Europe Economics

Analysis of aspects of the CMA's provisional decision

September 2020

Europe Economics
Chancery House
53-64 Chancery Lane
London WC2A 1QU

Tel: (+44) (0) 20 7831 4717
Fax: (+44) (0) 20 7831 4515

www.europe-economics.com

Contents

1 Introduction

This document sets out Europe Economics' analysis of certain aspects of the CMA's provisional decision in the funeral directors market. We first analyse the CMA's calculation of consumer detriment – this section of the paper is intended to accompany the NAFD's response as a standalone annex.

We then provide points of analysis for other aspects of the decision, as requested by the NAFD. These are intended to be incorporated into the NAFD's response.

2 Analysis of Consumer Detriment

2.1 Introduction

Europe Economics has been asked by the NAFD to analyse the CMA's estimation of consumer detriment quoted in its provisional decision paper, and explained in more detail in Appendix V: Calculation of detriment.[1] The CMA estimated that for the sample of Large funeral directors, comprising 42 per cent of the market, the detriment arising in the form of economic profits is approximately £402 on average per funeral. This was calculated by taking the average annual economic profits across 13 Large firms (£90.5 million, including losses for three of these firms) and dividing this by the average annual number of funerals these 13 firms were responsible for.[2]

The CMA further states that as its profitability analysis indicates that a number of Small firms are "likely to be earning economic profits similar to those of The Large firms", a "proportion of customers of the remaining 58 per cent of the market are likely to have been overpaying for each funeral to a similar extent to those of The Large firms."[3]

The CMA therefore concludes that the average consumer detriment across the market is at estimated to be at least £400 per funeral, with further reasons why this figure is likely to be an underestimate.

We consider there to be a number of reasons why this detriment figure of £400 per funeral across the market is an inaccurate representation of the market. In summary:

- We have concerns with the estimation of economic profits for the Large firms and the conclusions drawn around the profitability and detriment caused by these Large firms.
- Further, there are plausible reasons why the profitability of the Large firms would be higher than that of Small firms (and clear reasons why it is implausible to expect these to be the same), such that it is unreasonable to apply the detriment figure calculated for the Large firms to the remaining 58 per cent of the market.
- Applying this figure across the whole of the market takes no account of the distribution of funerals across different providers, such that a median detriment figure may be significantly lower than an average figure.

2.2 Concerns with the estimation of economic profits

The CMA's profitability analysis for the 13 Large firms feeds directly into its estimation of consumer detriment. We have concerns with aspects of this analysis, and therefore with the estimated detriment figure.

The value of intangible assets

The CMA in its profitability analysis did not take into account much of the Large firms' representations about the role of intangible assets – namely goodwill, reputation and software – in their profit and loss figures. The CMA concluded that the examples of these assets did not satisfy its criteria for being recognised for the purposes of profitability analysis, namely that:

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

---

[1] CMA Funeral Market Investigation Provisional Report, Appendix V: Consumer Detriment (2020) online

[2] Appendix V does not set out the exact number of funerals that forms the denominator of this calculation, or the data source for this figure. We assume that the average number of funerals undertaken by the 13 Large firms over the period is the figure that was used.

[3] Appendix V, pV1.

b) This cost must be additional to costs necessarily incurred at the time in running the business.

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

However, there are credible reasons why the existence of intangible assets can legitimately enable a Large firm to earn profits regardless of how these have been incurred. Reputation in particular is likely to be a very important intangible asset in this market. Given the infrequent nature of the purchases there are few opportunities for customers to 'learn' from buying funerals and thus to better judge the quality and price of the funeral director they visit. This, combined with the inability to fully judge the quality of the funeral before it has taken place, means that customers will place a greater weight on the recommendations of friends and families than in other markets. Indeed, the CMA found that customers tend to rely on familiarity and personal recommendations when choosing funeral directors.[4] Consumers want to be assured that their loved one will receive a dignified funeral which will run smoothly and in accordance with their wishes. Therefore, the role of reputation in this market is important, and funeral directors will want to be known for the quality of their service and that they are a 'safe pair of hands'.

Reputation can be built up through dedicated expenditure, for example a firm may have incurred costs in building its reputation in the past, and is now recovering the profits from this expenditure. Reputation can also be built on higher skills and greater levels of competence, all contributing to a better quality of service, for which consumers are willing to pay a higher price. The value of a brand across multiple branches can therefore be significant.

The disallowance of costs related to brand and reputation building can certainly be legitimate in the case where a firm is a monopoly, where this expenditure contributes in part to the generation of excess profits. In these situations regulators are right to be wary of special pleading. However, in the context of this market investigation the CMA's position is not that these Large firms are monopolies.[5] We do not consider reputation to be driving market power, but rather that reputation is legitimately driven by the quality assurance process. Therefore, we consider that allowing some consideration of the role of reputation in driving economic profits is legitimate and that the resulting average profits for the 13 Large firms should not automatically be assumed to be evidence of consumer detriment.

