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Funeral Home Values

Myths, Methods and Strategies

By Robert L. Pierce

Understanding funeral home valuation is a critical piece of funeral home ownership. Armed with an understanding of the valuation process and a plan, a funeral home owner will be in position to more than double the value of their funeral home in many cases. It can mean the difference between a simple retirement and a more comfortable one.

There is a prevalent illusion in the funeral industry that profits can be managed without effort which is, of course, not true. The management of one's profits takes a specific and focused effort. It is this disconnects that creates an illusion of profitability in the industry and, it is this illusion of profitability that comes between funeral home owners and a comfortable post-retirement lifestyle.

Myths and Misconceptions

There are many myths relating to rules of thumb for valuing a funeral home business and I have heard them all in my twenty or so years of valuation experience; real estate value plus one times sales, one point seven times gross sales, two times gross sales, five times EBITDA, six times EBITDA, $10,000 per call, etc. I am here to tell you that none of them work except by the wildest of coincidence. The value of a funeral home business is more complex than is indicated by the simplistic rules of thumb that victimize the industry.

The most common misconception in the industry is that a business has some sort of intrinsic value because it is special for some reason. It may have nice or valuable real estate. It may have a well-constructed succession plan and an enthusiastic successor. It may be well-managed. It may have a great backlog of preneed. It may have a healthy seller willing to stay involved for a period of time. These are all things that affect the value of a business somewhat. But, the key word in the last sentence is somewhat. While these are things that affect the value of a business, their contribution to value is dwarfed by the contribution to value of the earnings of the business.

Real Estate

The most difficult to understand fact of funeral home valuation relates to the relationship between the value of the real estate and the value of the business inclusive of the real estate. The value of a business is based on its earnings. Valuable real estate can contribute somewhat to the value of a funeral home business but there are also times when the value of a business including the real estate can decrease as the value of the real estate increases. This is counterintuitive but valuable real estate often comes with significant costs such as property taxes, insurance, utilities, and maintenance. It is the increase in costs associated with more valuable real estate that reduces the earnings of the business and that reduction in earnings can actually result in a lesser business value.

There are times, however, when valuable real estate can increase the value of a business. Valuable real estate can lower the interest rate and increase the term of the purchase note which will tend to increase the amount that a buyer can pay. Valuable and attractive real estate may cause a buyer to lower his or her expected return which argues for a greater purchase price, but with the proviso that the transaction still has to be acceptable to the buyer's banker who is a major stakeholder in the transaction. And, valuable real estate can change the tax implications of a transaction either positively or negatively which will either increase or decrease the amount that a buyer can pay for a business. Over-all, however, the value of real estate does not have the direct impact on the value of a business that people usually expect it to have.

Building Blocks of Value

Before I get started, let me define a term in an attempt to make your reading a little easier. The basic building block of the value of a business is its earnings before interest, income taxes, depreciation and amortization. I will refer to this very basic building block of value as Cash Flow in my article to simplify the reading. The Cash Flow of a business is the starting point in the valuation process.

I will also refer to Tax-effected Cash Flow. I will use this term because the buyer of a business will not only take into account the historical Cash Flow of the business but will also take into account the amount of income taxes that he or she will have to pay. The income taxes of a buyer depend on both the value of the assets delivered and the manner in which they are delivered by the seller. The impact of income taxes on the value of a business can be significant.

The value of a funeral home is based on its Tax-effected Cash Flow. Period. That means that the value of your business is going to be based on its profitability.

The acceptability of adjustments to historical Cash Flow has decreased as the influence of the banker in a transaction has increased and, as a result, the acquisition process has tended to be more fact based than in the past. The primary “surviving” adjustment to the historical Cash Flow of the business relates to owner’s compensation, which is adjusted up or down to account for the salary of the replacement position.

It is common to apply a multiple to the adjusted operating Cash Flow of the business in order to arrive at a tentative value, usually in the range of five to six times depending on the impact of income taxes, financing, and other factors.

The valuation of a business is very different than that of a car. There is no “Kelly Blue Book” value” to which one can refer to determine the value of a business. The overall value of a business is the result of three basic components, the historical profitability of the business, the buyer’s financing and the income tax implications of the transaction to the buyer. The seller is not selling a funeral home. The seller is selling the financial impact of the business on the buyer, and that is exactly what they are paid for.

A Startling Observation

Now for the part that is absolutely mind boggling to the uninformed observer. A buyer would rather pay five million dollars for a funeral business than two or three million; same building, same employees, identical number of calls, same market share, etc. They are buying Tax-effected Cash Flow and buyers usually prefer to buy larger firms with a higher concentration of revenue and profit.

It is this simple fact that puts the seller of a business squarely in control of the value of their business.

The Parties to a Transaction

There are three equal parties in the typical transaction; the seller, the buyer and the banker. All have vested interests and all have differing degrees of influence at different times.

