The Sure Bet of Corporate Morticians

By Mohnish Pabrai

Most start-ups are high-risk ventures with a strong likelihood that the business won't be around in a few years. Predictably, restaurants have among the highest rate of business failure.

However, it's intriguing to note that the industry with one of the lowest rates of failure is the funeral home business. Here are some reasons why that makes perfect sense:

- Families want the last rites of their loved ones to be done right. They don't go shopping for the low bid. They're likely to follow tradition and use the services of the same funeral home that the family has used in the past.

- I don't know anyone who aspires to become a tycoon in the funeral business. The morbid nature of the industry serves to keep upstarts down to a trickle.

- As Warren Buffett stated, industries with rapid change are bad for the investor. The choices that most humans consider for their last rites are pretty set and slow to change over hundreds of years. Even the growing preference for cremations over burials is a gradual shift that existing players have easily adapted to.

- The population of the U.S. continues to grow and is expected to for the coming decades, leading to an increasing revenue stream for years to come.

- While increased life expectancy puts a damper on near-term revenue, pre-need sales counterbalance this trend. Pre-need sales make up about 25% of total revenue for many operators. How would you like to be in a business where your customers pay you today for a service you might not deliver for forty years?

Historically, the industry was highly fragmented, until it became fashionable in the early 1990s to roll funeral homes up into billion dollar enterprises. Companies like Stewart Enterprises (STEI), Service Corp. (SRV) and Carriage Services (CSV) went on rapid buying sprees of the mom and pop businesses at high multiples, ending up heavily debt-laden. Wall Street began to doubt the debt-servicing ability of these funeral service behemoths and priced their equity as if they were going to go bankrupt.

However, an examination of each underlying funeral home reveals that they are excellent businesses with lucrative and predictable free cash flow characteristics. The weak balance sheets of the parent companies are the culprits.

More Than Enough Losers

The morbid task of death care is a very good business. Corporate death care is a very lucrative industry, as well. There are about 20 million nonfarm businesses in the U.S. About a million new ones are started each year and about a million old ones die each year. The cycle of birth and death is endless, and the dead and distressed need burial and life-support services.

Predicting winners among the million-odd newborns is a crapshoot. But servicing the dead is for sure. With that stated, what follows is a sampling of some of these low-risk, high-return businesses.

Challenger, Gray & Christmas (outplacement services; privately held).
During boom times, this firm's business is good, and during recessions, business booms. All businesses have finite life spans. Many large businesses run into trouble even when times are good, and they're forced to downsize. And when the economy goes through recessions, layoffs become commonplace.

That's when firms like Challenger, Gray & Christmas thrive. Outplacement firms have a far lower rate of failure or volatility of earnings than headhunters. Not surprising, Challenger, Gray & Christmas is highly profitable, has grown organically from nothing to dozens of offices worldwide and has been thriving for several decades with no need to tap the public markets for capital.

Liquidation World (LIQWF) (asset recovery services; merchandise liquidators)
Headquartered in Alberta, Canada, Liquidation World specializes in purchasing and marketing inventory from a variety of distressed situations (bankruptcies, receiverships, buybacks, over-production and cancelled orders). The company then remarkets these goods through a chain of more than 90 outlets across Canada and the U.S. Over 7 million bargain hunters visit their stores annually.

Overstock.com (OSTK) (merchandise liquidators)
The digital version of Liquidation World is Overstock.com. The company has built relationships with manufacturers and troubled retailers to purchase their excess inventory at distressed prices. Prices to consumers are routinely below manufacturer's cost.

eBay (EBAY) (merchandise liquidation)
A growing base of eBay sellers is made up of troubled retailers looking to quietly dump excess inventory. They've discovered that eBay can be a simple, confidential means to get rid of excess inventory at the best price the market will bear.

Priceline.com (PCLN) and **Hotels.com** (ROOM) (perishable inventory liquidators)
The hotel and airline industries are, in general, terrible businesses. They have very high fixed costs and price is determined by their dumbest competitor – a lethal combination. On the other hand, Priceline and Hotels.com are great businesses that are a win-win for the troubled operators and consumers alike by maximizing revenue and minimizing travel costs.

Gordon Brothers (liquidators; privately held)
In Retailers Aren't Worth the Risk (Real Money, Feb. 24, 2003), I outlined how retailing was a lousy business. Well, there's money to be made from the follies of retailing. Take the example of Gordon Brothers. This firm is celebrating its 100th year in business and is the mortician of the retailers.

The company annually manages thousands of liquidating stores on behalf of its troubled clients, helping convert their inventory into billions in cash. Clients include Kmart, Montgomery Ward, Sears Catalog, Woolworth's, Caldor, Bradlees and Lechters. And it does all this with a staff of fewer than 500 employees. Gordon is a big cash cow that has had no need to tap the public markets for capital.

Alix Partners (turnaround and restructuring specialists; privately held)
When companies like Enron, National Rent-a-car and Worldcom undergo bankruptcy liquidation or reorganization, shareholder value is all but decimated. However, firms like Alix Partners do very well by advising courts and companies on the arduous task of restructuring or systematically liquidating these businesses. Alix has grown consistently since its inception 22 years ago, and the company has never been inclined to seek capital in the public markets.

To conclude, as you look at various businesses to invest in, take a hard look at firms that are, in one way or another, involved in the burial of the million or so companies that shutter their doors each year. The best players in the sector are likely to thrive, regardless of how well or poorly the economy performs. It also serves as a natural hedge against the damage recessions can do to the rest of your portfolio.

Death and taxes are for sure. And it's always good to make bets that are for sure.

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