More than 50 years of investing has produced a rich archive of research and investment thinking. While much of it remains proprietary, our Quarterly Commentary articles, which have been shared with clients since 2000, are available via the Literature library on our website. From time to time, we will share a piece from the archive to explore how our thinking has evolved. Below is Simon Marais' 2001 article on Sun International – best read alongside Pieter Koornhof's current analysis in our Q3 2026 Quarterly Commentary. You can access the full Q3 2001 Quarterly Commentary on our website.

Quarterly Commentary

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Q3



Seeing through the smoke and mirrors

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"The most room for earnings manipulation is where a company is involved in mergers or acquisitions."

Companies that manage to grow their earnings faster than inflation over long periods are invariably good long-term investments. Yet no company can do this consistently. In fact, all companies in South Africa have encountered at least one period during the last 20 years in which their earnings were under pressure. The major challenge for us as managers of your money is to try and find those companies that will show real earnings growth over long periods of time and whose shares are reasonably priced. At the same time it is equally important to avoid paying high prices for shares in companies which appear to offer strong earnings growth, but where a careful analysis will indicate that the growth is unsustainable.

To ascertain whether a company's growth is due to long-term business fundamentals or to factors that may be of a temporary nature, is far from easy. In many cases the stock market, with its hundreds of highly educated analysts, will not be aware of the lack of real growth in a company until it is too late. A typical example is the growth through the issue of highly priced shares (e.g. Dimension Data) that we highlighted in our March 2000 quarterly.

Why would the growth of a company not be sustainable, especially if the company has a record of five or more years of spectacular growth? The main reason is that the growth reported by the company may not be a fair reflection of the true increase in the earnings of the company's operations. Accountants have significant latitude when it comes to reporting a company's earnings. While the earnings numbers may be narrowly defined in a simple operating company, the scope for reporting different numbers increases dramatically with an increase in the complexity of a company's structure.

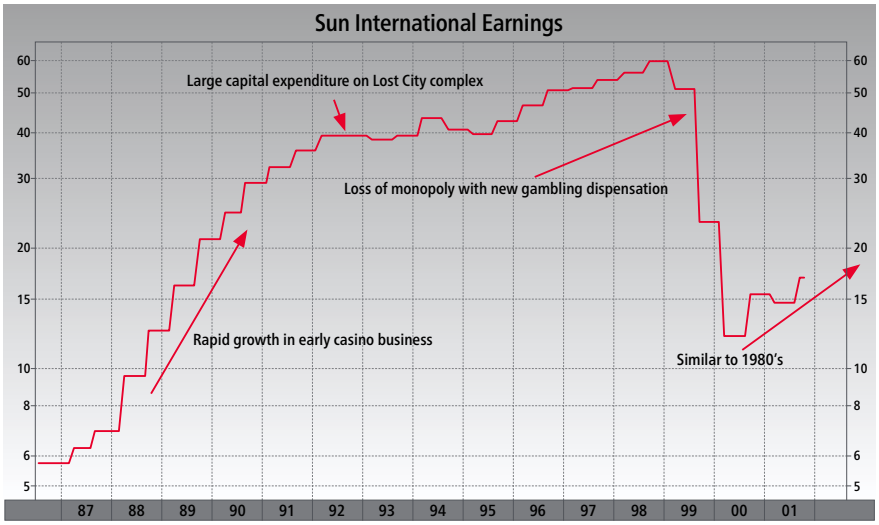
The most room for earnings manipulation is where a company is involved in mergers or acquisitions. For example, assume Company A acquires Company B and merges their operations. The details of both companies are listed below:

	A	B	New A
Net Assets	100	100	200
Earnings	10	10	20

Not much complication here. But this is before potential 'enhancement' by A's corporate accountants. For example, it can be decided that certain of Company B's stock is obsolete and must be written down to a more 'realistic' level - say by R10. In addition, it may be deemed prudent to create a reserve against potential bad debts in B (another R10 provision). Further provisions amounting to R30 for costs associated with the merger can also be motivated.

The statement of New A's accounts after the merger would now read:

Net Assets (With total provisions of R50)	150
Earnings	20



Source: Inet

Still nothing that appears alarming. If anything, the second set of accounts appear more conservative. But the same is not true for future earnings.

Assume that the merger is not as successful as originally planned and New A shows no earnings growth for the next two years, i.e. earnings stay at R20. However, during the first year, the company may sell half the stock that it wrote down as obsolete. This will add R5 to profits (half the R10 by which the value of the stock was decreased during the merger).

