Wesfarmers

# FINANCIAL SERVICES GUIDE
# AND
# INDEPENDENT EXPERT'S REPORT
# IN RELATION TO THE PROPOSED DEMERGER OF COLES GROUP LIMITED
# BY WESFARMERS LIMITED


GRANT SAMUEL & ASSOCIATES PTY LIMITED

ABN 28 050 036 372


5 OCTOBER 2018

GRANT SAMUEL

# FINANCIAL SERVICES GUIDE

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> ***"Grant Samuel and its related entities do not have at the date of this report, and have not had within the previous two years, any business or professional relationship with Wesfarmers or any financial or other interest that could reasonably be regarded as capable of affecting its ability to provide an unbiased opinion in relation to the Demerger.***
>
> ***Grant Samuel had no part in the formulation of the Demerger. Its only role has been the preparation of this report.***
>
> ***Grant Samuel will receive a fixed fee of $1.5 million for the preparation of this report. This fee is not contingent on the conclusions reached or the outcome of the Demerger. Grant Samuel's out of pocket expenses in relation to the preparation of the report will be reimbursed. Grant Samuel will receive no other benefit for the preparation of this report.***
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> ***Grant Samuel considers itself to be independent in terms of Regulatory Guide 112 issued by the ASIC on 30 March 2011."***

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## 1 Details of the Demerger

On 16 March 2018, Wesfarmers Limited ("Wesfarmers") announced its intention to undertake a demerger of Coles Group Limited ("Coles"), owner of its *Coles* supermarkets, liquor, convenience and financial services businesses, to create a separate company listed on the Australian Securities Exchange ("ASX") (the "Demerger").

As part of the Demerger:

- Wesfarmers will retain a 15% interest in Coles, with the remaining Coles shares distributed to existing Wesfarmers shareholders on the basis of one Coles share for each Wesfarmers share held; and
- *flybuys* will be established as a standalone business held on a 50/50 joint venture basis by Wesfarmers and Coles.

To facilitate the Demerger, an internal restructure will be undertaken to separate and align the relevant businesses, assets and liabilities with the appropriate group. A number of steps have been, or will be, taken to establish Coles and *flybuys* as standalone entities. In particular, it is intended there will be:

- an internal restructure of corporate entities to remove Kmart Australia Limited ("Kmart"), Target Australia Pty Ltd ("Target") and Officeworks Limited ("Officeworks") from Coles Group Limited;
- simplification of Coles' corporate structure;
- a restructure of *flybuys*[1]. Prior to implementation of the Demerger, it is expected that:
  - Wesfarmers and Coles will have entered into a Shareholders Agreement, setting out the ongoing ownership and governance arrangements for the joint venture; and
  - Coles and *flybuys* will have entered into a Participation Agreement, setting out the ongoing commercial and operational relationship between *flybuys* and Coles.

  *flybuys* will operate independently of Coles but will have a Transitional Services Agreement with Coles under which Coles will continue to provide certain core services to enable *flybuys* to continue business as usual operations while it establishes its standalone capability. Wesfarmers will also provide some ongoing support services to *flybuys* during the establishment period;
- an elimination of all intercompany loans between Coles (and its subsidiaries) and Wesfarmers (and its subsidiaries); and
- the establishment of standalone debt facilities by Coles.

The Demerger is to be effected by a scheme of arrangement between Wesfarmers and its shareholders and a reduction of Wesfarmers' share capital. The following steps are required to implement the Demerger:

- Wesfarmers will reduce its share capital by an amount calculated by reference to the market values of Coles and Wesfarmers immediately after implementation of the Demerger;
- the capital reduction and a demerger dividend (collectively referred to as the "distribution amount") will be applied on behalf of Wesfarmers shareholders as payment for Coles shares; and
- an application will be made for Coles to be separately listed on the ASX.

The effect of the Demerger is that Wesfarmers shareholders (other than ineligible overseas shareholders[2] and selling shareholders[3]) will receive shares in Coles that represent, in aggregate, 85% of Coles' issued

[1] flybuys is jointly owned by Wesfarmers Loyalty Management Pty Ltd and Coles and is operated by Coles. Notwithstanding the joint ownership, 100% of flybuys' revenue and earnings are included in the reported earnings of Coles.

[2] Wesfarmers shareholders other than those with registered addresses in Australia, Canada, Hong Kong, New Zealand, Singapore, the United Kingdom or the United States or any other jurisdiction in which Wesfarmers reasonably believes it is not prohibited or unduly onerous or impractical to implement the Demerger and to transfer Coles shares to the Wesfarmers shareholder.

[3] Wesfarmers shareholders holding 160 or fewer shares who elect to have all the Coles shares that they would otherwise receive under the Demerger sold on the ASX via a share sale facility.

capital. Wesfarmers will hold the remaining 15% of Coles as well as its other business operations and will remain listed on the ASX. The ongoing company is referred to in this report, where the context requires it, as "Wesfarmers post Demerger".

Ineligible overseas shareholders and selling shareholders will not receive Coles shares. Such shareholders will receive in cash the proceeds (on an averaged basis) from the sale on the ASX of the Coles shares to which they would otherwise have been entitled, free of any brokerage costs or stamp duty. Selling shareholders may also elect to have the proceeds from the sale of these Coles shares donated to the charity ShareGift Australia.

The Demerger requires Wesfarmers shareholders to approve the following resolutions:

- a members scheme of arrangement under Section 411 of the Corporations Act, 2001 ("Corporations Act"). Under Section 411, a scheme of arrangement must be approved by a majority in number (i.e. more than 50%) of Wesfarmers shareholders present and voting (either in person or by proxy) at the meeting, representing at least 75% of the votes cast on the resolution. The scheme of arrangement will then be subject to approval by the Federal Court of Australia; and
- an ordinary resolution to approve the capital reduction pursuant to Section 256C(1) of the Corporations Act.

The resolutions to be voted on by Wesfarmers shareholders are interdependent. If either resolution is not approved, the Demerger will not proceed.

If the Demerger is approved and implemented, Wesfarmers and Coles will operate independently of each other apart from the following arrangements:

- a Separation Deed, which deals with certain commercial, legal and transitional issues to facilitate the demerger of Coles from Wesfarmers and the establishment of Coles as a separate corporate group;
- a Transitional Services Agreement, which sets out the terms on which:
  - Coles will provide a number of IT, payroll, finance and other services to Kmart, Target and Officeworks; and
  - Wesfarmers will provide workers compensation services (including claims management), general insurance services and other services to Coles;

  for a transitional period of up to 24 months as those services migrate to, or are replicated by Coles, Kmart, Target and Officeworks. All services provided under the Transitional Services Agreement will be charged at cost;
- ongoing contractual agreements between Coles and Kmart, Target and Officeworks for the:
  - provision of payment switch services (processing of credit/debit card transactions);
  - production and management of gift cards; and
  - facilities management in relation to shared use of utilities and heating, ventilation and air conditioning services at sites shared by Coles and Wesfarmers where it is prohibitively expensive or otherwise not possible to establish separate services.

  Each of these agreements represents the formalisation of arrangements that have been in place between the parties for a number of years on terms and pricing consistent with existing arrangements; and
- the Shareholders Agreement in relation to the joint ownership and operation of *flybuys* (referred to above).

## 2 Scope of the Report

### 2.1 Purpose of the Report

The Demerger is subject to the approval of Wesfarmers shareholders in accordance with:

- Section 256C of the Corporations Act ("Section 256C"); and
- Section 411 of the Corporations Act ("Section 411").

Section 256C governs reductions in capital. It requires the prior approval of shareholders before a capital reduction can be effected. Section 256C does not require an independent expert's report to be prepared.

Section 411 governs schemes of arrangement. It requires the prior approval of shareholders before a scheme of arrangement can be effected.

Part 3 of Schedule 8 to the Corporations Regulations prescribes the information to be sent to shareholders in relation to schemes of arrangement pursuant to Section 411. Part 3 of Schedule 8 requires an independent expert's report in relation to a scheme of arrangement to be prepared when a party to a scheme of arrangement has a prescribed shareholding in the company subject to the scheme, or where any of its directors are also directors of the company subject to the scheme. In those circumstances, the independent expert's report must state whether the scheme of arrangement is in the best interests of shareholders subject to the scheme and must state reasons for that opinion.

Although there is no requirement in these circumstances for an independent expert's report pursuant to the Corporations Act or the ASX Listing Rules, the directors of Wesfarmers have engaged Grant Samuel & Associates Pty Limited ("Grant Samuel") to prepare an independent expert's report setting out whether, in its opinion, the Demerger is in the best interests of Wesfarmers shareholders and to state reasons for that opinion. Grant Samuel has also been requested to give its opinion as to whether the capital reduction associated with the Demerger materially prejudices Wesfarmers' ability to pay its creditors. A concise version of the report will accompany the Notice of Meeting and Explanatory Memorandum ("the Scheme Booklet") to be sent to shareholders by Wesfarmers. The full report will be available on the Wesfarmers website at www.wesfarmers.com.au or available to Wesfarmers shareholders on request.

This report is general financial product advice only and has been prepared without taking into account the objectives, financial situation or needs of individual Wesfarmers shareholders. Accordingly, before acting in relation to their investment, shareholders should consider the appropriateness of the advice having regard to their own objectives, financial situation or needs. Shareholders should read the Scheme Booklet issued by Wesfarmers in relation to the Demerger.

Voting for or against the Demerger is a matter for individual shareholders based on their views as to value and business strategy, their expectations about future economic and market conditions and their particular circumstances including risk profile, liquidity preference, investment strategy, portfolio structure and tax position. Shareholders who are in doubt as to the action they should take in relation to the Demerger should consult their own professional adviser.

Similarly, it is a matter for individual shareholders as to whether to buy, hold or sell securities in Wesfarmers (pre or post the Demerger) or Coles. These are investment decisions upon which Grant Samuel does not offer an opinion and independent of a decision on whether to vote for or against the Demerger. Shareholders should consult their own professional adviser in this regard.

### 2.2 Basis of Evaluation

Schemes of arrangement pursuant to Section 411 can encompass a wide range of transactions. Accordingly, "in the best interests" must be capable of a broad interpretation to meet the particular circumstances of each transaction. There is no legal definition of the expression "in the best interests".

The Australian Securities & Investments Commission ("ASIC") has issued Regulatory Guide 111 ("RG111") which establishes guidelines in respect of independent expert's reports. RG111 differentiates between the analysis required for control transactions and other transactions. In the context of control transactions (whether by takeover bid, scheme of arrangement, the issue of securities or selective capital reduction or buyback), the expert is required to distinguish between "fair" and "reasonable". A proposal that was "fair and reasonable" or "not fair but reasonable" would be in the best interests of shareholders (being the opinion required under Part 3 of Schedule 8).

For most other transactions the expert is to weigh up the advantages and disadvantages of the proposal for shareholders. This involves a judgement on the part of the expert as to the overall commercial effect of the proposal, the circumstances that have led to the proposal and the alternatives available. The expert must weigh up the advantages and disadvantages of the proposal and form an overall view as to whether shareholders are likely to be better off if the proposal is implemented than if it is not. If the advantages outweigh the disadvantages, the proposal would be in the best interests of shareholders.

RG111 also states that where a demerger or demutualisation involves one or more of a change in the underlying economic interests of shareholders, a change of control or selective treatment of different shareholders, an expert might need to consider whether using the "fair" and "reasonable" tests is appropriate.

The Demerger is not a control transaction and there is no change in the underlying economic interests of shareholders. Accordingly, Grant Samuel has evaluated the Demerger by assessing the overall impact on Wesfarmers shareholders and formed a judgement as to whether the expected benefits outweigh any disadvantages and risks that might result. By definition, if the advantages outweigh the disadvantages, shareholders are likely to be better off if the Demerger is implemented than if it is not.

In forming its opinion as to whether the Demerger is in the best interests of Wesfarmers shareholders, Grant Samuel has considered the following:

- the impact of the Demerger on the business operations of Wesfarmers and Coles, including any strategic implications;
- the impact of the Demerger on earnings and dividends attributable to existing shareholders;
- the impact of the Demerger on the financial position and financial risk profile of the demerged entities;
- the implications of ongoing relationships between the demerged entities;
- the likely impact of the Demerger on the market value of shareholders' interests and the market for shares in Wesfarmers and Coles generally;
- any other advantages and benefits arising from the Demerger; and
- the disadvantages, costs and risks of the Demerger.

In forming its opinion as to whether the capital reduction materially prejudices Wesfarmers' ability to pay its existing creditors, Grant Samuel has considered the following:

- the effect of the capital reduction on the financial position and size of Wesfarmers and Coles;
- the impact of the capital reduction on the credit rating of Wesfarmers and Coles; and
- the debt facilities available to Wesfarmers and Coles after the capital reduction.

## 2.3 Sources of Information

The following information was utilised and relied upon, without independent verification (subject to Section 2.4 below), in preparing this report:

**Publicly Available Information**

- the Scheme Booklet (including earlier drafts);
- annual reports of Wesfarmers for the five years ended 30 June 2018;
- press releases, public announcements, media and analyst presentation material (including in relation to Coles) and other public filings by Wesfarmers including information available on its website;
- brokers' reports and recent press articles on Wesfarmers; and
- sharemarket data and related information on Australian and international listed companies engaged in the retail and chemical sectors.

**Non Public Information provided by Wesfarmers**

- selected presentations and board papers regarding the Demerger;
- information on Wesfarmers post Demerger and Coles provided to ratings agencies; and
- other confidential documents, board papers, presentations and working papers.

In preparing this report, representatives of Grant Samuel held discussions with, and obtained information from, senior management of Wesfarmers and Coles.

## 2.4 Limitations and Reliance on Information

Grant Samuel believes that its opinion must be considered as a whole and that selecting portions of the analysis or factors considered by it, without considering all factors and analyses together, could create a misleading view of the process employed and the conclusions reached. Any attempt to do so could lead to undue emphasis on a particular factor or analysis. The preparation of an opinion is a complex process and is not necessarily susceptible to partial analysis or summary.

Grant Samuel's opinion is based on economic, sharemarket, business trading, financial and other conditions and expectations prevailing at the date of this report. These conditions can change significantly over relatively short periods of time. If they did change materially, subsequent to the date of this report, the opinion could be different in these changed circumstances.

This report is also based upon financial and other information provided by Wesfarmers and its advisers. Grant Samuel has considered and relied upon this information. Wesfarmers has represented in writing to Grant Samuel that to its knowledge the information provided by it was then, and is now, complete and not incorrect or misleading in any material respect. Grant Samuel has no reason to believe that any material facts have been withheld.

The information provided to Grant Samuel has been evaluated through analysis, inquiry and review to the extent that it considers necessary or appropriate for the purposes of forming an opinion as to whether the Demerger is in the best interests of Wesfarmers shareholders. However, Grant Samuel does not warrant that its inquiries have identified or verified all of the matters that an audit, extensive examination or "due diligence" investigation might disclose. While Grant Samuel has made what it considers to be appropriate inquiries for the purposes of forming its opinion, "due diligence" of the type undertaken by companies and their advisers in relation to, for example, prospectuses or profit forecasts, is beyond the scope of an independent expert.

Accordingly, this report and the opinions expressed in it should be considered more in the nature of an overall review of the anticipated commercial and financial implications rather than a comprehensive audit or investigation of detailed matters.

An important part of the information used in forming an opinion of the kind expressed in this report is comprised of the opinions and judgements of management. This type of information was also evaluated through analysis, inquiry and review to the extent practical. However, such information is often not capable of external verification or validation.

Preparation of this report does not imply that Grant Samuel has audited in any way the management accounts or other records of Wesfarmers. It is understood that the accounting information that was provided was prepared in accordance with generally accepted accounting principles and in a manner consistent with the method of accounting in previous years (except where noted).

The information provided to Grant Samuel included pro forma historical financial information for Wesfarmers, Wesfarmers post Demerger and Coles:

- for the three years ended 30 June 2018 in relation to income and cash flow statements; and
- as at 30 June 2018 in relation to balance sheets.

Wesfarmers and Coles are responsible for this financial information. The pro forma historical financial information was subject to review by Ernst & Young Transaction Advisory Services Limited ("EY"). The Independent Limited Assurance Report is set out in Section 6 of the Scheme Booklet. On this basis, Grant Samuel considers that there are reasonable grounds to believe that the pro forma historical financial information on Wesfarmers post Demerger and Coles as presented in the Scheme Booklet has been prepared on a reasonable basis.

In forming its opinion, Grant Samuel has also assumed that:

- matters such as title, compliance with laws and regulations and contracts in place are in good standing and will remain so and that there are no material legal proceedings, other than as publicly disclosed;
- the assessments by Wesfarmers and its advisers with regard to legal, regulatory, tax and accounting matters relating to the Demerger are accurate and complete;
- the information set out in the Scheme Booklet sent by Wesfarmers to its shareholders is complete, accurate and fairly presented in all material respects;
- the publicly available information relied on by Grant Samuel in its analysis was accurate and not misleading;
- the Demerger will be implemented in accordance with its terms; and
- the legal mechanisms to implement the Demerger are correct and will be effective.

