Australian Shareholders' Association

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FY19: The year when Wesfarmers cut out Coles and got their groove back?

Company/ASX Code	Wesfarmers Limited/WES
AGM date	14 November 2019
Time and location	Perth Convention and Entertainment Centre, Mounts Bay Road, Perth
Registry	Computershare
Webcast	Yes
Poll or show of hands	Poll on all items
Monitor	John Campbell assisted by Ian Berry
Pre AGM Meeting?	Yes with Chair Michael Chaney

Item 1	**Consideration of accounts and reports**
ASA Vote	No vote required

Summary of ASA Position

FY19 (financial year 2019) was a good year for shareholders. The successful demerger of Coles and divestment of Kmart Tyre & Auto, as well as profits from the sale of interests in Bengalla and Quadrant energy gave WES an added net statutory profit of $3.2 billion in significant items. This enabled the Company to declare a Net Profit After Tax (NPAT) of $5.5bn (FY19 NPAT excluding significant items was $1.9bn, up from FY18's $1.2bn). The company declared $2.78 in interim, special and final dividends (FY18 $2.23), 12.2% total shareholder return (TSR) (FY18 28.6%), and the opportunity to realise $13 per share or so on the demerger of Coles Ltd. WES shareholders received one Coles share for each WES share held as a result of the demerger. The initial VWAP (volume weighted average price) of Coles shares after listing was approx $12.85 whereas their value at the time of writing is close to $15 per share. Over the same period, WES shares post-demerger have increased from approx $31.60 to over $40.00 at the time of writing. Given WES is a smaller group after the disposal of Coles and coal mines, your monitor was hoping for a shorter annual report – but no such luck – 172 pages vs 156 in FY18! Climate-change reporting, changes in accounting standards, expanded remuneration report, and notes about discontinued businesses are mainly responsible but the annual report is also well presented and relatively easily understood.

<u>Governance and culture</u>

With three retirements and two new appointments, the board of 10 will comprise 9 non-executive, independent directors and the managing director if AGM resolutions are passed. Four directors will be women (40%) and board members have a wide range of background expertise and experience. Corporate culture reads well and the only minor hiccup in this regard has been the recent revelation of two payroll processing issues one at Bunnings and another at WES Industrial and Safety division, resulting in under-payment of superannuation contributions. They

would be quite immaterial to results, but are of concern due to damage to reputation and they raise questions about adequacy of internal audit. Defining corporate culture is a matter of finding the weakest link in the chain.

Financial performance

As mentioned in the opening paragraph, shareholders have benefitted from the achievements in demerging Coles and selling other assets. The breakdown of significant items is shown on page 6:

	FY19 $m	FY18 $m
Earnings after tax from continuing operations	1,940	1,709
Earnings after tax from discontinued businesses (ex significant items)		
Coles	321	1,037
Bunnings UK & Ireland	-	- 259
Bengalla and Curragh coal mines	65	246
Kmart Tyre & Auto	9	25
Quadrant Energy	4	14
Significant items after tax		
Coles demerger gain	2,264	
Bengalla coal mine sale	645	
K-Mart Tyre & Auto sale	244	
Quadrant Energy sale	120	
Coles Supply Chain provision	- 102	
Bunnings UK & Ireland write-downs and closure provisions		- 1,023
Bunnings UK & Ireland loss on sale		- 375
Target impairments		- 300
Curragh coal mine sale		123
NPAT	5,510	1,197

After the demerger of Coles and the sale of the two coal mines, there are just 5 separately disclosed segments with two of those, Chemicals Energy & Fertilisers (CEF) and Industrial and Safety grouped together as Industrials and the other three, Bunnings, Kmart/Target and Officeworks grouped as Retail.

Of the retail segments, Bunnings is the dominant earner generating over $13 billion in sales revenue (up 5% from FY18), $1,626m (FY18 – 1,504m) in earnings before interest and tax (EBIT) at a similar margin to 2018 and yielding a return on capital of 50.5% (FY18 49.4%). Continued growth expected in FY20.

