STANDARD & POOR'S

STRUCTURED FINANCE

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Transaction Update

Dignity Finance PLC

£210 Million Secured Fixed-Rate Notes

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Class	Credit rating	Current amount (Mil. £)	Closing amount (Mil. £)	Interest rate (%)	Final maturity
A	A	107	110	6.31	Dec. 31, 2023
B	BBB	100	100	8.15	Dec. 31, 2031

Transaction Features	
Collateral	A portfolio of 512 funeral homes and 22 crematoria owned and managed by the borrower.
Borrower	Dignity (2002) Ltd.
Obligors	Dignity (2002) Ltd., Dignity Services Ltd., Dignity Securities Ltd., Plantsbrook Group Ltd., Birkbeck Securities Ltd., Dignity Funerals Ltd., Dignity Pre-Arrangement Ltd., and Advance Planning Ltd.
Guarantors	The obligors, Dignity PLC, Dignity (2004) Ltd., Dignity Holdings No. 2 Ltd., Dignity Holdings Ltd., and Dignity Mezzco Ltd.
Underwriter	JP Morgan Securities Ltd.
Liquidity facility provider	The Royal Bank of Scotland PLC
Account bank and swap counterparty	JPMorganChase Bank
Security trustee and issuer trustee	JPMorgan Corporate Trustee Services Ltd.
Working capital facility provider	Lloyds TSB Bank PLC

Supporting Ratings	
Institution/role	Ratings
The Royal Bank of Scotland PLC as liquidity facility provider	AA/Stable/A-1+
JPMorganChase Bank as account bank	AA-/Stable/A-1+

Transaction Summary

This transaction update follows a review of the Dignity Finance PLC transaction. The review concludes that no rating action is required on the ratings on the notes.

Dignity Finance PLC, which closed in April 2003, is a corporate securitization backed by operating cash flows generated by the borrower in the transaction, Dignity (2002) Ltd., as the primary source of repayment of an underlying secured loan. The ultimate parent of the borrower is Dignity PLC (Dignity), the second-largest provider of funeral services in the U.K. market, with operations in three main areas: funeral services (80% of revenues), crematoria (16%), and pre-arranged funeral plans (4%). Dignity conducted 67,800 funerals in the year to June 2004, and is the largest independent operator of crematoria in the U.K., conducting 38,500 cremations over the same period. The company has 512 funeral homes and 22 crematoria located throughout the U.K.

In April 2004, Dignity undertook an IPO on the London Stock Exchange. The listing raised a net amount of £115 million, which was primarily used to repay expensive group level debt, being a £40 million mezzanine loan and £63 million of loan notes from previous equity interests. The securitization debt now remains the only external debt within the capital structure, and equity is held by a variety of institutional shareholders, with no one prevailing interest.

Surveillance Analysis

Transaction performance is governed by receipts generated from the provision of funeral services, cremation services, and pre-arranged funeral plans. There have been no changes to the credit ratings to date, but as in other corporate securitizations, the future variability of the ratings on the notes depends, among other things, on the performance of the underlying operating assets and business risk of the obligors, which may change over time. In this particular transaction, the ratings continue to reflect the facts that:

- The business risk profile is driven by Dignity's strong U.K. market position, the stable nature of the business, and a solid track record in terms of funeral service provision. These fundamentals could be somewhat offset by possible profit margin pressure, should funeral price increases be proportionately lower than cost increases, together with the modest entry barriers in the long term in the funeral home market.
- The underlying cash flow continues to be strong and has demonstrated growth since closing.

- The initial LTV ratio at 77%, based on an open-market valuation of £273 million, has not materially changed in light of limited net acquisition activity, principal amortization, and variation in this market value.
- The credit, security, and covenant package in the transaction structure is supportive. Key structural features include an undrawn dedicated liquidity facility provided by the Royal Bank of Scotland PLC (AA/Stable/A-1+) amounting to £30 million (or approximately 15% of the outstanding debt); an elective capex (capital expenditure) reserve funded with £11 million as of June 2004; a strengthened equity position of the parent group following the IPO, funds from which were used to repay existing indebtedness to an amount equivalent to 55% of outstanding debt; financial and operational covenants; and information requirements.
- The strong management team, which undertook the securitization, remains in place post the IPO and has been active in the U.K. funeral market since the early 1990s.

Operating performance since close has been strong. EBITDA rose 17% in the year to June 2004 to £43 million. This took place in an environment of a short-term fall in recorded death rates: total recorded deaths in the first six months of the year were 295,800, 3.6% lower than the comparable period in 2003 and a further 2.0% fall from the 2003 year-end figure. Reduced volumes in funeral services and cremations led to a slowdown in revenues from historical rates, but cost efficiencies and flexibility in managing pricing growth ensured an improving margin performance. EBITDA DSCR remains healthy at 2.5x.

