

# [Financial analysis of company 1780](https://assignbuster.com/financial-analysis-of-company-1780/)

The Loewen Group Inc. was founded in 1969. The company has two major headquarters in North America, one in Burnaby, British Colombia and a second in Cincinnati, Ohio. Loewen Group Inc. (L. G. I.) is the largest funeral services enterprise in Canada and is the second largest company in the North American Funeral Services Industry. L. G. I. owns 918 funeral homes and 269 cemeteries and also engages in the pre-need selling of funeral services including cemetery and cremation services. The company strives on respecting its Eagle Principle, which is displayed on the first page of its 1995 Annual Report:

“ To soar to heights of possibilities one needs two equally

healthy, strong wings – one being that of people or service

concerns, the other that of responsible planning and fiscal

management. It is the balance of these wings that enables

the eagle to soar beyond all heights” 1

In 1995, the company defended itself against two major lawsuits, as well as continued to negotiate acquisition agreements. The Loewen Group Inc. stresses that once an acquisition has been completed, local management is encouraged to remain and offers long term contracts to its key employees, rarely dismissing the other employees. L. G. I. provides many services to its acquired companies including offering training to new employees on its management information systems and covering costs for any renovations which are needed on the acquired locations. Each funeral home and cemetery is operated as a distinct profit centre, with monthly and annual financial performance monitored by regional and corporate management in accordance with budgeted projections.

This report includes a study of The Canadian Funeral Services Industry practices, a review of the take-over attempt by Service Corporation International, an analysis of the Loewen Group Inc. 1995 Annual Report for the period ending December 31, 1995, and examination of the revenue recognition practices used by L. G. I..

The Funeral Services Industry

According to a paper issued in August 1995, by Statistics Canada’s Services, Science and technology Division Final Purchase, Growing Demand: The Canadian Funeral Services Industry, the funeral services industry, in comparison to other industries, has historically been considered a low risk industry. The Funeral service industry is not significantly affected by economic cycles. The stability of the industry is increased by future demographic trends. Individuals from the “ baby boomer” generation are now entering their fifties and the death rate is growing slowly at 1. 5% per year, compounded, as demonstrated in Appendix A: Deaths, Actual and Projected. The industry is characterised by above-average profitability and revenue growth.

Public Health issues and consumer protection issues are primarily regulated at the provincial level of government. These regulations are implemented to protect the dignity of the deceased as well as his or her estate. These regulations are described in detail in the revenue recognition section.

Loewen Group Inc. Strategies

The Provident America Corporation lawsuit was settled in February, 1995 for

US $19 million. On November 2nd, 1995, a jury in Jackson, Mississippi, awarded US $500 million in Breach-of-contract lawsuit brought by Gulf National. This amount is almost twenty-six times high than what was originally asked for. In order to appeal, Loewen was required to post a US $625 million bond, which was later reduced to US $125 million with the condition that there would be no significant change in assets or increases in dividends without prior notification to the court and the other party. No provision on was made on the financial statement at this point since the result was hard to predict on the appeal. On January 29th, 1996, Loewen settled the lawsuit for US $175 million and recorded US $135 million, present value of $175 million.

Loewen decided to settle because of two reasons: the first is that the appeal would have a financial impact on the company’s income and the second reason is that prolonging the lawsuits would create uncertainty and speculation amongst the company’s shareholders.

S. C. I. Take-over Attempt

On September 17, 1996 Service Corporation International (S. C. I.), the largest Funeral Service Company in the world, placed a $ 2. 5. billion take-over bid for Loewen Group Inc. The bid’s share value is equivalent to US $ 43 each. Houston based S. C. I.’s bid was considered to be fair by many analysts like Todd Richter of Dean Witter Reynolds Inc. (New York) and Ivar Leipens of Moss, Lawson & Co. (Toronto). Another analyst, Dean Martin of TD securities Inc. (Toronto), stated that the bid was too low and that the a bid of US $ 50 would be fair. He noted that Chairman Ray Loewen and his management team retain 20 % (15 % + 5 % respectively) of the company’s stock. Canadian institutional holders of the company’s stock would be more likely to support the company because they must follow constraints such as a cap of 20 % on foreign holdings in regards to Canadian Pension funds. Therefore S. C. I. will has had a difficult time gaining the support of 75 % of Loewen Group Inc. shareholders needed as per the Canadian securities law.

