

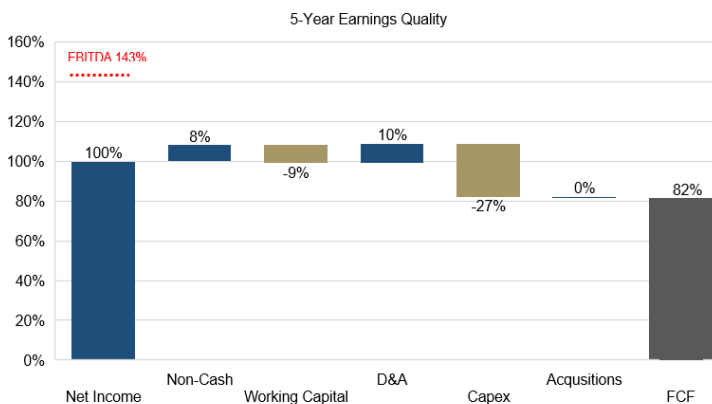
## CHART FOCUS: Not all Earnings are Equal

When investing in a company, it's important to remember that you aren't only buying a stock – you're ultimately buying that company's future earnings stream. In turn, how much of that company's reported earnings (Net Income) is converted to cash, determines what can be reinvested to fuel growth. This is what we call free cash flow conversion – which is a measure of earnings quality. This quarter, we compare Mr. Price with Foschini, to highlight which has higher-quality earnings, and is therefore better equipped to grow returns and compound investor wealth.

For any investor, it's important to understand how much a company earns in their day-to-day operations. However, it is equally important to understand how much of that reported earnings is collected as cash in the bank – or Free Cash Flow (FCF). This is the cash available to either reinvest in the business (growth) or distribute to shareholders (dividends / share buybacks). In calculating FCF, investors will better grasp how companies allocate spending to both Working Capital (the cost of running the business) and Capital Expenditures (investment in new projects and maintenance). This assists investors in understanding if a company is performing in-line, better, or worse than its historical trend.

Figure 1 shows the breakdown of Mr. Price's Net Income, and the charges and additions required to arrive at FCF. For every Rand of reported earnings, Mr Price has generated an average of 82c over the past 5 years.

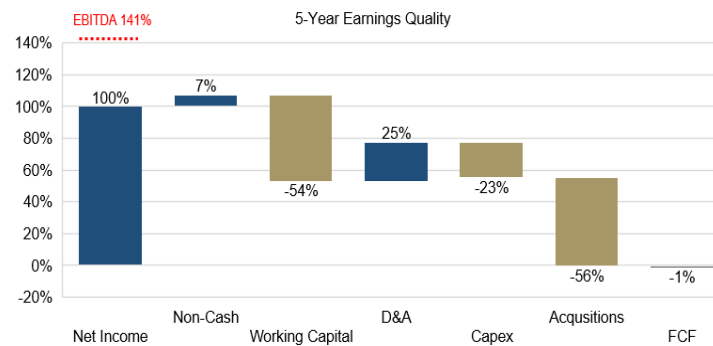
Figure 1: Mr. Price's Free Cash Flow Break-Down



Source: BlueAlpha Research, Bloomberg

In comparison, Figure 2 shows the same breakdown for Foschini. Over the same period, for every Rand reported, Foschini has generated zero FCF. This is largely due to two aspects – sizeable acquisition costs, and a bigger Working Capital charge.

Figure 2: Foschini's Free Cash Flow Break-Down



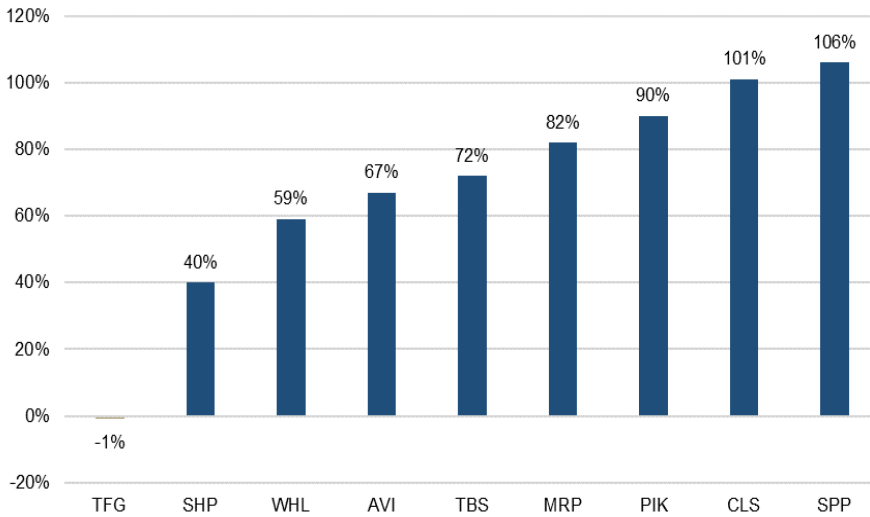
Source: BlueAlpha Research, Bloomberg

Cash flow conversion is a measure of earnings quality. In this case, Mr. Price's earnings quality is higher than that of Foschini's. This is not to say that Foschini is a bad business. It simply highlights that between the two, Mr. Price is better positioned to fund growth, walk through difficult trading environments, or pay dividends from internally generated funds – in other words, they wouldn't have to issue stock or take on additional debt to finance new store openings or pay a dividend.

When comparing companies' earnings quality, understanding the nature of an industry is also important. For example, the mining industry typically has FCF conversion rates in the region of 40%. For retailers, this is higher, as their Working and Fixed Capital requirements are typically lower. Figure 3 shows a ranking of retailing peers' FCF conversion, with Foschini and Shoprite at lower conversion rates, and Clicks and Spar with the highest.

## CHART FOCUS: Not all Earnings are Equal Cont.

Figure 3: Free Cash Flow Conversion - Peers Ranking



Source: BlueAlpha Research, Bloomberg

A company's ability to convert its earnings into cash flow is an important consideration when determining its future growth potential. However, FCF conversion doesn't give investors any hard-and-fast rules on whether a company is a good business or not. It simply allows you to assess the trend of how a company allocates its capital and in turn, what they have left to either fuel growth or return capital to shareholders. In this case, Mr. Price proves to have higher earnings quality than Foschini, leaving it better positioned to grow their business and compound investor returns.