Fluctuations in the death rate are expected to naturally self-correct and the longer-term perspective on the death rate remains unchanged. With high levels of repeat business through recommendations, cost efficiencies, and strong levels of free cash flow to finance future acquisitions, the outlook remains stable, although potentially subject to reduced pricing flexibility over the long term given Dignity's status as a public company.

Transaction Strengths, Risks, and Mitigants Update

Strengths

- Dignity continues to exhibit favorable cash flow characteristics, with moderate operating costs and stable capital expenditure requirements.
- Dignity continues to hold a position as one of the major funeral service providers in the U.K.
- The possibility remains of using land and property sales as a way of realizing value, reflecting the "utility" nature as well as the stable and predictable demand for funeral and cremation services in the U.K.

Risk and Mitigants Regarding Decline in Earnings

- The rated notes remain exposed to potential short-term declines in long-term mortality rates, and a potential decline in Dignity's reputation leading to a weakening business position.
- Long-term mortality rates are, however, predictable, and U.K. projections already incorporate an increased life expectancy. Any increase or drop in year-to-year mortality should average out over the term of the transaction, and short-term fluctuations have been demonstrated to be no greater than 5% above or below forecasts within a five-year window. Current softening in the death rate remains well within that range.
- Reputation is a key factor as business is typically sourced through word of mouth recommendations based on reputation and prior experience. Under current management, Dignity is conscious of its reputation, only engaging in marketing campaigns consistent with U.K. market best practice. The company carefully tracks customer satisfaction and quality, which are at high levels - latest surveys indicate that nearly 90% of customers would "definitely recommend" Dignity's services. Standard & Poor's stress assumptions were for a fall in market share of 1% in funeral services and cremation business at various times throughout the transaction, yet there is no evidence to date of a weakening of Dignity's competitive position.

Although Standard & Poor's continues to expect stable demand for funeral and cremation services in the U.K., initial cash flow stresses used to assess the effect of sudden decreases in mortality rates, and shocks related to reputation and competition effects remain valid, and continue to support the debt amounts outstanding at the current rating levels.

Risk and Mitigants Regarding Increased Costs and Capex

The rated debt remains exposed to wage increases and above-average capex. Although salaries in the industry are in line with semiskilled labor, wage costs may increase at above-average rates to retain experienced, dedicated, and seasoned personnel. Standard & Poor's expects that Dignity's wage costs will increase at a slightly higher rate than inflation. However, Dignity's current costs are in line with its competitors, and the likelihood that Dignity's relative labor costs increase disproportionately to its competitors is not considered a material risk.

In 2003, total capital expenditure was £9 million, including both maintenance and development capex (excluding acquisition costs). Covenants require Dignity to spend at least £7 million (retail price index - RPI - adjusted) maintenance capex per year, primarily related to the ongoing refurbishment of funeral outlets and the renewal of its car fleet. Given the long-term record of the capex program, and an assessment of its adequacy compared to the asset base, the need for significant and sustained increases in maintenance capex from historical levels remains unlikely.

Risk and Mitigants Regarding Long-Term Downward Trends in Funeral Service and Cremation Margins

Demand is generally price inelastic given a reluctance to negotiate or compare industry prices. Furthermore, both the U.K. industry and Dignity have enjoyed a period of strong pricing increases. As prices rise, Standard & Poor's believes clients may become more price sensitive, and the rate of price increases may slow over the longer term.

The competitive environment may also toughen, although the attractiveness to new entrants is low. Barriers to entry in the fragmented and unregulated funeral business market remain moderate over the long term. There are no material U.K. licensing requirements for providing funeral director services. Nevertheless, sudden changes in the competitive and pricing profile of the U.K. industry remain unlikely. Any new entrant needs time to establish its position, yet the market favors soft marketing campaigns due to the sensitive nature of the business. The U.K. market is mature and there are limited growth prospects, no underserved areas, and no excess profits. Furthermore, it takes a long time to establish a local presence, size is a major advantage in the industry, and the increasing acceptance of pre-arranged funeral plans stabilizes pricing. In the cremation business, competition is limited as the number of new builds is regulated and the absolute price of a cremation is low.

Given the remaining debt quantum and its amortization term, Standard & Poor's does not consider potential price stagnation to constitute a material threat to Dignity's ability to service its rated debt obligations.

