

CARRIAGE SERVICES INC
Form 10-K
March 06, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K
ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF
1934

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For the fiscal year ended, December 31, 2013
or
TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE
ACT OF 1934

..

For the transition period from _____ to _____
Commission file number: 1-11961

CARRIAGE SERVICES, INC.
(Exact name of registrant as specified in its charter)
Delaware 76-0423828
(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification No.)
3040 Post Oak Blvd., Suite 300, Houston, Texas 77056
(Address of principal executive offices) (Zip Code)
Registrant's telephone number, including area code: (713) 332-8400
Securities registered pursuant to Section 12(b) of the Act:
(Title of each class) (Name of each exchange on which registered)
Common Stock, \$.01 Par Value New York Stock Exchange
Securities registered pursuant to Section 12(g) of the Act:
None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act of 1933. Yes No
Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934. Yes No
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was

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required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerator filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer

Non-Accelerated filer (Do not check if a smaller reporting company) Smaller Reporting Company

Indicate by check mark whether the registrant is a shell company as defined in Rule 12b-2 of the Securities Exchange Act of 1934. Yes No

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant as of June 30, 2013 was approximately \$278.2 million based on the closing price of \$17.45 per share on the New York Stock Exchange.

The number of shares of the registrant's Common Stock, \$.01 par value per share, outstanding as of February 28, 2014 was 18,243,722.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive proxy statement for its 2014 annual meeting of stockholders, which will be filed with the Securities and Exchange Commission within 120 days of December 31, 2013, are incorporated in Part III of this Annual Report on Form 10-K.

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CAUTIONARY NOTE

Certain statements and information in this Annual Report on Form 10-K (this “Form 10-K”) may constitute “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. The words “believe,” “expect,” “anticipate,” “plan,” “intend,” “foresee,” “should,” “would,” “could” or other similar expressions are intended to identify forward-looking statements, which are generally not historical in nature. These forward-looking statements are based on our current expectations and beliefs concerning future developments and their potential effect on us.

While management believes that these forward-looking statements are reasonable as and when made, there can be no assurance that future developments affecting us will be those that we anticipate. All comments concerning our expectations for future revenues and operating results are based on our forecasts for our existing operations and do not include the potential impact of any future acquisitions. Our forward-looking statements involve significant risks and uncertainties (some of which are beyond our control) and assumptions that could cause actual results to differ materially from our historical experience and our present expectations or projections. Known material factors that could cause our actual results to differ from those in the forward-looking statements are those described in Part I, “Item 1A. Risk Factors.”

Investors are cautioned not to place undue reliance on forward-looking statements, which speak only as of the date hereof. We undertake no obligation to publicly update or revise any forward-looking statements after the date they are made, whether as a result of new information, future events or otherwise.

PART I

ITEM 1. BUSINESS.

GENERAL

Carriage Services, Inc. (“Carriage,” the “Company,” “we,” “us,” or “our”) was incorporated in the State of Delaware in December of 1993 and is a leading provider of deathcare services and merchandise in the United States. We operate in two business segments: funeral home operations, which currently account for approximately 75% of our total revenue, and cemetery operations, which currently account for approximately 25% of our total revenue. At December 31, 2013, we operated 161 funeral homes in 26 states and 32 cemeteries in 10 states. We mainly serve suburban and rural markets, where we primarily compete with smaller, independent operators and believe we are a market leader (first or second) in most of our markets. We provide funeral and cemetery services and products on both an “at-need” (time of death) and “preneed” (planned prior to death) basis.

Our operations are reported in two business segments:

Funeral Home Operations. Funeral homes are principally service businesses that provide funeral services (traditional burial and cremation) and sell related merchandise, such as caskets and urns. Given the high fixed cost structure associated with funeral home operations, we believe the following key factors affect our profitability:

- demographic trends in terms of population growth and average age, which impact death rates and number of deaths;
- our ability to establish and maintain market share positions supported by strong local heritage and relationships;
- our ability to effectively respond to increasing cremation trends by packaging complimentary services and merchandise;
- our ability to control salary, merchandise and other controllable costs; and
- our ability to exercise pricing leverage related to our at-need business to increase average revenues per contract.

