

CARRIAGE SERVICES INC

Form 10-K

March 14, 2008

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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  
For The Fiscal Year Ended December 31, 2007**

**Transition Report Pursuant To Section 13 Or 15(d) Of The Securities Exchange Act Of 1934**

**Commission File Number: 1-11961**

**CARRIAGE SERVICES, INC.  
(Exact name of registrant as specified in its charter)**

**Delaware  
(State or other jurisdiction of incorporation or  
organization)**

**76-0423828  
(I.R.S. Employer Identification No.)**

**3040 Post Oak Blvd., Suite 300, Houston, TX  
(Address of principal executive offices)**

**77056  
(Zip Code)**

Registrant's telephone number, including area code: **(713) 332-8400**

**SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:**

Common Stock, \$.01 Par Value  
Series G Preferred Stock Purchase Rights  
**(Title Of Class)**

New York Stock Exchange  
New York Stock Exchange  
**(Name of Exchange on which registered)**

**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 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K 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. Yes  No

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  Smaller Reporting Company   
(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company as defined by 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 29, 2007 was approximately \$140.7 million based on the closing price of \$8.26 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 29, 2008 was 19,260,820.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the definitive proxy statement to be delivered in connection with the 2008 annual meeting of stockholders are incorporated in Part III of this Report.

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**CAUTIONARY NOTE**

This annual report contains forward-looking statements of our management regarding factors that we believe may affect our performance in the future. Such statements typically are identified by terms expressing our future expectations or projections of revenues, earnings, earnings per share, cash flow, market share, capital expenditures, effects of operating and acquisition initiatives, gross profit margin, debt levels, interest costs, tax benefits and other financial items. All forward-looking statements, although made in good faith, are based on assumptions about future events and are therefore inherently uncertain, and actual results may differ materially from those expected or projected. Important factors that may cause our actual results to differ materially from expectations or projections include those described under the heading *Forward-Looking Statements* in Item 7. Forward-looking statements speak only as of the date of this report, and we undertake no obligation to update or revise such statements to reflect new circumstances or unanticipated events as they occur.

**PART I**

**ITEM 1. BUSINESS**

**GENERAL**

We are a leading provider of death care services and merchandise in the United States. We operate two types of businesses: funeral homes, which currently account for approximately 75% of our total revenue, and cemeteries, which currently account for approximately 25% of our total revenue. As of December 31, 2007, we operated 139 funeral homes in 25 states and 32 cemeteries in 11 states. We primarily serve suburban markets and believe we are a market leader (first or second) in most of those 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 burial and cremation services and sell related merchandise, such as caskets and urns. 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;

strong, entrepreneurial local leadership that capitalizes on local heritage and relationships;

controlling salary and merchandise costs; and

exercising pricing leverage related to our *at-need* business to increase average revenues per contract.

*Cemetery Operations.* Cemeteries are primarily a sales business that provides interment rights (grave sites and mausoleums) and related merchandise, such as markers and memorials. Our cemetery operating results are impacted by the success of our sales organization because approximately 37.8% of our cemetery revenues during the year ended December 31, 2007 was generated from *preneed* sales of interment rights. We believe that changes in the level of consumer confidence (a measure of whether consumers will spend money on discretionary items) may impact the amount of such *preneed* sales. Cemetery revenues generated from *at-need* service and merchandise sales generally are subject to many of the same key profitability factors as in our funeral home business. Approximately 11.2% of our cemetery revenues during the year ended December 31, 2007 was attributable to investment earnings on trust funds and finance charges on installment contracts.

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. Our Standards Operating Model, called *Being the Best*, was implemented at the beginning of 2004. We use the Standards Operating Model to measure the sustainable revenue growth and earning power of our portfolio of deathcare businesses. The standards based 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. This model also requires our local and corporate

leaders to change our focus from short-term profitability to the drivers of success that create long-term profitability and value for our stockholders. Our operating model emphasizes:

decentralized management of our local businesses;

financial and operational standards based upon key drivers of success of our best businesses;

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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 sustainable increasing 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

executing our Strategic Portfolio Optimization Model, a disciplined program that will guide our acquisition and disposition strategies, to change the sustainable earning power profile of our portfolio.

**HISTORY**

Carriage Services, Inc. was incorporated in Delaware in December of 1993. Prior to 2001, Carriage grew dramatically through acquisitions of funeral homes and cemeteries. A significant amount of debt was incurred in financing these acquisitions. Our business strategy during the four years ended December 31, 2004 focused on increasing operating cash flow and improving our financial condition by reducing debt to lower our interest expense and improve our credit profile. During that same period we initiated a process to identify underperforming businesses and, where appropriate, sold those businesses to reduce our debt. We sold 36 funeral homes and 12 cemeteries along with 20 parcels of excess real estate. We reduced our debt and contingent obligations by approximately \$87 million during the period January 1, 2001 through December 31, 2004. During January 2005, we refinanced our senior debt by issuing \$130 million of Senior Notes due in 2015. This refinancing represented a milestone. The refinancing was the culmination of the effort to reaccess the capital markets and to extend the maturities of our senior debt and to gain the flexibility to reinvest our cash flow in our core business. We used the net cash proceeds from the offering and our cash flow to grow our Company through selective acquisitions. During 2005, we acquired a funeral business consisting of two chapels in northern Florida, the first acquisition since 2002. During 2007, we completed seven acquisitions. See Note 5 to the Consolidated Financial Statements for acquisitions during 2007.

