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Carriage Services Inc Announces Call to Discuss Senior Notes Refinancing and New Intrinsic Value Roughly Right Range Corporate Call

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PRESENTATION

Operator

Good day, and thank you for standing by. Welcome to the Carriage Services Conference Call and Webcast. (Operator Instructions) Please be advised that today's conference is being recorded. (Operator Instructions) I would now like to hand the conference over to your speaker today, Steve Metzger, Senior Vice President and General Counsel. Thank you. Please go ahead.

Steve Metzger ***Carriage Services, Inc. - Senior VP, Secretary & General Counsel***

Thank you, Chelsea, and good morning, everyone. Today, we'll be discussing our press release, which was made public yesterday after the market closed. We have posted the press release, including supplemental financial information on the Investor page of our website. In addition to myself, on the call this morning from management are Mel Payne, Chairman and Chief Executive Officer; Ben Brink, Senior Vice President and Chief Financial Officer; Shawn Phillips, Senior Vice President and Regional Partner; Peggy Schappaugh, Vice President of Operations and Acquisitions Analysis; Paul Elliott, Senior Vice President and Regional Partner; Chris Manceaux, Senior Vice President, Regional Partner; and Carlos Quezada, Senior Vice President of Sales and Marketing.

Today's call will begin with formal remarks from management, followed by a question-and-answer period. Before we begin, I'd like to remind everyone that during this call, we will make some forward-looking statements. Any comments made by our management team that state our plans, beliefs, expectations or projections for the future are forward-looking. These forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those contemplated in such statements.

These risks and uncertainties include, but are not limited to, both factors identified in our press release, and in our filings with the SEC, all of which are available on our website.

During this call, we'll also discuss certain non-GAAP financial measures. A reconciliation of these non-GAAP measures to the appropriate GAAP measures can also be found in our press release as well as on our website.

Thank you for joining us this morning and now I'd like to turn the call over to Mel.

Melvin C. Payne ***Carriage Services, Inc. - Founder, Executive Chairman & CEO***

Thank you, Steve. Well, the press release I wrote and we put out yesterday, I've been waiting to write it for almost 30 years. June 1, '91 is when I co-founded the company with the idea that one day will become a great investment vehicle and wealth creation would be the primary goal over 5- and 10-year periods. It took me a little longer to get the company to the critical mass, almost 30 years. And I told my team, all of which are here. "look, it took us 30 years to get to $30 a share. I don't have another 30 years to get to $60 or $90 or $100. Let's speed it up."

But before I turn it over to Ben, I would like to just comment on my history of studying master investors ever since I got wiped out on October 19, 1987. And that's what I do in my off time, which is not much, just here at the company and then learning how to invest more when I'm not here at the company, my kids have grown, and my wife and I are empty nesters.

So I started out this press release, with a little segment on Barron's interview with Larry Puglia, but I would like to do an acknowledgment that I've studied 2 great investors, the best of all time, Warren Buffett, Charlie Munger and Doug Reinke. Doug Reinke has been an investor in Carriage for 25 years. And he's also the only Carriage leader who claimed a mountain -- I mean a real tall mountain in planted a Carriage flag on the top. I ended with Doug and an e-mail he wrote me recently, so if you gave up and didn't get to the end, get to the end and read about Doug.

With that, I'll turn it over to Ben.

Carl Benjamin Brink ***Carriage Services, Inc. - CFO, Senior VP & Treasurer***

All right. Thank you, Mel. And thank you all for joining us on the call this morning.

Like Mel said, yesterday, after the close of market -- we issued a press release to announce the closing of our senior notes refinancing transaction and introduced a new roughly right range of Carriage's intrinsic value. I encourage current and prospective shareholders to review the release and its entirety as it certainly provides significantly more detail and color than my remarks here, but I can also guarantee this will be the first press release you will ever read that assigns the roles of Mr. Bond and equity market to Tom Brady and Rodney Dangerfield, respectively.

We issued $400 million of unsecured senior notes due 2029 at a coupon rate of $4.25, representing a 276 basis point spread to the corresponding treasury bond on the day we priced. As detailed in the release, we had significant demand for the $400 million of notes and have the opportunity to engage with the leading high-yield investors throughout the roadshow process where we highlighted the high-performance transformation that has occurred here at Carriage over the past 2.5 years. The rapid de-leveraging we have achieved over the course of the past 15 months, the high amount of reoccurring and growing free cash flow and our commitment to maintain a leverage ratio at or below 4x as a matter of policy going forward.