Cemetery Operations. Cemeteries are primarily a sales business providing interment rights (grave sites and mausoleums) and related merchandise, such as markers and memorials. Our cemetery operating results are impacted by the size and success of our sales organization, as approximately 48% of our cemetery revenues during the year ended December 31, 2013 were generated from preneed sales of interment rights and related merchandise and services. We believe that changes in the economy and consumer confidence may impact the amount of preneed cemetery revenues. Cemetery revenues generated from at-need service and merchandise sales generally are subject to many of the same key profitability factors as our funeral home business. Approximately 19% of our cemetery revenues during the year ended December 31, 2013 were attributable to investment earnings on trust funds and finance charges on installment contracts. Changes in the capital markets and interest rates affect this component of our cemetery revenues, along with changes that we make in the investment securities within the trust funds.

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RECENT DEVELOPMENTS

Credit Facility. On April 24, 2013, we entered into a third amendment (the “Third Amendment”) to our secured bank credit facility (the “Credit Facility”), which increased the revolving credit commitments under our revolving credit facility from \$105 million to \$125 million and decreased the interest rate margin. The Third Amendment decreased the applicable margin for our outstanding borrowings (for both prime rate and LIBOR base rates) by 50 basis points at each leverage ratio threshold. In connection with the Third Amendment, we recorded a pre-tax charge of approximately \$0.4 million in the second quarter to write-off unamortized loan costs. The Third Amendment also contains amendments which (a) allow us to issue subordinated debt or convertible subordinated debt in an amount not to exceed \$100 million, (b) provides us the ability to repurchase up to \$15 million of stock-based employee awards, and (c) allows us to refinance our existing convertible junior subordinated debentures with the proceeds of certain issuances of subordinated debt or convertible subordinated debt. Our Credit Facility matures on September 30, 2017 and is collateralized by all personal property and funeral home real property in certain states. We have the option to pay interest under our Credit Facility at either the prime rate or LIBOR rate plus a margin based on the our leverage ratio. As of December 31, 2013, the prime rate margin was equivalent to 1.50% and the LIBOR margin was 2.50%. The weighted average interest rate on our Credit Facility for the year ended December 31, 2013 was 3.20%.

Acquisitions. We completed one acquisition during 2013 consisting of two funeral homes, one in Tennessee and one in Georgia, and are positioned to acquire more funeral home and cemetery businesses in the future. The aggregate consideration paid for these businesses was approximately \$13.7 million. We acquired substantially all the assets and assumed certain operating liabilities, including obligations associated with existing preneed contracts.

Discontinued Operations. We sold seven funeral homes and one cemetery in 2013. The aggregate consideration received for these divestitures was approximately \$10.2 million. At December 31, 2013, we had one letter of intent for the sale of a cemetery in Florida, which we subsequently sold in January 2014.

Capital. Our Board of Directors (“our Board”) approved four quarterly dividends of \$0.025 per share. For fiscal year 2013, we paid approximately \$1.8 million in dividends.

Performance-Based Stock Awards. On January 3, 2014, we cancelled all the outstanding Performance-Based Stock Awards. All holders of these performance-based stock awards surrendered their shares in exchange for a cash payout of approximately \$16.1 million.

DEATHCARE INDUSTRY

Deathcare companies provide products and services to families in three principal areas: (i) ceremony and tribute, generally in the form of a funeral or memorial service; (ii) disposition of remains, either through burial or cremation; and (iii) memorialization, generally through monuments, markers or inscriptions. The deathcare industry in the United States is characterized by the following fundamental attributes (the statistics included in this Form 10-K are from reports compiled by Sundale Research which are based on information from the United States (“U.S.”) Department of Commerce).

