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PRESENTATION

Operator

Hello, ladies and gentlemen, and welcome to the Carriage Services Second Quarter 2018 Earnings Conference. (Operator Instructions) As a reminder, this conference call is being recorded. I would now like to turn the conference over to your host, Viki Blinderman. Please go ahead.

Viki King Blinderman - *Carriage Services, Inc. - Principal Financial Officer, CAO, Senior VP & Secretary*

Thank you, and good morning, everyone. Today, we'll be discussing the company's results for the second quarter of 2018, which was released yesterday after the market closed. Carriage Services has posted a press release, including supplemental financial tables and information, on its Investors page of our website. This audio conference is being recorded, and an archive will be made available on our website later today through August 6. Replay information for the call can be found in the press release distributed yesterday. On the call today from management are Mel Payne, Chairman and Chief Executive Officer; and Ben Brink, Chief Financial Officer.

Today's call will begin with formal remarks from management, followed by a Q&A period. Please note that during the call, we will be making forward-looking statements in accordance with the safe harbor provision of the Private Securities Litigation Reform Act of 1995. I'd like to call your attention to the risks associated with these statements, which are more fully described in the company's report filed on Form 10-K and other filings with the SEC. Forward-looking statements, assumptions or factors stated or referred to on this conference call are based on information available to Carriage Services as of today. Carriage Services expressly disclaims any duty to provide updates to these forward-looking statements, assumptions or other factors after the date of this call to reflect the occurrence of events, circumstances or changes in expectations. In addition, during the course of this morning's call, we will reference certain non-GAAP financial performance measures. Management's opinion regarding the usefulness of such measures, together with a reconciliation of such measures to the most directly comparable GAAP measures for historical periods, are included in the press release and the company's filings with the SEC. Now I'd like to turn the call over to Ben.

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

Thank you, Viki. To begin with, Mark Bruce is unable to join us on the call today due to a previously scheduled commitment. So you just get me this morning. For the second quarter, our revenue was flat at $63.8 million. Adjusted consolidated EBITDA declined $1.3 million to $15.3 million. Adjusted consolidated EBITDA margin declined 200 basis points to 23.9%, and adjusted diluted EPS declined 26.7% to $0.22 versus the same period last year. The declines in earnings per share and adjusted consolidated EBITDA compared to the second quarter of 2017 were primarily attributable to broad volume declines and increased cremation rates in our funeral home businesses and increased interest expense from our recently completed balance sheet recapitalization, partially offset by continued improved performance from our Cemetery portfolio and a lower effective tax rate.

Year-to-date, our revenue has increased 4% to $137.2 million. Adjusted consolidated EBITDA has increased 1.7% to $37.7 million, and adjusted diluted EPS has increased 8% to $0.81.

The consolidated results for the second quarter represent a period during which many of our same store and acquired funeral businesses experienced challenges related to a broadly lower call volumes and significant change in disposition mix. While the numerical results for the period do not meet our expectations for high performance, the leadership of our managing partners and the execution by their teams during this period continue to reinforce our positive outlook on the underlying trends throughout our same-store funeral operations and the continued progress in our Cemetery sales and acquired funeral home portfolios.

So let me provide some color, starting with our same-store funeral home operations. In our decentralized operating model, our funeral businesses are grouped into 8 geographical subregions. During the second quarter, 6 of those 8 same-store funeral subregions experienced both volume declines and decreases in their burial service mix of between 170 to 540 basis points for the period, translating into an overall increase in our cremation rate of 150 basis points versus second quarter of last year. This stands in contrast to our year-to-date results, where funeral contract volume has increased 123 calls, and our burial service mix has decreased 100 basis points, which is consistent with our historical experience.

As we've communicated in our 2017 shareholder letter, the best insights into results for this most recent period are learned by reviewing the operating trend data for businesses, which we have owned and operated over long periods of time.

During the previous weeks, we reviewed businesses that we've owned since 2011 through June of 2018 with the following results. Contract volumes have remained essentially flat even as we lost a large county coroner contract in 2016.