Kmart and Target had a disappointing trading year, with reduced margins on static sales (up 1.1%), The department stores earned $540m EBIT (FY18 $626m) at a return on capital of 29.4% after substantial write-downs of asset values in 2018 and prior. Despite a disappointing year, management believes that the Kmart Group remains well positioned, with sales momentum improving following resolution of stock availability issues before year-end. Officeworks continues to operate on an EBIT margin of about 7% and a slowly improving return on capital of 17%, with revenue of $2,314m up 8% on FY18 and EBIT of $167m (FY18 $156m).

The industrial segments had a mixed year. CEF achieved a 13.6% increase in revenue to $2,078m, earning EBIT of $433m (FY18 $379m), at the same EBIT margin as last year, and at a return on

capital of 32.6%. It is benefiting from the resurgence in mining activities, particularly iron ore (explosives) and gold (both cyanide and explosives). Financial performance will be impacted when a competitor gets a new explosives plant in the Pilbara operating at full capacity in FY20, which will provide over-supply to the market for some years to come. Industrial and Safety's main units include Blackwoods (tools, safety gear and industrial supplies), Coregas (medical & industrial gas), and Workwear. Overall revenue was steady at $1,752m, but EBIT was down significantly from $118m in FY18 to $86m in FY19. The result was disappointing to management and is expected to improve after remedial measures.

Key events

The main event of FY19 was the demerger of Coles Supermarkets into a separately listed company, now located in Victoria. Coles net assets were $14,744m at demerger and the fair value of its enterprise based on the share price post-demerger was $17,136m. This gave rise to a gain of $2,264m after adjusting for demerger costs and tax adjustments. WES was roundly criticised in 2008-9 for paying too much (about $20bn) for the Coles Group (which included Kmart, Target and Officeworks which remain within WES after the demerger), and for several years there were concerns over the Coles' carrying value, particularly goodwill. The Coles Group was bought substantially on borrowed funds just before the Global Financial Crisis (GFC), necessitating a major dilution of existing shareholders through a 3-for-7 rights issue in 2009 at just $13.50ps, less than a year after a 1-for-8 rights issue at $29.00ps, whereas WES' pre-GFC price was about $45ps. In the intervening years, Coles has brought controversy over executive pay and trading issues, and the group has spent very substantial amounts on modernising the supermarket presentation. So to have come out of it at a profit to shareholders is good news, but, to the writer's mind, the wisdom of the original acquisition is still in some doubt, particularly given the difficult trading conditions facing Kmart and Target (net investment $1,853m). WES provided $102m for a provision relating to Coles' supply chain upgrade mere months before demerger. We have queried why this was done rather than leaving the provision to be made after demerger when it was for the benefit of Coles' shareholders. We are advised that the provision related to lease exit costs and redundancies arising from a contractual commitment for the supply chain upgrade, which occurred during WES ownership of Coles.

Other disposals during the year were:

- the sale of WES' interest in the Bengalla coal mine, completing its disposal of coal mines commencing in FY18 with the sale of Curragh. Bengalla's sale was for $860m, earning a profit after tax of $645m.
- the sale of KMart's Auto & Tyre division for $350m, earning a profit after tax of $244m.
- the sale of WES' interest in Quadrant Energy to Santos for $170m, earning a profit after tax of $120m.

Acquisitions included Geeks2U (tech customer support for Officeworks) for an undisclosed amount, Catch Group (online retailer for Kmart group) for $230m, and subsequent to balance date, WES completed the acquisition of Kidman Resources, a lithium miner, for $776m, with which it plans to build a lithium hydroxide plant in Kwinana, to be owned on a 50/50 basis in the Covalent joint venture (in conjunction with Sociedad Química y Minera de Chile, the world's largest lithium producer), who share ownership of the Mt Holland lithium resource. WES also made a takeover offer for Lynas Corporation Ltd at $2.25 ps. Lynas has a rare earth mine in WA

and a processing facility for its products in Malaysia. The acquisition would have cost $1,500m had it been successful, but it was rejected by Lynas' board and was later withdrawn.

