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Re-Engineering Your Value

Those old rules of thumb just don't work when appraising a funeral home.

If you own a business, you care about the value of that business. The problem is that you can't just go to your online trading site and look up the value of your business – unless, of course, your last name is Waltrip, Payne or Miller (SCI, Carriage and StoneMor, respectively). Nevertheless, you want to know the value, which leaves you with two options: You can hire an appraiser of funeral homes or you can try to steal the above identities. If you're not sure what to do, remember, one will cost you some money, but the other will cost you time behind bars as well.

The problem with funeral home appraisals is they are often performed by people who don't know how to do an appraisal of a funeral home. This business is different from any other. While there are many well-qualified and -educated appraisers who do not specialize in funeral home appraisal work, their qualifications lead them into a false sense of comfort. For example, there are databases to which I can subscribe that will tell me the sale price of a car wash business. Those same databases will also let a guy who appraises car washes see the sale price of a funeral home.

The problem is that, even armed with this data, you don't know if the valuation subject and the database listing are comparable. Suppose I tell you that two funeral businesses sold for $1 million. Do you know if real estate was involved? Do you know the average revenue per call? Do you know if it was an asset sale or a stock sale? Do you know how many locations one funeral home had versus the other? Obviously, the answer to all of these questions is a resounding no. Therefore, a well-educated person who is ignorant of the funeral service business cannot do an appraisal even with access to these databases.

I get phone calls regularly from appraisers who want to know, "Do funeral homes routinely sell for blah, blah, blah?" The blahs are various rules of thumb. Do funeral homes sell for:

- X times Revenue
- Y times EBITDA
- $Z times Calls?

Regardless of what you substitute for the alphanumeric reference, the answer is a well-qualified "maybe"!

I had a chance to discuss funeral service rules of thumb with Robert Waltrip, SCI founder, when I was a young man in the 1980s. I asked him, "Mr. Waltrip, who started the rumor that funeral homes were worth [back in 1985] $2,000 a call?" He modestly but assertively replied, "I did." I was shocked because at that time, if we were to use this rule of thumb, the value might have been $2,500 for most funeral homes, not $2,000. I asked him why. He explained, "If a man thinks his funeral home is worth $2,000 a call and I offer him $2,300 a call, he is going to think I am overpaying and sell to me!" This was genius, I thought to myself. In reality, he was buying at 10 percent less than the market, but sellers thought he was overpaying. This defines a win-win situation in a macabre way.

Funeral directors love rules of thumb. They take complex financial risk-based equations and turn them into simple math someone can do on the back of a napkin. While the math might be right, the logic of the result is usually wrong.

Assume that funeral homes sell for $10,000 a call. Now, does that apply to a Florida funeral home with average revenue per call of $2,500 due to its 80 percent non-casketed rate? Does this math apply to an Italian Catholic funeral home that sells 50 percent bronze and copper caskets? The same answer to both of these extremes is no.

The value of any business is locked in by understanding two factors: earnings and risk of transference.

I've learned there is only one real measure of earnings, and that is EBITDA. (I wish to have my grave marker include the phrase, "Educator, Enunciator and EBITDA Lover.") EBITDA is an acronym for earnings before interest (expense), taxes, depreciation and amortization. This measure of earnings allows a valuator or management consultant – and remember, I am both – to compare dissimilar businesses.

EBITDA needs to be established. For example, when looking at a tax return, we can see the financials, but when looking to establish EBITDA, we have to look at the operations of a business another way. The valuator does not just take the

accountant's profit and loss statement and agree with it. Part of the EBITDA analysis is to determine the real profit of a company. Often, owners take out profits by increasing expenses. An appraiser has to see through this.

Look at this side-by-side comparison:

	FINANCIALS	EBITDA
Revenue	$1,000,000	$1,000,000
Cost of Goods Sold (COGS)	$200,000	$200,000
Gross Profit	$800,000	$800,000
Staffing	$300,000	$280,000*
Fixed Facility	$100,000	$60,000*
Variable Facility	$40,000	$40,000
Advertising	$40,000	$30,000*
Auto	$30,000	$20,000*
General and Administrative (G&A)	$130,000	$90,000*
EBITDA	$160,000	$300,000*

There's no doubt that revenue and cost of goods sold are what they are. However, if someone has his or her 18-year-old child on the payroll while the child is a full-time student, that needs to be added back into EBITDA. If rent is more than a fair-market rent should be, that gets added back as well. If advertising includes country club dues and you claim to only use it to take priests and nuns to lunch, that clearly needs to be adjusted. If part of your auto expense includes the '67 Camaro you use for drag racing, that, too, should be adjusted. Your G&A will need adjustment if includes travel to foreign countries to study burial customs.

An accountant who signs the tax return on behalf of a client should not do his or her client's valuation. He or she cannot on the one hand claim a deduction is realistic and then acknowledge that it is really a distribution of profits. EBITDA is not a simple calculation but takes study.

The second component of valuation is the risk of transference (ROT). The math of computing ROT is simple: You compute EBITDA and then divide it by the risk. That equates to a measure of goodwill, which, by its definition, is, "the expectation of continued patronage." Goodwill can be placed in the business itself or with the individuals associated with the business. When goodwill is in the business, it's called commercial goodwill; when it is in the individuals, it is called personal goodwill. As a comparison, cemeteries tend to be commercial goodwill while funeral homes are a blend of the two.

Some funeral home businesses have more personal goodwill than others, and when that person leaves the business, the patronage may scatter. This is particularly true in minority funeral homes, where we tend to see each funeral director having a large degree of personal goodwill. The same exists in Jewish and Catholic funeral homes. To protect personal goodwill in a transfer of a funeral business, it is often segregated from the total value and paid

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There is risk in everything. However, the transfer of a business may involve more risk than you understand. Funeral service tends to have a very predictable continuity of patronage. Some funeral homes have more risk than others. When there is higher ROT, the value goes down. In some cases, such as minority businesses, the risk is so high that there are no successful acquisition companies. Several have tried but few have succeeded.

Smaller businesses have more risk than larger businesses. Oftentimes in a small business, the business owner is doing more tasks and therefore his or her name is more closely associated with the business. Thus, he or she has more personal goodwill. So if a new buyer comes in and there is not an effective transfer of goodwill, the result will be lost patronage. That is the risk of transference.

The key takeaway when re-engineering a funeral business is to understand how to manage these two dynamics, earnings and transference. We manage earnings by making sure that revenue is correct, cost of goods is the right percentage and the cost of operations is where it should be. Earnings of a typical funeral home today are 7 percent to 10 percent of revenue. Our target is to be in the 28 percent to 32 percent range.

Controlling or reducing ROT is tougher than controlling the risk of earnings. Typically, rural and smaller businesses have more risk, as do minority businesses. I can't change the racial makeup of a business. However, I can increase the value by having larger earnings regardless of where the business is located, what community it serves or how large it is. This is akin to having a child who loves basketball, but, due to his or her size, he or she cannot dunk. I have to teach that child to find his or her game with other skills. Small, minority and rural businesses can be very profitable.

The math of valuation is complex. People like to think they can apply a rule of thumb to the multiple of earnings, but they can't. It takes a professional to read an x-ray and do a valuation. Don't let your accountant read your x-ray or try to guess at your valuation. Either way, you'll end up walking with a limp! ✶

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