Net revenue has grown 0.5% at a compound annual growth rate. Field level EBITDA has grown at a 1.2% compound annual growth rate, and EBITDA margin has improved 190 basis points from 38.2% to 40.1% even in the face of cremation rates increasing 780 basis points over that period from 44.8% to 52.6% in our same-store funeral portfolio. What this shows is that we have historically proven performance track record of modestly growing same-store volumes, revenue and field level EBITDA, while overcoming the revenue challenges associated with changes in service mix from burial to cremation. We believe that our managing partners and their teams will continue to meet these challenges and execute at a high level moving forward.

During the second quarter, our acquired funeral operations were also challenged with lower call volumes and/or significant service mix changes. As we've previously shared, it does take time for newly acquired businesses to fully integrate into our Being the Best Standards Operating Model, and we are encouraged by the progress of the big businesses acquired in 2016 as well as the early progress of another big business acquired in late 2017. Both of these businesses were challenged in the most recent period, with a combination of lower volumes and changes in their service mix.

As with our same-store funeral operations, we believe that our managing partners and their teams will continue to meet these challenges, and that the current period results are more short term in nature.

A bright spot on our operating results has been our Cemetery sales results. Year-to-date, overall revenue has increased 5.7% to $25.8 million, while field level EBITDA on our Cemetery segment has increased 13% to $8.1 million. This has been incredible work by our teams to repopulate a lot of our great parks with fantastic leaders and sales manager talent. And we're excited by the results, and we're excited about the opportunities that they have moving forward.

Moving on to our recent completed balance sheet recapitalization. Just as a reminder, we've issued $325 million of new unsecured 8-year notes at 6.625%. We've entered into new revolver with 5 banks, $150 million with a $75 million accordion that currently has no borrowings outstanding. We do have a stub piece of our 2.75% convertible note that will remain outstanding as $28.75 million. Our diluted share count, moving forward, we expect to be normalized at 19.4 million shares outstanding. This is in contrast to the 18.2 million shares that we'll report today. That's a weighted average for the first 6 months. And we expect interest expense on a normalized run rate to approximate $25 million.

We believe this was an important step for Carriage as we look towards the future to normalize our capital structure, lock in an attractive interest rate over the next 8 years and really rightsize our balance sheets, so that it is more simple and easy to understand for the investment community. We'd like to thank our partners that helped us during this process, and for the many investors who took the time and the energy to listen to our story and invest in our high-yield bonds.

We were pleased to announce the acquisition of Covenant Funeral Homes in Fredericksburg and Stafford Virginia, and we welcome the entire Covenant team to the Carriage family. This acquisition expands our footprint in the large strategic market of Northern Virginia and Washington, D.C. area, and we look forward to continuing to serve and grow in this region for many years to come.

We're also pleased to announce 3 new signed letters of intent on acquisitions that we intend to close within the next 90 days, and we remain excited by the opportunities for Carriage to continue to grow through disciplined execution of our strategic acquisition model. Our belief is that Carriage is the succession planning solution of choice for the best remaining independent funeral homes and cemeteries in the country based on our innovative operating model, strong and differentiated high-performance culture and long-term track record of integrating great businesses on to our operating platform.

We are also raising our Rolling Four Quarter adjusted diluting per share outlook to $1.35 to $1.40 based on the 3 letters of intent we signed and expect an improved operating performance versus the second quarter.

Now as our custom, I'd like to honor and announce our High Performance Heroes for the quarter: Wayne Lovelace, Lotz Funeral Home, Vinton, Virginia; Michele Wegner, Buckler-Johnston, S.R. Avery Funeral Homes in Westerly, Rhode Island; Dan Simons, Everly Community Funeral Care in Falls Church, Virginia; Cyndi Hoots, Schmidt Funeral Home in Katy, Texas; Lois Keller-Nelson, Cypress-Fairbanks Funeral Home here in Houston, Texas; Chris Cordell of Moore Funeral Home in Moore, Oklahoma; and Troy Knutson, Austin Funeral Home and Columbia Mortuary in Whitefish, Montana. Congratulations to all of our High Performance Heroes.

And with that, I will turn the call back over to Mel.