There were no restructures, buy backs or capital raisings, and WES has no large store of franking credits because its practice has been to distribute dividends up to the level of its franking account balance where appropriate. Its free cash flow did not entirely cover its dividends this year for that reason. After the Coles' demerger, WES is left with a large debit demerger 'reserve' of $5,860m, being the dividend element of the Coles' share value as determined and accepted by the ATO – the capital element was treated as a reduction of share capital. Because WES has effectively distributed as dividends all of the profits earned by Coles during its period of ownership, the debit balance on this reserve really represents a reduction of paid-up equity – giving back to shareholders value in terms of the one-for-one distribution of Coles' shares.

Key Board or senior management changes

Two directors resigned during the year, James Graham to take on the chair at Coles and Paul Bassat, whilst long-serving director Tony Howarth will retire at the conclusion of the AGM. Two new directors, Michael Roche and Sharon Warburton, are seeking shareholder endorsement as set out later in the voting intentions. The key executive group changes included the departure of Coles' leaders and the appointment of Ian Bailey as managing director of Kmart Group, replacing Guy Russo in November 2018. Long-serving company secretary Linda Kenyon retired on 30 June and was replaced by Aleks Spaseska.

ASA focus issues

We comment below and in the remuneration report item on WES' failure to disclose actual pay information for key executives. In other respects, WES achieves or goes most of the way to achieving the goals of our focus issues.

Summary

(As at FYE)	**2019**	**2018**	**2017**	**2016**	**2015**
NPAT ($m)	5510	1197	2873	407	2440
UPAT ($m) 'NPAT excluding significant items'	2339	2772	2873	2353	2440
Share price ($)	$36.16	$49.36	$40.12	$40.10	$39.03
Dividend declared (cents)	278c	223c	223c	186c	200c
TSR (%)	12.2%	28.6%	5.0%	7.9%	0.3%
EPS (earnings per share cents)	487.2	105.8c	254.7c	36.2c	216.1c
CEO remuneration expense (not actual) ($m)	6.749	6.550	12.097	5.490	9.863

For 2019, the CEO's total reported remuneration was **77 times** the Australian Full time Adult Average Weekly Total Earnings ($1695.20 based on May 2019 data from the Australian Bureau of Statistics).

TSR has been calculated apportioning WES' 2018 year-end share price between WES (71%) and Coles (29%), based on their respective VWAP post-demerger. On a comparable basis, excluding significant items and discontinued operations (impairments in 2018 and profits on sale/demerger in 2019), EPS were 151.1c in 2018 and 171.5c in 2019.

WES does not publish actual remuneration information but provides enough information for us to be able to calculate it on the basis that it includes the cash element of the KEEPP (Key Executive Equity Performance Plan) 2018 scheme, and any shares vested during the year under remuneration arrangements. The Group MD, Mr Rob Scott, received his annual fixed salary and leave accruals etc of $2,583,349, a cash bonus of $250,000, vesting of 85,595 2017 KEEPP restricted shares on 30 June 2019 (market value on that day at $36.16 ps = $3,095,115). No performance shares vested in September 2018 because the hurdles for 2014 WLTIP (Wesfarmers Long Term Incentive Plan) performance were not met. The WLTIP 2015 performance shares were vested in September 2019 so would form part of his FY20 take-home pay. On this basis, his annual actual income for FY19 was $5,928,464 or 67 times AWOTE (Average Weekly Ordinary Time Earnings).

Item 2(a)	**Re-election of Vanessa Wallace as a Director**
ASA Vote	**For**

Summary of ASA Position

Ms Wallace is a management consultant who was appointed to WES' board in 2010. She is a member of WES' remuneration and nomination committees and is a director of one other listed company, Seek Ltd. As an independent director who has already served more than 9 years, this may be her final term being classified independent after 12 years, ASA guidelines do not recognise long-serving directors as independent.

