

Business Valuation In Layman's Terms

By Daniel M. Isard

Business valuation is a simple concept with many complex procedures. The work of a business appraiser is to determine the value of a business without exposing the business for sale. This lofty professional service can be done in a 100-page report or on the back of a napkin. It can take hundreds of hours or only the time it takes to finish dessert. The difference in the result is the level of reliability on the accuracy of the conclusion.

In our industry, one owner might have ownership in funeral homes, cemeteries, cremation businesses, or combinations of the three. The theoretical process of a business valuation is the same for any one or all three businesses. Because of this, I do not need to write one article for each of these businesses. The process is the same but the application may change. I will elaborate throughout this article to bring clarity.

People get appraisals for many reasons. Usually a business owner or buyer gets an appraisal as part of a buy or sell decision. Frequently, appraisals are done to provide opinions of value for estate and gift tax purposes, shareholder litigation and divorce or collateral for lending purposes. Speaking as an appraiser, the most important reason to get your business appraised is to make certain it is operating properly.

In my three decades of working within this industry, I have valued more than 2,000 funeral homes, 500 cemeteries and 50 stand-alone cremation businesses. I learn something new every day. In the midst of the appraisal process, the marketplace is changing, creating a moving target. An appraiser needs to be able to arrive at a realistic value of these businesses at any moment in time, even though the value is, by nature, constantly evolving. I have valued the public companies, large and mid-sized private companies and small mom and pop businesses. These businesses have variables that make each assignment slightly different.

HOW *NOT* TO VALUE A BUSINESS

Let me first address how not to do a business appraisal. You should not use Rules Of Thumb (interesting that the acronym is "ROT"). In my life I have seen ROT that are a multiple of revenue, multiple of calls, multiple of interments, multiple of book value and multiple of earnings. These are all poor indicators to use as a method of determining value. I am not against

using them as comparisons after reaching a valuation conclusion, but I do not like them as a method of valuation.

Recently I was involved in an expert witness assignment where opposing expert said that the funeral business was “worth 1.8 times revenue”. He studied the industry and this was his conclusion. The stupidity of this conclusion is that it assumes that all funeral businesses have the same profit in their dollar of revenue. For example, a funeral home with a 10% cremation rate and 80% of all calls having a visitation and using the chapel has a much higher opportunity for profit than does a business with a 50% cremation rate and 20% visitation rate. When asked about that on cross examination the opposing expert said, “Well, how would I be able to find that out?!” Case won by my client.

Another funeral home contest of experts had a college professor demonstrate that funeral homes sell for \$7,000 per call and therefore this business of 200 calls was worth \$1,400,000. He had researched more than 50 sales to reach this conclusion. I had the lawyer for my client ask this tenured professor, “Did all of the businesses you studied have real estate included in their corporation?” The professor said, “I don’t know”. Within six questions, this person who taught accounting at a big college was in tears on the stand.

Cemeteries are not immune from this either. Many cemeteries are “at-need-oriented”, meaning they have about 80% of their revenue from at-need purchases and about 20% advance sales. Would an “at need” cemetery have the same value as one that is professionally managed with an emphasis on advance sales? Cemeteries like the latter could have 60% or more advance sales and only 30% to 40% at-need revenue. Looking at these businesses as being comparable will not demonstrate the real value.

Rules Of Thumb are essentially hearsay, originating in rumors of what businesses sell for. If they are accurate, it is coincidence and not a learned opinion as they are not based on facts. A “ROT” is a way of giving someone a “down and dirty” method of knowing value. With a “ROT”, the conclusion can be reached by a 12-year-old, but the chance of it being correct is quite small.

About 20 years ago, I met a man who was the founder of a large consolidator. During a casual moment I asked him, “Sir, who started the Rule Of Thumb that funeral homes are worth \$2,000 per call?” He laughed and said, “I did!” I asked him why he would promote that valuation method, when clearly many well run, larger businesses were worth more than twice that amount. He replied with a grin, “If they think they are worth \$2,000 a call and I offer them \$2,500 a call, they will sell to me, thinking I am a fool. My board of

directors will reward me with a big bonus for buying it at 60% of value". I learned an important lesson about the use of Rules Of Thumb.

HOW TO VALUE

The valuation of all businesses, regardless of industry, is a similar process.

1. Determine the value of the tangible assets used in the business.
2. Determine the value of the goodwill (or intangible assets) of the business.
3. Add the two together.
4. Test your conclusion for reasonableness.

Determining the value of assets owned by businesses in this industry is a matter of converting the Accountants Balance Sheet to an Economic Balance Sheet. The accounting world must record assets and liabilities under certain accountancy rules. These rules are not necessarily rules that the real world would agree with. For example, accountants put real estate on the balance sheet at its purchase price. Each year, as the accounting firm takes depreciation off the company's tax return, it reduces the value of the real estate. In most cases, that real estate may either stay the same or rise in. Just because we can depreciate it for tax purposes does not mean it has lost that much value. The Economic Balance Sheet adjusts the assets and liabilities to their true economic value.

I love the concept of preneed. I especially love the fact that accountants do not understand how to account for preneed on the balance sheet. The simple answer is that preneed for a funeral home or for a cemetery should not be on the balance sheet. It should not be an asset, nor should it be an offsetting liability. The only time it might be on the balance sheet is if the preneed is underfunded, in which case it is a liability. However, we all know that preneed for funeral accounts or cemetery accounts should not be underfunded.