Most importantly, we detailed the current and future Carriage where the accelerating shareholder value creation is funded from internally generated free cash flow equity while maintaining a more moderate debt leverage ratio, thereby eliminating the perceived risk to both credit and equity investors about us relevering the company.

These themes resonated with the investors we met with throughout the process, and we are grateful for the support from both long-term and our new bondholders. We additionally closed on a new 5-year $150 million revolving secured credit facility. Current borrowings under the facility are approximately $58 million, which included an approximately $20 million premium payment to call our existing 6.625% senior notes. Our current borrowing rate on the new facility is LIBOR plus 1.75% compared to 3%, plus a 75 basis point LIBOR floor on our previous credit facility. Our current pro forma leverage ratio is 4x at closing.

As a result of this transaction, our annual interest expense from the senior notes will be reduced by $9.5 million or equal to an increase of $0.36 of earnings per share per year. Interest expense from the credit facility will also be reduced by approximately $1.1 million based on our current borrowings outstanding. Importantly, as a result of this refinancing, our weighted average cost of capital will fall 100 basis points from 7.4% to 6.4%.

I'd like to echo Mel's comments in the release by thanking the team of Bank of America for leading this transaction and for the successful execution we achieved. Additionally, I would like to thank all of our underwriting, legal and honor partners for their support on this transaction and for their continued valued partnership. In our release, we introduced for the first time, our view of the roughly right range of intrinsic value per Carriage share of $50 to $60 using what we view as a conservative range of free cash flow equity yield of 6.4% to 7.4% on a normalized $74 million of recurring free cash flow. We will use free cash flow equity yield as our preferred valuation methodology for calculating and communicating our intrinsic value going forward as well as it will be used as an important part of our capital allocation decision process.

What is important to recognize is that the range of intrinsic value only accounts for Carriage as it stands today and does not take into account any future capital allocation activity. With the completion of this refinancing transaction, we now have the necessary financial flexibility to pursue a range of shareholder value creation capital allocation options, which combined with our lower cost of capital, will lead to a growing amount of free cash flow and improve rates of return on our invested capital. A central topic during our discussions with credit investors was around the sustainability of our free cash flow and our ability to maintain a more moderate leverage ratio in the future.

Our answer was pretty simple. Conservatively, we will generate $600 million of free cash flow over the next 8 years that we will have to allocate to grow the intrinsic value of Carriage without adding any debt. We also reiterated that the $600 million of free cash flow will be allocated with discipline and savvy, and we have no intention of relevering the company as we did in late 2019.

As Mel said in the release, "you only have to transform the company once." Our capital allocation going forward will include the following: we will continue to pursue transformative acquisitions. We believe that Carriage remains the best succession planning solution for independent owners looking for that transition of their business. We have seen activity levels pick up recently, but we will continue to remain disciplined in focusing on growing in the best markets with the best businesses for future growth.

We believe our reputation within the industry has only been enhanced with the acquisition and integration of the 4 recent acquisitions, and we are excited for the opportunities, like we said, to grow selectively over the next 3 to 5 years through acquisitions. With the completion of this transaction, we now have the flexibility to continue to regain or restart our share repurchase program. We currently have $25 million of availability under our share repurchase program.

We will opportunistically repurchase shares when they remain under our intrinsic value as they do today. We will also prioritize share repurchases in combination with other capital allocation activities while maintaining our leverage ratio policy of 4x or below. We also continue to focus on internal growth projects. This will focus on cemetery inventory development, funeral home remodels and greenfield funeral home opportunities that we are currently evaluating today.

We are excited about the multitude of opportunities we have across our portfolio to invest capital within our existing businesses to grow value, and we believe the rates of return on those individual projects will continue to improve as we move forward. We will also look to incrementally increase our dividend over time and maintain a dividend policy of 1% dividend equity yield and approximately 10% of our adjusted free cash flow.

And finally, I will leave everybody with this: Almost 18 months ago when we announced the acquisition of Fairfax, we committed to de-lever the company through high-performance execution and disciplined capital allocation. At that time, we laid out a 3-year roughly right scenario in which we have achieved -- overachieved all of those goals within the last 18 months. The successful completion of the senior note refinancing is the recognition from the bond market of Carriage's high-performance transformation. We view the discrepancy between our 10.7% free cash flow equity yield and the 4.25% unsecured long-term bond yield as the next hurdle that we will overcome here at Carriage.

All of us here, at Carriage, are focused with discipline through high-performance execution and through disciplined capital allocation, to close that valuation gap between our peer comparisons and that spread between our free cash flow yield and our unsecured bond yield. And we are excited about where we are on this journey, who wants to come along with us.

