

# US Death Care Companies

February 5, 2019

## Consumer Staples – Death Care Services

Industry Rating

**Underweight**

### Investment Thesis

We recommend an underweight position in this industry. Cremation services are expected to continue outgrowing traditional burial services in the future. The high level of environmentally-damaging output from cremations is expected to increase prices as companies shift towards more environmentally-conscious methods. Many companies are consolidating in this industry, leaving few options for investment potential.

### Drivers of Thesis

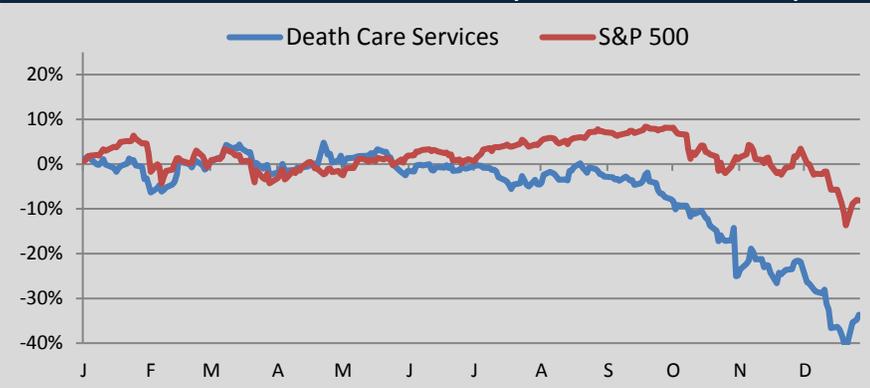
- The US death care market is expected to grow at a CAGR of 4% from 2017-2023<sub>4</sub>. The US death total is expected to grow at a CAGR of 1.17% over the next 10 years. This means approximately 30% of growth will come from increases in volume, while 70% comes from price appreciation.
- Cremations provide approximately one-third the revenue of traditional burial services. Traditional burials are expected to drop considerably in the next 15-20 years in favor of cremations.
- The industry is highly fragmented. Many firms are small, private entities that operate in a specific geographic area. The large firms purchase these properties, although at sometimes inflated prices due to competition.

### Risks to Thesis

- Increasing focus on boutique funeral items could increase margins by compensating for declining revenues in traditional areas.
- M&A activity is allowing companies to offer wider lines of products and reduce overhead for non-traditional items at the expense of increased debt.

Historic Cremation and Burial Rates (US) (Source: NFDA)						
Year	2010	2015	2019E	2025E	2030E	2035E
Burial	53.3 %	45.2%	39.0 %	30.1 %	22.5%	15.0 %
Cremation	40.4 %	47.9 %	55.1 %	64.0 %	71.6 %	79.1 %

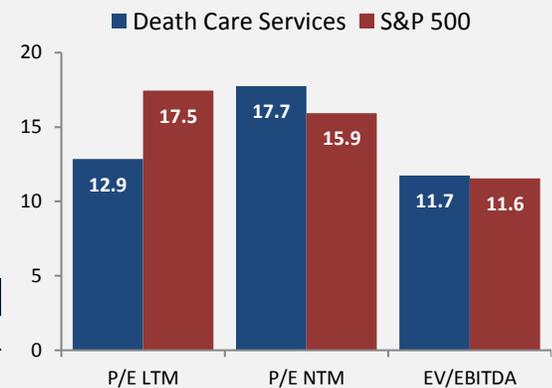
### 12 Month Performance vs. S&P 500 (Source: Yahoo Finance)



### Key Statistics

<b>Top Competitors</b>	Market Cap (\$Mil)
Carriage Services, Inc.	\$373.00
Service Corporation Int'l	\$7,766.40
StoneMor Partners L.P.	\$89.20
<b>P/E (TTM)</b>	
Carriage Services, Inc.	9.44
Service Corporation Int'l	16.26
StoneMor Partners L.P.	N/A
<b>ROA</b>	
Carriage Services, Inc.	4.10 %
Service Corporation Int'l	3.90 %
StoneMor Partners L.P.	(4.10) %
<b>ROE</b>	
Carriage Services, Inc.	5.40%
Service Corporation Int'l	28.40%
StoneMor Partners L.P.	(308.1)%
<b>EPS (TTM)</b>	
Carriage Services, Inc.	\$2.04
Service Corporation, Int'l	\$2.66
StoneMor Partners L.P.	\$(1.96)

Source: Factset



Source: Factset

### Industry Description

This industry engages in the sale of after-death services such as funeral planning, burials, and cremations. These sales also include pre-need items such as caskets, burial plots, and pre-planned funeral arrangements. Most companies also sell unique, non-traditional arrangements to individualize the funeral service for the customer. These firms operate primarily in the United States, although SCI has properties outside of the U.S.

