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Lodgement of Open Briefing

Wesfarmers Limited
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Title: Open Briefing. Wesfarmers. CEO on 26% Profit Rise

Record of interview:

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Wesfarmers Limited announced a 26% increase in profit after tax to $339 million for the half year ended 31 December 2003 (eps before goodwill amortisation of 90 cents per share, up 26%). Profit after tax was $601 million after including profit after tax of $304 million from divesting Landmark. Is the profit growth of 26% representative of what you expect for the full year?

CEO Michael Chaney
No, the rate of earnings growth for the full year will be lower. The trend from the first half where some divisions achieved earnings growth and some divisions reported earnings decline is likely to continue through the full year.

We expect a favourable outlook for the industrial and safety businesses, a positive outlook for insurance, improved earnings from CSBP and ARG, and solid retail sales growth in hardware. Hardware trade sales will continue to be subdued, short term earnings for coal will be lower but with the medium term improving and the LPG outlook is dependent on international LPG prices.

corporatefile.com.au
For the full year results in 2003, you provided EBITDA by division. Can you provide these numbers for the half year to 31 December 2003?

CEO Michael Chaney
For the half year to 31 December 2003, EBITDA for hardware was $237.3 million, energy was $153.2 million, industrial and safety $59.0 million, rural $11.4 million, CSBP $39.0 million, insurance $37.9 million and other (includes sale of Landmark) was $487.7 million.

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The Gresham Private Equity Fund 1 contributed some $45 million in post-tax earnings, almost entirely from the Repco IPO. You've stated that further profits are expected to be generated from this activity over the next few years. Can you give more detail?

CEO Michael Chaney
It's difficult to do so because we don't know the timing of the divestments. However, there are still some potentially lucrative investments in the fund. We expect Cashcard to be sold within the next six months.

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Wesfarmers recently announced a commitment of up to $150 million to the second Gresham Private Equity Fund. Why have you invested in Fund 2 when Fund 1 is in divestment mode?

CEO Michael Chaney
These are ten year closed-end investment funds. The typical profile of the fund is for investments to occur in the first few years and with divestments occurring thereafter. So by rolling out new funds you should be able to maintain a fairly stable level of investment with a continuous divestment profile.

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Earnings before interest tax and goodwill amortisation (EBITA) from the Bunnings hardware merchandising business increased by 8% over the same period last year to $212 million. Operating revenue increased by 12% to $2.0 billion. How difficult is it for Bunnings to maintain its position of lowest price merchandiser and maintain or improve margins at the same time?

CEO Michael Chaney
Bunnings actually has a strategy of reducing the sales margins over time on the basis that lower prices will generate more sales. We can do this and still achieve EBITA growth because of the economies of scale. It's been a successful strategy.

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Retail sales growth was strong but trade sales again underperformed the retail sector. You expect this to continue. Why are these market segments performing so differently and do you remain committed to the trade segment?

CEO Michael Chaney
The trade segment continued to suffer from account rationalisation and store closures, the slowing housing construction market and strong competition. Trade credit sales fell by 5% in Australia during the half.

We are committed to the trade segment, because it's an important part of the business, although by far the strongest focus has been on retail. Bunnings' strength lies in the retail segment and it will continue to be our main focus.

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During the half, you opened eight new warehouses and closed two warehouses and six traditional stores. As at 31 December 2003, the Bunnings network consisted of 122 warehouses, 88 traditional stores and 18 WA Salvage stores. How much more improvement is there in Hardwarehouse/BBC stores relative to Bunnings and at what stage is the refitting and upgrading program for the Hardwarehouse/BBC stores?

CEO Michael Chaney
At this stage we've refurbished more Bunnings than Hardwarehouse stores – in fact, less than 10 in the latter case. We are planning to refurbish 10 to 15 Hardwarehouse stores per annum, which should take three to four years. We expect good sales uplift when we do that, but not to the level of Bunnings Warehouses because of individual site issues and so on.

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EBITA from Wesfarmers' Energy business fell by 7% to $115 million. In the coal segment, the major influences were lower inventory levels, higher A$ exchange rate, lower export prices, dragline maintenance expenses and higher demurrage costs. Production costs at Bengalla increased. What influence will these have on profitability in the second half? Can you explain the extent to which recent contract and spot price increases will affect your coal revenue?

CEO Michael Chaney
Inventory levels are less likely to be an issue but we will incur higher maintenance expenses because of the dragline shutdown at Curragh in the fourth quarter. Ports are still quite congested so higher demurrage costs are likely to continue. In the latest half year, demurrage costs rose to $2.0 million at Gladstone from $0.04 million in the December half 2002 and to $1.2 million from $0.4 million at Newcastle.

