

# Seeking Alpha $\alpha$

## Dark Clouds for the Death-Care Industry

by: Morningstar

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Although much has been written about two uncertainties in life, none is more famous than a letter written by Benjamin Franklin to Jean-Baptiste Leroy in 1789, in which Franklin stated, "In this world nothing can be said to be certain, except death and taxes". While death can be considered one of the two certainties in life, several unfavorable secular trends are hampering longer-term growth and profitability in the death-care industry.

Firms in the death-care industry have several qualities that, on the surface, make for solid investments. Firms like **Service Corporation International (SCI)** and **Stewart Enterprises (STEI)** generate robust positive free cash flow. The industry's largest player, Service Corporation consistently generates roughly \$250 million in equity free cash flow on average, equating to a free cash flow yield of 9%. Stewart generates roughly \$55 million of equity free cash on average, with a three-year average yield of almost 8%. Additionally, these firms have a track record of repurchasing their own shares, and issuing albeit modest dividends.

Despite looking good on paper, digging deeper into the death-care business model and industry trends give us pause. While death can be considered one of the two certainties in life, a growing reliance on preneed sales creates top-line volatility, and generates investment risk for the industry's players. Preneed sales occur when individuals specify in advance - and prepay for - cemetery and funeral property, products, and services prior to death. After booking a preneed sale, the proceeds are put into trust accounts, and are drawn down upon completion of certain activities in preparation of death or upon death. As such, when trust assets decline in value as they did over the Great Recession of 2009, the firm could be subject to capital injections to make up the difference. In a worst-case scenario, any sustained investment losses or insufficient investment yields could result in funds needed to pay for the cost of future services, merchandise, or cemetery maintenance. Death-care firms believe that the balances in trusts and escrow accounts - coupled with future earnings on trust balances - will be sufficient to cover the estimated cost of providing preneed services in the future. However, there is no guarantee, and from an investment standpoint, we would feel more comfortable if these services were priced or underwritten by life insurance actuaries, due to the massive size of the trust portfolio assets.

The reliance on preneed sales in the death-care industry is due to a lack of overall deaths in the marketplace. According to the United States Census Bureau, the number of deaths in the United States is expected to increase by roughly 1% per year, to only 2.9 million by 2020, from 2.5 million in 2008. Additionally, life expectancy and average life spans have increased due to increases in medical innovation and preventative health care, a trend that should persist, in our view. This low level of growth, coupled with intense competition from other traditional death-care firms - and less traditional big box retailers like Costco ([COST](#)) and Wal-Mart's ([WMT](#)) Sam's Clubs - put additional emphasis on cost-cutting initiatives and operational efficiency to drive margins. Furthermore, while paying for a funeral at the time of death is unavoidable, paying in advance is not. Individual preneed purchases tend to be discretionary during economic downturns, which was apparent during the Great Recession, as revenue declined.

Adding additional pressure to operational results is the fact that cremations are gaining popularity relative to more traditional funeral services. Same-store cremation rates have risen to 42% today from 32% in 2000, and cremations typically provide lower absolute dollars on the margin line, given that they don't carry as many ancillary, or up-sell services. Countries like Japan have almost a 100% cremation rate, while China cremates more individuals a year than any other country (with almost a 50% cremation rate). The United Kingdom has seen its cremation rate increase with the national average, rising to 70% currently from 35% in 1960. Even domestically, states on the West Coast tend to use cremations as a method of burial more so than the southeastern U.S. (with 60% cremation rates versus 20% cremation rates on average). The death-care industry is currently struggling with ways to convince consumers to purchase auxiliary services for cremations in an effort to increase profitability. However, we find it hard to believe that any amount of innovation, if possible, would supplant revenue from higher-margin, traditional interment services.

Ultimately we believe the old adage of two certainties in life - death and taxes - don't necessarily hold in the investment world. Longer life expectancies, unfavorable secular trends toward cremations, and intense price competition will haunt the death-care industry for years to come, in our opinion.