Australian Shareholders' Association

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# Wesfarmers shines brighter in FY21

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| **Company/ASX Code** | Wesfarmers Limited/WES |
| **AGM date** | 21 October 2021 |
| **Time and location** | 1 pm AWST at Perth Convention & Exhibition Centre, Mounts Bay Road, Perth |
| **Registry** | Computershare |
| **Webcast** | Yes - hybrid meeting using Lumi AGM online platform |
| **Poll or show of hands** | Poll on all items |
| **Monitor** | John Campbell assisted by Ian Berry |
| **Pre-AGM Meeting?** | Yes with Remuneration Committee chair Mike Roche |

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

**Summary of issues for meeting**

We are pleased with Wesfarmers' results and the steps taken to strengthen its trading position in the various divisions. Its past success has been considerable and we hope the steps taken lead to a continuation of this success. We look forward to a trading update and on hearing about progress with the bid for control of Australian Pharmaceuticals Industries Limited Group.

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

**Summary of ASA Position**

Wesfarmers has performed well both in terms of results and in share market returns. The share price increased approximately one third during FY21 and total dividends paid and payable increased from $1.70 to $1.78 per share. WES is proposing a $2 per share capital return if shareholders approve. Even with cash on hand diminished by the final dividend and capital return, WES will still have significant resources available for entrepreneurial activity such as its current bid for Priceline owner API and its share of construction of the Covalent lithium hydroxide plant at Kwinana.

Wesfarmers continues to focus on a variety of technology initiatives. Across its divisions this include the ongoing expansion of eCommerce capabilities, development of mobile applications (e.g. the Bunnings product finder app) and increased use of data analytics. In June Wesfarmers also announced a $100 million investment to develop a so called "Group data and digital ecosystem", which is intended to facilitate a more seamless and personalised experience for customers across its various retail websites, and provide opportunities to use data more effectively.

**Governance, culture and ESG**
The board comprised 8 non-executive, independent directors and the managing director throughout most of the year, with one non-executive, Diane Smith-Gander retiring at the last AGM and a new director Anil Sabharwal, appointed in February 2021. Wayne Osborn is not seeking re-election at this year's AGM, and WES has appointed two new non-executive directors, Alison Watkins and Alan Cransberg, since balance date.

Board members have a wide range of background expertise and experience, and, taking into account the foregoing changes, the board of 10 will have 4 female members. Corporate culture reads well and it is evident that the group takes employee wellbeing and safety very seriously, continuing to pay all staff during lock-downs, without drawing on Jobkeeper. The annual report contains comprehensive reports on group sustainability and climate-related financial disclosures, together with emissions targets and aspirations.

The group remains very focussed on ethical sourcing of product and opposition to modern slavery in the supply chain, although WES must be experiencing some difficulty in monitoring suppliers to prevent such practices under covid travel constraints.

**Financial Summary**

| (As at FYE) | **2021** | **2020** | **2019** | **2018** | **2017** |
|---|---|---|---|---|---|
| NPAT ($m) | 2,380 | 1,697 | 5,510 | 1,197 | 2,873 |
| UPAT ($m) | 2,421 | 2,083 | 1,940 | 2,772* | 2,873* |
| Share price ($) | $59.10 | $44.83 | $36.10 | $49.36 | $40.12 |
| Dividends declared(cents) | 178c | 170c | 278c | 223c | 223c |
| Simple TSR (%) | 35.8% | 28.4% | 12.2% | 28.6% | 5.0% |
| EPS (cents) | 210.4c | 150.0c | 487.2c | 105.8c | 254.7c |
| CEO remuneration expense (not actual) ($m) | 6.934 | 7.763 | 6.749 | 6.550 | 12.097 |

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

The foregoing information reflects post-AASB16 leases results and information for FY20 and FY21, but pre-AASB leases results and information for the earlier financial years shown. Most of WES's divisions, particularly Bunnings, Kmart Group and Officeworks, are lessees of their premises and the introduction of lease accounting for operating leases may have had significant effects if implemented retrospectively. WES labels 'UPAT' as NPAT from continuing operations excluding significant items.

