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Preneed and its Value at the Point of Sale

A Seriously Misunderstood Concept

By Robert L. Pierce

The value of a preneed program is one that has been debated within the industry for decades. The impact of a specific preneed program on the value of a funeral home is simply not understood.

It is one of the two questions that I am most asked and one to which I hope to add some insight by my writing of this article. It is only with knowledge that we can guide our companies to added value.

Framing the Question

We have a retiring funeral home owner at the final stages of negotiations with potential buyers. As part of our review, we need to ensure that everything has been addressed: Is the appropriate buyer for this funeral home involved? Do the potential buyers have reasonable estimates of continuing cash flow? Have the potential buyers appropriately factored in the tax advantages of the purchase? Have the buyers appropriately reflected the effects of real estate value on the transaction? Is the owner-seller's employment agreement appropriate given his or her age and life goals? Do the offers reflect the demographics of the market area? Are the tax implications appropriate? Are employees treated well? Etc.

Invariably, the question comes up. "Am I being paid fairly for my book of preneed?" This article will help funeral home owners understand how preneed affects the value of a funeral home

business. Unfortunately there is no universal formula that calculates the value of a preneed portfolio. Before we can find the value of your preneed program, we have to understand how your program is run and how it will impact a buyer.

Defining the Preneed Program

“How much is my book of preneed business worth?” The answer to this question is not an easy one. Truthfully, it could be the subject of a book. There are many relevant aspects to the question. First, we must recognize that all preneed programs are not created equal. For purposes of this article, I have defined three basic types of programs.

A Passive Program - I define the first type as a passive because it offers prearrangements as a service to its families, sometimes even without funding. The beneficiary of a passive program is almost always the spouse or family member of a client family. This type of program does very little if anything to protect or expand the market share of a funeral home

A Market Protective Program – The second tier of preneed program is more proactive. It invites people to prearrange their funerals but it does so in manner that is most likely to reach families that have traditionally used the funeral home. It usually involves a rather passive advertising program and a person in the funeral home, often a funeral director, who takes time from their busy day to respond to calls or walk-ins. The primary purpose of a protective preneed program is to protect market share and to stop an aggressive competitor from writing prearrangements with the funeral home’s traditional clientele.

An Aggressive Program - An “aggressive program” is just what the name implies. It is out there trying to locate people who are not part of the traditional clientele of the funeral home. It may utilize mail-outs, speeches, a kiosk, community activities, events for retirement homes, estate planning seminars, living will seminars, a phone room, coupons, a cemetery resale program, response cards in the lobby of the funeral home during visitation and funerals, etc. It uses any means that is can to increase its clientele and its market share.

It is obvious that the value of a preneed program increases as it becomes more aggressive. That is for two reasons, one because an aggressive preneed program increases the number of calls that a funeral home does over time and two, because it builds a strong case for continuing

growth if the funeral home owner actually take the time to present their case for continuing growth to a potential buyer which few do.

There are other factors inherent in an aggressive preneed program that can affect the value of the underlying business.

Factors that Affect the Value

The Cash Flow Impact of the Program - The preneed program can become a significant part of the cash flow of a funeral home. Preneed programs tend to generate gross income or a contribution to lead costs if the preneed program is insurance funded. Incentives, advertising and lead systems cost money. The cost of the preneed program net of outside contributions is referred to as the current income or cost of the preneed program, in effect, the impact of the preneed program on the current income of the company.

The principal component of a funeral home's value is the continuing cash flow of the business. On first blush, the net income or net cost of an aggressive preneed program has a very direct impact on the value of the funeral home, either positive or negative depending on whether the preneed department results in a net positive cash flow or net cost in the financial statements. Any negative impact on the value of a funeral home can often be managed as part of the sale planning process but, if it is not, a preneed program with a net cost in the financial statements will reduce the sale price of the business.

A funeral home owner is responsible for presenting the preneed program appropriately in the financial statements and in the presentation to potential buyers. It is important that potential buyers understand the preneed program and its affect on current and future profits. If the preneed program is presented poorly or improperly, you will be paid less for your funeral home and the fault will be yours.