To the extent that there are legal issues relating to assets, properties, or business interests or issues relating to compliance with applicable laws, regulations, and policies, Grant Samuel assumes no responsibility and offers no legal opinion or interpretation on any issue.

# 3 Profile of Wesfarmers

## 3.1 Background

Wesfarmers originated in 1914 as a Western Australian farmers' co-operative, with a focus on providing services and merchandise to the rural community. Its purpose was to "add materially to the services offered by Wesfarmers and to its overall surplus for the year". Wesfarmers listed on the ASX in November 1984 with a unique structure that guaranteed that the co-operative's farmer members retained control and a market capitalisation of $84 million. By 2001, it had restructured to become a freely-traded publicly listed company with open ownership.

Following its listing on the ASX, Wesfarmers diversified its operations considerably by expending its existing businesses and entering new industries and countries, including coal (Western Collieries, Bengalla, Curragh), home improvement and building supplies (Bunnings in Australia and New Zealand ("Bunnings ANZ"), Homebase in the United Kingdom and Ireland), industrial and safely product distribution (Blackwoods and Coregas), rail freight, insurance underwriting (Lumley Insurance in Australia and New Zealand) and insurance broking (OAMPS). Wesfarmers' largest acquisition was the November 2007 acquisition of Coles Group Limited ("Coles Group") for $19.3 billion. The acquisition initially created three new divisions, Coles, Kmart and Target (with Officeworks becoming part of a big box retailing division along with Bunnings ANZ), and doubled Wesfarmers' earnings.

Wesfarmers actively manages its portfolio of businesses to maximise shareholder value. This approach resulted in the sale of its foundation rural business (then known as Landmark) in 2003. Other key divestments have included its 50% interest in Australian Railroad Group, its insurance division, its coal assets (with the sale of the last remaining asset, a 40% interest in the Bengalla joint venture, announced on 7 August 2018), the Kmart Tyre and Auto Service business (announced on 12 August 2018) and its 13.2% interest in Quadrant Energy Holdings Pty Ltd ("Quadrant Energy") (announced on 22 August 2018). The loss-making Bunnings United Kingdom and Ireland business ("BUKI", formerly Homebase), was sold for a nominal consideration in June 2018.

Today, the Wesfarmers conglomerate is one of Australia's largest listed companies, with a market capitalisation prior to announcement of the Demerger of almost $47 billion. It is also one of Australia's largest private sector employers with around 217,000 employees.

## 3.2 Business Operations

Wesfarmers' portfolio of business operations can be classified as either retail or industrial. The key retail divisions are summarised below:

**WESFARMERS – RETAIL DIVISIONS**

| DIVISION | BUSINESS | DESCRIPTION |
|---|---|---|
| Coles | coles | Full service supermarket providing fresh food, groceries and general merchandise with 809 supermarkets throughout Australia |
| | coles.com.au | Online supermarket with multiple delivery channels operating throughout Australia |
| | coles express | Fuel and convenience store retailer with 711 outlets throughout Australia operating under an exclusive alliance agreement with Viva Energy |
| | Liquorland<br>Vintage Cellars<br>first choice liquor | Liquor retailer with 899 stores throughout Australia |
| | spirit hotels | Operator of 88 hotels in Queensland, Western Australia, South Australia and New South Wales |
| | coles Financial Services | Distributor of *Coles* branded home, car and landlord insurance (manufactured by Insurance Australia Group) and credit cards (manufactured by Citigroup) |

### WESFARMERS – RETAIL DIVISIONS (CONT)

| DIVISION | BUSINESS | DESCRIPTION |
|---|---|---|
| **Coles (cont)** | Flybuys | Loyalty program where members are able to earn and redeem points and rewards across most of Wesfarmers' retail businesses as well as a range of partner entities. Australia's largest rewards program with over 8 million active members covering around 6 million Australian households (around 72% of all households)[1] |
| **Bunnings** | Bunnings Warehouse, Bunnings, Bunnings Trade | Leading supplier of home improvement and outdoor living products in Australia and New Zealand to consumer and commercial customers through a network of 369 large warehouses, smaller format stores and trade centres |
| **Department Stores** | Kmart | One of Australia's largest retailers of apparel and general merchandise at low prices with 228 stores throughout Australia and New Zealand |
| | Kmart Tyre & Auto Service | Retail automotive service, repair and tyre business, with 256 stores throughout Australia[4] |
| | Target | Retailer of apparel, homewares and general merchandise through a network of 303 stores across Australia |
| **Officeworks** | Officeworks | Leading retailer and supplier of office products and solutions for home, business and education through a network of 165 stores and four fulfilment centres across Australia |

Source: Wesfarmers

The key industrials divisions are summarised below:

### WESFARMERS – INDUSTRIALS DIVISIONS

| DIVISION | BUSINESS | DESCRIPTION |
|---|---|---|
| **Chemicals, Energy and Fertilisers ("WesCEF")** | CSBP | Manufacturer and supplier of ammonia, ammonium nitrate and industrial chemicals to the Western Australian market |
| | CSBP | Manufacturer, importer and distributor of phosphate, nitrogen and potassium-based fertilisers for the Western Australian agricultural sector and provider of a soil and plant analysis service in regional Western Australia |
| | Australian Vinyls, Modwood | Supplier of polyvinyl chloride resins (used in piping, cable insulation, floor coverings, building profiles, packaging and compounds) and producer of wood-plastic composite products from recycled wood and plastic in Australia |
| | AGR | Manufacturer of sodium cyanide (used for gold extraction) which is distributed to the Western Australian and international gold mining industry (75% joint venture) |
| | QNP | Fully integrated ammonia/ammonium nitrate facility located near Moura, Queensland, with a manufacturing capacity of approximately 230,000 tonnes per annum (50% joint venture) |
| | Kleenheat, EVOL LNG | Producer, importer and distributor of liquefied petroleum gas ("LPG") to residential and commercial markets across Western Australia and the Northern Territory, retailer of natural gas to residential and commercial markets and electricity to businesses in Western Australia and producer and supplier of liquefied natural gas ("LNG") as a fuel for remote power stations, industrial facilities, marine bunkering and transportation |
| | Quadrant Energy | Supplier of domestic gas in Western Australia and oil across Australia (13.2% ownership interest)[5] |

4 Wesfarmers announced the sale of its Kmart Tyre and Auto Service business to Continental AG for \$350 million on 12 August 2018. The sale is expected to complete in the first quarter of FY19.

5 Wesfarmers announced the sale of its 13.2% interest in Quadrant Energy to Santos Limited for approximately US\$170 million on 22 August 2018. The sale is expected to complete in the second or third quarter of FY19.

**WESFARMERS – INDUSTRIALS DIVISIONS (CONT)**

| DIVISION | BUSINESS | DESCRIPTION |
|---|---|---|
| **Industrial and Safety ("WIS")** | Blackwoods | Full service supplier of tools, safety gear, workwear and other industrial supplies to businesses in Australia |
| | NZ Safety Blackwoods | Leading supplier of safety equipment, engineering supplies, uniforms and packaging products to businesses in New Zealand |
| | GREENCAP | Integrated risk management and compliance business with more than 360 professional, technical and engineering staff based in 10 offices in Australia and Asia, servicing private and government clients across all sectors |
| | coregas | Producer of industrial, medical and specialty gases at two facilities in New South Wales and Queensland and a specialty gas laboratory in New South Wales servicing markets across Australia and New Zealand |
| | WORKWEAR GROUP | Portfolio of eight apparel and footwear brands including *King Gee*, *Hard Yakka*, *Stubbies*, *Bates*, *Wolverine*, *Totally Workwear*, *NNT* and *Incorporate Wear* which adopts an end-to-end, solution-focused approach, manufacturing more than a million units per annum and shipping to businesses of all sizes in more than 30 countries |
| **Resources** | BENGALLA | Open-cut coal mining joint venture in the Hunter Valley, New South Wales capable of producing approximately nine million tonnes per annum of thermal coal for domestic and export markets (40%)[6] |

Source: Wesfarmers

In addition, Wesfarmers has non-controlling interests in a number of other businesses:

**WESFARMERS – OTHER BUSINESS OPERATIONS**

| OTHER BUSINESSES | BUSINESS | DESCRIPTION |
|---|---|---|
| **Other** | bwp TRUST | ASX listed property trust which owns 81 retail warehouse properties across Australia (primarily Bunnings ANZ warehouses) (24.8%) |
| | GRESHAM | Independent financial services business providing financial advisory services, structured finance, and property financing and funds management (50%) |
| | WESPINE | Plantation softwood sawmill in Dardanup, Western Australia producing machine-graded pine for use in building construction (50%) |

Source: Wesfarmers

Wesfarmers also has a small corporate office which includes company secretariat, group corporate affairs, group accounting and statutory reporting, taxation, treasury, insurance, investor relations, group human resources functions, business development and other functions Wesfarmers requires as a listed company.

Wesfarmers operates under a model of divisional autonomy. Each division in the group:

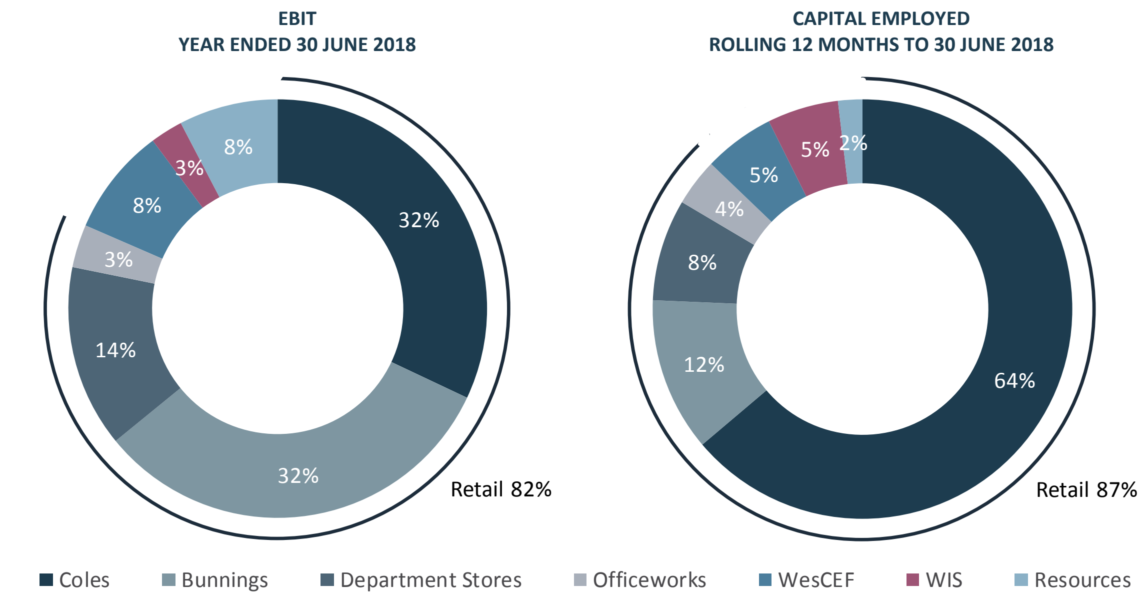
- has a strong management capability, with divisional management responsible for strategy development and execution as well as day-to-day operational performance; and
- is overseen by a divisional board of directors or steering committee that includes the Wesfarmers Managing Director and Chief Financial Officer ("CFO").

Wesfarmers' retail business operations are the largest contributor to Wesfarmers' EBIT[7] and represent the majority of capital employed by the group:

6 Wesfarmers announced the sale of its 40% interest in the Bengalla joint venture to its joint venture partner, New Hope Corporation, for $860 million on 7 August 2018. The sale is expected to complete in the fourth quarter of 2018.

7 EBIT is earnings before finance costs, tax and significant items. It is before corporate and other EBIT (primarily corporate expenses and profit after tax from non-controlling interests in BWP Trust, Gresham Partners and Wespine).

**WESFARMERS – CONTRIBUTION BY BUSINESS[8]**




Source: Wesfarmers

In FY18[9], Wesfarmers' retail business operations contributed 82% of group EBIT and 87% of group capital employed, with Coles representing 32% of group EBIT and 64% of capital employed.

## 3.3 Business Strategy

The primary objective of Wesfarmers is to provide a satisfactory return to its shareholders over the long term through financial discipline and active management of a diversified portfolio of businesses.

Returns are measured by comparing Wesfarmers' total shareholder return ("TSR") against the return achieved by the broader Australian market index. Wesfarmers aims to provide a superior TSR (relative to the broader Australian market) over time. Growth in TSR requires generating rates of return on invested capital that are greater than the cost of that capital and growing the capital base at a satisfactory rate. TSR incorporates both dividends and capital appreciation and is calculated assuming dividend reinvestment and full participation in capital management initiatives.

This primary objective is driven by four key strategies:

- strengthening Wesfarmers' existing businesses through operating excellence and satisfying customer needs;
- securing growth opportunities through entrepreneurial initiative;
- renewing the portfolio through value-adding transactions; and
- ensuring sustainability through responsible long-term management.

At its 2017 Annual General Meeting in November 2017, the incoming Managing Director, Rob Scott, outlined three priorities for Wesfarmers which were re-emphasised at the 2018 Strategy Briefing Day on 7 June 2018:

- continuing to attract, develop and retain the best talent;

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8 EBIT and capital employed include Curragh (up to 29 March 2018) but exclude BUKI and "other" EBIT and capital employed.

9 FYXX is the year end 30 June 20XX.

- accelerating its digital and data capabilities by increasing its investment at a group and divisional level and collaborating in areas where it can improve its customer offer and competitive position. As part of this focus, Wesfarmers has established an Advanced Analytics Centre with 10-20 data scientists and data engineers to support divisional teams; and
- being entrepreneurial in taking opportunities, challenging the status quo and learning from mistakes.

In actively managing its portfolio of businesses, Wesfarmers' approach to capital allocation is focused on:

- opportunities to invest in and grow its existing portfolio of businesses;
- adjacent opportunities that leverage Wesfarmers' existing assets and competencies; and
- disciplined investment in value accretive transactions (either through strategic stakes, joint ventures or 100% ownership).

At a divisional level, detailed strategies are developed specific to the opportunities to improve each of the individual business operations.

## 3.4 Financial Performance

### 3.4.1 Historical Group Performance

Wesfarmers' historical financial performance for the five years ended 30 June 2018 and its continuing operations financial performance for the year ended 30 June 2018[10] are summarised below:

**WESFARMERS – SUMMARISED HISTORICAL FINANCIAL PERFORMANCE ($ MILLIONS)**

| | YEAR ENDED 30 JUNE | | | | | |
|---|---|---|---|---|---|---|
| | 2014 ACTUAL | 2015 ACTUAL | 2016 ACTUAL | 2017 ACTUAL | 2018 ACTUAL | 2018 CONTINUING OPERATIONS |
| **Revenue** | **62,348** | **62,447** | **65,981** | **68,444** | **69,878** | **66,883** |
| **EBITDA[11]** | **4,909** | **4,978** | **4,903** | **5,668** | **5,571** | **5,565** |
| Depreciation and amortisation | (1,123) | (1,219) | (1,296) | (1,266) | (1,283) | (1,198) |
| **EBIT[12]** | **3,786** | **3,759** | **3,607** | **4,402** | **4,288** | **4,367** |
| Finance costs | (363) | (315) | (308) | (264) | (211) | (211) |
| **Operating profit before tax[13]** | **3,423** | **3,444** | **3,299** | **4,138** | **4,077** | **4,156** |
| Income tax expense (on operating profit) | (1,025) | (1,004) | (946) | (1,265) | (1,305) | (1,252) |
| **Operating profit after tax[13]** | **2,398** | **2,440** | **2,353** | **2,873** | **2,772** | **2,904** |
| Significant items (after tax) | 291 | - | (1,946) | - | (1,575) | (300) |
| **Reported NPAT[14]** | **2,689** | **2,440** | **407** | **2,873** | **1,197** | **2,604** |

[10] FY18 continuing operations financial performance excludes discontinued operations (i.e. Curragh coal mine and BUKI) and significant items. It is prepared on the same basis as the Wesfarmers post Demerger financial performance set out in Section 5.2.2 of this report.

[11] EBITDA is earnings before finance costs, tax, depreciation and amortisation and significant items. It includes share of profits of equity accounted associates and joint ventures and other income (including interest income), consistent with the basis on which Wesfarmers reports. Interest income is included on the basis that a significant proportion of interest income was from finance advances and loans through Coles' financial services operation (which was disposed of on 1 February 2017).

[12] EBIT is earnings before finance costs, tax and significant items. It includes share of profits of equity accounted associates and joint ventures and other income (including interest income, refer to footnote 11 above), consistent with the basis on which Wesfarmers reports.

