

Legal Business Reality Check



*Business
Reality
Check #1*

SCENARIO: Randall T. Smith and his wife, Petaluma (“Peta”), had owned and operated their own funeral home and crematory business, Mesa West Funeral Home & Crematory in Midland, Texas, for nearly seven years serving their community with the highest level of service at affordable prices. Then, in 2019, Randall was diagnosed with liver cancer, and in 2020, he passed away. Before Randall died, he told Peta that, “if you ever sell the business, I think it’s worth at least \$1.4 million.”

Randall and Peta, who were both licensed funeral directors and embalmers, had built Mesa West Funeral Home & Crematory on money they had saved up from years working for a corporate consolidator. Mesa was serving a solid 210 families a year, with total annual Revenue just north of \$1 million by 2019. During peak COVID periods between 2020 and 2021, the funeral home was serving up to 400-plus cases, but the call volume began normalizing back down to around an average of 285 cases in 2022 and 2023 – showing that Peta was still able to gain market share post Randall’s death.

And while Peta was the better funeral director and arranger than her husband, Randall was better at managing the business, as she will readily admit. In Randall’s last full year in 2019, Mesa served 210 cases while bringing in \$1.087 million in revenue with an EBITDA of \$200,000 (or 18% EBITDA margin). Mesa served 208 cases in 2018 on \$1.068 million revenue with an EBITDA of \$198,000 (or 19% EBITDA margin). With Peta managing Mesa without Randall, the

business averaged \$1.15 million in annual revenue serving about 400 families over the 2020-21 time period but only retained about \$114,000 in EBITDA (or 10% EBITDA margin). Peta also agreed to perform cremations for the Texas Tech University Health Services Center in Odessa, Texas, in 2021. As a result, the Mesa crematory essentially began “paying for itself; however, this placed additional stress on her staffing as well as increased her operating expenses.

By the time Peta decided it was time to sell in October 2022, she was experiencing health issues and could barely maintain proper staffing at the funeral home and the crematory. Revenue had fallen below \$800,000, and EBITDA was lower than \$100,000 by year-end 2023, even though Mesa was still serving 275 cases. Peta had also publicly announced that the business was for sale at the beginning of 2023 and was willing to share her accountant-produced profit & loss statements for anyone interested. Even when there were bona fide interested buyers, no party would submit offers meeting Peta’s asking price of \$1.4 million.

SO, WHAT IS THE FAIR MARKET VALUE OF MESA WEST FUNERAL HOME & CREMATORY?

The short answer is this: true market value is based on what someone is willing to pay to purchase this business.

The reality, however, is that what someone might be willing to pay for this business is still strongly supported by the story that the financial numbers tell about this business. Hence, this financial “story” is supported by any trends over time in key areas such as call volume, revenue, average revenue per case, and EBITDA. While EBITDA is not a perfect measure – certainly investment gurus like Warren Buffett and Charlie Munger have criticized it, EBITDA is still what is generally accepted in the financial world as being a measure for cash flow profitability of a business.

EBITDA is still used by buyers, large and small, to apply buying multiples to in order to ascertain a reasonable Offer or Indication of Interest. EBITDA is certainly used by banks and financial institutions to see whether or not debt coverage ratios can be

met when a independent buyer might seek financing to hypothetically buy Peta's business. Both EBITDA multiples in the funeral profession and financing requirements in the funeral profession are whole topics that can be covered with their own articles. But I always substitute the term "buyer" with the term "investor."

In order for Peta to justify her asking price of \$1.4 million, Mesa would have had to maintain its revenue and EBITDA ranges from when Randall was still managing the business – roughly \$1,077,500 in annual revenue and \$200,000 in EBITDA. A seven-times multiple on \$200,000 of EBITDA is reasonable for \$1.4 million as an asking price. As of year-end 2023 for Mesa, a 14-times multiple on \$100,000 of EBITDA is not reasonable for \$1.4 million as an asking price.

WHAT COULD PETA HAVE DONE DIFFERENTLY?

There are multiple things that Peta could have done differently. The chief among them were:

- Peta should *not* have publicly announced that Mesa West Funeral Home & Crematory

was for sale. Without any confidentiality, it makes her vulnerable to her competitors and what they might say about her in the community – true or not. Secondly, this public announcement likely did not help Peta in securing and maintaining talent and staffing, especially in this day and age where it is tough enough as it is. Lastly, Peta's announcement invites the perception of being desperate, and that is not the perception or position you want to be in when negotiating a transaction of your business.

- Peta should have made preparations to sell the business much sooner. Hindsight is always 20/20, and no one could have accurately predicted the effect of COVID. However, the reality of what this fact pattern lets us know, is that Peta knew and admits that she was not as good a manager as her husband was. This knowledge and the likelihood of Peta maintaining the financial performance as Randall did should have urged Peta to sell the business sooner.

- Other than seeking help from others who could have possibly helped sooner, Peta needed to be more flexible with what her asking price was for this business. It is terribly sad to lose a loved one – much less your

spouse and partner in life and in business – and Peta probably believed in her heart of hearts that this business "could" be worth \$1.4 million, and there is no doubt that there was sentimentality included in this figure for Peta. However, unless she put in the very hard work of making better financial decisions, received some help from others, and improved her cash flow profitability, Peta was not likely going to receive the offer she wanted given the state of the financial "story" at the time she went on the market.

Finally, it is worth noting that assessments of value for any given business can change year-over-year. Was Mesa West Funeral Home & Crematory worth the \$1.4 million asking price? Perhaps, it very likely was in 2019 when revenue was \$1,087,000 and EBITDA was \$200,000. Was it worth \$1.4 million at the end of the year 2023 based on the fact pattern above? I am going to conclude this article by asking you to put yourself in the shoes of a possible buyer – better yet, you are an investor. Would you pay \$1.4 million for this business when its revenue since 2019 has fallen by 26% to just below \$800,000 and EBITDA has been reduced by over 50% to just under \$100,000? •

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