Invocare 01/06/2010 **FAT-AUS-476**

IVC AUD $5.96 Special **LOW** B

What it lacks in glamour it makes up for in reliability

Our broad longer-term view is that the global recovery will continue to push forward. Growth will however be sedate due to the necessity of lower spending and higher taxation across much of the western world as governments re-balance the books. Equity market volatility is likely to remain elevated as valuations follow a pattern of running ahead of themselves, before pulling back. In many cases the correctional phases will over-extend to the downside, as has occurred recently.

We introduced Ramsay Healthcare to the Fat Prophets Portfolio earlier this year in view of our outlook for increased volatility. This week we have added a second defensive stock, funeral services company Invocare (IVC). Invocare's business is very effectively buffered from the business cycle in that its sales are driven by mortality rates.

Business overview

Invocare is a provider of funerals, burials and cremations. The company operates a network of around 170 funeral locations across Australia as well as 12 cemeteries and crematoria in NSW, Queensland and the ACT.

Invocare's CEO Andrew Smith hasn't been in the role for particularly long, having been appointed in January 2009. Mr Smith has however been with the company since 2006, previously serving as its Chief Financial Officer before being promoted to Chief Operating Officer in March 2007. He therefore has an excellent understanding of the business and is also able to draw on previous executive roles, CFO of Oroton Group.

The funeral business is the core of Invocare, consistently contributing more than 75% of group sales. The company owns the only two national funeral brands in Australia. These are White Lady Funerals, which has 43 locations in Australia and a further 45 Simplicity Funeral locations.

White Lady Funerals is an all-female service that markets itself as providing a "women's understanding" and it is Australia's fastest growing funeral brand. The brand has been in existence since 1987 and almost half of its outlets are located in NSW. Simplicity Funerals is also a less traditional approach. The brand has been established since 1979 and is also predominantly in NSW.

In addition to White Lady and Simplicity, the rest of Invocare's funeral business operates under traditional, typically family owned brands. The geographic distribution of the traditional brands is similar, with South Australia and WA least represented. This is purely a function of the various state populations.

The various brands are structured around a common back office which centralises functions such as marketing, personnel, IT and accounting. The centralisation enhances the efficiency of the overall business, while also making it relatively easy to enhance the profitability of individual acquisitions.

Indeed, the company has expanded over the years through acquisition and this looks set to continue into the future. Management has also taken the business overseas, with the 2006 acquisition of Singapore Caskets, which is currently comprised of 9 parlours and has about a 11% market share. Invocare's Australian businesses accounted for some 29% of industry sales last year.

In addition to the funeral businesses, Invocare operates 12 cemeteries and crematoria, of which 9 are in NSW and 3 in Queensland.

Financials

Invocare's financial performance is, as we would expect from such a defensive business, impressively non-cyclical. The company's sales and earnings have both steadily tracked upwards over the last five years. The company's sales totalled $176.8 million in 2005, rising to $257 million last year.

This impressive 46% expansion has of course been driven by acquisitions. In addition though, the company's strong market position facilitates some degree of pricing power. This enables Invocare to push through annual price rises without impacting volumes. Indeed, average Australian funeral services revenue increased 5.3% last year.

A strategy of growth through acquisition can often deliver success at the top line, but in fact erode shareholder value through lower levels of profitability. This doesn't appear to be the case for Invocare. Management has sustained the company's EBITDA margin at around 25-26% over the last five years.

The real litmus test of the company's performance is its return on equity. Invocare delivered a 68.1% return on equity in 2005, which softened to 47.4% in 2009. Declining return on equity isn't something we would ordinarily associate with successful growth.

Delving a little deeper into the numbers, we can separate return on equity into various components. These are most simply the net margin, asset turnover and financial leverage ratios. In doing this it is clear that the company's return on equity decline is a function of lower financial leverage, the ratio of assets to equity.

Net debt to equity has declined from 512% in 2005 to 194% last year. Indeed, had Invocare's financial leverage remained unchanged over the years, 2009 return on equity would have exceeded 90%.

The company's net margin has softened only marginally over the five years in question, from 13.2% to 12.7%. Asset turnover, which measures the level of sales relative to the company's assets has increased from 56.2% in 2005 to 77%. On this evidence it is clear that management's expansion strategy has not been achieved at the cost of shareholder value.

