Issuer Profile:
Neutral (3)

Neutral (3)

Ticker:
WESAU

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Wesfarmers Limited ("WESAU")

Recommendation

- **On the back of resilient performance of its Retail businesses (incudes "category killers" Bunnings and Officeworks), in FY2020, WESAU had reported a revenue growth of 10.5% y/y to AUD30.8bn though profit before tax (from continuing operations) was AUD2.4bn, down 15.2% y/y, dragged by non-cash impairments from Target (within the Retail segment) and the Industrials and Safety ("WIS") business.**
- **Since the application of a new accounting change, WESAU's sizeable lease liabilities have been brought onto balance sheet. Despite that, EBITDA/Interest coverage was healthy at 11.7x while gross debt (including lease liabilities)-to-EBITDA was manageable at 2.3x.**
- **We are maintaining our issuer profile on WESAU at Neutral (3) following the resilient results of the company despite COVID-19, while it had further shore up liquidity by selling down a 10.1%-stake in Coles Group Ltd and increasing its banking facilities in May 2020.**
- **We will cease coverage of WESAU upon the maturity of its existing AUD-bullet bond by 18 November 2020. The company has another two tranches of AUD-floaters and two tranches of EUR-denominated bullet bonds.**
- **Recommendation: Given the very short tenure of the remaining AUD-bullet bond, we are neutral the WESAU 3.66% '20s.**

Background

- Wesfarmers Limited ("WESAU") is part of the ASX50 index with a market cap of AUD54.6bn as at 2 September 2020. WESAU originated from a farmer's co-operative set up in 1914 in Perth, Australia. The company had grown through mergers and acquisitions, culminating in its current corporate structure focusing on two key industry segments, namely Retail (Bunnings, Kmart Group, Officeworks) and Industrial (Wesfarmers Chemical Energy & Fertiliser ("WesCEF"), Wesfarmers Industrials and Safety ("WIS")).
- WESAU's holding company functions as a capital allocator and emphasizes divisional autonomy of its various businesses. Each segment is managed separately, with businesses having separate brand identities. WESAU also holds stakes in other entities, notably a 4.9%-stake in Coles Group Ltd ("Coles", formerly an associate, now recorded as a financial asset), a 24.8%-stake in BWP Trust ("BWP", recorded as an associate, owns properties used for Bunnings' operations) and a 50%-stake in the Mount Holland lithium development project, held as a joint operations.
- WESAU's largest shareholders include BlackRock Inc and Vanguard Group Inc Norges Bank (collectively ~12.0%). The rest of the shareholders hold less than 1.0% in the company. WESAU is part of the Dow Jones Sustainability World Index as of writing.

Key Considerations

- **Resilient profitability despite COVID-19:** WESAU reported its preliminary results for the financial year ended 30 June 2020 ("FY2020"). Revenue was up 10.5% y/y to AUD30.8bn, driven by strong sales growth its Retail segment, which continued to be the main earnings driver. During the year, WESAU took large impairments of AUD941mn,mainly from the impairments of the "Target" brand name and other assets amounting to AUD525mn and impairment at WIS amounting to AUD310mn. Other income though was higher at AUD661mn (FY2019: AUD239mn), driven by the gain on the sale of a 10.1%-stake in Coles and the revaluation of WESAU's remaining 4.9%-stake in Coles (now recorded as a financial asset). Reported finance cost was higher by 111.4% y/y to AUD370mn though, as WESAU had recorded an interest on lease liabilities in FY2020. The company reported profit before tax (from continuing operations) of AUD2.4bn (FY2019: AUD2.8bn), down 15.2% y/y. The company's all-in effective borrowing costs have reduced in FY2020 while average debt balance had also fallen. The company did not receive subsidies from the JobKeeper programme (we think this is because for the most parts, it did not meet the criteria for large firms with an aggregate turnover of more than AUD1.0bn) though received ~AUD40mn from wage subsidies from New Zealand.

- **Retail grew despite lockdowns:** In FY2020, the Retail segment as a whole contributed 88% to total revenue and 85% of total EBITDA (excluding one-off items including impairments at the Kmart Group, WIS and one-off gains from Coles). Total retail revenue grew 12.1% y/y to AUD27.0bn while total retail EBITDA was AUD4.0bn. We find y/y EBITDA comparison not meaningful given that WESAU has applied AASB16-Leases from 1 July 2019 with no restatement of FY2019 results for comparability.