In the week following the announcement of the take-over bid, the fourth largest company in the industry, Equity Corp. International, based in Lufkin, Texas had contacted the Federal Trade Commission in regards to how to become eligible to bid for divested properties if the take-over took place. Equity Corp. International is 40 % owned by Service Corp. International. Another company, Continua LLC, offered Loewen Group Inc. $ 500 million in exchange for some of Loewen’s southern US holdings. On September 27, 1996 the State of Florida launched an antitrust probe into the take-over bid. The state was worried about the impact it would have on Medicare issues, pricing and other areas.

S. C. I. would raise the bid to US $ 45 per share before Loewen rejected the bid on October 10, 1996, while at the same time launching an antitrust lawsuit against S. C. I. and Equity Corp. International. The lawsuit accused the two companies of conspiring to eliminate L. G. I. from the industry.

All companies in the Funeral Service Industry are continuing to reposition themselves as the industry continues to expand. If successful, S. C. I. would be able to monopolise the North American market. S. C. I.’s take-over proposal is intended to eliminate the competition in North America. S. C. I. wanted to buy cheap after the one time event with the jury. By taking over Loewen, S. C. I. would become the preferred buyer in the industry.

Loewen rejected their offer because of the following reasons:

1) inadequate proposal which has a potential anti-competition effect in the commonwealth of the industry.

2) Although both companies encourage the integration of new acquisitions in their structures, Loewen felt that its structure would not be preserved.

3) Loewen is considered as the preferred acquirer in the industry after the acquisition of

two of its key assets: Prime Succession, and Ross Hill Memorial Park, two major

cemeteries in the United States of America.

Loewen decided that it is best to continue implementing the company’s long term business plan as an independent company. Loewen has created a good corporate culture and has a record for caring for its employees, customers, and communities it serves.

Annual Report Analysis

The Loewen Group Incorporated 1995 Annual Report covers the period beginning January 1, 1994 and ending December 31st, 1995. This analysis will cover the following items: the report to the company’s shareholders, the “ Striking a Balance” section of the report and the operational highlights. The operational highlights analysis will include Management’s Statement of Responsibility, the Auditor’s report to the Shareholders, a ratio analysis of the financial statements disclosed in the report as well as the pertinence of the notes regarding the financial statements.

The annual report stresses the company’s belief in its Eagle Principle. In the report to the company’s shareholders, The chairman and chief executive officer, Ray Loewen stresses that the company showed ‘ outstanding growth’ despite the inflicting costs associated with the two major lawsuits it dealt with. He thanked the shareholders for their support, then stated promising figures that were overshadowed by the above for mentioned events. He continued with the aspect of growth by discussing the company’s acquisitions. Mr. Loewen concluded by promising to continue to uphold the company’s standards in 1996.

The “ Striking a Balance” section of the annual report’s purpose is to provide answers from management and executive members about questions shareholders might have about the Loewen Group Inc. beliefs, operations and structure. The topics ranged from the effect of the Gulf National lawsuit to how the services provided by Loewen benefit the communities it serves. This section does not disclose monetary figures, its responsibility lies in creating or restoring the trust of its potential shareholders and current shareholders before they analyse the financial statements in the following section of the annual report, by demonstrating the personal accountability of its staff .

Operational Highlights

The management’s statement of responsibility states that management has presented fairly the financial position of the company while respecting the generally accepted accounting principles in Canada. Management also states that it maintains its control systems to assure that also transactions are completed and recorded properly. The letter conclusion indicates that the auditors selected are independent.