Deaths and Death Rates

Death rates and the number of deaths in the United States have been relatively stable on a long-term historical basis. The number of deaths in the United States increased at an annual rate of approximately 1% for the period from 1980 to 2000. Beginning in 2001, the number of deaths has trended slightly lower as the general population is living longer and because of low birth rates in the period from the early 1930’s to the mid 1940’s during the Great Depression and World War II. In 2012, the number of deaths fell by 0.6% compared to 2011. The number of deaths is estimated to drop again in 2013. The recent trend is projected to reverse in coming years due to the aging of the “baby boomer” generation. The number of people age 65 and over is expected to increase from 42.6 million in 2012 to 49.6 million in 2017, reflecting an average annual growth rate of 3.1%.

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Cremation

In recent years, there has been a steady, gradual increase in the number of families in the United States that have chosen cremation as an alternative to traditional methods of burial. Cremations represented approximately 43.2% of the U.S. burial market in 2012 and are predicted to increase to 50% by 2017. In 2012, the number of cremations increased by 2.2%, following increases of 6.4% and 7.5% in the previous two years, respectively. Cremation rates can vary significantly based upon geographic, religious and cultural traditions. Direct cremation has been offered as a less costly alternative to a traditional funeral service. However, cremation is being increasingly accepted as part of a package of funeral services that includes memorials, merchandise and options for the interment of cremated remains. Cremations result in lower absolute revenue dollars, but higher gross margins. Cemeteries are more affected by the increasing cremation trend than funeral homes.

Highly Fragmented Ownership

The largest public operators, in terms of revenue, of both funeral homes and cemeteries in the United States are Service Corporation International (“SCI”), StoneMor Partners L.P. (“StoneMor”) and Carriage. In December 2013, SCI completed its acquisition of Stewart Enterprises, Inc., which, prior to the merger, was one of the largest public operators, in terms of revenue, of both funeral homes and cemeteries. We believe these three companies collectively represent approximately 20% of deathcare revenues in the United States. Independent businesses along with a few privately owned consolidators represent the remaining amount of industry revenue, accounting for an estimated 80% share. The top 50 deathcare companies account for only 25% of industry revenue. All of our acquisitions in both 2012 and 2013 were independent businesses.

Heritage and Tradition

Deathcare businesses have traditionally been family-owned businesses that have built a local heritage and tradition through successive generations, providing a foundation for ongoing business opportunities from established client family relationships and related referrals. Given the sensitive nature of our business, we believe that relationships fostered at the local level build trust in the community and are a key driver of market share. While new entrants may enter any given market, the time and resources required to develop local heritage and tradition serve as important barriers to entry.

BUSINESS STRATEGY

Our business strategy is based on strong, local leadership and entrepreneurial principles that we believe drive market share, revenue growth, and profitability in our local markets. The business strategy is executed through our “Standards Operating Model,” a decentralized and entrepreneurial operating model for our funeral home and cemetery businesses. To date, our Standards Operating Model has driven significant changes in our organization, leadership and operating practices. We use the Standards Operating Model to measure the sustainable revenue growth and earning power of our portfolio of deathcare businesses. Our Standards Operating Model emphasizes growing market share and improving long-term profitability by employing leadership and entrepreneurial principles that fit the nature of our local, personal service, high value business. Leadership qualities are evaluated using the 4E leadership characteristics – Energy, Energize Others, Edge and Execution. This model requires our local and corporate leaders to focus on the drivers of success that create long-term profitability and value for our stockholders. Our Standards Operating Model emphasizes:

- decentralized management of our local businesses;
- financial and operational standards based upon key drivers of success of our best businesses;
- variable compensation that rewards our managers as if they were owners;
- finding, developing and retaining the best people in our industry; and
- information technology designed to support local businesses and corporate management decisions, measure performance of our businesses against our financial and operational standards, and ensure adherence to established internal control procedures.

Our business objectives include:

- growing market share, creating new heritage, producing consistent, modest revenue growth and sustaining increased earnings and cash flow;
- continuing to improve our operating and financial performance by executing our Standards Operating Model;
-

upgrading the leadership in our businesses, as necessary; and searching for well-qualified personnel that we feel will lead and excel within our Standards Operating Model; and
• executing our Strategic Acquisition Model, a disciplined program that will guide our acquisition strategies, to accelerate growth while maintaining financial discipline.

