BUSINESS AND FINANCE

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Tracking Your Business' Worth

The highs and lows of business valuation and the tools and processes you need in place for a successful transfer of ownership.

It's been difficult not to notice the craziness happening all around us and how it impacts the economy in turn. Just consider that the funeral service profession also experienced some of the most significant ups and downs throughout the COVID pandemic and its aftermath. With death rates fluctuating year to year and competent staffing becoming increasingly more difficult to retain, combined with the overall shift in the economic environment today, tracking the value of your business has been anything but linear lately.

In the 2023 NFDA Member Succession Planning Study, only 53.1% of owners surveyed responded that they knew the value of their business. Even then, this does not differentiate "yes" responses among those who know the value of their business today versus as of 12 months ago, two years ago, etc. As noted in the opening, the world has been anything but constant in the past few years, so valuations are changing quickly.

In my role with Foresight, I have the privilege of helping owners navigate the ups and downs of their business valuations through these interesting times. In our valuation meetings, not only do we cover the financial framework of a business valuation, but we discuss numerous other factors constantly exerting their influence on the conclusion of value. Understanding what these variables are and how they impact the value of a business is vital to setting your business up for success for years to come.

First, we have to understand how a business is valued. And without getting too in the weeds on the financial mechanics of a business valuation, simply put, most businesses are ultimately valued as a function of the cash flow they are capable of producing. If you have heard someone cite a "valuation multiple," they are typically referring to a multiple applied to the cash flow generated by the business. Cash flow is the net result of the revenue generated on sales, less the cost of merchandise sold, staffing costs, funeral supplies used and all other operating expenses incurred throughout the year (office supplies, vehicle costs, accounting costs, etc.). This number does not, however, include expenses like interest paid on loans, income taxes, depreciation or amortization. Those expenses are dependent on your individual tax treatment, capital structure or accounting methods, so they are not consistent from operator to operator.

The final number we arrive at is called EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) – interchangeably referred to as either EBITDA or cash flow. This is the number to which we apply the "valuation multiple" in order to arrive at our conclusion of value.

How do we know what multiple to use? In order to keep our assumptions standardized, we will assume our hypothetical business owns its own real estate and generates positive cash flow.

All too commonly, I hear people refer to the rule of thumb that EBITDA multiples are estimated to be 6x-7x, but this range has fluctuated over time, despite the rule of thumb never being updated. Based on internally compiled Foresight data since 2019, EBITDA multiples have fluctuated year to year. In 2019 (pre-COVID), valuation multiples were consistently in the 6.5x-to-7.5x range on average.

Then, in the heat of COVID in 2021, multiples jumped to the highest heights we've seen in decades, ranging from 7.5x to -9.0x, and larger deals (greater than $10 million enterprise value) averaged closer to 10x. Multiples quickly subsided in the following years, returning to pre-COVID levels in 2023 and 2024.

Interestingly, so far in 2024, multiples for smaller businesses (less than $5 million enterprise value) have fallen below 2019 levels due to the impact that elevated interest rates have had on smaller acquirers. Today, we are seeing valuation multiples fall within a wider range of 6x to 8x EBITDA on average.

So, how do we determine where within this range a specific business' valuation multiple should fall? This is dependent on a culmination of operational and market factors.

• ***Certainty of Future Cash Flows:*** The certainty of future cash flows (often referred to as "goodwill") has a great influence on the strength of the multiple applied to EBITDA. A faltering business with downward-trending cash flows does not promote confidence in its ability to produce positive cash flows in the future. Therefore, this would have a negative influence on the EBITDA multiple applied to this business.

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However, a business with an increasing trend of cash flows and stable cost management bolsters confidence in the future success of the business. This, in turn, has a positive impact on the EBITDA multiple.

