By Daniel M. Isard

VALUATION

FINANCING

CASH FLOW

Buying a Funeral Home

Evaluate all contributing factors to make sure you're getting the best price.

Dear Dan,
Aloha from the 50th state! Dan, I have the chance to buy a business. It's a great business with a wonderful reputation. The only negative is that I'm buying the business and not the real estate. The real estate cost is far beyond what I can afford, so I will continue to be renting the real estate just as the former owner had. There are 14 years maximum left of the lease. What should I be aware of?

Aloha Al

Dear Al,
Aloha! Thanks for the note. I've managed funeral homes and cemeteries on the islands, so I know what you mean by the high cost of real estate. Anytime beachfront is measured by the linear inch, the real estate has to be expensive.

Based on your letter, there are several key points to address. First, let me address the issue of valuation. The value of a funeral home is a topic on which I have written many articles and even a few books. In this case, there are several components that could be affecting the conclusion of value (meaning we don't want you to overpay).

The core of the computation for goodwill is the *capitalization rate,* also known as the cap rate. A cap rate is a financial risk assessment. In my normal methods of appraisal, I use a built-up number for a cap rate. It is made up of one financial point and three risk points. The financial point is the rate of U.S. 10-year Treasury bonds. Assuming that risk today is 2.5%, that is the first step of the cap rate computation.

To this rate, I add some subjective rates based on my 30 years of doing this. These include:

• *Liquidity Rate:* This is a risk that could be as low as 2% or as high as 10% based on the difficulty of finding a buyer within a reasonable time period. The lower the risk of finding a qualified buyer, the lower the liquidity rate premium.

• *Burden of Management:* This risk takes into consideration how difficult it is to run this particular business. The rate could be 3% on the low side and 10% on the high side. The less risk to patronage by the business management, the lower the risk premium.

• *Overall Risk Rate:* Many outside factors could adversely affect the operation of a funeral service business (any business, really). A low risk would be about 3% and a high risk could be 10%. The risk could grow due to such factors as a state law or changes in society that are going to affect funeral service in this location.

I don't want to get into building out a capitalization rate in your case, but I do want to make this clear as a Waikiki bikini: Liquidity rate could very well be a factor. Selling a funeral business with real estate is easier than selling it without real estate. The key is going to be the length of the lease or lease options that exist. A business with fewer lease options will have fewer interested buyers, which cuts down the ability to find a qualified buyer in a reasonable amount of time.

So, Al, be prepared to say aloha to the deal if you can't get either a price reduction or more options, as 14 years will be here and gone before you can say *humuhumunukunukuapuaa* (yes, that's really the name of the state fish).

This also impacts the financing, which is the second issue to be concerned with. Today, most financing is SBA supported if the business has a goodwill component. The SBA is very clear. It will finance a business that doesn't own the real estate, but it is limited to a 10-year amortization rate. Businesses with real estate included in the purchase can get as much as 25-year financing amortization.

What does length of time have to do with the financing? Assume the business has $100,000 of EBITDA (earnings before interest, taxes, depreciation and amortization). Assume the bank wants a debt coverage ratio of 1.5 (which means the business has EBITDA of 150% of the principal and interest charged). Assume the interest rate is the same regardless of whether the real estate is being purchased or not. At a 6% interest rate, then:

10-Year Amortization	25-Year Amortization
$500,000	$850,000

So, with the same amount of EBITDA, you can buy about 70% more business when the real estate is being financed as well, making the financing amortization term a very important benefit. Without this, you are going to have a shorter loan term, which means more principal to be paid each year.

The amount of principal is a problem with both the financing and the third issue, cash flow. Imagine, if you will, that you have to pay $10,000 of principal on a note. That principal is not deductible. Therefore, you're going to need to earn about $15,000 after taxes to pay $50,000 in taxes and $10,000 to the bank. That gets onerous, as you are working to pay off the bank and do not have profit for your own reward.

The issue of cash flow ratios is evidence of the bigger problem. As I have frequently written in this column, the maximum rents a funeral home should pay its landlord (even when the landlord is owner of the funeral home) is 8% of revenue. Revenue, of course, is net of all cash advances. The rent payment should be triple net lease (meaning the tenant pays the taxes, repairs and insurance). If the property is an average property, the ratio should change to 6% of revenue.

Assume you are buying a business with $1 million in revenue. That would normally be a triple net lease payment of about $80,000 for a great business and $60,000 for an average one. If the rent, due to the high cost of rent in Hawaii, is $150,000, that means the rent is about 15% of revenue instead of 8%. The profit from operations is the only thing that can give, so profit will be about $70,000 less than if the real estate was owned or under a reasonable lease.

I can tell you that when real estate prices are high, we see a corresponding increase in payroll since your staff is probably paying a higher rent for their living accommodations, so they need to be paid more. Higher real estate costs often mean a much lower profit. Lower profit means the valuation of a business is going to be less.

Imagine two businesses with $1 million in annual revenue. If one has EBITDA of $200,000 and the other (due to higher rent and higher payroll) has EBITDA of $100,000, even if the two businesses have the same cap rate, one will have a business value half that of the other. In reality, the cap rates might change as well, so the business with higher real estate and payroll costs might be valued by a higher cap rate (higher capitalization rate = lower value). This is a very big factor going back to the valuation issue we first looked at.

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Lease terms refer not to the length of the lease but the written conditions of the lease. When entering into a lease to use a property, you must look at the terms during your use and after! Too often, we just protect the property during your use period. When a funeral home leaves a site at the end of the lease (assuming the lease cannot be extended), there is a value left behind in the building no matter how well you clean it out. That is the community knowledge of the property as "the funeral home." I have seen many cases in which a funeral home leases a property, and upon the firm leaving the site, the building owner tries to recruit a new funeral home to come into the property. A new funeral operator can move into that site and maybe gain some of the case count. A lot of people want to go back "where Dad was."

Protecting yourself from this possible loss of patronage is a deed restriction. Deed restrictions are rules and regulations that govern one or more lots or parcels of land. The restrictions "bind" or restrict the land or building to which they are set and are written into the title of the land, limiting the use. Someone leasing a building can negotiate for a deed restriction to be in place upon their vacancy, assuming the tenant was not in violation of the lease or its terms. If you leave a location, you want to take your patronage with you.

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