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Wesfarmers shines in FY20

Company/ASX Code	Wesfarmers Limited/WES
AGM date	12 November 2020
Time and location	Virtual AGM via Lumi, 1pm AWST
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 and Remuneration Committee chair Mike Roche

Individuals and their associates involved in the preparation of this voting intention have shareholdings in this company.

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

Summary of ASA Position

Another good year for shareholders despite Covid-19 – NPAT from continuing operations excluding significant items was $2,099m (FY19 $1,940m). There were significant items in both years and reported NPAT for FY20 was $1,697m compared to $5,510m in FY19. FY19's significant items include $2,162m profit on demerger of Coles (net of a provision for supply chain changes) and $1,009m profits on sale of other businesses. By comparison, significant items were negative in FY20 - $735m impairments for Target and Industrial & Safety, partly offset by a profit on sale of 10% interest which had been retained in Coles of $203m, and a write-up of the remaining 5% interest in Coles to market value of $154m. There were other significant items netting to a gain of $83m, largely relating to the finalisation of tax positions on prior year asset sales. The net impact of the new leasing accounting standard AASB 16 at an NPAT level was negative $16m. Of minor impact on profits, this has had a major effect on WES balance sheet because of property leases for its retail operations – Bunnings, Kmart, Target and Officeworks. Total debt was $3,029m as against total assets of $18,333m at FY19 end, whereas including lease liabilities and right of use assets in FY20 increased debt to $9,898m and total assets to $25,425m – a ratio increase from 16.5% to 38.9%. The level of gearing including lease liabilities does not concern us partly because a large portion of the lease liabilities are owed to the BWP Trust (formerly Bunnings Warehouse Property Trust). A WES subsidiary with independent directors is the responsible entity of BWP, and in all reality BWP is a part of the group although not meeting the definition of subsidiary per accounting standards.

The year-end market price of WES shares increased from $36.16 to $44.83, whereas they were $44.22 immediately prior to the Coles demerger in November 2018. If shareholders who held WES shares at that time have retained their Coles shares, which were worth $17.17 at 30 June 20, they have made a gain of about 50% in value since the demerger.

Governance and culture

The board has comprised 8 non-executive, independent directors and the managing director throughout most of the year, with one non-executive, Tony Howarth, retiring at last year's AGM, and Sharon Warburton being appointed in August 2019. Diane Smith-Gander is not seeking re-election at this year's AGM, leaving three female directors (37.5%). Board members have a wide range of background expertise and experience. Corporate culture reads well and the only minor hiccup in this regard was the 2019 revelation of payroll processing issues at Bunnings, Target and WES Industrial and Safety , resulting in under-payment of salaries and superannuation contributions. They were immaterial to results, but are of concern due to damage to reputation and they raised questions about adequacy of internal audit which have been addressed. Defining corporate culture is a matter of finding the weakest link in the chain.

Financial performance including dividends and shareholder returns (pre AASB 16)

After the demerger of Coles and the sale of the two coal mines, there are just 5 separately disclosed segments – retailers Bunnings, Kmart Group (Kmart/Target/Catch), and Officeworks, plus Chemicals Energy & Fertilisers (CEF) and Industrial and Safety.

Of the retail segments, Bunnings is the dominant earner generating $14,999m in revenue (up 14%), $1,852m (FY19 – 1,626m) in EBIT at a similar margin to 2019 and yielding a return on capital of 61.8% (FY18 50.5%). It expects its trading performance to moderate in FY21 following extraordinary growth in the second half of FY20, attributed in part to customers bringing forward purchases during (or anticipating further) Covid-19 restrictions.

Kmart Group (comprising Kmart and Target stores) had another disappointing trading year; revenue improved 7% but EBIT margin fell and EBIT reduced from $550m in FY19 to $414m in FY20. The underperformance of Target led to a decision to close many Target stores and in some instances to convert them to Kmart stores after the group conducted an experimental trial of small format Kmart stores in the US. A write-down of assets values and provisioning for lease costs on vacated stores has reduced group profits by $520m, and is in addition to Target write-offs of $300m in FY18. Officeworks continues to operate on an EBIT margin of about 7% and a slowly-improving return on capital of 19.6%, with revenue of $2,787m up 20% on FY19 and EBIT of $190m (FY19 $167m).