All divisions posted improved results with WES recording NPAT of $2,421m (FY20 $2,083m) excluding significant items, or $2,380m (FY20 $1,697m) after significant items. Significant items were negative in both years, $41m in FY21 for post-tax provision for Kmart restructuring whereas FY20's significant items totalled $378m post-tax, with the main items being a provision for Kmart Group restructuring, and impairments for Target and Industrial & Safety, partly offset by a profit on sale of 10% interest in Coles.

All divisions reported increases in revenue whilst most improved their EBT margins and returns on capital employed with Bunnings reporting a commendable ROC of 82%. As WES is a conglomerate with about 20 different businesses, it is impractical to go into individual performances in this summary, but the divisional reports on pages 26 to 58 of the AR make encouraging reading. WES is paying a final dividend of 90 cents per share bringing total dividends for 2021 to $1.78 per share (FY20 $1.70) and is proposing a capital return of $2 per share if approved at the AGM.

Gearing is quite high with total debt including lease liabilities at $10,127m (FY20 $9,898m) and total assets $26,214m (FY20 $25,425m) – a ratio of 38.6%. This does not concern us as WES is holding $3,023m (FY20 $2,913m) in cash assets at year-end and also partly because a large portion of the lease liabilities are owed to the BWP Trust (formerly Bunnings Warehouse Property Trust). BWP has a WES subsidiary with independent directors as its responsible entity, 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 $44.83 to $59.10, so shareholders have benefited from a significant total shareholder return as shown above. Bloomberg is quoted in the AR as reporting a 21.5% per annum 5-year rolling TSR to 30 June 2021 for WES which would be hard to beat.

For FY21, the CEO's total statutory remuneration was 74 times (FY20 – 87 times) the Australian Full time Adult Average Weekly Total Earnings (based on May 2021 data from the Australian Bureau of Statistics $93,444 pa).

**<u>Key events</u> such as restructures, acquisitions, buy backs and capital raisings**

There have been no significant external events in FY21. Subsequent to year-end, WES made an offer to acquire all the shares of a listed pharmacy business, Australian Pharmaceutical Industries Ltd (API). The offer has subsequently been revised upwards to a $764 million cash bid. A rival mainly scrip bid from Sigma of $773 million at current prices may complicate the bid. Wesfarmers is currently conducting due diligence.

Internal events included the restructure of Target stores with many being converted to Kmart or K hub formats, group-wide measures to upgrade data and digital assets and capabilities, and a final investment decision to go ahead with the Covalent Joint Venture with Chilean market leader SQM to build a lithium refinery at Kwinana to process ore from the Mt Holland lithium mine. WES is proposing a capital return of $2 per share if approved at the AGM. We have suggested to WES that it consider a capital reduction to absorb the negative reserves, particularly the Coles Demerger Reserve with a debit balance of $5,860m, but we understand there might be adverse tax consequences of so doing.

**<u>Key Board or senior management changes</u>**

The board changes have been identified above and there were no changes to the leadership team as set out in the AR from the executives listed in the FY20 annual report. Subsequent to balance date, WES appointed a new member of the leadership team, Nicole Sheffield, as Managing Director, Data and Digital.

**<u>ASA focus issues</u>**

WES is compliant with or has satisfactorily addressed our focus issues for 2021.

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| **Item 2(a)** | **Re-election of Sir Bill English KNZM as a Director** |
| **ASA Vote** | **For** |

**Summary of ASA Position**

Sir Bill was appointed as a non-executive director in April 2018 after retiring from the New Zealand parliament. He is a member of the Audit & Risk and Nomination Committees. He is a former Prime Minister, deputy Prime Minister and treasurer of NZ and his ministerial experience included health, education, housing and revenue portfolios. His qualifications and experience are relevant to WES activities in many aspects of its businesses. We will support his re-election.