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

Thank you, Ben. Thank you, Viki. I thought that was an excellent job in profiling a weak quarter in our funeral business. I'd like to comment about normalizing our balance sheet for the long term. I wish we've got a quarter that had normal call volumes and averages in our funeral business, but that's the luck of the draw. We decided not to normalize the balance sheet last December and waited. I can't say that any of us regret waiting. Rates are moving up. The economy seems to be strong. We had a weak quarter, but it was only a quarter. I'd like to say, and I've often told our people, the data don't lie. But in order to derive the deepest truths about reality, you have to look at the data much more long term and much more in depth business-by-business. And we finished that review. We're happy with our portfolio. We're happy with the opportunity to grow through acquisition with bigger, better candidates, and we're happy about the outlook for our future. So with that, I'll open it up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Alex Paris with Barrington Research.

Alexander Peter Paris - *Barrington Research Associates, Inc., Research Division - Director of Research and Education & Business Services Analyst*

So I'm looking at the call volume in the quarter. Same stores, it was down 2.2%. You did 7,340 calls. That's down from first quarter when call volumes were up 3.4% you did 8,148 calls on a same-store basis. So based on what you said in the press release, Mel, it's a temporary aberration in the quarter, as you just finished saying it's only a quarter. Does that mean that you expect full year call volumes to kind of be in line with what we've experienced recently in line with the death rate?

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

I don't remember if anybody remembers our year-end call, but I was asked about the strong flu season at the time because everybody was talking about the accelerated deaths during the flu season. And memories are very short, Alex. I was asked about that on our year-end call, are we seeing that into the early part of the year, which we were into January. And in that call, I said, "Look, this reminds me of 1994 when I got my first group, and they had a huge flu season in Chattanooga, North Georgia. And at the end of January, I annualized it and said, "Oh my god. I'm going to be rich." And by the end of the year, I was poor, and that's when I started learning about seasonality and unpredictability of this. Yes, by year-end, I would assume that we'll be back about flat or up. And when we do a deep dive through our portfolio, Alex, we don't pay attention to CDC or anything else. We look at the market -- market-by-market and competitor by competitor over long periods of time. We track each business against their competitor each month for 10 years. Our people know where they're losing market share, where they are not, where the death rate is up or down, for no reason. And that's what we care about. And so this is, like I said, a temporary aberration. Am I worried about it? No. I've seen this so many times in 27.5 years, and I lost count. And what I'm excited about is what we're doing in operations and what the future looks like, not just by year-end, but over the next 3 or 4 or 5 years. If we had not issued these bonds, let me put it another way, and found out several things over the last several years. Number one, our balance sheet was screwed up because of the converts. Number two, a lot of equity investors felt like we were overleveraged. We bought in our shares a few times knowing we'd have to repurchase the converts. If -- and we're about 4.5x. I don't think Ben touched on the leverage right now but we're about 4.5x. Is that right, Ben?

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

Yes. We're consistent with what we communicated to investors and publicly and on the road and with the rating agencies. Our intention is to have a financial policy of leverage between 4 and 4.5x. Excited to say that we're just below that 4.5x as of June 30 on a net debt to pro forma EBITDA basis. That doesn't include the acquisition we made in July. So I feel like we made progress. We accomplished the goal we set out to do, bringing down leverage. We've still got work to do in that arena, and we fully intend to be closer to that 4 to 4.5x as we move forward.

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

But my point -- thank you, Ben. My point is this. If we were back before the bonds, and this happened, and we were below 4.5x, we'd be buying our shares in like crazy right here (inaudible). But we promised that we wouldn't do that, and we'll try to get below -- I mean, we'll try to operate more at 4x. And that's what we're going to do. Our word is our bond.

Alexander Peter Paris - *Barrington Research Associates, Inc., Research Division - Director of Research and Education & Business Services Analyst*

Okay. And then similarly, the cremation rate, I don't suspect that, that changes significantly. We're talking about huge numbers of people here. And if I recall correctly, the nationwide cremation rate is 52% or something in that neighborhood. 20 years ago, it was 30%. And it is a reasonable expectation to assume that that's going to increase by 100 basis points a year. You could have a 3-month period where that cohort of deaths choose cremation at a higher rate. But over the course of the year, I would, again, assume it normalizes. Is that the way to think about it?