## EXECUTIVE SUMMARY

The death care services industry is a mature industry that has little room for investment potential. The estimated increase in deaths per year in the US is very low, and consumers are choosing cheaper options year-over-year, making consolidation the best growth prospect for the established companies in the industry. Many consumers believe funeral costs are too high as they currently stand, and some have gone as far as crowdfunding funeral expenses. This has partially influenced the increasingly popular choice to be cremated rather than buried. The increase in the cremation rate has put the environmental effects of cremation under scrutiny, causing crematoriums to evaluate their processes. A push towards more environmentally-friendly cremation options could increase the price of cremations, at least in the short-run.

To compensate for the lost revenue from traditional burials, companies are starting to increase their digital presence, allowing customers to pre-plan their after-death care. Allowing a certain niche of customers to personalize their care has created a business segment that did not exist in a large capacity 10 or more years ago. M&A activity from the larger firms in the industry has allowed them to offer more products for these unique arrangements while capturing economies of scale that can increase margins. This has increased their debt levels in recent years, and for some companies this is not a sustainable method for growth.

After-death care is a unique consumer staple in that the demand is constant and these services have very high barriers to entry for the industry. Although there will always be demand for these services, consumer sentiment has mainly shifted towards low-cost options evidenced by the cremation rate surpassing the burial rate. This gap is expected to widen in the next several years<sup>5</sup>. We believe the industry has a negative trajectory due to these changes, leading to our underweight recommendation.

## INDUSTRY OVERVIEW

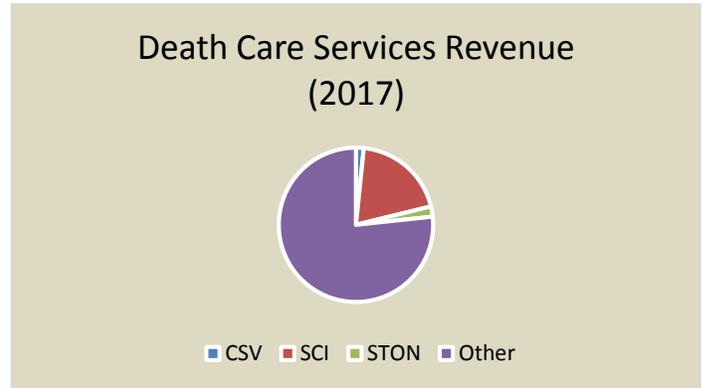
The major, public firms operating in this market segment are Carriage Services, Inc. (CSV), Service Corporation International (SCI), and StoneMor Partners L.P. (STON). These firms primarily handle funeral services, burials,

cremations, and cemetery properties. Some of their comparable statistics are shown below.

Figures in (\$M)	CSV	SCI	STON
<b>Mkt Cap</b>	350.5	7,688.7	146.5
<b>Revenue</b>	269.3	3,190.2	316.1
<b>Net Income</b>	11.6	447.2	(71.9)

Source: Factset

Many large firms handle the entirety or majority of the funeral process, but some smaller firms specialize in sales of individual items such as caskets and burial monuments. Two public companies that specialize in monuments are Matthews International Corporation (MATW) and Hillenbrand Inc. (HI). These companies are conglomerates with their monument units comprising a small portion of revenue. For this reason we believe they are not apt comparisons for companies in this industry.



Source: SCI, CSV, STON 10Ks, 2018

SCI has the largest market share by far of the three major competitors. The “Other” category is made up of many small, private firms that usually operate in a small geographic region.

### Funeral Services

The funeral services provided by these firms typically cover the whole process from the time a person passes away to the disposition of remains. They transport the body, prepare it for viewing, and handle the burial or cremation that occurs after. They also handle some smaller tasks such as placing obituaries in newspapers, the paperwork associated with funerals, recording donations, and sometimes ordering floral and other arrangements for the service and/or burial site<sup>1</sup>. Around three-quarters of

revenue is generated from funeral home activities, which includes revenue from cremation and burial<sup>1,2,3</sup>. Revenue from prepaid funeral plans are put into a conservative trust. The balances of these trusts are in the companies' annual reports and are broken into funeral and cemetery accounts.

CSV, SCI, STON, and other large firms should recognize economies of scale through their vertical integration of the funeral process. We do not see this in CSV or STON, however. Smaller firms usually specialize in one or two steps or sales of specific items, or only operate in a relatively small geographic region.