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

**Summary of ASA Position**
Vanessa Wallace has already served 11 years on the WES board and ASA's guidelines ask boards to limit directors' tenure to 12 years. We will no longer be able to regard her as an independent non-executive director after she passes that milestone but the board has a large majority of independent directors anyway. She is a member of the Remuneration and Nomination Committees. She is well qualified and has relevant experience for her role and we will not oppose her re-election.

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| **Item 2(c)** | **Election of Anil Sabwarhal as a Director** |
| **ASA Vote** | **For** |

**Summary of ASA Position**

Anil Sabwarwal, who was appointed in February 2021, has impressive qualifications of relevance to group ambitions to improve its data and digital ecosystems. He is a member of the Audit & Risk and Nomination Committees. Resident in Sydney, he is a vice-president of Google Inc responsible for product management.

Previously he was responsible for development and implementation of Google's Chrome web browser on a worldwide basis but has stepped back from that role to make time available for his non-executive role at WES to which he brings singular qualifications and experience. We will support his election.

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| **Item 2(d)** | **Election of Alison Watkins as a Director** |
| **ASA Vote** | **For** |

**Summary of ASA Position**
Alison Watkins, who was appointed in September 2021, has relevant retail experience as CEO of Coca-Cola Amatil and has held other senior roles after a career in management consulting. She is a member of the Remuneration and Nomination Committees. She is a director of the Reserve Bank, and of CSL Ltd, and chancellor of the University of Tasmania. We will support her election.

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| **Item 2(e)** | **Election of Alan Cransberg as a Director** |
| **ASA Vote** | **For** |

**Summary of ASA Position**
Alan Cransberg, who has been asked to join the board in October 2021, graduated as a civil engineer and joined Alcoa Australia in 1980, becoming its CEO in 2008, following in the footsteps of Wayne Osborn, who is leaving the board after the AGM. He is well known in WA as a previous chair of the West Coast Eagles Football Club. His experience in the mining and chemical processing industry is very relevant to WES' new lithium project. He is to become a member of the Remuneration and Nomination Committees. We will support his election.

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| **Item 3** | **Adoption of Remuneration Report** |
| **ASA Vote** | **For** |

**Summary of ASA Position**

The report sets out clearly the remuneration framework and the consequent remuneration elements for key executives and non-executive directors. FY21 remuneration for the group MD and CFO in the statutory remuneration table on page 110 is less than FY20 remuneration for these executives because the group MD and CFO did not earn their target awards in FY20 because adjusted group NPAT fell short of the required threshold.

In FY22, it is to be expected that the share-based payment expense will be significantly incremented when it starts to reflect the cost of FY21 results where maximum awards were earned for NPAT achievement. In any event and in accordance with accounting standards that apply to all listed companies, share-based payment expense in the statutory remuneration table reflects the accruing cost of this element of remuneration over the period from grant up to vesting of the relevant shares over a number of financial years.

Contrary to ASA guidelines, WES does not disclose actual take-home remuneration, so the relative amount of remuneration actually derived by executives from year to year is unknown and undisclosed. From a shareholder's perspective in ascertaining this information, the information presented in the remuneration report is confusing and complicated. In the absence of disclosure, we assess Mr Scott's total take-home pay with respect to FY21 as comprising his fixed remuneration of $2.5m, plus his deferred share allocation if approved by shareholders $3.7m and the vesting of 81,743 shares from his 2017 performance share allocation at a date subsequent to 30 June 2021 – if we assume a valuation of $57.50 for these shares they were worth $4.7m, giving total remuneration of $10.9m.

The equivalent assessment of his FY20 take-home pay would have been fixed $2.5M, deferred $1.4m and 45,138 shares from his 2016 performance share allocation at an assumed price of $48 ($2.2m), totalling $6.1m. Another way of looking at his take-home pay is to look at it in terms of his package for the year in which he had fixed and deferred shares as above totalling $6.2m and an entitlement to performance shares maturing in 2023 of $3.7m, so a total of $9.9m, compared to $6.5m in FY20 on a similar basis. Extracting this information from the remuneration is possible but takes effort which shareholders would not need to take if actual pay tables were disclosed.