Risk and Mitigants Regarding Regulatory Risk

Consultation remains ongoing about the potential introduction of legislation requiring existing crematoria sites to be upgraded to reduce mercury and dioxin emissions. Should this new legislation be introduced, costs for upgrading Dignity's 22 crematoria are estimated to be at least £10 million. Upgrades to existing sites are unlikely to be required immediately, as the sudden strain may cause the closure or relocation of a large portion of crematoria, many of which are owned and operated by local authorities. Regulations under various European, U.K., and local environmental laws would probably give operators several years to upgrade crematoria, and costs are likely to be passed on to the customers. Local authority ability to phase out the emissions is likely to reduce the amounts that Dignity would require to comply with any new legislation.

Risk and Mitigants Regarding Commingling Risk

Commingling risk is mitigated by the cash collection mechanics in place. Monies from deposits and final payments for funerals and cremations are paid into collections accounts, and are potentially at risk before and after being deposited in the event of insolvency. The same is true for funds in other accounts such as the capex, disposal, and principal accounts. All the accounts, however, have a security interest in favor of the security trustee, although such fixed charge might be recharacterized as a floating charge, resulting in preferential creditors ranking ahead of the security on an insolvency of the borrower. Although this risk is mitigated by restrictions on the borrower's ability to withdraw monies and use these at its discretion, there is no certainty that recharacterization will not occur. This risk was sized for in Standard & Poor's initial cash flow assumptions, which assumed a credit loss up to the amount of the preferential creditors' potential claims.

Risk and Mitigants Regarding Forfeiture Risk

Approximately 40% of Dignity's existing funeral homes are leaseholds, of which most are renewed within the term of the transaction. Most of Dignity's leaseholds have provisions that give the landlord the ability to forfeit the leases on an insolvency of the tenant, therefore jeopardizing the cash flow stream from these properties in a post-insolvency scenario. Of 22 crematoria, nine are long leaseholds, of which five could also be subject to forfeiture risk upon insolvency. Standard & Poor's continues to consider forfeiture risk for the funeral homes from two perspectives: (i) the likelihood of forfeiture is assessed where there is an ability to demonstrate a capacity to increase and maintain rent payments to the diverse universe of largely nonprofessional landlords, and (ii) taking into account the nature of the underlying business to conclude that, even on forfeiture, the business is "portable" within certain limits of location and is not absolutely dependent on the property as a destination.

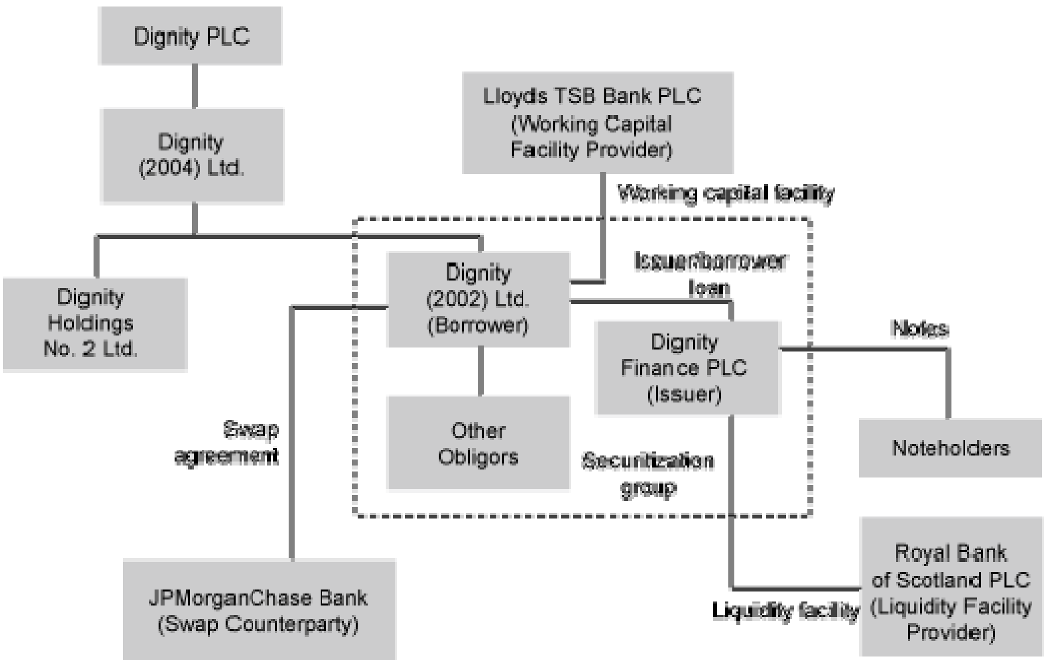
Standard & Poor's continues to believe that alternative premises could be found (most funeral homes continue to be located in secondary commercial locations where there is a wide choice of alternative properties), and with rent expenses for funeral homes accounting for less than 3% of revenues, cash flows continue to demonstrate a capacity to meet higher rent demands if required.