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**DEATH CARE INDUSTRY**

Death care 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 death care industry in the United States is characterized by the following fundamental attributes (the statistics included in this report are based on public reports from financial research firms or public websites):

***Death Rates***

Death rates 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, death rates have trended lower very slightly as the general population is living longer and because of low birth rates in the period from early 1930's to mid 1940's during the depression and World War II. The number of deaths per year in the United States is expected to increase from approximately 2.4 million in 2006 to 2.6 million in 2010 according to the United States Bureau of the Census. In addition, the segment of the United States population over 65 years of age is expected to increase by over 10% from approximately 36.7 million in 2005 to 40.2 million in 2010.

***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. According to industry studies, cremations represented approximately 32% of the U.S. burial market in 2005. That number is expected to increase to 38% by 2010 and 51% by 2025. Cremation rates can vary significantly based upon geographic, religious and cultural traditions. Historically, direct cremation has been offered as a less costly alternative to a traditional burial. 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.

***Highly Fragmented Ownership***

We understand that there are approximately 22,000 funeral homes and 10,500 cemeteries in the United States and that the domestic funeral service industry generates approximately \$15 billion of revenue annually. The largest public operators, in terms of revenue, of both funeral homes and cemeteries in the United States are Service Corporation International, StoneMor Partners L.P., Stewart Enterprises, Inc., and Carriage Services, Inc. We believe these three companies collectively represent approximately 20% of death care revenues in the United States. Independent businesses represent the remaining amount of industry revenue, accounting for an estimated 80% share. During most of the 1990s, there was a trend toward independent firms consolidating with public operators. However, few acquisitions of independents by the public companies have occurred since 1999 and there have been a number of independent entrants in local markets. As a result, the industry continues to be characterized by a large number of locally-owned, independent businesses. Service Corporation International acquired what was the second largest public company in the industry, Alderwoods Group in 2006. During 2007, we acquired three businesses from Service Corporation International and four independent businesses.

***Heritage and Tradition***

Death care 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**

Key elements of our overall business strategy include the following:

*Implement Operating Initiatives.* On January 1, 2004, we introduced our Standards Operating Model, a more decentralized and entrepreneurial financial operating model for our funeral homes. On January 1, 2006 we implemented a similar model to our cemetery business. These models are based on standards designed to grow market share and increase profitability developed from our best operations, along with an incentive compensation plan to reward business managers for successfully meeting or exceeding the standards. The model essentially eliminated the



use of financial budgets. The operating model and standards, which we refer to as Being the Best, focus on the key drivers of a successful operation, organized around three primary areas – market share, people and operating and financial metrics. The model and standards are the measures by which we judge the success of each business. To date, the Standards Operating Model has driven significant changes in our organization, leadership and operating practices. Most importantly, the Standards Operating Model allowed us to measure the sustainable revenue growth and earning power of our portfolio

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of deathcare businesses, which then led to development of a Strategic Portfolio Optimization Model during 2006 that will guide our acquisition and disposition strategies in the future. Both models, when executed effectively, should drive longer 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.

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. We believe our managing partners have the opportunity to be compensated at close to the same level as if they owned the business.

*Presentation and Packaging of Services and Merchandise.* We believe packaging funeral services and merchandise offers both simplicity and convenience for our client families. Well-conceived and thoughtful packages eliminate much of the effort and discomfort experienced by client families concerning matters about which they do not have much knowledge during a very stressful and emotional time. We also anticipate that our packaging strategy will result in increased revenue per cremation service over time as more families select packages that provide services and merchandise. The percentages of funeral services conducted by us in which cremation was chosen as the manner in which to dispose of remains was 34.4% for the year ended December 31, 2006 and 35.8% for the year ended December 31, 2007. For the year ended December 31, 2007, approximately 63.1% of the number of our total cremation services were direct cremations (where no viewing, visitation, or merchandise is involved, although a memorial service may be held) and 36.9% included additional 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. We emphasize insurance-funded contracts over trusted contracts in most markets, as insurance products allow us to earn commission income to improve our cash flow and offset a significant amount of the up-front costs associated with preneed sales. In addition, the cash flow and earnings from insurance contracts are more stable 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.