### Burial and Cremation Services

Burials and cremations are the two most common types of after-death body disposal. The choice to use cremation has been rapidly increasing due to the price difference compared to a traditional burial. The prices for each service have both increased around 2.5-3% between 2014 and 2017, but the median cremation price is still around \$1,000 cheaper. That 2.5%-3% equates to a three-year CAGR slightly below 1%. To us, this indicates that death care service companies have little pricing power and struggle to keep up with inflation. We believe prices will continue to grow at slow rates due to price competition between firms.

	2014	2017
Median Cost, Funeral and Burial	\$ 7,181	\$ 7,360
3-year CAGR		0.82 %
Median Cost, Funeral and Cremation	\$ 6,078	\$ 6,260
3-year CAGR		0.99 %
		Source: NFDA

This price difference is almost entirely due to the cost of caskets. The median cremation casket costs roughly \$1,000. The median burial casket costs just under \$2,400<sup>5</sup>. The price difference comes from the materials used. Caskets for cremation are typically wood, whereas burial caskets are metal, so they do not rot in the ground.

### Cemetery Services

It is common for firms in the industry to own cemeteries as well as funeral homes. Cemetery revenue comes from the purchases of plots for people to be buried as well as maintenance fees to provide upkeep. Many people elect to pay for their plots before passing. These revenues are put into trusts with very conservative investments. If a cemetery is "full" or runs out of plots, these trusts ideally provide a constant stream of revenue to pay for maintenance costs. Below is a table of total cemetery locations for each company as well as revenue per cemetery in millions of dollars.

	CSV	SCI	STON
Cemeteries	29	481	316
Rev/cemetery	\$1,975	\$2,686	\$876

Source: CSV, SCI, STON 10-K 2018

CSV has very few cemeteries as their primary focus is on their funeral home segment. They still have relatively high revenue per cemetery compared to STON who has many more cemetery properties. SCI has the most cemetery locations as well as the highest revenue per cemetery. We believe they are the company in the best position to exercise economies of scale in their cemetery segment. They have a large presence in the U.S. and should be able to leverage their buying power on cemetery products.

### Sector Analysis

There are currently no death care services companies in the S&P 500. SCI is in the S&P 400 midcap and CSV is in the Russell 2000. At this time, STON is not included in any major indices.

### KEY DEVELOPMENTS

The death care services industry is experiencing a shift in how they conduct business and offer services. The rise in cremations has put scrutiny on their environmental impact and led crematoriums to reconsider their processes. This has also led to customers opting for "green" funerals that minimize the negative impact on the environment. These services cost between \$2,000-3,000 on average, more in-line with cremation costs<sup>17</sup>. Funeral homes and cemeteries are also expanding their online presence to engage with more potential customers and offer personalized services. Careers in the industry are projected to grow at a healthy rate in the next decade as many older employees retire.

## Environmental Impacts

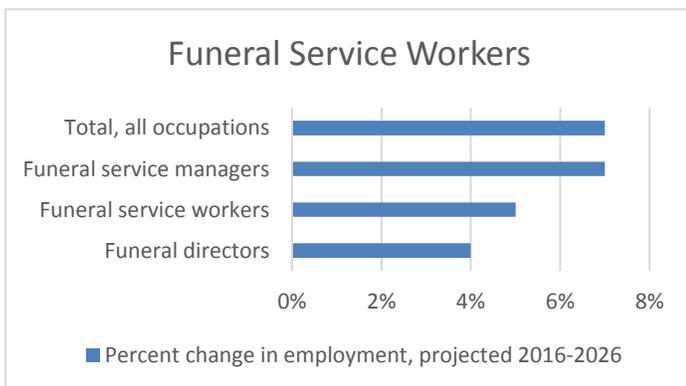
Traditional burials put a high amount of materials and chemicals into the environment every year. It is estimated they're responsible for 4.3 million gallons of embalming fluids, 1.6 million tons of concrete, 17,000 tons of copper and bronze, and 64,500 tons of steel being used every year<sup>9</sup>.

Desire to reduce the damage done to the environment has led to "green" burials becoming more popular. Funeral homes are offering new services designed to minimize the carbon footprint of funerals. These services include being buried in a shroud without a casket, having plants and flowers being planted on the gravesite, or even being buried in a conservation park.

The growth of cremations has put more focus on their environmental impact as well. It takes a large amount of energy to fully burn a human body in addition to the casket. One alternative is a type of "water cremation" where the body is dissolved through a chemical mixture. This process, called alkaline hydrolysis, is estimated to keep 180 kg of carbon dioxide out of the atmosphere with each cremation<sup>11</sup>. This process is not widely implemented as its ethics are being debated in the US and abroad.

