incurred had growth occurred through expansion rather than acquisition in the section below.

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[25] Because profits would be capitalised into the capital employed based on future cashflows discounted at the WACC. So, capital employed = profits/WACC (the formula for discounting into perpetuity) and therefore ROCE = profit/capital employed = WACC.
[26] Funeral Partners response to Provisional Decision Report.

Purchased trade names or reputation

128. Next, we considered whether funeral directors employ capital in the form of a trade name or reputation. We note that parties' submissions on marketing spend, start-up losses and staff costs all effectively relate to this type of intangible asset:

(a) Per paragraph 109, Dignity noted that additional marketing spend would have been required had it expanded organically as opposed to through acquisition.

(b) Dignity also submitted that an '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.'[27] It suggested that these start-up losses 'are the investment required by a new funeral business to establish a reputation in its local area and reach a sustainable scale.[28] Dignity suggested that its branches incur on average £[✂] of losses across their first three years.[29]

(c) Funeral Partners argued that staff costs should be considered in addition to marketing costs when calculating the brand/trade name asset. Funeral Partners argued that while 'some level of staff training and salaries are essential costs to running a business' there is a nuance to the difference between providing the essentials of a service and 'extra costs incurred beyond this to provide a high quality service needed to build a brand.'[30] Funeral Partners told us that 'there are strong arguments that the value of a highly skilled workforce should be included in a cost-based assessment of brand value.'[31]

129. We consider that when firms either acquire trade names by buying other firms or develop their own trade name, brand or reputation organically, they are incurring costs with the aim of generating earnings in the future. Moreover, we consider it likely that many such costs are additional to the costs incurred in running the business.[32] On this basis, such expenditure meets two out of three of the CMA's criteria for recognition of intangible assets. With respect to the third criteria, ie that the asset created be separable from those assets arising from the general running of the

[27] Dignity response to funeral director profitability working paper, para 4.23
[28] Dignity response to funeral director profitability working paper, para 4.23
[29] Dignity response to funeral director profitability working paper, para 4.29
[30] Funeral Partners response to profitability working paper, para 4.25
[31] Funeral Partners response to Provisional Decision Report
[32] For example, there are certain costs which give rise to brand values that may not be addition to those incurred from the running of the business. For example, consistently providing a good quality service, via well-trained and well-paid staff may give rise to a higher brand value.

business, we considered that the evidence was less clear. We are not aware of transactions in the funeral director market in which trade names or brands have been acquired without the underlying business also being acquired.

130. In this context, we are not convinced that trade names / reputation meet our criteria for recognition per se. However, we found Dignity's argument regarding higher marketing and/or start-up costs in a situation of organic growth persuasive and we considered that a reasonable way to reflect such costs was via their recognition in capital employed as a "trade name or reputation" asset.

131. In our PDR we explained that we were not convinced by Funeral Partners' argument with regards to staff costs as we did not believe that the costs of providing a high-quality service were costs which were primarily aimed at earning income in the future. Rather, we considered that these costs were primarily incurred in order to provide the service that the current customer is paying for, ie such costs do not meet the CMA's first criterion for recognition.

132. In response to this view, Funeral Partners submitted that 'the right approach is to differentiate between different types of staff costs and consider what element is primarily focused at maintaining a reputation for quality and thereby aimed primarily at earning income in the future (…) These costs do go above and beyond in order to drive future income and therefore could be capitalised in certain instances.'[33] Funeral Partners suggested that 'some element of salary costs, such as higher salaries or bonus / incentive schemes to attract and retain higher quality of staff are incurred only because of a need to maintain quality with a view to future income' and therefore should be capitalised.[34]

133. However, we do not find this argument to be either persuasive in theory or workable in practice. To the extent that paying higher salaries and/or bonuses produces a higher quality service, such costs are still aimed *primarily* at meeting customers' requirements in the present rather than towards attracting future business. Practically, it is unclear how one would go about apportioning salary costs between those required to provide a quality service in the present and those which represent an investment in earning future income in an objective and robust manner.

[33] Funeral Partners response to Provisional Decision Report
[34] Funeral Partners response to Provisional Decision Report

134. As such, we do not consider it appropriate to capitalise any staff costs in our calculation of the reputation/trade name asset.

135. We considered how to value a trade name/reputation asset in line with the points discussed above. We concluded that we should adopt a cost-based approach, taking care to capitalise only those costs that are additional to those incurred from running the business.

136. Funeral Partners suggested the potential of alternate methods in calculating an appropriate trade name/reputation asset, referring to the market-based and income-based approaches. It highlighted that the market-based approach (making use of comparable transactions to benchmark the value of assets) would be difficult for the funerals sector given the lack of benchmarks. Funeral Partners followed that the income-based approach (which captures the expected future economic benefits accruing to the owner of the brand in the valuation) has been utilised by Funeral Partners in valuing its own assets in its balance sheet.[35] Funeral Partners also suggested we consider the amount paid to acquire a business and use this as an imperfect proxy.[36]

137. We do not consider either market-based or income-based approaches to be appropriate for the purposes of our profitability analysis, since these approaches risk introducing a circularity into the analysis whereby the exercise of market power, which allows a firm to charge high prices and earn high profits, would also result in a high valuation of the firm’s trade name / reputation, increasing capital employed and reducing the measured ROCE. Thus, we consider a cost-based approach to be the most appropriate measure of the replacement cost of the asset to a firm

138. Next we considered which costs should be taken into account in valuing firms’ trade names / reputations.

139. We considered Dignity’s submissions regarding both marketing costs and start-up losses and concluded that either of these approaches might, in principle, be a reasonable means of estimating the replacement cost of firms’ trade names / reputations.

[35] Funeral Partners response to profitability working paper, para 4.10
[36] Funeral Partners response to profitability working paper, para 4.9

Approach to revaluing trade name/reputation

- *Marketing costs – branch-level*

140. Firstly, with consideration of marketing costs, we obtained information from the Largest funeral directors on their marketing spend, both at a company-level and with regards to the opening of new branches.

141. Per our analysis, we calculated an approximate spend of £[✂] on marketing across the first three years of a new branch, which could be seen as investment in establishing the trade name / reputation of the branch in its local area.[37]

142. This analysis was based on annual marketing spend on new branches provided by Co-op and Funeral Partners.[38]

- *Start-up losses*

143. We also considered the start-up losses argument proposed by Dignity. Dignity told us that it incurred start-up losses of around £[✂] per new branch opened (not acquired). In determining this £[✂] loss figure, Dignity calculated the average EBIT less any margin earned on disbursements and less an allocation of central overhead costs.

144. We reviewed the underlying financial data from Dignity for these organically opened (ie opened as new by Dignity, and not acquired from another funeral director firm) branches. We did not consider it appropriate to remove from EBIT the margins earned from disbursements, as these represent revenues earned by Dignity in the provision of funeral director services. Similarly, in the context of estimating the costs avoided by expanding via acquisition rather than organically, we did not consider it appropriate to allocate central overhead costs to branches for the purposes of estimating start-up losses. When estimating the start-up loss arising from the opening of a new branch, we consider that the relevant costs are those that are incremental to the firm. While there may be a small amount of incremental central overhead as the result of opening a new branch, we

[37] Co-op provided us with the marketing spend on new branches, detailing the total spend across the first three years of operation. We assessed the average 3-year spend for branches with approximately 3 years of activity and calculated a result of £[✂] per branch. Similarly, we assessed the 3-year marketing spend of Funeral Partners' new branches with 3 years of activity, calculating an average result of £[✂] per branch. Thus, we consider an average of £[✂] to be applicable to all parties. We note that Dignity was unable to provide us with similar information.
[38] Dignity does not record marketing spend at a branch level, rather at 'community group level' meaning that actual marketing spend with respect to individual new branches is not maintained.

would expect this to be minimal in practice, and certainly significantly less than a uniform allocation of central overheads across all branches.

145. Based on forecast data, and with consideration of the points above, we noted that Dignity estimated a £[✄] loss, on average, for each branch in the first year of operation, and an average profit of £[✄] over the first three years of operation. However, based on the actual results of branches opened from 2010 to 2015, new units made a loss of approximately £[✄] in the first year of operation, and an average profit of £[✄] across the first three years, ie they were more profitable than Dignity forecast. Both the forecast and actual results included the expenses incurred to market the branch, hence such start-up losses represent an alternative estimate of the costs of establishing a trade name/reputation in a local area rather than an incremental cost of doing so.

146. Taking into account the evidence collected from Co-op and Funeral Partners on marketing expenses and that provided by Dignity on start-up losses in the first few years, we consider that £10,000 provides a reasonable estimate of the incremental costs associated with establishing a trade name / reputation for a new branch in its local area.

147. We considered what the useful economic life of this trade name / reputation asset was and how we should treat the costs of maintaining this asset on an on-going basis. We noted that firms were likely to have to incur on-going marketing and other expenditure in order to avoid the decline of this reputational asset over time. However, we did not have any evidence on which to base our assessment of its useful economic life. Therefore, our analysis treats this asset, once acquired, as having an indefinite life, ie the asset is not amortised but is written off in full when a branch is closed. However, consistent with that approach, we have also assumed that on-going maintenance expenditure should be expensed (rather than capitalised) in the year in which it is incurred.

- *Marketing costs – company level*

148. In addition to considering the valuation of trade name/reputation asset at a branch level, Co-op told us that it ‘does not limit its marketing efforts at the branch level but instead invests in Co-op Funeralcare brand across different branches and a wider Co-op brand across different segments.’[39] Co-op told us that ‘Co-op trades on customers’ trust to the group brand,

[39] Co-op response to profitability working paper, para 3.15

which has been built over the years' and that 'the costs of building this brand are additional to those necessary to run the business.'[40] As such, it argued that 'the marketing costs at the company and group level incurred over the years should be capitalised in addition to capitalising the branch marketing.'[41] It told us that for funeral networks like Co-op, which operate under a single brand, it is normal to incur marketing costs at the company and group level.[42]

149. We therefore considered whether some, or all, of the firms' broader marketing spend should be capitalised. [✂], it appears that this spend largely has an effect in the year that it is spent and not thereafter. [✂].

150. In addition, we have some concerns that what firms see as 'customers' trust' in their brand, which is the "asset" generated by this centralised marketing spend, may be a symptom of a poorly functioning market in which customers do not consider alternative providers to obtain the best service for their needs.

151. Co-op told us that its experiences suggest that company and group-level marketing efforts can have long-lasting business impacts. Co-op argued that 'customers' trust' resultant from centralised marketing efforts can exist in a well-functioning competitive market, where customers have the option to 'shop around.'[43]

152. Based on the evidence we have, we consider that the majority of company-level marketing spend has an impact in the year in which it is incurred, but we recognise that a small element may carry over into future years. We therefore have allowed for a percentage of company-level marketing spend to be capitalised. In calculating the relevant percentage, we considered Co-op's representation that 'the majority of media impact spend is believed to be in the first year, with c.90% in year 1, another c.9% of the effect in year 2, and around c.1% in year 3.' Taking this into account, we consider the capitalisation of 10% of company-level marketing spend in the first year to be appropriate. This should then be written off in the following year. We consider our approach in this respect to be generous to the funeral directors as it is not clear that any central marketing spend asset should be capitalised.

153. We note that we obtained company-level marketing spend from the Largest firms only. As such, the asset for the Largest firms is based on actual

[40] Co-op response to profitability working paper, para 3.15
[41] Co-op response to profitability working paper, para 3.15
[42] Co-op response to Provisional Decision Report, para 6.48.
[43] Co-op response to Provisional Decision Report, paras 6.45 and 6.47.

company-level marketing spend incurred over the period. For the remaining firms, we calculated a weighted average asset based on the results of the Largest firms. This was then applied to the remaining firms based on the number of branches operated.

- *Adjustment to financial information*

154. Based on the above, we noted that the firms' financial results would be impacted in both the capital employed and EBIT. With regards to the branch-level adjustment:

(a) Capital employed: capital employed would be adjusted for each firm for each year by the value of £10,000 for each branch operated by the funeral director at the year-end; and

(b) EBIT: for simplicity, we have assumed that the costs of establishing a trade name / reputation would be incurred in the first year of operation. Considering the asset has been recognised on the balance sheet per the adjustment at point (a), we have added back £10,000 to EBIT in the year, for each new branch opened in that year. We note that these cost add-backs have only been applied where branches were opened organically rather than acquired.[44] We have also reduced EBIT by £10,000 for any branches closed in the year, to reflect the write-off of the asset.

155. In terms of the company-level marketing adjustment:

(a) Capital employed: for the Largest firms, capital employed has been adjusted for each firm for each year by 10% of total company-level marketing spend in the year. For the Other Large firms, we have followed the same methodology, but due to not having the advertising spend incurred by these firms, we used a weighted average advertising spend figure based on the data from the Largest firms, and applied this to the Other Large firms based on the number of branches operated by the firm, in order to reflect the firms' relative size.

(b) EBIT: we have worked on the assumption that the majority of spend is incurred in the first year, with the remaining 10% written off by approximately the end of the second year. As such, we have added back 10% of the central marketing spend to EBIT in the year incurred, and then written off that 10% in the following year. As with capital employed, we have used actual spend incurred for the Largest firms, and for the Other

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[44] Where branches have been acquired, we have included the trade name asset at a value of £10,000 per branch but we have not made any adjustment to EBIT.

Large firms we have used a weighted average figure and applied this to the firms based on the number of branches operated in order to reflect relative size.

Software

156. We consider the treatment and consideration of software to be the same as it is for tangible assets. This is because software is needed to provide the services in question, and the asset would be needed in a well-functioning market. Further, the cost of replacing software is usually relatively straightforward to establish.

157. As such, we include software, as recorded on the balance sheet, in our calculation of capital employed.

158. We recognise Dignity's point per paragraph 113 above regarding internally developed software. We agree that it may be appropriate to include internally generated software which is required for the provision of funeral director services but not recognised on the balance sheet due to being created in-house.

159. However, we are not convinced of the appropriateness of Dignity's comparable estimate based on the £4m that InvoCare spent to upgrade their software system.[45] While InvoCare operates in a similar industry to Dignity, the value of its upgrades is not necessarily reflective of the value of Dignity's own software system and we do not have sufficient insight in order to make this comparison.

160. Further, per Dignity's Annual Report and Accounts we note that software is amortised over a period of three to eight years. We therefore consider that the overall impact on the underlying capital employed and EBIT, based on this depreciation policy, would not be material.

161. As such, in calculating capital employed we have used the value per the balance sheet.

Working capital and cash

162. Working capital comprises inventory, trade debtors and other debtors and operating current liabilities such as trade creditors and other creditors.

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[45] Dignity response to funeral director profitability working paper, para 4.19.

163. These assets are considered necessary for the provision of funeral director services and therefore we have included them in our calculation of capital employed. Due to their current nature, we have not revalued these assets.

164. As noted in paragraph 37(b), financing costs and balances are excluded from the calculation of EBIT and capital employed.

165. We have therefore excluded cash balances from the calculation as this represents a means of funding the capital employed of the business rather than being an operational balance.

166. Co-op told us that an element of 'required cash' should be included in the capital employed. It argued that a minimum level of cash balances is required for efficient operation in order to deal with unpredictable cash flow fluctuations. Co-op referred to 'uncertainties such as the fluctuation of the death rates, volumes uncertainty due to competition, average revenues uncertainty due to the variety of customers' preferences.' Co-op continued that 'part of the cash is held by the company to ensure the day-to-day operation of the business' and that this 'required cash' 'enables the company to smooth out the gap between receiving money from sales and paying invoices for purchases.' It closed by suggesting that 'the required cash is, in effect, employed by the company to generate the operating income and hence should be included in the capital employed calculation.'[46]

167. We do not agree with Co-op on the need to include an element of required cash in the calculation of capital employed. We consider that cash need only be included in capital employed where the cash itself is essential to the running of the business, for example 'trapped' in a supermarket till. Co-op argued that this concept is no different to the cash available for payments to suppliers, stating that cash is liquidity which is essential to the running of the business and therefore, should be added to capital employed.[47] We agree that businesses require liquidity and note that this might be provided by holding cash or by arranging an overdraft (or some combination of these two). However, there is a clear conceptual difference between cash that is 'trapped' compared to that used to finance the business, ie through payments to suppliers. The liquidity Co-op refers to is financing rather than operational capital.