The auditor’s report to the shareholders notes that the audits made by KPMG Peat Marwick Thorne (independent auditors) were based on the generally accepted auditing standards and summarises its criterion: finding evidence of amounts and disclosure policies and the manner in which the company adopted the generally accepted accounting principles. The auditors concluded upon the completion of the audits that the information provided in the consolidated financial statements to be presented fairly because the company applied generally accepted accounting principles consistently.

Ratio Analysis of Financial Statements

All ratios presented show 1995 in the first column and 1994 in the second column. As shown with the return on equity ratio. The dollar figures in the annual report are in American currency.

Performance Ratios

1995 1994

Return on equity (76684)/614682 = (0. 125) 38494/411139 = 0. 094

Return on equity based on the Scott formula

(Please refer to Appendix E: for complete figures)

ROE = SR \* AT + [ ROA – IN ] \* D/E

1995 (0. 125) = (0. 011) \* 0. 265 + [(0. 003) – 0. 043] \* 2. 682

1994 0. 094 = 0. 146 \* 0. 315 + [0. 046 – 0. 025] \* 2. 226

In 1995, $50 million of cash and 1. 5 million Common shares are paid off to Gulf National. The settlement decreases Loewen’s 1995 net income and retained earnings while increasing their owner’s equity. Therefore the shareholders lost 12. 5 % on their initial investment, compared to a gain of 9. 4 % in 1994.

Return on equity, calculated without the lawsuit settlement, shows a smaller decrease of 7. 8 % from the previous year. This is primarily due to the increase in share capital of $210 million made by the company to cover the debts incurred through the litigation proceedings.

Based on the Scott formula results, the decrease on the return on equity ratio was caused by a loss on overall operating return before interest cost and a high leverage return.

Return on assets (72949)/2262980 = (0. 032) 95113/1326275 = 0. 0717

Total assets increased by 70. 6 % however, the costs associated with the legal settlements ($165 million) resulted in a net loss. These occurrences resulted in a negative return on assets.

The negative return on assets normally indicates trouble in ability to pay interests.

Only $53 million of $165 million was paid in cash and the remainder was recorded as a long term liability without interest.

We can also relate these figures to the decrease in credit ratings of Loewen Group Inc. by the following credit facilities: Duff & Phelps Credit Rating, Standard & Poor’s Rating Group and Moody’s Investor Services as stated in the ‘ Current Credit Facilities and Credit Ratings’ section of the 1995 annual report.

Sales return (76684)/599939 = (0. 128) 38494/417328 = 0. 092

In 1994, 9. 2 % of all revenues ended up as profit, while in 1995, 12. 8 % of all revenues were recorded as a loss. 0. 080

If the company would not have had to incur the costs relating to the lawsuit, 8 % of its revenues would have been profit.

The costs relating to funeral homes and cemeteries expenditures exceeded the revenues they generated, because their revenues were not considered revenues of L. G. I. until the acquisitions were completed.

Gross margin [599939-373131]/599939 = 0. 378 [417328-258474]/417328 = 0. 381

Average interest rate 50913/1648298 = 0. 031 34203/91536 = 0. 037

The gross margin and the average interest rate both remained steady.

Cash flow to total assets 39454/2262980 = 0. 017 11649/1326275 = 0. 009

Cash flow to total assets ratio shows an increase, because the new acquisitions generated more revenues. The majority of the costs related to the Gulf National lawsuit were not included in the ratio, since a large percentage of the costs were recorded as long term liabilities. These liabilities did not involve a cash transaction.

Earnings per share (1. 690) 0. 970

Book value per share 614682000/48167765 = $12. 761 per share 411139000/41015447 = $10. 024 per share

Price-earning ratio 34. 380/(1. 690) = (20. 343) 36. 750/0. 970 = 37. 887

Dividend payout ratio 0. 050/(1. 69) = (0. 030) 0. 070/0. 970 = 0. 072

Earnings per share shows a large decrease in percentage, since the company issued US $ 210 million dollars worth of new shares. Therefore the dividends were distributed to a larger number of shares.