With respect to the crematoria, Standard & Poor's continues to believe that there is a limited likelihood that all conditions necessary to trigger qualified forfeiture would be met. All crematoria have qualified and not absolute forfeiture, under which insolvency is not sufficient to forfeit the lease, which can only be forfeited if, in addition, there has been a substantial breach of covenant by the tenant or the premises have been closed for a significant period.

Transaction Structure

The proceeds of the issuance of the notes were used to refinance a bridge loan provided by JPMorganChase Bank (AA-/Stable/A-1+) in December 2002, to refinance, in turn, existing debt and equity incurred in connection with the management buyout of Dignity by Montagu Private Equity (Montagu, the former HSBC Private Equity) in February 2002. In April 2004, Dignity undertook an IPO on the London Stock Exchange, with subscriptions from a variety of institutional shareholders. The current structure of the transaction is shown in the following chart.

Chart 1
Dignity Finance PLC Simplified Corporate Securitization Structure



Business Description Update

Dignity was established in 1994 as the U.K. subsidiary of Service Corp. International (SCI; BB/Stable/--), the world's largest funeral service provider. Dignity was formed from the consolidation of Great Southern Group PLC and Plantsbrook PLC, two companies with a long history of operations in the U.K. In February 2002, it was acquired by Montagu through a £235 million management buyout.

In April 2004, Dignity PLC, the ultimate holding company of the Dignity (2002) Ltd. group, listed on the London Stock Exchange. Total funds raised on a gross basis amounted to £123 million, which were used to:

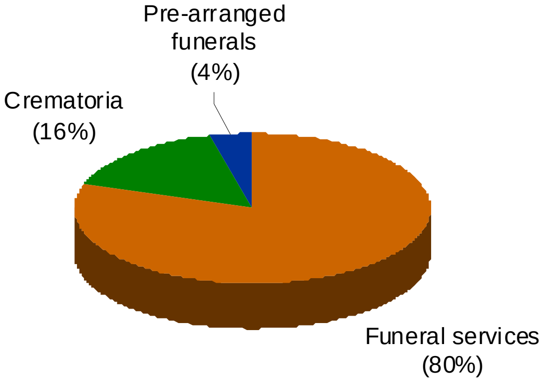
- Repay the £40 million mezzanine facility; and
- Repay the £63 million of loan notes held by SCI and Montagu.

This left the secured loan notes as the only external debt within the capital structure, which will reduce financing costs going forward, create additional free cash flow to pay dividends to institutional equity, and provide management with capital for future investments.

The company's business consists mainly of funeral services. Cremation services comprise a smaller, but key, proportion. Coffin manufacturing services is a negligible contributor to sales and is not considered as a business line by Dignity. During the 52 weeks to June 2004, Dignity generated £131.4 million in sales and £42.9 million in EBITDA, from £121.0 million sales and £34.7 million EBITDA as of year-end 2002. Dignity's funeral services had an 11.7% share of British deaths in 2003, while crematorium services were provided for 6.6% of those deaths.

Chart 2

Dignity Division of Revenue by Business Line



Business Profile Update

The U.K. funeral market is fragmented and, although it has gone through a period of consolidation, includes a large proportion of independent operators. The main market competitors are the Co-operative Group (14% market share), Dignity (12%), United North-West Co-op (4%), and others (70%). The U.K. crematoria market is led by local authorities (over 80% of cremations), followed by Dignity (9%), and minor participants.

Chart 3

Market Share of Funeral Services

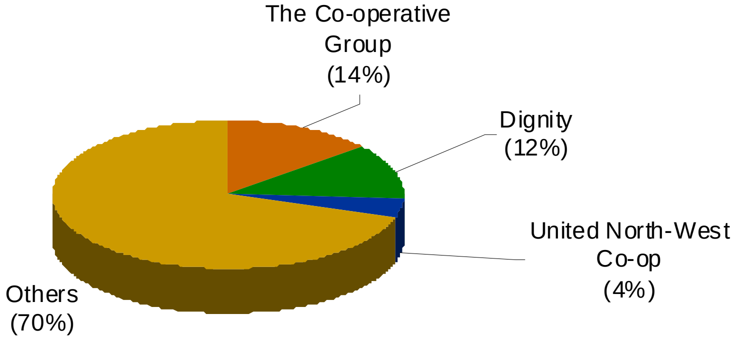
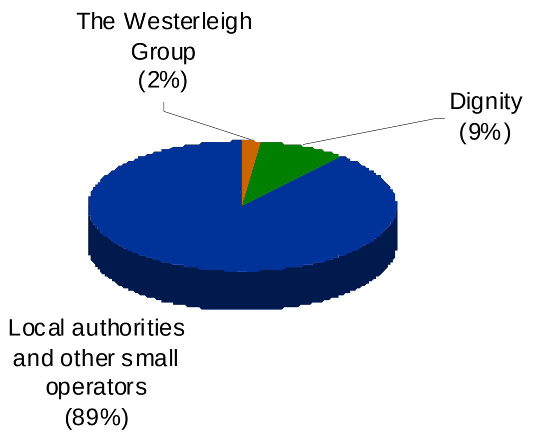


