By Daniel M. Isard

Step 10: Borrowing and Cash Management

Neither a borrower nor a lender be. – *Hamlet,* Act 1, Scene 3

I quoted Lord Polonius from Shakespeare's famous play because I needed someone expressing the wrong opinion on the merits of borrowing. Sure, I could have quoted any of 200 different radio talk show hosts, but then I might appear narrow-minded or opinionated. I also could have quoted several funeral home owners, but then they might feel offended.

Anyway, in this 10th installment of our 12-part 20/20 vision of rebuilding your funeral business, I will explain borrowing, give examples of when and when not to borrow and note from whom you should and should not borrow. And, of course, I will do all of this without using mathematics or being opinionated…

BORROWING DURING A PANDEMIC

There is only one certainty during a pandemic to a business owner: You can never have too much cash. During pre-pandemic times, it's generally best to have about two months of total overhead under your control in cash at any time. Typically, that cash, along with guaranteed receivables, should equal three or more months of overhead.

Simple, right? But can you predict what will happen to your normal business operations during a pandemic? I can't either, so clearly it is better to have more cash.

Perhaps you're thinking, "I don't need cash because I have a line of credit." Well, that line of credit can be taken away from you in an instant.

Why would a bank do that? Well, banks must keep X% of their total deposits in cash at any given time. The Federal Reserve also limits the total outstanding loan amount banks can have at any time. That requirement can change during a pandemic, however, because the U.S. national debt might have increased several trillion dollars by the time this article is published. Thus, the line of credit you consider a reserve today might become a contingent liability for the bank tomorrow, and the bank might need to get that liability off its books.

Therefore, draw it down now. Yes, there is a cost to drawing down your line of credit, but let's assume the cost is 5% on $100,000, for example, meaning $5,000 a year in interest. Well, if you deposit the principal into some form of easily accessed account or certificate of deposit (CD) that earns 1% (or $1,000) per year, the cost of the line of credit interest becomes $4,000 net.

Interest is a deductible expense, however, so that tax deduction will offset the $5,000 line of credit cost by about 32%, resulting in tax savings of roughly $1,600. Thus, those tax savings plus the interest of $1,000 earned by that CD effectively lower the line of credit cost to about $2,400, or 2.4%. Where else can you get money during a pandemic (or any emergency) at 2.4% net cost?

"Better to have and not need than to need and not have." No, I'm not quoting Shakespeare again, but instead every good preneed salesperson!

LONG-TERM DEBT: TYPES OF LENDERS

During this pandemic, many funeral home owners will choose to sell their firms for one reason or another. Thus, this might actually be an opportune time to expand your business footprint and acquire another firm. If you need to borrow, you should know there are essentially four types of lenders, each with different strengths and weaknesses.

1. Cash Flow Lenders use the anticipated earnings of the company to secure payments for the debt. Thus, the value of the tangible assets is less important than the anticipated cash flow. In fact, cash flow lenders are not even as concerned about the appraised value of the business. They're looking at the cash flow to pay their debt.

Imagine you want to buy a business and its real estate and that, in this example, the business earns $100,000 annually. If the business buyer seeks financing from a cash flow lender, the latter will determine how much they are willing to lend based on the cash flow, as well as on the interest rate and loan amortization term. At 5% interest and a 20-year term, for instance, that lender might be willing to loan between $930,000 and $1 million to buy the business, real estate and the other business assets. Typically, a cash flow lender will not loan more than 90% of the total purchase price.

2. Tangible Asset Lenders look at the appraised value of the assets that can be liquidated in the event

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of default. The largest such asset in a funeral business is its real estate, and lenders usually loan a percentage of the tangible assets – typically 75% to 80%. If the real estate appraises for $500,000, for example, the lender will be prepared to loan about $375,000 to $400,000.

While cash flow lenders focus on the cash flow, they'll secure their loans just as tangible asset lenders do – with liens on all property and the borrower's personal guarantee. They might require some operating covenants as part of the loan as well.

3. Sellers As Lenders Sometimes sellers are willing to serve as lenders. This might occur when selling a small funeral home in a rural situation or when the buyer is a family member or longtime employee. Often, the seller is just aware that the business will not be sold at a reasonable price otherwise.

In these cases, the seller will have a lien, but there are two types of liens or sale contracts – a "contract for deed" (aka a land contract) or a mortgage. In a contract for deed, the seller retains legal ownership of the business until the note is paid in full. As a buyer, this can prove very dangerous. If interest rates change, you might not be able to refinance. In some cases, there are steep prepayment penalties. If the buyer defaults on any amount due, they might lose any built-up equity.

With a mortgage, the sale contract sells the business and real estate to the buyer at closing, and the business and real estate secure the mortgage. If the buyer defaults, once the mortgage holder is paid off, any excess goes back to the buyer.

4. Friends/Family/Investors For the record, my partner, Doug Gober, and I fall into this category, and we have invested in many buyers. Frankly, we did so because they were good investments.

In many cases, a buyer might not have enough personal equity to fill the gap between the sale price and the financing, so they need investors. Whether a family member or not, and depending on the first lender's rules, these investors can be a second-position lender or an equity investor. (In all of our investments, Gober and I are equity investors.) The bank puts up perhaps 80% or 90% of the purchase price, and the buyer puts up the balance.

If a buyer can't secure the entire balance up front, they can look for additional "silent" investors. This could be the most expensive form of borrowing, however, because the investors are paid back as the value of the business increases. That increase might occur due to its performance or via the pay-down of the first mortgage. Equity investors are paid a percentage of the business earnings each year.

EVALUATING LENDERS

You should investigate potential lenders with a discerning eye because they might serve as banks for other institutions. Here are a few things you need to learn about them.

- Have they made and underwritten funeral home loans before? This is an unusual business. At best, the members of this profession are honorable and hard working. At worst, they are patient. You cannot make mortality happen, and if you try to borrow from someone who doesn't know the business, they might decline a loan that normally would be approved. If they don't know the business and mortality hits a slow period (as it typically does one in every five years), they might be too willing to declare default if you need some relief.
- Are they using their money or are they a conduit for the Small Business Administration? The SBA is a great solution, but it's not perfect. There are limits on the loans, as well as rigid underwriting. Most people think all lenders that place loans with the SBA are the same. This is a huge error, however, because not all SBA lenders are the same.

There are two entrances at the SBA – the "general lender" door and the "preferred lender program" door. Your bank will deliver you to the general lender door, and whoever is up next at the SBA will handle your loan. This accounts for about 90% of all SBA affiliates and means they might not have made a funeral home loan before.

The other 10% are members of the "preferred lender program." The important difference is that these lenders handle the underwriting and approvals in-house, which can save 90 or more days. The bigger fear is that someone who has not underwritten a funeral business before might still make a bad underwriting decision and decline the loan.

Here's the bottom line: Borrowing money is risky, and owning a business during a pandemic is very risky. There is so much more to know, so talk to a qualified advisor. Have 20/20 vision at all times and stay safe!

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