Open Briefing. Wesfarmers. CEO Chaney on Record Profit (11.08.00)

Record of interview :

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Operating profit after tax and before abnormals rose nine percent to $201.8 million for the year to June 30 2000. The EBIT contribution from Hardware and Forest Products, Energy and Rural, and Insurance all rose strongly while Fertilisers and Chemicals fell significantly. Which divisions were you pleased with and which can you get more out of?

CEO Chaney
We're very pleased with Hardware and Forest Products and the Rural sector. In Rural, we were above budget in all segments and in Hardware we exceeded a pretty ambitious budget.

Fertilisers and Chemicals was the main disappointment as our budget was considerably higher than the outcome. It was difficult to manage the impact of low international prices on our margins. Also, we gave away more in price than we needed to. We thought like a price taker rather than a price maker.

Fertilisers and Chemicals earnings should significantly improve this year as international prices move up, as we approach the market a little more intelligently and as some new chemical projects come on stream.

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The group earned a return on shareholders funds of 16.6 percent. You recently lifted your target return on equity from 14 to 16 percent. Can you explain why and do you think there’s a risk this move may price you out of potential investments?

CEO Chaney
The reason is simple. We seek to be in the top 20 percent of Australian companies. Recent data shows 10 of the top 50 companies achieved more than 16 percent return on shareholders’ funds. We need to achieve that if we're to provide a satisfactory return.

It's also a little odd earning 16.5 percent and maintaining a lower target of 14 percent.

On the surface you’d expect lower returns as margins are squeezed due to increased competition, greater transparency and e-commerce threats. But e-commerce is an opportunity so it’s sensible to target higher returns. In the US, companies are getting better shareholder returns through process re-engineering, company re-structuring and e-commerce initiatives.

The higher target won't affect our ability to do deals. We assess potential investments on a DCF basis for which we have a hurdle rate of about 10 percent after tax. This, of course, is different to the profit-based hurdle rate discussed above.

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The final dividend of 48 cents per share fully franked brings the full year dividend to 73 cents per share, versus 67 cents last year. Net debt to equity is now 67 percent and above your target

range of 40-65 percent. Did you consider lowering your traditional dividend payout ratio of 100 percent to reduce debt?

CEO Chaney
We reviewed dividends and the appropriate payout ratio in light of recent tax changes but not in relation to debt. We’re comfortable with our debt level.

Our net debt to equity range has always been pretty conservative and our interest cover is high.

When the shareholder position is modelled we conclude all shareholders are better off if the company pays out its franking credits. As a result, EPS growth is marginally sacrificed but more than made up for by the cash benefits of higher dividends.

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Is the gearing target range of 40-65% too conservative given your interest cover on a cash basis is 18.9 times?

CEO Chaney
Our internal minimum target is 4 times. The current level of 18.9 is well above that.

In the coming year cash cover should be a little under 10. We've now got more debt following the share buy-back and the Curragh acquisition. Given our high cash cover we could handle more debt, so we're not concerned about the current level of net debt to equity.

Over coming years we see strong cash flows and falling debt levels.

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Hardware and Forest products EBIT rose 41% to $140.0 million. Central to this growth, you opened nine new Bunnings warehouse stores totaling 39 at year end. Have you maintained margins while increasing market share?

CEO Chaney
Yes. EBIT margins have improved because of the economies of scale. Over the last five years the EBIT growth rate has exceeded the sales growth rate.

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What was the EBIT impact of the GST during the year? What impact will the GST and the abandoning of other taxes have on sales in the current year?

CEO Chaney
In the June rush, particularly from trade buyers, the GST's introduction may have achieved an additional $10 million in EBIT in the 2000 year. Whether that amount was brought forward from 2001 into 2000 is another issue. I hope only part of it will have been removed from 2001.

In July we're very close to budget in Bunnings Building Supplies which was quite a significant increase on July 1999.

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What level of growth do you plan for warehouse stores in the current financial year?

CEO Chaney
We hope to get ten completed but that may be a stretch. It's difficult to predict the actual number due to planning approvals and other regulations. Seven seem definite and an additional three are likely. In the year ending June 2002, we'll have more than that because of the timing of planning approvals.

The current year is pretty normal in terms of projected roll-outs. The rate of profit growth won't be the same as last year because of the GST but the underlying growth rate will be just as good.

The other factor that should not be forgotten is the expected significant slump in housing construction come October or November. This is when we'll really see a fall on the trade side.

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From July 2 Bunnings began Sunday trading in metropolitan Brisbane and extended Sunday hours elsewhere in Queensland. Has this been successful and what's the likely impact on profit and future strategy?

CEO Chaney
It's been very successful. In July the Queensland EBIT was quite a bit above budget and it should have a full year effect of about a $4 million EBIT increase.

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How are you tackling the issue of acquiring suitable land in Sydney and what are your plans for NSW?

CEO Chaney
Half the stores we expect to open this year are in NSW, predominantly regional.

In Sydney we're looking at different car park configurations. Store formats will remain the successful warehouse style but we're experimenting with parking above and below the store as well as the front.

Large flat sites are more limited in Sydney due to geography and we're looking to overcome that problem. We would also hope the property market will cool off a bit post the olympics.