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[46] Co-op response to funeral director profitability working paper, paras 3.2 to 3.5
[47] Co-op response to Provisional Decision Report, para 6.42

Adjustments to EBIT

168. In addition to considering capital employed, we considered the need to make adjustments to EBIT.

169. EBIT is a firms' earnings before interest and tax. Therefore, interest and tax revenues and costs are excluded. We made some additional adjustments to EBIT to ensure we used a figure which was meaningful for profitability purposes. This section details the adjustments we made.

Exceptional items

170. Exceptional items typically occur infrequently or relate to transactions outside of the normal course of business (eg large gains on the sale of property). As such, we do not consider them to be relevant to understanding the underlying profitability of the activity we are seeking to analysis, ie the provision of funeral director services.

171. Approximately £[✄] of exceptional items were excluded from Funeral Partners' EBIT over the five-year period. The exceptional items are almost exclusively costs (rather than income) incurred by the group, that are one-off/non-recurring in nature, and are non-trading related. As such, these costs are excluded from EBIT in order to report a financial result that is reflective of the underlying profitability of the business. No other exceptional items were noted.

The Large funeral director profitability results

172. In this section, we detail the metrics of comparability used and present the profitability results of the Large funeral director firms. This includes the Largest, as well as the Other Large firms.[48]

Financial and profitability metrics

173. We have used a variety of metrics in analysing the profitability of the firms, including:

   (a) Average revenues

   (b) Cost-plus

   (c) ROCE and economic profits

[48] In both the Large and the Smaller firm profitability results we use nominal figures.

174. In considering the average revenues of the Large firms, we have considered two metrics: (i) average total revenue per funeral (ATR) and (ii) average revenue per funeral (ARF). ATR is calculated as the total revenue earned by the firm (inclusive of disbursements) divided by the number of funerals performed. ARF is calculated as the revenue earned from funeral services (exclusive of disbursements) divided by the number of funerals performed.

175. Cost plus is the calculation of all costs relevant to funeral director services through the P&L plus the cost of capital (ie the capital employed multiplied by the weighted average cost of capital (WACC)).This demonstrates the total cost of the provision of funeral services, including an allowance for a reasonable return on capital (debt plus equity).

176. 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. It is calculated as EBIT less WACC x Capital Employed. This measure of profitability is, therefore, based on the same logical building blocks as ROCE and simply expresses returns above or below the cost of capital in absolute amounts (£).

177. For the purposes of our profitability analysis, we have used a CMA calculated WACC of 8%.

178. Economic profits as a percentage of cost plus demonstrates how much above the 'normal' or 'competitive' price, prices have been, assuming that the firms' costs have been efficiently incurred. We note that this will not necessarily be the case, ie some firms may be operating with an inefficiently high level of costs, such that their economic profits will understate the extent to which their prices have exceeded the competitive level. Using these percentages provides another means of understanding the scale of any economic profits and of making comparisons across The Large funeral director firms.

Results tables for The Large firms

179. In this section we set out the results of each party in turn, [✂].[49]

[49] The order in which results are presented below is not reflective of the lists at paragraph 8. In presenting the results of The Large firms, we have replaced the name of the firm for confidentiality purposes and replaced with 'Firm' followed by a letter (eg Firm A).

[Firm A]

Table 1: [Firm A] profitability results

	2014	*2015*	*2016*	*2017*	*2018*	*2019*[50]	*Weighted average*
ATR (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
ARF (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Cost-plus per funeral (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Economic profit per funeral (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[200-250]
EP/CP (%)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
ROCE (%)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[20-30]
Funerals per branch	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis

180. ROCE is above our estimate of the WACC (of 8%) throughout the 2014 to 2018 period, with an average return of [20-30] %. It is particularly high in the first three years before declining through the later period. This equates to economic profits of between £[100-150] and £[450-500] per funeral over the 2014 to 2018 period, ie around [✂]% over [Firm A's] total cost base, including an appropriate return on capital employed.

181. [Firm A] sees increases in average revenue per funeral year-on-year until 2018 in which it falls for the first time. Cost-plus, however, increases year-on year. Economic profits are at their highest point in 2015, at £[450-500] per funeral, but by 2018 this has declined to £[100-150] per funeral, with a particularly sharp drop (of more than 50%) between 2017 and 2018.

182. In 2019, [Firm A] demonstrates fall in profitability that brings ROCE below the cost of capital for the first time at [0-(5)] %. This comes about as the result of a decline in average revenue and a continued increase in cost plus per funeral in 2019. This reduction in profitability reduces the average ROCE over the 2014 to 2019 period to [20-25%] and [Firm A] earns an economic loss, of £[(200)-(250)] for the first time.

183. [✂].

[50] We obtained sufficient information from [Firm A] to perform 2019 profitability analysis. However, we have been required to make assumptions on two key points. Firstly, we have based the 'other current liabilities' figure on an average of that across 2014 to 2018; the balance is generally low so we do not expect any differences between our average and the actual figure to have a material impact. Secondly, we did not have detailed information on [Firm A's] branch openings or closures in the year. [✂]. This results in a slightly lower increase in capital employed as a result of branch marketing compared to 2015 to 2018 figures, however it remains greater than that of 2014. Any differences between this methodology and the actual figures is not expected to have a material impact on the results.

[Firm B]

Table 2: [Firm B] profitability results[51]

	2014	*2015*	*2016*	*2017*	*2018*	*2019*	*Weighted average*
ATR (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
ARF (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Cost-plus per funeral (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Economic profit per funeral (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[600-650]
EP/CP (%)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
ROCE (%)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[30-40]]
Funerals per branch	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis

184. [Firm B] has earned a ROCE significantly above its WACC throughout the 2014 to 2018 period, with an average return of [30-40%]. This equates to economic profits of between £[450-500] and £[700-750] per funeral over the period, ie around [✂] over [Firm B's] total cost base, including an appropriate return on capital employed. While [Firm B] also sees a drop in ROCE and economic profit per funeral in 2018, the absolute figures remain high.

185. [Firm B] increased its average revenues year-on-year from 2014 to 2017, before seeing a fall in 2018. Similarly, its cost-plus figures have increased year-on-year.

186. In 2019, the trend in [Firm B's] ROCE continues downwards but remains significantly in excess of the cost of capital at [20-30%]. The firm earns economic profits of £[350-400] per funeral which as a percentage of cost-plus is [✂]%.

[Firm C]

Table 3: [Firm C] profitability results[52]

	2014	*2015*	*2016*	*2017*	*2018*	*Weighted average*
ATR (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
ARF (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Cost-plus per funeral (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Economic profit per funeral (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[400-450]
EP/CP	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
ROCE	[✂]	[✂]	[✂]	[✂]	[✂]	[50-60]
Funerals per branch	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis

[51] In revaluing [Firm B's] property assets we did not include negative cost items. [Firm B] told us that these items are related to either [✂] or [✂]. We did not consider it appropriate to revalue these items but note that there is the potential for the exclusion of these items to somewhat bias up the overall asset value, however we note that these items (as per [Firm B's] response) make up less than [✂]% of the overall property related assets, so we do not consider this exclusion to have a material impact on the results.

[52] In completing the financial template used to calculate the figures per the table above, [Firm C] included margin disbursement revenue only, ie it did not include non-margin disbursement revenues and costs. We have calculated non-margin disbursement revenue for [Firm C] based on other data they provided us with and applied this equally to the revenue and cost-lines. Further, [Firm C] include a small element of 'other revenue' in its results which we have included for consistency with its cost base.

187. The ROCE of [Firm C] is high and fluctuates significantly across the five-year period (between [30-40%] and [80-90%]). This equates to economic profits between £[200-250] and £[650-700] per funeral over the relevant period. We note that while [Firm C's] ROCE figures are higher, on average, than those of [Firm A] and [Firm B], this appears to be partly due to the lower levels of capital employed, ie it can be seen as an artefact of their capital structure rather than a substantive difference in profitability. [Firm C's] average economic profits per funeral over the period are higher than those of [Firm A] but lower than those of [Firm B].

188. The average revenue per funeral of [Firm C] is lower than that of [Firm A] and [Firm B] on average across the period. However, while [Firm A] and [Firm B] see a drop in average revenue per funeral in the later years, this is not the case for [Firm C]. [Firm A] and [Firm B] see an increase in cost-plus for each year of the period. [Firm C] follows a similar trend aside from a dip in cost-plus in 2016.

189. Similarly, [Firm C's] economic profits as a percentage of cost plus, at [✂]% on average, sits between that of [Firm A] ([✂]%) and [Firm B] ([✂]%).

Commentary

190. The financial performance of the Largest firms over the 2014 to 2018 period exhibits significant similarities, with their average revenues per funeral being within 7% of each other, and their total cost plus per funeral being within 5% of each other. All firms have earned returns significantly in excess of their cost of capital, demonstrated by their substantial economic profits per funeral. [Firm B] has achieved the highest overall level of profitability as a result of achieving the highest average revenue and the lowest average cost-plus of these three firms.

[Firm D]

Table 4: [Firm D] profitability results

	2014	*2015*	*2016*	*2017*	*2018*	*Weighted average*
ATR (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
ARF (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Cost-plus per funeral (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Economic profit per funeral (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[450-500]
EP/CP (%)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
ROCE (%)	[✂]	[✂]	[✂]	[✂]	[✂]	[30-40]
Funerals per branch	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis

191. [Firm D's] ROCE is significantly above the cost of capital in all years, averaging [30-40%] over the period, which is consistent with the most

recent three years. Economic profits are on average [✂] of cost-plus, ranging between £[250-300] and £[500-550] per funeral.

192. ATR and ARF both increase year on year, demonstrating an increase in prices for each year from 2014 to 2018, alongside an increasing cost-plus in all years aside from 2015.

[Firm E]

Table 5: [Firm E] profitability results

	2014	*2015*	*2016*	*2017*	*2018*	*Weighted average*
ATR (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
ARF (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Cost-plus per funeral (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Economic profit per funeral (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[200-250]
EP/CP (%)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
ROCE (%)	[✂]	[✂]	[✂]	[✂]	[✂]	[50-60]
Funerals per branch	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis

193. The data available for [Firm E] is limited in that disbursement revenues and costs are not available. As such, we present ATR only in our analysis of revenues.

194. [Firm E] sees significant fluctuation in ROCE throughout the period. However, the ROCE remains high and above the cost of capital, ranging between [30-40%] and [60-70%]. Economic profits average at [✂] of cost-plus, ranging from £[100-150] to £[350-400] per funeral. We note that [Firm E] is relatively capital-light, hence ROCE figures are apparently high in comparison with the absolute level of economic profits per funeral.

195. Aside from a small decline in 2016, [Firm E] has increased its ATR progressively over the period. The cost-plus figures demonstrate that costs have also been increasing across the period.

[Firm F]

Table 6: [Firm F] profitability results

	2014	*2015*	*2016*	*2017*	*2018*	*Weighted average*
ATR (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
ARF (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Cost-plus per funeral (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Economic profit per funeral (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[250-300]
EP/CP (%)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
ROCE (%)	[✂]	[✂]	[✂]	[✂]	[✂]	[10-20]
Funerals per branch	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis

196. [Firm F] earns ROCE in excess of the cost of capital in each year, and economic profits between £[200-250] and £[350-400] resulting in a weighted average EP/CP of [✂]. Average revenues (both ATR and ARF)

have increased each year while there has been a similar increase in cost-plus per funeral.

[Firm G]

Table 7: [Firm G] profitability results[53]

	2014	*2015*	*2016*	*2017*	*2018*	*Weighted average*
ATR (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
ARF (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Cost-plus per funeral (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Economic profit per funeral (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[250-300]
EP/CP (%)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
ROCE (%)	[✂]	[✂]	[✂]	[✂]	[✂]	[20-30]
Funerals per branch	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis

197. [Firm G] earned a ROCE of [20-30%] on average over the 2014 to 2018 period, which is significantly in excess of the cost of capital. The firm shows economic profits ranging between £[200-250] and £[300-350] per funeral, which are [✂] of cost-plus, on average. The firm sees increasing revenues year-on-year, with cost-plus also growing.

[Firm H]

Table 8: [Firm H] profitability results

	2014	*2015*	*2016*	*2017*	*2018*	*Weighted average*
ATR (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
ARF (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Cost-plus per funeral (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Economic profit per funeral (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[(150)-(200)]
EP/CP (%)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
ROCE (%)	[✂]	[✂]	[✂]	[✂]	[✂]	[0-5]
Funerals per branch	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis

198. [Firm H's] results demonstrate a ROCE lower than the cost of capital, with the firm making economic losses in every year from 2014 to 2018.

199. The firm demonstrates average revenue per funeral figures within the range of the other larger firms but its cost-plus is significantly higher. This suggests that its economic losses may be being made due to cost-base issues as opposed to low revenues.

[53] The profit figures for [Firm G] include those from [✂]. These activities comprise around [✂] of total revenues. As a result, ATR per funeral and cost-plus per funeral will have been artificially increased by the inclusion of revenues from other activities. As such, the difference between ARF and ATR is a combination of both disbursement revenue ([✂] per funeral, on average) and other revenue. Other revenue amounts to a weighted average of [✂] per funeral, thus ATR less other revenue is, on average, [✂]. We also note that EBITDARS per funeral and economic profit per funeral may be overstated for the same reasons.

[Firm I]

Table 9: [Firm I] profitability results[54]

	2014	*2015*	*2016*	*2017*	*2018*	*Weighted average*
ATR (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
ARF (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Cost-plus per funeral (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Economic profit per funeral (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[350-400]
EP/CP (%)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
ROCE (%)	[✂]	[✂]	[✂]	[✂]	[✂]	[20-30]
Funerals per branch	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis

200. ROCE is significantly greater than the cost of capital in the first two years, before seeing a decline in 2016 and falling closer to (but still greater than) the cost of capital in 2017 and 2018. Weighted average ROCE is greater than the cost of capital at [20-30%]. Economic profits average £[700-750] in the first two years before dropping to £ [50-100] per funeral in 2018. This decline in profitability appears to result from relatively static average revenues per funeral against a backdrop of increases in the cost base, which appears to have been driven by its significant expansion in branch numbers over the period, with a steep decline in the number of funerals per branch.[55] The firm saw a 91% increase in branch numbers over the 2014 to 2018 period. EP/CP averages [✂].

201. While cost-plus per funeral has increased year-on-year for [Firm I], average revenue has not reflected the same trend. Average revenues peak in 2015 before dropping in 2016 and then remaining reasonably steady.

[Firm J]

Table 10: [Firm J] profitability results

	2014	*2015*	*2016*	*2017*	*2018*	*Weighted average*
ATR (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
ARF (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Cost-plus per funeral (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Economic profit per funeral (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[0-50]
EP/CP (%)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
ROCE (%)	[✂]	[✂]	[✂]	[✂]	[✂]	[5-10]
Funerals per branch	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis

202. [Firm J's] ROCE is largely in line with the cost of capital, and the firm makes economic losses in four out of the five years. The comparatively high profit in 2015 results in a weighted average economic profit of £[0-50]

[54] For [Firm I], balance sheet information was not available for any year, however asset registers were provided detailing relevant fixed asset information. We used a weighted average of debtor, creditor and inventory days based on the information available from the other Large firms included in our analysis in order to calculate working capital. Information per the asset registers combined with calculated working capital formed capital employed in the analysis of this firm.
[55] [Firm I] operated [✂] branches in 2014 which increased to [✂] in 2018.

per funeral. EP/CP is in the range of [✄]% (aside from a peak of [✄]% in 2015), suggesting that the firm is charging prices largely in line with cost-plus.

203. [Firm J] demonstrates both particularly high average revenues per funeral and particularly high cost-plus per funeral, when compared with other funeral directors.