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Key elements of our overall business strategy include the following:

Implement Operating Initiatives. Our Standards Operating Model is based on operating standards designed to grow market share and increase profitability, developed from our best operations, along with an incentive compensation plan to reward business managers known as “Managing Partners” and their staff for successfully meeting or exceeding such standards. Our Managing Partners participate in a variable bonus plan in which they earn a percentage of their business’ earnings based upon the actual standards achieved. Our Standards Operating model and the underlying standards, which we refer to as “Being the Best,” focus on what we believe are the key drivers of a successful operation, organized around three primary areas - market share, people and operating financial metrics. Our Standards Operating Model is the measure by which we judge the success of each business. In 2012, we began a five year incentive plan, called “Good to Great,” which rewards Managing Partners with a bonus at the end of five years, equal to a ratio of 4 to 6 times their average annual bonus, if such Managing Partners are able to achieve an annual compound growth rate of 2% over a five year period. To date, our Standards Operating Model has driven significant changes in our organization, leadership and operating practices. Most importantly, our Standards Operating Model has allowed us to measure the sustainable revenue growth and earning power of our portfolio businesses. Our Standards Operating Model led to the development of our “Strategic Acquisition Model” during 2006, which guides our acquisition and disposition strategies. Both models, when executed effectively, should drive long term, sustainable increases in market share, revenue, earnings and free cash flow. The standards are not designed to produce maximum short-term earnings because we do not believe such performance is sustainable without ultimately stressing the business, which often leads to declining market share, revenues and earnings.

Enhancement of Funeral Services. A significant trend in the deathcare industry is an increasing preference of our client families for cremation. The percentage of funeral services performed by our funeral homes for which cremation was chosen as the manner in which to dispose of remains was 45.1% for the year ended December 31, 2011, 46.1% for the year ended December 31, 2012 and 46.8% for the year ended December 31, 2013. For the year ended December 31, 2013, 67.1% of our total cremation services were direct cremations (where no memorial service or visitation is involved, although merchandise may be sold) and 32.9% included services, as compared to 64.8% and 35.2%, respectively, for the year ended December 31, 2012. Shifting preferences will likely continue to lead to a considerable rise in cremations; as such, we are focused on increasing the percentage of our cremation customers that choose services. All of our funeral homes offer cremation products and services. While the average revenue for a cremation service is generally lower than that of an average traditional, full-service funeral, we have found that these revenues can be substantially enhanced by our emphasis on offering services and merchandise.

Preneed Funeral Sales Program. We operate under a local, decentralized preneed sales strategy whereby each business location customizes its preneed program to its local needs. The performance of preneed funeral contracts is usually secured by placing the funds collected in trust for the benefit of the customer or by the purchase of a life insurance policy, the proceeds of which will pay for such services at the time of need. Insurance-funded contracts allow us to earn commission income to improve our near-term cash flow and offset a significant amount of the up-front costs associated with preneed sales. Trust funded contracts typically provide cash that is invested in various securities with the expectation that returns will exceed the growth factor in the insurance contracts. The cash flow and earnings from insurance contracts are more stable, but are generally lower than traditional trust fund investments. In markets that depend on preneed sales for market share, we supplement the arrangements written by funeral directors with sales sourced by sales counselors and third party sellers.

Preneed Cemetery Sales Program. A significant portion of our historical cemetery revenues are represented by sales of cemetery property sold by our sales professionals on a preneed basis and finance charges earned on preneed installment contracts. General consumer confidence and discretionary income have a significant impact on our preneed sales success rate. In 2013, preneed cemetery sales increased 10.8% compared to 2012.

Corporate Development Efforts. We believe that our capital structure positions us to pursue a strategy of disciplined growth, affording us the flexibility to redeploy our cash and cash flow toward selective acquisitions that meet our criteria. We expect to continue to improve our earning power as we invest in businesses that will contribute incremental revenues, earnings and cash flow. Our Strategic Acquisition Model is a primary driver of our acquisition strategy. We use strategic ranking criteria to assess acquisition candidates in order to optimize the sustainable earning

power of our deathcare portfolio.

