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Can't take it with you

On Wall Street, nothing changes but the details. Take corner-cutting. It's always with us, though in a changing array of guises. One season it's games-playing with pension accounting, the next it's capitalizing costs that should properly be expensed. And now? We identify heavy borrowing against non-GAAP earnings for empire-building and share repurchases. The exemplar of the technique is the Pittsburgh senior citizen Matthews International Corp. (MATW on the Nasdaq). In preview, *Grant's* is bearish on it.

Don't touch that dial, please, bullish paid-up subscribers. This is a story for the many who buy long as much as for the few who sell short. In Matthews—maker of, among other things, the monuments that enshrine the heroes at the National Baseball Hall of Fame—you can see what drives today's stock market higher and what might drive it, albeit in the opposite direction, tomorrow.

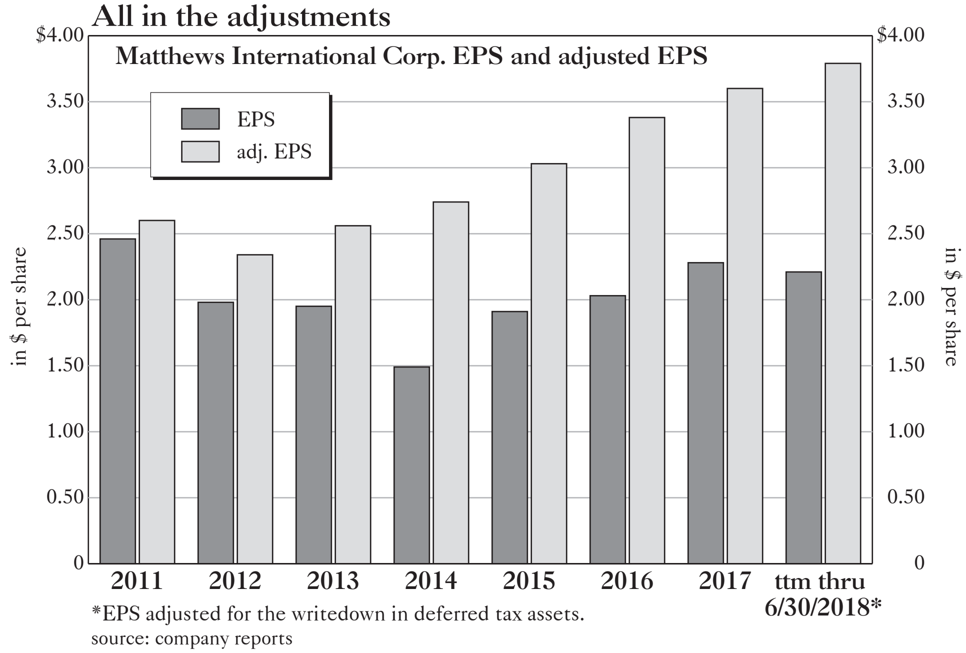
Matthews, founded in 1850, has survived 33 business cycles, as the National Bureau of Economic Research does the counting, so it gets points for longevity. It also commands (or has, until fairly recently, commanded) respect for the profitability of its core business of "memorialization." By memorialization, management means everything you need for earthly remembrance: bronze plaques (including the ones at Cooperstown), markers, memorials, urns, statuary.

The plaque business is more or less the legacy line that the eponymous Matthews, John Dixon Matthews, a metal engraver from Sheffield, England, founded so long ago. Now it's absorbed into the funeral and eternity-themed division that delivers 39% of the $1.6 billion corporate top line. The bigger revenue-generator is the packaging, marketing and advertising-production segment called SGK. It's responsible for 51% of sales. An industrial technologies unit accounts for the remaining 10%. Altogether, Matthews employs 11,000 people in more than two dozen countries and boasts a $1.6 billion market cap. Some 5.5% of the shares are sold short, and the debt, garden-variety speculative-grade, is rated Ba3/double-B.

The bull case, such as it is, starts with memorials and funeral impedimenta. Death is on the upswing, a good thing as far as it goes. It's a fact that 2.7 million Americans died in 2016, a population the size of Chicago's. You'd suppose that the country would be immobilized by grief, but we go about our business, we 325.7 million survivors, just as we did in 2006, when 2.4 million died. The rub is that traditional burials are on the way out. In 2005, one-third of the deceased were cremated. In 2017, slightly more than half were.