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

Yes, that is the way to think about it.

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

Yes. I think, Alex, I think what we saw was a decrease in our burial rate, increase in cremation rate about 150 -- 180 basis points in this quarter, where year-to-date it has only been 100 basis points, consistent with exactly what you said.

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

One of the interesting things, Alex, is, which you know about, we have a Standards Council. And on that council are our best managing partners in the country. These are people who have proven themselves over many, many, many years. They're the best of the best. That's how they make it to the council. And we just picked out a handful of them to look at, and it's just what we've described. And some of them had some of the worst variances in cremation and burial mix of anybody. Will it continue? Absolutely not. Not to that degree. It's going to be normalized.

Alexander Peter Paris - *Barrington Research Associates, Inc., Research Division - Director of Research and Education & Business Services Analyst*

Right. And over the course of the year, this business is pretty predictable. Over the course of 3 to 5 years, it's pretty predicable. Over the course of 3 months, you can have a big flu season, which pulls forward some contract volume, and then it normalizes the next quarter. So for every big outperformance in any given 90-day period, you could give a little bit of that back over the next 3 months or 6 months.

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

This has been a long, humbling experience learning the unpredictability of short-term...

Alexander Peter Paris - *Barrington Research Associates, Inc., Research Division - Director of Research and Education & Business Services Analyst*

No, I get it. That's why you don't like to put too much focus on any given quarter.

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

That's right.

Alexander Peter Paris - *Barrington Research Associates, Inc., Research Division - Director of Research and Education & Business Services Analyst*

Rather that's -- and that's reflected in your guidance. Your guidance is a rolling forward 12 months.

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

Yes. Yes, it is.

Alexander Peter Paris - *Barrington Research Associates, Inc., Research Division - Director of Research and Education & Business Services Analyst*

So on that point, Rolling Four Quarter guidance. You've raised guidance, again, to some extent to reflect the 3 letters of intent that you expect to close on. You've said in the press release that you expect higher performance during the latter half of the second half, which, again, reading between the lines suggest a bigger performance in Q4 than Q3 at this point?

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

Yes. I mean, just being savvy about history, you had a good first quarter. The January was off the charts. By March, it weakened a lot. That carried into the second quarter, which we report. And I think the third quarter will have part of that carry over, and then I think we'll come back in the fourth quarter. This is just what I've seen forever, so I wrote that in there the way I've seen it.

Alexander Peter Paris - *Barrington Research Associates, Inc., Research Division - Director of Research and Education & Business Services Analyst*

Okay, great. And then last question, and I'll get back in the queue. Can you give us a little color on the 3 LOIs, what part of the country? I see it's 600 families per year. So I'm assuming that's -- yes.

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

Yes, yes. These are not big businesses, but they're in markets where we know the markets. We already have businesses in all 3 cases. All 3 are strategic areas. So we know our own businesses, and they know these businesses. They vouch for these businesses. And in one case, it's in a really high-growth demographic area, where we have several businesses, and would like to have more. And the whole concept here is where we know an area or market well. And then we have businesses that we really trust who they are and what they've done over long periods of time. And we come across somebody -- may not be a big business, but it's a quality business. And so we've reached out to our own people. In all 3 cases, that is the case. These are really good businesses. One in particular had the opportunity to grow a lot bigger over time. And I think these will turn out to be very additive, even though at this point they're not huge.

Alexander Peter Paris - *Barrington Research Associates, Inc., Research Division - Director of Research and Education & Business Services Analyst*

Well, I would also say that if on average there are 200 families a year, that's still a little bit bigger than the Carriage Services average portfolio, right?

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

Yes. And their averages are very good in all 3 cases.

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

Our average revenue is...

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

Yes.

Operator

Your next question comes from the line of Komal Patel with Goldman Sachs.

Komal Rohit Patel - *Goldman Sachs Group Inc., Research Division - Fixed Income Analyst*

On the margin side, aside from the spike in cremation, could you talk about some of the factors that drove performance there? Anything related to changes in sales leadership that has changed kind of spending there?