The value of shareholders equity per share increased from US $ 10. 02 in 1994 to US $ 12. 76 in 1995.

The dividend payout ratio decreased because earnings per share decreased.

The price earning ratio lowered due to the decrease in earnings per share, as well as the current market price per share.

Activity Ratios

Total asset turnover 599939/2262980 = 0. 265 417328/1326275 = 0. 315

The total asset turnover remained steady because of the new acquisitions off balanced the legal settlements and litigation cost.

One American dollar of total assets generated US $ 0. 27 in 1995, whereas in 1994, it generated US $ 0. 32.

Inventory turnover 373131/[[27489+19673]/2]= 15. 800 210471/[[19673+15952]/2]= 11. 820

Collection ratio 115953/[599939/365] = 70. 500 70547/[417328/365] = 61. 700

The inventory turnover was 15. 8 times in 1995, an increase from 11. 8 times in 1994.

In 1995, it took 70. 5 days to collect accounts receivables compared to 61. 7 days in 1994. This has a negative impact on the company’s liquidity.

Financing Ratios

Debt-equity ratio 1648298/614682 = 2. 682 915136/411139 = 2. 200

Long-term debt-equity 934509/614682 = 1. 520 516654/411139 = 1. 260

Debt to assets ratio 1648298/2262980 = 0. 728 915136/1326275 = 0. 690

The company’s reliance on debt increased because the costs it had to incur relating to the Gulf National lawsuit as well as the insurance liabilities incurred created by the two insurance companies it received during the acquisition of S. I. Acquisitions Associates, L. P.

Liquidity and Solvency Warning Ratio

Working capital ratio 191081/241275 = 0. 790 109868/97665 = 1. 125

The working capital ratio lowered to 0. 790 from 1. 125 in 1994. This means that their current liabilities increased at a faster rate than their current assets in 1995. This is cause for concern because ideally this ratio should be at $ 2 of assets to $ 1 of liabilities.

Acid test ratio [39454+115953]/241275 = 0. 644 [15349+70547]/97665 = 0. 880

Interest coverage ratio [72949-47178]/50913 = 0. 506 [24029+19738]/34203 = 1. 280

Both the acid test ratio and the interest coverage ratio both fell from last year. The acid test ratio decrease was caused by larger increase in liabilities than assets. The interest coverage ratio decreased below to 0. 506 which is below the ideal target of 1. The company is not generating sufficient income to cover its obligations as they become due.

Revenue Recognition

This analysis of the revenue recognition practices by Loewen Group Inc. is divided into two sections. The first section will concentrate on revenue recognition practices relating to funeral services and the second section will develop those relating to the cemetery operations of this company. We have included three Appendixes,

Appendix B: Average Funeral Costs, Appendix C: Revenue by Source in the Funeral Service Industry and Appendix D: Total Revenue of the Funeral Service Industry by Sector for additional references .

Funeral homes offer services, which include everything from the actual service and registration of the death of an individual to the sale of a casket. These services can be purchased “ at-need”, which is considered as a purchase at the time of death, or

“ pre-need”, which is a prearranged contract established while the deceased is still living.

Provincial regulations in Ontario protect the consumer with respect to pre-need funeral and cemetery services. In general, the regulations require a specific percentage of pre-paid funds to be deposited in trust. Ontario requires 100% deposits in trust on the sale of pre-arranged funeral services. This is required in order to protect the consumer from service non-delivery due to the closure or failure of the firm where they purchased the funeral services. Firms within the province of Ontario can not take the fullest financial advantage of pre-need services due to regulatory restrictions on the funds in question. However the firms still benefit, in that they are gaining control of future market share, and can be certain of future revenue flows.