## Employment Prospects

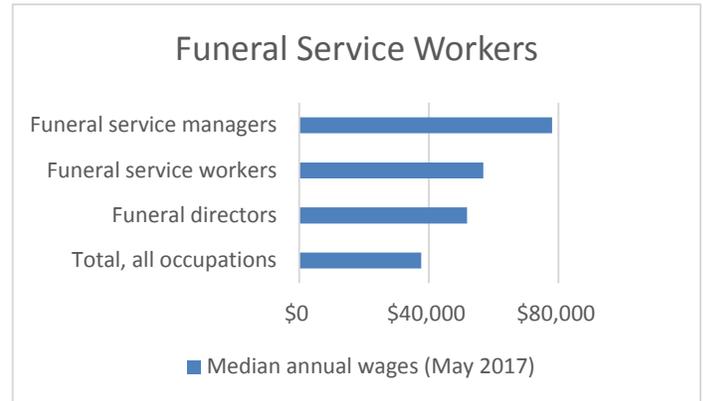
Employment of all funeral service workers is expected to grow approximately 5% from 2016 to 2026<sup>8</sup>. Morticians, undertakers, and funeral directors have the lowest expected growth rate at 4%<sup>8</sup>.



Source: BLS

Funeral service jobs have relatively low barriers, requiring only an associate's degree in most cases. The median

wage is also considerably higher than that of all occupations<sup>8</sup>.



Source: BLS

Many companies face the challenge of finding employees looking to enter the funeral business, especially those with funeral director and embalming licenses<sup>18</sup>. This problem is more common at locations in areas with lower population density. CSV, SCI, and STON theoretically have the means to incentivize employees to move to less desirable locations. We do not believe companies in the industry will see significant margin pressure from higher wages, but it is a factor to monitor in the future.

## Digital Presence

Firms are beginning to emphasize their online presence through their company websites. Some consumers prefer the ability to select services and products on their own time, outside of what can feel like a high-pressure sales environment. Funeral homes are now offering direct cremations in which the body is cremated, and the remains are sent directly to the family. This process includes no funeral service and there is no need to go into a funeral home.

## INDUSTRY TRENDS

The most significant trend is the shift from traditional burials to cremations. This trend is impacting the bottom line of firms due to lower margins on cremation services.

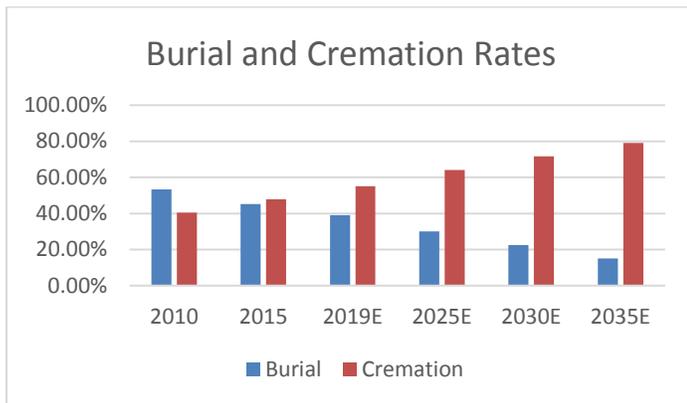
Death care services has few large, public firms and many small, private ones. The primary driver of growth has been the acquisition of smaller firms. Small firms are having to find ways to differentiate themselves from national brands

that can offer lower prices. Although funeral home owned by large firms don't explicitly use their parent company's name, they are able to get better prices on products. This means small, independent funeral homes must compete on service and reputation.

Religious sentiments in the US have also affected the death care industry. The decline of the perceived importance of religion in funeral services has introduced consumers to services that would not have been acceptable previously.

### Burial and Cremation Rates

The cremation rate has been rising rapidly over the past several years. It is expected to keep rising in the next 2 decades.



Source: NFDA

The cremation rate first passed the burial rate in 2015. This is an unwanted trend for funeral service providers, as the margins on cremation are much less than traditional burials. These NFDA predictions imply a 2.03% CAGR for cremation growth as well as a -5.12% CAGR for burial decline between 2019 and 2035.

