Dignity PLC (DTY LN) **SELL** **December 9th, 2018**

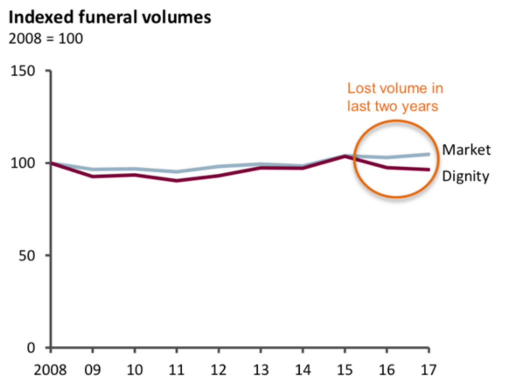
Recommendation and Investment Thesis

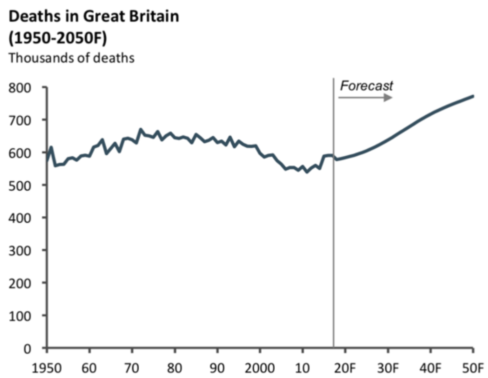
We have a SELL call on Dignity PLC (Dignity), as we feel the company is overpriced relative to its market capitalisation in the funeral services industry. Our call is based on the following negative catalysts:

- **Regulation:**
  - The Competitions and Markets Authority's (CMA) recent investigation into the funeral services industry has shown that over the last decade, industry prices have not been rising at par with inflation. The CMA suggests the current pricing strategy of the firms in this industry are not warranted, and therefore too high.
  - While the CMA could just demand greater pricing transparency, it is still unclear if further remedy requirements would be necessary, thus adding to the unpredictability. Consequently, Dignity's share price has declined significantly owing to the extent of uncertainty this investigation has created.
- **Pricing strategy and competition:**
  - In response to their main competitor, Co-op Funeralcare's price cuts in 2016, Dignity slashed its price of basic funerals by 25%, declaring that this would result in considerably lower profits in 2018F.
  - As such, the company expects its average revenue per funeral to be impacted, with 2018F average revenue projected to be 7.3% lower from 1Q18. Additionally, there has been a declining trend in its market share from funeral services (largest proportion of revenue – 68% as of 2017), from 12.0% in 1H16 to 11.5% in 1H17, to 11.4% in 1H18. This goes to show that the price war has not had a favourable impact on company performance.
  - Given its current cash flow and working capital performance, the unsustainable pricing policy has impacted the company's investment strategies, as shown by the halted acquisition activities.
- **Heavy capital expenditures towards its 'Transformation Plan':**
  - In order to regain market share, Dignity has conducted a 'Transformation Plan' that consists of 3 main points: to modernise the client proposition, simplify operating model, and streamline support to enable investment. For this plan, Dignity requires GBP 50 million of investment over 3 years that will be funded internally from cash and disposals.
  - We believe that the three-year, internally funded investment would not be significant, given that the management expects only an additional GBP 8 million gain towards EBIT in 2021F and long-term gains of GBP 13 million. We have not included these gains in our forecasts in the financial model, considering the uncertainty of the CMA regulation and the ongoing price war. However, as shown below, this investment will only boost its share price (from our target price) by 9%, but it is still overvalued relative to its market capitalisation by 20%.

	With investment			Without investment			Difference		
	2021F	2022F	2023F	2021F	2022F	2023F	2021F	2022F	2023F
EBIT (GBP Mn)	110.1	117.3	128.6	102.1	110.8	122.1	8%	6%	5%
Net Income (GBP Mn)	58.2	64.3	73.6	51.7	59.0	68.3	13%	9%	8%
Share Price (GBX)	595.2			547.8			9%		

Business Description and Industry Analysis





Source: Company Presentation

Dignity operates through three reportable segments namely Funeral Services, Crematoria, and Pre-arranged Funeral Plans. As shown above, Dignity is struggling in the industry through its declining market share and the number of deaths in the UK (one of the company's value drivers) will only surpass its previous high by 2030-2040F. With operations in the UK, Dignity possess a market share of 11.5% and 10.7& in the funeral services and crematoria market, respectively. The company offers its services through a network of 826 funeral locations and 45 crematoria in the UK.

