InvoCare 15/05/2018 **FAT-AUS-873**

IVC AUD $11.92 Core **MED.** **S**

Fat Prophets Take Profits

Australia's largest mortuary player, InvoCare (ASX.IVC) recently released a trading update covering its first quarter operations. So far, there seems to be decent progress on the company's "Protect & Grow" 2020 refurbishment plan, however this has also led to a substantial impact on profitability. That aside, we are seeing question marks raised on this project's ability to accelerate earnings.

Having taken profits on the stock around $14.28 back in February, we are now inclined to bank further gains, and exit what has been a strongly performing recommendation. **We recommend Members sell their holdings in Invocare.**

What's New?

In our previous coverage back in February (FAT-AUS-861) we closely looked at the company's 2017 results where we noted a solid performance and double digit growth. The clincher, though, was that management had provided a disappointing 2018 outlook and hence our recommendation to Sell Half, and take some profits off the table.

In their plan, management intended to invest about $200 million into a reinvestment programme dubbed "Protect & Grow 2020 Plan" which involved refurbishing 25 other sites, "enhancing" 11 sites and opening 15 new sites. That aside, management also noted that they will seek operational efficiencies through implementing better software and sharing service facilities across different operations.

In light of this, the sites undergoing refurbishment will likely be closed in the interim and likewise management has issued a profit warning noting that 2018 operating EBITDA growth will be in the "Low single digits" while Operating EPS will be "Flat". None of which are good signs in our view and warranted the profit taking move.

Unsurprisingly, the market responded with selling down the shares as the expected earnings decline made the company somewhat expensive given its defensive profile. Since then there have been only a couple of updates with one being a minor acquisition and a trading update which will be the key focus in today's report.

Acquisition

First off, before moving on to the trading update, the company, in early March, announced an acquisition of a J.A. Dunn Funeral Services based in Launceston, Tasmania for an undisclosed figure. The location is captured in an image below:

Image Credit: Google Maps

The acquisition will allow InvoCare to penetrate the Launceston market with an already established brand and operating mortuary. We believe that **this acquisition will unlikely be a large impact in the near term considering the ongoing "Protect & Grow" programme** with ongoing refurbishing of sites. The <u>location services approximately 200 funeral cases a year and generates about $1 million in revenues</u>.

1Q Trading Update

Now, moving on to the latest trading update issued early this month held at the annual Macquarie conference.

At the event the company provided an update on the progress of its "Protect & Grow" programme. It is indeed quite transformative and, in our view, could open up avenues to new markets as it has a more modern and non-denominational look (providing appeal to all faiths) as shown in the images below:

Chapel (Old)

Chapel (New)

Source: 02 May 2018 Company Presentation

That aside, the company is also making steady progress with the transformation as shown in the graphic below:

Protect & Grow – Q1 Progress

Refresh & Enhance	
2018 Key Deliverables	**Q1 2018 Update**
Refresh > 41 sites due to be delivered (incl. 12 relocations) > 13 additional sites due to be commenced	**Refresh** > 2 sites delivered in Q1 > 15 sites due for delivery in Q2 > 24 sites due for delivery in Q3/Q4 > 13 additional sites due to be commenced in 2018
Enhance > 12 sites due to be delivered > 8 sites due to be commenced	**Enhance** > 2 sites delivered in Q1 > 10 sites underway and due for delivery in Q4 > 8 additional sites due to be commenced in 2018

Growth	
2018 Key Deliverables	**Q1 2018 Update**
> 15 sites commenced in 2017 and to be delivered in 2018	> 4 sites delivered in Q1 > 9 sites due for delivery in Q2 > 2 sites with DA approvals with local council

InvoCare
Innovation Vocation Care

Source: 02 May 2018 Company Presentation

However, the more salient development, in our view, is the actual business performance. In the first quarter (1Q) update, **the business interruptions have led to a significant $6.6 million or 6% drop in gross sales year-on-year to circa $103-104 million.** For a business that grows at circa 1-3% per annum, this impact is substantial.