We have noted her involvement as a director of AMP following revelations about its conduct at the banking Royal Commission and subsequent damage to share value. She was a director of AMP from March 2016 until her resignation in March 2018, and her involvement therefore commenced at the tail-end of the misconduct reported to the Royal Commission. After consideration of the circumstances, we have decided to support her re-election.

Item 2(b)	**Re-election of Jennifer Westacott AO as a Director**
ASA Vote	**For**

Summary of ASA Position

Ms Westacott held a number of senior leadership positions in state government before becoming a consultant and a company director, who was appointed to WES' board in 2013. She is a member of WES' audit and risk and nomination committees.

Item 2(c)	Election of Michael Roche as a Director
ASA Vote	For

Summary of ASA Position

Mr Roche is an actuary who has moved from insurance to a broader role as head of Deutsche Bank's merger and acquisitions division. He was appointed a WES director in February 2019 and is a director of a number of unlisted entities. His skills in mergers and acquisitions will be useful to WES which as always is on the lookout for investment opportunities to expand its conglomerate portfolio. He has been appointed chairman of WES's remuneration committee and is a member of the nominations committee.

Item 2(d)	Election of Sharon Warburton as a Director
ASA Vote	For

Summary of ASA Position

Ms Warburton is an accountant who was appointed a director in August 2019. After leaving the accounting profession she took on senior executive management positions at companies including Brookfield Multiplex, Citigroup and Rio Tinto. Her accounting and corporate management skills are an appropriate addition to the board's unpublished skills matrix. She is a member of the audit and risk and nomination committee. Our only reservation about her appointment is her heavy workload as co-deputy-chair of Fortescue Metals, together with three other board appointments, NEXTDC Ltd, WorleyParsons and Gold Road Resources, and other appointments such as directorship of Perth Children's Hospital and membership of the Takeover Panel.

Item 3	Adoption of Remuneration Report
ASA Vote	For

Summary of ASA Position

Only 5 of the 20 largest companies don't disclose actual remuneration: WES, WPL, CBA, MQG and Amcor. The reason given by WES for not doing so is that there is no standard or common framework for determining which remuneration components should be included and at what point in time in terms of share-based payments. However, unsophisticated shareholders do not understand terms like accrued fair value increments necessary for an understanding of the statutory disclosure table for executive pay, and they need a table of actual take-home pay for

clarity and comparability with company investment performance. We are close to recommending a vote against the remuneration report for this reason alone.

In all other respects, the report sets out clearly the remuneration framework and the consequent remuneration elements for key executives and non-executive directors. WES's executive remuneration structure (KEEPP) differs from many other companies by not having a short-term incentive as such, other than a comparatively small cash bonus (5% of the Group MD's and CFO's target award and 20% of the other executive KMPs' target award, all subject to a hurdle).

All executive KMP are set a scorecard objective showing target and maximum opportunity for cash and share-based incentive pay, the latter divided equally into restricted and performance shares. Restricted shares are allocated subject to a 12 month service condition, vesting after that period subject to 5- and 6-year trading restrictions, basically preventing the executive from selling those shares for that period in normal conditions. The remaining 50% of the share-based award is allocated in performance shares which have 4-year performance hurdles only vesting after that end of that period to the extent that the hurdles are passed. For the MD & CFO, the hurdles are relative total shareholder return (RTSR) to ASX100 companies (60%), portfolio management, investment outcomes and strategic measures (40%), whilst divisional MDs have divisional financial hurdles of 80% and relative TSR for 20%.