Losses sustained

We also note that three of the 13 Large firms make losses over the period 2014 – 2018, either across the whole period or for a number of years. The CMA addressed this by simply netting off the losses from the other firms' economic profits to arrive at an annual average profit figure for the sample. However, this fails to recognise the significance of the implications of there being Large loss-making firms in the sector.

That 3 of the 13 firms considered made losses over an extended period (2014-2018) has implications for the treatment of the net cashflows the CMA identifies, in determining their value. The CMA's approach treats all losses and profits as if they were fully diversifiable in any one year. However, the presence of losses for an extended period, even when the economy was growing (as it did from 2014-2018) – and for a non-trivial share of the firms considered – suggests that firms may go through extended cycles of profit and loss. This would imply that firms making economic profits now are not necessarily doing so due to market power, and undermines the CMA's use of a simple average of net profits as a basis for its consumer detriment calculation.

4 CMA Funeral Market Investigation Provisional Report, p393.

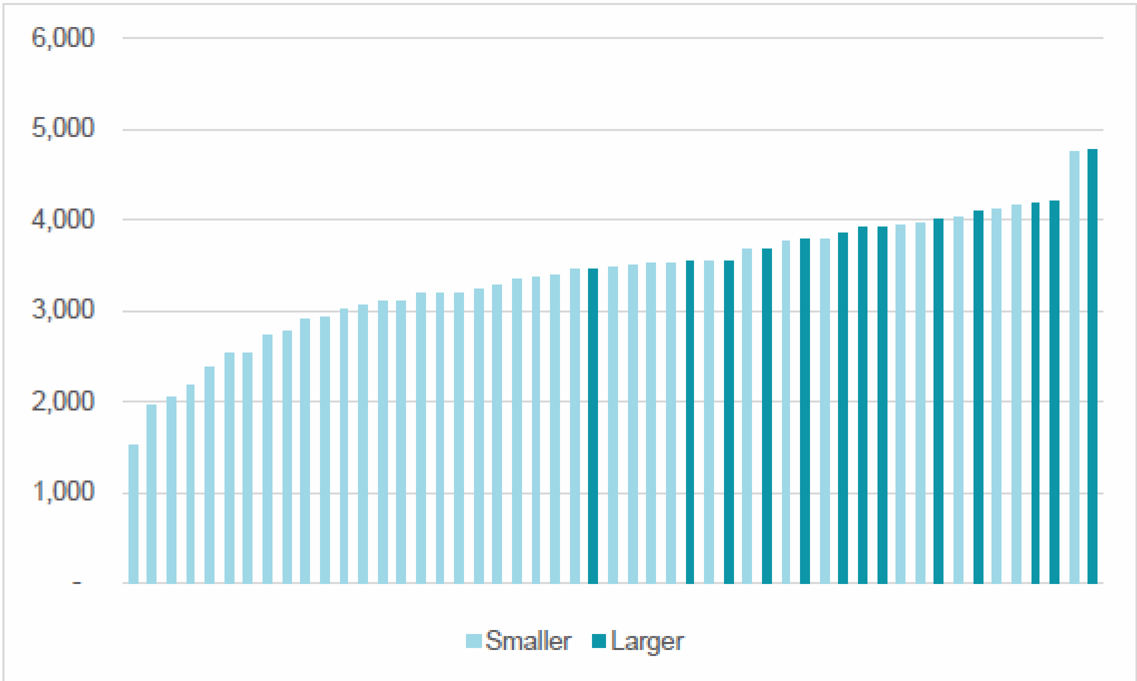
5 That the 13 firms account for only 42 per cent of the market between them is one clear sign that we are not dealing with monopolies. Indeed, we consider the use of the term "Large" somewhat misleading as it may imply a degree of monopoly power to the reader, when in fact it is simply how the CMA has grouped certain firms within the sample.

2.3 Implausibility of Small and Large firms having the same scale of profits

Even setting aside concerns over the validity of the CMA's estimated detriment figure of £400 per funeral for the Large firms, there are clear problems with the further use of this figure. The CMA's extrapolation of the detriment figure to the rest of the market appears to be a significant overstatement of the total likely detriment in the market. The 13 Large firms account for less than half of the market, and the CMA's assumption (in the absence of convincing evidence) that the approximate 60 per cent of the rest of the market is earning the same levels of economic profit is simplistic and misleading.

This is particularly the case as the CMA's analysis of average total revenues of the Small firms does not provide evidence of economic profits across the remaining 60 per cent of the market. For example, the chart below shows that 24 of the 38 Small firms in the sample (63 per cent) had average total revenues over the period which are lower than the lowest Large firm's ATR. This includes the three Large firms making sustained losses.

Figure 1: Weighted average ATR from 2014 to 2018 split between the Smaller and the Large firms



Source: CMA "Funeral Market Investigation Provisional Report, Appendix S pS49.

Whilst the CMA considers its analysis of EBITDARs shows that *some* Small firms in the sample could be capable of making economic returns on the same scale at the Large firms, this can by no means be extrapolated to the rest of the Small market segment (the Small sample being around 46 firms out of a population of thousands).