“ Payments made for pre-need contracts are either placed in

trust by the company or are used on behalf of the purchaser

of the pre-need contract to pay premiums on life insurance

policies under which the company is the designated

beneficiary. At the date of performance of a pre-arranged

service, the company records as a funeral revenue the

amount originally trusted or the insurance contract amount,

together with all related insurance contract amount,

together with all related accrued trust earnings and

increased insurance benefits” 2

Pre-arranged funeral services are included in other assets and amortised over a period of ten years approximating the period the benefits are expected to be realised.

The regulations regarding cemeteries focus on public health aspects and the care and maintenance of cemetery grounds. Funeral home companies are required to deposit a certain percentage from the proceeds of sales of interment rights (ie: the lot, crypt or riches for the final disposition of the remains). These perpetual care funds are held in perpetuity and is not considered an asset to the firm. The firm does however have the right to the interest earned on the funds in order to provide the care and maintenance of their cemeteries. The percentage required to be deposited into the perpetual care fund varies from 5% to 40%, depending on the area. In the event that the firm suspends its operation these funds can be made available through the province or municipality.

“ The pre-need sale of interment rights and other related

products is recorded as revenue when customer contracts

are signed and, concurrently, related costs are recorded

and an allowance is established for customers cancellations

and refunds based on management’s estimated of expected

cancellations.” 3

1995, was a controversial year for The Loewen Group Inc. The company showed its desire to expand within the funeral industry by acquiring funeral homes and cemeteries from Osiris Holding Corp., MHI Group as well as other companies. The speed in which they attempted to acquire new holdings made the company vulnerable to lawsuits. The company stated in its annual report that it has become more aware of this issue after the Gulf National incident. Although the company was severely affected financially by the settlement as demonstrated by the financing and liquidity ratios, the company showed its potential to maintain its position in the industry, as shown by the relative unchanged gross margin.

The company now finds itself highly leveraged (as demonstrated by the Scott Formula calculations) and therefore has the potential for big earnings for shareholders. This has also made the company vulnerable to outsiders, as demonstrated by the Service Corporation International’s attempt to take-over the company. If Loewen Group Incorporated is able to stop the take-over attempt, it will prove its stability.

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APPENDIX A: Death, Actual and Projected

Source: p. 18 of Final Purchase, Growing Demand The Canadian Funeral Services Industry.

APPENDIX B: Average Funeral Costs

Source: p. 13 of Final Purchase, Growing Demand The Canadian Funeral Services Industry.

APPENDIX C: Revenue by Source in the Funeral Services Industry

Source: p. 6 of Final Purchase, Growing Demand The Canadian Funeral Services Industry.

APPENDIX D: Total Revenue of the Funeral Services Industry by Sector

Source: p. 4 of Final Purchase, Growing Demand The Canadian Funeral Services Industry.

APPENDIX E: The Scott Formula

(Expressed in thousands of U. S. Dollars)

1995 1994 Symbols

Total assets 2262980 1326275 A

Total liabilities 1648298 915136 L

Total equity 614682 411139 E

Total revenue 599939 417328 REV

Net income (76684) 38494 NI

Interest expense 50913 34203 INT

Income tax rate (38. 1) % 33. 9 % TR

After-tax interest expense 50913 \* 1. 381 = 70311 34203 \* . 661 = 22608 ATI = INT (1 – TR)

ROE (return on equity) (76684) / 614682 = (0. 125) 38494 / 411139 = 0. 094 NI / E

SR (sales return before interest) [(76684) + 70311] / 599939 = (0. 011) [38494 + 22608] / 417328 = 0. 146 [NI + ATI] / REV

AT (asset turnover) 599939 / 2262980 = 0. 265 417328 / 1326275 = 0. 315 REV / A

ROA (return on assets) [(76684) + 70311] / 2262980 = (0. 003) [38494 + 22608] / 1326275 = 0. 046 [NI + ATI] / A

IN (average interest rate after tax) 70311 / 1648298 = 0. 043 22608 / 915136 = 0. 025 ATI / L

D / E (debt-equity ratio) 1648298 / 614682 = 2. 682 915136 / 411139 = 2. 226 L / E