*Renewed 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 Portfolio Optimization 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. As we execute this strategy, we will acquire larger, higher margin strategic businesses and sell smaller, lower margin non-strategic businesses.

Ideal candidates would be those that are demonstrated market leaders, have strong local management, have owners and family members whose objectives are aligned with ours, and have field-level operating margins consistent with our best performing properties. In our quest to find ideal candidates, we have analyzed and projected key statistics in the deathcare industry and believe the following will be true by 2015:

The number of national deaths will begin a long-term rise as the death rate among the baby boomer generation accelerates, notwithstanding a longer life expectancy.

The aging baby boomers will possess sufficient wealth and the financial flexibility to migrate to attractive retirement and part time second career areas primarily in the southern and western states and other select markets.

The general population of the United States will continue to grow and migrate to attractive urban and suburban centers in the southern and western states.

Cremation rates will continue to increase and migrate eastward. The accelerating cremation rate will have a significant impact on the revenue base of more traditional deathcare businesses in the Central and Eastern regions of the United States and a lesser impact on the already high cremation states in the West.

With the above considerations in mind, our vision over the next ten years is to change the profile of our practice to be heavily weighted in about 10-15 major markets that have an especially attractive demographic profile and where over time, we could acquire or build up operations in each of these markets by doing one to three thousand calls annually. We believe there are large enough markets for us to increase our presence in existing markets by acquisition or enter a new market with a substantial acquisition while leveraging our strong local franchise brands and entrepreneurial leadership. We will 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. Most of our suburban markets have populations of 100,000 or more. In over 70% of our funeral home markets, we believe that we are either first or second in local market share.

*Partnership Culture.* Our funeral homes and cemeteries are managed by individuals that we refer to as Managing Partners, with extensive death care 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.* In January 2005, we completed our \$130 million senior debt offering. We used the net proceeds to pay off the existing senior debt that had near term maturities and accrued interest on our TIDES, described below. This transaction eliminated all near-term debt maturity issues. We believe that our capital structure provides us with financial flexibility, which allows us to invest in our growth. Currently, we have four primary components in our capital structure:

the \$130 million senior notes which have a 2015 maturity;

a revolving credit facility, described under the heading "Liquidity and Capital Resources" in Item 7;

our convertible junior subordinated debenture payable to our affiliate trust, which has the ability to defer payments of interest, and a 2029 maturity (our TIDES); and

our common stock.

*Stable Cash Flow.* Since 2000, we have demonstrated the ability to generate stable cash flow. Prior to 2005, our primary use of cash flow was to repay debt. Free cash flow (cash flow from operations less maintenance capital expenditures) for 2007 totaled \$11.7 million. We intend to use cash flow to fund a selective growth strategy. Our growth strategy is the primary way we expect to increase stockholder value. We will reassess our capital allocation strategy annually, but at this point we believe that our financial goals will best be achieved by continuing to improve the operating and financial performance of our existing portfolio while selectively investing our free cash flow in growth opportunities that generate a return on invested capital in excess of our weighted average cost of capital.

*Strong Field-Level Operating Margins.* We believe that our field-level operating margins are among the highest reported by the public companies in the death care industry and that this performance is a testament to the success of our business strategies. 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-based 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 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 revenues are generated from at-need sales, we retain significant pricing leverage in our funeral business.

*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 in order to 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 and Chief Executive Officer (CEO) Mel Payne, is characterized by a dynamic culture that reacts quickly and proactively to address changing market conditions and emerging trends. We believe this culture has been critical to our recent successful efforts and will provide an important advantage as the death care industry evolves. We are committed to continue operating an efficient corporate organization and strengthening our corporate and local business leadership. We believe that our Being the Best Standards Operating Model will ensure this commitment at all levels of the

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organization. At mid-year 2006 we reorganized our funeral and cemetery divisions into three Regions, each headed by a Regional Partner. This change promotes more cooperation between our funeral and cemetery operations and supports the goal of market-share and volume growth in our most significant markets. The three Regional Partners report to our CEO.

**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, 2007, we operated 139 funeral homes in 25 states. Funeral home revenues currently account for approximately 75% of our total revenues. The funeral home operations are managed by a team of experienced death care industry professionals and selected region-level individuals with substantial management experience in our industry. See Note 22 to the Consolidated Financial Statements for the year ended December 31, 2007, for segment data related to funeral home operations.

Our funeral homes offer a complete range of services to meet a family's funeral 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 worship, and transportation services. Most of our funeral homes have a non-denominational chapel on the premises, which permits family visitation and religious services to take place at one location and thereby reduces our transportation costs and inconvenience to the family.

Funeral homes are principally a service business that provides burial and cremation services and sells related merchandise, such as caskets and urns. 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;
- leading market share positions;
- strong, entrepreneurial local leadership that capitalizes on local heritage and relationships;
- controlling salary and merchandise costs; and
- exercising pricing leverage related to our at-need business to increase average revenues per contract.

