Daniel M. Isard

Of Buyers and Sellers

There are myriad things you need to investigate before buying a business, even from a family member. Make sure you are prepared.

Dear Dan,
I have a problem. I am 34 years old and trying to buy the business in which I'm employed. The seller is willing to sell. In fact, he and I agreed on price and terms for the business and the real estate. We've signed a letter of intent outlining these terms, and I have financing secured for the cash required to purchase the assets.

Now the seller's lawyer is involved and everything has changed, including the terms and the price. He wants to increase the selling price. I retained my own attorney, and he is befuddled by all of these changes given that we nearly had a deal in place.

My lawyer tells me that the seller's lawyer claims the seller is coming up with all of these demands.

The seller is my father. What am I to do?
Signed, Adoptable in Arkadelphia

Dear Adoptable,
Your situation is very common. By my estimate, there are more than 13,000 privately owned funeral homes, and more than half of them are transferred to a child or grandchild in the business. The odds are very high that the seller will pull some shenanigans that are unconscionable. So, with that in mind, let me explain why some sellers pull these renegotiating ploys and what you can do about it.

First, learn from it. When the dust settles, let's assume you'll buy this or another business. Odds are that you'll have one or more children to succeed you. Do not repeat this behavior 30 years from now.

Second, understand it. When people sell their businesses, it is often a signal that their purpose in life is coming to an end. Since they have so strongly been associated as "the funeral director," this causes insecurity. Sellers should do a financial security test before selling their business. If they pass, then they should move on with the next phase of life.

The financial security test is complex, as it assumes that a lifetime need for principal and interest must be met. I have outlined it in past articles, and I recently had someone restate it to me in these simple terms: Determine how much your pretax income needs to be and multiply that amount by 20. If you need $100,000 a year before taxes, you need to have $2 million available to meet that need. This will come from your savings, retirement account and the sale of the business. Notice I did not say Social Security. That is your asset, but by not figuring it into the equation, it is your margin for error. If a person lives 20 years after retirement, the first 10 years are generally more active than the last 10 years. So there is a chance that a person will overspend during the first 10 years, and that is made up during the last 10 years.

If you have $2 million in your retirement account, in 2016 markets, you should be able to invest in a stock and bond portfolio yielding 4 percent to 5 percent in aggregate. So interest earnings will provide about $80,000 to $100,000 a year. In addition, Social Security payments will be collected. So you should be able to live your life financially secure.

Third, as to the specific issues of your broken negotiations, you need to assert yourself. If your parent(s) want to renegotiate the deal, determine whether there is a bad valuation or if the terms really need to be changed. Speak to your lender and determine if there is any concession it can give in its lending package.

Determine the debt coverage ratio (DCR) of your transaction, a measure of the cash flow available to pay current debt obligations. The numerator is the net operating income or EBITDA of the business and the denominator is the debt obligations due within one year to your bank and seller. Let's assume you applied for a $1 million loan (10-year amortization and 6.5 percent interest) and you have a 10-year $200,000 covenant not to compete with the seller. This results in an annual debt payment of approximately $140,000 to the bank and $20,000 a year to the seller. That is a denominator of $160,000. If the EBITDA is $250,000 a year, your debt coverage is 1.56 times. A DCR of greater than 1 means you have sufficient income to pay your current obligations; the bank, however, will want to see 1.37 or higher (minimum is 1.25 times).

If the seller wants more money, the bank might think the loan is too risky. Suppose the seller wants another $250,000. That changes the total debt payment to about $195,000 per year and therefore reduces the DCR to 1.28 times. Well, the bank is not going to be willing to lend you the funds you need, so the seller will need to understand that.

My oldest repetitive adage in the world is Isard's Rule Number 1: "You don't make money selling a business; you make money when you buy a business!" Overpaying for a business, regardless of whether it is a family business or from a third-party seller, leads to problems. So why do it?

The seller has leverage on you now. You have leverage, though, if he ever needs an organ you can spare (and I don't mean the instrument in the back of the chapel).

Ask your father to imagine the tables turned. Ask him how he would feel if you renegotiated the purchase price after it was agreed to. In that case, he actually has less leverage than he assumes. If your father thinks he can sell the business to a third party, he will be hard pressed to do this at the terms of your offer. An outside buyer will want you to sign a non-compete covenant or he or she will not buy the business. You, of course, will not do that unless you are paid for giving up that right. If it makes sense for your father to get $200,000 from you to ensure he does not compete, then you will need to be paid the same amount or maybe more. In the short term, Dad is actually one of the risks of competition, but in the long term, it is you! Even if he can get more from a third party, some of the sale price will go to you for your promise not to compete. In actuality, Dad might not get more.

Another option to regain leverage is to look for another business to purchase. Let him know you are ready to buy someone else. Maybe even plan this disclosure just after he books a trip to a warm Southern climate for the next winter. His deposits and his call coverage might go up in smoke.

The lawyer he chose could also be the problem. There are many disciplines of law. A real estate attorney is not skilled in business transactions. Often they attempt to treat everything like a real estate attorney. Family law and divorce attorneys are also not experienced in this matter.

Ironically, even if the attorney is a transaction or business attorney, the unique nature of funeral service can be a

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problem. No other business has preneeds or some of the other silly business matters funeral service has. Oftentimes, designing a contract to cover these points is a guess to these people. I like that we in funeral service have about a dozen lawyers with experience in funeral service. When in doubt, use someone who speaks the language of funeral service.

So, Adoptable, there is a reason why only about 30 percent of family businesses make it to the second generation. Sometimes it's a lack of buyers within the family. In your case, it could be the seller. Be strong and find your alternative approaches. ✶

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