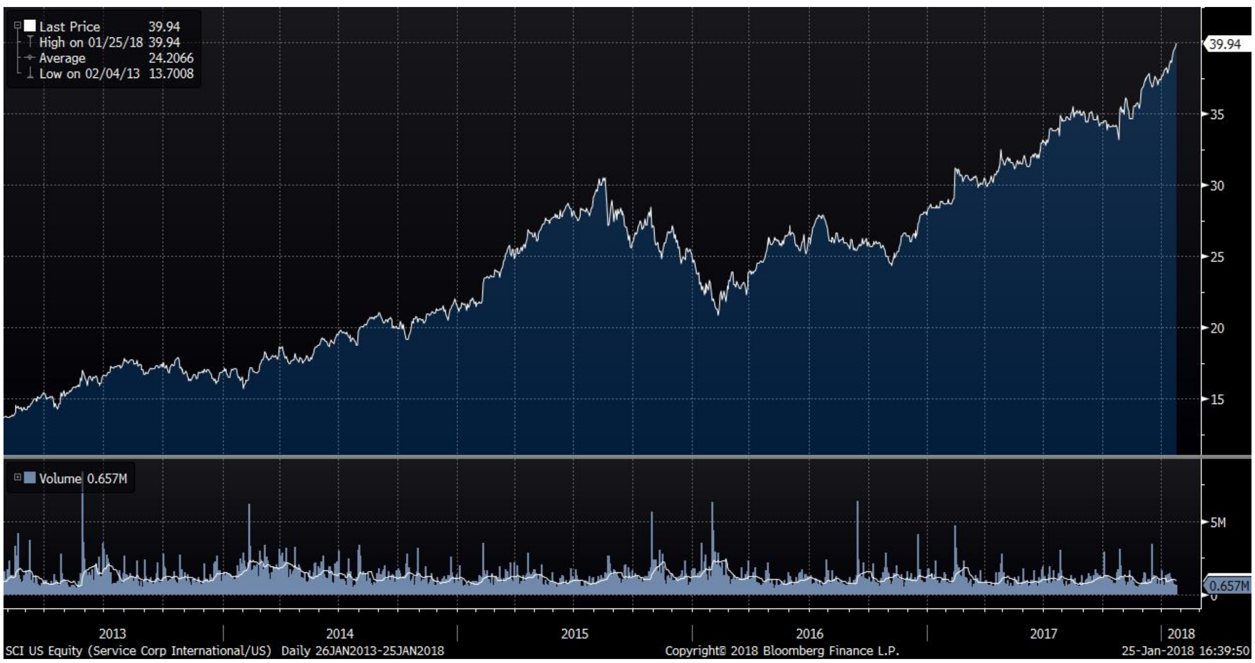
Service Corporation International ($SCI)

1/25/18

Jackson Allen

Price target: 47.50



Company Overview

Service Corporation International is North America’s largest provider of deathcare products and services, with a network of funeral service locations and cemeteries unequaled in geographic scale and reach. At December 31, 2016, they operated 1,502 funeral service locations and 470 cemeteries, which are geographically diversified across 45 states, 8 Canadian provinces, the District of Columbia, and Puerto Rico.

They are known for the Dignity Memorial® brand, North America's first transcontinental brand of deathcare products and services. The other brands are Dignity Planning™, National Cremation Society®, Advantage® Funeral and Cremation Services, Funeraria del Angel™, Making Everlasting Memories®, Neptune Society™ and Trident Society™. The funeral service and cemetery operations consist of funeral service locations, cemeteries, funeral service/cemetery combination locations, crematoria, and related businesses, which enable them to serve a wide array of customer needs. They sell cemetery property, funeral services, cemetery merchandise, at the time of need and on a preneed basis.

The company was first incorporated in Houston, Texas in 1962. The company's business model was to create efficiencies of scale within the Houston area. By sharing personal and overhead costs such as preparation services, accounting, transportation, and personnel among funeral service locations in a business "cluster.", local and independently owned funeral homes flourished. The company has grown out of the Houston area and grown all throughout the continental United States and Puerto Rico.

Beginning in 2006, the company reached a strong financial position within the deathcare industry and began to acquire major competition within the industry. They acquired the then second largest company in the North American deathcare industry, Alderwoods Group. In early 2010, they acquired the then fifth largest company in the North American deathcare industry, Keystone North America. In June of 2011, they acquired 70% of the outstanding shares of The Neptune Society, Inc. (Neptune), which is the nation's largest direct cremation organization, now known as SCI Direct. Subsequently, in 2013 and 2014, they acquired the remaining 30% of the outstanding shares of Neptune. In December 2013, the company purchased Stewart Enterprises, Inc. (Stewart), the then second largest operator of funeral service locations and cemeteries in North America.