[Firm K]

Table 11: [Firm K] profitability results[56]

	2014	*2015*	*2016*	*2017*	*2018*	*Weighted average*
ATR (£)	[✄]	[✄]	[✄]	[✄]	[✄]	[✄]
ARF (£)	[✄]	[✄]	[✄]	[✄]	[✄]	[✄]
Cost-plus per funeral (£)	[✄]	[✄]	[✄]	[✄]	[✄]	[✄]
Economic profit per funeral (£)	[✄]	[✄]	[✄]	[✄]	[✄]	[450-500]
EP/CP (%)	[✄]	[✄]	[✄]	[✄]	[✄]	[✄]
ROCE (%)	[✄]	[✄]	[✄]	[✄]	[✄]	[30-40]
Funerals per branch	[✄]	[✄]	[✄]	[✄]	[✄]	[✄]

Source: CMA analysis

204. [Firm K] earns ROCE in excess of the cost of capital in all years. Economic profit per funeral averages £[450-500] per funeral over the period. The EP/CP results show that the firm is charging prices approximately [✄]% greater than cost-plus.

205. Average revenues have increased over the period, with costs also increasing but at a lower rate which means that economic profits per funeral have more than doubled between 2014 and 2018.

[Firm L]

Table 12: [Firm L] profitability results

	2014	*2015*	*2016*	*2017*	*2018*	*Weighted average*
ATR (£)	[✄]	[✄]	[✄]	[✄]	[✄]	[✄]
ARF (£)	[✄]	[✄]	[✄]	[✄]	[✄]	[✄]
Cost-plus per funeral (£)	[✄]	[✄]	[✄]	[✄]	[✄]	[✄]
Economic profit per funeral (£)	[✄]	[✄]	[✄]	[✄]	[✄]	[0-50]
EP/CP (%)	[✄]	[✄]	[✄]	[✄]	[✄]	[✄]
ROCE (%)	[✄]	[✄]	[✄]	[✄]	[✄]	[10-20]
Funerals per branch	[✄]	[✄]	[✄]	[✄]	[✄]	[✄]

Source: CMA analysis

206. In all years apart from 2015, [Firm L] demonstrates ROCE in line with the cost of capital. As a result, economic profits are around zero in three of the

[56] [Firm K] could provide comprehensive balance sheet information from 2016 onwards but not prior. In order to obtain capital employed figures for 2014 and 2015, we: (i) used the information provided on owned properties and calculated NBV based on a 50 year useful economic life; (ii) used an average of 2016, 2017 and 2018 figures for vehicles and 'other' fixed assets based on the asset registers provided, and (iii) calculated average debtor, creditor and inventory days based on the information provided for 2016, 2017 and 2018 to create an estimate of working capital for 2014 and 2015.

five years, and average £[0-50] per funeral over the period as a whole. The firm appears to be charging prices largely in line with cost, with an average EP/CP of [✂]%.

207. Cost-plus per funeral is largely in line with ATR which, as with ARF, sees an increase year-on-year.

[Firm M]

Table 13: [Firm M] profitability results[57]

	2014	*2015*	*2016*	*2017*	*2018*	*Weighted average*
ATR (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
ARF (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Cost-plus per funeral (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Economic profit per funeral (£)	[✂]	[✂]	[✂]	[✂]	[✂]	[300-350]
EP/CP (%)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
ROCE (%)	[✂]	[✂]	[✂]	[✂]	[✂]	[20-30]
Funerals per branch	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis

208. [Firm M] earned ROCE in excess of the cost of capital in all years, averaging [20-30%]. The firm earned economic profit per funeral of £[300-350] on average, and economic profits as a percentage of cost plus of [✂]%.

209. The firm has increased average revenues per funeral each year over the period. Cost-plus per funeral increased in most years in the period.

Commentary

210. The results presented above from Table 1 to Table 13 demonstrate that the Large 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.

211. Ten of the 13 firms earn ROCE in excess of the 8% cost of capital in all years of the 2014 to 2018 period. Of the firms earning ROCE equal to or lower than the cost of capital, the key driver appears to be relatively high cost bases as opposed to low revenues. While [Firm A] and [Firm B] see a significant decline in profitability in recent years, the same cannot be said for the rest of the sample. There is some reduction in some cases, but not a sample-wide drop in profitability in most recent years, with some firms significantly increasing their profits over the 2014 to 2018 period (eg [Firm K]) and some remaining comparatively stable.

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[57] [✂].

212. [Firm A] and [Firm B] undertake a similar number of funerals per branch throughout the five-year period, at around [✂]. [Firm C] has seen significant movement in the number of branches over the period and has therefore seen greater variation in number of funerals per branch, which has been increasing overall. We note that the rest of the firms see more variation in the number of funerals undertaken by branch, with one firm completing as many as 141, and another only 48, on average.

213. We note that there are significant differences in ARF and cost-plus across the Large firms. We discuss these patterns in more detail from paragraph 253 below.

Smaller funeral director profitability results

214. Next, we present the results of the Smaller funeral directors.

215. As set out in more detail in Annex A: Obtaining information from the fragmented market, we 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, we found that the Smaller funeral directors were largely unable to provide robust balance sheet information. We have, therefore, examined the profit and loss information provided in order to understand their financial performance both on a stand-alone basis and in-comparison with the larger funeral directors.

216. 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. We note that this approach is to be expected since no such distinction between salary and profit is made for unincorporated business for tax purposes with both being treated as "drawings".

217. Therefore, our analysis has focussed on average revenues per funeral and a measure of operating profit which seeks to control for differences in both capital structure across firms (both Large and Smaller funeral directors) and this difference in approach to recording salaries: "EBITDARS", or earnings before interest, tax, depreciation, amortisation, rent and salaries. We have calculated EBITDARS on a £-amount per funeral basis.

218. In our PDR, we excluded the financial information of some of the Smaller funeral directors when seeking to interpret their profitability due to concerns about the reliability of some of the information. In response to the PDR, we

received submissions from Dignity putting forward the view that a greater number of the Smaller funeral director financial information appeared to be unreliable and that we should take this into account when drawing conclusions regarding the profitability of the market as whole.[58] We have considered these submissions in detail (see Annex A and in the interpretation of our analysis, from paragraph 318). In the following section, we have set out the financial information we collected on all firms, highlighting in the footnotes to the tables those where we have concerns about the reliability of that data.

ATR per funeral

219. We requested total revenues from funeral director services inclusive of disbursements from the firms. The information presented below demonstrates the total revenue provided by each firm divided by the volume of funerals provided in the period to obtain the ATR figure.[59]

220. We have presented the results for all firms for which we had sufficient data to perform financial analysis. We note that some of the ATR figures below appear too low to credibly include disbursements.

[58] Dignity plc response to the CMA's Provisional Decision Report, Annex 1: Critical observations on the CMA's profitability analyses and customer detriment figures, para 2.20 to 2.31.
[59] Where results have not been available from a party for a given year 'n/a' has been indicated. The results are presented from lowest to highest average revenue per funeral across the five-year period based on the weighted average figure. This table presents the results of the 'Smaller' funeral directors only and does not include the Large funeral directors whose results have been presented on a party by party basis in the prior section.

Table 15: ATR of the Smaller firms (£)[60]

	2014	*2015*	*2016*	*2017*	*2018*	*Weighted average*
FD 1[a]	328	379	1,111	495	575	584
FD 2[a]	680	530	756	660	728	664
FD 3[a]	876	884	898	868	986	900
FD 4	1,435	1,613	1,441	1,501	1,597	1,519
FD 5	1,900	1,900	1,950	2,000	2,100	1,970
FD 6[b]	1,913	2,059	2,044	2,204	2,029	2,049
FD 7	1,996	2,098	2,279	2,303	2,246	2,186
FD 8	n/a	n/a	2,290	2,381	2,450	2,376
FD 9	2,509	2,704	2,712	2,072	2,695	2,531
FD 10[c]	2,264	2,191	2,602	2,787	2,769	2,627
FD 11	n/a	n/a	n/a	n/a	2,726	2,726
FD 12	2,693	2,913	2,834	2,848	2,609	2,772
FD 13	n/a	n/a	n/a	2,727	3,063	2,892
FD 14	2,652	2,857	2,812	3,112	3,211	2,935
FD 15	2,801	2,914	3,025	3,113	3,231	3,021
FD 16	2,545	2,932	2,723	3,448	3,658	3,072
FD 17	2,745	2,474	3,434	3,574	3,323	3,078
FD 18	2,454	2,518	3,590	3,395	3,571	3,114
FD 19	2,240	3,532	2,948	3,744	3,539	3,160
FD 20	2,970	3,035	3,173	3,227	3,500	3,181
FD 21	3,132	3,107	3,205	3,138	3,364	3,189
FD 22	3,267	3,145	3,167	3,129	3,492	3,236
FD 23	3,375	3,064	3,282	3,390	3,288	3,277
FD 24	3,065	3,102	3,374	3,535	3,623	3,341
FD 25[d]	3,568	3,065	3,463	3,204	3,639	3,369
FD 26	n/a	n/a	n/a	3,292	3,456	3,369
FD 27	3,318	3,447	3,126	3,544	3,921	3,461
FD 28	3,357	2,869	3,784	3,778	3,702	3,462
FD 29	2,973	3,418	3,654	3,571	3,650	3,463
FD 30[e]	3,500	3,500	3,500	3,500	3,500	3,500
FD 31	3,005	4,136	2,981	3,342	4,165	3,523
FD 32	3,594	3,347	3,560	3,565	n/a	3,527
FD 33	3,314	3,428	3,584	3,700	3,690	3,542
FD 34	3,324	3,980	3,402	3,698	3,948	3,674
FD 35[f]	8,025	4,964	2,214	3,374	4,037	3,676
FD 36	3,530	3,694	3,827	3,834	3,932	3,762
FD 37	3,504	3,730	3,816	3,951	3,977	3,786
FD 38	3,682	3,741	3,908	4,025	4,265	3,908
FD 39	3,177	3,593	4,176	4,523	4,168	3,913
FD 40	3,708	3,898	3,984	3,999	4,211	3,962
FD 41	3,670	4,613	4,642	3,371	3,839	4,019
FD 42	5,171	3,701	3,612	3,992	n/a	4,021
FD 43	3,970	3,796	4,273	4,442	4,281	4,162
FD 44	4,314	5,235	5,172	4,750	4,262	4,710
FD 45[g]	n/a	n/a	n/a	n/a	7,033	7,033
FD 46[g]	n/a	n/a	n/a	14,859	8,539	10,582

Source: CMA analysis
Notes:
[a] These firms demonstrate ATR figures which we believe to be too low to credibly include disbursements. As such, they have been presented for demonstration purposes, but they will not be discussed in our narrative consideration of the results.
[b] This firm has both a relatively low ATR as well as a very low EBITDARS per funeral figure. Combined, we consider that the data may be inaccurate
[c] This firm demonstrates a significantly fluctuating EBITDARS margin (EBITDARS per funeral/ATR) and a low EBITDARS figure. Combined, we consider that the data may be inaccurate.
[d] This firm has a very low EBITDARS margin and a low EBITDARS figure, which combined suggests potential inaccuracies in the data.
[e] We recognise that the ATR for this firm is the same in each period, at £3,500. This suggests data inaccuracy, and the potential that information has been provided to reach this ATR of £3,500.
[f] This firm incorporated as a business in 2016. The information received appears more reliable from the time of incorporation thus we believe the figures from 2016 onwards to be most accurate.
[g] The results of these two firms appear particularly high. We believe this to likely be a result of data inaccuracies.

221. The ATR figures for the Smaller firms demonstrate a very broad range, on average between around £2,000 to £4,700, with almost half of the firms for

[60] As per the notes to this table, there are a number of firms which we have identified as potentially having presented data which may be inaccurate. We include the results for transparency, but the results of these firms are not included in any corresponding charts, nor in the narrative discussion of the financial performance of the Smaller firms.

which we collected data having lower average revenues per funeral than the Large funeral directors (on average across the relevant period). The other half of the firms had average revenues per funeral that were within the range of those of the Large firms, ie none of these firms for whom we consider to have provided reliable data had higher average revenues per funeral than the most expensive of the Large firms ([Firm J]).

222. The Smaller funeral directors show greater year-on-year volatility in their average revenues per funeral, which may be the result of changing product mix within smaller volumes of funerals.[61]

223. We recognise concerns around the inclusion of disbursements in ATR, and consider both ATR and ARF in more detail from paragraph 250 below.

EBITDARS

224. We consider earnings before interest, taxation, depreciation, amortisation, rent and staff costs (EBITDARS) per funeral.

225. Using this metric allows for comparability of the Smaller funeral directors regardless of financing, capital structure (ie whether they own or rent properties), and the means by which staff are reimbursed (ie through staff costs or dividends).

226. We present absolute EBITDARS per funeral for the Smaller firms.

[61] Where a firm undertakes smaller volumes, a change in product mix from year to year (ie a change in the packages offered or in the number of simple vs standard funerals undertaken) will have a greater impact on the overall average ARF.

Table 16: EBITDARS per funeral (£)[62]

	2014	*2015*	*2016*	*2017*	*2018*	*Weighted average*
FD 1[a]	326	377	1,109	493	572	582
FD 2[a]	166	112	129	79	50	104
FD 3[a]	(1,206)	(1,579)	(1,434)	(1,513)	(1,652)	(1,472)
FD 4	1,053	1,134	1,035	1,124	1,112	1,091
FD 5	713	691	764	909	876	791
FD 6[b]	219	360	284	314	124	260
FD 7	1,316	1,420	1,593	1,546	1,563	1,490
FD 8	n/a	n/a	1,473	1,562	1,632	1,558
FD 9	760	1,274	1,374	879	1,383	1,169
FD 10[c]	658	747	369	769	1,077	776
FD 11	n/a	n/a	n/a	n/a	709	709
FD 12	1,739	1,942	1,868	1,840	1,522	1,769
FD 13	n/a	n/a	n/a	1,848	1,625	1,738
FD 14	1,236	1,581	1,437	1,602	1,631	1,506
FD 15	1,215	1,290	1,368	1,139	1,337	1,269
FD 16	952	1,293	1,094	1,527	1,704	1,320
FD 17	909	880	1,096	826	1,284	1,001
FD 18	1,052	968	1,947	1,817	1,438	1,458
FD 19	913	1,796	1,426	1,686	1,835	1,506
FD 20	1,016	954	1,097	1,240	1,126	1,087
FD 21	774	807	807	837	875	820
FD 22	633	684	667	823	738	707
FD 23	1,642	1,453	1,526	1,409	1,486	1,502
FD 24	1,425	1,507	1,527	1,688	1,633	1,559
FD 25[d]	414	311	516	526	n/a	442
FD 26	n/a	n/a	n/a	1,902	2,120	2,003
FD 27	1,416	1,293	1,141	1,239	1,273	1,271
FD 28	1,096	902	1,096	948	1,225	1,046
FD 29	1,197	1,492	1,620	1,465	1,538	1,466
FD 30[e]	247	312	399	564	317	373
FD 31	919	1,692	572	1,357	1,193	1,154
FD 32	1,550	1,442	1,431	1,313	n/a	1,423
FD 33	1,855	1,912	1,994	2,063	2,088	1,981
FD 34	3,174	3,864	3,312	3,600	3,840	3,563
FD 35[f]	8,025	3,939	444	1,265	1,820	1,805
FD 36	1,024	882	1,104	1,059	728	962
FD 37	2,450	2,611	2,744	2,769	2,667	2,646
FD 38	n/a	n/a	n/a	n/a	n/a	n/a
FD 39	1,582	1,736	2,151	2,413	1,696	1,899
FD 40	1,818	1,715	1,876	1,644	1,956	1,804
FD 41	1,672	2,149	1,909	1,326	1,930	1,797
FD 42	1,311	969	958	945	n/a	1,017
FD 43	1,871	1,929	2,272	2,318	1,981	2,076
FD 44	1,286	2,353	2,069	1,611	1,452	1,727
FD 45[g]	n/a	n/a	n/a	n/a	1,816	1,816
FD 46[g]	n/a	n/a	n/a	5,494	2,247	3,297

Source: CMA analysis
Notes:
[a] These firms demonstrate ATR figures which we believe to be too low to credibly include disbursements. As such, they have been presented for demonstration purposes, but they will not be discussed in our narrative consideration of the results.
[b] This firm has both low ATR as well as a very low EBITDARS per funeral figure. Combined, we consider that the data may be inaccurate
[c] This firm demonstrates a significantly fluctuating EBITDARS margin (EBITDARS per funeral/ATR) and a low EBITDARS figure. Combined, we consider that the data may be inaccurate.
[d] This firm has a very low EBITDARS margin and a low EBITDARS figure, which combined suggests potential inaccuracies in the data.
[e] We recognise that the ATR for this firm is the same in each period, at £3,500. This suggests data inaccuracy, and the potential that information has been provided to reach this ATR of £3,500.
[f] This firm incorporated as a business in 2016. The information received appears more reliable from the time of incorporation thus we believe the figures from 2016 onwards to be most accurate.
[g] The results of these two firms appear particularly high. We believe this to likely be a result of data inaccuracies.