An example of how the certainty of future cash flows influences valuation lies within the logistics of a hypothetical attempt to purchase a business. As futures studies author John Naisbitt famously said, "Value is what someone is willing to pay." So, what can someone pay for a business? If they plan to obtain financing from a bank, the annual cash flow of the business will have requirements to cover the annual debt service of the loan, plus a margin of error. From this perspective, we can work backward into a maximum viable purchase price for a buyer. Therefore, if the cash flow of a business doesn't support the financing requirements, a buyer will be constrained when purchasing the business as the buyer's valuation adjusts to what they can afford. (Note that valuation and financing are dependent on different factors. This example simply illustrates how value can be influenced by cash flow constraints.)

• ***Macroeconomic Factors:*** Overarching economic factors also contribute to business valuations and can even influence changes in valuation over time. When interest rates were at an all-time low during the peak of COVID in 2021, death rates spiked and the market was flooded with private equity investors looking to buy businesses in the funeral profession. This combination of positive market factors lifted EBITDA multiples to their peak levels. Low interest rates allowed buyers to pay more for businesses, the multitude of motivated buyers fostered a competitive acquisition landscape, and spiking death rates increased forward-looking performance expectations.

In contrast to the market factors observed just a few years ago, the current economic climate has calmed significantly and EBITDA multiples have adjusted accordingly. Interest rates recently reached their highest levels since Y2K, death rates have regressed from their COVID heights, and buyers who were aggressive when interest rates were near 0% are no longer acquiring until they improve their balance sheets.

• ***Number of Viable Buyers:*** Because a business is only as valuable as someone would pay for it, we need to understand who the potential buyers of a business would be when determining its value. Even though you may not plan to sell your business today, every business will eventually undergo a transition in ownership one way or another.

A large business in a growing metropolitan area performing well compared to its competitors would present a favorable opportunity to a buyer. The number of viable buyers for an opportunity like this would be high: family/key employees, local competitors, regional operators and national and public consolidators. Having a wealth of interested buyers encourages a competitive buying market, allowing a business to capture as much of its potential value as possible.

On the contrary, a small, isolated business in a rural area with a fleeting population spells minimal opportunity to a buyer, limiting the number of parties that might be interested. When the number of interested parties dwindles, the business value becomes increasingly dependent on what someone can actually afford to pay.

An additional consideration on this topic when planning the succession of your business is to understand who your potential buyers are and how implementing additional restrictions to this list subsequently restricts value. If, for instance, you do not want to sell to any of your competitors or national consolidators, know that you might have just potentially eliminated a significant share of the viable buyers. Therefore, your business value is now at the mercy of the wallets of the remaining parties that are allowed to participate.

• ***Management Team and Succession Plan:*** Another crucially important consideration in any valuation analysis is the management team and succession plan. A business led by a strong management team

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beyond the owner is more valuable than a business in which the owner is the lynchpin to everyday operations. Understand that from a buyer's standpoint, the value of the business is based on the continuity of operations after the current owner has moved on. If the success of a business rides squarely on the shoulders of its owner, then much of the business value leaves when the owner does. This is why succession planning and installing the proper team to manage operations with you is so critical to the sustained value of any business.

A startling discovery from NFDA's 2023 Member Succession Planning Study was that 46% of owners surveyed stated that they planned to retire within the next five years, but only 23.7% said they have an exit strategy/succession plan in place. As Ben Franklin said, "Failing to plan is planning to fail." Mapping out an effective succession plan is the key to achieving the highest possible valuation multiple for your business. Succession planning forces you to comprehensively review every aspect of your business, articulate your goals and lay the proper groundwork in order to achieve those goals. It also helps to open your eyes to vulnerabilities within your business, while still giving you ample time to correct them before you eventually have to transition ownership – because ultimately, that's when the value of your business matters most.

In summary, while we can distill a business valuation down to a simple multiple of EBITDA, there is an amalgamation of variables influencing how that precise valuation multiple is derived. Some variables are within your control and some are not. But by setting forth an effective succession plan and executing on the steps of that plan each year, you will be doing all the right things to maximize the value of your business.

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