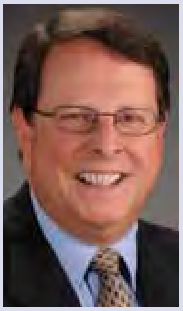
by Daniel M. Isard, MSFS



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ICCFA Magazine spotlight

➤Isard is president of The Foresight Companies LLC, a Phoenix-based business and management consulting firm specializing in mergers and acquisitions, valuations, accounting, financing and customer surveys.

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More from this author

➤Educational information, including copies of this article, can be found at ***www.theforesightcompanies.com***

➤You can follow Isard on Twitter at *@f4sight,* LinkedIn and "like" The Foresight Companies on Facebook.

Editor's note

The Cemetery Impossible column is written by the staff of The Foresight Companies. **If you have a question you want to be featured in this column, please send it to danisard@f4sight.com.** Dan Isard or a member of his staff will call you to get more information and a recommendation will be provided via this column, helping not only you but also others who are facing similar challenges.

If you're buying a cemetery that has funded its merchandise trust through surety bonds, you need to understand what that means and how it affects what that cemetery is worth.

Buying a cemetery that is trusting via surety bonds

Dear Dan,
I want to buy a neighboring cemetery. I was doing my due diligence and learned that all of their merchandise trust is funded by surety bonds. Why would someone do this? What can I do now if I want to buy this business?
Not Surety in Bondville

Dear NSB,
I have had the privilege of standing in this profession for four decades with one foot in the funeral world and one in the cemetery. I love the balance and perspective. I also get to see the problems.

The funeral world became cursed when it invented something called "cash advances." The cemetery world suffered the same curse when the business followed the advice of the first guy who said, "Hey, I am going to take all that cash out of my merchandise trust and replace it with a third-party promise to deliver."

In my opinion, bonds are the peril of the cemetery world.

First, let's be sure you understand what a surety bond is. A surety bond is "a promise by a guarantor (normally an insurance company) to pay one party (the obligee) a certain amount if a second party (the principal, which is in this case is the cemetery that has promised to provide merchandise) fails to meet some obligation." The obligation is often fulfilling the terms of a contract.

In this case, the promise is the delivery of the merchandise that can be used to fulfill a cemetery contract. This can be vaults, bases, markers or vases. The ability to fulfill the delivery of these items is pretty basic, so the risk of default is relatively low.

The issue is the exchange. The cemeterians take the trust principal dollars

and, rather than investing them for the future, buy a surety bond. Surety bonds have no economic value. They only have a value of performance.

The surety bond is problematic in situations where a death occurs and the cemetery does not provide the merchandise in a timely fashion.

The family is out of luck. The funeral and interment may be delayed. The state regulators get involved. This process moves at the speed of turtles or bureaucrats.

A claim would be made, but the very information that the trust is satisfied by a surety bond is not public knowledge. The failure of even one merchandise trust can give a black eye to all cemeteries in that market.

The claim on a surety bond can take weeks or even longer. The insurer or guarantor is going to look to the principal, who is probably the buyers of the bonds. The risk of the insurer getting reimbursed for the loss is small.

As you can see, this is not a good matter to have to deal with.

What happens in a sale

We tend to see the problem reach its zenith in a case such as you are describing. The cemetery owner wants to sell. They expect a buyer to be willing to buy with the bonds in place. However, two matters come under review:

- The due diligence of the strength of the insurance company.
- The ability of the original bond holder, the principal, to get rid of the risk (as they

are selling the company) and the new bond holder to be taken on as the new principal.

This second matter is where this whole matters gets ludicrous. If you are the insurance company, you were happy issuing the bond, as the principal has a high net worth, since they took all the cash out of the trust.

The new buyer has a modest net worth, since they never got the cash in the trust. Therefore, the insurance company doesn't want to release the original principal of the bond from their personal obligation.

The premium is a calculation based on the credit worthiness of the principal. In simple terms, say you wanted a $1 million surety. Assume your credit score is above 750. If the prime rate is 4 percent, you might pay a premium of 7 percent. So, your annual premium would be $70,000 (7 percent times $1 million).

The premium is a cost to the operation of the cemetery. However, there is another cost. It is the cost of purchasing the merchandise due for delivery.

Assume you are the new owner and are supplying 50 vaults, bases and markers a year at a cost of about $1,200 per interment. So, you are supplying a cost of goods sold of $60,000 with no current cash to pay for that merchandise.

If the previous owner did not take the cash out of the merchandise trust to purchase a surety bond, there would be no premium to pay, and each time you had to supply merchandise, you could be reimbursed by the money in the trust.

To my simple mind, this latter situation creates a business that could have had no net costs ($60,000 cost of goods sold, covered by $60,000 income from the trust). Instead, you are looking at owning a cemetery that has a $130,000 annual net outlay ($70,000 premium and $60,000 cost of goods sold with no income).

The cemetery owner took the $1 million, whereas they could have invested it in their own name. Of course, they could have lost the money in the market just as easily.

I had a client who came to me after a closing to audit their purchase of some cemeteries. They bought cemeteries that had surety bonds in the merchandise trust. The problem was, they didn't figure the bond premium as a new cost under their ownership, nor did they assume the cost of goods sold for the merchandise.

Using the figures from the example above as an example, that was a loss of $130,000 per year. Therefore, the business was worth about $1 million less than the client paid. The seller told them "they could make it up in the future," which makes no sense to me. They had an unfunded liability.

The use of surety bonds is not legal in all states. A few states once allowed them in funeral trusts. The idea was that if the funeral home did not perform, the guarantor would provide and find another funeral home to make good on the promised goods and services.

In one case, the insurer secured a funeral home to provide services, but it was a racially different firm from the one that had defaulted on their trust obligation. These things usually don't end well. ❒