Live Oak Bank®

SELLER'S GUIDE

HELPING FUNERAL HOME OWNER'S NAVIGATE SUCCESSION

liveoakbank.com/funeral

INTRODUCTION

The purpose of this guide is to help you understand the appropriate steps to complete a successful business transition.

In most cases, the financial health of a business determines whether or not the seller's price expectations will be satisfied. Unfortunately, most asking prices exceed what a business can actually support in debt, which can cause difficulties in transitions. A successful transition takes place when both the buyer and the seller have a clear understanding of the financing options available to them, and what criteria is considered to get a loan approved.

Based on data from CNBC and the Financial Planning Association[1], a large portion of small business owners intend to sell their companies to support more than half of their retirement. Many of these owners do not have an exit plan. In an era of retiring baby boomers, transitions in ownership are inevitable, and Live Oak Bank is ready to help.

I. UNDERSTANDING YOUR BUYER'S FINANCING OPTIONS

When it comes to buying a funeral home, we typically see two scenarios: a key employee purchasing the funeral home where he or she currently works, or an owner purchasing a funeral home from a retiring business owner. Every loan situation is different and financing solutions vary.

The key, as a seller, is to be educated on the financing options for future buyer(s) and on the process during which a bank will evaluate the value of your business. Take the time to educate yourself in the following ways:

1. Identify qualified buyers based on high-level information.

- Understanding typical equity, liquidity and personal credit requirements will help you weed out non-qualified buyers.

2. Understand tax implications based on your purchase agreement structure.

- It's important to avoid changing the structure of the purchase agreement late in the loan process, as it can cost both you and your buyer money and time. There are tax implications and debt liabilities associated with various structure types (for example asset purchase versus stock purchase) - for both you and your buyer. It is important to consult legal counsel before approaching the buyer to set proper expectations. The buyer may or may not agree to your terms, so having a clear understanding of the alternatives is crucial.

3. Consider possible seller financing options and non-compete fee structures.

- The SBA 7(a) financing option, which is a common solution, allows for 5% of the required 10% equity injection to be satisfied by a seller carry note. This reduces the required amount of cash from the buyer and reduces the bank-financed portion of the purchase price. If you decide to take on some financial risk with a seller carry, you reflect your faith and trust in the business moving forward, thereby providing additional strength toward a loan approval from a financial institution.

4. Know the value of the real estate property being sold.

- Although real estate is viewed differently among various financing options, it is important to have an accurate value prior to working with the buyer's bank. This can help the bank structure the loan properly and save time.

1. "Own a Business and Retiring? Should You Sell?" RothIRA.com, 3 July 2018

5. Use the historical cash flow of your business to assist in setting your purchase price expectations.

- It is easy to assume that the price of your business equals the business real estate value. However, many banks put more focus on the ability of the business to service the debt associated with a new loan for your buyer. The price should be determined after a cash flow analysis. Complete the analysis three to five years prior to your planned succession to set appropriate expectations.

Thinking about these things on the day you decide to sell is like planning your retirement on the day you decide to retire. We have seen hundreds of funeral home owners make costly mistakes related to the factors listed above, but we have also helped many of them avoid disaster and successfully navigate their business transition.

II. FUNERAL SERVICE MARKET TRENDS TO CONSIDER

Many business trends are driven by the surrounding market, so it is important to understand the demographics in your area and trends in the funeral industry. Future indicators will impact the price you may be offered by a potential buyer. Some things to evaluate regarding your own community:

1. What are the demographics of the area and how are they changing?

- Demographics include age, gender, education, income and experience of people in a certain area. These factors have major impacts on small businesses and can guide forecasting for financial performance projections.
- Explore how your community is planning to enhance schools, roadways, residential/ commercial areas. Any positive changes can spark population increases and introduce your business to future growth.
- Research corporations looking to buy land in your area. Jobs being added to the area could enhance your ability to shift pricing and product offerings.
- Decide if the current and future job market in your area can support the demands of a millennial population.The millennial generation is not only the largest generation in history, but also the most racially diverse, and is also predicted to be the most educated to date.
- Take note of the religious makeup of your community and any changes occurring. Religion can help drive product offerings to ensure growth.

2. What competition do you face in your local community, and is your business positioned to remain competitive?

- Be aware of your competition and their product/service offerings, strengths and weaknesses.
- Make sure your funeral home is well-prepared for cremation rate increases with a crematory or partnership to satisfy this growing need.
- Create flexibility in your marketing plan to allow for updates and scalability that will help attract more customers. Small businesses with strong marketing platforms are naturally more competitive.
- Develop relationships with the local government, law enforcement, churches, schools, etc., that you can leverage to help buyers see the impact your business has had on the community.

3. Is the local population growing, and if so, how quickly? What is the cremation rate and how much is it rising?

- Remain aware of the population and cremation trends in your area. You can’t manage what you don’t measure.

4. How much will a buyer need to invest to make your business competitive in the long run?

- Understand all areas of marketing, product offerings and facility enhancements so you can determine which investments have direct impacts on your future sale price. Some of these investments will be more costly than others; therefore, some may not make business sense as a result of low impact to future value.