  (1) Bunnings: Bunnings is the leading home improvement and outdoor living products retailer in Australia and New Zealand (including being a supplier to builders and tradespeople for the housing industry). Bunnings is the largest contributor to WESAU's Retail revenue and saw revenue growth of 13.9% y/y to AUD15.0bn in FY2020, with strong store-on-store sales growth of 14.7% y/y. Per company, growth in consumer sales was particularly strong as customers spent more time on home improvement works while under lockdown although there could be some forward spending by consumers, with 2HFY2020 store-on-store sales growth at 25.8% y/y. Bunnings' reported EBITDA was AUD2.6bn in FY2020. Bunnings continue to progress on its online rollout.

  (2) Kmart Group: Comprises the (1) Kmart discount department store (2) Target, which is a mid-price department store and (3) Catch, which is an online retailer that is newly acquired in August 2019. Kmart Group saw revenue growth of 7.2% y/y to AUD9.2bn. While comparable sales growth (52 week retail calendar basis) was positive for Kmart, the discounter, Target which has been underperforming saw a negative comparable sales growth. Catch saw strong gross transaction value growth of 49.2% y/y (from 12 August 2019 to 30 June 2020). Kmart Group's reported EBITDA was AUD1.1bn. While the breakdown between these three sub-segments was not provided, directionally Target was loss-making in FY2020 and expected to continue to be loss-making in FY2021. Post a strategic review, Target is being scaled down and re-positioned to prioritise online growth, focusing on improving soft home and apparel product categories. During the year, Kmart Group took a pre-tax AUD525mn impairment on the "Target" brand name and other assets (which are non-cash) while restructuring costs and provisions were AUD110mn. Per company, Target will continue as a standalone business (rather than a full exit) though its sales contribution would decline as a percentage of total revenue overtime. A one-off AUD120-140mn one-off non-operating cost relating to the conversion and closure of Target stores is expected to be incurred for FY2021.

  (3) Officeworks: Officeworks is the largest supplier of office and stationary products in Australia. The business has similarly benefitted from the lockdown in 2HFY2020 as consumers demanded products and services to basis in their work and learning spaces at home, in addition to a strong back-to-school trading period. Revenue growth was 20.4% y/y to AUD2.8bn while EBITDA was AUD307mn. While Officeworks currently only contributes 10.3% to total Retail revenue and 7.6% to total Retail EBITDA, it is being positioned as a "category killer" – similar to Bunnings in the home improvement space. Online sales make up ~30% of sales for Officeworks.

- **WesCEF – lithium investment decision has not been made:** Within the Industrials segment, WesCEF reported relatively flat revenue of AUD2.1bn (up 0.3% y/y) and EBITDA of AUD481mn. The revenue growth was driven by volume growth in Chemicals and Fertilisers though this was offset by a weaker Energy business with lower prices for liquefied petroleum gas (benchmark prices down 17.3% y/y on average). Within WesCEF, WESAU owns a 50%-interest in the Mt Holland Lithium joint venture following its acquisition of Kidman Resources Limited ("Kidman"). The transaction was accounted for as an asset purchase with carrying value of identifiable net assets of AUD776mn. The other joint venture partner of the project, located in Western Australia, is Sociedad Quimica y Minera de Chile SA ("SQM"), a fertilizer, iodine and lithium producer headquartered in Santiago, Chile. As of writing, WESAU and SQM have decided to defer the final investment decision on this project to 1HFY2021. Lithium is used in the manufacture of aircraft and batteries. Since the acquisition of Kidman in September 2019 to 31 August 2020, prices of lithium have fallen ~28% according to a lithium price index by Benchmark Mineral Intelligence, a specialist information provider. An updated proposed investment size was not provided though in 2019, the media reported WESAU's estimated cost was AUD700mn for its share of the capital expenditure (~AUD300mn higher than what SQM and Kidman estimated).

- **Overall revenue at WIS relatively stable although large impairments taken**: WIS saw its revenue decline somewhat by 0.4% y/y to AUD1.7bn while EBITDA was AUD121mn. The small decline was driven by revenue declines at Workwear Group due to lower corporate uniform sales which was hit by COVID-19 though Blackwoods and Coregas' revenue increased. Blackwoods, an industrial tools and supplies company saw demand growth in critical products (eg: personal protective equipment, cleaning and hygiene products) while Coregas, a gas supplier saw demand growth in the medical segment which boosted top line. AUD310mn of non-cash pre-tax impairment (primarily on goodwill) was taken at WIS following deterioration in outlook for customer demand in the Workwear Group and Greencap along with macro-uncertainty. The Workwear Group was bought in December 2014 for AUD180mn while Greencap, a risk management consultancy was bought for AUD21mn in November 2013.