***Cemetery Operations***

As of December 31, 2007, we operated 32 cemeteries in 11 states. The cemetery operations are managed by a team of experienced death care industry and sales professionals. Cemetery revenues currently account for approximately 25% of our total revenues. See Note 22 to the Consolidated Financial Statements for the year ended December 31, 2007, for segment data related to cemetery operations.

Our cemetery products and services include interment services, the rights to interment in cemetery sites (including 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 services, finance charges from installment sales contracts and investment income from preneed cemetery merchandise and perpetual care trusts.

Our cemetery operating results are impacted by the success of our sales organization because 38% of our cemetery revenues was generated from preneed sales of interment rights during the year ended December 31, 2007. An additional 15% of our 2007 cemetery revenues was from deliveries of merchandise and services previously sold on preneed contracts. We believe that changes in the level of consumer confidence (a measure of whether consumers will spend money on discretionary items) impact the amount of cemetery revenues. Cemetery revenues 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 13% of our cemetery revenues was attributable to investment earnings on trust

funds and finance charges on installment contracts during the year ended December 31, 2007. Changes in the capital markets and interest rates affect this component of our cemetery revenues.

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In addition to sales of funeral merchandise and services, cemetery interment rights and cemetery merchandise and services at the time of need, we also 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 death care plans at the time of need and allow input from other family members before the death occurs.

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, are not recognized until the time the funeral service is performed. 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). Additionally, we generally earn a commission from the insurance company from the sale of insurance-funded policies. Prior to 2005, the direct marketing commissions and costs incurred from the sale of preneed funeral contracts were deferred and amortized on an actuarial method to match the expected maturity of the preneed contracts. Effective January 1, 2005, we changed our method for accounting for deferred obtaining costs and began expensing all costs as incurred. See Note 3 to the Consolidated Financial Statements for the year ended December 31, 2007, for more detailed discussion of this accounting change.

In addition to preneed funeral contracts, we also offer preplanned 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. Preplanned funeral arrangements permit a family to avoid issues of making death care 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. In substantially all cases, we receive an initial down payment at the time the contract is signed. The interest rates generally range between 12% and 14%. Preneed sales of cemetery interment rights are generally 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 customer cancellations and refunds are recorded at the date that the contract is executed and periodically evaluated thereafter based upon historical experience.

We sold 4,998 and 5,161 preneed funeral contracts during the years ended December 31, 2006 and 2007, respectively. At December 31, 2007, we had a backlog of 68,909 preneed funeral contracts to be delivered in the future. Approximately 21% of the funeral revenues recognized during each of the last three years and during the twelve months ended December 31, 2007 originated through preneed contracts. Cemetery revenues that originated from preneed contracts represented approximately 52% of our net cemetery revenues for both 2006 and 2007.

As of December 31, 2007, we employed a staff of 168 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 law. Such trusts include (i) preneed funeral trusts; (ii) preneed cemetery merchandise and service trusts; and (iii) perpetual care trusts. These trusts are typically administered by independent financial institutions selected by the Company. Independent financial advisors are also used for investment management and advisory services.

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, while trust fund holdings and deferred revenue are reflected currently on our balance sheet. 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 receipts to offset any administrative and selling expenses. The aggregate balance of our preneed funeral contracts held in trust, insurance contracts and receivables from customers was approximately \$280.0 million as of December 31, 2007.

We are generally required under applicable state laws to deposit a specified amount (which varies from state to state, generally 50% to 100% of selling price) into a merchandise and service trust fund for cemetery merchandise and services preneed sales. The related trust fund income earned is recognized when the related merchandise and services are delivered. We are generally permitted to

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withdraw the trust principal and accrued income when the merchandise is actually purchased, when the service is provided or when the contract is cancelled. Cemetery merchandise and service trust fund balances, in the aggregate, totaled approximately \$61.1 million as of December 31, 2007.

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 a portion of the 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 \$37.2 million at December 31, 2007.

For additional information with respect to our trusts, see Notes 9, 10, 11 and 12 to the Consolidated Financial Statements for the year ended December 31, 2007.

**COMPETITION**

The operating environment in the death care industry has been highly competitive. Publicly traded companies operating in the United States are Service Corporation International, Stewart Enterprises, Inc, Keystone North America, Inc. and StoneMor Partners L.P. In addition, a number of smaller, non-public companies have been active in acquiring and operating funeral homes and cemeteries.

Our funeral home and cemetery operations usually 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**

Our operations are subject to regulations, supervision and licensing under numerous foreign, 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. We operate in the United States under the Federal Trade Commission (FTC) comprehensive trade regulation rule for the funeral industry. The rule contains requirements for funeral industry practices, including extensive price and other affirmative disclosures and imposes mandatory itemization of funeral goods and services.