Create a priority list of the factors and the implied improvement on your overall return on the sale of your business. Let this information drive your decisions.

III. FINANCING YOUR SUCCESSION

To successfully purchase a funeral home, your buyer will likely need financing. Historically, seller financing was the primary method to complete the transaction, but today, buyers have financing options through financial institutions. Your buyer will work directly with a lender to receive funds to purchase the business. Ultimately, the lender will base approval on the personal credit of the buyer as well as strength of the funeral home itself – its ability to service all new and existing business debt (including the new owner's salary).

Understanding the financial institution's expectations will help save time when trying to align with the right buyer. It will also help you understand the information the buyer will need from you to help the bank fully understand the business and the transition.

Initial borrower qualifications include:

- Three years of funeral home experience
- Licensed funeral director
- No bankruptcies

Your buyer will then work with their lender to complete/provide the following items:

- Staffing plan – consider any existing staff who plan to exit upon the succession of the business
- Cost savings plan:
    - Your personal expense items will need to be verified with statements and/or business tax returns. This will help the lender understand the true cash flow available for your buyer.
    - Expenses that will be alleviated upon succession
- Identify unusual, one-time expenses that ran through income statements (new parking lot, new roof, A/C unit, etc.) over the past three years.
- Total call volume for the past 3 years and year-to-date (YTD) interim call volume, including cremation percentage
- Market share and competition overview
- Preneed insurance and trust backlog and at-need volume for the past three years
- Letter of intent (LOI) stating:
    - Purchase price
    - Stock or Asset Purchase
    - A portion of the purchase price allocated to real estate
    - A portion of the purchase price allocated to business assets (goodwill)
    - A portion of the purchase price allocated to FF&E (Furniture, Fixtures, & Equipment)
    - Seller Carry Note (if applicable) – In the example of an SBA 7(a) loan, the rate and term of the seller note are at the discretion of you and the buyer. If just a portion or all of the seller carry is being used to satisfy 5% of the required equity injection, the seller carry must be on standby with no principal or interest payments to be made until the buyer's loan is paid in full. Interest can accrue during the standby period.

- Financials:
  - Three years of business tax returns
  - YTD interim profit loss and balance sheets – matching current and previous year
  - Two years of projections, beginning once the succession is complete

At Live Oak Bank, our mission is to create a straightforward lending experience for you and your buyer during the succession of your funeral home. Live Oak is not your traditional bank. Our leaders are innovators in finance and technology, and we bring efficient excellence to the lending process. We deeply believe in personal service and taking care of each one of our customers throughout the life of their loan.

IV. SUCCESSION FINANCING FAQS

1.How long does this process take?

- A Live Oak Bank lender will work to gather all required information to begin underwriting the loan. The underwriting process typically takes 5-7 business days with a credit decision 1-2 days after the loan is submitted. Once accepted, we budget a 60-day closing period. Live Oak has the capability to close loans prior to the 60-day mark, but it is commonly seen that buyers and sellers take 60 days to submit all required information to close the loan.

2. I would like to stay on as an employee. Is this an option?

- If a seller wishes to stay on staff after the sale is complete, they may do so only if their salary can still be supported by the business cash flow. The seller must also recognize that they may not hold a title that reflects control of the business, such as "Manager," or have major business decision rights. This rule is in place so that the new owner can run business operations without feeling restricted.

3. I don't want a bank looking at my financials until I know the buyer can be approved for the loan:

- Live Oak Bank uses historical cash flow to make loan decisions. This ensures that the new buyer steps into a healthy business and is able to make the debt payments and pay themselves a sufficient salary. In order to start the process, the bank needs to look at the historical financials and model a budget based on the purchase price to assess the condition of the cash flow. Live Oak ensures that all information is kept confidential.

4. My cash flow doesn't look great, but that is because I run many personal expenses through the business.

- Live Oak understands that many funeral home owners weave personal expenses into their business financials. The bank may be able to add back those items in the cash flow analysis that will discontinue once there is a new owner. Here are some common items that can be added back:
  i. A salary for a family member/in-law that will not continue moving forward
  ii. One-time expenses, such as a new roof or new parking lot
  iii. Additional staffing/expense changes that will occur that are easily defendable
  iv. Personal debt that is expensed through business – travel and entertainment, car leases, life insurance

Let common sense be your guide. Added-back expenses should easily be justified as discontinued once the new buyer begins operation.

5. I plan on holding a seller note that will not be used for equity injection purposes. Since I can begin receiving payments after the closing date, how am I protected if the buyer begins to default on my loan?

- The bank must be in a first lien position on the business, which means you would file a secondary lien for your note. This stresses the importance of your having high confidence in your buyer to succeed with the business, as well as confidence that you have set the appropriate asking price.

6. Can my pre-need be included in the valuation of my business?

- While pre-need is a great indicator of the future success of a business, most financial institutions will value the business via a historical cash flow approach (past three years), as mentioned above. The approval and valuation will be primarily based on the business's ability to service the proposed debt to support your desired purchase price.

CONCLUSION

Live Oak Bank is dedicated to preparing you for a seamless succession. We speak your language and are ready to assist at any time. Please let us know how we can help you prepare for your succession.

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