THOUGHTS OF THE SALMON™

"What is your forecast for the year?
..I think 21 machines ...
...I meant sales forecast, it's one month down the road....
..Oh, so fast I don't know...I have to get some notes in my office..."
CEO, automated transfer lines company, November 2009

EBITDA collateral damages

The effort of the last few decades to make people understand the importance of moving from thinking of volumes (pieces, liters, number of machines or whatever) to value (money) has been a major one. Then, as soon as it was finished, we all understood that it was not enough: you need to look down the p/l to profit (EBIT or EBITDA). Regardless of which of the two is better, the efforts have been positive, as is the effort to stress the importance of cash as well.

But, there is a but....Today there are too many people in companies who have become "artists" of the math behind EBITDA, losing contact with business fundamentals.

Profitability is revenues minus costs, and if I stop before interest, taxes and depreciation/amortization I get EBITDA: it gives an indication of my capability to be profitable regardless of how I finance my activity. EBITDA is money, if divided by revenues it is a percentage (EBITDA margin).

Now the issues:

- Since EBITDA is revenues minus costs, if revenues go down, I quickly understand that I have to also act on costs. ALSO on costs, not only on costs. Unfortunately understanding how to stop revenues from falling, or increasing growth is much more difficult than cutting costs: I have to look at the market, at my competitors, at my products, I have to go into my stores….Cutting costs is necessary, but not sufficient.
- The EBITDA margin is a percentage: EBITDA divided by revenues. So, even if EBITDA in absolute value is decreased, I could be in a situation where the EBITDA margin is constant or even higher…after a while many become artists of the math behind these indicators…
- If the company is listed, many people after reading reams of "analyst reports," so fine in their polished English, start thinking that all those percentages are as important as absolute values…Unfortunately into bank accounts we deposit cash, not percentages.
- Dulcis in fundo: of course, managers, shareholders, the owner, the capital market, blah, blah, more and more often talk of "value", and sooner or later the concept of multiples will pop up (maybe just in those nice analyst reports): the company value as a multiple of EBITDA. And here it can be very dangerous: I start thinking (and maybe someone even states it) that my company multiple is high because the EBITDA margin is high…unfortunately it is not like that. Even accepting using multiples to value a company (and maybe we could find a young intern to discourage us from doing so…), a high multiple should be linked to a high growth rate of EBITDA, not to a high percentage of today's EBITDA margin.

If a company makes good products, better than those of its competitors, at a lower cost, it is fine. If we spend too much time on the math to keep the EBITDA margin constant, sooner or later we get hurt.

Let's not all try to be little CFOs.

Giovanni Carlino
(2011)

CARLINO & ASSOCIATI