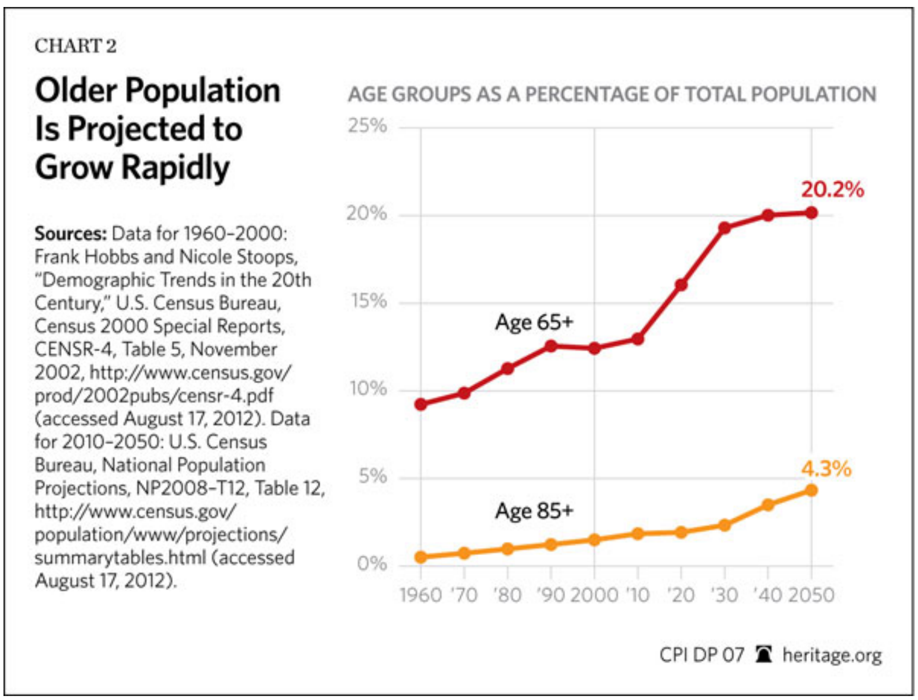
Sector Information

The deathcare Industry is often broken into two distinctive categories. The first, complied of a few large, often publically traded companies, maintain dominance of the sales of caskets and headstones for memorials. The other is complied of nearly 20,000, small and independently owned funeral homes and nearly 120,000 cemeteires maintianed by families or nonprofits. These indepenedent companies operate in what are known as "clusters" and are forced to compete with one another which leads to decreased sales and increasing costs.

Service Corporation Intenational fits into the industry as one of the only large publically traded operators of funeral homes. According to the National Funeral Directors Association, the average funeral costs Americans $7,323.

Sector Strength

The countries demographics will lead to continued growth and strength within the deathcare industry. According to the US Census Bureau, there are approximately 67 milion people over the age of 60 with the figure expected to grow to 77 million by 2020 as the baby boomer generation continues to age. As more people age over 60, the need for preneed options will increase as well as overall deaths leading to greater revenue in the present and secured for the future.



Sector Trends

One of the major trends within the industry has been a shift towards advance funeral planning. Advance funeral planning allows clients to personalize their own funeral prior to a time of need. This new trend will grow current year and future revenue growth in all business segments. Prepackaged deathcare services will help to build brand awareness for the company as well as secure future market share. Within the cemetery sector, preneed sales will provide a basis for judging demand for property. This will provide the company with a direction of exactly how many new properties they must purchase to meet demand and therefore reduce the risk of over investing in new property.

A rise in cremation services within the industry stands as a risk factor for the company and an industry as a whole. In 2016, 52.4% of all operations were cremations, which has increased from 50.1% just two years prior. Cremations provide far less revenue than that of a traditional burial and could have a long-term negative effect on companies' earnings. Service Corporation will be forced to invest in more cremation services in the coming years to satisfy growing demands. However, within the industry the company has the size, scale to effectively grow, and continue to be the largest provider of services in the country.