H1 Performance Update

> As foreshadowed in February IVC's performance in 2018 will be impacted by the Protect & Grow plan due to decreased volume following the temporary closure of renovated sites and increased depreciation / finance costs

– Q1 gross sales were down $6.6m (6.0%) year on year

– Q1 year on year funeral case volume is down by 721 cases or 6.7%

> The volume decline was mainly driven by:

	% of Volume Decline
Planned closure of the Singapore, re-opening May 2018	16%
Closure of the US business	20%
Closure of sites in Australia for renovation (net of growth)	21%
Lower volumes in the core Australian / NZ funerals business	43%
Total	100%

> Market intelligence suggests number of deaths in Q1 is down year on year. This will be confirmed by data from Birth, Deaths & Marriages

> Performance in Q2 will improve as Singapore location re-opens in May and as further Protect & Grow sites come on-line in Australia and NZ

> H1 Operating EBITDA Forecast is circa 12% year on year decline with more than half as a result of new operational and one-off Protect & Grow related expenses

InvoCare
Innovation Vocation Care

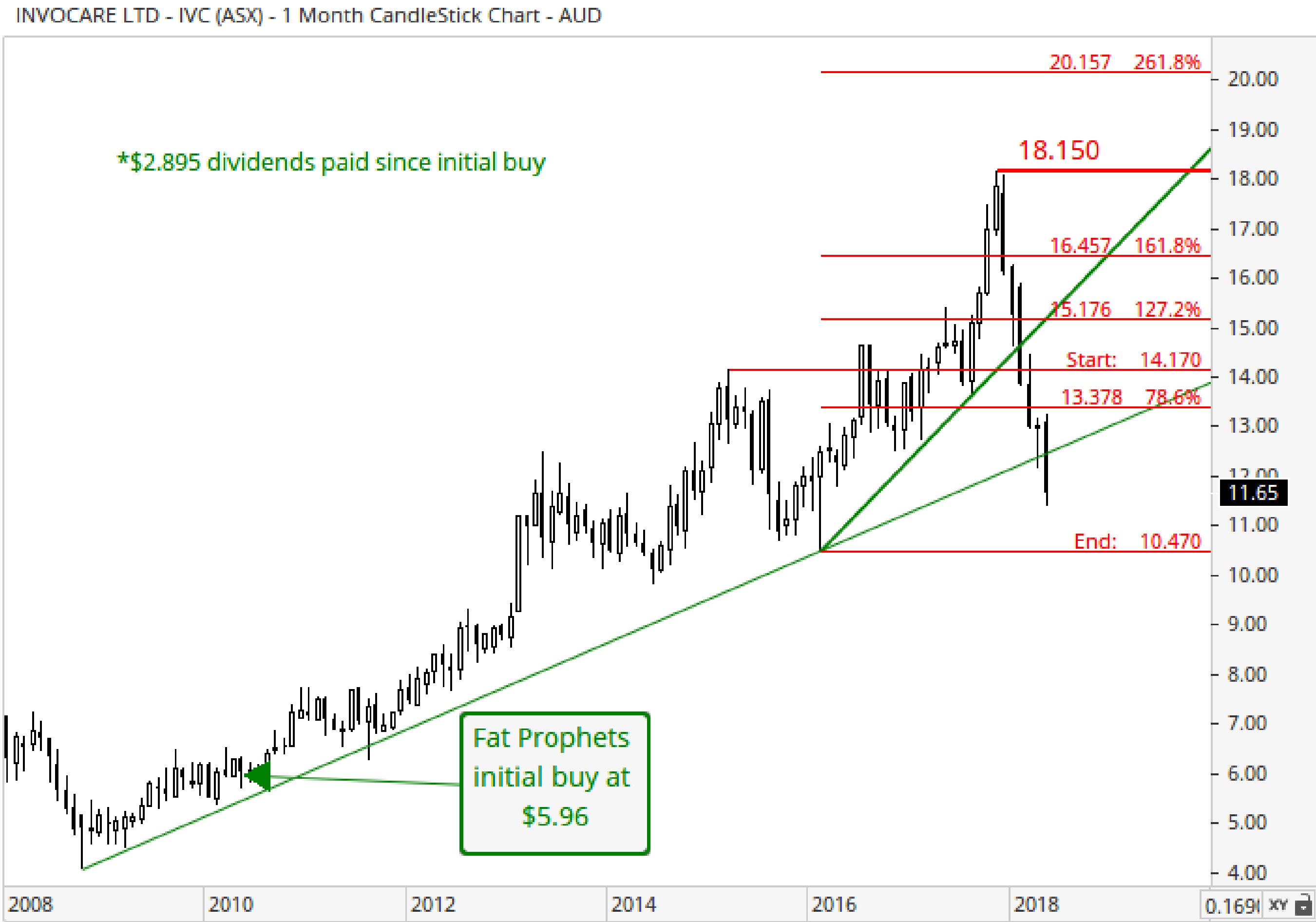
Source: 02 May 2018 Company Presentation