[62] As per the notes to this table, there are a number of firms which we have identified as potentially having presented data which may be inaccurate. We include the results for transparency, but the results of these firms are not included in any corresponding charts, nor in the narrative discussion of the financial performance of the Smaller firms.

227. Next, we present the absolute EBITDARS per funeral figures for the Large firms.

Table 17: EBITDARS per funeral of the Large firms (£)

	2014	*2015*	*2016*	*2017*	*2018*	*Weighted average*
[Firm A]	[✂]	[✂]	[✂]	[✂]	[✂]	[1,500-2,000]
[Firm B]	[✂]	[✂]	[✂]	[✂]	[✂]	[2,100-2,500]
[Firm C]	[✂]	[✂]	[✂]	[✂]	[✂]	[2,000-2,500]
[Firm D]	[✂]	[✂]	[✂]	[✂]	[✂]	[1,000-1,500]
[Firm E]	[✂]	[✂]	[✂]	[✂]	[✂]	[1,500-2,000]
[Firm F]	[✂]	[✂]	[✂]	[✂]	[✂]	[1,500-2,000]
[Firm G]	[✂]	[✂]	[✂]	[✂]	[✂]	[1,500-2,000]
[Firm H]	[✂]	[✂]	[✂]	[✂]	[✂]	[1,000-1,500]
[Firm I]	[✂]	[✂]	[✂]	[✂]	[✂]	[1,500-2,000]
[Firm J]	[✂]	[✂]	[✂]	[✂]	[✂]	[2,000-2,500]
[Firm K]	[✂]	[✂]	[✂]	[✂]	[✂]	[1,500-2,000]
[Firm L]	[✂]	[✂]	[✂]	[✂]	[✂]	[1,500-2,000]
[Firm M]	[✂]	[✂]	[✂]	[✂]	[✂]	[1,500-2,000]

Source: CMA analysis

CMA commentary

228. The Large firms that we have analysed are generally earning EBITDARS per funeral of between £1,500 and £2,200.[63] These earnings have allowed them to make returns that are significantly in excess of their weighted average cost per capital over the relevant period.

229. The Smaller firms that we have sampled exhibit a broader range of EBITDARS per funeral at between around £700 per funeral and around £2,600 per funeral. This is consistent with their lower (on average) average total revenue per funeral. We note that the results for the Smaller firms do not suggest a downwards trend in EBITDARS in most recent years.

Analysis of results

230. In this section, we present analysis of the results, including consideration of what could be driving the ranges and trends. We consider:

(a) Profitability

(b) Average revenue per funeral

(c) Cost-plus

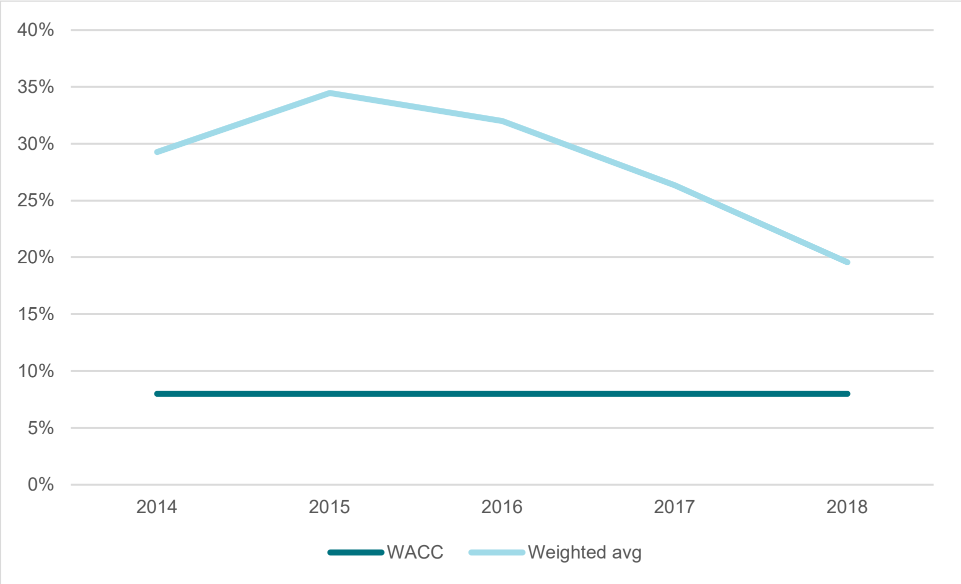
[63] The figures quoted in this paragraph exclude [Firm H], which is an outlier in terms of its absolute and percentage EBITDARS and which is making economic losses as detailed above.

Profitability

231. When analysing profitability of the firms we take into account ROCE, economic profits and economic profits/cost-plus, where data permits. We consider that these three metrics provide us with a rounded view of profitability across firms which may have different capital structures.

232. We have considered profitability on a firm-by-firm basis for the Large firms above. With consideration of the results in the round, we believe that there is evidence of generalised excess profitability in the industry.

Chart 1: [Weighted average] ROCE of the Large funeral directors from 2014 to 2018, including WACC benchmark (%)



Source: CMA analysis
Notes:

a) The chart above is a line chart with two lines, spanning from 2014 to 2018 inclusive. The lighter coloured line represents the weighted average ROCE of The Large funeral directors, and the darker line demonstrates WACC.
b) The results of individual parties have been removed for confidentiality purposes. A consequence of this change is that the text in paragraph 233 and related chart, were also excised.
c) The chart demonstrates that in all years the weighted average ROCE is significantly higher than the WACC benchmark, which sits at 8% throughout the period.
d) The average line shows that ROCE starts at around 30% in 2014 before reaching its peak in 2015, at around 35%. Average ROCE then follows a downwards trend to around 20% in 2018.

233. [✂].

Chart 2: [✂]

234. [The underlying data shows] that ten of the firms have earned returns in excess of the cost of capital in all years from 2014 to 2018. Two of the thirteen firms display ROCE results that have fluctuated around the WACC over this period and only one firm has earned returns that have been persistently below the WACC.

235. Based on weighted averages, ROCE results for each party range from [0-5%] to [50-100] over the five-year period. The main body of the group ranges between [20-30%] and [40-50%].

236. Eight of the 13 firms have seen an overall decline in ROCE from 2014 to 2018, with two firms experiencing an increase in ROCE over the same period and three remaining broadly constant. While [Firm A] and [Firm B] see a significant drop in ROCE in 2017 and 2018, respectively, this is not evident across the majority of the other firms.

237. Of the firms that have seen a decline in ROCE over the period, the results in 2018 remain above WACC for all but one of the parties, ranging from 10% to 30%. Thus, while there is a downward trend in some instances, it is not significant enough to bring the resulting ROCE in line with WACC.

238. In line with the ROCE results, there are similar patterns in terms of absolute economic profit per funeral figures, and economic profits as a percentage of cost plus.

239. The majority of firms earn economic profits in all years, with only three firms showing economic losses in some or all years from 2014 to 2018. Those firms making profits show an average of between £[200-250] and £[600-650] per funeral.

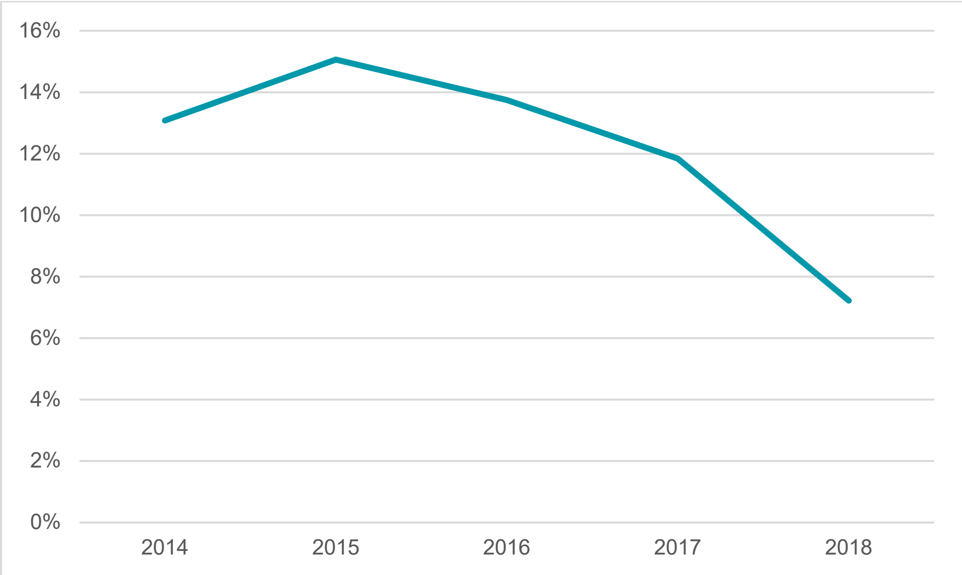
240. As with ROCE, [Firm A] and [Firm B] see a fall in their economic profit per funeral results in more recent years, however the results are still between £[100-150] and £[450-500] per funeral in 2018. In 2019, [Firm A] earns economic losses for the first time, of £[(200-250)]. [Firm B] also sees a decline in economic profits in 2019, however even in the case of decline, these remain significant at £[350-400] per funeral.

241. Economic profit (EP) as a percentage of cost-plus (CP) compares the economic profits of a business to its cost base (ie the costs through the profit and loss account plus the cost of capital). Thus, it shows us how much higher than cost prices have been.

242. This metric uses the cost-base of the company in question. Using economic profits as a percentage of cost plus therefore allows us to make a direct comparison of price versus cost for each party, and to compare the results across the group, regardless of the revenues charged or cost-base of each individual company.

243. There is a range of EP/CP percentages across the larger firms with a weighted average result of 12%.

Chart 3: [Weighted average] economic profits as a percentage of cost-plus from 2014 to 2018 for the Large firms



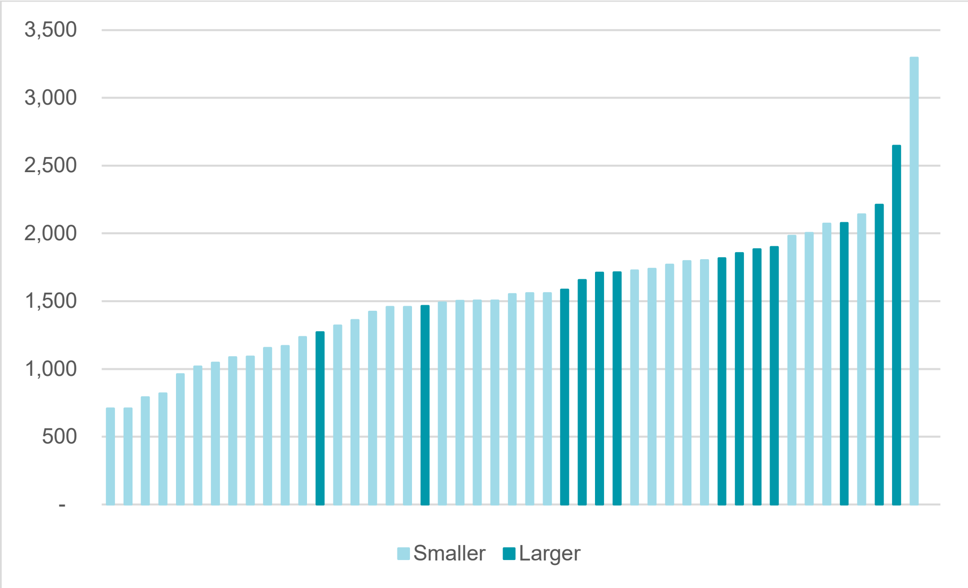
Source: CMA analysis
Notes:
a) The chart above is a line chart with one line demonstrating the weighted average economic profits as a percentage of cost-plus of the Large firms from 2014 to 2018 inclusive.
b) The results of individual parties have been removed for confidentiality purposes.
c) The chart starts at around 13% in 2014, increasing to more than 14% in 2015 before seeing a downwards trend to 2018 where it sits at around 7%.

244. [The underlying data shows that] one firm returns EP/CP percentages below zero for all years of the relevant period. Two other firms demonstrate EP/CP percentages of close to 0% in the majority of years. Otherwise, ten of the firms earn EP/CP percentages that are consistently greater than 0% in the period from 2014 to 2018, demonstrating that they are generating economic profits over and above their cost-base, even with the inclusion of an allowance for cost of capital.

245. Looking at trends over time all three of the Largest firms earn profits in excess of the cost-base (inclusive of an allowance for cost of capital) in all years from 2014 to 2018. However, in 2019, [Firm A's] EP/CP percentage drops to [✂]%, while [Firm B's] continues to earn profits in excess of the cost-base, with an EP/CP percentage of [✂]%.

246. EBITDARS per funeral is the main metric of comparability across the Smaller and the Large firms.

Chart 4: EBITDARS per funeral of the Smaller and the Large firms (£)[64]



Source: CMA analysis
Notes:

a) The chart above is a bar chart. Some of the bars are lighter in colour, representing The Smaller funeral director firms. The bars which are darker in colour represent the Large funeral director firms.
b) The firms can be identified only by 'Smaller' and 'Larger' and not by party name for confidentiality reasons.
c) The chart is structured with bars representing the lowest average EBITDARS per funeral on the left, and the highest on the right.
d) The Smaller firms (lighter in colour) dominate the lower end of the chat but are otherwise largely mixed in with the Large firms.
e) The lowest bar is less than £500 per funeral, and the highest around £3,500 per funeral.

247. Per the chart above, the Smaller firms dominate both the lower and higher ends of the EBITDARS per funeral results, however overall are mixed with the larger firms.

248. Thus, the evidence suggests that smaller firms have the potential to earn returns equal to those of the Large firms.

249. The generalised high level of profits appears to come from firms with very different average revenues and costs, and therefore we have examined these further to understand what may be driving this observation.

Average revenues

250. Our analysis of average revenues is split between two metrics:

(a) Average revenue per funeral (ARF): being the revenue earned in relation to funeral director services (ie excluding disbursement revenue) in the year divided by the number of funerals; and

[64] This chart excludes the firms which demonstrate results which do not appear credible. These have been identified in the notes to Table 16.

(b) Average total revenue (ATR): being the total revenue earned by the firm (ie including disbursement revenue) in the year divided by the number of funerals

251. Due to poor data availability, we were unable to collect revenue data exclusive of disbursements for the smaller firms. Therefore, our consideration of the results for these firms and their comparison to the larger firms, is based on ATR.