Company Management

Mr. Ryan was elected Chairman of the Board of SCI effective in January 2016 and, previously, he had been appointed Chief Executive Officer in February 2005. He joined the Company in 1996 and served in a variety of financial management roles until November 2000, when he was asked to serve as Chief Executive Officer of European Operations based in Paris, France. In July 2002, Mr. Ryan returned to the United States where he was appointed President and Chief Operating Officer of SCI. Before joining SCI, Mr. Ryan was a certified public accountant with Coopers & Lybrand LLP for eight years. He holds a bachelor's degree in business administration from the University of Texas at Austin. Mr. Ryan serves as a member of the Board of Trustees of the United Way of Greater Houston. Mr. Ryan also serves on the Board of Directors of the Greater Houston Partnership, the Greater Houston Community Foundation Governing Council, the Board of Directors of Genesys Works, and the University of Texas McCombs Business School Advisory Council. Mr. Ryan is a member of the Board of Trust Managers of Weingarten Realty Investors (NYSE: WRI) and serves as a director of Chesapeake Energy (NYSE: CHK).

Mr. Webb was elected President and Chief Operating Officer of Service Corporation International in February 2016. Prior to that, he served as Executive Vice President and Chief Operating Officer beginning in February 2005. Mr. Webb joined the Company in 1991 when SCI acquired Arlington Corp., a regional funeral and cemetery consolidator, where he served as Chief Financial Officer. In 1993, Mr. Webb joined the Company's corporate development group, which he later led on a global basis. Prior to joining Arlington Corp., Mr. Webb held various executive financial and development roles at Days Inns of America and Telemundo Group Inc. He holds a bachelor's degree in business administration from the University of Georgia.

Source: Service Corporation International 10-K 2017

Significant Investors

Service Corporation International is largely held by large institution investors holding 77.68% of shares outstanding and 7.98% of shares being held by hedge funds. There are only four companies that hold stakes larger than 5% of all shares outstanding and all are passive investors, which will shield the company from the growing trend of activist investing.

Investment Thesis

As the nation's largest provider of deathcare services in the United States, SCI will continue to capitalize on increasingly favorable age demographics in the United States. As the Baby Boomer, generation continues to age, the company's emphasis on preneed sales contracts will gain market share and continue to grow a trust fund portfolio.

Key Points

Deploy Capital

Management is incredibly friendly to investors, as dividends have grown consistently from 2005 at .025 cents per share to .15 cents in 2017. Dividend rates have increased every year since 2012 with a five year Compounded Annual Growth Rate (CAGR) of 20.5%. In addition, in 2016, the Board of Directors allowed an allocation of 400 million dollars for continued share buyback programs. Since 2010, the company has repurchased 21% of outstanding stock and plan to continue share buyback programs. During the first nine months of 2017, the company repurchased 4,793,635 shares of common shares.

The company will also continue to make strategic acquisitions and build new funeral homes in markets that can help grow economies of scale. By continuing to foster growth through acquisitions, the company can create greater consolidation of market share and grow the company's footprint throughout North America.

Grow Revenue

The increasing trend in preneed sales of funeral services will continue to grow and be a source of revenue growth. At the end of 2016, Service Corporation International had a $10 billion backlog of future revenue that can not be realized in their trust and insurance preneed sales. These numbers are expected to grow and not only secure future market share, but also harms competitor's potential sales in the future. An increased emphasis on preneed sales in the future will establish stability within the company for the years to come as they will have contracts proving future revenues.

Leveraging Unparalleled Scale

The company has instituted a plan to increase the presence of its salesforce for the continue to grow the company and create greater efficiencies of scale. By increasing the number of salesman to over 4,000, a greater emphasis on preneed sales will lead to more growth. In addition, the company successfully instituted and completed the transition to Salesforce.com, which will lead to greater effectiveness and productivity from the sales team.