We are subject to the requirements of the federal Occupational Safety and Health Act ( OSHA ) and comparable state statutes. The OSHA hazard communication standard, the United States Environmental Protection Agency community right-to-know regulations under Title III of the federal Superfund Amendment and Reauthorization Act and similar state statutes require us to organize information about hazardous materials used or produced in our operations. Certain of this information must be provided to employees, state and local governmental authorities and local citizens.

Our operations, including our preneed sales activities and the management and administration of preneed trust funds, are also subject to regulation, supervision and licensing under state laws and regulations. We believe that we are in substantial compliance with all such laws and regulations.

**EMPLOYEES**

As of December 31, 2007, we and our subsidiaries employed 1,776 employees, of whom 872 were full-time and 904 part-time. All of our funeral directors and embalmers possess licenses required by applicable regulatory agencies. We believe that our relationship with our employees is good. None of our employees are represented by unions.



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**AVAILABLE INFORMATION**

We file annual, quarterly and other reports, and any amendments to those reports, and information with the United States Securities and Exchange Commission ( SEC ). You may read and copy any materials we file with the SEC at the SEC's Public Reference Room at 100 F Street, NE, Washington, DC 20549. You may obtain additional information about the Public Reference Room by calling the SEC at 1-800-SEC-0330. In addition, the SEC maintains an Internet site <http://www.sec.gov> that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC, including us.

Our website address is [www.carriageservices.com](http://www.carriageservices.com). Available on this website under Investor Relations-Investor Relations Menu SEC Filings, free of charge, are Carriage's annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, insider reports on Forms 3, 4 and 5 filed on behalf of directors and officers and amendments to those reports as soon as reasonably practicable after such materials are electronically filed with or furnished to the United States Securities and Exchange Commission ( SEC ).

Also posted on our website, and available in print upon request, are charters for the Company's Audit Committee, Compensation Committee and Corporate Governance Committee. Copies of the Code of Business Conduct and Ethics and the Corporate Governance Guidelines are also posted on the Company's website under the Corporate Governance section. Within the time period required by the SEC and the New York Stock Exchange, Inc., we will post on our website any modifications to the Codes and any waivers applicable to senior officers as defined in the applicable Code, as required by the Sarbanes-Oxley Act of 2002.

**ITEM 1A. RISK FACTORS**

**RISKS RELATED TO OUR BUSINESS**

**Marketing and sales activities by existing and new competitors could cause us to lose market share and lead to lower revenues and margins.**

We face competition in all of our markets. Most of our competitors are independently owned, and some are relatively recent market entrants. Certain of the recent entrants are individuals who were formerly employed by us or by our competitors and have relationships and name recognition within our markets. As a group, independent competitors tend to be aggressive in distinguishing themselves by their independent ownership, and they promote their independence through advertising, direct mailings and personal contact. Increasing pressures from new market entrants and continued advertising and marketing by competitors in local markets could cause us to lose market share and revenues. In addition, competitors may change the types or mix of products or services offered. These changes may attract customers, causing us to lose market share and revenue as well as to incur costs in response to competition to vary the types or mix of products or services offered by us.

**Our ability to generate preneed sales depends on a number of factors, including sales incentives and local and general economic conditions.**

Declines in preneed sales would reduce our backlog and revenue and could reduce our future market share. On the other hand, a significant increase in preneed sales can have a negative impact on cash flow as a result of commissions and other costs incurred without corresponding revenues.

As we have localized our preneed sales strategies, we are continuing to refine the mix of service and product offerings in both our funeral and cemetery segments, including changes in our sales commission and incentive structure. These changes could cause us to experience declines in preneed sales in the short-run. In addition, economic conditions at the local or national level could cause declines in preneed sales either as a result of less discretionary income or lower consumer confidence. Declines in preneed cemetery property sales would reduce current revenue, and declines in other preneed sales would reduce our backlog and future revenue and could reduce future market share.

Preneed sales of cemetery property and funeral and cemetery merchandise and services are generally cash flow negative initially, primarily due to the commissions paid on the sale, the portion of the sales proceeds required to be placed into trust or escrow and the terms of the particular contract such as the size of the down payment required and the length of the contract. As a result, preneed sales reduce cash flow available for other activities, and, to the extent preneed activities are increased, cash flow will be further reduced.

**Price competition could also reduce our market share or cause us to reduce prices to retain or recapture market share, either of which could reduce revenues and margins.**

We have historically experienced price competition primarily from independent funeral home and cemetery operators, and from monument dealers, casket retailers, low-cost funeral providers and other non-traditional providers of services or products. New

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market entrants tend to attempt to build market share by offering lower cost alternatives. In the past, this price competition has resulted in our losing market share in some markets. In other markets, we have had to reduce prices thereby reducing profit margins in order to retain or recapture market share. Increased price competition in the future could further reduce revenues, profit margins and our backlog.