[13] Operating profit before tax and operating profit after tax are before significant items.

[14] NPAT is net profit after tax.

**WESFARMERS – SUMMARISED HISTORICAL FINANCIAL PERFORMANCE ($ MILLIONS) (CONT)**

| | YEAR ENDED 30 JUNE | | | | | |
|---|---|---|---|---|---|---|
| | 2014 ACTUAL | 2015 ACTUAL | 2016 ACTUAL | 2017 ACTUAL | 2018 ACTUAL | 2018 CONTINUING OPERATIONS |
| *STATISTICS* | | | | | | |
| *Basic earnings per share (before signif. items)* | *$2.09* | *$2.16* | *$2.10* | *$2.55* | *$2.45* | *$2.57* |
| *Basic earnings per share (after signif. items)* | *$2.35* | *$2.16* | *$0.36* | *$2.55* | *$1.06* | *$2.30* |
| *Ordinary dividend per share* | *$1.90* | *$2.00* | *$1.86* | *$2.23* | *$2.23* | *$2.23* |
| *Ordinary dividend payout ratio*[15] | *91%* | *93%* | *89%* | *88%* | *91%* | *87%* |
| *Amount of dividend franked* | *100%* | *100%* | *100%* | *100%* | *100%* | *100%* |
| *Special dividend per share* | *$0.10* | - | - | - | - | - |
| *Capital management distribution* | *$0.50* | *$1.00*[16] | - | - | - | - |
| *Revenue growth* | *+4.2%* | *+0.2%* | *+5.7%* | *+3.7%* | *+2.1%* | *+3.0%*[17] |
| *EBIT growth* | *+3.5%* | *-0.7%* | *-4.0%* | *+22.0%* | *-2.6%* | *+4.5%*[17] |
| *Operating profit after tax growth* | *+6.1%* | *+1.8%* | *-3.6%* | *+22.1%* | *-3.5%* | *+5.2%*[17] |
| *EBIT margin* | *6.1%* | *6.0%* | *5.5%* | *6.4%* | *6.1%* | *6.5%* |
| *Fixed charges cover*[18] | *3.2x* | *3.0x* | *2.7x* | *3.1x* | *3.0x* | *3.0x* |
| *Interest cover*[19] *(cash basis)* | *15.9x* | *20.5x* | *16.8x* | *25.0x* | *30.4x* | *30.4x* |
| *Return on capital*[20] | *13.1%* | *12.9%* | *13.0%* | *16.0%* | *nc*[21] | *16.8%* |

Source: Wesfarmers and Grant Samuel analysis

Wesfarmers' group results reflect the benefits of the conglomerate structure. It generated modest growth in revenue and relatively flat EBITDA and EBIT (on the back of falling margins) over the period from FY14 to FY16 as declining performance across most of its industrials businesses (in particular, Resources) was offset by growth in its retail businesses (other than Target). There was a considerable upturn in performance in FY17, driven by Bunnings ANZ, Kmart and a turnaround in the resources division, but offset by a decline in earnings from Coles and a second year of losses at Target. Performance in FY18 was impacted by losses at BUKI prior to its disposal in June 2018 and a further decline in Coles' performance, which more than offset strong results achieved by Bunnings ANZ, Department Stores, Officeworks and WesCEF (see Section 3.4.2 for further discussion of business division performance).

Wesfarmers has strong liquidity metrics:

- fixed charges cover has been reasonably conservative at around 3 times over the past five years, reflecting Wesfarmers' robust financial performance; and
- interest cover has been very high, increasing to 30.4 times in FY18. Finance costs have generally declined over the past five years as Wesfarmers has repaid debt and benefited from a reduction in its effective borrowing cost (which has fallen from 5.4% in FY14 to 4.2% in FY18).

15 Dividend payout ratio calculated using basic earnings per share before significant items.

16 FY15 capital management distribution was a $0.25 per share fully franked dividend and a $0.75 per share capital return.

17 Revenue, EBIT and operating profit after tax growth have been calculated based on restated FY17 figures.

18 Fixed charges cover is (EBITDA (before significant items) plus minimum lease payments) divided by (finance costs (net of discount adjustment) plus minimum lease payments).

19 Interest cover (cash basis) is EBITDA (before significant items) divided by net cash interest expense (finance costs less non-cash finance costs).

20 Return on capital is calculated as EBIT (before significant items) divided by capital employed. Capital employed is working capital plus fixed assets and investments less provisions and other liabilities.

21 nc = not calculated.

Return on capital (excluding significant items) was around 13% from FY14 to FY16, with capital employed remaining relatively flat (in line with EBIT) over this period. The increase to 16-17% in FY17 and FY18 reflects the combination of EBIT growth and a reduction in capital employed (reflecting impairments at Target and the Resources business in FY16 and BUKI and Target in FY18).

Wesfarmers' financial performance over this period also reflects the impact of business transformations, acquisitions and divestments, in particular:

- significant items in FY14, FY16 and FY18 (there were also one-off items in FY15 and FY17 although these were, collectively, not material):

**WESFARMERS – REPORTED SIGNIFICANT ITEMS ($ MILLIONS)**

| | YEAR ENDED 30 JUNE | | | | |
|---|---|---|---|---|---|
| | 2014 ACTUAL | 2015 ACTUAL | 2016 ACTUAL | 2017 ACTUAL | 2018 ACTUAL |
| Net gains/(losses) on disposal of businesses | 1,135 | - | - | - | (255) |
| Restructuring provision – Coles Liquor | (94) | - | - | - | - |
| Impairment – Target | (677) | - | (1,266) | - | (306) |
| Restructuring costs and provisions – Target | - | - | (145) | - | - |
| Impairment – Curragh | - | - | (850) | - | - |
| Impairment, write offs and store closure provisions – BUKI | - | - | - | - | (931) |
| **Significant items (before tax)** | **364** | **-** | **(2,261)** | **-** | **(1,492)** |
| Income tax (expense)/benefit | (73) | - | 315 | - | (83) |
| **Significant items (after tax)** | **291** | **-** | **(1,946)** | **-** | **(1,575)** |

Source: Wesfarmers

The major significant items have been impairments and restructuring costs relating to the transformation of Target, the underperformance of BUKI, lower coal prices for Curragh and the loss on disposal of BUKI in FY18, offset by gains on the disposal of the insurance division and Air Liquide WA in FY14 and Curragh coal mine in FY18; and

- acquisition and divestment of businesses in line with Wesfarmers' strategy of active portfolio management. Over the past five years, Wesfarmers has:
  - invested more than $1 billion in Mineral Development Licence ("MDL") 162 (adjacent to Curragh coal mine) (FY14), Workwear Group (FY15), the remaining 50% interest in the Coles credit card joint venture (FY15), an effective 13.7% interest in Quadrant Energy (FY15) and BUKI (FY16); and
  - divested its insurance division (FY14), its 40% interest in Air Liquide WA (FY14), Kleenheat's east coast LPG gas distribution business (FY15), Coles' credit card receivables (FY17), the Curragh coal mine (FY18) and BUKI (FY18).

In considering dividends, the Wesfarmers board has regard to available franking credits, current earnings and cash flows, future cash flow requirements and targeted credit metrics. The result of applying this dividend policy over the past five years has been a consistently high ordinary dividend payout ratio of ~90%.

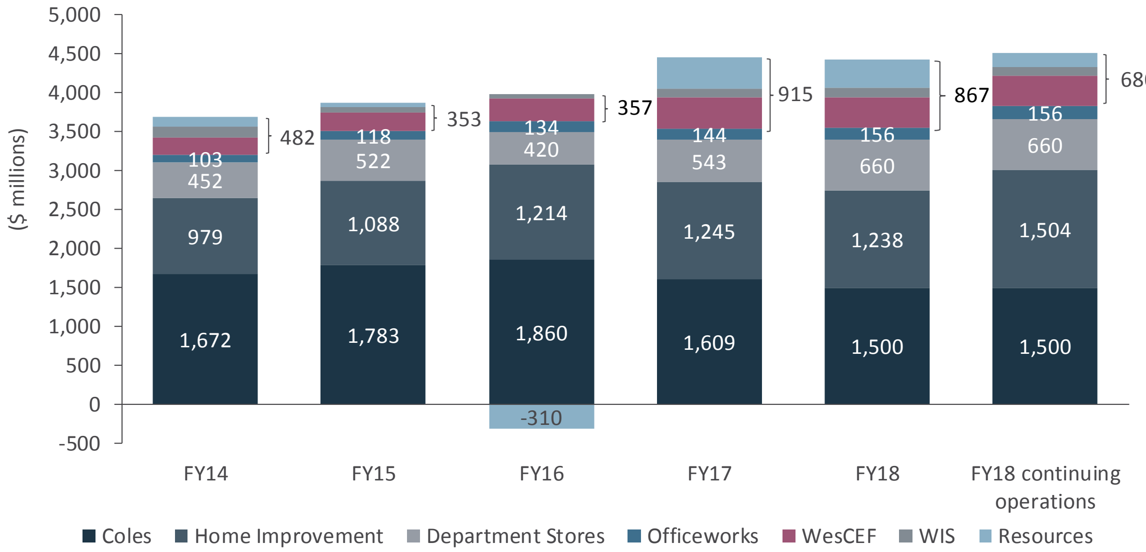
In addition to ordinary dividends, Wesfarmers has undertaken further capital management initiatives (in FY14 and FY15) to return surplus capital to shareholders and to ensure an efficient capital structure. In FY14, it returned $579 million to shareholders through a $0.50 per share capital return and paid a special dividend of $0.10 per share to commemorate its centenary. In FY15, $1.1 billion was paid out to shareholders in the form of a $0.75 capital return and a $0.25 fully franked dividend. The payment in FY15 related to the divestment of Wesfarmers' insurance division and its 40% interest in Air Liquide WA, which generated a combined pre-tax profit of $1.135 billion.

### 3.4.2 Historical Performance by Business

Wesfarmers' EBIT by business over the past five years is shown in the chart below:

**WESFARMERS – EBIT BY BUSINESS**

**FY14 – FY18**




Source: Wesfarmers

Over the past five years, Coles has represented the single largest contribution to Wesfarmers' group EBIT, although its contribution has declined from a peak of 51% in FY16 to as low as 32% in FY18. Coles performed strongly over the period from FY14 to FY16, but earnings fell in FY17[22] and FY18 as it traded through a challenging period in a competitive market. In particular, the large investment in price and service by Woolworths Group Limited's ("Woolworths") required a competitive response involving significant investment by Coles in value and service. As a result, sales were flat in FY17 and FY18 and margins fell considerably. In addition to the supermarkets business, Coles' EBIT includes earnings from:

- the liquor business, which commenced a five year transformation program at the end of FY14 that has resulted in positive comparable sales growth since 2HY16[23];
- the *Coles Express* convenience store business where there has been consistently strong growth in store sales but declining fuel volumes over the past five years (resulting in declining total sales);
- 100% of the earnings from *flybuys*; and
- property activities of around $20 million per annum (although this can vary depending on the level of disposal activity).

The Bunnings ANZ business has grown strongly over the past four years, achieving average annual growth in EBIT of around 11% and equalling Coles as the main contributor to earnings in FY18. The contribution of the Home Improvement division includes BUKI from its acquisition at the end of February 2017. While BUKI had no impact on EBIT in FY16, it contributed a loss of $89 million in FY17 and a loss of $266 million (before impairments and asset write downs) prior to its divestment in FY18. Bunnings ANZ's earnings includes a net property contribution of around $40 million per annum (although this can vary depending on the level of disposal activity).

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22 FY17 includes a $39 million profit on sale of properties and an $11 million contribution from the Coles credit card business that was divested in February 2017.

23 2HYXX = Six months ended 30 June 20XX.

The Kmart business has also performed strongly with average annual growth in EBIT of almost 15% over the three years to FY17[24]. However, this growth has been offset to some extent by underperformance by Target. Despite performance turnaround initiatives that had been out into place a few years earlier, Target's EBIT declined substantially in FY14 due to lower margins from price deflation and a competitive market. While there was a slight recovery in FY15, challenging trading conditions resulted in a $50 million EBIT loss in FY16, before $145 million of restructuring costs and provisions to reset the business in line with a revised strategic plan. The restructuring of the cost base resulted in performance improving in FY17 (a reduced EBIT loss of $10 million) and FY18 (reaching profitability).

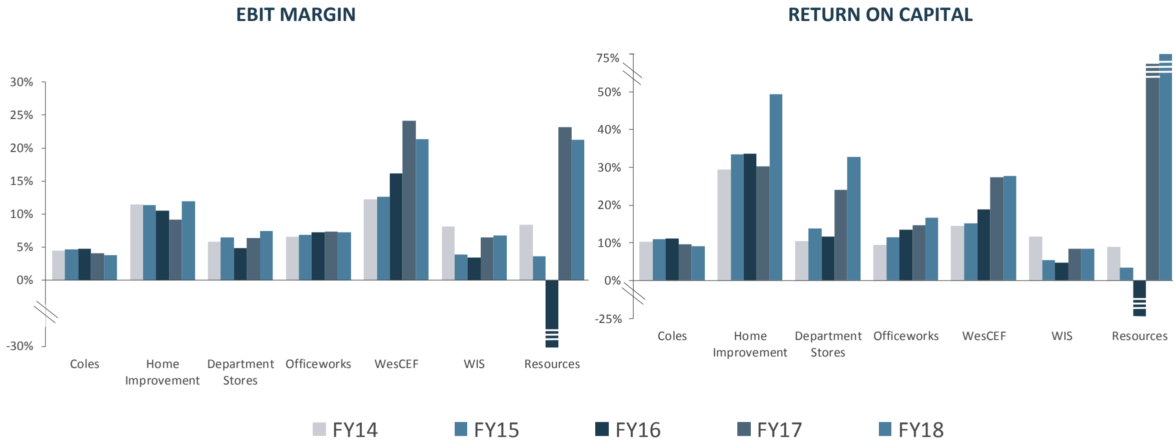
Officeworks is a relatively small contributor to Wesfarmers' group EBIT. While representing only around 3% of group EBIT, it has achieved average annual growth in EBIT of 11% over the past four years through its continued investment in the customer offer (product, price and service) and its "every channel" strategy.

The industrials division (comprising WesCEF, WIS and Resources) has had mixed performance over the past five years. The EBIT contribution from all three business fell in FY14 due to a challenging external environment including continued deterioration in LPG production economics, reduced industrial customer demand and lower export coal prices. These conditions and the consequent earnings decline continued for WIS and Resources in FY15, with their combined EBIT contribution less than half the prior year (although WIS's result included $20 million of restructuring costs), resulting in Resources reporting a $310 million EBIT loss in FY16. Both divisions achieved a strong turnaround in performance in FY17, with WIS almost doubling EBIT (albeit still below FY14 levels) as benefits from the restructuring of Blackwoods and Workwear Group emerged, and Resources reported a $405 million EBIT on the back of higher export coal prices, increased coal production and improvements in productivity. However, growth stalled in FY18. WIS earnings were affected by ongoing investments to build capabilities at Blackwoods and by increased competition and higher energy costs at Coregas, while the earnings for Resources reflect only nine months' contribution from Curragh coal mine. WesCEF turned around its performance from FY14 and has grown strongly (in particular through an additional ammonium nitrate plant and cost reduction programs), achieving average annual growth in EBIT of more than 15% over the past four years.

The EBIT margin and return on capital for each of Wesfarmers' businesses are set out below:

**WESFARMERS – EBIT MARGIN AND RETURN ON CAPITAL BY BUSINESS**

**FY14 TO FY18**




Source: Wesfarmers

These charts highlight Coles as a low margin, low return on capital division relative to most of Wesfarmers' other divisions, albeit this primarily reflects the nature of the supermarket industry. The relatively low return on capital is exacerbated by the significant goodwill and intangible assets recognised on the acquisition of Coles in 2008.

[24] Wesfarmers did not report the performance of Kmart and Target separately in FY18.

Coles' EBIT margins have declined in recent years (from a peak of 4.7% in FY15 and FY16 to 3.8% in FY18). Home Improvement's EBIT margins have been impacted by losses in BUKI in FY17 and FY18 and Department Stores' EBIT margins have been impacted by underperformance at Target, which is implementing a transformation program. However, over the past five years, Bunnings ANZ has consistently achieved EBIT margins of around 11.5%, and Kmart has grown its EBIT margin from 8.7% in FY14 to 9.9% in FY17[24]. Similarly, Officeworks has grown its EBIT margin from 6.5% in FY14 to 7.3% in FY18.

Within the industrials division, WesCEF has consistently been Wesfarmers' highest margin business, almost doubling its EBIT margin from 12.2% in FY14 to 21.3% in FY18 (albeit it is a more capital intensive business). The WIS and Resources divisions' margins have been more variable, due to transformation projects at WIS and the impact of commodity prices on Resources' margins. The results of these transformation projects can be seen in FY17 and FY18, with WIS EBIT margins consistently improving and Resources EBIT margins matching those of WesCEF.