Ideal acquisition candidates include businesses that are demonstrated market leaders, are larger businesses located in growing markets with high barriers to entry and have field-level operating margins consistent with our best performing businesses. We believe there are large enough markets for us to increase our presence in existing markets by acquisition or to enter a new market with a substantial acquisition while leveraging our strong local franchise brands and entrepreneurial leadership. We also use our Standards Operating Model to evaluate acquisition candidates to ensure they can be readily integrated into our portfolio.

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OUR STRENGTHS

Market Leader in our Suburban and Rural Markets. Our operations are located in principally suburban and rural markets, where we primarily compete with smaller, independent operators. We focus on markets that perform better than the industry average and are generally insulated from economic and demographic changes.

Partnership Culture. Our funeral homes and cemeteries are managed by Managing Partners, individuals with extensive deathcare experience, often within their local markets. Our Managing Partners have responsibility for day-to-day operations, but are required to follow operating and financial standards that are custom designed for each of four groupings using size of business and cremation rate as specific grouping criteria. This strategy allows each local business to maintain its unique identity within its local market and to capitalize on its reputation and heritage while our senior management maintains supervisory controls and provides support services from our corporate headquarters. We believe our culture is very attractive to owners of premier independent businesses that fit our profile of suitable acquisition candidates.

Flexible Capital Structure. We have no near-term debt maturity issues. We believe that our capital structure provides us with financial flexibility by allowing us to invest our cash flow in growth opportunities, such as business acquisitions and cemetery inventory projects. Currently, we have four primary components in our capital structure: a \$130 million term loan with a 2017 maturity, of which \$117.0 million was outstanding at December 31, 2013; a \$125 million revolving credit facility with a 2017 maturity, of which \$36.9 million was outstanding at December 31, 2013; the \$89.8 million convertible junior subordinated 7% debenture with a 2029 maturity; and our common stock.

For additional information, please see Part II, Item 7, Liquidity and Capital Resources.

Stable Cash Flow. We have demonstrated the ability to generate strong and stable cash flow. Cash flow from continuing operations for 2013 totaled \$39.8 million, which was used primarily to acquire two funeral homes and for payments on our revolving credit facility, as well as other working capital needs. Going forward, we intend to use our cash flow to acquire funeral home and cemetery businesses and to fund internal growth projects, such as cemetery inventory development. Our growth strategy is the primary way we expect to increase stockholder value. While we reassess our capital allocation strategy annually, we currently believe that our financial goals will best be achieved by continuing to improve the operating and financial performance of our existing portfolio of businesses while selectively investing our net cash flow in growth opportunities that generate a return on invested capital in excess of our weighted average cost of capital.

Strong Field-Level Gross Profit Margins. We believe that our field-level gross profit margins are among the highest reported by the public companies in the deathcare industry and that this performance is a testament to the success of our business strategies. As a percentage of revenues, the total field-level gross profit margin was 30.1% for the year ended December 31, 2013. These strong margins and the ability to control costs are important advantages in a business such as ours that is characterized by a high fixed-cost structure. We will continue to seek ways to improve our financial performance, and we believe that our Standards Operating Model will continue to yield long-term improvement in our financial results.

Effective Management of Funeral Preneed Sales. We believe our local, decentralized strategy allows us to adapt our preneed sales selectively to best address the competitive situation in our particular markets. In highly competitive markets, we execute a more aggressive preneed sales program. In less competitive markets where we have a strong market position, we deploy a more passive preneed sales program. In certain of our markets, we do not deploy a formal preneed program. This approach allows us to target the investment in preneed sales to markets where we have the opportunity to reinforce our market share. Since approximately 80% of our funeral revenues are generated from at-need sales, we retain significant pricing leverage in our funeral business without having to rely on preneed sales.