To make things worse, the company provided an update on EBITDA forecasts which turned out to be a double-digit decline due to "new operational and one-off" expenses. At this pace, we believe that the "Low single digits" growth forecast is unrealistic and management seems to hint at their view as well considering **the new forecast of EBITDA being "in line with 2017" and leaving growth out altogether.**

We suspect that management is gradually reducing expectations by lowering the forecast at an incremental pace. That said, these trends already foreshadow a deterioration of the fundamentals which warrants our view for a **complete exit**.

Turning to the technical picture and on the daily chart a zone of support between $13.61 and $13.92 has given way. This was made up of the August 2017 low (horizontal solid-blue line) and the February intra-month low (horizontal thin-blue line) respectively.

Regarding the monthly chart, prices have also dropped below the 78.6% Fibonacci retracement of $13.38. There has been an accompanying breach of the upward slowing trend-line (green) which has further weakened the technical picture. Next support from here exits around $10.47, the February 2016 low.



Key Takeaways

Though investing for the future is normally seen as a positive, and which we are usually supportive of, we do foresee some underlying issues with Invocare. The ”Protect & Grow” programme may in fact be towards “keeping the status quo” instead of growing earnings.

First off, death rates are relatively fixed and for developed markets which have access to better healthcare, sales growth may be capped at 2-3% per annum at most. Therefore, growth will likely be found in acquisitions or increasing competitiveness against rival firms via price setting (could reduce margins) or differentiation (could increase costs), both of which will impact earnings negatively.

The current moves the company is making seems to be leaning towards the latter as sizable acquisition targets are coming too few and far between with the most recent one being relatively modest in size. That said, the company’s efforts to transform the business will not necessarily accelerate earnings, thus, we believe it is best to take profits now and sit on the sidelines and wait for the dust to settle.

Summary

InvoCare recently released its first quarter trading update with a bearish update to its 2018 guidance as the ongoing “Protect & Grow” programme has increased costs. In addition, after a close inspection of the company’s competitive position, we believe that the current efforts will lead to just sustaining the status quo and not accelerate earnings.

On the valuation front, Invocare shares are trading at 21.8 times FY18 earnings, falling to 20.4 times the following year, which is still somewhat demanding for a defensive/low growth business. The projected yield over the same time frame expands from 3.9% to 4.1%.

Accordingly, <u>we recommend Members SELL their remaining holdings in InvoCare around current prices. Coverage of this stock will cease immediately</u>**.**

Snapshot IVC

InvoCare

Latest Closing Price: $11.92

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:$1.31b

	FY1	FY2
Price to Earnings	21.8	20.4
Dividend Yield (%)	3.9	4.1
Price to Book	4.5	4.3
Return on Equity (%)	20.9	21.6
EV/EBITDA	12.4	11.3