And with that, I'll open it up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes the line of George Kelly with ROTH Capital Partners.

George Arthur Kelly ***ROTH Capital Partners, LLC, Research Division - MD & Senior Research Analyst***

Congrats on closing the transaction, that's really a big achievement. So first question for me has to do with your points in the letter about the valuation that your stock carries. And so as you're kind of weighing where to put your excess cash as you generate cash going forward, are you finding M&A -- potential M&A transactions that are as attractive as the cash that you would generate just by buying your own stock?

I mean looking at that 10.5% yield, are there transactions out there that are competitive with that? And then part 2 of the question is, if not, should we assume that of 100% of your kind of excess or debt discretionary free cash flow will just go towards share repurchases?

Melvin C. Payne ***Carriage Services, Inc. - Founder, Executive Chairman & CEO***

Thank you, George. This is Mel. Yes, I'll lay it all right out. And it wasn't -- I mean, it didn't take a scientist to figure it out. What we believe will happen over the next 5 years through the end of '24 certainly, is that we will grow organically, much faster than we historically have grown organically. That's both on the funeral side and the cemetery side, particularly on the cemetery side. We also have the financial side that is -- will even improve more than what we've expressed publicly.

We recently took a lot of big gains. We have huge gains, push them down to the pre-need merchandising service, the pre-need funeral and then rotate it from those gains into more high recurring income. So we will have an increased flow of financial revenue and financial EBITDA than what I -- what we expressed in the shareholder letter in the first quarter. So yes, we've got to have a lot of organic growth. We have a lot of capital allocation opportunities within the company for growth.

We're already looking at a fantastic new opportunity to put a funeral capital. I mean, a fantastic one, maybe one of the best ones I've seen and lots of opportunities to allocate capital to master plan, high-end product development in 10 or 12 large cemeteries. So looking at acquisitions, we've recently turned down 1 that 10 years ago, we would have said, "Hey, that's a fantastic opportunity, we want it." We turned it down. And the reason we turned it down was we didn't see it could grow as fast as the rest of Carriage.

So right now, the best funeral and cemetery operation acquisition we can make by far with no risk is our own shares. It's a no-brainer. But we want to do it, we can manage our leverage very carefully with this free cash flow coming in, we can manage our leverage more carefully with share repurchases than we can with big acquisitions, which -- even though we had 4 there were home runs. There's always more risk when you do an acquisition than when you know what you got in your own company for 5 or 10 years. So you're 100% right.

George Arthur Kelly ***ROTH Capital Partners, LLC, Research Division - MD & Senior Research Analyst***

And then what do -- so let's assume that your share price continues going up and it's less of a no-brainer decision to buy back stock, it becomes more sort of closer to that intrinsic value that you've put out. How has the M&A environment changed since pre-COVID, are you seeing a lot of opportunities, again, have multiples changed much? Like just in general, what's the dynamic like versus pre-COVID?

Shawn R. Phillips ***Carriage Services, Inc. - Senior VP, Regional Partner and Head of Strategic & Corporate Development***

So this is Shawn. Post-COVID, the activity has picked up. We haven't got into the multiple part of it. Again, we're looking at some really nice acquisition opportunities now, both greenfield and acquisitions of existing businesses.

Melvin C. Payne ***Carriage Services, Inc. - Founder, Executive Chairman & CEO***

Yes. It's hard to say, we're at the very beginning of normalization, and we got a lot of questions during the past year about are you getting a lot of calls? No, everybody was trying to survive, and many of the independents were -- even the good ones were overwhelm depending on where they were with severe outbreaks or their own staff being short. But we are beginning to see people who are now raising their heads saying, "look, I don't want to have to go through something like that again by myself." And we're using the shareholder letter.

Shawn is the point man, while he's got 10 other jobs, but he and I and Peggy's team and the RPs, we're all over that. It's going to be hard to get in the company. You're going to have to be very good. And the next 10 years is going to have to be a lot better than the last 5 or 10 or 20 demographically, and we've got to have the #1 -- strong #2 brand and competitive standing. It's going to be hard to get in the company.

These things are not just around every corner. It's going to be hard to get in this company because we want it to be viewed as a high-performance club, only for the high-performance businesses in the future, not the past. Only for high-performance people, who want to climb the mountain and plant a flag on the top of the peak. And that's where we're going. And now we have the financial flexibility to execute that vision without needing somebody else's money to do it.