Chart 4

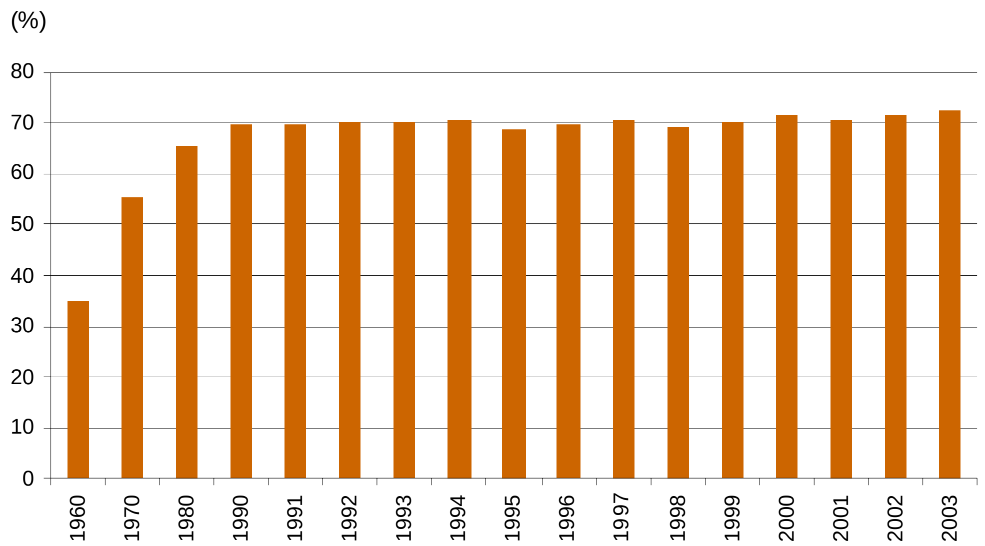
Market Share of Crematoria Services



The funeral business remains largely distinct from burials and cremations. Dignity, for example, conducts approximately 85% of its cremations stemming from third-party business. Cremations as a proportion of total deaths have remained relatively stable in recent years, at about 70% of total funerals. Given stable burial rates, the business profile remains healthier than in other countries, aided further by lower levels of competition. There remains no obvious low-cost niche in the U.K. market, and the average cost of a U.K. funeral is expected to remain much more price inelastic than in comparable markets, due to the much lower starting base. While barriers to entry are moderate, additional competition is limited in the near term, given that custom continues to be driven by word of mouth recommendation, while supply of additional crematoria remains limited given the levels of capital investment required and public resistance to new builds.

Chart 5

Cremation as a Percentage of Total Funerals in the U.K.