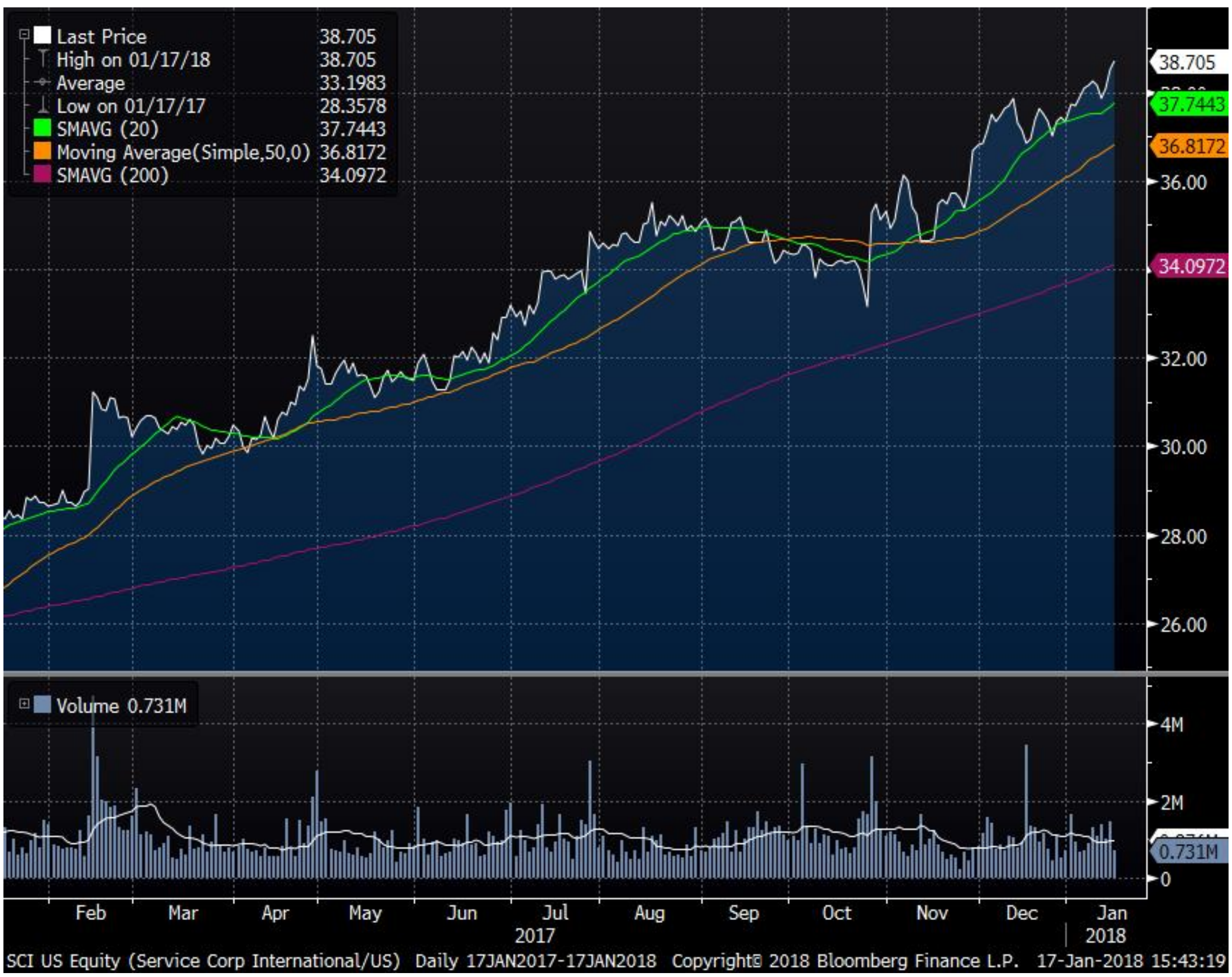
Favorable Competitive Environment

The company faces very little competition within the deathcare industry, specifically from other operators of funeral homes and other service companies. With Service Corporation being an exception, the large publically traded companies in the sector operate as suppliers of caskets and other products, rather than operators. This gives the company the unique advantage of operating with an unprecedented size and control over the industry. While $SCI maintains a 16% market share of all funeral homes and services, the next 3 companies only hold 5% combined. The two largest operators that are publically traded are Carriage Services Inc. and Stonemor LP, which have market caps of 425.15 million and 204.9 million dollars, respectively. Stonemor has failed to turn a profit in the last five years while Carriage Services had annual net income of merely 19.6 million dollars for the year ended December 31, 2016. Service Corps lack of competition will serve as a catalyst for growth in the future, as they can utilize their size and scale to continue to grow in the market with minimal competition affecting sales and overall expenses.

Trust Fund

As SCI continues to emphasize pre-need funeral services, the backlog of unrecognized revenue is places in trust funds. These funds are managed by premier money mangers to ensure that that the future liabilities will adequately be appreciated in the present. SCI's directors have outlined an expectation of 3% growth per year will adequately cover the appreciating costs of funeral services. Any gain greater than 3% will lead to increase EPS for the current year. With the success of the overall equity market in 2017, I expect the trust funds to largely outperform the 3% yearly target. This should lead to increased EPS for 4Q17 that exceed the consensus estimate of $1.51. For every 100 basis points that the fund outperforms the target 3%, this increase should account for approximately one-half of a cent of EPS.