Economics explains the shift. Cremations can cost as little as $800, a middling-grade burial about $7,000, including the casket. Even an $800 cremation is a stretch at a time when, according to the Federal Reserve's "Report on the Economic Well-Being of U.S. Households," 41% of Americans couldn't come up with $400 on the spur of the mo-

All in the adjustments



*EPS adjusted for the writedown in deferred tax assets.
source: company reports

ment. Death is inevitable but frequently unexpected. Extrapolating from these trends, the National Funeral Directors Association projects that the cremation rate will reach 78.8% in 2035.

Still, the Matthews bulls—Dan Moore, of CJS Securities, Inc. is one—say that the memorialization division compensates for flat sales with bounding profits. Matthews shares four-fifths of the national burial-products market with Batesville, a subsidiary of Hillenbrand, Inc. There's not much incentive for the pair to compete on price, which is one reason why the memorialization unit chips in 72% of company-wide operating profits.

"Matthews," observes colleague Evan Lorenz, "uses the cash flows generated by memorialization to shop for acquisitions for each of the three business segments, including the funeral segment. You can call it a triplex of platform companies. Thus, since fiscal 2011, it's paid $211 million for the Aurora Casket Co.; $617 million (in cash and stock) for Schawk, Inc., a packaging and brand-protection business; and $50.8 million for Compass Engineering Group, Inc., an industrial-software concern (among many other acquisitions). At a glance, you'd say that the strategy has succeeded: Between fiscal 2011 and the 12 months ended June 30, 2018, Matthews almost doubled sales, to $1.591 billion from $899 million, and boosted adjusted earnings per share by 46%, to $3.79 from $2.60."

A certain ratings agency is among the admirers of this accretive roll-up strategy. "Matthews has been successful in identifying and integrating attractive acquisitions across its three segments, which has driven its sustained consolidated revenue growth," write Standard & Poor's analysts Arthur Wong and Viral Patel in a Sept. 10 report. "We believe that the company will continue with tuck-in acquisitions as it seeks to expand its offerings and drive growth. The industrials segment will likely grow the fastest over the next year, given its smaller base and greater focus on acquisitions."

Nor have the stockholders had much cause to object. After a succession of raises to the quarterly dividend, the shares are priced to yield 1.5%. Matthews repurchased $58 million of stock in fiscal 2016, $14 million in fiscal 2017 and $20.1 million in the first three quarters of fiscal 2018.

Four out of the four analysts who follow the company rate it a buy, according to Bloomberg. Not that every Matthews shareholder necessarily reads what the analysts say about the business, or, indeed, what the business says about itself. Passive investing giants BlackRock, Inc., the Vanguard Group, Inc. and State Street Corp. hold 26.6% of shares outstanding. MATW is a constituent of the iShares Russell 2000 ETF, the Vanguard Dividend Appreciation Index Fund and the SPDR S&P 600 Small-Cap Value ETF.

"The company's success in managing its three platforms depends entirely on an investor's trust in non-GAAP adjustments to earnings," Lorenz points out. "Between fiscal 2011 and the 12 months ended June 30 of this year, GAAP operating profit declined to $115.5 million from $118.5 million. GAAP earnings per share (adjusted for the write-down in deferred-tax liabilities attendant to the Tax Cuts and Jobs Act of 2017) fell to $2.21 from $2.46. Since 2011, acquisition-related charges have amounted to $193 million, an outsize proportion of the cumulative $1 billion cash cost of the acquisitions.

"Adjustments to non-GAAP earnings are opaque and aggressive," Lorenz goes on. "From those earnings, Matthews subtracts the non-service portion of pension and post-retirement benefits expense; as of June 30, there was a $116 million pension and post-retirement deficit. Management offers little explanation as to what acquisition-related expenses pertain to or why those charges persist for as long as they do. For instance, the purchase of Aurora Casket dates from August 2015, but the front office does not anticipate completing the integration of Aurora until fiscal year 2019."

Why deploy the cash flows from a shrinking business to acquire more such shrinking businesses in the same declining industry? Lorenz put the question to CEO Joe Bartolacci, who replied: "Because we are getting substantial returns. We are looking at businesses that we will ultimately bring in under five times EBITDA [earnings before interest, taxes, depreciation and amortization], which is a 20% return. Even if that is declining over time, it significantly exceeds our cost of capital and it is a good deployment of capital."