The Value of an Aggressive Program – Very few funeral homes can implement and sustain an aggressive high volume preneed program. Those that sustain an aggressive preneed program and a high volume of high quality preneed sales over a long period of time, add considerable value to their businesses but only if the preneed program is presented correctly to potential buyers. With that said, a preneed program, even the best one, will never trump the

impact of continuing cash flow in the valuation equation. Tax-effected cash flow is always the dominant determinant of value.

There are other preneed related factors that impact the value of a funeral home business more directly than the mere existence of a preneed program. There are traps out there waiting to suck up the value of unsuspecting funeral home businesses and they are, for the most part, avoidable.

The Funding Vehicle

The manner in which one funds preneed has a more dramatic effect on the value of a business than the mere existence of a preneed program, aggressive or not.

There are two basic methods of funding prearrangements, life insurance and trust. Both have very different opportunities and “misuse” of either can affect the value of a business significantly and directly.

Insurance is the most practical funding vehicle from a long-term profit perspective because it generates current commissions to pay the preneed representatives and it offers the opportunity in some cases to generate a source of current revenue to the funeral home to offset the costs of lead sources. The effect of this is that the funeral home’s initial out of pocket costs are reduced by an insurance funeral preneed program and its current profit and cash flow is increased. The increase in cash flow, in theory at least, increases the value of the funeral home business because it increases its operating profit.

The alternative of using a preneed trust to fund one’s prearrangements often has many options depending on state law. The choices that one makes can have a dramatic affect on the value of a funeral home business.

Trust funded preneed contracts have no revenue source and there is no opportunity to share lead costs with another party. All of the costs of the program including commissions paid to the preneed representative and the cost of obtaining preneed leads come out of the cash flow of the business or are borrowed as we will explore later.

Some funeral homes elect to retain a portion of preneed contract receipts to defray the cost of the preneed program and to generate current cash flow. We will explore the effect on the value of a business when the funeral home makes the decision to retain preneed funds.

If we compare a funeral home with an aggressive insurance funded preneed program to a funeral home that deposits 100% of their preneed sales to a managed trust account, they are very different. The insurance funded program will initially be considerably less costly than a trust funded program because the insurance company pays the commissions to the preneed counselor and further may pay for some or all of the lead costs of the program. This means that a funeral home that funds its preneed program via a life insurance contract will be more profitable at the point of sale than a funeral home that funds via trust. In theory then, the funeral home with the insurance funded preneed program will be more valuable because it has greater initial reported profits.

Let's look at a program that deposits less than 100% of its preneed contracts into trust which is allowed in some states. The portion of the funds that the funeral home retains represents cash flow to the funeral home but not income or profit. The retained funds are, in effect, borrowed funds that will be paid back out of future profits or when the funeral home is sold. This is true from a purely accounting standpoint and from a practical standpoint also. The retained funds are properly reflected on the balance sheet of the company as a net liability, one that will be repaid with certainty on fulfillment of the preneed contract. Retained preneed funds reduce the value of a funeral home at the point of sale.

This brings us to the conclusion that a funeral home that funds its prearrangements with insurance will be more valuable than one that funds with a trust but once again, it is not that simple. Insurance products and companies vary quite a bit.

Appreciation and Yield

The impact of the annual incremental increase in insurance policies and trust yields have a significant impact on the profit and value of a funeral home, one which is usually not understood or is overlooked by funeral home owners. Finding an appropriate life insurance product is very important. The life insurance product that one chooses will have a significant but often hidden impact on the future profit and value of the business.

With a life insurance product, there may be options for choosing differing rates of policy increase depending on the life insurance product chosen and the commission rate that is paid to the funeral home and its representatives. I have seen policies that escalate for a period of time and then stop increasing on the insane theory that most buyers will die within five years or so. I have seen simple interest policies. Over time, the appreciation factor that you choose will affect your profit and value more than any other preneed related factor. Your funeral home has a choice of insurance companies and a choice of insurance products. There is no excuse for choosing an inappropriate insurance product that is going to make you less profitable and less valuable.

Trusts have similar issues. Trusts may be subject to market fluctuations or poor investment decisions. If you elected to retain a substantial portion of preneed sales up front, even a good yield is going to leave your funds seriously impaired at fulfillment and reduce your cash flow and value.