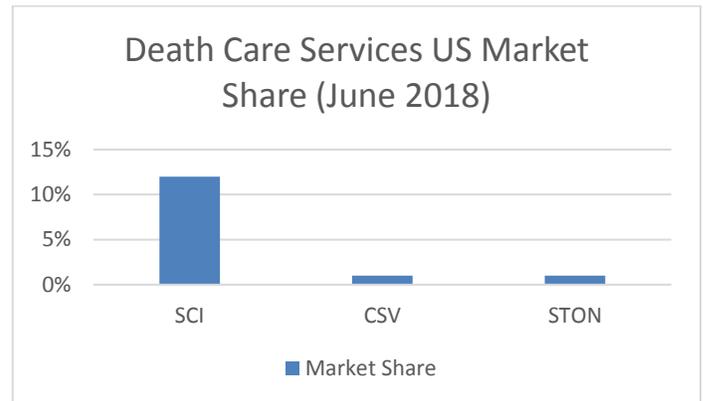
	2014	2015	2016	2017
<b>Burial contracts</b>	10,284	10,572	10,875	11,914
<b>% change</b>		2.80%	2.87%	9.55%
<b>Average revenue</b>	8,581	8,681	8,819	8,886
<b>% change</b>		1.17%	1.59%	0.76%
<b>Cremation contracts</b>	10,800	12,868	13,801	15,536
<b>% change</b>		19.15%	7.25%	12.57%
<b>Average revenue</b>	3,085	3,217	3,274	3,376
<b>% change</b>		4.28%	1.77%	3.12%

Source: CSV 10K 2015-2018

This table shows the discrepancy between the average revenue for burial and cremation contracts for Carriage Services. Although there has been a slight rise in burial contracts, cremations have strongly outpaced them. Firms are having to look at new product and service lines to make up for the smaller margins of cremation services.

### Fragmented Ownership

The market share for death care services is highly fragmented. There are only three public companies that specialize in these services – SCI, CSV, and STON.

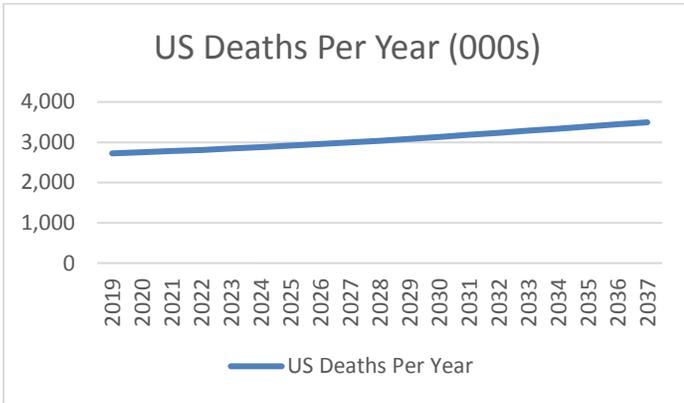


Source: Statista

SCI has around 12% of the market share by property count while CSV and STON have approximately 1% each. The remaining 86% is comprised mostly of small, private companies. There is relatively low demand for new funeral homes and cemeteries. SCI, CSV, and STON primarily grow through acquisition of smaller funeral homes and cemeteries. These acquisitions are primarily financed through debt issuances. This method is usually unsustainable in the long-term as it requires taking on large amounts of debt.

### US Death Trends

The number of deaths in the US is expected to grow around 1-1.5% annually over the next two decades. Advances in medicine have led to higher life expectancy and the US will not see the slight uptick in deaths until around 2027. This is when many from the baby boomer generation will start to pass. The CAGR for US deaths per year is expected to be 1.17% over the next 10 years<sup>12</sup>.



Source: US Census Bureau

Medical advancements have increased the life expectancy in the US. This is most notable at the age of 65. This table shows the life expectancy of men and women in the US who reach the age of 65, in these respective years.

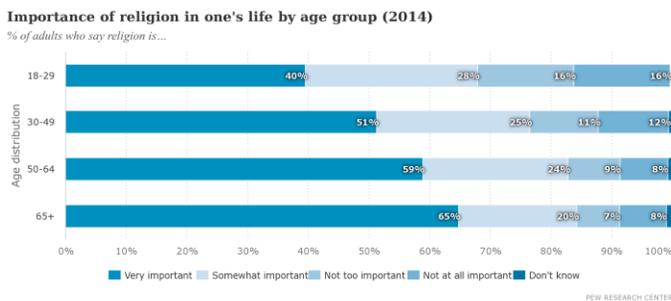
	1980	1990	2000	2015
<b>Male</b>	14.1	15.1	16.0	18.0
<b>Female</b>	18.3	18.9	19.0	20.5

Source: Center for Disease Control

This trend indicates those who reach 65 are expected to live longer than those in previous generations. Although the death rate is growing at a relatively constant rate, it is not due to people dying sooner.