Financial Overview



After an incredibly successful year, Service Corporation International stock has increased over 30.05% on the year. The company looks ready for continued growth, as both short-term and long-term trends are positive. The 20-day moving average is well above the 50-day average and the 50-day is far above that of the 200-day average. Analyst estimates have a year-end price target of $41.75 for April 6, 2018.

Service Corp International/US (SCI US) - Adj Highlights

In Millions of USD 12 Months Ending	FY 2015 12/31/2015	FY 2016 12/31/2016	Current/LTM 09/30/2017	FY 2017 Est 12/31/2017	FY 2018 Est 12/31/2018
Market Capitalization	**5,094.01**	**5,379.11**	**7,453.80**		
- Cash & Equivalents	134.60	194.99	267.96		
+ Preferred & Other	4.71	2.53	0.27		
+ Total Debt	3,124.43	3,286.59	3,369.13		
Enterprise Value	**8,088.55**	**8,473.25**	**10,555.24**		
Revenue, Adj	**2,986.04**	**3,031.14**	**3,091.35**	**3,098.40**	**3,219.20**
Growth %, YoY	*-0.27*	*1.51*	*3.34*	*2.22*	*3.90*
Gross Profit, Adj	**674.59**	**676.43**	**721.09**	**724.41**	**775.18**
Margin %	*22.59*	*22.32*	*23.33*	*23.38*	*24.08*
EBITDA, Adj	**785.90**	**806.74**	**846.79**	**836.20**	**891.20**
Margin %	*26.32*	*26.62*	*27.39*	*26.99*	*27.68*
Net Income, Adj	**248.73**	**265.02**	**297.01**	**308.00**	**309.00**
Margin %	*8.33*	*8.74*	*9.61*	*9.94*	*9.60*
EPS, Adj	**1.21**	**1.35**	**1.54**	**1.51**	**1.64**
Growth %, YoY	*-13.58*	*11.35*	*31.50*	*11.81*	*8.62*
Cash from Operations	**472.19**	**463.60**	**494.70**		
Capital Expenditures	**-150.99**	**-193.45**	**-203.90**		
Free Cash Flow	**321.20**	**270.15**	**290.80**	**285.33**	**341.14**

Source: Bloomberg

The statement shows that SCI has shown strong top and bottom line growth that should continue into a strong 2018. As the company continues to grow and create improved efficiencies of scale, then profit margin will continue to improve, boosting per share earnings. Cash from Operations has shown consistent growth over the previous three years, exemplifying the successful direction the company's directors have outlined for the company.

In Millions of USD except Per Share 3 Months Ending	Q3 2016 09/30/2016	Q4 2016 12/31/2016	Q1 2017 03/31/2017	Q2 2017 06/30/2017	Q3 2017 09/30/2017
Balance Sheet					
Current Assets					
Cash and Equivalents	177.57	194.99	238.25	224.89	267.96
Accounts Receivable - Trade	74.29	98.46	86.95	72.25	77.43
Inventories	28.53	26.43	27.38	27.33	27.16
Other Current Assets	64.46	34.52	38.18	30.40	32.34
Total Current Assets	**344.85**	**354.40**	**390.76**	**354.87**	**404.88**
Noncurrent Assets					
Property Plant & Equipment - Net	3,597.72	3,604.52	3,593.08	3,613.12	3,652.25
Goodwill	1,801.89	1,799.08	1,805.59	1,804.49	1,807.82
Other Noncurrent Assets	2,016.04	1,974.99	2,025.34	2,043.28	2,082.66
Other Receivables (Long-Term)	4,290.97	4,305.17	4,444.40	4,572.52	4,677.59
Total Assets	**12,051.48**	**12,038.15**	**12,259.17**	**12,388.28**	**12,625.20**
Current Liabilities					
Accounts Payable and Accrued Expenses	447.31	439.94	—	—	—
Current Portion of Long-Term Debt	—	89.97	63.61	70.73	76.31
Income Taxes Accrued/Payable	1.00	7.96	72.38	12.23	9.40
Other Accruals	447.31	—	477.00	441.40	494.02
Current Portion LT Debt and Capital Leases	89.53	—	—	—	—
Total Current Liabilities	**537.84**	**537.87**	**612.99**	**524.35**	**579.73**
Non Current Liabilities					
Long Term Debt	3,181.69	3,196.62	3,224.65	3,290.94	3,292.82
Deferred Income Taxes (Liabilities)	459.16	454.64	446.09	442.53	451.27
Deferred/Unearned Revenue (Long-Term)	1,753.99	1,731.42	1,761.06	1,777.83	1,796.76
Other Noncurrent Liabilities	5,029.09	5,022.36	5,030.62	5,147.65	5,265.67
Stockholder Equity					
Minority/Non Controlling Int (Stckhldrs Eqty)	2.41	2.53	2.58	0.29	0.27
Common Stock	190.49	189.41	187.95	187.32	187.75
Additional Paid In Capital	1,015.27	990.20	968.19	958.43	971.13
Treasury Stock (Amount)	—	-6.00	-8.81	—	—
Accumulated Other Comprehensive Income	24.27	16.49	19.66	30.09	46.66
Retained Earnings (Accumulated Deficit)	-142.74	-103.39	5.37	28.86	33.14
Shares Outstanding	190.49	189.41	187.95	187.32	187.75
Par Value	1.00	1.00	1.00	1.00	1.00
Shares Issued	203.12	195.40	196.76	197.28	198.54
Total Shareholders Equity	1,089.70	1,095.25	1,183.75	1,204.98	1,238.95
Shares Authorized	500.00	500.00	500.00	500.00	500.00
Total Shareholders Equity Excluding Minority	1,087.29	1,092.71	1,181.17	1,204.70	1,238.68