**Our ability to execute our growth strategy is highly dependent upon our ability to successfully identify suitable acquisition candidates and negotiate transactions on favorable terms.**

There is no assurance that we will be able to continue to identify candidates that meet our criteria or that we will be able to reach terms with identified candidates for transactions that are acceptable to us. We intend to apply standards established under our Strategic Portfolio Optimization Model to evaluate acquisition candidates, and there is no assurance that we will continue to be successful in doing so or that we will find attractive candidates that satisfy these standards.

**Increased or unanticipated costs, such as insurance, taxes or litigation, may have a negative impact on our earnings and cash flow.**

We have experienced material increases in certain costs during the previous years, such as insurance, taxes or legal fees, which result from external factors difficult to estimate. These costs may impair our ability to achieve earnings growth in excess of revenue growth. Our 2008 plan assumes that we will be successful in increasing earnings at a rate that is greater than revenue growth. We can give no assurance that we will be successful in achieving such increases.

**Improved performance in our funeral and cemetery segments is highly dependent upon successful execution of our Standards Operating Model.**

We have implemented our standards-based operating model to improve and better measure performance in our funeral and cemetery operations. We developed standards according to criteria, each with a different weighting, designed around market share, people, and operational and financial metrics. We also incentivise our location managing partners by giving them the opportunity to earn a fixed percentage of the field-level earnings before interest, taxes, depreciation and amortization based upon the number and weighting of the standards achieved. Our expectation is that, over time, the Standards Operating Model will result in our maintaining or improving field-level margins, market share, customer satisfaction and overall financial performance, but there is no assurance that these goals will be met. We have learned that success using the model is highly dependent on having the right leader in the business.

**Our smaller businesses are typically dependent upon one or a few key employees for success.**

Death care businesses have built local heritage and tradition through successive generations, providing a foundation for ongoing business opportunities from established client family relationships and related referrals. We believe these relationships build trust in the community and are a key driver to market share. Our businesses, which tend to serve small local markets, usually have one or a few key employees that drive our relationships. We can give no assurance that we can retain these employees or that these relationships will drive market share.

**Earnings from and principal of trust funds and insurance contracts could be reduced by changes in financial markets and the mix of securities owned.**

Earnings and investment gains and losses on trust funds and insurance contracts are affected by financial market conditions and the mix of fixed-income and equity securities that we choose to maintain in the funds. During 2004 and 2005, we revised the mix of investments within the cemetery trusts according to our new asset allocation model in an effort to increase earnings and lower volatility. We made similar changes in some of the funeral trusts in 2006. We may not choose the optimal mix for any particular market condition. Declines in earnings from perpetual care trust funds would cause a decline in current revenues, while declines in earnings from other trust funds could cause a decline in future cash flows and revenues.

**Covenant restrictions under our debt instruments may limit our flexibility in operating our business.**

The terms of our credit facility and the indenture governing the Senior Notes may limit our ability and the ability of our subsidiaries to, among other things:

- incur additional debt;
  
- pay dividends or make distributions or redeem or repurchase stock;

- make investments;

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- grant liens;
- make capital expenditures;
- enter into transactions with affiliates;
- enter into sale-leaseback transactions;
- sell assets; and
- acquire the assets of, or merge or consolidate with, other companies.

Our credit facility also requires us to maintain certain financial ratios. Complying with these restrictive covenants and financial ratios, as well as those that may be contained in any future debt agreements, may impair our ability to finance our future operations or capital needs or to take advantage of other favorable business opportunities. Our ability to comply with these restrictive covenants and financial ratios will depend on our future performance, which may be affected by events beyond our control. Our failure to comply with any of these covenants or restrictions when they apply will result in a default under the particular debt instrument, which could permit acceleration of the debt under that instrument and, in some cases, the acceleration of debt under other instruments that contain cross-default or cross-acceleration provisions. In the case of an event of default, or in the event of a cross-default or cross-acceleration, we may not have sufficient funds available to make the required payments under our debt instruments. If we are unable to repay amounts owed under the terms of our amended senior secured credit facility, the lenders thereunder may be entitled to sell certain of our funeral assets to satisfy our obligations under the agreement.

**RISKS RELATED TO THE DEATH CARE INDUSTRY**

**Declines in the number of deaths in our markets can cause a decrease in revenues. Changes in the number of deaths are not predictable from market to market or over the short term.**

Declines in the number of deaths could cause at-need sales of funeral and cemetery services, property and merchandise to decline, which could decrease revenues. Although the United States Bureau of the Census estimates that the number of deaths in the United States will increase through 2010, longer life spans could reduce the rate of deaths. In addition, changes in the number of deaths can vary among local markets and from quarter to quarter, and variations in the number of deaths in our markets or from quarter to quarter are not predictable. These variations may cause our revenues to fluctuate and our results of operations to lack predictability.