Relative returns on capital across the business divisions are broadly in line with EBIT margins. Excluding the variable performance of the Resources division, Bunnings ANZ achieves the highest return on capital of Wesfarmers' businesses at 49.4% (having increased from 29.3% in FY14). Department Stores, Officeworks and WesCEF have also reported increasing return on capital. Five years ago, Department Stores and Officeworks were achieving a return on capital not dissimilar to Coles (at around 10%), but both have increased their return on capital considerably (Department Stores to 32.8% and Officeworks to 16.6%) whereas Coles' return on capital peaked at just over 11% in FY16 and has fallen below 10% in FY17 and FY18. Equally, WesCEF has increased its return on capital from 14.4% in FY14 to 27.7% in FY18 and WIS has reported an increase in return on capital over the past four years (albeit still below FY14 levels).

### 3.4.3 Outlook

Wesfarmers does not provide earnings forecasts. However, on 15 August 2018, in conjunction with the release of its FY18 results, Wesfarmers stated that "the group's strong balance sheet position, cash flow generation and capital discipline will be prioritised enabling it to take advantage of growth opportunities to create value for shareholders over the long term". In particular, Wesfarmers provided the following statements in relation to the outlook for its key business divisions:

- Coles will continue its "Fresh Tomorrow" strategy and build on its customer-led approach with an increasing focus on delivering greater convenience and innovation for customers. Coles aims to differentiate its offer in a dynamic retail environment to deliver long term growth in earnings. Sale momentum has continued to build in the first quarter of FY19, driven by the Little Shop campaign, other promotional initiatives and improved store execution. The underlying supermarkets business is expected to continue to improve, but earnings will be impacted by the annual impact of additional employee costs following the implementation of a new Enterprise Bargaining Agreement in the second half of FY18. These additional costs are expected to be largely offset by cost efficiency benefits.

  The Liquor business will continue to execute its transformation plan and Coles Express remains focused on providing a differentiated, market-leading shop offer underpinned by value pricing ad food-to-go offers, as well as providing a competitive fuel offer.

  Net capital expenditure in FY19 is expected to increase to $600-800 million, subject to property activities, as Coles invests in strategic growth initiatives, including stores and supply chain;

- Bunnings ANZ will continue to focus on creating better experiences for customers and leveraging further efficiencies through the business. Key objectives for FY19 include offering a wide range of products and services, further development of the digital platform, engaging more effectively with the commercial market and delivering further customer value

- the Department Stores division is well positioned for the future:
  - Kmart will continue to focus on delivering the lowest prices on everyday items (aiming to deliver profitable growth through increased volumes and improvements in its product offering, as well as expansion of its digital strategies), category growth opportunities and ongoing operating efficiencies in stores and the supply chain. It will continue to invest in its store network, planning to open five new stores and refurbish 33 stores in FY19; and
  - Target (a much smaller part of the Department Stores division) will continue to implement its transformation plan, focusing on further improving profitability and cash generation which are expected to be supported by improved sales momentum. The business will continue to advance the fashionability and quality of its products, accelerate improvements in its online proposition and optimise its store network while focusing on end-to-end cost reduction and further improving working capital management;
- Officeworks is well placed to drive growth in highly competitive sector. Key areas of focus for FY19 include continuing to strengthen and expand its customer offer, extending its "every channel" reach both physically and digitally and enhancing productivity and efficiency; and
- the Industrials businesses will continue to focus on operational efficiencies and growing revenues from new and existing customers:
  - WesCEF is focused on developing new growth opportunities and contracts to help mitigate the oversupply of ammonium nitrate in Western Australia. Earnings will continue to be impacted by international commodity prices, exchange rates, competitive factors and seasonal outcomes; and
  - following the strategic reset of WIS, it is well positioned to grow across its different market sectors and drive additional operating efficiencies. Market conditions and demand are expected to remain generally stable. While the transformation of Blackwoods continues, the turnaround of Workwear is nearing completion.

Following announcement of the sale of Wesfarmers' 40% interest in the Bengalla joint venture on 7 August 2018, the exit from the Resources business has been completed.

## 3.5 Financial Position

The financial position of Wesfarmers as at 30 June 2018 is summarised below:

**WESFARMERS – SUMMARISED FINANCIAL POSITION[25] ($ MILLIONS)**

| | AS AT 30 JUNE 2018 ACTUAL |
|---|---|
| Receivables and prepayments | 1,939 |
| Inventories | 6,011 |
| Trade and other payables | (6,552) |
| Other | 492 |
| **Net working capital** | **1,890** |
| Property, plant and equipment | 8,408 |
| Intangible assets | 17,860 |
| Investments in associates and joint ventures | 748 |
| Other assets | 222 |
| Provisions and other liabilities | (3,187) |
| **Total capital employed** | **25,941** |

[25] The above balances reflect the management balance sheet, which is based on different classifications and groupings than the balance sheet in the FY18 Annual Report.

**WESFARMERS – SUMMARISED FINANCIAL POSITION[25] ($ MILLIONS)**

| | AS AT 30 JUNE 2018 ACTUAL |
|---|---|
| Cash (excluding cash in transit) | 191 |
| Borrowings | (4,124) |
| Cross currency and interest rate swaps (net) | 353 |
| **Net borrowings** | **(3,580)** |
| Net tax balances | 393 |
| **Net assets** | **22,754** |
| *STATISTICS* | |
| *Shares on issue at period end (million) (including reserved shares)* | *1,133.8* |
| *Net assets per share* | *$20.07* |
| *NTA[26] per share* | *$4.32* |
| *Gearing[27]* | *15.7%* |

Source: Wesfarmers and Grant Samuel analysis

Net working capital of $1.9 billion reflects a combination of negative working capital at Coles, Kmart and Officeworks (i.e. inventory is sold faster than creditors are paid) which is more than offset by positive working capital at Wesfarmers' other retail and industrials businesses. Working capital includes cash in transit (shown as "other" above).

Property, plant and equipment is primarily plant, vehicles and equipment ($6.5 billion). Wesfarmers does own some land and buildings ($1.9 billion), but the majority of its retail premises are leased. Operating lease commitments as at 30 June 2018 were $18.4 billion, over 50% of which ($9.8 billion) related to Coles. More than half of Wesfarmers' lease commitments expire within five years, with options used to provide long term security. This approach provides Wesfarmers with operational flexibility in its retail businesses.

Intangible assets primarily relate to Coles (around 75% or $13.3 billion) and include goodwill on the acquisition of Coles, brands, software, gaming and liquor licences and contractual and non-contractual relationships.

Investments in associates and joint ventures represent Wesfarmers' non-controlling interests in BWP Trust, Wespine and Gresham Partners, as well as the 40% interest in the Bengalla joint venture, the 75% joint venture interest in Australian Gold Reagents Pty Ltd interests in Queensland Nitrates and Quadrant Energy and property and property management joint ventures.

Approximately 50% of the provisions balance relates to employee benefits but it also includes a provision of $585 million for self-insured risks as Wesfarmers self-insures for workers compensation and general liability claims.

Wesfarmers has a diversified funding mix that includes unsecured bank debt with a number of domestic and international banks (approximately 20% of total borrowings) as well as capital markets debt in the form of domestic and Euro bonds (approximately 80% of total borrowings). For the year ended 30 June 2018, Wesfarmers' average cost of funds was 4.18%. Wesfarmers' banking facilities are generally structured on a revolving basis with expiry dates out to July 2019 and its bonds have maturities out to August 2022 (with more than 50% repayable in FY22). The combined average term to maturity is 2.3 years. Borrowings are impacted by the seasonal working capital requirements of Wesfarmers' retail businesses and dividend payments and, excluding other impacts on borrowings (such as proceeds from asset sales), are typically higher in December than June.

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26 NTA is net tangible assets, which is calculated as net assets less intangible assets.

27 Gearing is net borrowings divided by net assets, consistent with the basis on which Wesfarmers reports.

Wesfarmers has an investment grade credit rating of A-/Stable/A-2 from Standard & Poor's and A3/Stable/P-2 from Moody's. Wesfarmers expects to retain existing investment grade credit ratings following the Demerger.

## 3.6 Cash Flow

Wesfarmers' cash flow for the five years ended 30 June 2018 is summarised below:

**WESFARMERS – SUMMARISED CASH FLOW ($ MILLIONS)**

| | YEAR ENDED 30 JUNE | | | | |
|---|---|---|---|---|---|
| | 2014 ACTUAL | 2015 ACTUAL | 2016 ACTUAL | 2017 ACTUAL | 2018 ACTUAL |
| **EBITDA** | **4,909** | **4,978** | **4,903** | **5,668** | **5,571** |
| Tax paid | (1,172) | (1,102) | (1,009) | (951) | (1,308) |
| Net interest paid | (234) | (256) | (157) | (151) | (180) |
| Change in working capital and other adjustments | (277) | 171 | (372) | (340) | 3 |
| **Operating cash flow** | **3,226** | **3,791** | **3,365** | **4,226** | **4,086** |
| Capital expenditure (net) | (1,216) | (1,552) | (1,336) | (1,028) | (1,209) |
| Acquisitions (net of cash) and investments | (136) | (383) | (750) | (26) | - |
| Divestments | 2,641 | 124 | 1 | 947 | 534 |
| Other[28] | (377) | (87) | (47) | 54 | 17 |
| **Free cash flow** | **4,178** | **1,893** | **1,233** | **4,173** | **3,428** |
| Dividends paid | (2,160) | (2,597) | (2,270) | (1,998) | (2,528) |
| Capital return paid | (585) | (864) | - | - | - |
| Proceeds from exercise of options | 4 | 4 | 1 | 1 | - |
| Demerger transaction costs | - | - | - | - | (7) |
| **Net cash generated/(used)** | **1,437** | **(1,564)** | **(1,036)** | **2,176** | **893** |
| *STATISTICS* | | | | | |
| *Cash realisation ratio[29]* | *92%* | *104%* | *95%* | *102%* | *99%* |

Source: Wesfarmers and Grant Samuel analysis

Wesfarmers' businesses are highly cash generative, illustrated by the consistently high (~100%) cash realisation ratio. This has been primarily because of its heavy weighting to retail businesses, in particular, Coles, Kmart and Officeworks (which have negative working capital). Where the cash realisation ratio has been below 100%, this has been due to one-off factors. In FY14 the ratio increases to 101% when it is adjusted for year-end timing differences relating to Coles' creditors. The drop in FY16 related to investments to improve stock availability at BUKI, with the ratio at 100% excluding this investment.

Wesfarmers has a history of ongoing investment in its businesses to generate shareholder value. Gross capital expenditure has been in range $1.7-2.2 billion per annum over the past five years, representing continued investment in improving store networks (new and replacement stores as well as refurbishments and resizes) and online capabilities in the retail businesses. Capital expenditure in the industrials businesses is lumpier due to the one-off nature of expansions. Gross capital expenditure declined to $1.9 billion in FY16 and $1.7 billion in FY17, reflecting fewer retail store openings and refurbishments and, in FY17, lower capital expenditure by the industrials businesses. Gross capital expenditure was $1.8 billion in FY18, reflecting an increased number of Bunnings ANZ store openings and the acquisition of the previously licensed *Kmart* brand name for $100 million.

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28 Other is net acquisition of insurance deposits in FY14 and net redemption of/(investment in) loan notes associated with the investment in Quadrant Energy in FY15 to FY18.

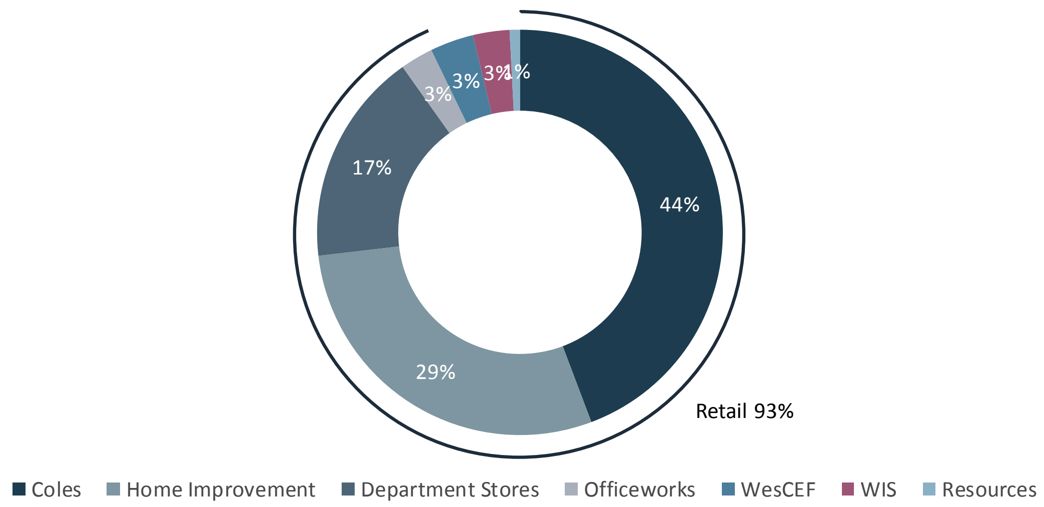
29 Cash realisation ratio is operating cash flow as a percentage of net profit after tax before depreciation and amortisation. It is calculated before significant one-off items, discontinued operations and non-trading items.

Capital expenditure in the table above is shown net of property sales. Wesfarmers' retail businesses regularly acquire, develop, sell and lease back properties, with sale and leaseback in a typical year releasing more than $650 million to fund reinvestment in new property. Decisions about sale and lease back are made at a divisional level. The majority of Bunnings ANZ's properties have historically been sold to the BWP Trust and other property investors or via securitised lease transactions. Coles has a property joint venture with ISPT but also sells properties directly to third parties.

The vast majority of Wesfarmers' capital expenditure (generally around 90%) relates to its retail businesses:

**WESFARMERS – CAPITAL EXPENDITURE BY BUSINESS (INCLUDING ACCRUALS)**

**YEAR ENDED 30 JUNE 2018**




Source: Wesfarmers

Since 2008, 40-45% of Wesfarmers' capital expenditure has been invested in Coles. Gross annual capital expenditure (including accruals) for Coles has ranged from around $760 million (in FY16 and FY18) to $1.0 billion (FY14).

Acquisitions and divestments by Wesfarmers over the past five years reflect Wesfarmers' strategy of active portfolio management (see Section 3.4.1 for details).

Dividends and capital returns paid reflect Wesfarmers' capital management initiatives, with the increase in dividends paid in FY15 reflecting the special dividend ($114 million) and the dividend component of the capital management payment ($287 million) paid in that year.

## 3.7 Taxation Position

Under the Australian tax consolidation regime, Wesfarmers and its wholly owned Australian resident entities have elected to be taxed as a single entity.

As at 30 June 2018, Wesfarmers had $678 million in accumulated franking credits (before taking into account the impact of payment of the final dividend for the year ended 30 June 2018).

## 3.8 Capital Structure and Ownership

### 3.8.1 Capital Structure

As at the date of this report, Wesfarmers had the following securities on issue:

- 1,133,840,242 ordinary shares; and
- 915,821 performance rights over unissued ordinary shares.

Ordinary shares include 2.3 million reserved shares. Reserved shares are ordinary shares that have been repurchased by Wesfarmers and are being held for future use, and include employee reserved shares issued to employees under the Wesfarmers Employee Share Plan[30].

Wesfarmers operates a Key Executive Equity Performance Plan ("KEEPP") under which key senior executives receive cash (although the cash component will reduce over time), as well as restricted shares and performance shares. 50% of restricted shares are released after five years, with the remaining 50% released after six years. Performance shares are subject to the achievement of performance hurdles (cumulative divisional EBIT targets subject to a divisional return on capital gateway and TSR relative to the S&P/ASX 100 index) measured over a four-year period for divisional Managing Directors and return on equity, TSR and strategic measures for the group Managing Director).

The KEEPP was implemented in FY17 and replaced:

- the annual incentive plan, where key senior executives received cash and restricted shares for achieving or exceeding target performance based on relevant financial and non-financial measures; and
- Wesfarmers' Long Term Incentive Plan, where key senior executives received performance rights based on achieving a specified TSR and compound annual growth in return on equity relative to the S&P/ASX 50 index over a four-year performance period.

The purpose of the KEEPP was to reflect Wesfarmers' autonomous operating model and to reward executives for achieving the objectives for which they are accountable and responsible.

Wesfarmers also operates the Wesfarmers Employee Share Acquisition Plan under which employees are invited to acquire Wesfarmers shares under a salary sacrifice arrangement or are granted Wesfarmers shares as an award, subject to Wesfarmers achieving a NPAT performance hurdle. Under the latter, employees are granted an award of Wesfarmers shares or an equivalent cash payment at the end of a three-year employment period.

Wesfarmers has a dividend reinvestment plan which enables shareholders to reinvest some or all of their distributions in shares at a discount determined by the Wesfarmers board. The plan is currently active. Shares issued to shareholders under the dividend reinvestment plan have been acquired on-market.