The Quality of Preneed Sales

Today's preneed sales averages are going to affect the future profit and value of the company. The sales averages of a company's preneed sales program are, more often than not, unmanaged because there is no immediate impact on current profits. They are under the radar. This happens for a variety of reasons. Preneed sales averages are not usually included in the company's reporting systems, preneed sales reports often include cash advances which can distort one's perception of preneed sales averages, and because managers often inappropriately focus on the rate of sales rather than the quality of sales.

Make no mistake about it. Untrained, unmanaged and underperforming preneed sales agents are going to cost you big time in the future both in terms of profit and value. If you do not have an effective program to manage preneed sales averages versus at-need averages, put one in now or pay the price later.

Accounting for Preneed Fulfillments

The accounting systems of funeral homes in general are all over the place. Many were set up by accountants who used the chart of accounts of a book store when the records were set up. They are totally inadequate for any reasonable management purposes but that is a topic for a future article. Today, we are doing a study of preneed and its affect on the value of a business.

As to the accounting for fulfillments, there are many theories of reporting for fulfillments. Some reporting systems mask the cost of inappropriate and unmanaged preneed programs so management never understands what their preneed program is doing to or for them. I like to use a Gain or Loss on Fulfillment account to measure the impact of the funding decision versus current at-need prices. This puts the income or cost of the funding decision in the income statement where it can be managed. There is always a cost associated with poor reporting and this is an area where the cost of a lack of knowledge is great.

It is important to have reporting systems that contrast the impact of at-need contracts versus fulfillments so corrective action can be taken before a poorly implemented preneed program becomes a cancer. If fulfillments are reported properly, management is more likely to give the preneed program the focus and respect that it deserves and the funeral home will be more profitable and more valuable as a result.

Preneed programs are so manageable and yet so often unmanaged. It is particularly unfortunate when the preneed program has a serious negative impact on the cash flow and value of a business because it takes so little effort to make a preneed program contributive to value.

The Value of Preneed

There is one thing that you can take to the bank. Funeral home values are based on the tax-effected cash flow of the business. Everything else tends to be a distraction. And, that is true when one assesses the importance of a preneed program. The value of the company and the value of the preneed program are going to be based, for the most part, on current company operating profits. Everything else is going to be relegated to being an intangible and intangibles are much harder to value and bank than cash flow. As a result, intangibles like the preneed program are often overlooked at the point of a sale.

The impact of the preneed program is often masked by poor reporting systems. If, however, the reporting systems of the company measure the contribution of fulfillments versus the same contract at current prices, one can begin to assess part of the direct impact of the preneed program by applying a theoretical multiplier to the net overage or shortage. For example, let's assume that fulfillment shortages represent an annual expense of \$50,000. Given a cash flow multiple of say five to six, the preneed program will have caused the value of the funeral home business to decline by \$250,000 to \$300,000, a lot of money to lose for a little mismanagement.

I recognize that my methodology is simplistic. I recognize that there are other factors inherent in a preneed program that may have affected the value of a funeral home. The program may have caused the funeral home to grow more than it would have without the program in place. It may have caused calls and market share to increase. It may be driving current growth. It may have caused bad debts to decrease. It may result in a better call mix. And, an aggressive high volume preneed program in itself may add value for some buyers.

There are a lot of theoretical valuation issues that may affect the value of a business but they are dwarfed by the direct impact of tax-effected cash flow. If the preneed program results in a decrease in your cash flow, then your best indicator of value is working against you and you have an uphill battle.

Conclusion

A preneed program is an important part of a funeral home today. It would be very difficult to be an aggressive funeral home without one. One must recognize, however, that a preneed program is going to have a significant impact on the future profitability and value of the business and, as a result, it is very important to manage it effectively.

Decide on the purpose of your preneed program and build a program that is responsive to its purpose. Build reporting systems that will help you assess its effectiveness so you will have the information to manage it effectively. Monitor preneed sales averages vs. at-need sales averages and supply training to underperforming people. Choose an investment option that will give you the best shot at keeping up with your price changes and carefully monitor your fulfillments versus your current prices and react to negative results.

Never forget that your preneed program is going to have a bigger affect in your future than you expect. If you forget this, you or your successor will pay the price.

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