The higher A$ will impact coal earnings in the second half, although that is mitigated to a certain extent by hedging. Curragh's revenue for FY04 is 100% hedged at US$0.6109 and 77% of FY05 revenue is hedged at US$0.6349. We have a progressively lower proportion of A$ hedging in place for Curragh from FY06 to FY08.

During the December half, coking coal prices received were lower but steaming coal prices improved. The recent strong rises in coking and steaming coal prices will take a while to flow through. We should be receiving the full benefit of these from July and much of the benefit from 1 April.

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In the December half 2003, Wesfarmers produced 2.2mt coking and 1.1mt steaming from Curragh, 1.6mt steaming from Premier and 1.3mt steaming from

Bengalla (Wesfarmers 40%). Can you lift production in the short term or increase the amount exported?

CEO Michael Chaney
We have been increasing production at Curragh by about half a million tonnes per annum. We plan to continue that and there's a reasonable prospect that the increase will be larger in 2006 with the Curragh North development.

It's likely that the export/domestic sales mix at Bengalla will remain pretty constant.

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International LPG prices were broadly in line with those recorded last year. Do you expect LPG demand to change after the resolution of excise arrangements?

CEO Michael Chaney
No we don't really expect excise changes to affect demand for LPG. Sales of auto gas will be more sensitive to the changes in excise rates and while the resolution is helpful, the government's decision to impose an excise might have a negative impact on demand in the longer term.

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Wesfarmers is bidding to build the proposed $350 million base load power station project in WA. However, electricity market reform in WA has been delayed for various reasons. What is the status of the project and is it possible to secure long term electricity supply contracts, if Wesfarmers is the successful bidder, when there is so much uncertainty surrounding market reform?

CEO Michael Chaney
We're involved in the bidding process but the way things have been going, I don't expect any great advances in the short term. The direction and pace of electricity market reform in WA is unclear and that's just one of the factors that will affect the timing of the new base load station.

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EBITA for the industrial and safety business fell 4.5% to $53 million even though revenue of $575 million was virtually unchanged. You had expected margin improvements but EBITA/Operating Revenue margin was down from 9.6% to 9.2%. Can we expect margin improvement in the second half?

CEO Michael Chaney
We think the margin will be comparable in the second half. However, some positive signs are emerging in industrial and safety. In the December quarter, EBITA was up 5.1% pcp and EBITA/Capital was up from 12.9% to 13.8% on a rolling 12 month basis.

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Revenue and profits from the Protector Alsafe business have stabilised but continue to be below budget. When do you expect to have successfully integrated this business and for it to reach an acceptable level of performance?

CEO Michael Chaney
We've stabilised Protector Alsafe over the last couple of months. It has new management, business improvement processes are in place and we're looking forward to a better performance. Realistically a sustained improvement will probably take us six to twelve months.

corporatefile.com.au
The insurance division returned EBITA of $36 million. The Lumley businesses contributed to earnings for two and a half months. Can you separate the contribution between the Lumley businesses and Wesfarmers Federation Insurance and can we extrapolate those performances for the full year?

CEO Michael Chaney
In the half year, the Lumley businesses contributed $21 million and WFI contributed $15 million to that divisional EBITA of $36 million.

We were very happy with the performance of the insurance division, although earnings in the first half should not be extrapolated for the full year. Claims in the first half were lower than budget. However, the full year will be a little better than the forecasts we modelled during the Lumley acquisition process. We expect modest savings from the merged reinsurance programs and also expect higher retentions in Lumley from 2005 onwards.

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Wesfarmers recently scaled back the Lumley Technology business both in Australia and overseas. This business is being restructured to align it with the objectives of the insurance operations. What IT structure do you envisage to support the insurance division? How much cost and work is involved?

CEO Michael Chaney
We have acquired a majority interest in a software system called Koukia and it's likely that will become the dominant software system. The additional amount involved is in the single digit millions, which we haven't yet paid. The system is in the process of being finalised and rolled out.

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Wesfarmers CSBP, your fertilisers and chemicals business, achieved a 31% increase in EBITA to $21 million. You've now successfully bedded down recent expansions and de-bottlenecking of your chemical plants. You expect volume improvements in both chemicals and fertilisers in the short term. Can you be more specific about these opportunities?

CEO Michael Chaney
WA had a good grain season last year so farmers will be cashed up. That should ensure that fertiliser sales in the current half are up on the previous corresponding period. Higher liquid fertiliser sales, greater product range and increased sales presence should also help push volumes up. The performance of the fertilisers segment has generally improved because of competitive pricing, distributor support and cost and supply chain benefits.

Our major chemicals plants are all operating at capacity because of the health of the mining sector. There will be some short term earnings weakness from the major ammonia plant shutdown scheduled for May 2004. The performance of the sodium cyanide solids plant has improved and we should see increased production from that.

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Thank you Michael.

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