### 3.8.2 Ownership

Wesfarmers has approximately 495,000 registered shareholders. The top ten registered shareholders account for more than half of the ordinary shares on issue and are principally institutional nominee or custodian companies. Wesfarmers has a significant retail investor base with a majority of registered shareholders classified as retail, representing approximately 50% of shares on issue. Wesfarmers shareholders are predominantly Australian based investors (albeit a number of international fund managers hold Wesfarmers shares through custodians with an Australian address).

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[30] Under the Wesfarmers Employee Share Plan, employees were invited to apply for Wesfarmers shares funded by an interest-free loan from Wesfarmers where the obligation for repayment of the loan is limited to the dividends declared and capital returns by Wesfarmers. The last issue under the plan was made in December 2004.

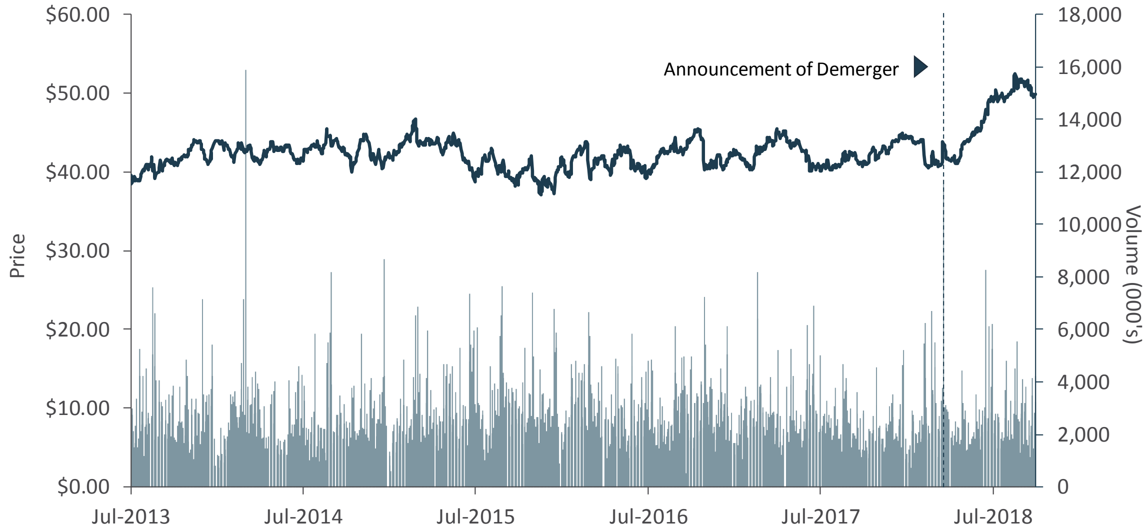
As at the date of this report, The Vanguard Group, Inc.[31] and BlackRock, Inc.[32] are the only shareholders that have provided substantial shareholder notices to Wesfarmers, with each disclosing a 5.0% beneficial interest in Wesfarmers shares.

## 3.9 Share Price Performance

The following graph illustrates the movement in Wesfarmers' share price and trading volumes over the past five years (since 1 July 2014):

**WESFARMERS – SHARE PRICE AND TRADING VOLUME**

**JULY 2013 TO SEPTEMBER 2018**




Source: IRESS
Note: Wesfarmers share price has been adjusted for the special dividend of $0.10 per share effective from 28 August 2014 and the 0.9827:1 share consolidation and $0.75 per share capital return effective from 25 November 2014.

Over the past five years (up to announcement of the Demerger), Wesfarmers' shares have traded in a reasonably tight range around $39-45 per share.

Immediately prior to announcement of the Demerger, Wesfarmers shares were generally trading in a range around $41. Following the announcement on 16 March 2018, Wesfarmers' share price increased by over 6% to close at $43.80, although this gain was not sustained, with the share price reverting to pre-announcement levels by mid-April 2018 (the market as a whole was relatively flat over this period). There has been a subsequent increase in Wesfarmers' share price, with the shares trading consistently above $45 since mid-May 2018 and peaking at just under $53 in mid-August 2018. This share price increase can be attributed to a number of significant announcements over this period, including the announcements of FY18 third quarter sales results on 26 April 2018 (that showed growing sales momentum for Coles' food and liquor business), the agreement to divest BUKI on better than expected terms on 25 May 2018, the 2018 strategy briefing day held on 7 June 2018 and Wesfarmers' FY18 results on 15 August 2018 (which reported very strong results for Bunnings ANZ, Department Stores, Officeworks, WesCEF and the Bengalla joint venture).

Wesfarmers is a liquid stock with no restrictions on its free float. Average weekly volume over the twelve months prior to announcement of the Demerger represented approximately 1.0% of average shares on issue or annual turnover of around 53% of total average issued capital.

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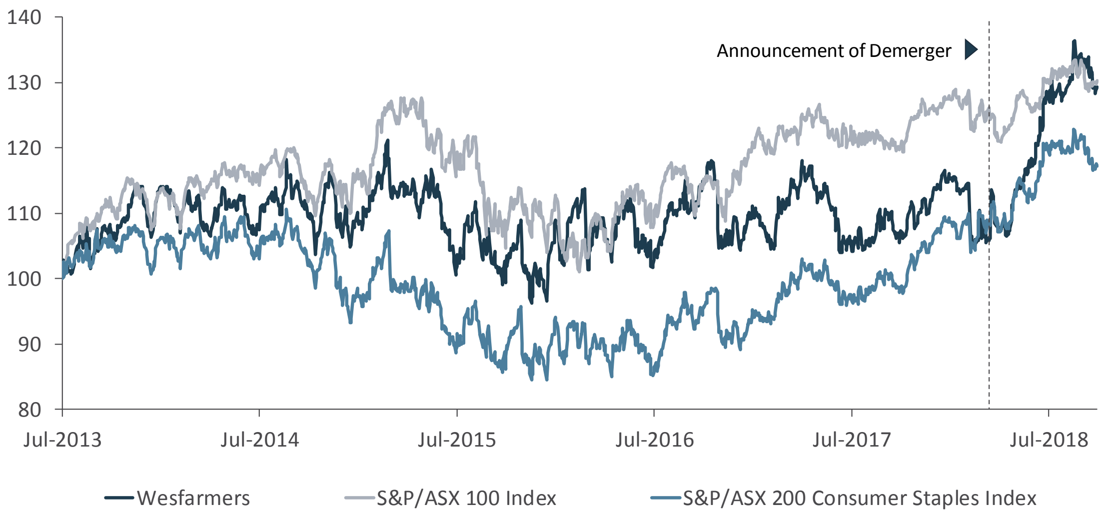
[31] The Vanguard Group, Inc. became a substantial shareholder on 5 September 2017.

[32] BlackRock, Inc. became a substantial shareholder on 24 January 2017.

Wesfarmers is the seventh largest company listed on the ASX, with a current market capitalisation of around $55.5 billion. It is a member of various indices including the S&P/ASX 20, S&P/ASX 50, S&P/ASX 100 and S&P/ASX 200 where its weighting ranges from 3-6%. It is also the largest member of the S&P/ASX 200 Consumer Staples index with a weighting of more than 40%. The following graph illustrates the performance of Wesfarmers shares over the past five years (since 1 July 2013) relative to the S&P/ASX 100 index and the S&P/ASX 200 Consumer Staples index:

**WESFARMERS VS S&P/ASX 100 INDEX AND S&P/ASX 200 CONSUMER STAPLES INDEX**

**JULY 2013 TO SEPTEMBER 2018**




Source: IRESS

Over the past five years, Wesfarmers' shares have outperformed relative to the S&P/ASX 200 Consumer Staples index despite Wesfarmers' significant weighting in the index. This reflects the relative performance of Woolworths (which makes up just under 30% of the index) at various times during this period, in particular, its underperformance during 2015 and its outperformance during the first half of 2017. Excluding these impacts, Wesfarmers has, as would be expected, largely traded in line with the S&P/ASX 200 Consumer Staples index.

Wesfarmers' shares have mainly traded in line with or slightly below the S&P/ASX 100 index over the past five years, with periods of underperformance coinciding with the February 2015 announcement of its FY15 half year results and the 2015 strategy briefing day in May 2015, declining quarterly comparable retail sales growth at Coles (during the first six months of 2017) and losses, impairments and write downs at BUKI and impairment at Target (in February 2018).

Subsequent to announcement of the Demerger, Wesfarmers initially generally traded in line with both the S&P/ASX 200 Consumer Staples index and the S&P/ASX 100 index but has outperformed both indices following announcement of the divestment of BUKI in late May 2018.

## 4 Background on Demergers and Spin-offs

A "demerger" or "spin-off" is generally understood to be a pro-rata transfer of shares in a wholly owned subsidiary to shareholders of the parent company. The broad principle underlying demergers is that sharemarkets do not reward corporate diversification unless there are substantial synergies available to a corporate holder of a diversified portfolio of assets or there is some other strategic rationale. Investors can achieve diversification themselves and it is generally accepted that investors prefer the investment flexibility resulting from the separation of assets into separate companies that have relatively focussed businesses. Consequently, demergers have typically been undertaken to create investment opportunities with a single geographic focus, a single industry focus or a single product focus. However, demergers may be undertaken for a variety of strategic reasons.

A pure demerger involves the transfer to existing shareholders of 100% of the shares in the subsidiary and there is no dilution of equity or transfer of ownership from the current shareholders. There are a number of variants that are also loosely referred to as demergers including:

- a partial demerger, where the parent distributes a portion of its interest in the subsidiary's shares to existing shareholders and either retains the remaining shares for a period or sells them immediately through an initial public offering ("IPO") or other sale process. The portion distributed could be a majority (>50%) or minority (<50%) interest. The carved-out subsidiary has its own board, management and financial statements while the parent company may provide strategic direction or central resources. The level of influence by the parent will reflect the interest retained and other factors;
- an equity carve-out, where the parent company sells a portion of a subsidiary's shares (usually less than 50%) though an IPO. Similar to a partial demerger, the carved-out subsidiary will have its own board, management and financial statements while the parent company provides strategic direction and central resources; and
- a divestiture IPO, where 100% of the shares in the subsidiary are sold to the public, often with some kind of preferential right offered to the parent company shareholders.

The use of demergers as a method of divesting a subsidiary has become a common feature of equity markets in recent years. Demergers implemented in Australia since 2000 include:

**SELECTED RECENT DEMERGERS IN AUSTRALIA[33]**

| DATE[34] | PARENT | BUSINESS/ MARKET FOCUS | DEMERGED ENTITY | BUSINESS/ MARKET FOCUS | % DEMERGED |
|---|---|---|---|---|---|
| Jun 2018 | Westfield Corporation | Shopping centre development, management and ownership | OneMarket Limited | Retail technology | 100%[35] |
| Nov 2017 | Fairfax Media Limited | Media | Domain Holdings Australia Limited | Online property | 40% |
| Aug 2017[36] | Reckon Limited | Accounting software | GetBusy Plc | Document management software | 100% |
| Dec 2016 | Metals X Limited | Base metals | Westgold Resources Limited | Gold | 100% |

33 The June 2013 demerger of the publishing business of News Corporation (now renamed Twenty-First Century Fox Inc.) as News Corporation has been excluded as both entities are United States companies although they have secondary listings on the ASX.

34 Implementation date (i.e. when trading commenced as separate entities).

35 While 100% of OneMarket Limited was demerged to Westfield Corporation securityholders, OneMarket Limited owned 90% of the OneMarket business, with the remaining 10% retained by Westfield Corporation and acquired by Unibail-Rodamco SE as part of its acquisition of Westfield Corporation.

36 Reckon Limited demerged GetBusy Plc on the AIM Market of the London Stock Exchange and raised £3 million of working capital by way of a non renounceable rights issues.

## SELECTED RECENT DEMERGERS IN AUSTRALIA[33] (CONT)

| DATE[37] | PARENT | BUSINESS/ MARKET FOCUS | DEMERGED ENTITY | BUSINESS/ MARKET FOCUS | % DEMERGED |
|---|---|---|---|---|---|
| Jun 2016 | APN News & Media Limited (renamed HT&E Limited) | Media and entertainment (Australia) | NZME Limited | Media and entertainment (New Zealand) | 100% |
| Feb 2016 | National Australia Bank Limited | Banking (Australia and New Zealand) | CYBG Plc | Banking (United Kingdom) | 75% |
| May 2015 | BHP Billiton | Resources | South32 Limited | Metals and mining | 100% |
| Dec 2013 | Amcor Limited | Flexible and rigid plastics packaging (global) | Orora Limited | Diversified packaging (Australasia) and packaging distribution (North America) | 100% |
| Dec 2013 | Brambles Limited | Pallet and container pooling solutions | Recall Holdings Limited | Document management | 100% |
| Jun 2011 | Tabcorp Holdings Limited | Wagering, gaming and keno | Echo Entertainment Group Limited | Casinos | 100% |
| May 2011 | Foster's Group Limited | Beer | Treasury Wine Estates Limited | Wine | 100% |
| Jul 2010 | Orica Limited | Mining services, chemicals | Dulux Group Limited | Coatings and home improvement products | 100% |
| Jul 2010 | Arrow Energy Limited | Coal seam gas (Australia) | Dart Energy Limited | Coal seam gas (international) | 100% |
| Jan 2010 | Macquarie Infrastructure Group (renamed Intoll Group) | Toll roads | Macquarie Atlas Roads Group | Toll roads | 100% |
| Dec 2007 | Publishing and Broadcasting Limited (renamed Consolidated Media) | Media | Crown Limited | Gaming | 100% |
| Jun 2007 | Toll Holdings Limited | Logistics | Asciano Limited | Ports and rail | 100% |
| Nov 2006 | Tower Limited | Multi-line insurance (New Zealand) | Tower Australia Group Limited | Life insurance (Australia) | 100% |
| Jul 2006 | Macquarie Infrastructure Group (renamed Intoll Group) | Toll roads (globally) | Sydney Roads Group | Toll roads (Sydney) | 100% |
| Nov 2005 | Mayne Group Limited (renamed Symbion Health Limited) | Healthcare | Mayne Pharma Limited | Pharmaceuticals | 100% |
| Feb 2005 | Tower Limited | Insurance (Australia/ New Zealand) | Australian Wealth Management Limited | Funds management (Australia) | 100% |
| Oct 2003 | AMP Limited | Life insurance, wealth management (Australia, New Zealand) | HHG Plc | Life insurance, wealth management (United Kingdom, Europe) | 85% |
| Mar 2003 | CSR Limited | Building materials, aluminium, sugar | Rinker Group Limited | Heavy building materials | 100% |
| Dec 2002 | WMC Limited (renamed Alumina Limited) | Bauxite mining, alumina refining and aluminium smelting | WMC Resources Limited | Resources | 100% |
| Jul 2002 | BHP Billiton Limited | Resources | BHP Steel Limited (renamed Bluescope Steel Limited) | Steel | 94% |
| Oct 2000 | The Broken Hill Proprietary Company Limited | Resources | OneSteel Limited (renamed Arrium Limited) | Steel | 100% |
| Apr 2000 | Amcor Limited | Packaging | PaperlinX Limited | Paper | 82% |
| Feb 2000 | Origin Energy Limited | Energy | Boral Limited | Building Materials | 100% |

Source: IRESS

Notably, most demergers in Australia have involved distributing 100% of the subsidiary entity and in the other cases the balance was a minority interest that was either sold through other means or retained for a limited period[37]. However, partial demergers have occurred in other jurisdictions.

There has also been a number of high profile divestiture IPOs in Australia since 2000 including:

**SELECTED RECENT DIVESTITURE IPOS IN AUSTRALIA**

| DATE | PARENT | BUSINESS/ MARKET FOCUS | DEMERGED ENTITY | BUSINESS/ MARKET FOCUS | % DIVESTED |
|---|---|---|---|---|---|
| Dec 2012 | Woolworths Limited | Retail | Shopping Centres Australasia Property Group | Property ownership | 100% |
| Dec 2011 | Fairfax Media Limited | Media | Trade Me Group Limited | Online classifieds in New Zealand | 34% |
| Dec 2010 | Westfield Group | Shopping centre development, management and ownership | Westfield Retail Trust | Property ownership | 100% |
| Apr 2007 | Transfield Services Limited | Infrastructure services | Transfield Services Infrastructure Fund | Energy and transport infrastructure | 51% |
| Dec 2005 | Burns, Philp & Company Limited | Food manufacture | Goodman Fielder Limited | Basic foods | 80% |
| Oct 2005 | Alinta Limited | Gas utilities | Alinta Infrastructure Holdings Limited | Gas pipelines and power stations | 80% |
| Oct 2003 | Foster's Group Limited | Alcoholic beverages | Australian Leisure & Hospitality Group | Hotels, liquor and gaming, property | 100% |
| Aug 2001 | Futuris Corporation Limited | Rural and automotive systems | Australian Agricultural Company Limited | Agriculture | 60% |
| Mar 2001 | Village Roadshow Limited | Media and entertainment | Austereo Limited | Radio | 55% |
| Jun 2000 | The Australian Gas Light Company | Energy | Australian Pipeline Trust | Gas pipelines | 70% |

Source: IRESS

The outcome is similar whether the transaction is undertaken by way of a distribution of shares or an IPO. For example, Fairfax Media Limited's IPO of a 34% interest in TradeMe in December 2011 created a standalone company (albeit controlled by Fairfax Media until it sold its residual 51% interest in December 2012).