The buyer and the buyer's banker have the greatest influence at the end-point of a transaction. They have very real and very practical limitations on what they can pay for a business and how they can pay it.

Banks have had an increasingly larger impact on the amount that a buyer can pay for a business in recent years. The banker will not make a business loan if it does not afford the bank a reasonable likelihood of being repaid. The practical of this is that the bank requires that the projected cash flow of the company be greater than the note payment that it will receive. As the cushion required by the bank goes up, the ability of the buyer to pay for a business declines. This cushion, referred to as the debt coverage ratio, represents the degree of comfort of the banker and the profit or return on investment of the buyer.

One thing for certain, the value of a funeral home business is not based on the goals, aspirations or retirement needs of the seller at the point of a sale. The seller had his or her opportunity to have a major impact on the transaction prior to the point of a sale. At the point of sale, the seller is a lesser player.

There is a lot, however, that a seller can do to increase the purchase price of a business before the point of sale.

Value Strategies

It might appear that buyers have an upper hand in today's environment but that is only true at the point of a sale. It is not at all true if you give the "seller" a two or three year head start. If you give the seller a head start, it is no contest.

As we have discussed, the sale price of a funeral home business is based on the projected Tax-effected post-sale Cash Flow of the buyer. The cash flow, and to some extent the income taxes of the buyer, are in the control of the owner prior to the point of sale and that means that the selling price of a business is controlled by the owner-seller, and not the buyer.

This means that a proactive owner-seller will sell their business for considerably more than a worn-out tired one.

A Practical Example

I will give you an actual example of the impact that management of the value of a business can have on the value of that business. Before I begin, I will give you some information about my example funeral home. It was very well managed two years ago, before the profit management process was started; certainly better than most funeral homes. Its prices were increased modestly during the past two years, only slightly more than inflation. Expenses were cut strategically, certainly not "to the bone." In fact, the funeral home added an employee during the period and picked up a considerable amount of fees related to the process of implementing its profit management programs and systems.

The year before beginning to manage its profits, our example funeral home had an operating profit of $313,000. Last year, it had an operating profit of $650,000, an increase of 107% or an $1,162 per call increase in its operating earnings The greater profit not only increased the cash flow of the business, it increased the value and salability of the business too. It was worth about $1,700,000 two years ago and today it is worth more than $3,500,000 and, based on the concentration of revenue theory that I discussed above, it is probably worth even more.

I know what you are thinking. OK, so you increased your profit and value, what now? The opportunities that are available to Example Funeral Home today are greater than the opportunity that was apparent two years ago. The management of a business is never complete. When it is complete, one begins the process of deterioration.

When a proactive owner makes the commitment to the management of the business' profits, it changes his or her ability to retire comfortably and it gives them an opportunity to be paid fairly for their business.

Value Management

So, what does it take to manage the value of a funeral home? First and primary, it takes the ability to manage egos. It takes the ability to look at the business critically, analytically, dispassionately, and honestly. There is a natural tendency to resist change and this, perhaps, is the greatest impediment to becoming profitable.

Then, it takes planning and budgeting. It takes reporting systems that provide the company with accurate, relevant, consistent and timely feedback. And finally, it takes courage, leadership, and two years of hard work.

The management of one's profits is not a complex exercise requiring an advanced business degree. It is not about finance or accounting or complex formulas. It is the application of simple common sense business principles. It is pretty much about doing the exact same thing that funeral home managers do today except with better tools, a road map and a serious focus on both service and profit.

I have critically analyzed thousands of funeral home businesses during my career and I have run across less than a dozen that effectively managed their profitability. The process of managing one's profit is not difficult but it is not a skill that one typically picks up on the job either. Funeral home owner-managers often dismiss Profit management as being "too corporate" and it is this attitude toward the management of profits that results in funeral home owners having a lesser retirement.

Summation

At the point of the sale, the buyer and bankers hold the better cards. A seller can do very little to affect the sale price of a business that late in the game. The seller is in fact a minor player at that point. An eventual seller can, however, increase its value substantially by proactively managing its cash flow for a period of two years prior to entering into the sale process.

The sale process should not be an afterthought that occurs when one is tired and worn out as it is in virtually every case. The sale of a business should be addressed aggressively and proactively. It should be a serious part of business ownership, a means of reaping the rewards of entrepreneurship.

Business owners typically work for their businesses for much of their lives like any other employee and often give up many of life’s simple pleasures to the rigors of entrepreneurship. When it is time for the business to provide its owner with a comfortable retirement, it is simply payback for decades of hard work.

A business owner who understands the manner in which funeral homes are valued and plans for the eventual sale of the business will have considerable control over their post-retirement lifestyle.

Bob Pierce is the President of and a partner with his son Mark in Pierce CFO, a Company that specializes in the management of funeral home profits and the application of profit management concepts to the purchase and sale of businesses. Formerly, he was a partner in Thomas Pierce & Company, a Company that specializes in purchases and sales of funeral homes and cemeteries.