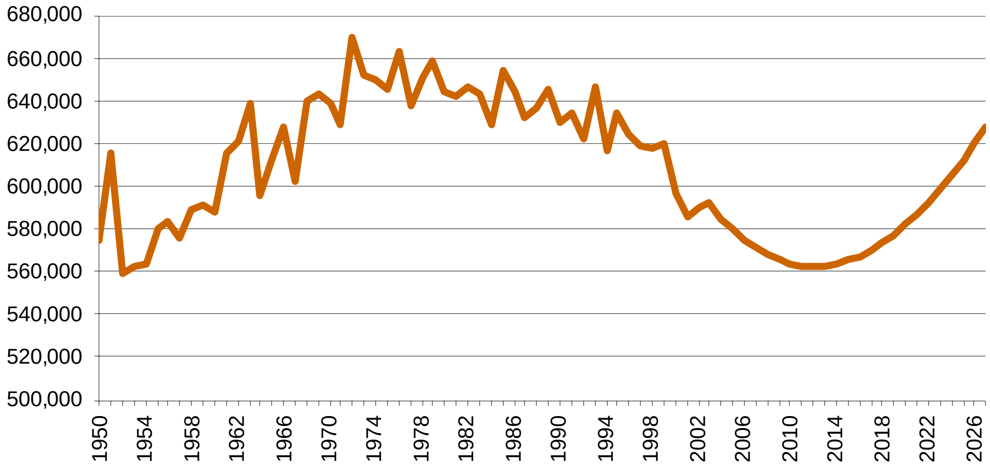


Performance of the Dignity Finance Transaction

Short-Term Decline in Death Rate

Chart 6

U.K. Death Rates

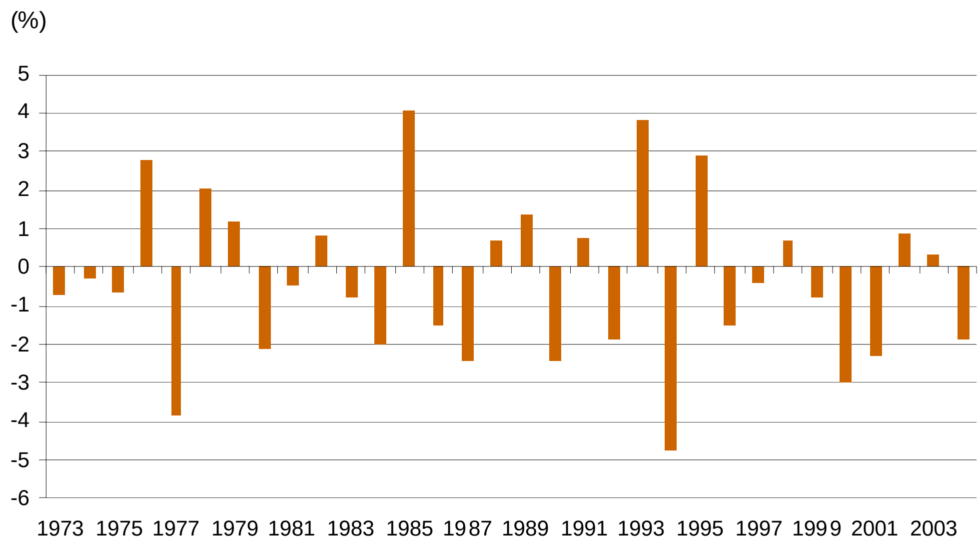


Source: Office for National Statistics for 1951 to 2001, Government Actuary's Department for 2002 to 2025

Although U.K. death rates are quite stable and predictable over the long term, rates sometimes drop temporarily due, for example, to sudden changes in weather conditions and influenza epidemics or as a reaction to particular demographic shifts. The death rate fell 3.6% year on year to 581,100 deaths in the year to June 2004. However, based on past experience, the death rate will typically self correct in the following years.

Chart 7

Great Britain Death Rates Variability



The fall in the death rate in the short term is therefore not considered material at this time. This amount of variability has already been accounted for in Standard & Poor's initial analysis, which stressed a fall in death rates by between 5% and 10%.

The result of the slowing death rate was a fall in volumes in the first six months of the year:

- Funeral volumes fell to 35,100 compared with 36,300; and
- Cremation volumes fell to 19,800 compared with 20,600.

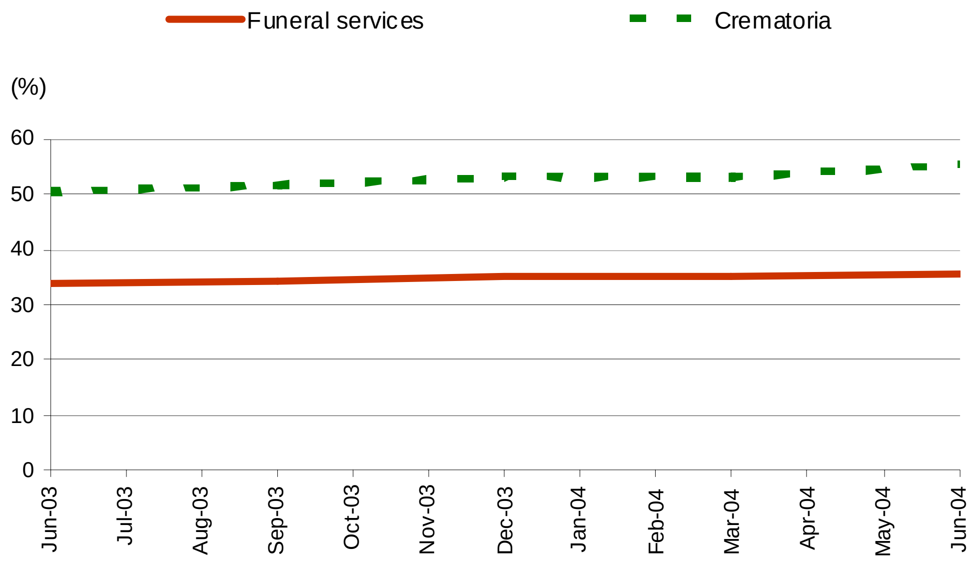
Pre-arranged funeral plan sales fell to 7,900 sales compared with 13,800 in the comparable period, with the fall primarily due to the timing of marketing campaigns conducted by Dignity's affinity partners. One partner, Royal London, has recently closed its direct sales force operation, which is likely to reduce pre-arranged sales volumes in the short term. However, the sale rate is outperforming the death rate, with over 170,000 plans outstanding as of June 2004, from 150,000 outstanding at the end of 2002.

