Stupid Investment of the Week

Commentary: Don't bury yourself in Service Corp. International stock

By Chuck Jaffe, MarketWatch
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BOSTON (MarketWatch) -- It has long been said that the only things certain in life are death and taxes.

From an investment standpoint, that should mean that the only sure things are government securities and mortuary and cemetery businesses. With Treasury securities yielding almost nothing, some investors are looking for recession-proof businesses that might be safe havens to ride out the current storm.

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And while death never takes a holiday, the funeral business is not quite the bellwether that it might seem. For proof, consider Service Corporation International (SCI) , the largest provider of death-care services in North America, and today's pick for Stupid Investment of the Week despite operating more than 1,300 funeral homes and 350 cemeteries in 43 U.S. states and throughout Canada.

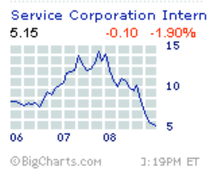
Stupid Investment of the Week highlights the flawed logic and beneath-the-surface issues that make a security less-than-ideal for the average investor. The hope is that showing where danger lies in one situation will make it easier for readers to uncover problems elsewhere. While obviously not a purchase recommendation, neither is this column intended as an automatic sell signal.

Grave decision

Investors in Service Corporation International clearly have a case for being optimistic. For starters, there is the fundamental idea that the funeral business will have customers in every type of economic condition. Moreover, with the Baby Boom generation now hitting retirement age, it's easy to assume that demand could actually grow in the near future.

As much of the focus of the death-services business has shifted to "pre-need planning," SCI has built up a tremendous store of future business, accumulating some $6.5 billion in pre-need deals, a backlog that grows with each new sale and which basically locks in a healthy chunk of future revenues.

After six straight years of strong stock performance, Service Corporation International has been hammered this year, losing more than 50% of its value during the market meltdown. That actually makes the stock more attractive to some investors, because the stock is now trading below many fair-value estimates.



Morningstar, for example, gives the shares a four-star rating, putting a fair-value estimate on the stock of $9.50 per share, which means that the current stock price could represent something of a bargain. And most of the firms that track the stock have it rated as a hold, not a sell.

But if you're looking at a cemetery company -- or any stock -- you need to dig beneath the surface to find the scary stuff, and there's the distinct chance here that Service Corporation International stock has further to fall before it provides any real growth.

Start with some history. A decade ago, SCI pursued an almost reckless growth-by-acquisition strategy, overpaying to acquire many independent death-care providers. The company reversed course in 1999, but there are some lingering effects, not the least of which is that auditors have found material weakness in the company's internal account controls.

Taxes on death

Typically, investors want an auditor's report that is brief and boilerplate; in SCI's case, the word is that the company may not have the controls in place to prevent or detect misstatements. It's no surprise the company has had a few restatements in the past; while management has taken steps to fix the problem, it will take time before an investor can truly have confidence in the numbers.

Further, the Internal Revenue Service and various states are auditing SCI tax returns dating as far back as 1999; additional tax costs and fines are a possibility.

When it comes to ongoing operations, the $6.5 billion in pre-need assets also presents a big challenge, given current market conditions. SCI must set aside those customer purchases in investment trusts until products and services are performed and delivered.

If the company can't grow the investment trusts faster than funeral costs are rising, Service Corporation International will wind up being squeezed -- and having to make up any shortfall -- when those future services come due.

Historically, the company's return on assets has been low. Return on assets is a sign of just how well the company is doing in its own business. Based on ROA, Service Corporation International might have been better off forgetting about the funeral business and simply investing in Treasurys. Moreover, the company's recent revenue growth has come more through acquisition than organically through additional sales; that has pinched profitability further.

Finally, while death is recession proof, that doesn't mean people will not cut their spending when sending loved ones to their eternal rest. Not only is cremation on the rise -- and cremation is a much lower-cost alternative to the traditional burial -- but consumers can also choose less-opulent, less-costly memorials. That's increasingly likely with pre-need planning on the rise and consumers laying out their own dollars in advance. Those customers are likely to want to keep extra cash available to cover their living expenses, rather than their dying ones.

Even the aging of the Baby Boom generation is no guarantee of increased revenues, as life expectancy has never been higher, so that the funeral business is not likely to experience a "Death Boom" based on demographics.

"SCI's current valuation implies growth expectations that would give most investors a heart attack," says David Trainer, president of New Constructs, a Nashville, Tenn. based research and hedge fund firm that scours the financial footnotes to determine a stock's true valuation. Such additional research is crucial on a stock like SCI, where the surface statements have been deemed suspect.

"To justify the current price," Trainer continued, "the company has to grow revenues and profits at over 10% for the next 20 years consecutively. Those expectations are steep considering that the five-year average revenue growth rate for SCI is zero ... SCI's stock might be lucky to avoid its own burial."

Chuck Jaffe is a senior MarketWatch columnist. His work appears in dozens of U.S. newspapers.