Members may consider that Invocare's high level of gearing is inconsistent with its low risk rating. While this would normally be the case, Invocare's situation is somewhat unique. First and foremost its sales are more certain than most other businesses, which in itself supports a higher level of gearing. The business also has a comfortable net interest cover, with EBIT covering the interest expense 6.6 times.

More importantly, the company's financial statements don't quite tell the full story. There is a growing trend towards pre-paying funeral expenses and Invocare has a significant pool of funds in relation to this. Indeed, prepaid sales currently account for some 13% of the company's total sales.

Prepaid funds under management have expanded from $221 million in 2005 to around $275 million currently. As is normal accounting practice, the funds are not recognised as revenue until the service is provided. As such this money sits in Trust and is not reflected on Invocare's balance sheet.

The pool of pre-paid funds essentially increases the certainty of future sales and therefore Invocare's ability to borrow against these future sales. Were the funds held on the balance sheet, Invocare would in fact have a healthy net cash position. The other point to note with regards to the prepayments is that the funds are invested and should therefore grow over time. As at the end of the year, the Trust was in surplus to the tune of $10 million relative to the original sales value. The surplus feeds into Invocare's income as each service is provided.

Valuation

An appropriate valuation effectively comes down to the price we are prepared to pay for future earnings. The price is dependent on the certainty attached to those earnings, so we would expect Invocare's high degree of earnings certainty to increase its valuation. This is certainly the case, with the stock trading on a consensus 2010 price to earnings ratio of 18 times, falling to around 15 times 2012 consensus earnings.

Management's policy is to pay out at least 75% of the company's earnings as a dividend. Given the high degree of confidence in the company's earnings, we have similar confidence in its dividend. Invocare's dividend yield is currently around 4.4% fully franked, or effectively 6.3%.

Invocare is in the interesting position of generating a reliable earnings stream that is attractive to income investors, while also generating a high return on equity. We would ordinarily expect a high return on equity to be associated with a lower dividend payout ratio. This is in effect the case for Invocare, given that the company operates a dividend reinvestment plan (DRP), which reduces the actual cash outflow from the company.

We would recommend that Members take up the DRP. Those long-term shareholders that do not will be steadily diluted as new shares are issued to participating shareholders. Moreover, Invocare's steady growth and reliability of income makes it an ideal compounding vehicle for those investors with a long term view.

Turning to the charts, Invocare is in a broad uptrend, with the current uptrend line supporting any downward move. Invocare recently bounced higher from a low of $5.70 on May 26. Currently, Invocare is experiencing resistance at the 50 day SMA (green line) at $6.05. Should a convincing break above this level occur, we would anticipate a strong move towards resistance at $6.30. Any downside move should be supported at the 200 day SMA (red line) at $5.94.

In summary, Invocare is a well-managed business that is underpinned by slow but reliable growth in terms of mortality rates. Australian deaths are projected to climb to an annual growth rate of around 2.7% in 2030. Invocare's growth will continue at a greater pace as it wins further market share, primarily through its acquisition strategy. Furthermore, its pricing power enables Invocare to push through annual price increases at little or no cost to its market share. These price increases have averaged 4.3% over each of the last five years.

While the company isn't cheap, its valuation is justified by the strength and certainty of its business. As such, the stock is an attractive low risk addition to an investor's portfolio, which can be used as a safe harbour during periods of heightened volatility.

We recommend Invocare as a buy to all Members around $5.96.

Snapshot IVC

Invocare

Reuters: InvoCare Limited is an Australia-based company. The Company is a provider of services to the funeral industry in Australia and Singapore. The subsidiaries of the Company include Dignity Pre-Arranged Funerals, Memorial Guardian Plan, Pine Grove Forest Lawn Funeral Benefit Company, The Australian Cremation Society, Metropolitan Burial and Cremation Society Funeral Contribution Fund, Labor Funerals Contribution Fund, Purslowe Custodians, Beresfield Funerals, Restbind, D & J Drysdale, Liberty Funeralsand InvoCare (Singapore).

Market Capitalisation:$613m

	FY1	FY2
Price to Earnings	18	16.7
Dividend Yield (%)	4.4	4.8
Price to Book	7.1	6.4
Return on Equity (%)	42.0	40.1