George Arthur Kelly ***ROTH Capital Partners, LLC, Research Division - MD & Senior Research Analyst***

Yes. Okay. And then last question for me. What you've talked about today and was in your letter as well just about not willing to lever up in the days of taking on big (inaudible) over. How could -- there are some multiunit operators out there that I imagine would cost -- sort of put you above that 4x range. And how could you -- it's -- are there larger acquisitions that you'd still consider? And how would you be willing to finance them? Is it -- assuming the equity's more fairly valued, would you consider using equity to buy this stuff perhaps? Any help?

Melvin C. Payne ***Carriage Services, Inc. - Founder, Executive Chairman & CEO***

You know, I don't want to go there, George. That's a speculation. And one of the things I almost put in here is one of my favorite sayings, I don't think it made the cut. Like anytime anyone tries to precisely predict the future and outcomes, he'll be precisely wrong at 100% of the time. The further out you go in precisely predicting the future, the greater the degree of the wrongness. And so you will find, much like Charlie Munger, I don't speculate much about that.

Right now, I know what we got. We have a plan to execute. We know the landscape. They're not -- I don't know another Fairfax. I don't know another Fairfax. And some of the others were fantastic businesses. They don't come along very often, and we know the landscape. There might be a transaction. I don't think it's any time in this year or next year. If something turns loose, we'll see how we finance it, but what we said is exactly what we intend to do.

And I don't want to get into talking about equity offering as the way I view it as the next 8 years, we have a secondary offering every year out of free cash flow, and that will grow, and there has been no secondary offering in this industry since August '99, and I wrote about SAI shrinking the industry. It's been unbelievable. That's why the sector is so small.

We get stuck underneath healthcare somehow, we don't get any government money for Medicaid or Medicare, we have to earn it from customers, but it's an amazing industry with incredible free cash flow characteristics. And so I mean, we finally got to a place where -- this is really what I mean. If we can do a $70 million to $80 million secondary offering every year without issuing shares, I want to own more of the company.

George Arthur Kelly ***ROTH Capital Partners, LLC, Research Division - MD & Senior Research Analyst***

Yes. Okay. So what I just heard is basically, larger scale acquisitions, there's absolutely still interest, but it just -- it could take a couple of years?

Melvin C. Payne ***Carriage Services, Inc. - Founder, Executive Chairman & CEO***

Well, yes, there might be, but I don't know any.

Operator

(Operator Instructions) Our next question comes from of Christopher McGinnis with Sidoti & Company.

Christopher Paul McGinnis ***Sidoti & Company, LLC - Special Situations Equity Analyst***

Mel and Ben, congratulations on getting the transaction completed. And we will say, I've never heard of Tom Brady and Rodney Dangerfield (inaudible) Doug planted the flag out. So we'll talk about that offline at some point. But a question was just around M&A. And now the -- you built that team with Carlos. Can you just talk about maybe your thoughts around whether you'd rather pursue more funerals going forward or cemetery? And I know that's really not up to you, but it's more of maybe the seller, but just your thoughts around how you view funeral versus cemetery M&A?

Melvin C. Payne ***Carriage Services, Inc. - Founder, Executive Chairman & CEO***

Yes. I mean, we started off -- I'm a credit guy, the people who offered me alone to start Carriage when I was 48 were former colleagues from Texas Commerce Bank, some of them I have trained in a prior job, and they did a finance company with SCI. So SCI loaned me the money, a finance company. And we grew up -- well, we really weren't growing up when we went public, as I explained in the letter. But it wasn't my idea to build a small group and then sell it to them on an exit strategy, and we grew up to become one of the main players. And just now, it's them and us. There are some others, but it's really them and us.

And we've had a cemetery portfolio, and it wasn't that big, but we've always been dominant on the funeral side that's what I learned: The first, I never did learn the cemetery sales side even though I was in the field for 15, 20 years. I never learned how to do that, even though I knew we didn't know how to do that is at the highest level. And I had all kinds of people coming to the company at different times to try and help me figure that out. None of them ever did even though we weren't doing that, we weren't doing anything close to what we're doing now and will do in the future broadly.

And so yes, absolutely. It's changed how we think about acquisition candidates. I now view cemeteries and the team that Carlos has built, along with the collaboration with all of other people, and we are one team with one vision, we want the businesses that can grow higher compounded revenue and over time, with the operating leverage will higher margins, expand margins and therefore, compound Field EBITDA even higher. And that's what you're going to see the rest of this year in the cemetery portfolio of our same-store acquisition.