## Religious Importance

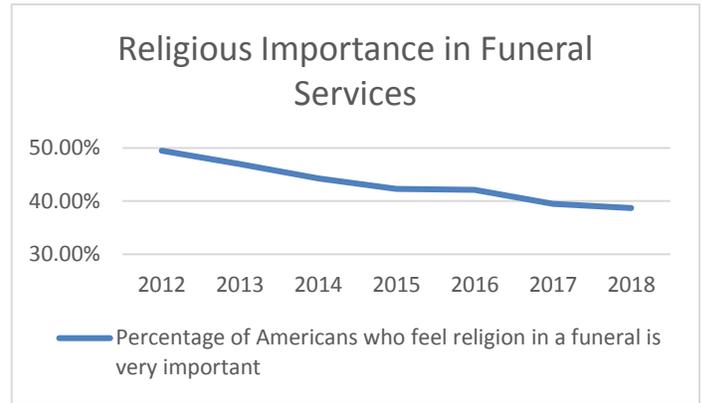
The impact of religion in funeral services has been declining in recent years. This can partially be explained by younger generations having a lower importance of religion in their lives, as shown below.



Source: Pew Research Center

The portion of Americans who believed a religious component was very important in the funeral of a loved

one fell from just under half in 2012 to around a third in 2018.



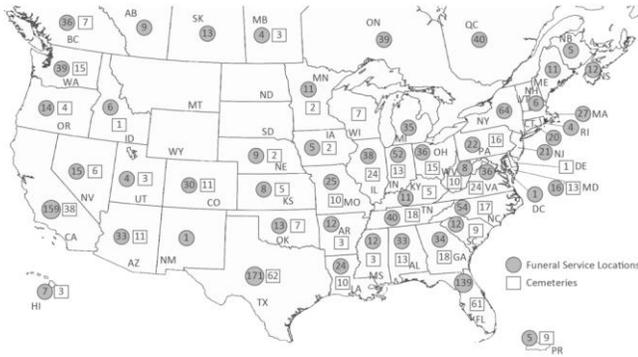
Source: Statista

The decrease in importance has led to a subsequent decrease in traditional religious services which usually include a burial. If this trend continues there could be a rise in non-traditional, less expensive funeral and disposition methods. A switch to these methods by mass numbers of consumers would hurt funeral homes' and cemeteries' bottom lines.

## FIRM COMPARISONS

Firms operating in this sector vary drastically in size and performance. Many firms are privately held. This is a highly fragmented industry.

Service Corporation International (SCI) is the largest provider of death care products and services in the US. Their 2017 revenues were \$3.095 billion. SCI estimates they have an approximate US market share of 15%. They operate 1,488 funeral homes and 473 cemeteries in 45 US states, Canada, and Puerto Rico as of 2017 end. 281 of those locations are funeral home and cemetery combinations. On the following page is a map of SCI's locations.



Source: SCI 10-K, 2018

SCI employs 15,508 full-time and 7,920 part-time employees. They are best known for their Dignity Memorial brand among several others. Their services consist of funeral home operations, cemetery property sales, crematoria, and funeral and cemetery merchandise sold on a preneed and at-time basis.

Carriage Services (CSV) is a leading provider of funeral and cemetery services in the US, although much smaller than SCI. Carriage Services' 2017 revenues were \$258.139 million in 2017. CSV operates 178 funeral homes in 29 states and 32 cemeteries in 11 states. Below is a map of their properties.

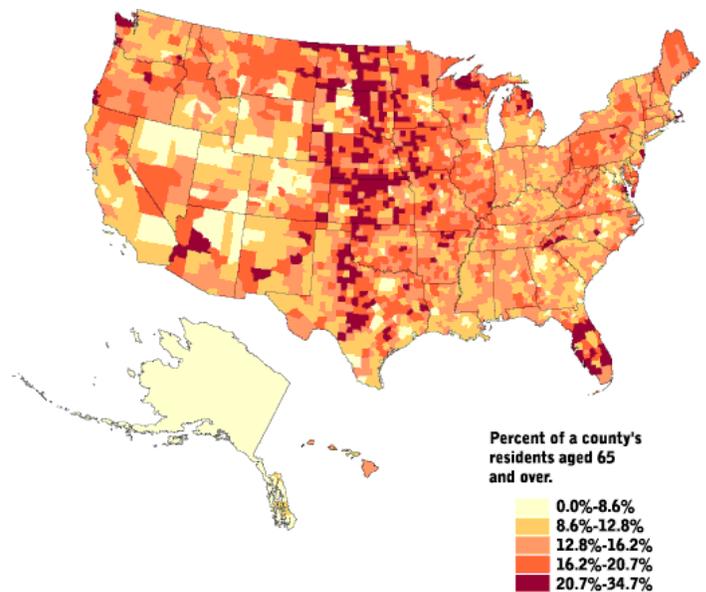


Source: [carriageservices.com/businesses](http://carriageservices.com/businesses)

At the end of 2017 CSV had 2,659 employees, of which 1,145 were full-time and 1,514 were part-time. Their services include collection and disposition of remains, funeral services and consultation, sales of funeral merchandise, cemetery plots, and cemetery markers

among others. These services are provided on both a preneed and at-time basis.