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 10% 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 (in 2020, they also received an allocation of performance-tested shares related to the Kmart/Target reorganisation).

Rob Scott's remuneration package for FY21 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% |

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. Financial objectives carry a 60% weighting, individual performance on business enhancement carries a 20% weighting and covers topics such data analytics, opportunities to use technology more effectively and business turnarounds, whilst sustainability topics such as reputation, risk management, people and culture and climate-related initiatives carry a 10% weighting.

A further 10% is allocated to safety targets. 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%). For divisional MDs the hurdles are relative total shareholder return (RTSR) to ASX100 companies (50%), divisional financial performance (for example, annual EBT and average ROC) (50%).

In order to get the allocation of deferred and performance shares, various thresholds are set in the scorecard. In FY20, the main financial hurdle of NPAT did not achieve its threshold so Mr Scott and Mr Gianotti missed out on a significant element of the award. All thresholds were met in FY21, and the maximum exceeded in several measures, including financial measures applicable to these executives. For the Group MD and CFO, achievement of the financial hurdle is worth 60% of their incentive.

One of the factors responsible for NPAT falling short of threshold in FY20 was provisioning for store closures and redundancies at Target as a result of its reorganisation in FY21. The board 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 profit achieved from the stores converted to Kmart is above 80% of the Board-approved proposal (which is not disclosed), without exceeding the capital expenditure budget. They vest as to nil if the profit equals or falls short of 80% of target, 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 was no equivalent allocation in FY21 but the board did increase thresholds in the scorecards at the half-year mark to reflect improved trading results during the uncertainties surrounding the covid pandemic. Even so, outcomes surpassed thresholds and were close to or in excess of the maximum hurdle set in all instances with the result that the 4 nominated executives earned almost the maximum award available to them for FY21.

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 other concerns about WES' remuneration arrangements as set out below.

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

1. 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 management & 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 EBT 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.

2. 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.
3. 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 has been to allocate shares, not rights to shares. This has been corrected for FY22 by the decision to issue executives with new shares carrying only suspended dividend rights until vested.

Taken overall, we are in favour of the innovative approach to remuneration taken by WES which is designed to provide incentives in line with strategic objectives and long-term shareholder returns. The above concerns are of a relatively minor nature and overall we have decided to vote proxies in favour of the remuneration report this year.

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| **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 a share-based award valued at $7,369,402 (ex-potential maximum $7.5 million), comprising an equal number of deferred shares and performance shares, determined by dividing his incentive amount for each type of shares of $3,684,701 by the volume-weighted average price of Wesfarmers' shares over a 10-day trading period commencing 4 weeks after the AGM after WES shares become ex-entitlement to the proposed capital return (item 6 below). Mr Scott had no entitlement to a cash incentive with respect to FY21 results.
The deferred shares will vest after Mr Scott remains employed by the group until December 2022 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 remuneration structure which (with some reservations) we have approved in previous years. The amount of these awards is high, but so have been the returns to shareholders in FY21. To earn the full value of these awards (which will of course only be determined when the relevant shares vest), Mr Scott needs to maintain the level of total shareholder returns during the performance period of 4 years to 30 June 2024. We propose to vote proxies in favour of the resolution.

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| **Item 6** | **Approval of capital return of $2 per share in December 2021** |
| **ASA Vote** | **For** |

**Summary of ASA Position**

It is perhaps disappointing that the board of WES cannot find a better use for $2.268m of company funds than to return them to shareholders when returns from term deposits are at all time lows and those from the stock exchange plagued with uncertainties. It is of course the same uncertainties which inhibit WES' investment decisions into potential new ventures, given the unsure timing of covid recovery and inflated asset values due to international monetary measures.

However, we are satisfied that this is not for want of looking for investment opportunities and it is not long since WES chewed up $1.3b in a failed attempt to establish Bunnings in the UK. Given the sophistication of WES strategic planning and forecasting and low levels of external debt, we can assume that there will be no need for these funds within the business if WES proposes to make a capital return, so we will support the above resolution.