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The 27 percent EBIT fall in Fertilisers and Chemicals to $45.1 million was the major negative in the result. What initiatives are there to boost margins?

CEO Chaney
There were a number of negative factors in last year's result but a combination of factors should help us achieve a much better profit in Fertilisers and Chemicals.

We’ll redress the fertiliser pricing issue with a more satisfactory strategy and we don’t expect plant breakdowns to recur this year. The ammonia plant is now running and producing good returns and the Queensland nitrate plant is operating continuously.

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During last year Urea prices hit a 30-year low. Is there scope for a price recovery?

CEO Chaney
The Urea price has already recovered about 30 percent since last year’s lows.

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What structural changes have occurred within the fertiliser industry and can margins ever recover to historic peaks?

CEO Chaney
In Western Australia we've progressively lost market share to new entrants. It’s now more competitive, as it is in the eastern states, and we’ve just got to get better at what we’re doing. Margins will never recover to the levels of the late 1980s and mid 1990s.

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Energy division EBIT rose 10% to $107.5 million due to a higher contribution from coal. What’s the outlook for the prices and the demand of both thermal coal produced at Bengalla and the thermal and coking coal produced at Curragh?

CEO Chaney
We're optimistic that we'll see price increases in the coming years. The market has already tightened and spot steaming coal prices are now approaching contract prices. Increased international steaming coal prices won’t affect Curragh's domestic contract, but would help at Bengalla.

On the coking coal side there are very positive signs. Four mines have closed in Canada which produce a similar product to Curragh. We're getting requests for volume that we can't meet because our production is already contracted. This will hopefully translate into higher contract prices in the coming year.

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Despite the EBIT rise, return on capital for the Energy division fell from just below 30% in 1999 to around 20% in 2000 - presumably because of the inclusion of Bengalla. Was this decrease planned and when do you expect Bengalla to lift its return?

CEO Chaney
Yes. It was planned and expected. Bengalla's returns are running above projected levels. We budgeted for a $5 million EBIT loss in FY2000 because of the low production rate on ramping up. We made an EBIT gain in 2000 and expect a larger profit this year. Bengalla will really start to generate good earnings in 2002.

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The Curragh coal mine purchase was finalised in late June. Have you had time to reflect on this acquisition from what you've seen first hand?

CEO Chaney
We're delighted with it. Curragh's July results are very encouraging and above budget.

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Kleenheat profits don't appear to have suffered despite a near doubling of international LPG prices. Why not?

CEO Chaney
Overall we had a good result in the gas business due to good management of the LPG plant. It was scheduled to shut down in the early financial year but we deferred that, taking advantage of high international LPG prices. This more than compensated for the significant margin squeeze and profit reduction suffered by Kleenheat because of the high prices.

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Rural and Insurance EBIT had a strong turnaround, rising 72% to $40.1 million. What were the key reasons and can they continue?

CEO Chaney
The business has been very well managed and we've achieved cost reductions. We've also expanded the revenue base by entering new markets in merchandise, expanding the real estate activities and maintaining our position in wool and livestock.

Although falling sheep prices offset higher cattle and wool prices, sector conditions were better overall and we benefited from that. We certainly think they'll continue.

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In July, Wesfarmers took a 15% placement in the rural merchandiser, IAMA Limited, for $16.4 million. The company's profit record is patchy. How might a merger with IAMA benefit your rural division?

CEO Chaney
It'd be beneficial for both companies. There's scope for rationalisation in the back office, in systems and in branches to some extent. A merger would benefit the supply side through larger purchasing power. It's really a case of one and one making two and a half.

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What's the status of your e-commerce strategy within the Dalgety rural business?

CEO Chaney
In partnership with Rural Press and McKinsey we'll develop a rural portal costing $40-50 million.
We hope it becomes a one-stop shop for farmers not only in obtaining information and supplies, but also helping them farm better.

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How will e-commerce applications impact Dalgety's traditional revenues and how do you envisage the business in five years?

CEO Chaney
I think they'll impact significantly. We don't exactly know how or by how much but I'd be surprised if the business is conducted along current lines in five years. Dalgety earns a substantial gross profit and has a significant cost structure. If profit is threatened by new ways of doing business the costs will have to be reduced accordingly.

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Will Bunnings duplicate the Wesfarmer Dalgety business to consumer e-commerce model?

CEO Chaney
No. Bunnings is realising the e-commerce potential through business to business e-commerce, already sourcing about $750 million of its supplies on the internet.

On the business to consumer level, we don't expect much activity in the next few years although we’re getting ready if it occurs.

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What overall progress have you made in your e-commerce strategy versus your competitors?

CEO Chaney
We've tried to stay ahead of the game. One of the things we've done is appoint a senior executive as Group Director e-Commerce to facilitate change and progress in each division. He provides the experience and knowledge to help each division think through the strategic implications of e-commerce.

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Can you comment on your profit expectations for the current financial year?

CEO Chaney
We expect a reasonable increase in profit and will be disappointed if we don’t get it. At this stage we're budgeting for an increase from all divisions. Many things can happen within 12 months but time will tell.

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Thank you Michael, we look forward to the next Open Briefing with Wesfarmers.