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

Really the decline in margin that you saw across our funeral home portfolio was pretty much entirely related to the changes we saw in volume and the changes we saw in mix. There's little stuff here and there around health care and people costs, but nothing that I would call out to be significant. And I think we're -- from a margin perspective, again, to what we said, there's nothing really broken there or no fundamental changes. It's really being driven by volume and mix changes.

Komal Rohit Patel - *Goldman Sachs Group Inc., Research Division - Fixed Income Analyst*

Okay, got it. Fair enough. And then just kind of we noted the financial EBITDA was down about 5% this quarter. Any kind of color to share there?

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

Yes. The big driver in that was a decrease in Cemetery financial revenue. And that was really coming from our perpetual care trust. We have the opportunity to take a little bit -- take some money out for capital gains in some of those of trusts. We did it last year in the second quarter. We didn't do this year in the second quarter. We think we want to keep that more normalized as we move forward. We're not satisfied. But managing our investment -- trust fund investment portfolio prudently, and sometimes you see that in those results, although as you can look at, they've been pretty consistent year-over-year.

Komal Rohit Patel - *Goldman Sachs Group Inc., Research Division - Fixed Income Analyst*

Got it. And then last one for me. Just kind of bigger picture. What are some of the key drivers for the increases or decreases? Or some of the fluctuations in the pre-need contract revenues, is it kind of more largely the elasticity of demand from consumers and kind of general affordability? Or are there kind of shifts in consumer trends about willingness to prepay funeral costs?

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

Yes. I think it's -- I think that's a great question. For us, pre-need is not a huge focus on the funeral side. Approximately 17% of our current revenue is coming from pre-need contracts turning into at-need. We believe strongly in protecting the pricing power that we have at the time of need. Our average pre-need customer is 72 years old. We think that, as a customer, that we are going to attract to our businesses anyways. And we'd expect that average 17% to 20% to be consistent moving forward. What you see in the reported results are actually maturing pre-need contracts. So you're seeing revenue that's being generated from somebody who's bought a pre-need contract previously and passed away in the current period. And as you can imagine, that's pretty variable quarter-by-quarter, who passes away and who has a pre-need contract. I would say if you look at the -- our pre-need sales are pretty consistent. Like I said, we'd expect that 17% to 20% to remain going forward.

Operator

Your next question comes from the line of Chris McGinnis with Sidoti & Company.

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

I guess, just to think about the guidance or the Rolling Four Quarter outlook. Can you maybe just talk a little bit about the increase? How much is that based on improving kind of trends itself versus the acquisitions or the LOIs you have outstanding?

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

Yes. I would say the majority -- the vast majority of the increase is coming from the 3 businesses and the LOIs that we announced versus the announcement we made when we did the balance sheet recapitalization press release. We don't -- we certainly don't expect a second quarter of next year like we've just experienced. We talked about normalization moving forward. And with the Rolling Four Quarter outlook, all -- the intent of that is to give investors our best look about what pro forma normalized annual earnings of this company will be in any given period. And we do our best. Sometimes, we're off, but it's really our best look at what we expect going forward.

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

Yes. Just it's Mel, Chris. I think we've been doing this a while and a long time ago, not because it's the current fashion and being preached by Larry Fink and others, short-termism and quarterly finish lines. I've been at this point for a very long time with this company. And we also run the company and view the company a certain way. It's very important for investors to understand. I view and the leadership views and the board views and our people view what happens over 5 or 10 years as really important. And we want what happens over 5 or 10 years, in this particular industry, to be trends that gradually go up with volumes, averages, revenue, margins a little faster. We didn't have this view in the '90s. So we have smaller businesses that are not as vetted on strategic long-term criteria as what we're doing now. We still have those. And in many ways, they're more unpredictable than our bigger businesses that we're adding now. And so when you think about this company, the way we think about it and the reason we say we -- if you read the section about the Rolling Four Quarter, you can see that we're growing the company and operating the company within a roughly right range of outcomes over time. We even put out such a roughly right outcome in our company and investment profile over 5 years. I don't know anybody else that is willing to do that. When we first started doing it, and I was told by outside counsel, "That's crazy. You will be sued." But if you went back and traced the history, we've been pretty close within that roughly right outcome over longer periods of time. I wrote about that in the shareholder letter this last time when I predicted what the company would look like in 2006 by 2016. I came real close on most of the metrics. And so this is how we view the company. A quarter is a quarter. We will operate and grow the company within a range of outcomes over 5 years that we define with numbers, and then we show a midpoint. That is not meant to be a forecast. It's meant to be our current view of what we will try to do. And we have shown history that we are really good at doing that over longer periods of time, notwithstanding a very weak quarter in the second quarter. That's how I view the company. That's how the team views the company. That's how our people in the field view the company. And this is how we view the creation of shareholder value slowly over time. Don't do anything stupid, don't do anything real big and risky, just do smart things, and try to get better at what you do continuously. This is what the company is all about.