StonMor Partners L.P. (STON) is the second largest owner and operator of funeral homes and cemeteries in the US. Their revenue for 2017 was \$338.227 million. At the end of 2017 they operated 316 cemeteries in 27 US states and Puerto Rico and 93 funeral homes in 17 states and Puerto Rico. 44 of these funeral homes were combined with a cemetery. STON had 2,821 full-time, 307 part-time, and 17 seasonal employees at the end of 2017. Their products include burial lots, mausoleums, perpetual care rights, caskets, grave markers and memorials, and installation of burial vaults and caskets among others. Their services are offered on both a preneed and at-time basis.



Source: [censusscope.org](http://censusscope.org)

This map shows the population density by county for residents age 65 and older. There are several hotbed areas in Florida and Texas, two states where CSV and SCI have a strong presence. This is because there are many retirement communities in these areas. Both public and private firms compete heavily in these areas.

Below is a table summarizing the size of CSV, SCI, and STON.

	CSV	SCI	STON
Revenue (\$M)	\$258	\$3,095	\$338
Funeral homes	178	1,488	93
Cemeteries	32	473	316
Employees	2,659	23,428	3,145

Source: CSV, SCI, STON 10-K, 2018

SCI has a large presence in both cemeteries and funeral homes. CSV has shifted their focus to funeral home operations in recent years, and we do not believe they will acquire or build new cemeteries in upcoming years<sup>1</sup>. STON primarily focuses on cemeteries.

Below is a table of common metrics for the three companies.

	CSV	SCI	STON
Op. Margin	16.16%	19.27%	(3.16)%
ROA	1.26%	3.50%	(4.16)%
ROE	5.56%	29.31%	(51.84)%
ROIC	2.07%	9.20%	(16.44)%

Source: Factset

CSV and SCI are well ahead of STON based on common ratio analysis. STON has had significant operating cost issues over the past decade. Management has not been able to give accurate guidance on when they will see improvement, and we do not foresee their position improving significantly in the near future.

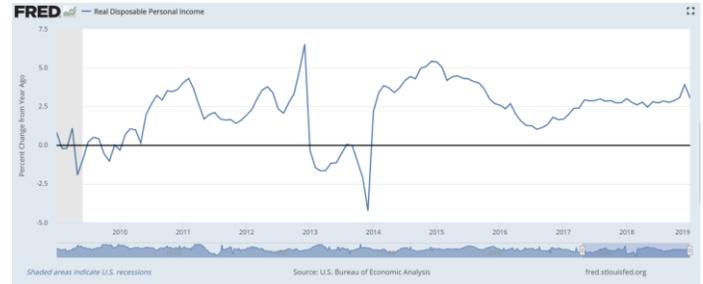
SCI is able to take better advantage of their size than CSV, as shown in their ratios. CSV does not necessarily need to compete directly with SCI, but they will inevitably compete for customers in their high-density areas.

Overall, SCI is best positioned to succeed in the industry due to their size and operating efficiency. They have nearly three-times the locations of CSV and STON combined, have the best ability to pay off their debt, and operate the most efficiently of the three companies.

## ECONOMIC OUTLOOK

### Disposable Income

Disposable income has risen relatively steadily in the US in the last several years. Consumers have more money to spend how they wish, especially in upper-class households. This income could be a boon for death care services as consumers spend more on personalized services.

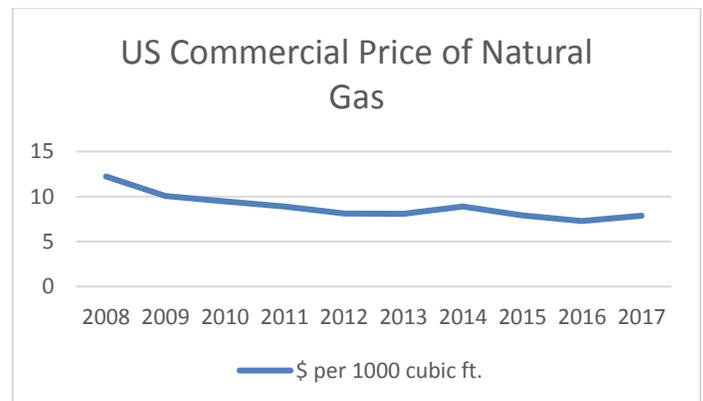


Source: FRED St. Louis

The increase in disposable income is not guaranteed to affect consumers spending habits related to death care services. It does leave the possibility for upper class individuals to spend more on their funeral service, however. We believe this factor is significant if firms can upsell individuals and families on high-end products for at-need services.