- **Healthy credit metrics:** Based on our calculation which does not include other income and expenses, WESAU's EBITDA was AUD4.3bn while interest expense (including interest on lease liabilities) was AUD370.0, with resultant EBITDA/Interest still at a healthy 11.7x. Unadjusted net gearing (though including lease liabilities which have been brought on balance sheet) was at 0.75x as at 30 June 2020 (31 December 2019: 1.0x), which optically looks on the high side. On a flow basis though Gross debt (including lease liabilities)-to-EBITDA is only 2.3x, in light of the significant income generation at the company.

- **Minimal refinancing risk:** WESAU's cash balance increased by AUD2.5bn from end-2019 to AUD2.9bn, mainly from the sale of a 10.1%-stake in Coles in 2HFY2020 (generating AUD2.1bn in net proceeds). Since the November 2018 demerger of Coles, WESAU had retained a ~15%-stake in the company with a stake sale expected to eventually happen. However, the timing of the 10.1%-stake sale through two separate tranches in February and March 2020 was to shore up WESAU's balance sheet amid the uncertainty from the virus outbreak. As at 30 June 2020, WESAU's short term debt was AUD503mn while another AUD1.0bn are in short term lease liabilities (collectively AUD1.5bn). Existing cash balance comfortably covers this by 1.9x. All debt remains unsecured while WESAU established an additional AUD1.95bn in committed undrawn facilities in May 2020, bringing its undrawn facilities to AUD5.0bn as at 30 June 2020. WESAU's committed capital expenditure, other expenditures, operating lease commitments and trading guarantees amounted to AUD779mn, manageable in our view though this does not include possible capital expenditures on the lithium project.

- **Active management of lease liabilities:** Lease liabilities are significant at WESAU, as a retailer who do not own all of the properties which are used to operate its businesses. In addition to AUD1.0bn of short term lease liabilities, another AUD6.2bn is classified as long term lease liabilities. Lease liabilities make up 73% of total gross debt (including lease liabilities), mostly off balance sheet prior to the adoption of AASB16-Leases. As at 30 June 2020, the reported weighted average lease tenure by rental payment was 4.8 years, somewhat shorter than the 5.0 years as at 31 December 2019. WESAU uses options on leases to ensure stability of tenure, rather than signing into long lease leases.

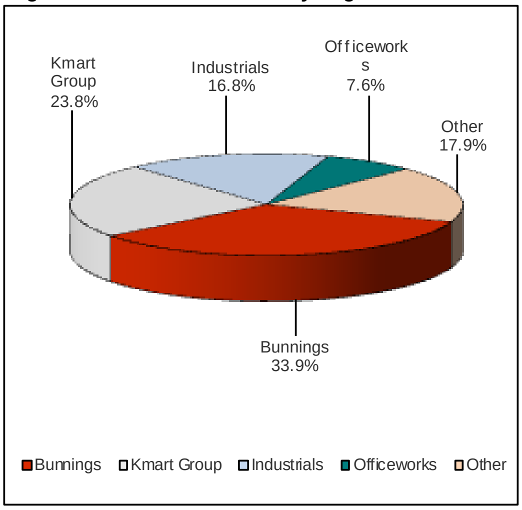
Wesfarmers Ltd

Table 1: Summary Financials

Year Ended 30th June	FY2018	FY2019	FY2020
Income Statement (AUD'mn)			
Revenue	26,763.0	27,920.0	30,846.0
EBITDA	3,065.0	3,043.0	4,339.0
EBIT	2,544.0	2,506.0	2,811.0
Gross interest expense	210.0	175.0	370.0
Profit Before Tax	2,134.0	2,799.0	2,374.0
Net profit	1,409.0	1,940.0	1,622.0
Balance Sheet (AUD'mn)			
Cash and bank deposits	683.0	795.0	2,913.0
Total assets	36,933.0	18,333.0	25,425.0
Short term debt	1,159.0	356.0	1,522.0
Gross debt	4,124.0	3,029.0	9,898.0
Net debt	3,441.0	2,234.0	6,985.0
Shareholders' equity	22,754.0	9,971.0	9,344.0
Cash Flow (AUD'mn)			
CFO	4,260.0	2,861.0	4,904.0
Capex	1,815.0	1,356.0	867.0
Acquisitions	0.0	17.0	988.0
Disposals	1,140.0	1,618.0	2,497.0
Dividends	2,528.0	3,628.0	1,734.0
Interest paid	195.0	170.0	367.0
Free Cash Flow (FCF)	2,445.0	1,505.0	4,037.0
Key Ratios			
EBITDA margin (%)	11.45	10.90	14.07
Net margin (%)	5.26	6.95	5.26
Gross debt to EBITDA (x)	1.35	1.00	2.28
Net debt to EBITDA (x)	1.12	0.73	1.61
Gross Debt to Equity (x)	0.18	0.30	1.06
Net Debt to Equity (x)	0.15	0.22	0.75
Gross debt/total asset (x)	0.11	0.17	0.39
Net debt/total asset (x)	0.09	0.12	0.27
Cash/current borrowings (x)	0.59	2.23	1.91
EBITDA/Total Interest (x)	14.60	17.39	11.73