There has also already been much feedback from the industry on the inappropriate use of average total revenue as a profitability metric, as this includes disbursements which are often substantial and does not take into account funeral prices driven by consumer preferences. However, the CMA continues to use ATR as a key profitability metric in its analysis of Small firms, which we consider to be poor evidence.

The absence of evidence of excess profitability among the Small firms highlights the weakness of the CMA's assumption that the economic profits and thus consumer detriment applicable to Large firms applies to Small firms. There are clear counterarguments for assuming the opposite, that Small firms are likely to make significantly lower economic returns.

The value of intangible assets

As discussed previously, the value of reputation is likely to be significant in the funeral sector. There are a number of reasons why Large firms may be better able to generate a good reputation for which consumers are willing to pay, such as having access to high quality skills and processes or investing in branding and high quality service. It is also possible that a degree of "survivorship bias" is at play, such that firms have been able to grow and become "Large" partly due to their quality and good reputation.

This is not to say that Large firms provide better quality across the board compared to Small firms – it is obvious that Small firms can have high levels of quality and strong reputations too. But on average a consumer may not be able to judge between a number of small firms who, to the outside observer, may all look very similar, even though some may be high quality and some poor quality. Such a consumer may prefer to choose a Large firm with a good reputation to ensure a certain level of quality in the funeral they are purchasing.

Therefore, Large firms who have built up a reputation over time and across many regions may be able to make higher profits than the average Small firm as consumers are willing to pay more for a perceived higher quality.

The acknowledgement of economic return

Another reason why the economic profits of Large firms are likely to be greater than the Small firms is that the CMA's analysis for the Large firms explicitly takes into account an allowance for economic return (the WACC of 8 per cent). However, for the myriad Small firms making up the majority of the market, it is highly likely that a large number are "lifestyle" businesses, i.e. a local, family-run business with a sole owner-manager where accounting profits are split between the owner's salary and, possibly, reinvestment. Thus "profits" are unlikely to be economic profits, as they would include the owner-manager's salary and not necessarily account for a return on investment.

In addition, owner-managers of lifestyle businesses may have no concept of an economic return as a target, and clearly no shareholders or Board to answer to. They are likely to be content with just a salary and non-financial returns (such as a position in the community, or the maintenance of a family business), such that any profits are likely to be very small indeed.

In the absence of convincing evidence to the contrary – particularly for a larger proportion of the market – it is an entirely plausible assumption that a sizeable proportion of funeral directors are making very small, if not negligible, economic profits. To conclude that consumers are facing on average a detriment of £400 per funeral across the market is thus a significant exaggeration.

Costs facing Small firms

Small firms are also likely to face relatively higher costs than larger firms, meaning that the ability to earn economic profits is reduced. Obvious examples include the cost of debt and economies of scale.

The size of debt a Small firm might incur compared to a Large firm could be orders of magnitude smaller. For example a Small firm may take a loan of £10,000 to build new refrigeration facilities or update a fleet of vehicles, whilst a Large firm may raise hundreds of thousands of pounds in debt to refurbish all its branches across a whole region. The relative costs of this debt are likely to be very different. This further underlines the rationale that Large firms are able to be more profitable than Small ones.

Similarly, Large firms may be better able to exploit economies of scale in their business operations and also in their purchasing of or contracting for disbursements. The average total revenue figures used by the CMA to compare profitability between Large and Small firms include disbursements. Therefore, the extent to which Large firms are able to negotiate lower disbursement costs, together with other economies of scale, means these firms are able to earn higher profits from even similar average total revenues.

Finally, we note again that 3 of the 13 Large firms have made sustained losses over the period. How much more likely is it that a greater proportion of smaller firms are also making losses, particularly regarding the points made above.

2.4 Distribution of funerals and providers

In comparing the average total revenue per funeral (which includes disbursements) and EBITDAR between Small and Large firms, the CMA found more than 60 per cent of the Small firms sampled earned revenues lower than the lowest Large firm (see Figure 1 above).[6] There is also great variation in EBITDARs across Small firms with many below the range of the Large firms. Finally, the sample of Small firms studied by the CMA is only a fraction of the market – around 46 firms (and not all of these firms' data were considered sufficiently robust to be included in the analysis). There is therefore likely to be great variation in the profitability of this market segment.

As set out in the section above, it is probable that a large proportion of the Small firms are not making economic profits to the same extent as the sample of Large firms. Further, applying the £400 as an average detriment per funeral does not take into account the *number* of funerals provided by the firms towards the lower range of the "profitability" range. Given that Small firms account for 58 per cent of the market, and of these more than half are estimated to have lower average revenues than the lowest of the Large firms, it is highly likely that a median figure of detriment – i.e. a level of detriment facing the largest group of customers – would firstly be more appropriate and secondly be significantly lower than the estimated £400 per funeral.

The same point applies to the estimation of detriment using the 13 Large firms' data. Of these, 3 made sustained losses over the period. Accounting for the number of funerals these firms provided and estimating a median detriment figure across the Large sample could also result in a different figure.

6 CMA Funeral Market Investigation Provisional Report, Appendix S: Profitability Analysis, pS65.