Price Flexibility Leads to Margin Stability

While the fall in volume has resulted in a slight reduction in top line growth (the 6% growth in full year 2003 was followed by a growth of 2% from the year-end figure in the first six months of 2004), that growth is being sustained signals that Dignity continues to maintain an element of pricing flexibility which should allow future price increases to be relatively easily absorbed by the market. With approximately 70% of the funeral market remaining in private hands, Dignity has relatively little pricing power, with pricing driven by the independent operators. However, given the nature of the market, pricing transparency remains limited, affording this degree of flexibility (although Dignity's status as a public company may lead to increased transparency). Margin continues to improve for each division as cost pressures are controlled.

Chart 8

Dignity Margin Performance by Business Line

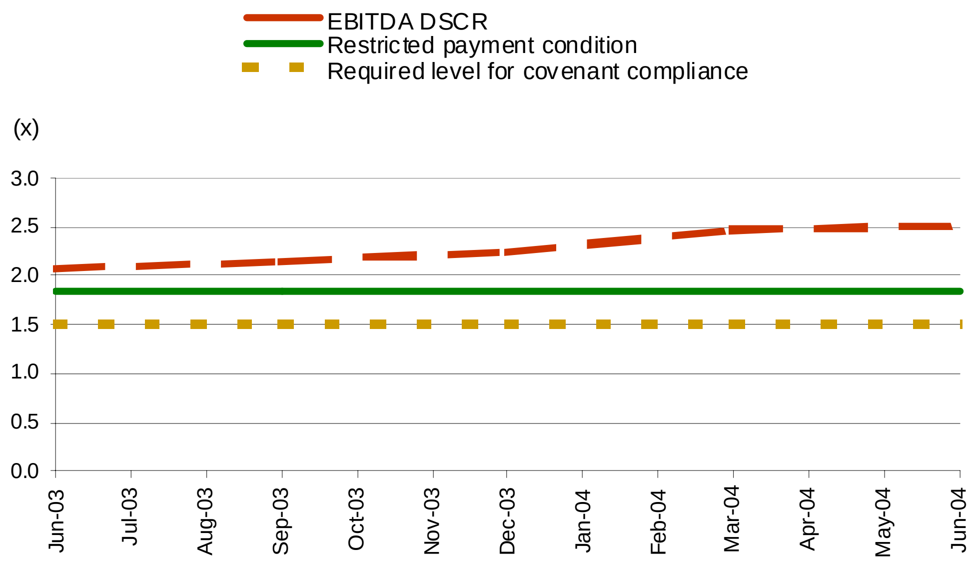


Financial Covenant Performance

A covenant breach occurs when the EBITDA DSCR falls below 1.5x on a historical 12-month basis, and is not remedied within 45 days. With improving EBITDA performance and stable debt service obligations, DSCR has remained above that covenanted level and currently stands at 2.51x.