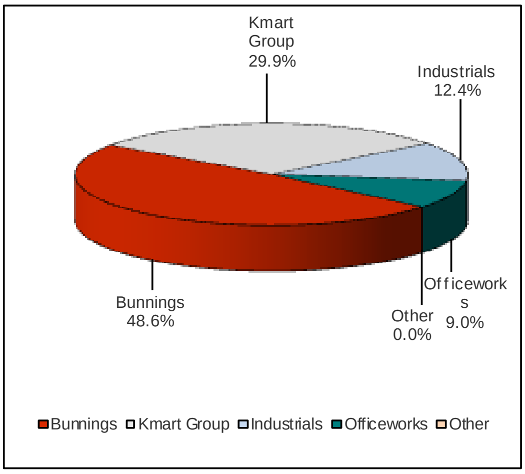
Source: Company, OCBC estimates

Figure 1: Asset breakdown by Segment - FY2020



Source: Company

Figure 2: Revenue breakdown by Segment - FY2020



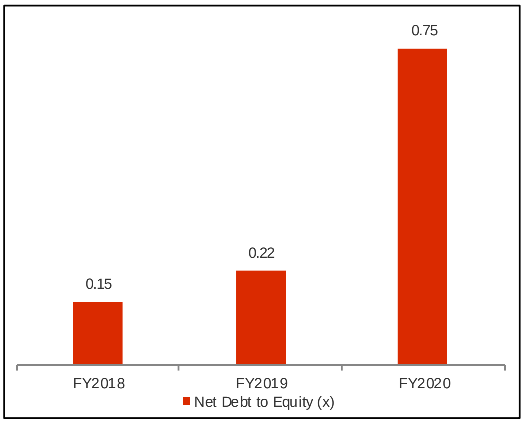
Source: Company

Figure 3: Debt Maturity Profile

	As at 30/06/2020	
Amount repayable in one year or less, or on demand		
Secured	0.0	0.0%
Unsecured	1522.0	15.4%
	1522.0	**15.4%**
Amount repayable after a year		
Secured	0.0	0.0%
Unsecured	8376.0	84.6%
	8376.0	**84.6%**
Total	**9898.0**	**100.0%**

Source: Company, OCBC estimates

Figure 4: Net Debt to Equity (x)



Source: Company, OCBC estimates

Explanation of Issuer Profile Rating / Issuer Profile Score

Positive ("Pos") – The issuer's credit profile is either strong on an absolute basis, or expected to improve to a strong position over the next six months.

Neutral ("N") – The issuer's credit profile is fair on an absolute basis, or expected to improve / deteriorate to a fair level over the next six months.

Negative ("Neg") – The issuer's credit profile is either weaker or highly geared on an absolute basis, or expected to deteriorate to a weak or highly geared position over the next six months.

To better differentiate relative credit quality of the issuers under our coverage, we have further sub-divided our Issuer Profile Ratings into a 7 point Issuer Profile Score scale.

IPR	Positive		Neutral			Negative	
IPS	1	2	3	4	5	6	7

Please note that Bond Recommendations are dependent on a bond's price, underlying risk free rates and an implied credit spread that reflects the strength of the issuer's credit profile. Bond Recommendations may not be relied upon if one or more of these factors change.

Explanation of Bond Recommendation

Overweight ("OW") – The bond represents **better relative value** compared to other bonds from the same issuer, or bonds of other issuers with similar tenor and comparable risk profile.

Neutral ("N") – The represents **fair relative value** compared to other bonds from the same issuer, or bonds of other issuers with similar tenor and comparable risk profile.

Underweight ("UW") – The represents **weaker relative value** compared to other bonds from the same issuer, or bonds of other issuers with similar tenor and comparable risk profile.

Other

Suspension – We may suspend our issuer rating and bond level recommendation on specific issuers from time to time when OCBC is engaged in other business activities with the issuer. Examples of such activities include acting as a joint lead manager or book runner in a new issue or as an agent in a consent solicitation exercise. We will resume our coverage once these activities are completed.

Withdrawal ("WD") – We may withdraw our issuer rating and bond level recommendation on specific issuers from time to time when corporate actions are announced but the outcome of these actions are highly uncertain. We will resume our coverage once there is sufficient clarity in our view on the impact of the proposed action.

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