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

No, I understand that. Obviously, I've read those letters. And I know you've had some great results with that. And you may not like this question, so I apologize upfront. But I'm just wondering, hypothetically, things do continue in this with the elevated cremation rate on the near term. Are there any levers you can pull? I know that's unlikely to happen. Just hypothetical scenario, is there anything you can do to kind of help offset that?

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

This is -- if you get on the treadmill of short-termism and reactionarism, you get stupid, you don't get better. The best thing we can do is ask our people, to lead it, and to improve it. Because our Standards Operating Model and how they're recognized and incentivized on standards achievement is what we will do. That's what we have done. We want more of our people to hit their average revenue per contract. We're going to reward them, recognize them like heroes, which they are, to challenge. I mean, if you went and looked at what they've done over -- which I know you have, over a long period of time, we've grown all this stuff in spite of these things being in our face for 27 years. And in the '90s, we would have all kinds of initiatives and reactions. We just don't want to get on that treadmill. And it is not a dumb question, it's like you're my straight man, okay? You offered up a really good question, and I hope my answer is a real clear.

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

It is, and I understand that. I just wanted to ask. So I appreciate the time, and I appreciate the answers.

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

I appreciate the question. Who planted that anyway?

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

(inaudible) I hope it improves.

Operator

Your next question comes from the line of Barry Mendel with Mendel Management.

Barry Mendel

Yes. Mel, I was wondering what the pipeline looks like now in terms of acquisitions. Because you talked about it being fairly rich last time. Now you made 4 acquisitions. You have 1, and then you have 3 LOIs. So what does it look like going forward beyond this?

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

Well, I mean, we've got a lot of activity. And I don't want to -- a few years ago, when we did have a very good pipeline -- somebody said we've got to define our pipeline better. And, yes, I mean, we've got good people out there building relationships, Barry. We're going to get our share. I view the space as being occupied by 2 choices, SCI and us. By the way, they had a great quarter. We didn't. Way to go over there, Tom and team. And so I think the better independent's going to have a -- I mean, the better ones are going to look at a choice. And over time, I think there will be more consolidation. And so I think we'll just have opportunities. They'll have opportunities. We'll get more than our fair share if I'm right about who we are and how we're presenting the company. And we're not worried about trying to do this much in this quarter and this much in that quarter. We're trying to get quality relationships deeply seated and understood their issues of succession, our solutions to those issues and, therefore, a good partnership for the long term. That's what we work on. There's plenty of that out there. We've got a lot of activity. We see some, they go away. We see some, they go away. We see some, we hug, we get married. That's increasingly -- I'm increasingly optimistic about the quality and quantity of the pipeline over the next 5 years. I can't tell you how it's going to fall in a quarter, even in a year.

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

Yes. And I'll just tag on to that. But I think, Barry, that we've been saying for a couple of years now about the change in the industry landscape, the favorability to Carriage, and there has been nothing that has changed our view. And I think over the first 6, 7 months of the year, it's only reinforced our view. And you're seeing that with the closing of Covenant and the 3 LOIs we announced.

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

Yes. On Covenant, that was a big deal. It's a fabulous business and a fabulous area of growth. And it won't be the last one in Virginia. And the way this industry works, and I think I wrote about this in the '15 shareholder letter, the biggest and best in the industry all know each other. They know about each other by reputation. Birds of a feather indeed flock together. And I think that we were not hugely known in Virginia. That put us on the map in terms of reputational differentiation. 100% certain. (inaudible)

Barry Mendel

I had a question on cremation. You gave your numbers. What were the industry numbers for cremation for the second quarter? Or what's the trend there for the industry as a whole?

