How to Pay For Your Next Improvement Project

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Project Financing . . .

Creating a WIN–WIN–WIN Relationship

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The method in which a capital project is funded often determines its financial success.

While not every project undertaken by a cemetery can be financially justified in terms of profitability or cost savings, the reality is few cemeteries can afford to initiate many projects having a negative financial impact. Even non-profit cemeteries need to place heavy emphasis on return-on-investment in prioritizing capital projects.

Later in this article we will discuss various methods that can be used to pay for a project. In its simplest sense however, there are only two ways to pay—with cemetery money or someone elses. While either method may be wrong or right for a given situation, each does have a different real cost associated with it.

For example, lets assume a cemetery has decided it wants to build a mausoleum that will cost $800,000. The cemetery is fortunate to have accumulated $2,000,000 in a general savings account and the cemetery has an active preneed sales staff. The question facing the Board of Directors is, does it build the project and pay construction expenditures from its savings or does it sell the structure on a preconstruction basis and fund construction from cash flow which results from sales?

The positives of paying for the building from accumulated savings are:

- Cemeteries enter construction contract at today's cost for a fixed amount
- Improved negotiating strength with contractors
- Need to make temporary entombments is eliminated
- Construction activity is usually seen as a positive event by public

From a negative standpoint, using savings to build the mausoleum are:

- Financing cost is relatively high. If the $800,000 was invested at say, 6.5% return, this method of funding will *cost the cemetery $55,250 per year* in lost interest earnings. This is what is known as the "opportunity" cost of capital and is the single largest hidden project cost most cemeteries ignore in preparing their financial evaluation of the project.
- Generally, projects sold on a preconstruction basis generate more excitement than projects sold after they are built. Admittedly, some people reading this statement will disagree; 23 years of preconstruction selling has taught me that the public enthusiastically supports these projects for two reasons. First, they benefit from preconstruction discounts and second, like many other events, anticipation can be greater than realization.
- I have also found preconstruction sales programs tend to develop a "cause" or "goal" that can bind a sales team. In fact, it is common to experience a dramatic downturn in sales *after* construction is completed. Sales people see that the goal has been realized and begin to look for a new "hill to climb."

A financing plan that combines the use of a preconstruction sales effort and some savings is generally best. The preconstruction program can be used to pay the cost of the project while savings can be used to pay up-front expenses needed to start sales and to negotiate favorable prices from suppliers who require extended lead times to produce the particular item needed for your project.

Before going on, lets discuss what items you should consider paying in advance and which you should pay when its supplied. Certain "services" are required before preconstruction sales can begin. They include the cost of surveying the site, soil borings of the area, an architect to design the project, and a rendering or two of the project so the sales department has something to sell from.

The next type of expense to pay in advance of receiving the product or service is for items that require an extended period of time to produce, thus requiring the manufacturer to have a large investment. Examples include marble and granite fabrication; precast concrete; and art work. Often, the owner can negotiate favorable prices and lock in costs early in the project by working with these select suppliers and making enough of a payment to cover the suppliers costs but not so much as to pay for his profit.

Costly mistakes are made when you prepay for materials, labor and

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services that will be delivered at a future date and that are readily available when needed. Owners often take comfort in "locking in" the future cost of an entire project by entering contracts with developers that require large lump sum down payments or monthly payments. On the positive side, this type of relationship can take some of the risk and uncertainty out of the project for the owner—but it has a cost. First, the "opportunity" cost of capital discussed early, now becomes a real project cost. Furthermore, early commitment does not allow the owner to competitively bid the project when it comes time to build.

Equipped with this knowledge, we are now ready to structure our approach to our next major project. Our primary objectives are:

- Minimize initial cash investment
- When possible, avoid using available cash
- Maintain flexibility with contractors
- Define the cost parameters of the project before starting
- Design a project that motivates the sales team

Our first step is to design the project. If we plan to eventually bid the project among several contractors and material suppliers and then we will want the contractors to be bidding based on the same design and specifications; we need to retain an architect. Architectural work should be limited to concept design, material specifications and a preliminary cost study. Working drawings, which account for a significant share of an architects overall fee, can be completed at a later date, just prior to the start of building.

Preconstruction sales can be started after the design and costs are accepted. Funds received from sales should be allocated to pay for sales and marketing expenses, perpetual care allocations, construction savings and if included in the sale price, for the memorial or inscription. Often state law determines the amount and timing of how each of these accounts are funded. A general rule calls for around 30% to go to sales expense, 15% to care, 50% to construction, 5% to memorialization. Two additional sources of income must be factored in; the interest that is generated from the savings accounts and from financing the installment sales.

Our objective is to accumulate enough money from preconstruction sales activity to pay for the project. Eventually when this goal is achieved, we can redirect our funds into savings, which represents our profit on the project.

I have found that there is an appropriate time in the life of most projects to initiate certain actions. This life span is driven by sales as represented in this time line:

	Percent of Project Inventory Sold	
Step 1	0%	Preparation Work and Initial Design
Step 2	0%	Begin Preconstruction Sales
Step 3	50%	Prepare Working Drawings
Step 4	60%	Bid Project
Step 5	65%	Begin Construction—Reduce Preconstruction Discount
Step 6	80%	Discontinue Preconstruction Sales and go to next Project—Raise prices by eliminating the preconstruction discount

You will note that the last 20% of inventory in a project is sold at the fully developed price. This inventory usually sells to at-need or walk-in clients.

By selling 65% of the project before we start construction, we either have or will soon achieve a breakeven financial point on the project. This does not however, guarantee that our project will never experience a negative cash position. This event occurs when construction expenditures exceed our cash inflow and is the result of our cemetery offering extended financing terms to our clients.

To enable many families the ability to afford mausoleum crypt, or lawn crypt or even a complete ground package, we have no choice but to offer terms of financing. Certain program parameters should be in place to protect the cemetery's interests. For example, limit the maximum period of time an account may be financed by the amount being financed. Require a minimum down payment to qualify for Family Security Plan benefits. Graduate the interest rates by the term of financing—the longer the term, the higher the rate. Offer to rebate a portion of the interest charged for early account payoff. Provide a bonus to your sales counselors who generate cash sales.

Now, lets deal with the negative cash flow experienced on our project. We know that we have sold enough product to pay for the project; our problem is that our money is tied up in accounts receivable. One option is to "factor" our accounts receivable to a financial institution; this simply means we sell our accounts, and future income stream, to a bank or similar institution in return for payment of all or a portion of the principal amount due on the account. This type of financing can be expensive and the cemetery gives up the direct relationship it

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had with its client.

A second, and preferred option is to pledge your accounts receivable for a short term conventional loan. Now you borrow only what you need to cover construction expenses; you borrow when you need to cover the costs and you can repay the loan early if your receivables pay off sooner than expected or sales increase faster.

This brief introduction to project financing is intended to show cemeteries how they can maximize their return on investment while at the same time, enabling their customers the benefits associated with making cemetery arrangements before the time of need and prior to construction completion. We have also discussed how you can work with contractors and suppliers on a basis that is fair to all parties but does not obligate you or commit resources too early in the life of the project. In summary, we have created a **WIN–WIN–WIN** relationship. ■

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