**The increasing number of cremations in the United States could cause revenues to decline because we could lose market share to firms specializing in cremations. In addition, direct cremations produce minimal revenues for cemetery operations and lower funeral revenues.**

Our traditional cemetery and funeral service operations face competition from the increasing number of cremations in the United States. Industry studies indicate that the percentage of cremations has steadily increased and that cremations will represent approximately 39% of the U.S. burial market by the year 2010, compared to approximately 32% in 2005. The trend toward cremation could cause cemeteries and traditional funeral homes to lose market share and revenues to firms specializing in cremations. In addition, direct cremations (with no funeral service, casket, urn, mausoleum niche, columbarium niche or burial) produce no revenues for cemetery operations and lower revenues than traditional funerals and, when delivered at a traditional funeral home, produce lower profit margins as well.

**If we are not able to respond effectively to changing consumer preferences, our market share, revenues and profitability could decrease.**

Future market share, revenues and profits will depend in part on our ability to anticipate, identify and respond to changing consumer preferences. In past years, we have implemented new product and service strategies based on results of customer surveys that we conduct on a continuous basis. However, we may not correctly anticipate or identify trends in consumer preferences, or we may identify them later than our competitors do. In addition, any strategies we may implement to address these trends may prove incorrect or ineffective.



**Because the funeral and cemetery businesses are high fixed-cost businesses, changes in revenue can have a disproportionately large effect on cash flow and profits.**

Companies in the funeral home and cemetery business must incur many of the costs of operating and maintaining facilities, land and equipment regardless of the level of sales in any given period. For example, we must pay salaries, utilities, property taxes and

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maintenance costs on funeral homes and maintain the grounds of cemeteries regardless of the number of funeral services or interments performed. Because we cannot decrease these costs significantly or rapidly when we experience declines in sales, declines in sales can cause margins, profits and cash flow to decline at a greater rate than the decline in revenues.

**Changes or increases in, or failure to comply with, regulations applicable to our business could increase costs or decrease cash flows.**

The death care industry is subject to extensive regulation and licensing requirements under federal, state and local laws. For example, the funeral home industry is regulated by the Federal Trade Commission, which requires funeral homes to take actions designed to protect consumers. State laws impose licensing requirements and regulate preneed sales. Embalming and cremation facilities are subject to stringent environmental and health regulations. Compliance with these regulations is burdensome, and we are always at risk of not complying with the regulations or facing costly and burdensome investigations from regulatory authorities.

In addition, from time to time, governments and agencies propose to amend or add regulations, which could increase costs or decrease cash flows. For example, federal, state, local and other regulatory agencies have considered and may enact additional legislation or regulations that could affect the death care industry. Several states and regulatory agencies have considered or are considering regulations that could require more liberal refund and cancellation policies for preneed sales of products and services, limit or eliminate our ability to use surety bonding, increase trust requirements and prohibit the common ownership of funeral homes and cemeteries in the same market. If adopted by the regulatory authorities of the jurisdictions in which we operate, these and other possible proposals could have a material adverse effect on us, our financial condition, our results of operations and our future prospects. For additional information regarding the regulation of the death care industry, see **Business Regulation** .

**ITEM 1B. UNRESOLVED STAFF COMMENTS**

None.

**ITEM 2. PROPERTIES**

At December 31, 2007, we operated 139 funeral homes in 25 states and 32 cemeteries in 11 states. We own the real estate and buildings for 83% of our funeral homes and leases facilities for the remaining 17%. We own 27 cemeteries and operate five cemeteries under long-term contracts with municipalities and non-profit organizations at December 31, 2007. Eleven funeral homes are operated in combination with cemeteries as these locations are physically located on the same property or very close proximity and under same management. The 32 cemeteries operated by us have an inventory of unsold developed lots totaling approximately 114,000 and 118,000 at December 31, 2006 and 2007, respectively. In addition, approximately 496 acres are available for future development. We anticipate having a sufficient inventory of lots to maintain our property sales for the foreseeable future. The specialized nature of our business requires that our facilities be well-maintained. Management believes this standard is met.

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The following table sets forth certain information as of December 31, 2007, regarding Carriage's properties used by the funeral homes segment and by the cemeteries segment identified by state:

State	Number of Funeral Homes		Number of Cemeteries	
	Owned	Leased(1)	Owned	Managed
California	21	2	4	0
Connecticut	6	2	0	0
Florida	6	3	6	3
Georgia	3	0	0	0
Idaho	5	1	3	0
Illinois	1	4	1	0
Kansas	7	0	0	0
Kentucky	10	3	1	0
Maryland	1	0	0	0
Massachusetts	12	0	0	0
Michigan	3	0	0	0
Montana	1	0	0	0
Nevada	2	0	2	1
New Jersey	4	1	0	0
New Mexico	1	0	0	0
New York	1	0	0	0
North Carolina	1	2	1	0
Ohio	4	2	0	1
Oklahoma	1	0	1	0
Rhode Island	4	0	0	0
Tennessee	3	0	0	0
Texas	13	1	7	0
Virginia	3	1	1	0
Washington	1	1	0	0
West Virginia	1	1	0	0
Total	115	24	27	5

(1) The leases, with respect to these funeral homes, have remaining terms ranging from one to seven years, and, generally, we have the right to renew past the initial terms and a right of first

refusal on any  
proposed sale of  
the property  
where these  
funeral homes  
are located.