And maybe the increases after this year, as Carlos and his team have built up, will be smaller, but they will be more than 2% or 3% a year. I can tell you that. And the Field EBITDA will go up even faster. So it only takes $260,000 of Field EBITDA to be $0.01 a share, and that's also pretax free cash flow. So we will definitely be more aggressive if we get a shot at a really nice combination.

We bought 3 at the end of '19 and all 3 of those are going to be home runs. Fairfax is going to be the engine for growth for 10 to 20 years like Carriage, much like Rest Haven was for Stewart enterprises. They bought it in '78, that was a company maker. SCI bought Rose Hill, $100 million revenue business in LA and some others. And so these big babies are wonderful. We just never had one like this. And so we now know what to do with it because we have the sales team, the framework systems, compensation and the teams are being built. And every Thursday, we get an update yesterday it was unbelievable. So you hear Carlos' teams and what they're doing in our bigger businesses, it's so exciting.

So absolutely, we're going to be looking to do that. And I think what will happen over time is that our revenue ratio and earnings and free cash flow ratio will change from the historical 75-25. I don't know what it will wind up being, it depends, but more like, hopefully, around 65-35, 60-40, something like that. Because that's not dependent on death rates. And then you can overcome the vagaries and the seasonality or COVID, no COVID stuff because you can actually produce revenue, Field EBITDA, free cash flow before someone does.

Christopher Paul McGinnis ***Sidoti & Company, LLC - Special Situations Equity Analyst***

Okay. And just thinking about those superstar assets that you're talking about in Canada scarcity. What makes a superstar asset. Is it the demographics in the region, can you just maybe explain the differences between maybe an A and a D asset now?

Melvin C. Payne ***Carriage Services, Inc. - Founder, Executive Chairman & CEO***

Yes. I mean it's -- we use 10 strategic criteria. These strategic criteria are not the natural criteria. There are more long-term data related to the competitive standing, take Fairfax. I've known that business for 15, 17 years, never thought we'd get a chance to get it, but every time I toured that I just all I could do is just go crazy dreaming what it might be like because it was really an incredible property, but it had never -- it was managed very passively, didn't have any very interesting product. Even though the demographics and all the groups there, high income. I mean, it was just -- it was prime time that had -- just like a gold mine.

Everybody knew it as a gold mine, but they were making so much money in dividending out most of the capital of 37 shareholders, so they weren't building the cemetery side and they didn't have really a pre-need sales program, it was more order taking and what -- and I've known this for a long time. I'm going, "Oh my God," you know, doing $17 million in revenue, but the demographics there, where that is in the future versus the past, it's incredible.

But what they weren't doing to what we can bring to the table is also incredible because here you can allocate capital. And I said this when we first did the press release announcing the acquisition, if you went back and look at it, you'll see what an egg business is as I described them. We allocate capital over the year. And seriously, I mean, you can sell those products, high end, they were mostly selling land. And this is a property that -- I mean, this property could easily get up to $30 million or more than $30 million, $35 million within 10 or 15 years of revenue at very high margins.

That's not a spreadsheet prediction. It's just my back with the envelope knowing what can happen because I've seen these over 30 years now, wondering what it must be like to get one of those early on. Fairfax is one, our business in Dallas, great cemetery. Population is exploding in this bedroom community. It's unbelievable. And so the next 10 years, 20 years, is going to be incredible versus the last 10 or 20. This is what an A is. And then Oakmont, I mean I known about that in California for a very long time. It had been run down, starved of capital, actually milked of capital. They sell a lot of the good product up the mountain recent on a dollar because they needed cash to not go bankrupt.

And we know what to do with that property. We know what to do with it, it needs capital, we put in management. So these 3 were just so rare. And the next 10 years, I mean -- so people say M&A well, these are three, like you're making a new acquisition every year with the incremental performance. That's pretty riskless. And there are other situations like that. So it's not just M&A. We want to grow the company organically with what we already got. And now we got the cash to do it.

Christopher Paul McGinnis ***Sidoti & Company, LLC - Special Situations Equity Analyst***

Congrats on welcoming 30 year.

Operator

There are no further questions. I will turn the call over to Mel Payne for closing remarks.

Melvin C. Payne ***Carriage Services, Inc. - Founder, Executive Chairman & CEO***

Well, I left all my remarks in the press release and then my shareholder letter. A lot of people said that's a long shareholder letter, but I don't think there's any fluff in it and in this press release. So this is all a dream come true for me. And I got a dream team sitting around this table.

More than that, we got dream teams all across the company in our businesses, they are unbelievably good, and I'm honored to be their spokesperson. So thanks, everybody, for your support.

Operator

This concludes today's conference call. Thank you for participating. You may now disconnect.