252. In considering and making comparisons between the larger firms, our analysis is predominantly focused on ARF.

253. Here we consider the range and trends over time of each of these metrics in turn.

Average total revenue

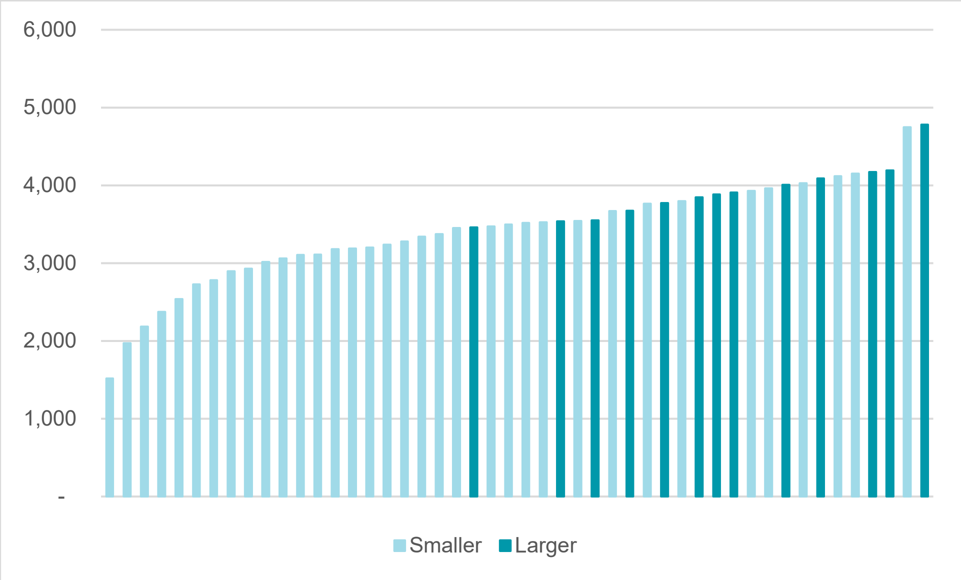
254. Our analysis of ATR includes the results from both the larger and smaller firms. Below, we consider both the range and trend with regards to ATR.

Range in ATR

255. The results presented at Table 15 show a significant range in ATR across the market, generally from £2,000 to £4,700.

256. The results demonstrate that the Smaller funeral director firms are, on average, charging lower total prices than the Large funeral director firms. Of the results presented, the lowest half of average revenues are entirely made up of firms within the Smaller category.

Chart 5: Weighted average ATR from 2014 to 2018 split between the Smaller and the Large firms[65]



Source: CMA analysis
Notes:
a) This chart is a bar chart. Some of the bars are lighter in colour, representing the Smaller funeral director firms. The bars which are darker in colour represent the Large funeral director firms.
b) The firms can be identified only as 'Smaller' or 'Larger' and not by party name for confidentiality reasons.
c) The chart is structured with bars representing the lowest ATR on the left, and the highest on the right.
d) The Smaller firms (lighter in colour) dominate the lower end of the chart but are otherwise largely mixed with the larger firms.
e) The lowest bar represents ATR of just over £1,500 per funeral, and the highest between £4,500 and £5,00 per funeral.

257. There is a greater mix of the Large and Smaller firms across the top 50% of average revenues. The Large firms are spread with the Smaller firms across the top 50% of average revenues. [The underlying data shows that] [Firm B] and [Firm C] charge average prices at the higher end of the spectrum, with average total revenues of £[✂] and £[✂] respectively.

Trends in ATR

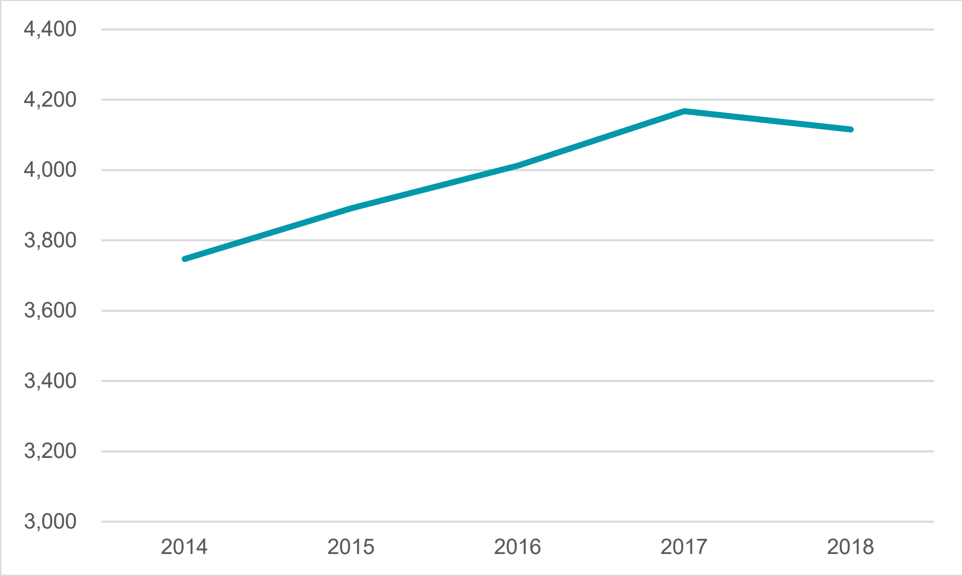
258. Both [Firm A] and [Firm B] have told us that the market is changing. [✂] told us that 'changes are now taking place' and 'they are moving very quickly.' They said that they are 'increasingly seeing customers shop around and consider price as well as quality and service.' [✂] told us that 'there is massive change coming through the funeral business' and that 'price competition is becoming more vigorous.'

259. As such, in considering average revenue results, it is relevant to consider trends across the five-year period in addition to evaluating averages. Chart

[65] Note that this chart excludes the results of firms for which we believe the data is not credible. Details of this can be found in the notes to Table 15.

6 below shows the [weighted average] ATR for the Large funeral directors over the relevant period.

Chart 6: The Large firms' [✂] [weighted average] ATR from 2014 to 2018



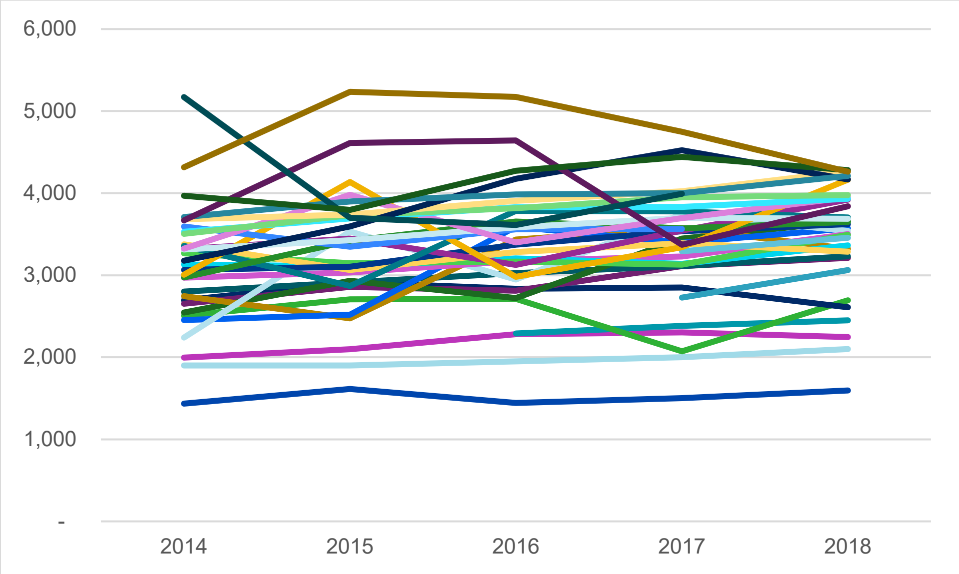
Source: CMA analysis
Notes:
a) The chart above is a line chart demonstrating the weighted average ATR of The Large firms from 2014 to 2018 inclusive.
b) The results of individual parties have been removed for confidentiality purposes.
c) The chart shows that ATR increases each year to 2017, beginning at around £3,750 in 2014 and peaking at just below £4,200 in 2017. In 2018, the weighted average line drops slightly, to just above £4,100.

260. [The underlying data shows that] eleven of the 13 Larger firms see a continued increase in ATR across the period. The increases in ATR have varied significantly across parties over the five-year period, with some of the biggest increases being observed among the regional larger players.

261. [The underlying data shows that] the decline in ATR in the later period does not appear to be a generalised trend – it only affects [Firm A] and [Firm B] with all of the other larger firms seeing year-on-year increases in ATR to a greater or lesser extent. While the chart above indicates a decline in ATR from 2017 to 2018, this is the result of the weighting of revenues by volume and not indicative of the trend across the firms more broadly.

262. The trends over time for the Smaller firms are mixed. Of the firms presented, the majority saw an overall increase in average total revenue for the period analysed. The majority of firms saw an increase of between £100 and £700 per funeral, with a small group of firms seeing increases of more than £1,200. Five firms saw a reduction in average revenues across the period.

Chart 7: Smaller firms' trends in ATR from 2014 to 2018[66]



Source: CMA analysis

263. The results per Chart 7 above demonstrate significant 'noise' across the Smaller funeral director firms' ATR. There is no evidence of a downward trend at the end of the five-year period, rather a continuation of the year-on-year volatility in average revenue per funeral that is likely to be the result of small volumes and composition effects.

264. Dignity told us that it thinks ATR 'is a less meaningful metric to assess funeral director performance because the disbursements create significant noise in the data and metric.' It continued by stating that 'as cremation and burial disbursement costs rise over time, these increase the funeral directors' ATRs. 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.'[67,]

265. Dignity concluded that 'funeral director fee growth appears to be below inflation for most firms – falling in real terms.'[68]

266. Dignity expressed concern with the volatility of ATR for some of the firms, noting that there is variation not only across firms but also within firms' results across the period.[69]

[66] Note that this chart excludes the results of firms for which we believe the data is not credible. Details of this can be found in the notes to Table 15.
[67] Dignity response to funeral director profitability working paper, para 3.4(a). Note that what Dignity refers to as 'ARF' in its response should be read as 'ATR' based on current wording in this appendix.
[68] Dignity response to funeral director profitability working paper, para 3.8. Note that what Dignity refers to as 'ARF' in its response should be read as 'ATR' based on current wording in this appendix.
[69] Dignity plc response to the CMA's Provisional Decision Report, Annex 1: Critical observations on the CMA's profitability analyses and customer detriment figures, para 2.26 (ii).

267. Co-op told us that 'since disbursements are external pass-through costs to most funeral service providers and are out of their control, the average ATR inclusive of disbursements is not representative of these providers' actual pricing power.'[70,71]

268. Co-op also told us that it thinks that when these ATR results are adjusted for inflation, there is evidence of a decreasing price trend across these Smaller funeral directors in recent years.[72]

269. First, we do not consider that fluctuations in ATR are necessarily reflective of unreliable data. Due to the lower volume of funerals undertaken by the Smaller firms compared to the Large, there is likely to be greater fluctuation in revenues year-on-year as a result of factors such as product mix. We have performed analysis to test the reliability of the underlying data of the Smaller firms, which is discussed in more detail at Annex A: Obtaining information from the fragmented market.

270. Second, we recognise that trends in ATR will be the product of both trends in ARF and trends in disbursement costs. However, we note that the decline in ATR seen in both Dignity and Co-op's results in 2018, which they have put to us is the result of changing market dynamics, does not appear to be a general market phenomenon. This suggests that this decline may be driven by factors which are specific to Dignity and Co-op, rather than broader market factors.

271. Finally, in response to Co-op's point on inflation, we note that from a profitability perspective, we are here considering nominal as opposed to real figures. In our review of pricing (see Appendix N) we take into account inflation when assessing the real changes in prices over time.

272. As noted previously, we were unable to split out disbursement revenue for the smaller firm analysis however have been able to do so for the larger firms. Thus, our consideration next turns to ARF for the Large funeral directors.

[70] Co-op response to funeral director profitability working paper, para 5.13
[71] For clarity, Co-op use the term 'ARF' in its response. The naming used in our narrative has changed since their response, thus Co-op's reference to 'ARF' refers to 'ATR' in the context of this appendix.
[72] Co-op response to Provisional Decision Report, Appendix 1, paras 3.30 to 3.32.

Average revenue per funeral

273. Average revenue per funeral is calculated as funeral services revenue (ie revenue exclusive of disbursements) divided by the number of funerals performed.

274. As noted previously, analysis of ARF is performed for the Large funeral director firms only due to data availability. We have data at an ARF-level for 12 of the 13 larger firms.[73]

Range in ARF

275. The weighted average ARF across the relevant period for each of the firms ranges from £[✄] to £[✄]. The lowest values occur in 2014 when two of the firms earned ARF of approximately £[✄], with the greatest ARF occurring in 2018 with a value of £[✄].

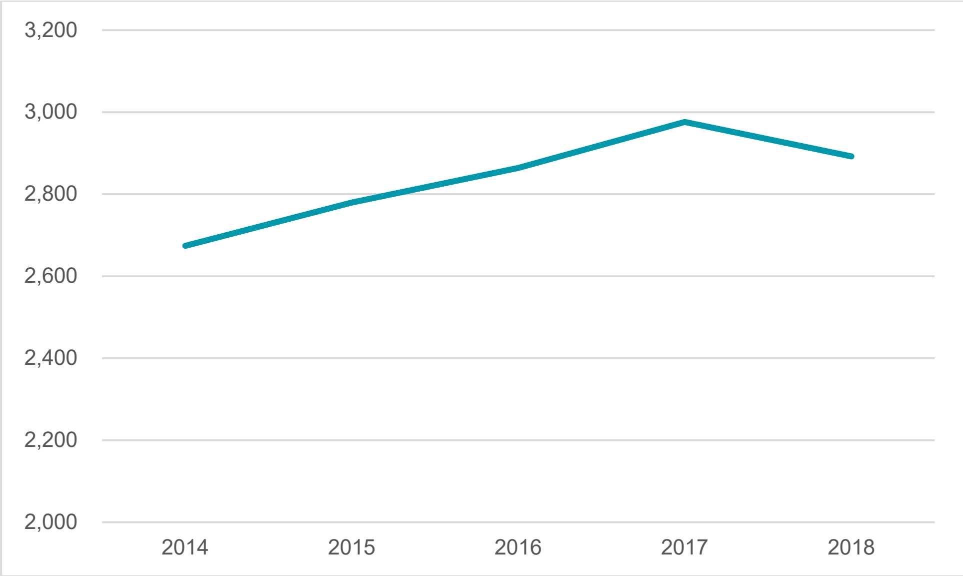
276. Disbursement revenues range from around £1,000 to £1,300 across the firms, averaging at around £1,200 per funeral. The consistency of disbursement revenues within this range, even for firms with the highest ATR and ARFs, demonstrates that the range in the total price paid by consumers when purchasing their funeral is largely a result of funeral director pricing as opposed to customers' choices regarding disbursements.

Trends in ARF

277. We present the trends in ARF over the relevant period for consideration in comparison of the downward trend demonstrated by ATR.

[73] Revenue data for [Firm E] was provided on a total basis, thus we are unable to split revenues between ATR and ARF.

Chart 8: Larger firms' [✂] [weighted average] ARF from 2014 to 2018



Source: CMA analysis
Notes:
a) The chart above is a line chart demonstrating the weighted average ATR of the Large firms from 2014 to 2018 inclusive.
b) The results of individual parties have been removed for confidentiality purposes.
c) The chart shows that ATR increases each year to 2017, beginning at around £3,750 in 2014 and peaking at just below £4,200 in 2017. In 2018, the weighted average line drops slightly, to just above £4,100.

278. [The underlying data shows that] again, even with the removal of disbursement revenue, it is evident that [Firm A] and [Firm B] are the only firms to see a downward trend in revenue in 2017 and 2018 respectively. The rest of the firms show an increase in ARF across the period.

Conclusions on revenue

279. The decline in average revenue per funeral is only observed for [Firm A] and [Firm B] among the Large firms and there is no discernible trend among the Smaller firms (see Chart 7), in part because they exhibit year-on-year volatility.

Cost-plus per funeral

280. Cost-plus is calculated as all costs relevant to funeral director services through the P&L plus the cost of capital. Due to the nature of the information obtained from the Smaller firms we have not calculated cost-plus per funeral for these firms. Thus, the discussion presented in this section relates to the larger funeral directors only.

Range across cost-plus

281. In considering cost-plus, we do so inclusive of disbursement costs. When considering economic profits, we do so inclusive of any margins earned on

disbursements, therefore we have presented cost-plus figures inclusive of disbursements.