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

I have no idea. We don't pay any attention to the industry. We only pay attention to what's going on in our company because it's the only thing we have any say over.

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

And I think, Barry, as we...

Barry Mendel

Compare yourselves to your direct competitors in each market.

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

I mean, I don't know what each obituary and each competitor is doing. Our local people do. Now for us to be worried all about that back at the Pentagon is ridiculous. Our local people know what's going on locally. There ain't no reason I would have a reason to know that.

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

And Barry, what we were talking about before is that we certainly saw an increase in our own portfolio, an increase in cremation rates for that 3-month period in the second quarter. But overall, for year-to-date, it's been 100 -- 1% increase in cremation rate, which has been consistent with what we've seen over the past many years. So nothing that we're going to say is outsized or changing rapidly or, to Mel's point, anything to get all stirred up about.

Barry Mendel

All right. So it sounds like the guidance going forward is [only] 1% based on your answer to Alex?

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

Correct, yes. What we intend going forward is what we've experienced historically, correct.

Operator

Your next question comes from the line of Pete Watson with D.F. Dent.

Pete Watson - *D.F. Dent and Company, Inc. - Associate Analyst*

Just a few questions on the outlook, and, Ben, you already answered most of these. But I think you said $25 million in interest expense. What diluted share count are you using? And you said that, I'm sorry, but I just missed it.

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

Yes. So normalized, it's going to be about 19.4 million diluted shares. We have reported about 18.2 million in this quarter, which is a weighted average. So we expect that to continue to climb. And so by the first quarter of next year, you're going to see that 19.4 million fully baked in. And that's when we talk about our Rolling Four Quarters is what we believe or what we bake into that assumption.

Pete Watson - *D.F. Dent and Company, Inc. - Associate Analyst*

Right. Okay. And then a small number, but what are your expectations now for the accretion of the discount on the convertible notes?

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

Yes. So we, on a -- sorry, on a monthly run rate, we're -- let me look here. We're at about 80,000, and we'd expect that to continue moving forward.

Pete Watson - *D.F. Dent and Company, Inc. - Associate Analyst*

Okay. And then just kind of a bigger picture question. I mean, how do you think about post the balance sheet restructuring the free cash flow generation of Carriage on kind of a maintenance level?

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

Yes. I think given our current outlook, we're in that $40 million to $42 million range on free cash flow. And that's what we would expect, given where we are today.

Operator

(Operator Instructions) Your next question comes from the line of Duncan Brown with Wells Fargo Securities.

Duncan Brown - *Wells Fargo Securities, LLC, Research Division - MD and Senior High Yield Health Care Analyst*

I just want to maybe circle back to a few things that you said earlier -- did I hear you right that if leverage is pro forma leveraged at 4.5x or above, you will not be buying back stock?

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

Correct. Our -- what we communicated through the process of the recapitalization is our financial policy moving forward is we're going to operate the business on a pro forma net debt basis on 4 to 4.5x leverage. Our intention is that we're closer to 4 versus 4.5x. We recognize it will take time for us to work down to that 4x number because we intend to continue to operate and grow the business as we have been. But that will color any decisions we make around share repurchases.

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

So Duncan, this is Mel. I wrote a nice letter yesterday to a famous money manager, been retired, but he runs his own money. Became a friend of mine, and he invited me to Vegas a few years ago as a CEO panelist on the second Tony La Russa Leaders and Legends conference, where they have a lot of football, baseball players and CEOs. And I was on the panel, and he asked me, "Mel, tell the group about the time your stock hit $1."

And I said, "Which time, [Nick]? The first time when it should have hit $1 or the second time in March '09, when we were ready and we were descent and we had an improving company?" And he said, "No. Tell them about the first time, when you were not very smart, you should have hit $1. Talk about that time." I said, "We would not be buying in our stock. But if it goes down too far toward $1, we're going to take back what we said." That was meant to be funny.