The benefits typically cited for demergers largely revolve around the differences in business focus or strategic direction between the parent company and the demerged entity. However, at the same time there are a number of disadvantages, potential risks and costs associated with demergers. The primary issues raised are listed below:

37 In relation to the less than 100% Australian demergers:

- Fairfax Media Limited has retained its controlling 60% interest in Domain Holdings Australia Limited;
- National Australia Bank sold the residual 25% interest in CYBG PLC via an IPO at the time of the demerger;
- AMP Limited sold its residual interest in HHG PLC in September 2005, almost as soon as it could under the arrangements put in place at the time of the demerger (October 2003);
- BHP Billiton Limited sold its residual 6% interest immediately following the demerger into a share sale facility and used the proceeds for general corporate purposes; and
- Amcor Limited offered its residual 18% interest in PaperlinX Limited for sale under retail and institution offers as part of the demerger transaction.

**ISSUES ASSOCIATED WITH DEMERGERS**

| ADVANTAGES/BENEFITS | DISADVANTAGES/RISKS/COSTS |
|---|---|
| • transparency<br>• investor attraction and interest<br>• enhanced flexibility to shareholders<br>• clarity in capital allocation<br>• flexibility in raising capital<br>• independence and strategic flexibility to undertake growth initiatives<br>• better targeted incentives and management/board focus | • loss of synergies<br>• transaction costs<br>• duplication of corporate costs<br>• increased financing costs<br>• loss of diversification and scale<br>• reduced sharemarket liquidity and rating in key indices |

There is little definitive evidence as to whether or not demergers have been successful in enhancing shareholder value, largely because it is not possible to measure what the share prices would have been had the demergers not occurred (i.e. there is no counterfactual). Some of the evidence and views that have emerged are summarised below:

- several studies[38] have found that there was a positive impact on the share price (of around 3-6%) at the time of the announcement. A similar rise occurred where there was a targeted share or equity carve-out. One study has shown that, in some circumstances, there is no decline in share price even if the demerger is ultimately withdrawn[39];
- several studies[40] have also found significantly positive abnormal returns over an extended period (of up to three years) following the demerger for the demerged company, the parent and the demerged company/parent combination. On the other hand, one study[41] found that demergers only delivered long term value benefits for the demerged subsidiary (and not the parent) and another study[42] found significant evidence that spin-offs create more value than carve-outs. In particular, recent studies[41,43] report weak evidence for long term wealth effects when using more refined measuring techniques;
- some of the reasons found to be associated with positive abnormal returns have included:
  - corporate restructuring activity[44]. Both the demerged subsidiary and the parent experience an unusually high incidence of takeovers in comparison to their control group comparable companies. The abnormal performance is limited to companies involved in takeover activity. The findings suggest that demergers provide a low-cost method of transferring control of corporate

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38 See for example: P.L. Anslinger, S.J. Klepper and S. Subramaniam, "Breaking up is good to do", The McKinsey Quarterly, 1999 Number 1; Thomas Kirchmaier, "The Performance Effects of European Restructures", Centre for Economic Performance, London School of Economics and Political Science, May 2003; UBS Investment Research, "Q-Series: Spin-offs and restructures", UBS Limited, 14 April 2005, Roger Rüdisüli, "Value Creation of Spin-offs and Carve-outs", Doctoral Dissertation, University of Basel (Switzerland), May 2005, CIMB Quantitative Research, "Spin-off Candidates", CIMB Securities (Australia) Ltd, September 2013, S. Zweiphenning, "Corporate Spin-Offs in the United Kingdom", Masters Thesis, Tilburg University, August 2014, D. Chai, K. Lin and C. Veld, "Value-creation through spin-offs: Australian evidence", Monash University, August 2016.

39 K. Alli, G. Ramirez and K. Yung, "Withdrawn Spin-offs: An Empirical Analysis", The Journal of Financial Research, Winter 2001.

40 See for example: J. Wyatt, "Why Spinoffs Work for Investors", Fortune, October 16 1995, p72; P.J. Cusatis, J.A. Miles and J.R. Woolridge, "Restructuring Through Spin-outs, The Stock Market Evidence", Journal of Financial Economics, Volume 33 No. 3, June 1993, T.A. John, "Optimality of Spin-outs and Allocation of Debt" Journal of Financial and Quantitative Analysis, 1993, B.J. Hollowell, "The Long-Term Performance of Parent Firms and their Spin-offs", The International Journal of Business and Finance Research, Volume 3, No.1, 2009 and Morgan Stanley Asia Insight, "BHP Billiton Limited: A Detailed Look at South32", Morgan Stanley, April 2015.

41 Thomas Kirchmaier, "The Performance Effects of European Restructures", Centre for Economic Performance, London School of Economics and Political Science, May 2003.

42 Roger Rüdisüli, "Value Creation of Spin-offs and Carve-outs", Doctoral Dissertation, University of Basel (Switzerland), May 2005.

43 S. Zweiphenning, "Corporate Spin-Offs in the United Kingdom", Masters Thesis, Tilburg University, August 2014, N. Zakaria and G.C. Arnold, "Spin-off and Value Creation: The Case of Malaysia", 2014 and D. Boreiko and M. Murgia, "European Spin-offs: Origin, Value Creation, and Long-Term Performance", Draft Paper, Free University of Bolzano-Bozen, April 2013.

44 P.J. Cusatis, J.A. Miles and J.R. Woolridge, "Restructuring Through Spin-outs, The Stock Market Evidence", Journal of Financial Economics, Volume 33 No. 3, June 1993.

assets to bidders who are able to create greater value. This benefit will not apply in the case of partial spin offs where the parent company retains control of the spun out entity;

- mitigation of information asymmetry[45]. The hypothesis was that value would be enhanced if the demerged subsidiary is able to convey more information about its operating efficiency and future prospects when it is a separate entity than when it is part of a larger combined unit. The findings were that firms that engage in demergers have higher levels of information asymmetry compared to their industry and size matched counterparts and the information problems decrease significantly after the demerger as analyst scrutiny increases. The relationship is more pronounced for those companies that demerge related subsidiaries;
- increased management and board focus[46] translating into better operating and sharemarket performance. The abnormal returns for focus-increasing demergers are significantly larger than the corresponding abnormal returns for the non-focus-increasing demergers. A focus-increasing demerger reduces the diversity of assets under management and thereby increases the efficiency of management. However, an analysis of non-focus increasing demergers showed that companies are likely to undertake these demergers to separate underperforming subsidiaries from their parents with efficiency not being a major motivating factor. Indeed, positive returns after the demerger have been found to be due to pre-announcement sharemarket weakness;
- improved financing decisions[47]. Conglomerates tend to divide resources evenly between divisions thus investing too little in strong industries and too much in weaker industries. The study showed that capital expenditure showed greater sensitivity to changes in growth opportunities after a division became independent; and
- rebalancing of shareholdings by investors[48]. The study indicates that the ratio of continuing investors who choose to only hold one of the entities after spin-off abnormal returns is a significant predictor of abnormal returns. Therefore, it is difference in opinions of shareholders about the relative prospects of the demerger entities which leads to excess returns rather than the business impacts of the transaction. This outcome is consistent with the thesis that separation will mean that each company will attract investors that are likely to value it the highest; and

- one analyst report[49] found that following a demerger, where the resulting entities are relatively similar in size, both entities generally underperform the market for a period of approximately six months. In the long term however, both stocks tend to outperform the market (implying that the market awaits a reporting period before committing to the new entities). In comparison, where the subsidiary is much smaller than the parent, the demerged entity is typically a strong outperformer while the parent moves with the market.

Most of the academic studies relate to demergers in the United States or in Europe. However, Grant Samuel has reviewed the relative performance of Australian companies that have undertaken demergers since 2000. While an admittedly imperfect basis of analysis and somewhat crude (given the wide range of factors that influence share prices), this review tends to support the thesis that demergers enhance shareholder value, particularly having regard to sharemarket performance one to two years after the demerger.

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45 S. Krishnaswami and V Subramaniam, "Information asymmetry, valuation and the corporate spin-out decision" Journal of Financial Economics, Volume 53, No. 1, July 1999.

46 See for example: H. Desai and P.C. Jain, "Firm performance and focus: long-run stock market performance following spin-outs", Journal of Financial Economics, Volume 54, No. 1, October 1999 and L. Daley, V. Mehrotra and R. Sivarenmar, "Corporate Focus and Value Creation: Evidence from Spinoffs", Journal of Financial Economics, Volume 45, 1997.

47 R. Gertner, E. Powers and D. Scharfstein, "Learning About Internal Capital Markets From Corporate Spinoffs", November 2000.

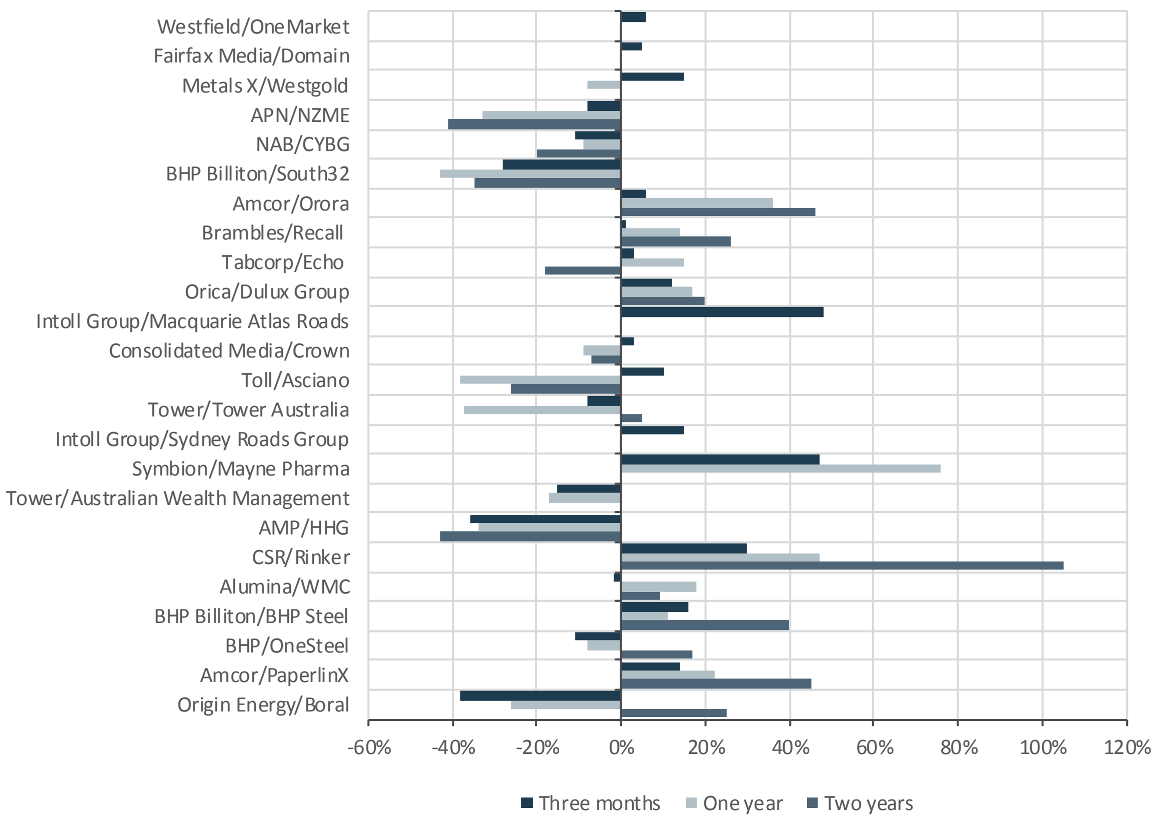
48 T. Bhandari, "Differences of Opinion and Stock Prices: Evidence from Spin-Offs and Mergers", Draft Doctoral Dissertation at MIT Sloan School of Management, November 2013.

49 Macquarie Research Equities, "Australian Gas Light: Acquisitions, Restructures and Au Revoirs", 1 November 2005.

The following graph summarises the combined share price performance of the parent company and the demerged entity relative to the S&P/ASX 200 index, from last close prior to announcement to three months, one year and two years after the date the demerged entity was listed on the ASX:

**RETURNS OF SELECTED RECENT DEMERGERS VS S&P/ASX 200 INDEX**

**(MEASURED FROM LAST CLOSE BEFORE ANNOUNCEMENT TO PERIOD AFTER LISTING)**




Source: IRESS

Notes:
(1) The share price performance from last close before announcement to listing is for the parent company. The share price performance subsequent to listing is the aggregated performance of the parent company and the demerged entity.
(2) No returns are shown in the chart for:
- Arrow Energy/Dart Energy as Arrow Energy was acquired by PetroChina Co. Ltd and Royal Dutch Shell plc upon implementation of the demerger; and
- Foster's Group/Treasury Wine Estates as Foster's Group received a takeover offer from SABMiller plc within two months of the demerger.
(3) No one and two year returns are shown in the chart for:
- Westfield Corporation (Unibail-Rodamco CDIs)/OneMarket which commenced trading separately on 31 May 2018;
- Fairfax Media/Domain which commenced trading separately on 16 November 2017;
- Intoll Group/Sydney Roads Group as Sydney Roads Group was acquired by Transurban Group within one year of the demerger; and
- Intoll Group/Macquarie Atlas Roads as Intoll Group was acquired by Canadian Pension Plan Investment Board within one year of the demerger.
(4) No two year returns are shown in the chart for:
- Metals X/Westgold which commenced trading separately on 6 December 2016;
- Tower/Australian Wealth Management as Tower demerged a second entity (Tower Australia) within two years of the demerger; and
- Symbion/Mayne Pharma as Mayne Pharma was acquired by Hospira Inc within two years of the demerger.

The above analysis indicates that the combined performance of demerged entities from announcement to immediately following a demerger has been mixed, but that demerged entities have generally outperformed the market within two years of listing[50]. However, this analysis must be treated with caution as, at best, it provides only a partial analysis of the market value consequences of demergers. In particular, it:

- does not fully reflect returns to shareholders following demerger as it either excludes entirely or only partially includes demergers where either the parent or demerged entity was acquired within two years of the demerger transaction (Arrow Energy/Dart Energy, Foster's Group/Treasury Wine Estates, Intoll Group/Sydney Roads Group, Intoll Group/Macquarie Atlas Roads and Symbion/Mayne Pharma). In these cases, shareholders also benefited from receipt of control premia;
- does not reflect that some of the entities were either acquired (Rinker and WMC Resources) or were involved in other corporate activity (Tower Australia, Australian Wealth Management) more than two years after, but within 3-4 years, of their demergers; and
- measures performance against an overall market index. The results may differ if performance is measured against a relevant sector index.

Furthermore, in many cases, significant underperformance or overperformance in the two years after listing reflects factors specific to the demerging companies or the industries in which they operate and may not be attributable to the demerger. For example:

- AMP/HHG was impacted by a substantial write down in certain assets and a capital raising at a significant discount which were announced in conjunction with the demerger. The returns from this demerger measured from listing (rather than announcement) are positive;
- Tower/Tower Australia was impacted by the underperformance of the insurance sector relative to the market during 2007;
- Toll/Asciano was impacted by Asciano's need to reduce high gearing levels following the global financial crisis in 2008/2009;
- Consolidated Media/Crown was impacted by the underperformance of the media industry relative to the market following the global financial crisis in 2008/2009;
- Tabcorp/Echo was impacted by various legal and regulatory decisions relating to gambling and casino operations as well as competitive concerns;
- the two year return for Brambles/Recall was impacted by the extended process of Recall's acquisition by Iron Mountain Incorporated which commenced in December 2014 but did not complete until April 2016;
- BHP Billiton/South 32 was impacted by significant falls in commodity prices; and
- APN/NZME was impacted by the underperformance of the legacy media sector relative to the market as well as termination of the proposed merger of NZME with Fairfax's Stuff Limited (previously Fairfax New Zealand Limited) on regulatory grounds and the acquisition proposal received for NZME's Adshel business.

On the other hand, some studies have found that demergers may negatively impact value and that conglomerates have outperformed the market over some periods[51]. Conglomerate structures do have

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[50] This is supported by analysis by Goldman Sachs & Partners Australia in "Equity Strategy: Reviewing Large Cap Demerger Strategies", 15 February 2011; Bank of America Merrill Lynch in "Delivering Returns in Tough Times", 29 May 2013, Macquarie Securities (Australia) Limited in "Demergers: Breaking Up is Hard to Do", 14 June 2013 and CIMB Securities (Australia) Ltd in "Spin-off Candidates", 3 September 2013.