Outside investors will have to take this on faith, however, as that five-times purchase multiple includes projected synergies. Thus, Matthews paid 10 times EBITDA to buy Aurora and around 7 times EBITDA to acquire Star Granite & Bronze International, Inc. on Feb. 1. Notably, those purchase multiples do not include acquisition-related charges and integration expenses.

Free cash flow is, for the most part, a tamper-proof, adjustment-proof accounting metric. "Cash flow from operations less capital expenditures," is the long and short of it. A business either generates cash or it doesn't. In a colorful departure from conventional practice, Matthews has redefined FCF.

You have to be as alert as Lorenz to spot it. A glance at page 21 of the third-quarter-earnings presentation shows that FCF spurted to $120.7 million in 2017 from $92.6 million in 2015, or by 30.4%. But that is the Matthews version of FCF, which the company redefines as EBITDA less capex, interest and taxes; no adjustment is made for changes in working capital, i.e., for the investments Matthews must make to remain a going concern. On the more rigorous and customary calculation, FCF would have grown to $104.4 million from $92.8 million over the same three years, a rise of only 12.4%.

At least, in this case, there's a disclaimer. On the vital question of growth ex-acquisitions, you have no clue, as there's no breakout of revenues from acquisitions. So, for instance, you can't determine if the SGK brand division is growing or not. An analyst may well wonder, given that not a few of SGK's clients are the kind of consumer packaged-goods companies that are standing still themselves (*Grant's*, March 25, 2016).

There are other analytical dead ends about which the index funds and ETFs don't have to trouble themselves. For example, you can't really know the meaning of the assertion that, in the three quarters through June 30, SGK's "revenue grew by 1.7% excluding fluctuations in foreign exchange," because there's no way to know how several small, recent acquisitions may have tilted results. Such contributions (if any), like the acquisitions themselves, sometimes go undisclosed. On the July 27 earnings call, management mentioned a $10 million-plus merchandising display project that had been completed in the third quarter of 2017. It was the first that the analysts had heard of it.

Which brings us to the smallest of the three Matthews divisions. Industrial revenue jumped in the first three quarters of fiscal 2018—by 29.8%, year-over-year and adjusted for foreign currency, to $117.8 million—but how that $50.8 million acquisition of Compass Engineering figured into the mix is a mystery. A little clearer is the downward trend in the division's operating margins: to 4.9% of sales in the past three quarters, from 5.4% in fiscal 2017, 6.7% in 2016 and 10.9% in 2015.

Enquiring minds in the Securities and Exchange Commission have likewise flagged reporting deficiencies. On Feb. 20, the agency directed Matthews to attend to the following:

– "Quantify the impact acquisitions had on revenues, gross profit and operating profit for all periods presented."

– "Quantify the benefits of productivity initiatives and realization of acquisition related synergies."

– "Identify the nature of the acquisition integration costs and other charges in each period presented."

– "We note that you adjust for acquisition-related items in arriving at your various non GAAP measures. Please tell us and expand your disclosure to address the underlying nature and material cost components of this adjustment. Please explain how you concluded that these expenses are not normal, recurring, cash operating expenses necessary to operate your business."

Matthews, in the person of CFO Steven Nicola, responded to the SEC's missive on March 6. "[T]he impact of acquisitions on the Company's financial results cannot always be determined with precision due to the nature of our businesses and the integration of these newly-acquired companies into our core operations," he wrote. "For example, where an acquired entity has overlapping customers with the Company, the Company may not be able to accurately determine the attribution of future sales to such customers between our legacy business and the acquiree following commenced integration."

It's not an entirely satisfying answer. For example, Matthews has not broken out organic growth in the memorialization division adjusting for the recent acquisition of Star Granite. Yet, Bartolacci told Lorenz, "Stone is a product that needs to be delivered locally. It can't be shipped across the U.S., so you need to be in-region." That would seem to imply that Matthews could, if it chose, separate the sales that came from Star.

Though, elsewhere—Nicola struck a tone of contrition and amendment—a reader of the company's third-quarter reporting would not have noticed much improvement. On the July 27 earnings call, an analyst asked if the SEC was still on the prowl. "No, that's really—that's not the case," Nicola replied. "The SEC sends comment letters on a routine basis once every three or four years. We received a routine comment letter with some questions. We answered those questions and there were—there were no issues. It's done."

