

BUSINESS

By Stephanie Ramsey

Business Reality Check

*True Stories of the
Everyday Funeral
Business Owner!*

Business Case Study #1



SCENARIO: Meet Tony Morgan (age 54), owner of Morgan Funeral Home and Cremation Services. Tony's business consists of a single location in the Midwestern United States, serving approximately 160 families annually. Tony began his business from scratch 25 years ago. Tony worked hard to make his dream of ownership come true. He raised the equity and qualified for a loan that allowed him to buy the real estate and build a reasonably sized funeral home that met the needs of the community that he decided to serve. It was a rural community that did not have a provider when he began his business.

Over time, Tony expanded his location to provide additional space within the facility, parking, and cremation by purchasing the adjoining real estate. The growth he has experienced has been rewarding, but it came through

long hours and stress to make sure he could meet his financial obligation while serving his families with the high standard of care he had established as his benchmark.

As the business has grown, Tony has hired additional staff to help

him serve the families efficiently. Through the years, this has been a struggle given his rural location. The community provides a great lifestyle for those who enjoy a slower pace of life, but it can be a challenge when many of the younger generation are

leaving the area for the bright lights of the larger cities. Many times, Tony has functioned by using part-time funeral assistants rather than another full-time licensed funeral director, as it was difficult to find and retain such a qualified individual.

A few years ago, Tony was fortunate enough to find Sarah, an experienced, licensed funeral director looking for a quieter area to raise her family, and who felt that Morgan Funeral Home and Cremation Services provided her with the opportunity to pursue her career path and meet the needs of her family perfectly.

The first few years of Sarah's employment passed without complications, and Tony was extremely pleased with her performance. He perceived she was also happy with her role in the firm and the lifestyle that she was able to have within the community. Then, a few weeks ago, Sarah approached Tony

and boldly stated that she wanted him to develop a plan whereby she could buy the business from him within five years, or she would be looking for another opportunity to grow her career. Tony was stunned. He had no idea that Sarah had any expectation of becoming a funeral business owner, especially of his business, within such a limited time frame. Rather than having a knee-jerk reaction, Tony was non-committal to Sarah, indicating that she had caught him off guard and he needed some time to think.

After informing his wife (Amy, who did the company bookkeeping), of the events with Sarah, they realized that they did not have a succession plan in place and had no idea whether a five-year timeline with Sarah was even feasible in terms of them retiring or the value of the business. They reached out for some help.

What are the first steps? Obvi-

ously, there is always a first step. For Tony and Amy needed to understand what questions needed to be answered about their succession planning:

1. At what age do they want to retire?
2. What are their financial needs? Mortgage? Travel? Health costs? Other expenses?
3. How much money did they have set aside for retirement currently?
4. Was selling the business necessary for them to retire?
5. Did they know the value of their business?
6. Who should they sell the business to, if that was the right direction to go?

Clearly, there are a lot of questions to be answered. However, the reality is that Tony and Amy took the real first step by reaching out to someone to assist them in this process. Now, let's address these steps and how they should respond to Sarah.

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ANSWERING THE FIRST FEW QUESTIONS

These are personal questions for everyone to address individually. The answers will be unique to each situation. Please consider working with a trusted advisor to make sure that you understand your financial situation today, tomorrow, and in the future.

Let's focus on Tony and Amy's specific situation. After much consideration, Tony and Amy concluded that in their perfect world, they would like to retire by the time Tony was 60 years old. Their financial adviser worked with them to determine that they needed to have a \$2 million nest egg when Tony retired for them to have the lifestyle they wish to have. Essentially, Tony and Amy want to be debt free upon their retirement to be able to maintain their current standard of living. They also want to have the ability to travel. They currently enjoy taking at least one 15-day cruise each year. They would enjoy traveling more if that was possible given their financial security.

Is selling the business necessary for them to retire? Their financial adviser counseled them that they were currently on track to have approximately \$550,000 set aside in retirement funds by their target retirement date. Based on this information,

the sale of their business would be a critical part of their retirement plan. Therefore, the value of their business is a very important factor in determining whether retirement at Tony's age of 60 is even a possibility.

Do they know the value of their business? Tony has never had a formal valuation of his business done, but his casket vendor told him that the value of his business is 2X the average revenue. Based on this information and his average annual revenue of \$1 million, Tony initially believed his business was worth \$2 million. Tony thought that his business could be sold for this value and meet their retirement targets. However, his financial adviser has suggested that Tony would be best served to have a professional funeral business appraiser provide a valuation of the business. This was auspicious advice by the financial adviser.