Duncan Brown - *Wells Fargo Securities, LLC, Research Division - MD and Senior High Yield Health Care Analyst*

No, I hear you. I hear you.

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

So we're going to try to do what we said we would do. Next time, we won't try. We'll do it.

Duncan Brown - *Wells Fargo Securities, LLC, Research Division - MD and Senior High Yield Health Care Analyst*

No, I appreciate it. And then maybe going to the LOIs. Could you give us any color on how we should be thinking about valuation for that? I don't know what numbers you're comfortable giving, but anything to help us frame it would be helpful.

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

Yes. I've written extensively on this in my shareholder letters about the 10 strategic criteria. And our sweet spot is in the 60% to 80% range. We're going to recalibrate the 10 criteria. My team and I will go through that over the next little while. If we can shrink those 10 criteria and their weightings, we will to make them a little bit more focused. Those 10 criteria are not short-term financial performance criteria, they are long-term predictive over 5 or 10 years of future revenue. And depending on where that ranking -- we call it a roughly right ranking of a candidate falls, that will also affect the multiple that we pay of current EBITDA. We're going to recalibrate those criteria based on the Covenant business we bought in Virginia. That's the biggest individual business we ever acquired out of one facility. And so I'm sure that one ranked well above 80%, between 80% and 90%. Let's call it 85%. And therefore, you can think of the multiple we will pay of current EBITDA is kind of equivalent to that ranking. Because if you look at the predictability of volumes and average and revenue and margins over 5 or 10 years, and you do the present value of that in an ROIC, you get higher returns by paying a higher multiple on a business like that than you would get if it's 60%, and you expect the revenue predictability to be 1% to 1.5%. We would rather pay more for a business like that than less for a smaller business that won't give us as much upside. That's -- it's a very sophisticated thing. You can't generalize this or that about a multiple. We've learned the hard way that you have to look at the predictability of what we're talking about in the second quarter. Revenue challenge, we want more of those that don't give us any challenge when others might.

Duncan Brown - *Wells Fargo Securities, LLC, Research Division - MD and Senior High Yield Health Care Analyst*

So I appreciate all of that. And I mean, maybe to drill down a little bit more, it makes good sense that you'd be willing to pay a higher multiple for a better business. (inaudible) Can you help us frame what the multiple off of current EBITDA we should be thinking about for these businesses? Or is that not something you're going to disclose?

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

Well, I'd rather not. I mean, everybody wants these. And so it's very competitive when they come out. And that'd be kind of dumb for me to just broadcast it.

Duncan Brown - *Wells Fargo Securities, LLC, Research Division - MD and Senior High Yield Health Care Analyst*

That's fair. And then my sort of last question is...

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

Whatever it is, if you're a shareholder, you'd want us to pay it. If you're a bondholder, you'd want us to buy it.

Duncan Brown - *Wells Fargo Securities, LLC, Research Division - MD and Senior High Yield Health Care Analyst*

Got you. So that makes good sense. And then on the cash balance, obviously, high post the deal. Obviously, I'd expect most of that to go to M&A going forward. Are willing to dip into your revolver to fund M&A going forward? Or how should we think about that?

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

Yes. Our -- and really, this is a shift, [and] we've communicated over the past couple of months, a shift in how we think about managing our capital structure, on our balance sheet, is that we had $40 million at the end of -- approximately $40 million coming out of the end of the quarter and after the deal. We're sitting on about $15 million today after the Covenant acquisition, right around $30 million. The -- our intention is that, yes, we will dip into our revolver and use our revolver on a shorter-term basis versus where we were previously, where we kind of lived on the revolver. We view the high-yield market as an attractive market for us for financing and capital as we move forward. So that will be the primary source of that. And that we continue to be responsible in how we look at acquisitions and multiples and what we're willing to pay. And certainly, the revolver is a part of that.

Operator

And there are no further questions in the queue at this time. I'll turn the call back over to your presenters for closing remarks.

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

We really appreciate this was not our favorite quarter in the last history of the company. But we got some of the best questions we've ever had, and we really appreciate that. So thank you for tuning in. Thank you for following us, and we look forward to reporting better quarters in the future.

Operator

This concludes today's conference call. You may now disconnect.