### Natural Gas Prices

Natural gas is the most common fuel used for cremations. Liquid propane can also be used, but typically only when natural gas is unavailable.



Source: US Energy Information Administration

The price movement of natural gas has been favorable in recent years. However, the cremation industry is still heavily exposed to the fluctuations in natural gas pricing. Currently, no firms disclose their fuel costs or if they have hedging positions. The cremation rate increase means firms offering cremation services will be more susceptible to natural gas price volatility going forward.

## Interest Rates

CSV, SCI, and STON all use debt to finance their property acquisitions. The table below shows each company's total debt, cost of debt, and debt ratios.

	CSV	SCI	STON
Total debt (\$M)	\$366.4	\$3,602.1	\$321.0
Cost of debt	6.63%	5.47%	7.56%
Total debt/total equity	165.41	220.37	N/A
Interest coverage	1.92	3.39	(1.06)

Source: Factset

All three firms have similar costs of debt with SCI being the lowest. This makes sense as they have the best interest coverage ratio of the three (EBIT/interest expense). We believe this is due to SCI generating more cash from the size of their operations, allowing them to record a higher operating margin. These firms have very high debt to equity ratios due to the large amounts of debt they use to finance acquisitions. STON's debt to equity ratio cannot be computed because they currently have negative equity. They also have negative EBIT, making their interest coverage ratio negative.

Since these companies are so highly levered, they are heavily exposed to interest rate risk. They tend to refinance debt every several years. If interest rates were to rise, they would have to refinance at higher rates. This could be problematic if they have cash flow problems, such as STON at the moment. We believe SCI is in the best position to withstand higher interest rates due to their higher cash flows. CSV could improve their position by reducing debt if they cannot improve cash flow. STON is in a very unfavorable position that should be closely monitored going forward.

## CATALYSTS FOR GROWTH

Increased concern for the environment may offer the most potential for the industry. Eco-conscious customers may

opt for alternative after-death services that have higher margins. The largest threat to this is government regulation that may prohibit certain disposal methods, such as alkaline hydrolysis.

The larger firms have been growing through acquisition in recent years. This pattern is mostly unsustainable as it usually involves taking out high levels of debt.

Personalized services offer higher margins while appealing to boutique customers. Although these services are still relatively uncommon, an uptick in disposable income could persuade consumers to opt for a unique service.

## INVESTMENT POSITIVES

- Death care services will always be necessary. Disposition of remains is a very niche industry with high barriers to entry.
- Large, established firms benefit from economies of scale. They can grow through acquisition while keeping overhead low.
- An increased online presence gives customers more personalization for their service. Boutique services and products have higher margins if companies can convince consumers they're worth the additional expense.

## INVESTMENT NEGATIVES

- The increasing cremation rate has hurt firms' margins. The price difference between traditional burials and cremations has driven firms to look elsewhere for revenue.
- The industry is highly fragmented. Many small firms have a firm grasp on the geographic region they operate in. The primary way to move into new areas is through acquisition.
- Traditional burials and cremations have high levels of pollution. At this time, there are no widely-adopted alternatives that are eco-friendly.
- The death rate in the US is expected to remain stagnant over the next decade. Firms should not expect to see natural growth from a higher number of services performed due to an increase in deaths year-over-year.

## KEYS TO MONITOR

It will be important to monitor the product lines the industry puts forward in the next several years. If upscale items establish a foothold with those with higher disposable income, that could be enough to drive revenue growth for firms.

It is also prudent to monitor legislation impacting alternative disposition methods. We will need to see if new alternatives are profitable for firms in the industry, or if they would cut margins further. A carbon tax on cremation pollution would also be harmful to the industry and could drive the change to different disposition methods.

It will be important to monitor firms' decisions to take on further debt to acquire companies. Shifts in interest rates could make it difficult to service debt especially if firms have lower cash flow because of declining revenues.

We believe SCI is the firm best positioned to succeed in the industry due to their size advantage. However, we are negative on the industry as a whole due to shifting consumer choices.

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18. Des Moines Register – Death isn't a dying industry, but Iowa funeral directors are becoming harder to find
19. Pew Research Center – Importance of religion in one's life by age group (2014)
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21. Censusscope.org

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