Integrated Information Systems. We have implemented information systems to support local business decisions and to monitor performance of our businesses compared to financial and performance standards. All of our funeral homes and cemeteries are connected to our corporate headquarters, which allows us to monitor and assess critical operating and financial data and analyze the performance of individual locations on a timely basis. Furthermore, our information system infrastructure provides senior management with a critical tool for monitoring and adhering to our established

internal controls, which is critical given our decentralized model and the sensitive nature of our business operations. Proven Management Team. Our management team, headed by our founder, Chairman and Chief Executive Officer, Melvin C. Payne, and our Vice Chairman of our Board and Executive Vice President, L. William Heiligbrodt, is characterized by a dynamic culture that focuses on addressing changing market conditions and emerging trends in the funeral services

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industry. We believe our culture emphasizing the 4E's (Energy, Energize Others, Edge and Execution) leadership characteristics is critical and will provide an important advantage as the deathcare industry evolves. We are committed to continue operating an efficient corporate organization and strengthening our corporate and local business leadership. We believe that our Standards Operating Model will ensure this commitment at all levels of the organization. Our businesses are organized into three regions, each headed by a Regional Partner. This promotes more cooperation and synergy between our funeral and cemetery operations and supports the goal of market-share and volume growth in our most significant markets.

OPERATIONS

We conduct our funeral and cemetery operations only in the United States. Our operations are reported in two segments: funeral operations and cemetery operations. Information for each of our segments is presented below and in our financial statements set forth herein.

Funeral Home Operations

At December 31, 2013, we operated 161 funeral homes in 26 states. Funeral home revenues currently account for approximately 75% of our total revenues. The funeral home operations are managed by a team of experienced deathcare industry professionals and selected region-level individuals with substantial management experience in our industry. See Part II, Item 8, Financial Statements and Supplementary Data, Note 21 for segment data related to funeral home operations.

Our funeral homes offer a complete range of services to meet a family's deathcare needs, including consultation, the removal and preparation of remains, the sale of caskets and related funeral merchandise, the use of funeral home facilities for visitation and services and transportation services. Most of our funeral homes have a non-denominational chapel on the premises, which permits family visitation and services to take place at one location and thereby reduces transportation costs and inconvenience to the family.

Funeral homes are principally service businesses that provide burial and cremation services and sell related merchandise, such as caskets and urns. The sources and availability of caskets and urns are from a small number of national providers that have distribution centers near our businesses. We typically order and receive the merchandise within twenty-four hours. Given the high fixed cost structure associated with funeral home operations, we believe the following are key factors affecting our profitability:

- demographic trends in terms of population growth and average age, which impact death rates and number of deaths;
- establishing and maintaining leading market share positions supported by strong local heritage and relationships;
- effectively responding to increasing cremation trends by packaging complementary services and merchandise;
- controlling salary, merchandise and other controllable costs; and
- increasing average revenues per contract.

Cemetery Operations

As of December 31, 2013, we operated 32 cemeteries in 10 states. The cemetery operations are managed by a team of experienced deathcare industry and sales professionals. Cemetery revenues currently account for approximately 25% of our total revenues. See Part II, Item 8, Financial Statements and Supplementary Data, Note 21 for segment data related to cemetery operations.

Our cemetery products and services include interment services, the rights to interment in cemetery sites (primarily grave sites, mausoleum crypts and niches) and related cemetery merchandise, such as memorials and vaults. Cemetery operations generate revenues through sales of interment rights and memorials, installation fees, fees for interment and cremation memorialization products, finance charges from installment sales contracts and investment income from preneed cemetery merchandise trusts and perpetual care trusts.

Our cemetery operating results are impacted by the size and success of our sales organization, evidenced by the statistic that approximately 40% of our cemetery revenues for the year ended December 31, 2013 were generated from preneed sales of interment rights. An additional 9% of our 2013 cemetery revenues were generated from deliveries of merchandise and services previously sold on preneed contracts. We believe that changes in the economy and consumer confidence impacts the success rate of preneed sales and is currently having an impact on our preneed sales success rate and the industry as a whole. Coming into a more stable economy, we have focused more on quality sales counselors rather than quantity. Cemetery revenues

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generated from at-need services and merchandise sales generally are subject to many of the same key profitability factors as in our funeral home business. Approximately 19% of our cemetery revenue was attributable to investment earnings on trust funds and finance charges on installment contracts during the year ended December 31, 2013. Changes in the capital markets and interest rates affect this component of our cemetery revenues.

