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Musings

#34: It is all about Cash
<u>April 25, 2020</u>

In case we needed a pandemic to remind us, running a business is all about cash. Like the old Greek restauranteur in Tarpon Springs, Florida once told me, "I put the cash coming in my pocket and pay my expenses out of it and hope there is some leftover." Unfortunately, GAAP accounting rules and professional investor valuation approaches can lead one to lose sight of cash. Stay focused on it.

I understand the logic behind GAAP and the need to match revenue and expenses, and to capitalize items to spread the expense against the future revenues. That said, it can obscure the true cash dynamic of a business by putting things on the balance sheet as accruals or capitalized expenses. Those less ethical can prop up their income statement by how aggressive they are with these accounting methods. This is why you always need the three statements (income statement, cash flow statement and balance sheet) when looking at a business and can't just accept an income statement. You also should start any diligence with the balance sheet.

The same basic businesses can have different cash needs. This is an underappreciated dynamic. Most businesses in today's services world have labor as their largest expense and run payroll every couple of weeks. You don't build up accounts payable (AP) for payroll, it is basically pay as you go. Rent is basically the same thing as well. So the only way to manage cash outflows is the percentage of the business expenses related to outside vendors. While it is possible to stretch your payables to improve cash, you don't want to screw your partners (not vendors).

The way to improve the cash dynamic of your business is by the payment terms of your revenue. Obviously, the best option is to get paid in advance and have a negative working capital business. Basically, the customers are financing the business and you take the cash up front (for the quarter or year) and credit deferred revenue. The growth rate of this deferred revenue becomes a key metric on what is happening. Too many businesses just don't try to require payment up front and instead go for the 30 or 45 days after the invoice is sent! Obviously, a less aggressive option is to get paid part up front and part later. This option more likely matches your cash inflow with outflow as you pay your employees and rent. In all cases, you need to have a good, tight collections process so you don't let money owed to you build up in accounts receivable.

An entrepreneur friend of mine launched a business with "pay up front" dynamics and he never had to raise money! You get pretty good returns when you own 100%.

The GAAP rules on capitalization are a real Siren. You spend a lot of cash on something now, but don't run it through the P&L because it is capitalized as the value of the activity is deemed to be realized in the future. Capitalization is thus a way to park expenses on the balance sheet and make the business look more profitable than it really is. I was taught to minimize any capitalization so you can really see what is going on. Even if the auditors make you capitalize, do it as an end of year audit entry so the audit is compliant but your monthly and quarter income reports are burdened by the expense.

Adjusted EBITDA is another dangerous one. Technically, ebitda (earnings before interest, taxes, depreciation and amortization) was created to be a short proxy for the cash flow of a business. Private businesses are generally value on a multiple of ebitda which might not properly account for what is happening on the balance sheet with working capital and capitalization. Even worse, the standard model is now “adjusted ebitda” where various items are added back and not included in the expenses. The logic is that certain items what are unique to this owner and not to a potential buyer, but it has become a way for some to put anything nonrecurring “below the line.” Don’t fall prey to that. Businesses have non-recurring items all of the time, it is part of business.

Watch your capital budget. Capex often doesn’t get the same level of scrutiny as operating expenses but it is still cash going out the door.

I encourage you to build your management incentive plans around good old cash flow in addition to ebit. Get the team focused on the balance sheet and minimizing any cash needed for working capital and making the business the most efficient generator of cash it can be.

Be safe.

Jml

Second Thought

In Musing #6 *The New Order for Consumers*, I wrote about how consumers were shutting down and locking up due to Covid 19. The University of Michigan is known for its reporting on consumer sentiment and yesterday released results. The decline in sentiment from March to April was the largest ever. This comes just after the most positive sentiment was ever recorded in February. One silver lining is that sentiment appears to be stabilizing. CNBC coverage here