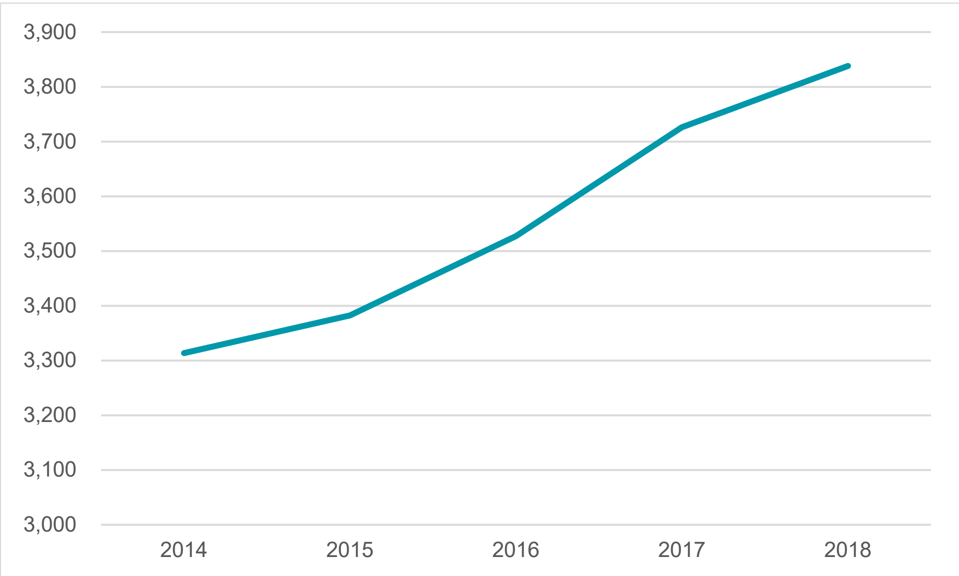
282. There is a significant range in average cost-plus incurred by the larger funeral directors, from just over £3,000 to almost £4,800. Most funeral directors incur average cost-plus of between £3,200 and £4,000.

283. Funeral directors demonstrating high revenue results typically also incur higher cost-plus. While the Largest funeral directors sat at the top of the range for revenues, and they continue to do so for cost-plus, they do (on average) move slightly further down the list.

Trends in cost-plus

284. Chart 9 below demonstrates trends in cost-plus for the Large firms from 2014 to 2018.

Chart 9: [Weighted average] cost-plus of the Large firms from 2014 to 2018 (£)



Source: CMA analysis
Notes:

a) The chat above is a line chart with one blue line which represents the weighted average cost-plus of the Large firms from 2014 to 2018 (inclusive) in pounds.
b) For confidentiality purposes, this chart presents the weighted average of all parties only, and not individual party results.
c) The chart starts in 2014 at just above £3,300 and increases to around £3,700 by 2018.

285. [The underlying data shows that] the Largest have kept cost increases to between £430 and £500 per funeral over the period, whereas the Other Large firms present a much more mixed picture.

286. Some funeral directors have seen small increases in costs. For example, [Firm D] has seen an increase in cost-plus per funeral of approximately £330, significantly lower than the approximately £500-750 increase of many

of the funeral directors, and four times lower than the increase of approximately £[1,200-1,300] we calculated for [Firm J].

287. As a result, the Largest firms have seen slightly lower increases in cost-plus than the Other Large firms over the period, and the Largest firms have cost-plus figures in the middle of the pack when considering the results of the Large firms as a group.

288. We note that all of the firms which have seen a fall in the number of funerals per home have also seen relatively large increases in cost-plus of between £490 to £1,200 (as per the firms' results tables, at Tables 1 to 13 above).

Interpretation of our analysis

289. In interpreting the results of our analysis, we note that returns are high for the majority of firms, and also that there has been a decline in profitability for some firms in recent years. In assessing this, we considered two main points:

(a) Whether high returns among the Large funeral directors are the result of superior efficiency; and

(b) The argument made to us by parties that the market is changing, and profitability is decreasing as a result of increased competition and costs.

290. We also consider various submissions from the parties in relation to market coverage, survivorship bias and the usefulness of the metrics we have used to understand the profitability of Smaller funeral directors.

Efficiencies

291. First, we considered whether the high returns displayed by the majority of the Large firms, with particular consideration of those of Co-op and Dignity, may be the result of superior operating efficiencies or scale economies. We had regard to our cost-plus analysis, as set out above, to internal documents as well as representations that parties have made to us on these matters.

292. Generally, we would expect large companies to be able to derive a competitive advantage over other firms from procurement efficiencies, the pooling of resources (thus achieving lower costs) and/or a superior ability to serve large-scale contracts. However, our cost-plus analysis does not support the finding that the Largest funeral directors are able to achieve lower average costs than the other large funeral directors. This observation is supported by the internal documents quoted below, which indicate that

neither Co-op nor Dignity considers that they have been able to achieve significant cost efficiencies:

(a) Co-op told us that 'whether you look at a very large funeral director or a very small funeral director, because of that nature of it being a legacy business and people having a very traditional way of doing things, it is just a scaled-up version of a small funeral director.' They went on to explain that as a result of the acquisition model of scale through purchase, 'a funeral business in its current guise is actually quite inefficient at scale' and it is an industry 'where being bigger means you are less efficient.'

(b) Co-op told us that effectively the funeral business in the Co-op looked like an amalgam of lots of small funeral directors. It also told us that it planned to take about £[✂] of costs out of the business and bring the workforce and operating model to the level expected in a fast-moving-consumer-goods business which, as it told us, it had not been in the past.

(c) A similar point was made in a document presented for discussion to the Dignity Board: "[✂]."

(d) [✂].

(e) The work carried out [✂] for Dignity identified a number of [✂]. Most notably, this work included evidence of smaller funeral director firms being able to provide a funeral at a cheaper cost compared to a larger firm as a result of the larger firms incurring: (i) higher staff costs per funeral; (ii) higher property costs per funeral; and (iii) central costs such as HR and finance. The net impact was an increase in costs of almost £[✂] per funeral when the funeral was provided by Dignity as opposed to a smaller firm. This suggests that Dignity's staff costs are higher than those of the smaller funeral directors they acquire as a result of layers of management and central costs.

293. In addition, the Large funeral directors do not generally serve contracts that smaller firms could not serve. Coroners' contracts are typically operated at a local or regional level and have been won by both large and small firms. We are aware of only one truly large-scale national contract, to serve Network Rail.[74]

[74] This is currently served by [✂].

Changing market conditions

Parties' views

294. We also considered representations made to us that the sector has been changing, with competitive pressure increasing, and there has been a consequential squeezing of profitability in recent years.

295. Co-op told us that it has been experiencing increased competition which has led to a decrease in market share and reduced revenues. Co-op submitted that there is evidence of declining profitability in the market, noting that a number of the larger firms have seen an overall decline in ROCE in the period.[75] It referred to Dignity's publicly available financial information and noted that Dignity also appear to be experiencing competitive pressures, demonstrated by a fall in market share and average income. Co-op argued that if we explore more recent information, for 2019 and 2020, for other firms then we may find similar trends as those for Co-op and Dignity.[76]

296. Co-op said that many large providers (including Co-op) may have committed investments in the hope of retaining their existing market shares in the increasingly competitive market.'[77]

297. Co-op told us that its 'competition-induced growth is not an anomaly' and referred to our analysis, noting that 'larger providers saw slower growth in ATR relative to the growth in cost-plus between 2014 and 2018.' Co-op suggested that 'this implies that the larger providers absorbed some of the cost increases, which resulted in the decline of their profitability.' Co-op argued that 'as such, the worsening market conditions and increased competition should, at least partly, account for the generalised market trend of declining volumes and increasing costs.'[78]

298. Central England Co-op raised concern with the focus of the analysis being on 2014 to 2018, [✂] and suggested that using more recent information may provide a significantly different conclusion to that shown in the report.[79]

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[75] Co-op response to funeral director profitability working paper, para 5.7
[76] Co-op response to funeral director profitability working paper, paras 5.3 to 5.7.
[77] Co-op response to funeral director profitability working paper, para 5.14
[78] Co-op response to funeral director profitability working paper, para 5.15
[79] Central England Co-op response to Provisional Decision Report, page 2.

299. Funeral Partners told us that it considers that the results demonstrate that in this market there are signs that excess profit is being eroded over time and that the market is seeing increased competition.[80]

300. Further, parties argued that the COVID-19 pandemic was causing an accelerated decline in profits. Co-op told us that it is seeing significant changes in the market, accelerated by the COVID-19 pandemic, and that conclusions should therefore not be drawn on 2014 to 2018 information only. It said that the market has moved since then and is likely to keep developing rapidly, arguing that conclusions drawn based on this time period are unlikely to be representative of profitability going forward.[81]

301. Co-op told us that the pandemic has led to operational disruption and a change in the way customers interact with the business. It noted that it is experiencing significant increased costs, particularly as a result of paying colleagues who have been self-isolating or sick as well as those required to perform the tasks those out of the business would have performed. It told us that other factors had contributed to increased costs, such as adding mortuary capacity in key urban areas and supplying sufficient PPE equipment to protect staff.[82]

302. Co-op continued by telling us that there has been a shift in the mix of funerals towards slimmed down propositions or options without ceremony, which has had a significant impact on the financial performance of the business. It told us that deaths have been brought forward as a result of the pandemic, meaning that there will be a decrease in the number of funerals following the outbreak.[83]

303. Co-op told us that funeral directors more widely may be incurring losses as a result of COVID-19 induced product mix changes, and that this is likely to impact the financial viability of funeral providers if the situation continues for some months. It noted that some of the impacts may be temporary, but that it considers that others will speed up or lead to permanent changes in the market.[84]

304. Dignity told us that we should update profitability analysis to capture the potentially long-lasting effective of the COVID-19 pandemic on the sector. It told us that it expects that the pandemic has accelerated the growth of

[80] Funeral Partners response to Provisional Decision Report, page 9.
[81] Co-op response to Provisional Decision Report, paras 6.29 to 6.34.
[82] Co-op response to funeral director profitability working paper, para 1.3.
[83] Co-op response to funeral director profitability working paper, para 1.3.
[84] Co-op response to funeral director profitability working paper, para 1.3 and 1.4.

alternative funeral options as consumers will be more familiar with alternative options following the pandemic, and that these impacts are likely to have lasting negative effects on revenues and profitability in the market.[85]

305. We received a response from SAIF with regards to the COVID-19 pandemic which highlighted similar points to those raised by Co-op and Dignity above.

Our assessment

306. There has been a decline in profitability for some of the Larger firms in recent years, [✂]. In considering this decline in profitability, we consider whether this is: (i) generalised across the market, and (ii) the result of competition pushing prices down, or increasing quality (to the benefit of customers), as opposed to being due to other factors which are not associated with long-term improvements in competitive conditions, such as regulatory pressures, firm-specific decisions or other factors.

307. In this context, we note that:

(a) On average over the 2014 to 2018 period, profits have remained comfortably above the cost of capital, indicating that firms have been able to exercise market power vis-à-vis consumers over a number of years;

(b) Up to 2018, the evidence does not support a finding of generalised downward pressure on prices but rather declines for the two largest firms only;

(c) The two largest firms, Co-op and Dignity, have undertaken price reductions which coincided with a period of enhanced public scrutiny of the market suggesting that they may have been influenced by general PR pressures and/or the threat of potential regulatory intervention;

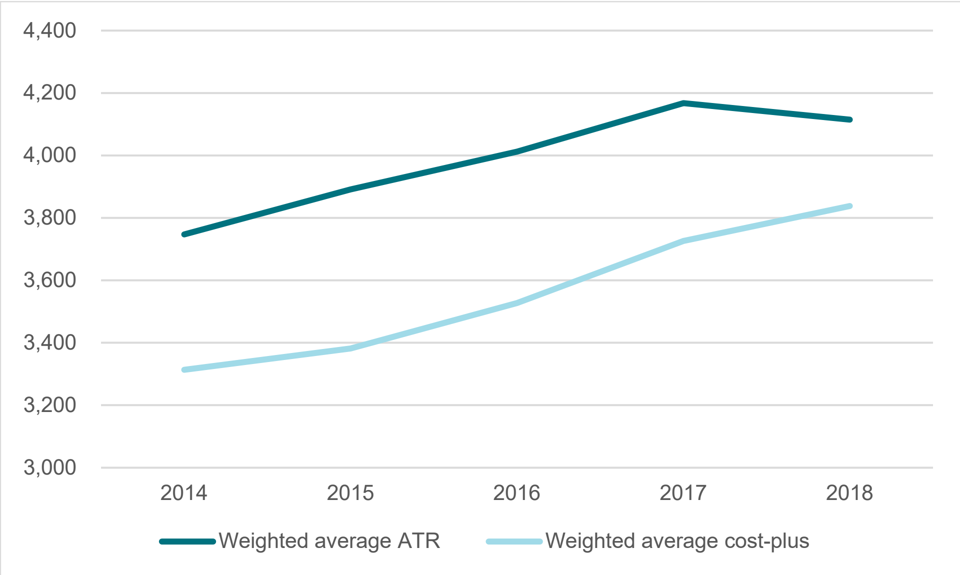
(d) The evidence suggests that the profitability of some firms has declined between 2017 and 2019 due to a combination of i) lower prices charged by some firms and ii) the over-expansion of branch networks, which pushed up cost bases without attracting the expected volumes which would make such expansion profitable. (See Chart 10, below). On balance, we see the significant growth in branch networks to be evidence of firms seeking to maintain share in a market which is functioning poorly.

[85] Dignity response to funeral director profitability working paper, para 1.2 (b)

We do not see any evidence that customers have been benefiting from these competitive dynamics.

308. Overall, in the context of significant excess returns over the 2014 to 2018 period, we think it is too soon to say that recent reductions in profitability provide clear evidence of changing market dynamics, ie competition disciplining market participants to the benefit of customers.

Chart 10: Weighted average ATR and cost-plus of the Large firms from 2014 to 2018 (£)[86]



Source: CMA analysis
Notes:

a) The chart above is a line chart with two lines, spanning from 2014 to 2018 inclusive. The darker coloured line represents the weighted average total revenue of The Large funeral directors, and the lighter line demonstrates the weighted average cost-plus of the Large funeral directors.
b) The difference between the two lines represents the economic profit figure.
c) The chart demonstrates that weighted average revenue increased in every year up until 2017, where it reached almost £4,200. In 2018 the weighted average revenue figure began to drop, with the line falling to just over £4,100.
d) Similarly, the chart demonstrates that weighted average cost-plus has been increasing in every year from 2014 to 2018.
e) The gap between the two lines (ie the average economic profits of the Large funeral directors) is greatest in 2015 and begins to reduce from then on. However, it is evident that the gap reduces not only due to a reduction in weighted average revenue, but also as a result of increasing weighted average cost-plus.

309. Chart 10 demonstrates both the weighted average revenue per funeral of the Large firms as well as the weighted average cost-plus of these firms. Economic profits are represented by the gap between the two lines. The chart demonstrates that declines in profitability in recent years is the result not only of a reduction in pricing, but also of increasing costs.

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[86] Note that this chart demonstrates the weighted average total revenue per funeral inclusive of disbursements and the weighted average cost-plus per funeral inclusive of disbursements. In calculating economic profits, we use revenues and costs inclusive of disbursements as firms have the potential to earn margins on disbursements.

310. Next, we considered the submissions made by Co-op and Dignity and their suggestion that COVID-19 has or can be expected to result in a decline in profitability in the market, by encouraging customers to shop online and purchase simpler funerals.

311. Co-op and Dignity's preliminary results for 2020 indicate an increase in profitability as opposed to a decline, largely as a result of significantly higher volumes of funerals. Co-op interim results demonstrated a 22% increase in funeral volumes resulting in an increase in underlying profit before tax of 70% for the Funerals business,[87] while Dignity's results showed a 23% increase in number of funerals, resulting in an 11% increase in underlying profit before tax.[88]

312. The impact of COVID-19 on pre-existing trends in the market is unclear at this stage; the market is still adjusting to the impact of the pandemic and we do not have evidence so suggest that changes in purchasing habits throughout the pandemic will continue. Dignity's interim report indicates that it expects the change in product mix caused by the COVID-19 pandemic to be reversed when conditions return to normal.[89]

313. We do not believe it is possible, as submitted by Dignity, to update our full ROCE analysis to capture the effects of the pandemic on the sector at this stage given that it is on-going. Moreover, we do not think that such analysis would be insightful given that the financial performance of funeral directors in 2020 will be affected in various ways that are unlikely to be representative of the situation after the pandemic is over, regardless of longer-term trends. For example, the increased volumes of funerals undertaken over a relatively short period, the increased costs of managing high levels of staff absences and of purchase of additional PPE etc.