Nicola might have spoken too soon. "What the SEC usually does is, if someone gives a reasonable answer and says, 'We didn't think it was material, but we will provide this information next quarter,' then usually they will let it go," Francine McKenna, a reporter for MarketWatch, a former director at PricewaterhouseCoopers and a speaker at the upcoming *Grant's* Fall Conference (*advt.*), tells Lorenz. "In some cases you won't see this until the next annual report. Some you might see in a quarter. If they are testing the SEC's patience, they will get another letter."

Whether or not the SEC comes calling again, the highly profitable funeral business is coming under competitive pressure. Cut-rate Chinese competition is one source of disruption. Jim Malamas, CEO of ACE Funeral Products Ltd., offers wholesale customers a mainland-manufactured coffin with a white metal shell and a pink velvet-lined interior ("very popular with the ladies") at a price of $795 for a single order. The comparable Matthews product runs to twice as much, even to very good customers, after discounts. Not even a 10% tariff on Chinese caskets is therefore likely to dent the ACE Funeral Products value proposition. In 2012, Matthews responded to Malamas's pricing with a patent-infringement suit. "There was no real basis for the lawsuit," Malamas tells Lorenz. "They were talking about intellectual property. But you know, a casket is a casket is a casket. It's a box with fabric in it. No big secrets there." Matthews lost its case.

But disrupting the "death-care" industry isn't just for the wholesale trade; anyone with a cellphone can have a go. You can buy a coffin for less than $1,000 on websites such as Amazon.com and Costco.com—about half the amount a funeral home would charge. The 1984 Funeral Rule, enacted by the Federal Trade Commission, requires an undertaker to use, at no additional fee, someone else's casket, whatever it cost.

When you need a casket, you need it now, so quick-time delivery networks are imperative. The high fixed costs that these systems entail lead incumbent producers to discount their wares, thereby, ultimately, to safeguard their profits. You can see the dynamics at work from time to time in the former duopolists' financial statements. Thus, adjusted EBITDA margins for Hillenbrand's Batesville division plummeted by a remarkable 461 basis points to 19.8% in a single quarter, the one ended June 30. In response to distraught analysts on the Aug. 2 earnings call, management explained that the company had chosen to pay an upfront incentive to sign a funeral home to a multi-year contract. "So," said CEO Joe Anthony Raver, "it's definitely a challenging environment, any time you have an industry that has relatively high fixed costs and is in sort of modest decline, if it's a challenging, competitive environment."

You can debate the Matthews M&A track record but not its effect on the company balance sheet. Net debt weighed in at $973 million as of June 30, an amount equal to 5.1 times conventional EBITDA or 4.0 times EBITDA with management's preferred adjustments. In the 12 months through June 30, operating income covered interest expenses by 3.5 times.

How much longer Matthews can sustain its borrow-to-buy strategy is a good question. As of June 30, the company had availed itself of $102.5 million of a 2017-vintage, $115 million accounts-receivable securitization facility. S&P says it would consider a downgrade from the current double-B rating if debt topped 4.5 times "adjusted" EBITDA.

"It's worth highlighting that management is potentially one of the few bids under the stock at the moment," says Ben Axler, the founder of Spruce Point Capital Management, and the publisher of a superb analysis, dated Jan. 11. (Insiders have confined their investing activity in the past 12 months to the net sale of 2,927 shares for proceeds of $153,818.)

"At what point do they run out of basket ability [i.e., cash not limited by debt covenants] to use excess cash to prop up the stock?" Axler continues. "If it gets to the point where they have to suspend the buyback and then direct it to deleveraging, then the underlying bid disappears. They are also paying an irrational dividend of 1.5%. If I were the company, with what I perceive as negative organic growth and a lot of debt over my head, I would probably be directing money to deleveraging rather than buying back inflated stock and paying a dividend. The capital management at this company is pretty poor on top of the fact that they've done a lot of poor acquisitions."

The Matthews valuation provides fodder for both bulls and bears: The shares trade at 13 times non-GAAP earnings or 22.4 times GAAP earnings (adjusting for tax swings from the 2017 tax cut). Either way, it doesn't look cheap to us.

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