The funeral and cemetery industry is characterized by a large number of locally-owned and independent operators. Factors such as changes in customer order patterns, changing incentive programs and competitors' new products and services could impact the company's competitiveness. However, the increasing use of internet and digitalisation of services represent key opportunities for Dignity.

Valuation

That said, our SELL call on Dignity is complemented with a target price of 547.8 GBX (26% downside), implying 2018F P/E ratio of 13.0x and 2019F P/E ratio of 13.6x. We derive our valuation using a DCF-based approach, given the company's relatively stable business.

Going forward, we expect no near-term positive catalysts for Dignity, primarily driven by the CMA investigation and the ongoing price war. Additionally, the company will be spending heavily on capital expenditures over the next three years. However, as mentioned above, we have not included this gain in our financial model, considering the uncertainty of the CMA regulation and the ongoing price war. Despite this, this investment will have minimal impact towards its EBIT and net income. In line with this, we feel the company will struggle with the cash it spends on capital expenditures vs its cash from operations, resulting in reduced free cash flow for the next three years.

DCF	2017	2018F	2019F	2020F	2021F	2022F	2023F
(GBP Mn) except per share items							
EBIT (1-Tax)	84.9	77.9	75.8	78.1	82.7	89.8	98.9
(+) D&A	17.1	19.1	21.1	23.0	24.2	25.4	26.6
(-) Changes in Non-Cash Working Capital	(0.6)	7.3	(3.5)	0.1	1.7	(0.1)	1.2
(-) Capex	(23.9)	(41.7)	(41.7)	(41.7)	(25.0)	(25.0)	(25.0)
FCFF	77.5	62.5	51.7	59.5	83.6	90.1	101.7
Discounted Free Cash Flow		**58.4**	**45.1**	**48.6**	**63.8**	**64.3**	**67.8**

Total Discounted FCFF	**348.1**	**Assumptions**	
Terminal Multiple	16.9	Risk Free Rate	1.3%
Terminal EV	1,145.1	Market Premium	12.1%
Discounted Terminal EV	**763.7**	Beta	1.7
Net Debt (Cash)	514.8	Debt Interest Rate	6.0%
		Debt Proportion	87.6%
NAV (Equity Value)	**597.1**	Tax Rate	18.0%
Shares Outstanding (Mn)	1.1	Equity Proportion	12.4%
		Equity Cost of Capital	21.6%
Target Price per Share (GBX)	**547.8**	Debt Cost of Capital After Tax	4.9%
Upside/Downside	-26%	Long Term Growth Rate	1.0%
Current Price per share (GBX) (8/12/18)	742.0	**WACC**	**7.0%**

	WACC					
Long-Term Growth Rate		5.0%	6.0%	**7.0%**	8.0%	9.0%
	0.50%	1,030.2	705.4	490.5	332.7	218.3
	0.75%	1,101.5	747.9	518.0	351.1	231.1
	1.00%	1,181.7	794.7	**547.8**	370.8	244.8
	1.25%	1,272.7	846.5	580.1	392.0	259.4
	1.50%	1,376.6	903.9	615.4	414.8	275.0

	BEAR	BASE	BULL
WACC	6.0%	7.0%	8.0%
Long-Term Growth Rate	0.5%	1.0%	1.5%
Target Price (GBX)	**903.9**	**547.8**	**332.7**
Upside/Downside	22%	-26%	-55%
Current Price (GBX)	742.0		

- Our **bull** case assumes: ongoing price wars, delay in 'Transformation Plan' and outcome of CMA regulation forces the industry to lower prices, resulting in 0.5% growth rate and 8.0% WACC (due to higher business risk).
- Our **bear** case assumes: less severe regulation, no further price cuts and successful 'Transformation Plan', resulting in 1.5% growth rate and 6.0% WACC (due to lower business risk).

Investment Risks

- A less-severe CMA investigation outcome could mean that there will be no further price cuts for Dignity's pricing model
- Transformation plan comes into effect within the expected timeline and delivers the expected turnaround for the business
- Better-than-expected crematoria segment performance would help Dignity to keep its earnings performance on track in the short-run