314. Furthermore, we believe that it is too early to form any views on the potential impact of COVID-19 on competitive dynamics in the funerals market in the longer term. It is not clear to what extent the pandemic might change customers' purchasing preferences in a lasting way, nor whether any such change would materially increase the level of competitive constraint on funeral directors. We note that any change in the types of products and services demanded – for example towards lower cost or simpler funerals – would not necessarily be sufficient to remove any market

[87] Co-op interim report 2020, page 8
[88] Dignity plc interim results for the 26 week period ended 26 June 2020, page 1
[89] Dignity plc interim results for the 26 week period ended 26 June 2020, page 6

power that firms were able to exercise when more costly or complex products and services were preferred.

315. While some firms have seen a fall in ROCE in recent years, profits generally remain well above the normal level and the evidence does not, in our review, support the argument that the market is changing such that profits could be expected to return to or close to normal levels in the foreseeable future. Further, we have not been able to obtain 2019 data from all firms in order to perform analysis of profitability across the Larger firms in 2019.

316. Significantly, while there is evidence of declining profitability in some instances, ROCE remains above the cost of capital for the majority of firms, and substantial economic profits continue to be earned.

317. We have also considered other representations made to us by parties with regards to how our analysis can be interpreted.

Market coverage

Parties' views

318. In relation to our original proposal to consider the three largest funeral director firms and a sample of 100 independent firms, Dignity told us that it was 'concerned that the proposed market coverage of the analysis is low and risks not being representative.' Dignity said that we propose 'to examine around a third of funeral services providers (by number of funerals) active in the market across the period 2014 to 2019', and that 'even if all were found to be earning profits exceeding cost of capital, this would not constitute a substantial part of the market.'

319. Dignity recognised the data limitations we faced in obtaining data from the fragmented market (as further detailed at Annex A: Obtaining information from the fragmented market) and told us that this combined with us obtaining data from a reduced number of the sampled firms meant that 'incomplete and unrepresentative data is a significant concern, as it means there is little insight into the majority of the market.'[90]

320. The NAFD told us that they were 'concerned 'at the sample size of 100 funeral director branches.'

[90] Dignity response to funeral director profitability working paper, para 3.1

321. Funeral Partners expressed concern ‘that the extent of the analysis the CMA proposes to undertake in the independent sector is not a representative sample of the remaining market’ and that ‘the analysis may place undue focus on the minority of the market’, which Funeral Partners noted as the large players.

322. In response to our profitability working paper, Funeral Partners told us that the percentage of the market considered as part of our Smaller firm analysis means that we cannot draw conclusions about the market as a whole.[91]

323. In response to the same paper, Co-op told us that it does not think that we have addressed concerns around market coverage, largely as the result of questions around (i) confirmation bias, (ii) correlations between quality of data and profitability resulting in upward bias and (iii) survivorship bias.[92] We consider point (i) at paragraph 21 of the Annex, and points (ii) and (iii) from paragraph 329 below.

Our assessment

324. In selecting the firms to include in our analysis, we have had to balance market coverage with the practicality of seeking to collect detailed financial information from very small firms.

325. We considered how we could extend our analysis to cover a greater proportion of the market by both market share and in terms of the types of firms covered. We decided to extend our information requests to the Other Large firms in addition to the Largest firms. These ten firms are made up of a mix of regional co-operatives and independent firms, with the largest of these firms operating 132 branches, and the smallest operating 24.[93] Expanding our analysis to include these firms means that we cover 42.4% of all branches in the market and that we have detailed profitability data on a broader range of firms, including mid-sized regional and family-run firms.[94]

326. While our analysis is more limited for the Smaller firms and may not be representative, we note that the pattern of ATR is broadly consistent with pricing data collected on the industry, ie we have no reason to believe that

[91] Funeral Partners response to profitability working paper, para 5.2
[92] Co-op response funeral director profitability working paper, paras 4.4 to 4.6.
[93] Central England Co-op (132); Midcounties Co-op (75); East of England Co-op (65); Southern Co-op (60); Lodge Brothers (42); CPJ Field (39); Beverley Funerals Ltd (33); A W Lymn (26); Alan Greenwood and Sons (26); William Purves (24)
[94] All of these firms have provided us with detailed financial information.

our sample is particularly biased towards either higher or lower priced firms. In addition, our sample covers a range of locations from across the UK so should reflect relevant geographic differences that affect funeral directors. Therefore, we believe this data allows us to make meaningful comparisons between these firms and the Large funeral directors and to gain an insight into the trends and patterns in the industry.

327. While we recognise that our profitability analysis covers a lower proportion of the market than has generally been the case in other market investigations where industries have been less fragmented, we do not agree with Dignity's view that just under 45% of a market does not constitute a substantial part of the market, or that, as a result of limited information on smaller firms, it is not possible to make inferences about profitability in the market more generally. We discuss our interpretation of our analysis further in paragraphs 337 to 342, below.

328. A more detailed consideration of issues we faced in obtaining data from the fragmented market can be found in Annex A: Obtaining information from the fragmented market.

Survivorship bias

Parties' views

329. NAFD noted that 'there may be a 'survivorship bias' such that the firms currently in the market, particularly the largest, are particularly profitable and efficient, and that other firms went bankrupt in the past.'

330. Dignity suggested 'there is a significant risk that there is bias in the CMA's sample of smaller funeral directors' as 'it is based only on firms that responded to the information request (a selection bias).' Further, Dignity told us that it remained 'concerned that there is a survival bias in the respondents' and that 'the lack of response from firms could be consistent with this.'[95]

331. Co-op echoed the concern around survivorship bias in response to our profitability working paper, noting that 'the CMA did not account for survivorship bias in choosing its small provider sample.' Co-op continued that 'it appears that 31 out of the 32 small branches that the CMA analysed reported ATR in 2018 and therefore, were open.' Co-op expressed concern that we 'did not consider the small branches that closed down before 2018.'

[95] Dignity response to funeral director profitability working paper, para 3.2

Co-op recognised that 'it would not be possible for the CMA to survey the providers that have stopped operating.'[96]

332. Further, Co-op responded to a point made in our profitability working paper that we had not seen evidence of firms exiting due to financial pressures. Co-op told us 'that the CMA would not be able to find any evidence of this, given that it is not possible to survey any firms that have stopped operating.' Co-op suggested that 'if the CMA were able to include the firms that exited the market before 2018, even if the reason is unclear, it would make the sample more representative of the market.' It argued that 'in addition, the CMA should monitor firms that exit the market as a result of the Covid-19 outbreak and include these in the sample.'[97]

333. With regards to the data obtained from smaller firms, Co-op expressed concern as to the correlation between the quality of data obtained and the profitability of the corresponding firms. Co-op told us that 'it is possible that more profitable funeral directors provide higher quality financial data.'[98] It suggested that the 32 small providers included in our analysis per the profitability working paper may be more profitable than other small providers in the UK, and therefore, [our] results may be upward biased.[99]

Our assessment

334. We do not agree that issues of survivorship bias were likely to be material in interpreting the results of our financial analysis in this particular industry. First, we are not aware of any large-scale exit, where a firm or firms with significant market share have made losses and ceased operating.[100] In the context of the very significant profits that we have observed among the Largest funeral director firms, large-scale exit would be required to alter the overall picture. Second, while we recognise that there is likely to be a certain amount of churn among independent firms, this may happen for a range of reasons, not only financial failure. For example, family firms may close due to a lack of succession planning or may be acquired by a competitor (for the same or other reasons). Finally, we note that many of the Smaller firms told us that they operated with a relatively capital-light model, renting premises and vehicles, at least until they were established in their local area, reducing the costs of failure. In this context, even the

[96] Co-op response to profitability working paper, para 4.6
[97] Co-op response to profitability working paper, para 4.6
[98] Co-op response to funeral director profitability working paper, para 4.5
[99] Co-op response to funeral director profitability working paper, para 4.8
[100] In such a case, it may be relevant to include the returns of such firms in our average profitability results.

failure of a small proportion of small firms each year, would not have a material impact on ROCE at the industry level.

335. With regards to the point on a potential relationship between quality of data and profitability resulting in upwards bias, we are not convinced of Co-op's argument. As further detailed in the annex to this appendix, there was a range in the quality of information obtained from the smaller firms. Further, there is a range in revenues and EBITDARS earned by these Smaller firms, some lower and some higher than that of the Large funeral director firms.[101]

336. As such, while we acknowledge that there is the potential that some funeral director firms in the UK for whom we did not obtain data may be less (or more) profitable than those sampled, we do not have reason to believe that our sample is upwards biased.

Metrics used in analysis of smaller firms

Parties' views

337. With regards to the EBITDARS per funeral and average revenue metrics used in our analysis of the smaller firms, Dignity expressed concern due to the fact that they do not consider capital employed and they consider them to be volatile measures. Further, Dignity expressed concern that they do not provide evidence of excessive economic profits.'[102]

338. Dignity noted that a comparison of ATR and EBITDARS per funeral of the Smaller firms demonstrates a mixed picture with a changing pattern year-to-year which they suggest makes drawing conclusions on the basis of each metric difficult.[103]

Our assessment

339. Although we have more limited financial information on the Smaller firms, in analysing our results, we have looked to make comparisons across the Large and the Smaller firms in order to understand relative profitability. Our use of EBITDARS per funeral comparisons to infer approximate levels of

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[101] We find Co-op's argument that our sample may be biased towards more profitable firms to be highly speculative. We consider that it is equally, if not more probable that Smaller funeral directors with high profits will have been less likely to respond to our request for financial information given the context in which it was requested, with the result that our sample would be skewed towards less profitable firms.
[102] Dignity response to funeral director profitability working paper, para 2.2
[103] Dignity response to funeral director profitability working paper, para 3.13 (c)

profitability among the Smaller firms sampled does make a couple of assumptions, including:

(a) The Large firms have efficient cost bases, such that the actual ROCE they earn from a given level of EBITDARS per funeral reflects the maximum level of economic profits a firm could earn from that absolute margin; and

(b) the Smaller firms are equally efficient and will, therefore, earn a similar level of ROCE for a similar level of EBITDARS per funeral as the Large firms.

340. To the extent that either of these assumptions is incorrect, we note that this would not change our conclusions regarding the interpretation of our findings. For example, if the Large firms were inefficient (see paragraphs 291 to 293), then by themselves our profitability estimates would understate the detriment to customers. Similarly, if the converse were true, ie the Smaller firms were less efficient such that with the same level of EBITDARS per funeral as the Large firms, they were making lower profits, this does not reduce the detriment to customers (who would still be harmed by the higher costs arising from inefficiency).

341. We note that the product offering of a small funeral director and a large funeral director is generally the same. There is no inherent scale advantage/complex service that requires a larger scale of operations and there is no reason to believe that larger firms will be earning higher returns for any given level of prices.

342. We provide a more detailed discussion of our analysis of the Smaller firm data and the use of the EBITDARS metric at Annex A: Obtaining information from the fragmented market.

Conclusions

343. The majority of the Large firms have been persistently earning returns in excess of the cost of capital.

344. There is some evidence that returns have declined in more recent years for some firms. The results demonstrate that the trend is more pronounced for [✄] and returns continue to exceed the cost of capital for the majority of firms in 2018, the latest period for which we have data for most firms.

345. The Smaller firms exhibit a broad range of average revenues and EBITDARS per funeral. As demonstrated in Chart 4, many of the Smaller firms are earning levels of EBITDARS per funeral which are similar to the Large firms. As a result, we may expect these firms to also be earning high

profits. A significant proportion of the Smaller firms have, however, persistently earned lower EBITDARS per funeral than the Large firms.

346. There is some evidence that at least some of the Large firms are not operating as efficiently as they could. Internal documents from Co-op and Dignity demonstrate the firms’ awareness of their own inefficiencies, which is reflected in our analysis of staff costs.

347. Regardless of trends in pricing and cost, profits in excess of the cost of capital, and greater than the cost of providing the service (including a consideration of the cost of capital) are being earned by the majority of the Large firms in all five years of our analysis.

Annex A: Obtaining information from the fragmented market

1. While we have been able to use the ROCE method as detailed above for the Large firms within our analysis, we faced challenges in obtaining information from some smaller funeral director firms. In this section, we cover the issues faced and methods taken to obtain data from these funeral director firms.

Challenges in obtaining data from smaller firms

2. Throughout this investigation we have come across many challenges in obtaining information from smaller funeral directors. Parties have raised questions as to how we obtained information from these smaller firms, and how we compared their results to the larger players in the market.

3. Here we explain our approach to evidence gathering and analysis particularly related to these smaller funeral director firms. We focus on:

   (a) Obtaining information, including:

      (i) our initial approach to obtaining information;

      (ii) comments made by parties on our information gathering approach; and

      (iii) our revised approach to obtaining information.

   (b) Analysis of information, including:

      (i) Parties' views;

      (ii) our interpretation of the information received; and

      (iii) comparability metrics used in our analysis.

Obtaining information

Our initial approach to obtaining information

4. Firstly, we collated a representative sample of 100 funeral director branches, to whom we sent a reasonably detailed questionnaire. These questionnaires requested financial information on a branch-level basis comprising:

   (a) Profit and loss, covering information such as:

(i) revenue split between (i) revenue comprised from funeral director services and (ii) disbursement revenue; and

(ii) costs broken down into key categories: cost of goods; overheads (rent, staff costs, vehicles, business rates, other); amortisation; and, depreciation.

(b) Balance sheet, as per our financial template, to allow for comparison across the parties. Key balances requested were: intangible assets; tangible assets; inventories; debtors; cash; other current assets; creditors due within one year; other current liabilities; long-term liabilities; capital and reserves.

(c) Asset registers categorising assets as (i) properties, (ii) vehicles, (iii) other, split between:

(i) owned;

(ii) finance leased; and

(iii) operating leased.

5. Despite attempts to assist companies in interpreting how to respond given their specific circumstances (including telephone conversations and additional written guidance), we received relatively few responses, often of poor quality.

6. We found that parties struggled to identify meaningful balance sheet data. Some of the key issues they faced included the following:

(a) Parties were unable to split assets by branch due to holding records at a total level, where the firm operated more than one branch;

(b) Parties could not provide information on key assets, such as properties, because these were owned by an individual (ie the funeral director themselves) and 'leased' to the company free of charge;

(c) Many firms did not maintain detailed asset register information and therefore could not provide the information at the level of the detail requested;

(d) Limited asset information was available from sole traders due to more limited record-keeping requirements.

7. Where we did receive balance sheet information from funeral directors, the cross-checks we carried out indicated that in some cases there were

inaccuracies in the way the information had been recorded and there was no way to address such inaccuracies.

8. We found one key issue with regards to profit and loss information, being that funeral directors were often not able to provide revenue figures that split out funeral director services from disbursements. Any estimates of percentage splits based on total revenue figures were their best guess.

Comments made by parties on our information gathering approach

9. In response to the financial questionnaire that we issued to smaller funeral directors, SAIF told us that 'most IFDs are simply not geared up to respond to such a detailed and forensic financial questionnaire' and noted that it considers 'that using such a financial model of research is highly inappropriate to SMEs across the plethora of IFDs.'

10. SAIF also queried the singular use of the profitability ratio model, noting that it is not easily applied across different models of funeral director firms.

11. In contrast, Dignity noted that 'the CMA has kept its financial requests to the Selected Branches *"*concise*"* and has asked for more limited information on capital employed in particular.' It said that 'given the crucial importance of understanding the independent sector, as it accounts for approximately 70% of the market overall, it appears inconsistent to not explore their financial performance in-depth.'