Preneed Programs

As discussed in the preceding sections, we market funeral and cemetery services and products on a preneed basis. Preneed funeral or cemetery contracts enable families to establish, in advance, the type of service to be performed, the products to be used and the cost of such products and services. Preneed contracts permit families to eliminate issues of making deathcare plans at the time of need and allow input from other family members before the death occurs. We guarantee the price and performance of the preneed contracts to the customer.

Preneed funeral contracts are usually paid on an installment basis. The performance of preneed funeral contracts is usually secured by placing the funds collected in trust for the benefit of the customer or by the purchase of a life insurance policy, the proceeds of which will pay for such services at the time of need. Insurance policies, intended to fund preneed funeral contracts, cover the original contract price and generally include an element of growth (earnings) designed to offset future inflationary cost increases. Revenue from preneed funeral contracts, along with accumulated earnings, is not recognized until the time the funeral service is performed. The accumulated earnings from the trust investments and insurance policies are intended to offset the inflation in funeral prices. Additionally, we generally earn a commission from the insurance company from the sale of insurance-funded policies reflected as Preneed Insurance Commission within Funeral Revenues. The commission income is recognized as revenue when the period of refund expires (generally one year), which helps us defray the costs we incur to originate the preneed contract (primarily commissions we pay to our sales counselors).

In addition to preneed funeral contracts, we also offer “pre-planned” funeral arrangements whereby a client determines in advance substantially all of the details of a funeral service without any financial commitment or other obligation on the part of the client until the actual time of need. Pre-planned funeral arrangements permit a family to avoid issues of making deathcare plans at the time of need and enable a funeral home to establish relationships with a client that may eventually lead to an at-need sale.

Preneed sales of cemetery interment rights are usually financed through interest-bearing installment sales contracts, generally with terms of up to five years with such earnings reflected as Preneed Cemetery Finance Charges within Cemetery Revenues. In substantially all cases, we receive an initial down payment at the time the contract is signed. Preneed sales of cemetery interment rights are recorded as revenue when 10% of the contract amount related to the interment right has been collected. Merchandise and services may similarly be sold on an installment basis, but revenue is recorded when delivery has occurred. Allowances for bad debts and customer cancellations are recorded at the date that the contract is executed and periodically evaluated thereafter based upon historical experience.

We sold 6,844 and 8,183 preneed funeral contracts during the years ended December 31, 2012 and 2013, respectively. At December 31, 2013, we had a backlog of 80,714 preneed funeral contracts to be delivered in the future. Approximately 20% of the funeral revenues recognized during the years ended December 31, 2012 and 2013 originated through preneed contracts. Cemetery revenues that originated from preneed contracts represented approximately 47% and 48% of our net cemetery revenues for 2012 and 2013, respectively.

At December 31, 2013, we employed a staff of 138 advance-planning and family service representatives for the sale of preneed products and services.

TRUST FUNDS AND INSURANCE CONTRACTS

We have established a variety of trusts in connection with funeral home and cemetery operations as required under applicable state laws. Such trusts include (i) preneed funeral trusts; (ii) preneed cemetery merchandise and service trusts; and (iii) cemetery perpetual care trusts. These trusts are typically administered by independent financial institutions selected by us. Investment management and advisory services are provided either by our wholly-owned investment registered advisory firm, CSV RIA, or by independent financial advisors. At December 31, 2013, CSV RIA provided these services to three institutions, which have custody of 78% of our trust assets, for a fee based on the market value of trust assets.

