FINANCE
101

By Daniel M. Isard

It Seemed So Simple

When it's time to sell your business, do it the right way.

Dear Dan,
In 2010, I was ready to sell my business, and my accountant did a valuation for me. I had two key people working for me for a decade, and they were honorable, hardworking and trustworthy. They wanted to buy. I wanted to sell.

It seemed so simple.

The accountant said the business was worth $2 million – $1 million for the real estate and $1 million for the business. So I told my key people that I would carry back the note on the $1 million business purchase agreement over 10 years at 8% interest. They would pay me $150,000 a year for 10 years. I also agreed to lease them the building for $100,000 per year. Once they paid off the purchase agreement, they could buy the real estate. I would even carry back the note for the real estate. I figured I would have income from the sale and rent (totaling $250,000) that I could live on for the rest of my days.

It seemed so simple.

Well, for the past four years, as cremation has increased and families are not buying copper caskets anymore, they have been late with their purchase payments and now the rent. My accountant's advice is to default the key people on their notes and take the business back to resell it.

I am almost 80. That doesn't seem like a very good idea, but I have no others. But I bet you do.

Did I happen to mention that it all seemed so simple?

Signed, Simply Afraid and Too Far Down the Road

Dear So Simple,
Let me get this right. Someone who doesn't know how to value a funeral home business and funeral home real estate gave you your valuations. Someone who is not a professional banker is collecting a note without tangible collateral and with a desire to foreclose. In addition, someone who is not a professional real estate manager is managing a special-use property for which the tenant is in default on the lease.

Sure, simple is one word I'd use.

On top of all that, someone who doesn't know the lending terms for business purchases told you to get the business paid for in 10 years, when it might normally be 15 to 25 years.

This is so bad, So Simple, that in Alabama, they would simply pat you on the head and say, "Aw, bless your heart!"

You have three options:

1. Default the buyers on the purchase note and the lease. Understand that you will have Armageddon as anything can happen at that moment. The buyers will probably sue you for a host of things. They might also sue your accountants. They will blaspheme your name in the community. They may find someone to hire them and then try to take all the business they were serving. In short, your accountants gave you some bad advice. I would not listen to them again.

2. Get into a time machine, go back and do it differently. Yes, time machines work. You can go back 10 years armed with the knowledge that the appraisal of the business and real estate was wrong. Make a different decision or come up with a different price based on 2008.

3. Get a current business appraisal. Restate the purchase agreement to the maximum value of the business and real estate as it exists today. This is the only realistic option that has known consequences, and none of them upset the apple cart.

I have seen this scenario plenty of times in business and have witnessed what happens when home values plummet. Many funeral homes that were merchandise-driven firms a decade ago now have declining values. Keep in mind, too, that families choosing cremation aren't just declining a burial, they will often use a much cheaper casket and won't buy a vault or full headstone either.

A decade ago, the U.S. cremation rate was about 20%. Now it's greater than 50%. That means each funeral home sells fewer copper and bronze caskets, replacing them with cremation caskets. The revenue/call in 30% of the cases is decreasing dramatically. How can cash flow not go down for many funeral homes? How can value not go down? Even if the valuation was accurate a decade ago, it is almost certainly going to be less today.

The appraisal will provide you certain points of security. An experienced appraiser of funeral homes will confirm that the two key people are operating the business properly. If these two are competent, then you can look for a long-term redo. If they are incompetent, then you have more problems.

The appraiser can look at the average revenue/call for the business and confirm that it's consistent with other regional and like firms. He or she can also determine the same for average wholesale/call. The yin/yang between average revenue and average wholesale should be consistent.

The appraiser will also be able to see whether there are any financial shenanigans going on. "Shenanigans" is a Latin word meaning "screwing around with the books." Is payroll too high because the buyers have put their kids on the payroll in no-work jobs? Is auto/livery too high because they're using Rolls-Royce Phantoms as personal transportation autos. Have the buyers put in place expensive retirement plans that are siphoning off money from the business?

As retired former owner, you need to know you can trust the buyers. If so, a workout can be found. If not… more problems.

Imagine you have EBITDA today of $50,000 after paying rent of about $100,000. This means you have EBITDA plus revenue (R) of $150,000 in rent and debt payment. The conclusion of value could be that the real estate is worth 10 times the rent payment. That means the real estate is worth $1 million and maybe the business is worth $200,000. Together they are worth $1.2 million and not the $2 million your accountant guesstimated a decade ago. That's off by 40% and akin to flying New York to Los Angeles but running out of fuel over El Paso. Of course there was a cash flow dilemma due at some point in the future.

Ultimately, you need to know the value today. It's all you have to work with. Once that number is known, you need to do a financial test called a debt coverage ratio (DCX to those in the biz). The debt coverage ratio, a measurement of risk when it comes to cash flow and debt service, is created by a fraction, in which the numerator is the amount of free cash flow (EBITDA) a business has and the denominator is the principal and interest on the note payments owed to a bank.

If the value of the business and real estate is $1.2 million, the payment to a bank would be about $105,000 today (25-year term with 7% fixed-rate interest). If EBITDAR is $150,000, that represents a debt coverage ratio of about 1.43-to-1.0, meaning the borrowers have EBITDAR of $1.43 for each dollar they have to pay the bank. I am certain a reasonable lender would do a loan of $1.2 million with this DCX. (A DCX of 1.25 is too low. At 1.35, DCXs for most people with fair credit scores are workable. At 1.45 or more, even a low credit score will be approved.)

To go on, So Simple, you assumed you could carry back the note and live off the rent and interest. One problem – you forgot to factor in risk. The rent and note payments equaled $250,000 at the highest point in the business lifetime. Your debt coverage ratio at the time of the sale was 1.0-to-1.0 – way too low. As casket sales went down, so did profit! It simply was a recipe for disaster.

Bring in an outside lender to finance based on the value today. Sell the business and real estate. Pay the tax. Let the buyer purchase everything for the appraised value today. You will be free of worry. A lender will even be able to do a good job for the borrower.

If the buyer/borrower asks, "What about the last eight years of payments?" well, it's like leasing an automobile – you get no equity buildup but you also won't be losing anything except a few years of your life. Both sides made bad decisions here.

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