[51] Boston Consulting Group, "Conglomerates Reports", 2002.

benefits including financial size and strength, better liquidity and higher index rating, lower earnings volatility and risk (if business units are not correlated in terms of economic cyclicality), greater depth of management and lower cost of capital (depending on other factors).

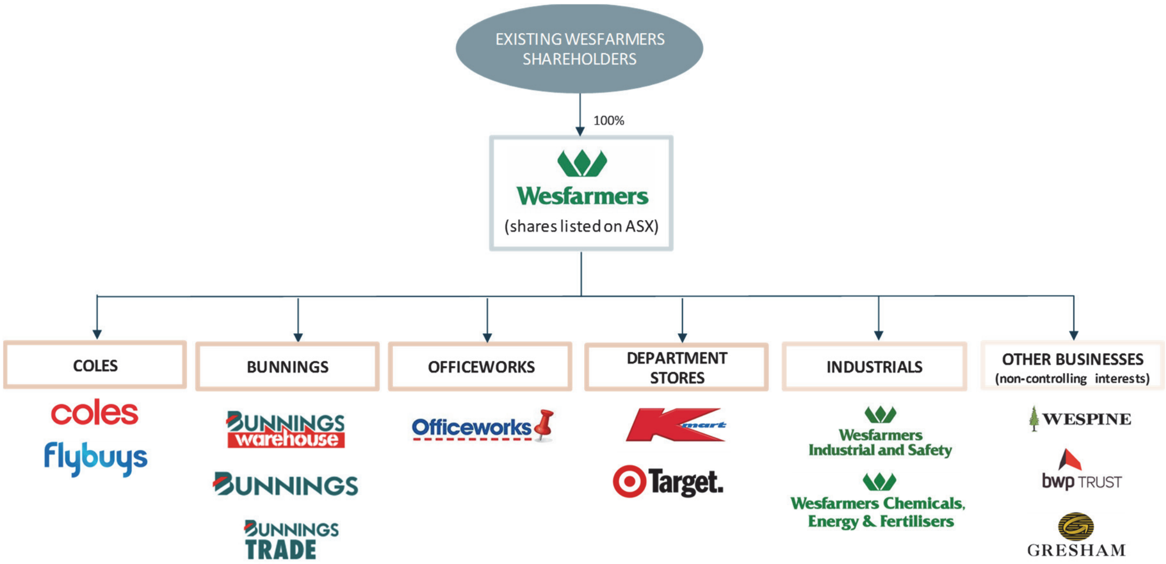
While the balance of evidence does favour demergers as adding value, the alternate views underline the fact that there is no universal structure for businesses. While some demergers create substantial value, others do not. In the end, the success of demergers depends on the specific circumstances of each case.

## 5 Impact of the Demerger

### 5.1 Structure and Ownership

The structure and ownership of Wesfarmers prior to the Demerger is shown below:

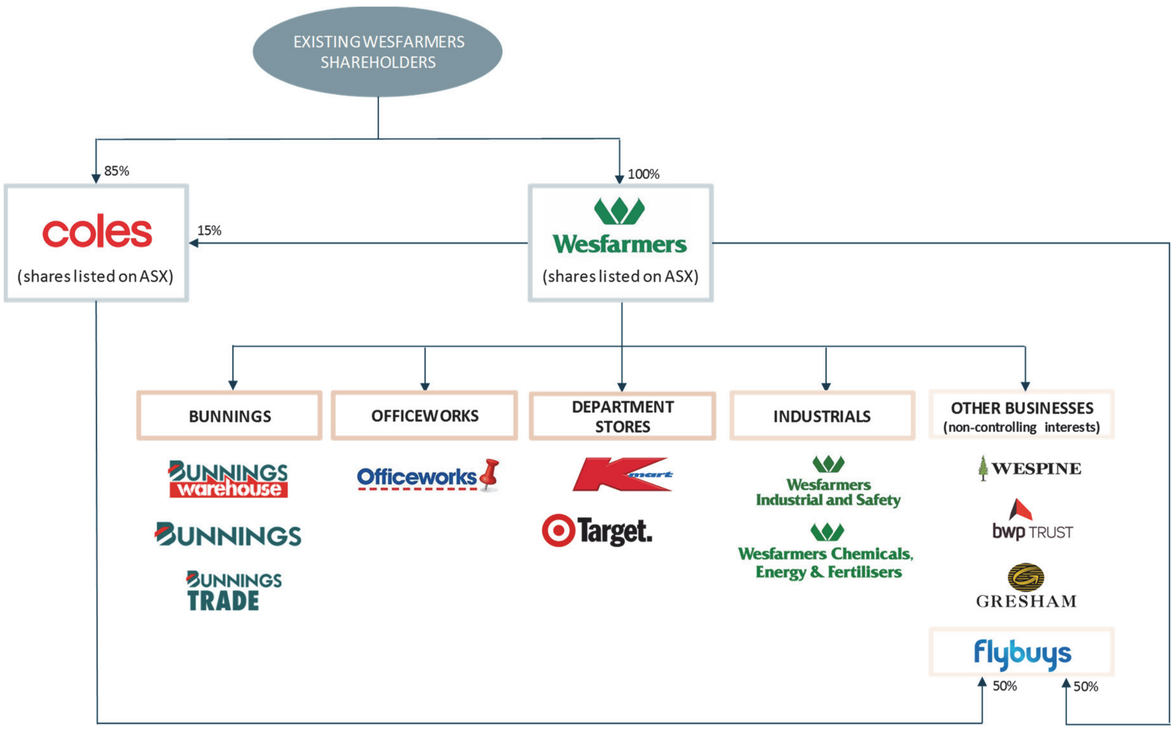
**WESFARMERS STRUCTURE – PRIOR TO THE DEMERGER[52]**




Source: Wesfarmers

The effect of the Demerger on Wesfarmers' structure and ownership is shown below:

**WESFARMERS STRUCTURE – AFTER THE DEMERGER[52]**




Source: Wesfarmers

52 Structure excludes businesses that Wesfarmers has entered into agreements to sell.

Following the Demerger, the relative ownership interest held by each Wesfarmers shareholder (other than ineligible overseas shareholders and selling shareholders) in Coles will be equal to their ownership interest in Wesfarmers immediately prior to implementation of the Demerger. However, the ownership interest will be held 85% directly and 15% indirectly (via Wesfarmers).

Coles' management will be standalone and the companies will operate at arm's length. However:

- Wesfarmers will own 15% of the issued capital of Coles and will nominate one non-executive director to the Coles board;
- there will be transitional arrangements in relation to certain services, including IT, payroll, finance and other services (from Coles to Kmart, Target and Officeworks) and workers compensation, general insurance and other services (from Wesfarmers to Coles) for a period post Demerger; and
- there will be agreed ongoing contractual agreements between:
  - Coles and Kmart, Target and Officeworks for the provision of payment switching services, production and management of gift cards and facilities management; and
  - Coles and Wesfarmers in relation to the joint ownership and operation of *flybuys*.

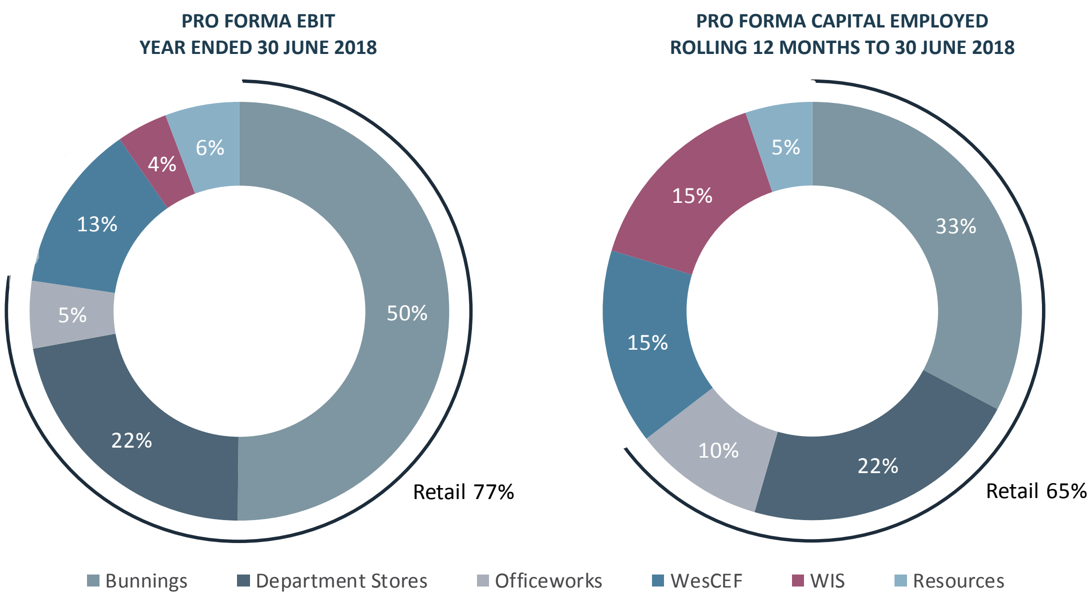
## 5.2 Wesfarmers Post Demerger

### 5.2.1 Operations and Strategy

If the Demerger is implemented, Wesfarmers will remain a diversified conglomerate, with a portfolio of cash generating businesses with strong market positions in growing markets. It will continue to be one of the largest companies listed on the ASX and will have around 105,000 employees.

Wesfarmers will still generate a substantial proportion of its earnings from, and have the majority of its capital invested in, retail businesses (in particular, Bunnings ANZ and Kmart):

**WESFARMERS POST DEMERGER – CONTRIBUTION BY BUSINESS[53]**




Source: Scheme Booklet

[53] Contribution by business excludes discontinued operations (i.e. Curragh and BUKI). It also excludes share of profit of associates and joint ventures and therefore does not include any contribution from Wesfarmers' 15% interest in Coles or its 50% interest in *flybuys*.

Wesfarmers will continue its primary objective of providing a satisfactory return to shareholders over the long term. The groupwide strategies that will continue to drive this objective are summarised in Section 3.3 of this report. The individual business strategies currently in place will also continue and are summarised in Section 3.5 of the Scheme Booklet.

### 5.2.2 Earnings and Dividends

The pro forma historical financial performance of Wesfarmers post Demerger for the three years ended 30 June 2018 is summarised below:

**WESFARMERS POST DEMERGER – PRO FORMA SUMMARISED HISTORICAL FINANCIAL PERFORMANCE ($ MILLIONS)**

| | YEAR ENDED 30 JUNE | | |
|---|---|---|---|
| | 2016 PRO FORMA[54] | 2017 PRO FORMA | 2018 PRO FORMA |
| **Revenue** | **24,928** | **25,696** | **27,495** |
| **EBITDA** | **2,792** | **3,281** | **3,587** |
| Depreciation and amortisation | (538) | (528) | (547) |
| **EBIT** | **2,254** | **2,753** | **3,040** |
| Finance costs | | | (127) |
| Income tax expense (on operating profit) | | | (836) |
| **Operating profit after tax** | | | **2,077** |
| Significant items (net of tax) | | | (300) |
| **NPAT – continuing operations** | | | **1,775** |
| NPAT – discontinued operations | | | (1,407) |
| **NPAT** | | | **370** |
| *STATISTICS* | | | |
| *Basic earnings per share (before significant items)* | | | *$0.33* |
| *Basic earnings per share (after significant Items)* | | | *$1.84* |
| *Revenue growth* | | *+3.1%* | *+7.0%* |
| *EBIT growth* | | *+22.1%* | *+10.4%* |
| *EBIT margin* | *9.0%* | *10.7%* | *11.1%* |
| *Fixed charges cover* | | | *3.8x* |
| *Interest cover (cash basis)* | | | *19.6x* |
| *Return on capital* | | | *25.9%* |

Source: Scheme Booklet and Grant Samuel analysis

The pro forma historical financial performance for Wesfarmers post Demerger has been prepared on the basis of the following assumptions:

- the Demerger was effective from 1 July 2015;
- Curragh coal mine and BUKI were disposed of effective from 1 July 2015 (i.e. these businesses are treated as discontinued operations in each year, not just FY18);
- the financial performance of Coles and *flybuys* has been excluded;

[54] The presentation of Wesfarmers post Demerger FY16 pro forma financial performance differs from that set out in Section 3.8.3 of the Scheme Booklet at it excludes $145 million of restructuring costs and provisions for Target that was included as a significant item in FY16 (see Section 3.4.1). As a result, pro forma EBITDA and EBIT are $145 million higher than the corresponding figures in the Scheme Booklet.

- the 15% interest in Coles and the 50% interest in *flybuys* are accounted for as interests in associates from 1 July 2015, with the result that EBITDA and EBIT in each year include Wesfarmers post Demerger's share of net profit after tax from Coles and *flybuys*;
- there are no incremental costs for Wesfarmers post Demerger on the basis that any such costs are not expected to be material;
- lower net borrowings reduce finance costs (assuming Wesfarmers' weighted average interest rate of 4.18% and a reduction in net borrowings relating to the effective transfer to Coles of $2 billion of debt); and
- no adjustments for:
  - future revenue and expenses under the Transitional Services Agreement or other ongoing contractual agreements between Wesfarmers post Demerger and Coles; and
  - transaction costs associated with the Demerger which are to be incurred by Wesfarmers, estimated at $148 million (before tax). These costs (net of tax) have been recognised in equity.

The detailed pro forma historical financial performance for Wesfarmers post Demerger (including a description of the assumptions and adjustments made) is set out in Sections 3.8.1 and 3.8.3 of the Scheme Booklet.

Wesfarmers post Demerger will be a higher growth, higher margin business compared to Wesfarmers. Average annual growth in pro forma EBIT from FY16 to FY18 was 16% (compared to 6% for Wesfarmers' continuing operations) and pro forma EBIT margins increase from 9.0% in FY16 to 11.1% in FY18 (compared to 6.1% to 6.5% for Wesfarmers' continuing operations). Total capital employed falls to $11.8 billion (compared to $25.9 billion for Wesfarmers). As a result, return on capital increases substantially to 25.7% (compared to 16.8% for Wesfarmers).

Wesfarmers' financial results for FY19 will fully consolidate Coles (including *flybuys*) up to the implementation date and after the implementation date will include its 15% interest in Coles and its 50% interest in the *flybuys* joint venture as equity accounted investments (i.e. Wesfarmers' share of Coles and *flybuys* net profit after tax from the implementation date to 30 June 2019 will be included in EBITDA and EBIT). FY20 will be the first full year following the demerger of Coles.

Following the Demerger, Wesfarmers will remain the head company of the Wesfarmers Australian consolidated tax group (from which Coles will have exited) and the franking credits and carried forward capital losses are expected to be preserved in Wesfarmers.

While the level of future dividend payments is a matter for the board of Wesfarmers, it is intended that there will be no change to dividend policy following the Demerger. Wesfarmers' first dividend post Demerger is expected to be for the half year ended 31 December 2018, for which it will have access to 100% of Coles' earnings for the period from 1 July 2018 to the implementation date (expected to be 28 November 2018). However, Wesfarmers will not receive any dividends from Coles until Coles declares its first dividend post implementation (which is expected to be a final dividend for the seven months of earnings post the Demerger and paid in September 2019).

### 5.2.3 Financial Position

The pro forma financial position of Wesfarmers post Demerger as at 30 June 2018 is summarised below:

**WESFARMERS POST DEMERGER – SUMMARISED PRO FORMA FINANCIAL POSITION ($ MILLIONS)**

| | AS AT 30 JUNE 2018 PRO FORMA |
|---|---|
| Receivables and prepayments | 1,080 |
| Inventories | 3,906 |
| Trade and other payables | (3,244) |
| Other | 167 |
| **Net working capital** | **1,909** |
| Property, plant and equipment | 4,149 |
| Intangible assets | 4,103 |
| Investments in associates and joint ventures | 3,011 |
| Other assets | 347 |
| Provisions and other liabilities | (1,712) |
| **Total capital employed** | **11,807** |
| Cash (excluding cash in transit) | 2,046 |
| Borrowings | (4,124) |
| Cross currency and interest rate swaps (net) | 353 |
| **Net borrowings** | **(1,725)** |
| Net tax balances | (70) |
| **Net assets** | **10,012** |
| *STATISTICS* | |
| *Shares on issue at period end (million)* | *1,133.8* |
| *Net assets per share* | *$8.83* |
| *NTA per share* | *$5.21* |
| *Gearing* | *17.2%* |

Source: Scheme Booklet and Grant Samuel analysis

The pro forma financial position of Wesfarmers post Demerger has been prepared on the basis that the Demerger was effective on 30 June 2018. Specifically, it:

- removes the assets and liabilities related to Coles;
- includes the 15% interest in Coles and the 50% interest in *flybuys* as equity accounted associates;
- reflects derecognition of self-insurance liabilities relating to Coles;
- reflects settlement of intercompany financing arrangements between Wesfarmers and Coles following the drawdown of debt by Coles; and
- assumes Wesfarmers will not record a profit or loss on Demerger (whether a profit or loss is recorded will depend on the trading price of Coles shares immediately after implementation of the Demerger).