Whilst benefiting from the resurgence in mining activities, CEF suffered an expected decline in profit margins due to a competitor ammonium nitrate plant achieving commercial production, providing an over-supply to the market, likely to be felt for some years to come. The acquisition of Kidman Resources involved acquisition costs and expense to study the feasibility of lithium processing plant at Kwinana. As a result, CEF's EBIT contribution fell from $433m to $393m and its return on capital fell from 32.6% to 20.2%. 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 $1,745m, but EBIT has fallen significantly from $118m in FY18 to $86m in FY19 and down to just $40m in FY20. As a result, there was a charge of $310m to group results being impairment of goodwill and other asset values. Results were affected by Covid-19 restrictions on trading, particularly in New Zealand.

The prospects for FY21 are generally not so bright. Victoria represents a quarter to a third of the Australian retail economy and has been in lock-down since the start of the financial year. There have been other Covid-19 disruptions to supply and sales, and a risk of more to come. There have been additional costs such as the group's Victorian employees being paid at full pay during the lock-down when stores are only open to trade customers. WES has not issued any guidance yet as to the effect on results and it is to be hoped that this will be forthcoming at the AGM.

Key events

After the demerger of Coles in FY19, and the purchase and sale of a number of other operations in that year, FY20 was a quiet year for the group. It made two acquisitions – Catch Group for $222m, an online sales operation on a smaller scale than Amazon, and the acquisition of Kidman Resources Ltd through a scheme of arrangement for $776m. It formed the Covalent Joint Venture with Chilean market leader SQM to build a lithium refinery at Kwinana to process ore from Kidman's Mt Holland lithium mine. We have suggested to WES that it consider a capital reduction to absorb the negative reserves, particularly the Demerger Reserve with a debit balance of $5,860m, but we understand there might be adverse tax consequences of so doing.

Key Board or senior management changes

As mentioned previously, Sharon Warburton replaced Tony Howarth as an independent non-executive director and Diane Smith-Gander is retiring from the board at the AGM after serving as a director since 2009. Aleksandra Spaseska took up another post within the group and was replaced as company secretary by Vicki Robinson. David Baxby, previously managing director of Wesfarmers Industrials, stepped down in March 2020 and was not replaced as a member of KMP. We do not understand how just 4 people (Group MD, CFO, MD Bunnings and MD Kmart) can have sole authority and responsibility for planning, directing, and controlling the activities of such a large and complex group as WES but they are the only ones designated as Key Management Personnel having these duties and included in the Remuneration Report. There are 8 other executives listed on pages 14-15 including managing directors and executive general managers who do not have such authority and responsibility apparently.

ASA focus issues

We comment 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)	2020	2019	2018	2017	2016
NPAT ($m)	1,697	5,510	1,197	2,873	407
UPAT ($m) 'NPAT from continuing operations excluding significant items' (pre AASB 16)	2,099	1,940	2,772*	2,873*	2,353*
Share price ($)	$44.83	$36.16	$49.36	$40.12	$40.10
Dividends declared(cents)	170c	278c	223c	223c	186c
TSR (%)	28.4%	12.2%	28.6%	5.0%	7.9%
EPS (cents)	150.0c	487.2c	105.8c	254.7c	36.2c
CEO remuneration expense (not actual) ($m)	7.763	6.749	6.550	12.097	5.490

*Underlying profit for these years included profits from Coles and a coalmine which were disposed of in 2019.

For FY20, the CEO's total statutory remuneration was 87 times (2019 – 77 times) the Australian Full time Adult Average Weekly Total Earnings (based on May 2020 data from the Australian Bureau of Statistics $89,122.80 pa).

TSR for 2019 was calculated apportioning WES' 2018 year-end share price between WES (71%) and Coles (29%), based on their respective VWAP post-demerger. Earnings per share are not comparable because of the disposal of Coles and other businesses in 2019.

