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Musings

#106: Musing
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Merry Christmas to those celebrating.

Good quote I heard (sorry don't remember who) – "You can't control your circumstances but you can control your response." For example, very critical to conduct yourself appropriately when leaving an organization. Goodwill built over years of work will be lost if you behave badly as you walk out the door. Ask how you can be helpful in transition. Thank the organization for the opportunity etc. See our current President for how not to act when departing.

I have previously written about the dangers of a leveraged balance sheet. Servicing debt didn't seem so difficult and then things like the pandemic hit and shareholders are getting wiped out. However, you also can overcapitalize a business. Personally, I think this was part of the WeWork problem. They raised so much money it never had to be disciplined about its cost structure. You can be too good at raising money and develop bad business habits. This also happens in higher education. Schools with large endowments often lose fiscal and operating discipline like a spoiled trust fund kid.

Great salespeople create demand. Good salespeople know how to position a product/service when you have an active buyer but great salespeople turn someone into a buyer.

You also can drive revenue by ensuring that your organization is "easy to deal with." Be responsive. Make sure your contract is not overly burdensome. Eliminate obstacles to buying or partnering with you. I recently have had some experience getting an app loaded up into Google/Android and the Apple app store. Night and day with Google easy to deal with and Apple very difficult.

Remember that Ebitda (earnings before interest, taxes, depreciation and amortization) is not cash flow. Private companies generally trade on enterprise value as a multiple of Ebitda. Ebitda is used so the capital structure is ignored (no interest) and non-cash expense (no depreciation/amortization). Enterprise value minus net debt is your equity value. But remember that Ebitda, and especially adjusted ebitda, is not cash. A business should be valued based on the cash it generates. So start your diligence with the balance sheet and cash flow statement. Check for capitalized expenses on the balance sheet. Figure out the working capital dynamics around accounts receivable/accounts payable. Use the cash flow statement to see actual cash generated by operations (often much less than ebitda) and see how much capex is needed. Too many operators don't focus enough on payment terms and cash flow. Get paid upfront if at all possible.

For those in recurring revenue software businesses (which are all of the current rage), focus on the "Rule of 40." Invented by Brad Feld, it speaks to the tension between revenue growth rate and sales & marketing expenses. You add your revenue growth rate and the your operating margin to calculate the

Rule of 40. So, if you are growing 50% per year, investors don't mind if you lose 10% in operating income so you are at 40. If you are only growing 20%, you should be making 20% operating income. However, it is key that the expense investment be around sales & marketing which will generate revenue and not around overhead expenses.

I am a big fan of using trailing averages if you have a metric that bounces around with volatility. For example, many stock investors focus on the 365 day moving average of a stock as the stock prices moves around day to day. Personally, I think the Covid metrics should be discussed on a three month trailing average and looking at that over time. Daily metrics not particularly insightful.

Stock market looks pretty pricey with stocks trading at a forward price / earnings (pe) multiple of 22x compared to historical norms of 15-16x. However, when compared to what your money can earn in other asset classes like debt, maybe not overbought? has-the-fed-rewritten-the-laws-of-investing

Lots of discussion on Tesla joining the S&P 500 but not enough on why it was delayed. Tesla is the largest company ever to be added (usually companies get added when they are much smaller) and was delayed in joining because it didn't have the profitability required. Even when it made an annual profit, it didn't get added because so much of the profit was from selling government credits. In the second quarter of this year Tesla made $428 million from sales of these credits. From CNBC: *"Here's one way Tesla racked up these credits over the past year…: selling them to other auto makers who want to avoid big fines. In California, and at least 13 other states, any auto manufacturer who wants to sell their cars into that state must sell a certain amount of electric, hybrid electric or other zero emission vehicles (or ZEVs). Auto makers who are not selling these vehicles yet, or not selling many of them anyway, will buy credits from someone who is for compliance. Since Tesla only sells ZEVs, it doesn't need to keep the credits that it earns and can sell them before they expire."*

Encourage all of you to lock your credit with the credit bureaus. Identity theft is booming. Lots of fraud with unemployment. Best to just go to the bureaus and freeze your credit so no one can do anything in your name.

While Amazon is in antitrust trouble, you have to admire how the business has kept its sense of urgency as it scaled to be a gigantic company. From WSJ, *"built Amazon.com Inc. from his garage with an underdog's ambition to take on the establishment. He imbued staff with an obsession to grow fast by grabbing customers using the biggest selection and lowest prices…..That ethos helps keep Amazon booming. Aggressive competition—including wresting market share from rivals—is often a hallmark of a successful business…..[Bezos] still exhorts employees to consider Amazon a startup. "It is always day one," he likes to say. Day two is "stasis, followed by irrelevance, followed by excruciating, painful decline, followed by death." Mr. Bezos originally considered calling his company Relentless, and www.relentless.com still redirects to Amazon's site."* There is a reason he is the richest man in the world.

Keep pushing through the holidays. Many companies "take these two weeks off" and you can get a step on your competition by making sure the organization is still working.

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