Chart 9

Dignity EBITDA DSCR Performance

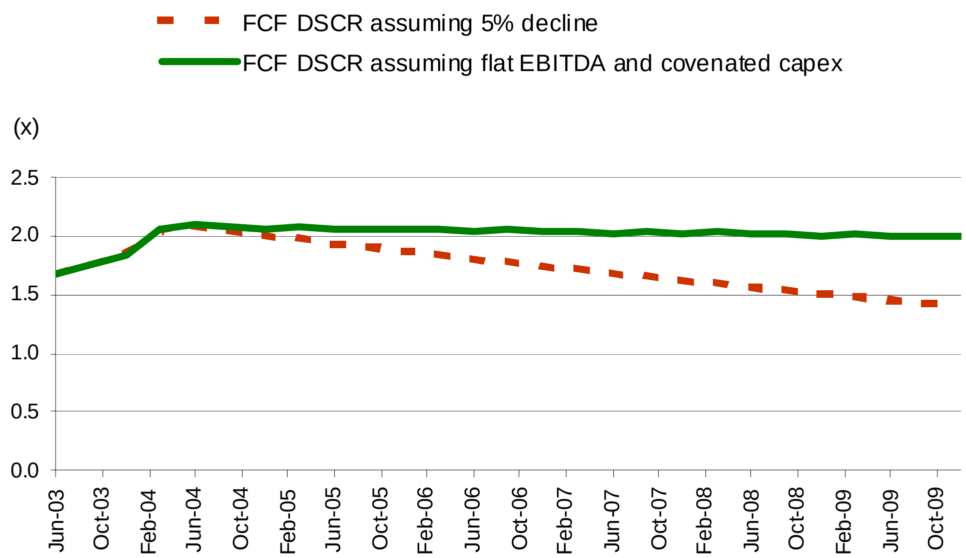


From January 2004, Dignity has been able to pay dividends. Payment of dividends is subject to EBITDA and free cash flow (FCF) DSCR exceeding 1.85x and 1.4x, respectively. FCF DSCR is currently at 2.09x. Current performance and the redemption of subordinated debt following the IPO has created a further cash cushion that will allow restricted payments to be made but also free up cash for reinvestment into the business or for potential acquisitions.

Senior debt of £3.5 million has amortized to date, bringing debt to EBITDA multiples down to 2.5x at the 'A' rating level and 4.8x at the 'BBB' rating level from 3.0x and 5.7x, respectively, at close. Strong operating performance is reinforced by a debt amortization profile that is relatively smooth, to the extent that a decline in EBITDA by as much as 5% on an annualized basis could be withstood, assuming covenanted minimum capex spend (as documented in the underlying loan agreement), while still allowing the restricted payment condition to be met over the next five years.

Chart 10

Simulated FCF DSCR Performance



Disposals, Acquisitions, and Developments

Since transaction close, Dignity has acquired opportunistically both leasehold and freehold properties, seeking to open satellite branches when appropriate to maintain catchment areas. The company now operates out of 512 homes, up from 499 in 2003, and bolt-on acquisitions have required an investment of £9.4 million. The number of crematoria remained unchanged at 21 (as a result of the required start-up costs, but also due to difficulties in obtaining planning consents and local authority domination) as of June 2004, although Dignity has been developing two new crematoria, the first of which, in Holytown, North Lanarkshire, opened in August 2004.

Capex

Dignity is required to spend at least £7 million in maintenance capex per year, with any shortfalls reserved and made up for in the following year. The aggregate amount of development capex available in connection with permitted development and funeral home start-ups funded from sources other than the elective capex account and the restricted payment account is limited to £5 million per year. Funding for development capex can also be derived from a special capex account, funded at Dignity's option if the FCF DSCR is at least 1.2x, and on the basis that the FCF does not fall below 1.0x.

Reporting Requirements

Comprehensive obligor reporting is important to Standard & Poor's, as it strengthens transaction transparency and owner and management accountability, as well as signaling potential problems and the need for remedy. Transaction reporting to date has been timely, with Dignity covenanting to provide:

- Audited annual accounts;
- Quarterly reports providing information within 45 days (from the end of the March and September quarters) and 90 days (from the end of the June and December quarters) with respect to net assets, revenue, and operating details;
- Calculation of free cash flow, EBITDA, and relevant DSCRs;

- Whether the financial covenant and the restricted payment condition have been met;
- Amount of expenditure on permitted developments;
- Details of any permitted acquisitions and disposals and any other material changes to the assets;
- Whether a loan event of default or financial adviser appointment event has occurred and, if it has occurred, a description thereof and the action taken or proposed to be taken to remedy it;
- The cumulative amount of capital maintenance expenditure spent in the current calendar year;
- The balances in the various accounts; and
- The level of permitted financial indebtedness.

Transaction reporting is likely to improve given the regulatory news flows that resulted from the stock exchange listing. Dignity will continue to report covenanted variables to Standard & Poor's quarterly, which is considered positive, although Standard & Poor's notes that the transaction covenants do not provide for, for example, net asset ratio tests that Standard & Poor's now requires to assess the level of equity stakeholder support within a corporate securitization.

Related Articles

- "Ratings and Surveillance Process in European Corporate Securitizations" (published on Sept. 28, 2004).
- "Guidelines to the Release of Excess Cash in European Corporate Securitizations" (published on Sept. 28, 2004).
- "European Corporate Securitization Market Continues to Display Dynamism" (published on Aug. 11, 2004).
- "Industry Report Card: European Corporate Securitizations" (published on March 22, 2004).
- "New Issue: Dignity Finance PLC" (published April 25, 2003).

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