Item 2	**Re-election of Michael Chaney AO as a Director**
ASA Vote	**For**

Summary of ASA Position

The only director required to stand for re-election at the AGM is the chairman, Michael Chaney, AO. He is well qualified as WES' former managing director from 1992 to 2005 and was appointed a non-executive director and chairman in 2015, leaving a 10-year gap between executive and non-executive roles. During that time, Mr Chaney served as chairman of Woodside and National Australia Bank but currently has no other listed board appointments. He was chairman of NAB from 2005 to 2015 and, whilst the effect of disclosures at the banking Royal Commission on bank shareholders has been significant, it would be unfair to blame that on Mr Chaney.

Item 3	**Adoption of Remuneration Report**
ASA Vote	**Against**

Summary of ASA Position

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 of 17.5% of the divisional managing directors' target award, subject to a hurdle. The Group MD (Mr Rob Scott) and CFO (Mr Anthony Gianotti) receive no cash bonus and the remainder of the incentive is (normally) equally split between deferred and performance shares but in 2020, they received an allocation of performance-tested shares which was not included in the KEEPP plan for the year.

Rob Scott's remuneration package for FY20 was as follows:

As awarded under KEEPP:	Target $m	% of Total	Max. Opportunity $m	% of Total
Fixed Remuneration	2.500	33.3%	2.500	25.0%
STI - Cash	0	0.00%	0	0.00%
Deferred shares	2.500	33.3%	3.750	37.5%
Performance shares	2.500	33.3%	3.750	37.5%
Total	7.500	100.0%	10.000	100.0%

Mr Scott was also awarded an allocation of performance-tested shares to the value of $1.25m, as discussed below, which were not originally included in the KEEPP plan for his FY20 remuneration.

All executive KMP are set a scorecard objective showing target and maximum opportunity for incentive pay and their achievement against this scorecard determines their incentive allocation of deferred and performance shares. Deferred shares are allocated subject to a 12 month service condition, vesting after that period subject to 4-, 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 Group MD & CFO, the hurdles are relative total shareholder return (RTSR) to ASX100 companies (80%), and portfolio management and investment outcomes (20%) (previously there was a 20% weighting for strategic objectives). For divisional MDs the hurdles are relative total shareholder return (RTSR) to ASX100 companies (50%), divisional cumulative EBIT and ROC (50%).

In order to get the allocation of deferred and performance shares, various thresholds are set in the scorecard. For the Group MD and CFO, achievement of the financial hurdle is worth 60% of their incentive. The target for this hurdle for FY20 was set to be NPAT of $1,896.7m, and to achieve an allocation under this criterium, NPAT needed to exceed a threshold of 92.5% or $1,754.4m. Actual NPAT was $1,697 so they missed out by a very small margin on this significant element of their KEEPP allocation notwithstanding the significant difficulty in meeting targets after covid-19 disruptions and the decision to provide for the closure of Target stores. Whilst of course shareholders have suffered some pain as a result of the covid-19 pandemic, there is some sympathy deserved for the group MD and CFO in the circumstances that, having met their targets in other scorecard criteria, they only received 55% of their target incentive award in deferred and performance shares.

We are firmly advised that there is no connection between the above situation and the board decision to add an allocation of performance-tested shares (with different vesting hurdles to those allocated under the KEEPP plan) to Mr Scott, Mr Gianotti and to Mr Ian Bailey, the head of Kmart. The board seeks positive results for shareholders in relation to the decision to substantially reduce the size of the Target network by closing some stores converting other stores to Kmart stores and believed that it was appropriate to provide an incentive for responsible executives to achieve the forecast results for the converted stores. It approved an allocation of additional performance-tested shares to the value of 50% of FAR for the Group MD and the CFO and of 75% for the divisional MD of Kmart, amounting to an allocation of shares of $1.25m, $0.675m and $1.0125m respectively. These additional performance-tested shares will only vest to the extent that an unspecified level of profit for the stores converted to Kmart is achieved without exceeding the capital expenditure budget, to the 80% level relative to the Board-approved proposal. They vest as to nil if the profit falls short of 80% and on a sliding scale to 100% if the profit achieves the board proposal. They vest immediately after determination of the hurdle as at 30 June 2023 without trading restrictions but there is no transparency as regards the amount of the hurdles.