Preneed funeral sales generally require deposits to a trust or purchase of a third-party insurance product. Trust fund income earned and the receipt and recognition of any insurance benefits are deferred until the service is performed. Trust fund holdings and deferred revenue are reflected on our Consolidated Balance Sheets, while the insurance contracts are not on our Consolidated Balance Sheets. In most states, we are not permitted to withdraw principal or investment income from such trusts until the funeral service is performed. Some states, however, allow for the retention of a percentage (generally 10%) of the

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receipts to offset any administrative and selling expenses. The aggregate balance of our preneed funeral contracts held in trust, insurance contracts and receivables from preneed trusts was approximately \$398.2 million as of December 31, 2013.

We are generally required under applicable state laws to deposit a specified amount (which varies from state to state, generally 50% to 100% of the selling price) into a merchandise and service trust fund for preneed cemetery merchandise and services sales. The related trust fund income earned is recognized when the related merchandise and services are delivered. We are generally permitted to withdraw the trust principal and accrued income when the merchandise is actually purchased and delivered, when the service is provided or when the contract is canceled. However, certain states allow the withdrawal of income prior to delivery when the regulations identify excess earnings in the trusts. We were able to withdraw \$1.4 million in trust income prior to delivery in those states in 2012 and \$1.7 million in 2013. Cemetery merchandise and service trust fund balances totaled approximately \$68.3 million as of December 31, 2013.

In most states, regulations require a portion (generally 10%) of the sale amount of cemetery property and memorials to be placed in a perpetual care trust. The income from these perpetual care trusts provides funds necessary to maintain cemetery property and memorials in perpetuity. This trust fund income is recognized, as earned, in Cemetery Revenues. While we are entitled to withdraw the income from perpetual care trusts to provide for maintenance of cemetery property and memorials, we are restricted from withdrawing any of the principal balances of the trust fund. Perpetual care trust balances totaled approximately \$42.3 million at December 31, 2013.

For additional information with respect to our trusts, see Part II, Item 8, Financial Statements and Supplementary Data, Notes 6, 8, and 10.

SEASONALITY

Our business can be affected by seasonal fluctuations in the death rate. Generally, the number of deaths is higher during the winter months because the incidences of death from influenza and pneumonia are higher during this period than other periods of the year.

COMPETITION

The operating environment in the deathcare industry has been highly competitive. Publicly traded companies operating in the United States include SCI, StoneMor and Carriage. In December 2013, SCI completed its acquisition of Stewart Enterprises, Inc. In addition, a number of smaller private consolidators have been active in acquiring and operating funeral homes and cemeteries.

Our funeral home and cemetery operations face competition in the markets that they serve. Our primary competition in most of our markets is from local independent operators. We have observed new start-up competition in certain areas of the country, which in any one market may have impacted our profitability because of the high fixed cost nature of funeral homes. Market share for funeral homes and cemeteries is largely a function of reputation and heritage, although competitive pricing, professional service and attractive, well-maintained and conveniently located facilities are also important. Because of the importance of reputation and heritage, market share increases are usually gained over a long period of time. The sale of preneed funeral services and cemetery property has increasingly been used by many companies as a marketing tool to build market share.

There has been increasing competition from providers specializing in specific services, such as cremations, who offer minimal service and low-end pricing. We also face competition from companies that market products and related merchandise over the Internet and non-traditional casket stores in certain markets. These competitors have been successful in capturing a portion of the low-end market and product sales.

REGULATION

General. Our operations are subject to regulations, supervision and licensing under numerous federal, state and local laws, ordinances and regulations, including extensive regulations concerning trust funds, preneed sales of funeral and cemetery products and services and various other aspects of our business. We believe that we comply in all material respects with the provisions of these laws, ordinances and regulations.

Federal Trade Commission. Our funeral home operations are comprehensively regulated by the Federal Trade Commission ("FTC") under Section 5 of the Federal Trade Commission Act and a trade regulation rule for the funeral industry promulgated thereunder referred to as the "Funeral Rule." The Funeral Rule defines certain acts or practices as

unfair or deceptive and contains certain requirements to prevent these acts or practices. The preventive measures require a funeral provider to give consumers accurate, itemized price informat