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Introduction

The National Association of Funeral Directors is the largest and most inclusive trade association for the UK funeral profession. It represents the interests of the entire spectrum of funeral directing businesses – including independent and family owned firms, co-operatives and major funeral groups – and has more than 4,100 UK funeral homes in membership. Between them, NAFD member firms conduct the vast majority of UK funerals each year.

Comments on CMA's approach to consultation on this working paper

On 24 July 2019, the CMA published a working paper setting out its proposed approach to assessing the profitability within the funerals market. Such exercises are inevitably contentious, since accounting measures of profit do not correspond to the concept of profit that is of interest to the CMA.

In particular, the method for estimating the rate of capital employed (ROCE) and the weighted average cost of capital (WACC) are essential elements to get right, as the difference between these two metrics will impact whether there is deemed to be a competition problem in the market. If an unsuitable methodology is used to determine these elements, there could be serious negative consequences for the sector.

It is therefore essential that the CMA equips itself with the best possible understanding of all relevant factors. The only way to do this is to consult properly with all stakeholders, ensuring that they each have fair opportunity to reflect on the proposed approach and provide comments. We are concerned that, on this occasion, the CMA's approach to consultation has fallen significantly short of this.

The CMA's 40-page working paper is difficult to read and understand. It is very technical and would be confusing to anyone who does not at least have a foundational understanding of economic theory. It contains a great deal of economic terminology that would be completely alien to the majority of working funeral directors. This will have served to deter funeral directors from engaging with the consultation process.

Furthermore, it is simply not reasonable to expect funeral firms, the majority of which are small and medium size businesses, to make sense of such an impenetrable document and provide meaningful feedback, within a 2-week consultation period. This is particularly true when the consultation in question is announced during the summer holiday season, when many firms are operating with reduced staff. In these circumstances, the average working funeral director wouldn't have stood a chance.

If the CMA is serious about consulting meaningfully with the sector, we would urge it to publish a follow-up consultation paper before reaching a decision about its approach to assessing profitability. This document should out some targeted questions and explain, in plain English, why each question is being asked. In particular, we would suggest seeking views on each of the underlined sub-headings we have outlined in our response below.

Provided respondents are given reasonable time to respond, this will help ensure the CMA has the information it needs to determine a suitable approach to estimating profitability in the funerals market.

Early comments about the CMA's proposed approach

It is too early to reach definitive conclusions about all aspects of the CMA's proposed approach to measuring profitability in the funerals sector. For example, we will want to see exactly how the CMA has allocated costs between in-scope and out-of-scope activities and what decision it has made when determining the level of capital employed.

While NAFD will reserve its final position until such information is available, there are some particular areas in which we feel we can provide a helpful early view.

Factors which may distort point-in-time estimates of the return of capital employed (ROCE)

There are a number of "life-cycle" issues that may distort estimates of ROCE, or suggest that a direct comparison with the weighted average cost of capital (WACC) is not valid in assessing the strength of competition in the sector.

Limitations of restricting the study to a 5-year time period

The working paper gives some recognition of asset life cycles in respect of new purchases, which implies that ROCE may be momentarily low in the beginning. However, this might be true more generally, in that there may be a life cycle to ROCE whereby there are losses early on and then positive returns later, such that over the life cycle returns are equal to the WACC. Established firms with mature asset bases may now be in the 'later part' of the life cycle with relatively high ROCE, but would have experienced low returns in the past. Therefore, 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.

Possible survivorship bias

The underlying premise of the CMA's assessment is to compare market average WACC with the ROCE. However, 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. Remaining firms might be earning above-WACC ROCE now, but the average for investors across the industry at the time when other firms were going bankrupt was only the WACC. If a sizeable share of firms goes bankrupt during a period, then just looking at the returns of surviving firms will overstate the returns available from investing in the sector, such that comparing ROCE with WACC will not give an informed picture of competition.

Impact of pre-paid funeral plan sales

The role of pre-paid plans could affect the implications of ROCE estimates. E.g. How widespread are the use of pre-paid plans in the sector? Has there been a significant expansion in their take-up and/or the number of funeral and cremations that were pre-paid? Is the answer likely to be materially different for the large companies and the smaller ones? The CMA's proposed methodology pays relatively little attention to this issue, on the basis that the sale of such plans is out of scope. Nevertheless, it may be possible that the estimated ROCE will be sensitive to how these plans are accounted for in the calculations.

There might also be a "survivorship bias" impact with regard to funeral plans – firms innovated by offering such schemes and the competitive process should be expected to reward such successful innovations with higher returns, given there will be other ideas that proved less successful. It may be that such returns are now visible in these firms' data, making their ROCE estimates seem higher than they should be (higher than the industry average WACC).

Questions and comments about estimating the weighted average cost of capital (WACC)

The use of data on a single firm to calculate the WACC for a very diverse industry

The working paper envisages using the WACC as a reference when assessing whether the returns on capital employed are excessive. We note that the CMA plans to use data on one publicly traded funeral business to estimate the beta [see para 74a-e]. The CMA mentions potentially adjusting the beta to take account of this firms activities as a provider of both crematoria and funder director services. However, there may be other ways in which this firm is different to other firms.

There could be various reasons why smaller, privately-owned funeral providers might differ in risk profile compared to a large publicly traded company. Such an approach could understate the WACC faced by smaller funeral providers and across the market as a whole. For example, an investor in a smaller funeral provider may face additional risks because: (i) smaller provider revenues would be less diversified in terms of the products and geographic markets served; (ii) smaller providers would face greater key-person risk; and (iii) an interest in a privately-held company may be less easy to trade than an interest in a publicly-traded company. These may be reflected in a small company premium to be added to the WACC.