ASA supports the overall KEEPP structure and sees it aligned to shareholder return. Rob Scott's remuneration package for FY19 was as follows under the KEEPP remuneration framework:

	Target $m	% of Total	Max. Opportunity $m	% of Total
Fixed Remuneration	2.500	33.3%	2.500	25.0%
STI - Cash	0.250	3.3%	0.250	2.5%
Restricted shares	2.375	31.7%	3.625	36.25%
Performance shares	2.375	31.7%	3.625	36.25%
Total	7.500	100.0%	10,000	100.0%

Under the KEEPP arrangements for FY19, he was awarded cash STI of $250,000, restricted shares to the value of $3,121,855 and performance shares to the same value, having achieved a scorecard performance of 86.6% of maximum opportunity. He needs to retain his employment until December 2020 for the restricted shares to vest but they will remain restricted until 2024 and 2025 (50% becoming unrestricted as to disposal in each year). The performance shares will be tested as regards RTSR (relative total shareholder return) and other measures as at 30 June 2023. These shares are expected to be purchased on-market and will be allocated to him if shareholders approve the resolution in item 4. The KEEPP structure for FY20 had not been finalised at the time of the report but the Group MD and CFO will not receive cash bonuses for FY20.

Our concerns with the WES remuneration structure are as follows:

1. We would prefer to see more definitive disclosure of scorecard targets set for the year in the remuneration report because it lacks transparency at present. It would be

preferable to see the level of NPAT and ROE (return on equity) set as targets for the Group MD and CEO in retrospect, and equivalent financial targets for divisional MDs. This is not disclosed because such disclosure might provide information to competitors and have detrimental effects as a result.

2. RTSR is the only financial hurdle for the vesting of performance shares for the group MD & CFO, accounting for 60% of the award. Whilst there are non-financial hurdles for them too – portfolio management/investment outcomes (20%) and strategic measures (20%), the ASA guidelines suggest that an absolute financial hurdle should be in the package. Other executive KMP (key management personnel) comply because they have EBIT and ROC (return on capital) as financial hurdles for 80% and RTSR for 20% of their awards. WES makes no secret of its active search for businesses to conglomerate with its other operations and setting an EPS or ROE hurdle might deter management from pursuing such opportunities because acquisitions would be expected to flatten or reduce growth in such measures. We understand the importance of the investment outcomes hurdle very clearly given WES' balance sheet strength and consequent borrowing capacity and hence 'soft' measures are set at a higher level than elsewhere.
3. Vesting of the relative TSR components commences at median performance rather than above median. There is low probability of this deficiency resulting in performance shares vesting when ASA guidelines indicate that they should not do so.
4. Use of board discretion to use adjusted NPAT and ROE in scorecard calculations (but this is in shareholders' favour as it was to exclude profit on demerger of Coles and sale of other assets) rather than using statutory NPAT and ROE determined from reported earnings. We want to see a return to using statutory NPAT in a normal year.
5. Dividends accrue on both restricted shares and performance shares from grant date. They are escrowed for performance shares so they are not paid if the shares are forfeited but otherwise are paid at the end of the 4-year performance period. ASA policy is that they should not be paid on unvested rights, but WES practice is to allocate shares, not rights to shares.

Overall, we think that the remuneration structure is fair to both management and shareholders and should be supported.

Item 4	**Approval of grant of restricted and performance shares to the Group Managing Director**
ASA Vote	**For**

Summary of ASA Position

It is proposed to allocate to Mr Scott 79,995 restricted shares and the same number of performance shares determined by dividing the incentive amount of $6,243,709 by the value-weighted average price of Wesfarmers' shares in the period after announcement of WES' results

in August, which was $39.03. This proposal is after payment of an amount equal to 5% of Mr Scott's target remuneration or $250,000 as a cash incentive.

The restricted shares will vest after Mr Scott remains employed by the group for until December 2020 but will be subject to trading restrictions which will be lifted for one half of the allocation after five years, and after six years for the other half.

The performance shares have financial and strategic performance conditions which will be tested after four years. The vesting of 60% of the shares will be determined by comparing Wesfarmers TSR against the ASX 100 with no vesting below 50% and progressive increments to 75% where full vesting occurs. The vesting of 20% of the shares will be determined by performance against portfolio management and investment outcomes after four years. The vesting of the remaining 20% is tied to success in relation to strategic outcomes such as talent development, leadership and corporate reputation.

The individual(s) (or their associates) involved in the preparation of this voting intention have a shareholding in this company.

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