Cash will always be king

Accounting profits vs cash

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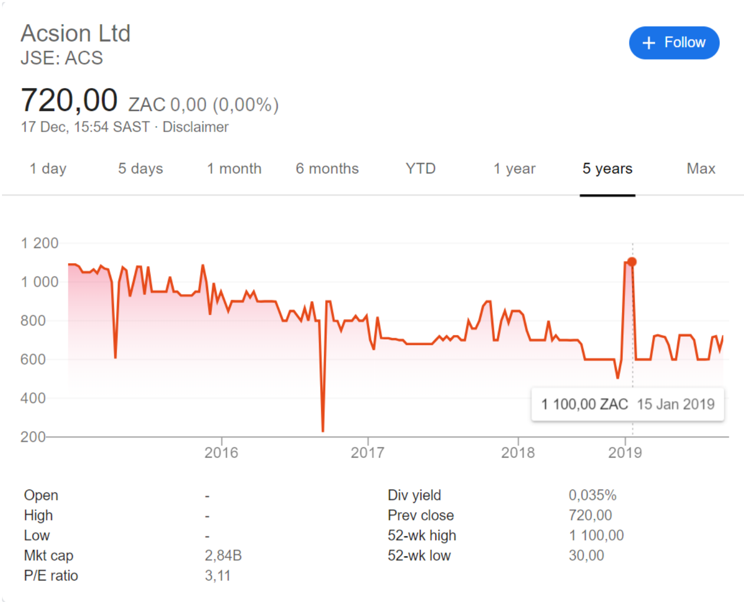

Acsion (ACS) is a listed property developer and landlord.

As at 19 December 2019:

The company has a market cap of R2.84 billion versus recent profits of R935 million for the financial year ended 28 February 2019 *(2018: 823 million)*, giving a PE ratio of 3.11;

Using the 2019 profits, the company is generating a return of 30% on its market cap of R2.8 billion.

It looked cheap.

Excited and wanting to dig in and find out more about the company:

I shared this with my mentor.

"Look closer" he said

To look closer I did and boy was I disappointed.

ACS builds properties such as *Mall@55* and then leases them out.

Under accounting rules this qualifies them as Investment property (IAS40).

A company must record its investment properties in its books as follows:

- Initially at cost.
- The company must then estimate annually what its investment properties are worth and
- Update its recorded amount to the estimated fair value of its investment properties.
- The adjusting amount is treated as an income or expense depending on whether the recorded amount of the property is increasing or decreasing respectively.

Illustrative example:

Say ACS builds a mall in Mankweng at a cost of R200 million.

At the end of its financial year it estimates that the mall is worth R220 million.

The R20 million fair value adjustment is treated as income in the income statement.

The property is reported at the amount of R220 million on its balance sheet.

The problem with fair value adjustments is that

- **There is no movement of cash,**
- **Its open to management abuse,**
- **Sudden macro-environment factors such as a "Brexit" can send property prices tumbling and make landlords financial statements look bad.**

Absolute bonkers!

For the 2019 financial year ACS had fair value adjustments of R837 million (2018: R744 million).

Therefore if we were to exclude the fair adjustments, the profit of ACS would be somewhere around R331 million, leaving the company trading at an earnings multiple of 8.6 times and enough to leave me less enthusiastic.

Table: Removal of fair value adjustments from Profit

	R'000 2019	**R'000** 2018
Profit	935 176	823 617
Adjustments		
Fair value adjustments	-837 877	-744 785
Tax effects@28%	234 606	208 540
Adjusted Profit	**331 905**	**287 372**

In my opinion:

Fair value adjustments are hot air and inflating of asset values and must be looked at cautiously.