Had we been given more time to consider our response we would have canvassed members' views on whether there are any other reasons why the firm in question's business model might be atypically low-risk. In particular, we feel it is important that the reasons behind the firm's decision to float are properly understood. It is possible, for example, that the firm has a different risk profile that makes floating more viable.

<u>The use of International comparators</u>

We would also question the assumption that the UK funeral industry is typical of the US, Canada, Australia and Europe. It could well be that these comparators have lower systematic riskiness than the average UK firm. Again, with additional time to respond we would have liked to consult with our members, both in the UK and overseas, to understand the differences and similarities between the UK and the identified overseas markets.

<u>The assumption that debt is of investment grade</u>

The working paper explains that the CMA's intention is to assume that debt is investment grade. The basis on which this assumption is made is unclear and we would question how typical this is of the sector, and particularly of smaller firms?

On the use of margin benchmarking (para 162ff), had we had additional time to respond we would have sought NAFD members views on what sectors might provide relevant comparators.

It is unclear from the working paper how the CMA proposes to proceed when thinking about the cost of debt if the comparator firms reveal costs of debt that are markedly different to each other. For example, will the cost of the most expensive, the cheapest, or an average be used?

Factors which may affect the assessment of inefficiencies

The CMA's proposed approach relies on the assumption that findings of low profitability may indicate inefficiency. However, given the nature of the funerals market, all providers will inevitably be inefficient at some points. This is merely a reflection of the commercial reality that the funeral industry is inherently uncertain, due to the impact of market death rate fluctuations. The effectiveness of the CMA's assessment of efficiency in the market will necessarily be undermined by this factor.

The analysis of inefficiencies [e.g. paras 76ff and 126ff] does not appear to recognise the possible implications of very different business models between firms. There is a question as to whether the shares *of* inputs used by different companies vary significantly (depending on different business models), such that looking at what one company pays for its inputs and how many it uses will tell you very little about what another firm should do.

If the CMA compares the costs of different inputs in isolation across a range of very different business models (and does not consider the mix of such inputs), it may conclude that some firms have inefficiently high costs for some inputs, and other firms have inefficiently high costs for other inputs, not recognising that if there are economies of scale in the purchasing of certain inputs then the costs for each company will be influenced by the shares of inputs they use.

A key example here might be differences between vertically integrated and non-vertically integrated firms. A non-vertically integrated firm may specialise in certain aspects of funeral care and achieve economies of scale in some inputs, but have higher costs in other areas (e.g. coffin purchases). A vertically-integrated firm may pay lower costs for some inputs e.g. those it provides itself like coffins, where it is able to achieve economies of scale through its wider coffin making business, but may more for other inputs for parts of its business which are smaller.

There is also a question of whether utilisation rates are a reasonable measure of efficiency [e.g. para 82]. There may be reasons why some firms in the sector have lower utilisation rates than others, for example due to conscious decisions regarding service quality. Some firms may place a greater premium on being able to accommodate almost any calendar request from clients and/or their staff not being rushed/late; other firms may require excess capacity for fluctuations in demand given their location.

Had we been given more time to respond, we would have surveyed our members to understand whether any deliberately 'under-utilise' their resources so as to be able to provide a better, more flexible service.

The analysis of inefficiencies also does not seem to recognise the possibility that there could be other sources of inefficiency that are relevant here, such as (in the crematoria market) local authorities could have inefficiencies that arise from their public sector nature.

Concern about proposed sample size

We note that the CMA is proposing to target a sample of 100 selected branches to assess profitability, stating that it considers this is likely to be a large enough sample to draw robust inferences, while remaining manageable in terms of stakeholder management and analysing responses. However, it is unclear how the CMA has arrived at this decision.

We are concerned that a sample of just 100 branches (only 2% of the total being represented[1]) may not be large enough to ensure it is representative of the market as a whole. The NAFD has not had time to consider what it believes a suitable sample size might be but would welcome a clearer explanation on how this figure was arrived at.

Relation to the theories of harm

One over-arching observation we would make about the CMA's proposed approach relates to how the exercise relates to its theories of harm. First, it is looking at profits for

[1] The CMA estimates that there are 7000 funeral branches in the UK. According to NAFD data, the total number of branches operated by the Co-operative Group, Dignity plc and Funeral Partners ltd is 2002. This indicates that the total number of branches intended to be represented by the 100 firm sample is 4994.

companies operating nationally. But if the geographic market is national, the level of concentration is very low. The CMA's proposal to focus on the profits of branches rather than firms when looking at smaller companies may make sense in this regard. But then the question arises as to how the CMA will interpret the results if and when there are significant variations. Would this be interpreted as meaning that competition is functioning well in some regions but not others? Or could it mean that competition works fine generally, but it is a process and at any point in time there will be some regions where the incumbents are very profitable?

In the case of cremation services, the exercise is complicated by the actions of different local authorities. Their actions (or inaction) may determine whether the large operators are able to make excessive profits in this sector. It is important that the CMA does not seek to use evidence that local authorities are generating excessive returns from cremation services to impose remedies on private-sector operators in this sector.

Future analysis from the NAFD

There are details of the CMA's proposed approach which will only become apparent once estimates and analysis have been produced. The NAFD is likely to wish to comment further as the process progresses.

National Association of Funeral Directors
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