Title: Buying Basics – How Much Can You Offer?
By: Matt Manske

Once you find a business you would like to purchase, how much can you offer? Since there are exceptions to every rule, this article will attempt to provide the business buyer with some general guidelines on the most common situations encountered when buying a funeral home.

Once you find a business you would like to purchase, how much can you offer? Since there are exceptions to every rule, this article will attempt to provide the business buyer with some general guidelines on the most common situations encountered when buying a funeral home. In that context, this article makes several assumptions including the following: the buyer will obtain bank financing to make the purchase; the buyer has excellent credit, strong industry experience and the ability to make a modest down payment; any seller financing will be at similar rates and terms as the bank financing; the buyer will own and operate the business for profit as a stand-alone facility; the value of the individual assets of the business, including real estate, are not greater than the overall value of the business.

An important point to remember when buying any business is that most good businesses sell in the price range of three to six times Seller's Discretionary Earnings or total cash flow available to the owner. Seller's Discretionary Earnings or SDE is calculated by adding together several components including: business profit or (loss), owner's salary, discretionary expenses, non-recurring expenses and non-cash expenses (i.e.: interest, depreciation and amortization).

Where your offer falls in this price range depends on the industry and the individual characteristics of the business. In industries where inventory and equipment are of significant value, those items are added to the purchase price, with the purchase price often being expressed in terms of sales revenue, plus inventory and equipment. In the funeral industry, most businesses sell in a price range between four to six times SDE. This price range typically includes all operating assets of the business.

Since most buyers are in business to make money, it makes sense to determine how much cash will be available to pay debt service after the purchase. This is also the method used by banks to determine how much they can loan on a purchase. SDE or cash flow available to the owner is often expressed in terms like: adjusted cash flow, seller's discretionary earnings and adjusted EBITDA (earnings before interest, taxes, depreciation and amortization). All of these terms are used to describe SDE. Please note that SDE is a higher number and is not the same as cash flow available to service debt.

www.4BSF.com

Matt Manske is the Managing Member of BSF, LLC (website: www.4BSF.com).
He can be contacted at 913.343.2357, or by email at matt@4BSF.com.

Cash flow available to service debt is always a lower number than SDE and it is calculated by subtracting a normal salary for the borrower from SDE. Most lenders require a borrower budget the minimum salary needed to take care of his or her personal liabilities and living expenses. They also require a small margin of safety over and above the actual debt service requirement which we will discuss shortly.

The minimum salary required by the borrower will vary depending on their personal debt level. A good rule of thumb to budget and estimate a borrower's personal salary requirement is to multiply their annual personal liabilities by two. For example, a borrower with annual personal liabilities of $15,000 will require a minimum personal salary of $30,000, which is then subtracted from SDE to arrive at cash flow available for debt service. Cash flow available for debt service or CDS is then used to determine how much the borrower can actually borrower for the purchase, which then allows the borrower to estimate how much they can offer the seller.

In addition to subtracting a salary requirement, most banks will also build in a margin of safety when calculating the actual debt payments they are comfortable with. This margin of safety is referred to as debt coverage and is usually expressed in a ratio called the debt coverage ratio. Some banks require a minimum debt coverage ratio of at least 1.25 and some up to 1.50. For example, if a bank required a minimum debt coverage ratio of 1.25 and the CDS was $125,000, the bank would only be comfortable with annual debt payments up to $100,000. This total would then be used with the amortization term and interest rate to determine how much the borrower could actually borrow for the purchase.

The following example will help illustrate both the minimum salary requirement and the debt coverage margin. Let us say over the past three years a business has achieved average SDE of $350,000. The borrower's personal salary requirement is estimated to be at least $50,000, which is then subtracted from SDE to arrive at CDS of $300,000. Let us say the lender is conservative and requires debt coverage of at least 1.5 on loans of this size. Dividing CDS of $300,000 by the minimum debt coverage ratio of 1.5 leaves $200,000 for total annual debt payments. In this example, $200,000 in annual debt payments over 15 years at 8.00% would allow the buyer to borrower approximately $1.7 million to make the purchase. If the buyer planned to put down $300,000 in cash, the buyer could offer the seller approximately $2.0 million for the business.

Whenever a buyer is getting financing for a purchase, some form of the process above is used to determine how much the buyer can borrower. Since banks like their loans to be paid back, the

www.4BSF.com

minimum personal salary requirement and debt coverage margin are both used to establish a realistic budget of how much annual debt service the business can actually afford.

WWW.4BSF.com

Matt Manske is the Managing Member of BSF, LLC (website: www.4BSF.com). He can be contacted at 913.343.2357, or by email at matt@4BSF.com.