Once we have established the value of the tangible assets at their Economic Balance Sheet value, we then need to solve for the value of goodwill, an intangible value. It represents "the expectation of continued patronage to a business". Goodwill can be expressed as commercial goodwill, "the expectation of continued patronage to a business without regard to who owns or works in the business". Or Goodwill can be expressed as personal goodwill, "the expectation of continued patronage to a business based upon the owners and employees". While funeral homes, crematories marketing to the public, and cemeteries have commercial goodwill, it is more common for a funeral home or crematory to have personal goodwill. Cemeteries rarely have a person's name or even an identifiable owner associated with them that is

used to market the business. When they do include an individual in their marketing efforts, it is usually because the local funeral home owner bought the cemetery and markets it with more personality than a classic cemetery.

The computation of goodwill is defined in accountant parlance as the value determined to be the difference between fair market value of the enterprise and the book value of assets (Economic Balance Sheet). That is nice when you buy a business, but how is it computed in a valuation?

The IRS has given us some guidance in how to compute goodwill in a valuation in their Revenue Ruling 59-60. This almost 50-year-old Revenue Ruling has withstood the test of time and, while modified by experience and other rulings, still gives a good framework for valuation. RR 59-60 basically establishes that, when a business has goodwill, it is based upon a computation of earnings in excess of a return on the Economic Balance Sheet. To determine the earning subject to the goodwill, you should allow for a return on the Economic Balance Sheet first of some safe return. The excess earnings above this return on the Economic Balance Sheet is the amount of earnings subject to goodwill. These can now be capitalized at a rate the market would bear. Imagine that a business has \$200,000 in earnings. If that same business has \$1,000,000 of Economic Balance Sheet value, you could assume a 5% return on the tangible assets. Therefore, the tangible assets would have a \$50,000 earnings and the excess of \$150,000 would be subject to the intangible assets. The excess earnings would be capitalized at some current market rate.

How do you measure the earnings of a business? Earnings can be expressed through different methods, including the following:

Acronym	Name	Explanation
EAT	<i>Earnings After Taxes</i>	This is a definition of earnings when studying public companies
EBT	<i>Earnings Before Taxes</i>	This is a definition of earnings when studying public companies
EBIT	<i>Earnings Before Interest (expense) and Taxes</i>	This is a definition of earnings when studying companies with a large amount of debt. It is also a way to compare businesses within an industry that typically do not have a large amount of assets.
EBITDA	<i>Earnings Before Interest, Taxes, Depreciation and</i>	This is a definition of earnings when studying companies regardless of their amount of debt and age of assets. It is also a way to compare businesses regardless of the type of corporation the business may be.

EBITDAR	<i>Amortization Earnings Before Interest, Taxes, Depreciation, Amortization and Rents</i>	This is a definition of earnings when studying companies which may have real estate that is sometimes found within the corporation and sometimes owned by the business shareholders. It is also a way to compare businesses regardless of the type of corporation the business may be.
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Different definitions of earnings require the appraiser to use different capitalization methods to arrive at a value for Goodwill. A capitalization rate that deals with Earnings After Taxes will be a different rate than one which deals with Earnings Before Taxes.

Once you have capitalized the excess earnings, you have the value of Goodwill. Add your Goodwill to the Economic Balance Sheet to determine the value of the business.

CONFIRMING VALUE

Up to now we have done a theoretical valuation. I have been an expert against accountants that can't spell the word "cemetery" and college economic professors who moonlight as appraisers. They can all do the above process with some degree of diligence. Regardless of their care and diligence, these people may not arrive at the correct conclusion of value! This is often the case because they do not have the ability to confirm their conclusion.

The way to confirm your value, in my opinion is to test the conclusion of value. I do this with three separate tests, described below:

First, I look to see if the business can get financed. You can't buy a house today without having a bank willing to do a loan. There are simple tests that banks can do based upon your income and your debt to determine how much home you can afford to buy. The same type of computation is needed when buying a business. We call this test the Debt Coverage Ratio. Subtract from the business value the usual amount you would expect a buyer to have of their own of equity to make the purchase. The net amount of the purchase price would be financed by a bank, and the bank would have usual and customary payment terms. The business must have a sufficient amount of earnings to pay the bank, and have a margin for error. If there is not enough earnings after the usual amount of the buyers equity, then the conclusion of value might be wrong.

Secondly, I look to see if the business will have a return for investors which will be acceptable to most passive investors.

Thirdly, I look at comparable sales. If we can compare what really takes place in the market, this information can help us determine if the price is reasonable. We have been involved in many transactions so we can keep our own data base. The IRS has their own data base also. If a business is sold or gifted in family situations, they can compare the business transfer price to their data base of sales.

Can you use Rules Of Thumb for a confirmation? Yes. But the businesses should be comparable. I think that funeral businesses which are comparable should have a common Cost Of Goods Sold as a percentage of revenue, number of locations, number of calls and maybe common Revenue Per Call. I think that cemetery businesses which are comparable should have a common ratio of at-need to advance-need revenue, comparable average revenue per internment, common Cost Of Goods Sold as a percentage of revenue and an approximately common number of internments. Cremation businesses which market to the public are going to be common based upon number of cremations and revenue-per-call.

CONCLUSION

For anyone reading this that is a business owner, if you have not had a valuation in the past two years you are making a big mistake. Your business probably represents more than 50% of your total net worth and provides a majority of your income. If you have 50% of your net worth tied up in any one public company stock, you would watch that stock daily or more frequently.

Learn what the issues are that drive your business value from your appraiser and emphasize those matters. Discover from your appraiser what the issues are which are impairing your value and work to correct those issues. An appraisal is an important part of owning your business and not just something to do before you buy or sell the business.

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