12. Dignity said that we 'should consider relevant information on the owner's personal earnings/dividends/assets used in the business if these are to be incorporated fully in the analysis, and on a comparable basis to the three larger corporate groups.'

13. Further, Dignity told us that it is its 'experience in acquiring smaller providers that cost items, in particular owner salary and appropriate overtime pay, must be included in the P&L to understand the economics of the business.'

14. Through discussions with funeral directors throughout our information gathering process, we noted that several of them were struggling to complete our information request. Further, we spoke with SAIF who highlighted a number of difficulties that their members were having with the questionnaire.

Our revised approach to obtaining information

15. In response to concerns raised and limited responses obtained in the first instance, we revised our approach to obtaining information from the smaller parties.

16. We spoke to SAIF to understand what difficulties companies were having with our information request and received other feedback from conversations with independent funeral directors who had responded to our questionnaire or who had attempted to respond. We then revised the questionnaires in the light of what these various parties told us. Key changes included:

    (i) requesting information at a company-level, rather than a branch-level;

    (ii) removing the requirement to split out disbursement revenue from revenue earned from funeral director services;[104]

    (iii) removing the need to provide asset registers and allowing balance sheets as submitted to Companies House to be provided, rather than requiring a specific template to be completed.

    (b) We issued the revised questionnaires using our powers under s174 of Enterprise Act 2002.

17. As a result, we achieved an increased response rate.

18. We still have some concerns around data quality, as set out below. We consider, however, that this is unavoidable given the nature of some of these businesses. It is clear, from the answers we received, that some of the smaller funeral directors still struggled to provide meaningful financial information, despite the relatively simple nature of the updated request we sent to them.

19. We believe that the information obtained is the best available bearing in mind their financial capabilities and constraints on their time.

20. While our request was initially sent to a representative sample, the limited number of responses received means that the sample can no longer be considered representative, but we believe the information obtained remains informative.

[104] All ATR figures presented in this paper therefore include disbursements.

Breakdown of requests sent and responses received

21. For clarity, here we detail the number of responses that we sent as well as the number of responses received, including explanations for any variances.

22. As part of our initial information gathering approach, we sampled 100 branches.

23. Of these 100 branches, we sent branch-level requests to 96 branches. Four branches did not receive a request because of issues such as closure, proprietor illness etc.

24. Of these 96 initial requests sent, we considered 15 to be of appropriate quality in order to be able to perform financial analysis.[105] In assessing the quality of the data available, we considered whether there was enough information available in order to perform our analysis. We did not exclude responses based on our perception of whether the information was correct (ie whether ATR was 'too high' or 'too low'). We have flagged any instances where we think there are inaccuracies in the notes to the corresponding results tables.

25. Of the remaining outstanding requests for information, we chose not to follow up on a small number as a result of extenuating circumstances such as firm closure (ie liquidation) or proprietor illness. Forty-seven of the outstanding firms received a follow-up request, requesting company-level information. Of the responses received, 31 were of sufficient quality for our financial analysis. Despite continued follow-up, we did not receive responses from the remaining firms.

26. Of the branch-level responses received, a number were from branches belonging to Other Large firms. As such, due to the extension of our analysis to analyse detailed financial information from these firms at a company-level as part of our Large firm analysis, we have not included these branches in our analysis of the Smaller firms in order to avoid double counting.

27. In total, we analysed:

(a) 15 branch-level responses; and

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[105] This does not include responses received from branches belonging to Other Large firms as discussed at paragraph 26.

(b) 31 company-level responses.

Analysis of information

28. In analysing the information that we obtained from the parties, we considered points raised by parties with regards to how information may be interpreted, as well as the quality and detail of the information itself. In this section we discuss: (a) points raised by parties with regards to how we may interpret the information; (b) how we interpreted the information; (c) thefinancial metrics that we believe to be most appropriate in comparing the results of the smaller funeral directors to those of the larger firms, and (d) tests applied to the underlying data to assess its reliability.

Parties' views

29. Below, we detail points raised by parties with regards to our analysis of smaller funeral director firms followed by our consideration of the points they raised.

- *Points raised by parties*

30. Funeral Partners said that 'very local level criteria will play into any findings' for the independents as 'the CMA's profitability analysis will take place at the branch level (rather than at a provider level).' It said that 'the approach would be likely to miss elements of 'back office' costs for the businesses and thus distort profitability comparisons.'

31. In relation to a large amount of the market being made up of smaller providers, Co-op told us that 'the robustness of the conclusions regarding any AEC will be dependent on the quality of evidence that is available on the profitability and the cost of capital of the independent providers.'

32. Co-op highlighted concerns around the stratification of our sample, noting that a range of dimensions will contribute to differences across the independent market, including points such as whether the funeral director is a new entrant or an established owner. It also referenced medium sized independent operators and noted that the representativeness of our sampling will be dependent 'on whether these regional scale players are adequately considered.'

33. Lastly, Co-op noted that 'local competitive conditions at the point in time the profitability is measured will also be an important driver of profitability.'

34. Dignity noted that ‘many of the independent providers are owner-operated.’ As such, Dignity said that we should ‘consider relevant information on the owner’s personal earnings/dividends/assets used in the business if these are to be incorporated fully in the analysis, and on a comparable basis to the three larger corporate groups.’

35. Similarly, Funeral Partners said that ‘within the independently owned part of the market, the full cost of ‘owners’’ inputs into businesses is typically not reflected in their financial performance and published results.’ It said that ‘owner managers of independently owned businesses tend to work extensively within their businesses without fully charging the costs of such input into the business, this resulting in a higher level of profitability being presented.’

36. Co-op also responded to our profitability working paper and told us that it is ‘concerned that excluding branches based on low ARF figures may have created confirmation bias in the CMA’s independent provider sample: the CMA has placed too little weight on data points that contradict its previously existing beliefs regarding the appropriate level of ARF.’ It continued that they ‘note that this confirmation bias could be significant if a large proportion of the 68 omitted branches (100 surveyed minus 32 presented) are excluded for having low ARF.’ Finally, Co-op stated that they ‘consider it important that the CMA discloses the exact reasons why the sample has reduced from 100 to 32 independent providers.’[106]

- *Our consideration of the points raised*

37. In terms of Funeral Partners’ point on the locality of the branch-level analysis and potential for ‘missed costs’ due to the apportioning of information for the purpose of providing branch rather than company-level data, we note that we revised our information requests to obtain company-level results from smaller funeral director firms, while also extending our analysis to obtain company-level information from more ‘larger’ firms.

38. Similarly, in terms of Co-op’s point on the inclusion of ‘regional scale players’, we have extended our analysis to cover this point by including the next ten largest firms by branch following the three largest firms, which means we now include results from a number of regional family-firms and regional co-operatives.

[106] Co-op response to funeral director profitability working paper, para 4.4

39. We recognise that many factors will contribute to differences across the sector such as being a new entrant or an established owner. The metrics used in our analysis (detailed further at paragraph 49 below) look to minimise these fluctuations as much as possible. However as further discussed in the results section of this appendix, we acknowledge that a number of factors related to revenues and costs will impact the results of all players in the market regardless of size, structure or location. Nevertheless, we observe that smaller firms have the capacity to earn EBITDARS per funeral in the range of that of the larger firms.

40. There is inevitable variation in the quality of the evidence obtained, which reflects the differences in the size and structure of the range of funeral directors who are active across the sector. We have, however, worked to obtain high-quality data and, based on the differing levels of detail we have been able to obtain, we have adjusted our metrics accordingly. We have excluded from our analysis any data which we consider to be entirely insufficient for the purposes of financial analysis. However, we believe that we have been able obtain sufficient data of appropriate quality to enable us to carry out profitability analysis which gives insight across the market.

41. The staff-cost issues raised with regards to owner-operated businesses have been a key consideration in our analysis of smaller funeral director firms. We note our approach to this in more detail at paragraph 46 below.

42. With regards to Co-op's concerns around confirmation bias, in presenting our results in this appendix we include the results of all firms for which we have obtained sufficiently detailed information in order to perform financial analysis. In the results tables we provide notes demonstrating where we are inclined to believe that there are data inaccuracies resulting in unreliable results. We have provided more detail as to the exact breakdown of the number of responses we received at paragraph 21.

How we have analysed the information received

43. In reviewing the information obtained from these Smaller funeral director firms, we noted some points of consideration with regards to our analysis and comparisons across the wider group of companies which we analysed. The two key points considered were (a) any limitations to the balance sheet information obtained, and (b) the reliability of salary cost information provided with regards to actual costs to organise a funeral.

44. Each of these two points is considered in turn below, followed by other more general data reliability issues we came across.

- *Comprehensive nature of balance sheet information*

45. While the balance sheets provided were useful in providing insight into the smaller providers in the funeral director market, the balance sheets were not detailed enough to calculate meaningful capital employed figures to allow for comprehensive ROCE analysis to be performed.

- *Salary costs*

46. As raised by parties and outlined the narrative above, we recognise that that smaller funeral director firms may not incur salary costs reflective of the work being undertaken by staff, or owner-operators. The key element to this is remuneration being taken in the form of a dividend rather than as a salary.

47. Owner-operators are likely to take the majority of their remuneration as a dividend or drawings as opposed to as a salary. By doing so, the cost to the business of the person's contribution is not reflected in the profit and loss. Thus, profitability will appear higher where remuneration is taken as dividends or drawings rather than expensed through the profit and loss as a salary expense.

48. In performing our analysis, we have therefore used earnings before interest, tax, depreciation, amortisation, rent and staff costs (EBITDARS) in comparing the results of smaller and larger firms.

Financial metrics used in our analysis

49. With consideration of the difficulties of obtaining meaningful data from smaller funeral directors, when analysing the financial results, we have focused on the following key metrics:

(a) average revenue per funeral; and

(b) EBITDARS per funeral

50. These metrics focus on profit and loss results only.

- *Average revenue per funeral*

51. Average revenue per funeral is inclusive of disbursements and is a comparable metric across all parties. This takes the total revenue generated by the funeral director firm for the provision of funeral director services and divides it by the number of funerals performed in the same financial year.

- *EBITDARS per funeral*

52. We consider the earnings before interest, depreciation, amortisation, rent and staff costs (EBITDARS) to be most appropriate in making comparisons across the firms. This metric presents the operating performance of the companies regardless of capital and financial structure.

  - *Appropriateness of EBITDARS metric*

53. Dignity raised concerns with the EBITDARS metric. Dignity queried how we adjusted for rental costs where the owner manager owns the premises (eg uses their personal home as the branch) which they claim would create a distortion in comparison between those funeral directors owning their properties and those leasing a separate property.[107]

54. Dignity also queried any adjustments 'for the leasing costs of assets or facilities that are not the main property', for example 'a small operator that [uses] shared mortuary facilities in the absence of having their own premises.'[108]

55. We note that the EBITDARS metric is calculated as the earnings prior to rental costs or depreciation, thus it allows for comparison of the parties regardless of whether they own or rent their properties.

56. Further, the metric allows for comparison regardless of other non-operational factors such as rent and interest on lending. Further, the metric excludes amortisation and depreciation therefore the age of a firm's assets will be excluded from the comparison.

57. Perhaps most significantly, with regards to the nature of the Smaller funeral director firms, this metric allows comparison of the returns being made through funeral operations regardless of the means or amount of remuneration paid to staff.

58. Dignity questioned the robustness of the EBITDARS metric and the results it produces. It suggested that there is no apparent relationship between a firm's ATR and its EBITDARS and queried what types of expenses are removed to explain the variation and scale of the difference between ATR and EBITDARS. Dignity further suggested that there is no reliable relationship between EBITDARS and ATR over time and that this volatility should be considered in order to have confidence in the reliability of the

[107] Dignity response to funeral director profitability working paper, para. 3.13 (a)
[108] Dignity response to funeral director profitability working paper, para 3.13 (b)

underlying data and the metric itself. [109] We consider these points with regards to the metric and underlying data reliability next.

Data reliability

59. With consideration of the points raised by Dignity above with regards to the reliability of the underlying data in the context of the EBITDARS results, we performed a number of tests to assess the reliability of the underlying data.

60. Firstly, we performed a general review of the results and noted various instances where the data appeared unreliable. For example, there are some cases where average revenue appears unrealistic, in the region of £500 or £14,000 per funeral. The results of these seven firms are presented in the results tables and we have identified them in the notes to these tables as potentially having provided unreliable data. We have not included these results in the presentation of charts or in the narrative discussion of the Smaller firm results.

61. Next, we performed specific tests on the results to probe the reliability of the results as well as the EBITDARS metric itself to assess whether any additional firms should be identified as potentially having provided unreliable or inaccurate data.

(a) Firstly, we took the ATR of the firms and compared it to a notional disbursement figure of £1,300 (based on the average disbursement revenue of the Larger firms) to assess whether the resulting figure appeared credible to cover the cost of funeral director services. Based on this, we found that four firms presented figures lower than what we may initially expect.

(b) Next, we considered EBITDARS per funeral as a percentage of ATR. Dignity told us that its review of the results of this EBITDARS margin suggested that there is volatility across and within the firms.[110] We considered this argument that some Smaller firm results are not credible as the EBITDARS margin fluctuates across firms and over time. We recognise that the Smaller firms are more likely to experience fluctuation in their results year-on-year compared to the Larger firms, as a result of the volume of funerals that they undertake and the corresponding impact of product mix. Therefore, in considering the extent of fluctuation, we consider that it is appropriate to allow for an extent of fluctuation in the

[109] Dignity plc response to the CMA's Provisional Decision Report, Annex 1: Critical observations on the CMA's profitability analyses and customer detriment figures, para 2.28 to 2.30.
[110] Dignity plc response to the CMA's Provisional Decision Report, Annex 1: Critical observations on the CMA's profitability analyses and customer detriment figures, Figure 2 and para 2.30.

EBITDARS margin over time before considering the results to be potentially inaccurate or unreliable. We found that two firms demonstrated EBITDARS margins which fluctuate widely across the period, and one with a particularly high EBITDARS margin.

(c) Third, we considered the question of costs impacting the EBITDARS figure. We tested whether removing a notional staff cost figure from the EBITDARS figure would result in an improbably low level of income to cover remaining costs. We used a notional figure of £730, being at the lower end of our analysis of the staff costs of the Large firms. Applying this to the EBITDARS of the Smaller firms, we found that:

(i) Excluding those firms already marked as potentially presenting inaccurate data, 8 firms demonstrated results of less than £0 per funeral in at least one year in the period;

(ii) the range across the firms is wide, with some firms demonstrating small losses in one or two years of the period, and others demonstrating significant repeated losses of between £(150) and £(600).

62. We considered what these cross-checks meant for our interpretation of the results. We considered whether the data appeared anomalous or whether it simply represented firms operating on a different basis from the Larger firms, and whether the potential inaccuracies in the data risked distorting our results.

63. We noted that while it is possible firms presenting very low revenues may have supplied inaccurate information, it is also possible that they provided data exclusive of disbursement revenues (ie ARF rather than ATR). A similar explanation may account for the firm with a particularly high EBITDARS margin. We do not consider that this type of error gives a strong reason to believe that the rest of the financial information provided is likely to be unreliable. Indeed, to the extent that these figures are ARFs, this suggests that the Smaller firms have ATRs more similar to the Large firms on average.

64. With regards to low EBITDARS per funeral, the evidence that we have collected throughout the investigation suggests that some Smaller firms may operate with lower costs and/or be less profit oriented and may not incur the same level of property costs. As a result, low EBITDARS per funeral figures are not necessarily indicative of inaccurate data.

65. We do consider that significantly fluctuating EBITDARS margins are likely to be the result of inaccurate underlying data.

66. Thus, taking these factors into consideration, we identified three additional firms which are noted in the results tables as potentially having provided inaccurate data.

67. In considering the Smaller firm data, we also noted that in some cases it is not clear whether depreciation or amortisation costs have been included in the presentation of cost data by the firms. Where these costs have been erroneously included, we note that EBITDARS per funeral will be understated, meaning that these firms will in fact be earning returns higher than the data suggests. This is not the result of inaccuracy in the data provided, rather a lack of granularity. On balance, this suggests that our analysis may underestimate Smaller firm profitability.