Total Liabilities and Shareholders Equity	**12,051.48**	**12,038.15**	**12,259.17**	**12,388.28**	**12,625.20**

In the following chart, all principal amounts of the company's debt agreements are listed. Not reflected in this chart is the refinancing of the 7.625% Senior Notes due 2018 with a 4.625% Senior Note due in 2027. The company has been able to renegotiate their debt in the last few years, which reflects its strong financial position. Although they are highly levered, I see no liquidity issues as the company can easily access funds through their credit facilities and other senior notes. As the Company continues to refinance existing debt obligations, I expect Net Interest expense continuing to decreasing as it has in the previous years. Service Corporation International has two covenants in their Banking Credit facility. They are well within these two covenants and pose no serious threat currently of violating them.

	September 30, 2017 (In thousands)	December 31, 2016
7.625% Senior Notes due October 2018	-	$250,000
4.5% Senior Notes due November 2020	200,000	200,000
8.0% Senior Notes due November 2021	150,000	150,000
5.375% Senior Notes due January 2022	425,000	425,000
5.375% Senior Notes due May 2024	850,000	850,000
7.5% Senior Notes due April 2027	200,000	200,000
Term Loan due March 2021	647,500	673,750
Bank Credit Facility due March 2021	470,000	350,000
Obligations under capital leases	191,627	208,758
Mortgage notes and other debt, maturities through 2050	6,134	3,753
Unamortized premiums, net	7,673	8,313
Unamortized debt issuance costs	(28,804)	(32,984)
Total debt	3,369,130	3,286,590
Less: Current maturities of long-term debt	(76,314)	(89,974)
Total long-term debt	$3,292,816	$3,196,616

Capital Allocation Considerations

		12/31/2016	9/30/2017
	Per Credit Agreement	Actual	
Leverage ratio	4.25 (Max)	3.83	3.62
Interest coverage ratio	3.00 (Min)	5.21	5.39

Effects of 2018 Tax Changes

Although the February 4Q17 earnings call will provide clarity on the overall benefits of the recently revised United States tax code, as a domestic, largely cash based company; SCI pays significantly higher tax rates than other US based companies. For the year ended 2016, SCI had an effective tax rate of 45.7%, twice that of the new base corporate tax rate of 21%. A significant reduction in taxes paid would unlock EPS as well as significantly increase free cash flow. A reduction in the tax rate would also allow for increased acquisitions, an increase in dividend, and increased share buybacks.

Price Estimate

Currently, SCI shares are trading at a 20X multiple of 2018 Free Cash Flow per share estimates of $1.99. Based on other industry leaders within the Services industry, P/FCF should trade within a 20-24X multiple. One could argue that SCI maintains a greater control in their expected industry than any other company does, and I believe this number should be higher for SCI. A multiple closer to 22x should represent a strong hold that SCI holds within the death care industry. In addition, with tax reform expected to provide higher earnings, I expect free cash flow to rise significantly. If SCI can lower their effective tax rate then this figure should jump significantly from its $1.99 estimate. Although the earnings call will provide greater clarity, I believe an estimate of $2.15 is attainable depending on management's capital decisions. Based on these factors, we recommend a price target of $47.50 for 2018.