Repeat business

Roger Montgomery analyses why an undertaker has taken the market's fancy

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DEATH AND TAXES – THE TWO great certainties in life. Investing – a pursuit in which the outcome is anything but certain. Could investing in the funeral industry bring some certainty to an uncertain pursuit? To address the question one needs to put emotions aside – good advice for investing too.

Historically, the death rate in Australia has been around 1%, and longer term, it's forecast to increase as the population bulge, known as the baby boomers, reach the twilight of their lives.

In addition, funeral operators have a high degree of discretion over their pricing. Price elasticity is not something most operators have to worry about; clients will pay more for packages they perceive as more valuable. Clients are also more likely to use the same operator again: repeat business accounts for 90% of an operator's revenues.

If our job as investors is to pay a rational price for a business whose earnings march upwards, funeral operators certainly have the right basic ingredients.

There's only one funeral operator listed on the ASX. InvoCare owns and operates funeral homes, cemeteries and crematoria in Australia, New Zealand and Singapore. Its two leading brands are White Lady and Simplicity. InvoCare is very profitable, has 36% market share and its earnings per share have grown at 13.3%pa since 2003.

So few chains exist in the funeral industry because it is dominated by family-run businesses. Emotional connections permeate the profession, in both operators and clients alike. As such, price is not the biggest consideration for operators when negotiating acquisitions. What's more, there is a constant stream of new entrants with which Invocare must compete. In Sydney, 40-plus new operators are reported to have entered in the past seven years.

A highly fragmented market makes it challenging for Invocare to grow by acquisition. So to sustain its leading position, it is transforming the industry by innovation.

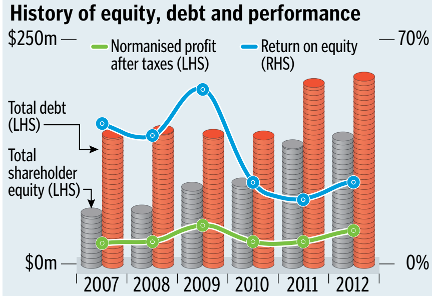
Management at Invocare has realised that technology can help with grieving and remembrance. One initiative is an online message board, allowing family and friends to share their memories on Facebook. HeavenAlready.com received 1 million hits on Facebook last year, and management expects usage to double in 2013. The strategy not only increases InvoCare's brand profile, it adds value to its services.

Another area is pre-need funeral packages. Many are taking a greater interest in how they would like to be remembered and InvoCare is helping people pre-book their funerals. Pre-booking provides stable cash flows, and an insurance-like "float", which the company can invest.

Turning to InvoCare's share price, we discover the market has cottoned on to its prospects. Intrinsic value has grown by almost 20%pa since 2003 and, as Ben Graham (a famous value investor) observed, in the long run the market is a weighing machine. Not surprisingly, the share price has also increased dramatically, from $1.88 in 2003 to a high of $11.20 in February.

INVOCARE

History of equity, debt and performance



Watching brief only

There is currently no margin of safety in InvoCare's share price and, given the relatively high debt and despite stable fundamentals, investors shouldn't pay any price even for the very best businesses.

In 2011 the company added $50 million to its equity through a dividend reinvestment plan and the acquisition of Bledisloe. But despite also increasing borrowings significantly, earnings growth has not kept up. The result has been a deterioration in profitability (the blue line in the chart). Return on equity is still extremely attractive at a forecast 31% for 2013, but it's nowhere near the 60% achieved in 2005-06.

Earnings are forecast to continue their steady growth and dividends will reflect a high payout ratio but, even when we plug in optimistic expectations for growth, we cannot obtain a valuation anywhere near the current share price. And if interest rates rise significantly, the debt burden – currently easily covered by cash flow – will cause investors some consternation.

Consistent with the observations of its competitors, InvoCare's data suggests the number of deaths is slowing in Australia and, with a sales mix that is shifting towards lower-margin Queensland, we are concerned that the short-term voting machine gives InvoCare more accolades than it deserves.

Investors seeking some certainty should have InvoCare on their watch list, but bargain hunters need a price below $7.50 to get seriously interested.

Roger Montgomery is a portfolio manager at Montgomery Investment Management. For his book, Value.Able, *see www.rogermontgomery.com.*