Our corporate headquarters occupy approximately 37,000 square feet of leased office space in Houston, Texas. At December 31, 2007, we operated 590 vehicles, of which 585 are owned and 5 are leased.

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**ITEM 3. LEGAL PROCEEDINGS**

We and our subsidiaries are parties to a number of legal proceedings that arise from time to time in the ordinary course of business. While the outcome of these proceedings cannot be predicted with certainty, we do not expect these matters to have a material adverse effect on the financial statements. Information regarding litigation is set forth in Part II, Item 8. Financial Statements and Supplementary Data, Note 16 of this Form 10-K.

We self-insure against certain risks and carry insurance with coverage and coverage limits for risks in excess of the coverage amounts consistent with our assessment of risks in our business and of an acceptable level of financial exposure. Although there can be no assurance that self-insurance reserves and insurance will be sufficient to mitigate all damages, claims or contingencies, we believe that the reserves and our insurance provides reasonable coverage for known asserted or unasserted claims. In the event we sustained a loss from a claim and the insurance carrier disputed coverage or coverage limits, we may record a charge in a different period than the recovery, if any, from the insurance carrier.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

No matters were submitted to a vote of our stockholders during the fourth quarter of 2007.

**Table of Contents****PART II****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

Our Common Stock is traded on the New York Stock Exchange under the symbol **CSV**. The following table presents the quarterly high and low sale prices as reported by the New York Stock Exchange:

	<b>2007</b>	<b>High</b>	<b>Low</b>
First Quarter		\$ 8.37	\$5.04
Second Quarter		\$ 8.93	\$7.50
Third Quarter		\$ 9.42	\$7.65
Fourth Quarter		\$11.09	\$8.12
	<b>2006</b>		
First Quarter		\$ 5.25	\$4.60
Second Quarter		\$ 5.16	\$4.40
Third Quarter		\$ 4.94	\$4.12
Fourth Quarter		\$ 5.19	\$4.61

As of February 29, 2008, there were 19,260,820 shares of our Common Stock outstanding and the closing price as reported by the New York Stock Exchange was \$7.90 per share. The Common Stock shares outstanding are held by approximately 255 stockholders of record. Each share is entitled to one vote on matters requiring the vote of stockholders. We believe there are approximately 5,000 beneficial owners of the Common Stock.

We have never paid a cash dividend on our Common Stock. We currently intend to retain earnings to fund the growth and development of our business. Any future change in our policy will be made at the discretion of our Board of Directors in light of our financial condition, capital requirements, earnings prospects and any limitations imposed by lenders or investors, as well as other factors the Board of Directors may deem relevant.

We have a compensation policy for fees paid to our directors under which the directors may choose to receive their fees either in the form of cash or equity based on the fair market value of our common stock calculated at the closing price published by the New York Stock Exchange on the date the fees are earned. Prior to May 2006, the shares issued to directors were unregistered. In connection with our Annual Meeting of Stockholders in May 2006, the stockholders approved our 2006 Long Term Incentive Plan and we registered the shares available for future issuance for this compensation policy and other corporate purposes. We issued 3,003 unregistered shares of common stock to directors in lieu of payment in cash for their fees for the year ended December 31, 2006, the value of which was charged to operations. No underwriter was used in connection with these issuances. We relied on the Section 4(2) exemption from the registration requirements of the Securities Act of 1933, as amended.

We did not repurchase any of our equity securities during the fourth quarter of the year ended December 31, 2007.

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The graph below matches the cumulative 5-year total return of holders of Carriage Services, Inc.'s common stock with the cumulative total returns of the Russell 2000 index, the Russell MicroCap index and a customized peer group of three companies that includes: Service Corporation International, Stewart Enterprises Inc. and StoneMor Partners L.P. The graph assumes that the value of the investment in the company's common stock, in each index, and in the peer group (including reinvestment of dividends) was \$100 on 12/31/2002 and tracks it through 12/31/2007.

**COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN\***

Among Carriage Services, Inc., The Russell 2000 Index,  
The Russell MicroCap Index And A Peer Group

\* \$100 invested on  
12/31/02 in stock or  
index-including  
reinvestment of  
dividends.

Fiscal year ending December 31.

**12/02      12/03      12/04      12/05      12/06      12/07**