There has also been some adjustment of hurdles since FY19 to be more specifically aligned to divisional performance and, for FY21 and ongoing, the Board decided to vary the KEEPP arrangements to provide that, if the scorecard results in an allocation of performance shares below 100% of fixed annual remuneration (or 85% of divisional KMP's FAR), additional performance shares would be allocated to the 100%/85% FAR level, subject to the normal hurdles to vesting. Other adjustments have been made to the scorecard criteria.

The ASA is keen to see companies devise remuneration plans which have a long term alignment of executive incentive and shareholder reward and we strongly disagree with making "fixes" of the nature

made in 2020. Our conclusion where such fixes are needed is that the basic plan must be unfit for purpose and accordingly we now have doubts about the suitability of KEEPP as a long term plan.

WES is in a significant minority of companies declining to disclose take-home pay. 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 have decided to recommend a vote against the remuneration report partly for this reason and in view of the need to make ad hoc changes to the remuneration plan of the nature described in the preceding paragraphs. We have other concerns about WES' remuneration arrangements as set out below.

Our other concerns with the WES remuneration structure are as follows:

1. We are pleased to see that scorecard targets for NPAT and ROE were disclosed retrospectively this year as we requested last year. However, we would prefer to see more definitive disclosure of scorecard targets set for the year for the divisional MDs.
2. RTSR is the only financial hurdle for the vesting of performance shares for the group MD & CFO, accounting for 80% of the award. Whilst there are non-financial hurdles for them too (portfolio mgt/investment outcomes for 20% of the award), the ASA guidelines suggest that an absolute financial hurdle should be in the package. Other executive KMP comply because they have EBIT and ROC as financial hurdles for 50% and RTSR for 50% 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.
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. Dividends accrue on both deferred shares and performance shares from grant date. They are escrowed for deferred shares over the 12-month service period, and 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.

Item 5	Grant of KEEPP deferred and performance shares to Mr Rob Scott, Group Managing Director
ASA Vote	For

Summary of ASA Position

It is proposed to allocate to Mr Scott 28,609 deferred shares and the same number of performance shares, determined by dividing his incentive amount under the KEEPP of $2,775,000 by the value-weighted average price of Wesfarmers' shares in the period after announcement of WES' results in August, which was $48.50. Mr Scott had no entitlement to a cash incentive with respect to FY20 results.

The deferred shares will vest after Mr Scott remains employed by the group for until December 2021 subject to 4-, 5- and 6-year trading restrictions, basically preventing him from selling those shares for that period in normal conditions.

The performance shares have financial and strategic performance conditions which will be tested after four years. The vesting of 80% 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 deferred and performance shares are proposed to be allocated in line with the KEEPP remunerations structure which we have approved in previous years, although now having some doubts about it due to the need for the board to vary its terms and conditions. These variations do not apply to the allocation so we propose to vote proxies in favour of the resolution.

Item 5	Approval of additional performance-tested shares Mr Rob Scott, Group Managing Director
ASA Vote	Against

Summary of ASA Position

In addition to the deferred and performance shares proposed in item 4, it is proposed to allocate to Mr Scott 25,774 performance-tested shares determined by dividing the incentive amount of $1,250,000 by the same share price of $48.50 as per item 4 above.

It is asserted that this allocation will provide an incentive for Mr Scott (and the other executives for whom similar incentives have been granted) to achieve positive results for shareholders in relation to the decision to substantially reduce the size of the Target network and invest to convert many of its stores to Kmart stores. The performance-tested shares will only vest to the extent that the level of profit for the stores converted to Kmart is achieved without exceeding the capital expenditure budget, determined at 30 June 2023.

The ASA is opposed to boards adjusting remuneration structures to boost incentives when established performance hurdles fail to provide them. This allocation of shares has the effect of boosting Mr Scott's performance bonus when the group failed to achieve the financial performance threshold required under his scorecard.

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