There is much more to a funeral business valuation than simply multiplying the average revenue by 2. One simple question that can hinder this common "rule of thumb" calculation is the definition of revenue. For example, Tony was assuming his total would be \$1 million, but his total revenue less cash advances is \$700,000. This revised revenue would lead to a perceived value of \$1.4 million, not

\$2 million. If the business sold for \$1.4 million, Tony and Amy would be slightly short of their \$2 million retirement target.

There are several methods used by appraisers to value funeral businesses. The one that is commonly used in the funeral profession is the excess earnings method. This method estimates the fair market value of the business by determining the sum of the net assets (assets less liabilities), plus the estimated value of goodwill. After hiring a professional funeral appraiser, Tony learned that the current business had an appraised value of approximately \$1.7 million. Less than what Tony's quick "rule of thumb" calculated. However, the appraised value combined with their retirement savings would allow Tony and Amy to achieve their retirement financial targets. It should be noted that the value of the business for six years in the future cannot be guaranteed. However, this is at least a starting point. The question now was, who would buy the business?

SELLING MORGAN FUNERAL HOME AND CREMATION SERVICES

Tony and Amy have now gone through the process to understand how they can achieve their retire-

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ment goals. A large part of their successful retirement hinges on their succession plan for their business. Knowing the value of their business is extremely important so they can determine the best option for their succession plan: 1) Selling to their key employee, Sarah, or 2) Putting their business on the market for an unknown third party to potentially acquire the business. There are advantages and disadvantages to both options. Let's evaluate each scenario.

Selling to Sarah would seem to be the easiest path. She knows the business, and the community knows her. There is already a trust level between Sarah and Tony that she would continue the legacy and commitment to quality family care that he has created. Tony also feels that he could continue to have input on the future of the business because he perceives that Sarah would welcome his advice and counsel in the future. However, there are a few concerns. Sarah has requested a five-year timeline, which is before Tony's preferred retirement date. Amy has also expressed doubts about Sarah's financial ability to pay for the purchase and believes that Sarah would be expecting Tony to provide 100% seller financing. Amy considers this too risky. Tony feels this risk would be managed because of his relationship with Sarah.

Placing the business on the market on the other hand means that the buyer would be completely unknown to both Tony and the community. That does not mean that the buyer would not be committed to maintaining the quality of care that Tony has provided nor that the buyer would not want to preserve the legacy that Tony has built. The reality is that a buyer such as this would be paying for the goodwill of this business and would not want to devalue that asset in operating the business going forward. Additionally, by offering the business on the market, there is the potential for the business to sell above its appraised value should there be multiple interested



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parties. Admittedly, given the rural market, this is not guaranteed to happen. Also, a third-party purchaser is likely to come in with at least some amount of cash at closing if not most of the purchase price as cash. This is less risky for Tony and Amy. From Tony's perspective, he would not be able to have continued input on the business's future operations since he would probably not have a long-term consulting agreement (likely only a one-year agreement).

HANDLING THE SITUATION WITH SARAH

After further discussion, Tony and Amy decided that they would be willing to enter into a succession plan with Sarah. However, they, not Sarah, established the parameters under which the succession plan would work. If Sarah did not like the parameters, then they were willing to live with losing her as an employee and putting their business on the market in the future. Tony and Amy sat down with Sarah and laid out their concept:

1. The succession plan would not be triggered until Tony turned 60.
2. The purchase price of the business would be established by an appraisal performed by a qualified funeral appraiser.
3. Sarah would have to obtain financing for most of the purchase price, though Tony and Amy were willing to provide some amount of seller financing to assist her in ob-

taining reasonable financing.

4. A buy/sell agreement would be executed with all these terms and conditions as well as termination language to protect both parties in case their relationship went bad over the next six years

THE OUTCOME

Sarah did push back during the meeting initially when Tony and Amy sat down with her. However, Amy and Tony were very consistent and did not waiver from their position. Ultimately, Sarah agreed to their terms and conditions. Currently, they have quarterly meetings to share the business's financial position so Sarah can learn how the business operates and help her learn more about what it means to be a business owner. Also, the business is valued every year so there will be minimal surprise as to the value of the business the year the buy/sell agreement is triggered. This success can be attributed to Tony and Amy first establishing their retirement needs and then determining the best path for them to sell the business. Their transparency with Sarah also helped her understand that her dream of ownership was attainable but had to be earned by working the six years until Tony was ready to retire and everyone understanding the process of arriving at the actual closing of the transaction.

While business succession can appear overwhelming, with the right advisors, a complex situation can turn into a win for all the parties involved. If you need assistance developing your succession plan, we stand ready to assist you. •

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