New A will thus unveil earnings of R25 - an increase of 25% over the previous year's result. In year two the company may find that the bad debts actually pay their accounts adding R10 to profits giving total earnings of R30 or growth of 20%. At this stage management can confidently state that the merger has been a huge success and that the outlook is excellent since they have R35 of their reserves still intact to help bolster future earnings - despite the true economic picture being one of stagnation and unexciting prospects.

Given the complexity of modern business, it is very difficult to determine whether the numbers published after a merger are real. Therefore at Allan Gray, we are extra careful about investing in companies that make constant acquisitions. While a well-timed acquisition can certainly add value, the quality of the results of a company with frequent acquisitions is much more difficult to ascertain than a single operating entity with easily comparable results.

Accounting conventions can sometimes also understate the true value of a company and thus offer attractive investment opportunities. This is most clearly illustrated in the case of SISA (Sun International South Africa), one of our clients' major investments. Their effective exposure to SISA is further enhanced by the fact that it accounts for a large portion of the value of Kersaf, another of our clients' major investments.

SISA has two major businesses: A resorts and hotel division that includes Sun City and the Table Bay Hotel in Cape Town, as well as a number of casinos. SISA was awarded licences in Gauteng, Cape Town, Durban, Port Elizabeth, Kimberley, Bloemfontein and Pietersburg, and have either recently completed their casinos or are in the process of constructing them. In a new casino business, accounting rules may hide the value of the company. The following table sets out the major operating statistics for a new casino as reported in the company's income statement. The terms are explained below the headings.

Gross Turnover	100

The total amount of money that the casino makes from its customers. For illustration purposes this number was taken to be R100.

Net Turnover	73

The casino has to pay VAT and various other levies amounting to about 27 cents in the Rand leaving it with R73.

Operating Costs	(40)

The cash costs incurred by the casino such as staff costs, electricity, security, etc. Accountants put expenses in brackets to indicate that they are negative numbers.

EBITDA	33

An acronym to ensure most people do not understand accounts! This is the earnings before interest, tax and depreciation. Another interpretation is the cash flow out of a business before the banks and receiver have been paid (a very temporary phenomenon) and before the business has made provision for maintaining its operations.

Interest	(12)

All SISA's casinos were built with about 60% debt. The typical interest charge on this debt is 12% of gross sales.

Depreciation	(12)

On the casino building and equipment.

Net Profit	9

This would be the earnings reported by SISA. For simplicity, tax has been ignored.

Note that most of the costs are fairly fixed. A small decline in gross revenue by R1 to R99 would reduce net profit by almost R1 or 10%. This explains the recent disappointing earnings results of SISA (they reported earnings per share of 17 cents versus expectations of 18 cents), because in some operations the revenue was a little below expectation.

The value of SISA lies in the fact that the current reported net profit is a poor reflection of the true underlying earnings power of the company. Since the assets are all brand new, very little money has to be spent on maintenance for a number of years. The free cash flow that management can use to repay debt is thus R21 instead of the reported R9 earnings.

With the strong cash flow, it is easy to work out that SISA can repay the debt on its casinos in four years. If we assume that the casino business grows at 8% p.a. for the next four years, this will yield revenue 36% higher than current levels. Assume the same growth in casino costs. The income

statement by 2005 will now look something like this:

Gross Revenue	**136**

Our assumption of 36% growth.

Net Revenue	**99**

Charges of 27% as above.

Costs	**(54)**

36% increase in costs.

EBITDA	**45**
Interest	**0**

SISA has repaid all debt.

Depreciation	**(12)**

This number remains fixed.

Net Profit	**33**

The net profit of SISA's casino operations is thus expected to increase from R9 to R33 or 38% p.a. even though we only assumed 8% growth (in line with costs which are likely to equal inflation) in the casino revenue. This is due to the high cash flow used to repay debt and the large fixed depreciation charge. SISA's total earnings will grow somewhat slower, since the resorts business will grow more in line with revenue. However, total earnings growth should still average 20% p.a. or more. This was the case in the 1980's as shown in the graph.

The share price of both SISA and Kersaf has fallen significantly after the 11 September attacks since there is an expectation of reduced tourism which could therefore impact on earnings. SISA is trading at about 10 times earnings at the moment. This may not look particularly cheap on the surface, but a closer analysis as simplified above, indicates that these earnings will show significant increases over the medium-term despite some shortterm weakness in the aftermath of the attacks. For a history and our expectations of earnings, see the graph. We believe it offers far better value than many other companies with better histories, but where current earnings' levels may be difficult to sustain beyond the immediate future.