The pro forma financial position of Wesfarmers post Demerger does not reflect payment of transaction costs associated with the Demerger as the majority of these costs (net of tax) have been recognised within equity.

A detailed pro forma financial position (including a description of the assumptions and adjustments made) is set out in Sections 3.8.1 and 3.8.4 of the Scheme Booklet.

The pro forma financial position of Wesfarmers post Demerger indicates that:

- its net investment in working capital will increase as the benefit of Coles' negative working capital position is removed;
- net assets per share falls from $20.07 to $8.83 but NTA per share increases from $4.32 to $5.21 as a result of the derecognition of goodwill and intangible assets associated with the acquisition of Coles in 2008; and
- net borrowings is reduced but pro forma book gearing increases marginally to 17.2% (from 15.7% for Wesfarmers) as a result of the substantial decline in net assets. All of Wesfarmers existing debt facilities are expected to remain in place and Wesfarmers post Demerger is expected to retain Wesfarmers' existing investment grade credit ratings. As a result, Wesfarmers post Demerger has substantial balance sheet capacity.

In addition, Wesfarmers post Demerger will have lease commitments totalling $8.6 billion, 57% of which expire in less than five years.

### 5.2.4 Cash Flow

The pro forma historical cash flow for Wesfarmers post Demerger for the three years ended 30 June 2018 is summarised below:

**WESFARMERS POST DEMERGER – PRO FORMA SUMMARISED HISTORICAL CASH FLOW ($ MILLIONS)**

| | YEAR ENDED 30 JUNE | | |
|---|---|---|---|
| | 2016 PRO FORMA | 2017 PRO FORMA | 2018 PRO FORMA |
| **EBITDA** | **2,792** | **3,281** | **3,587** |
| Tax paid | | | (801) |
| Net interest paid | | | (111) |
| Change in working capital and other adjustments | 41 | 110 | (186) |
| **Operating cash flow** | | | **2,489** |
| Capital expenditure (net) | (993) | (720) | (568) |
| **Operating cash flow after capital expenditure** | | | **1,921** |
| *STATISTICS* | | | |
| *Cash realisation ratio* | | | *95%* |

Source: Scheme Booklet and Grant Samuel analysis

The pro forma historical cash flow for Wesfarmers post Demerger has been prepared on the same basis as the pro forma historical financial performance set out in Section 5.2.2 of this report, except that it:

- removes Wesfarmers post Demerger's share of net profit after tax from its 15% investment in Coles and its 50% interest in *flybuys* (as these are non-cash items) and recognises dividends arising from these investments as part of other adjustments; and
- has been presented before investing activities (other than capital expenditure) and capital management as the financing facilities, tax consolidation status and capital structure will change following the Demerger.

Wesfarmers post Demerger will have significantly lower net capital expenditure as a result of no longer funding net capital expenditure associated with Coles (offset by loss of inflows from Coles' property sales). The FY18 cash realisation ratio falls from 99% to 95%.

### 5.2.5 Directors and Management

Wesfarmers post Demerger's board will comprise the current directors of Wesfarmers, other than James Graham AM, who retired as a non-executive director of Wesfarmers on 23 July 2018, following announcement of his appointment as Chairman-elect of Coles[55].

In addition, Archie Norman will step down as an adviser to the Wesfarmers board and David Cheesewright, the Wesfarmers nominee on the Coles board, will be appointed an adviser to the Wesfarmers board.

Michael Chaney AO will continue as Chairman, Rob Scott will continue as Managing Director and Anthony Gianotti will continue as CFO following completion of the Demerger. The Chief Executive Officers ("CEOs") of each of Wesfarmers' business divisions (Bunnings ANZ, Department Stores[56], Officeworks and Industrials) will also continue.

### 5.2.6 Capital Structure and Ownership

There will be no change to the number of Wesfarmers' ordinary shares on issue following the Demerger.

## 5.3 Coles

### 5.3.1 Operations and Strategy

If the Demerger is implemented, Coles will be a standalone leading Australian retailer with a strong market share, well recognised brands and an extensive product and service range across food, liquor, convenience, finance services and loyalty with an omni-channel offer through its extensive store network and online platforms.

Coles will have three key divisions:

- Supermarkets, comprising the Coles network of 809[57] stores, Coles Online and Coles Financial Services;
- Liquor, which operates a range of liquor retailing formats through its 899[57] *Liquorland*, *First Choice Liquor* and *Vintage Cellars* stores (as well as operating 88 hotels[58]); and
- Convenience, where Coles operates 711[57] fuel and convenience outlets under an Alliance Agreement[59] with Viva Energy (co-branded *Coles Express* and *Shell*). The Alliance Agreement expires on 2 February 2024, but there is an option for either party to extend the term by five years to 2 February 2029.

Coles will also retain a 50% interest in *flybuys* and will continue to generate revenue and earnings from its property activities.

The Coles Supermarkets business represents the vast majority of pro forma EBIT (around 80%):

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55 Mr Paul Bassat will retire as a non-executive director of Wesfarmers at the conclusion of the Annual General Meeting on 15 November 2018, but this retirement is unrelated to the Demerger.

56 The CEO of Department Stores and Managing Director of Target, Guy Russo, will retire effective from 1 November 2018. Ian Bailey, Managing Director of Kmart will assume the additional responsibility of leading the Department Stores division from 1 November 2018 and Marina Joanou, CFO of the Department Stores division was promoted to Managing Director or Target from 14 August 2018. Guy Russo will remain as an advisor to Wesfarmers and the Department Stores division.

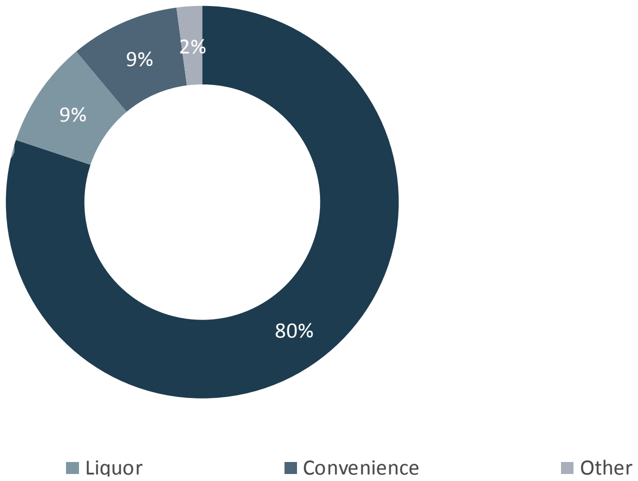
57 As at 30 June 2018.

58 Coles is currently undertaking a strategic review of its Spirit Hotels business including a potential transaction that would lead to the separation of hotel and gaming revenue. This review is ongoing and there is no certainty it will lead to a transaction.

59 Under the Alliance Agreement, Viva Energy acts as exclusive supplier of Shell branded products and provides a licence for *Coles Express* to operate a site using the Shell branding.

**COLES – PRO FORMA CONTRIBUTION TO EBIT**

**YEAR ENDED 30 JUNE 2018**




Source: Scheme Booklet
Note: Other represents Coles' property activities and its 50% share of earnings from *flybuys*

Coles will be a "pure play" consumer staples business with defensive growth characteristics (non-discretionary demand, resilient through economic cycles, cash generative business) where its scale and established relationships provide it with a competitive advantage. Coles Supermarkets has maintained a market share of around 30% over the past five years, despite a number of new entrants (*ALDI*, Costco) and the actions of its key competitor, Woolworths. On the other hand, Coles is a relatively mature business.

Following the Demerger, Coles will continue to pursue its own business strategy (as it has under Wesfarmers' autonomous model). This strategy is set out in Section 2.6 of Scheme Booklet, but in summary, comprises six key elements:

- transform its food offer through continuing to improve the fresh food offer and growing its own brand portfolio;
- continue to invest in price, with more products to be offered on "Every Day Low Prices";
- expand its ability to offer "anytime, anywhere" shopping, including through digital channels and convenient delivery options;
- improve its store network through store renewal programs as well as tailoring store size and layout and product range to the needs of local customers;
- reduce costs through leveraging technology to deliver a simpler store and supply chain model (including use of data and analytics to enhance decision making and drive efficiencies, simplifying product ranges and pricing terms and removing complexity from processes across the business).

  This includes modernising its supply chain through the development of two new automated distribution centres over a five year period, which are expected to deliver lower supply chain costs and higher service levels, improved efficiency and stock availability in stores, safer working environments and enhanced business competitiveness; and
- continue to engage with its employees, customers and communities (e.g. through the Coles Nurture Fund).

In addition, Coles Liquor will continue its transformation program involving filling in network gaps, improving the online offering, simplifying store processes and providing a more targeted product range to customers, and Coles Convenience will focus on initiatives to increase its shop sales (excluding fuel), including the rollout of an improved food-to-go offer and trialling of a fresh product offering.

The future strategy of Coles will be a matter for the Coles board and senior management to develop over time. While a new Managing Director and CEO has recently been appointed to Coles, the Coles board (including the new Managing Director and CEO) has confirmed that it intends to continue to focus on these strategic priorities following the Demerger.

### 5.3.2 Earnings and Dividends

The pro forma historical financial performance of Coles for the three years ended 30 June 2018 is summarised below:

**COLES – PRO FORMA SUMMARISED HISTORICAL FINANCIAL PERFORMANCE ($ MILLIONS)**

| | YEAR ENDED 30 JUNE | | |
|---|---|---|---|
| | 2016 PRO FORMA | 2017 PRO FORMA | 2018 PRO FORMA |
| **Revenue** | **39,155** | **39,125** | **39,288** |
| **EBITDA** | **2,390** | **2,165** | **2,061** |
| Depreciation and amortisation | (611) | (643) | (646) |
| **EBIT** | **1,779** | **1,522** | **1,414** |
| *4Revenue growth* | | *-0.1%* | *+0.4%* |
| *EBIT growth* | | *-14.4%* | *-7.0%* |
| *EBIT margin* | *4.5%* | *3.9%* | *3.6%* |
| *Return on capital* | | | *32.5%* |

Source: Scheme Booklet and Grant Samuel analysis

The pro forma historical financial information for Coles has been prepared on the basis of the following assumptions:

- the Demerger was effective from 1 July 2015;
- significant items have been excluded;
- it has only been prepared to the EBIT level on the basis that the directors of Wesfarmers do not believe that the financing arrangements and tax structure under which Coles operated from FY16 to FY18 reflect the anticipated financing arrangements and tax structure following the Demerger. As a result, pro forma fixed charges cover and pro forma interest cover are not able to be calculated;
- 100% of *flybuys* and associated costs borne by Coles have been deconsolidated and Coles' 50% interest in *flybuys* (including the increased costs of a standalone *flybuys* entity) is equity accounted as an investment in associates from 1 July 2015, with the result that EBITDA and EBIT in each year include Coles' 50% share of net profit after tax from *flybuys*;
- the following additional net operating costs have been included:
  - the costs that Coles will incur as a standalone, ASX listed company as well as additional costs associated with certain services and internal management systems that have previously been provided by or in conjunction with Wesfarmers. These costs are estimated to be approximately $38 million per annum, partially offset by $10 million of operating costs previously incurred by Coles that will be incurred by *flybuys* post the Demerger; and
  - the costs previously incurred by Wesfarmers that will be transferred to Coles upon separation (and largely relate to self-insurance and internal audit costs), estimated to be approximately $28 million per annum; and
- no adjustments for:
  - future revenue and expenses under the Transitional Services Agreement or other ongoing contractual agreements between Coles and Wesfarmers;
  - transaction costs associated with the Demerger, all of which are expected to be borne by Wesfarmers; and
  - the $25 million in separation costs that Coles is expected to incur in setting up new systems and processes to allow it to operate as an independent entity.

The detailed pro forma historical financial performance for Coles (including a description of the assumptions and adjustments made) is set out in Sections 2.13.1-2.13.5 of the Scheme Booklet.

As a result of additional operating costs and equity accounting its 50% interest in the *flybuys* joint venture, on a pro forma basis, the standalone Coles' generates lower EBIT margins (around 20 basis point lower) than as part of Wesfarmers. However, return on capital increases considerably on a pro forma basis (from 9.2% to 32.5%) due to the derecognition of goodwill and intangible assets that arose from Wesfarmers' acquisition of Coles in 2008.

As the Demerger is expected to complete in November 2018, FY20 will be the first full year of Coles as a standalone listed company.

At the time of the Demerger, Coles will exit Wesfarmers' Australian income tax consolidated group. A decision as to whether Coles will form a new Australian income tax consolidated group will be made after completion of the Demerger. If Coles chooses not to tax consolidate for Australian income tax purposes, its effective tax rate may vary from what it would have been if it had remained part of Wesfarmers.

Coles' approach to dividends will be determined by the Coles' board at its discretion and may change over time. Coles currently intends to follow Wesfarmers' dividend policy, which has regard to current earnings and cash flows, available franking credits, future cash flow requirements and targeted credit metrics. This approach is expected to deliver a dividend payout ratio in the range 80-90%. Coles intends that its dividends will be franked, although the extent to which a dividend can be franked will depend on Coles' franking account balance, which immediately following the Demerger will be nil and will depend on the amount of Australian income tax paid by Coles. Coles expects to pay its first dividend in September 2019, which will be a final dividend for FY19, with reference to the seven months of earnings post Demerger.

### 5.3.3 Financial Position

The pro forma financial position of Coles as at 30 June 2018 is summarised below:

**COLES – SUMMARISED PRO FORMA FINANCIAL POSITION ($ MILLIONS)**

| | AS AT 30 JUNE 2018 PRO FORMA |
|---|---|
| Receivables and prepayments | 566 |
| Inventories | 2,105 |
| Trade and other payables | (3,266) |
| Other (cash in transit) | 325 |
| **Net working capital** | **(270)** |
| Property, plant and equipment | 4,230 |
| Intangible assets | 1,687 |
| Other assets | 133 |
| Provisions and other liabilities | (1,433) |
| **Total capital employed** | **4,347** |
| Cash | - |
| Borrowings | (1,905) |
| **Net borrowings** | **(1,905)** |
| Net tax balances | 493 |
| **Net assets** | **2,935** |
| *STATISTICS* | |
| *Shares on issue at period end (million)* | *1,333.9* |
| *Net assets per share* | *$2.20* |
| *NTA per share* | *$0.94* |
| *Gearing* | *64.9%* |

Source: Scheme Booklet and Grant Samuel analysis

The pro forma financial position of Coles has been prepared on the basis that the Demerger was effective on 30 June 2018. Specifically, it reflects the:

- drawdown of external borrowings and settlement of intercompany financing arrangements with Wesfarmers;
- derecognition of goodwill and intangible assets that arose from Wesfarmers' acquisition of Coles in 2008 and the recognition of a deferred tax liability associated with Coles' own brand asset;
- recognition of the self-insurance liabilities relating to Coles; and
- deconsolidation of *flybuys* and recognition of Coles' 50% equity accounted investment in the *flybuys* joint venture (included in other assets).

A detailed pro forma financial position (including a description of the assumptions and adjustments made) is set out in Section 2.13.6 of the Scheme Booklet.

Immediately following the Demerger, Coles is expected to have a relatively conservative capital structure although it will have pro forma book gearing of 64.9%. This higher level of gearing in part reflects Coles' lower intangible assets as a result of the derecognition of goodwill and intangible assets. It will have:

- committed unsecured revolving and term bilateral facilities of approximately $4.0 billion from a group of domestic and international banks with maturities of three to five years and pro forma drawn net debt as at 30 June 2018 of approximately $1.9 billion; and
- lease commitments totalling $9.8 billion and a weighted average lease profile of 6.1 years (compared to Woolworths' ~$19 billion in lease commitments), giving it flexibility in managing its store network.

This capital structure is expected to support a strong investment grade credit rating.

Coles will have significant headroom in its debt facilities to cover seasonal cash flow variations, including peak working capital requirements, capital expenditure (with net capital expenditure estimated at $600-800 million for FY19, including capital expenditure associated with the distribution centre automation), dividend payments and bank guarantees. Subject to market conditions, Coles intends to further diversify is funding sources and lengthen its maturity profile through capital markets issuances.

While Coles' pro forma balance sheet as at 30 June 2018 does not include any net derivatives, Coles will continue to enter into foreign exchange derivative transactions to hedge a portion of its foreign exchange exposure associated with importing goods and services and capital expenditure denominated in foreign currency and may enter into interest rate derivatives or fixed rate bonds to hedge a portion of its interest rate risk.

### 5.3.4 Cash Flow

The pro forma historical cash flow for Coles for the three years ended 30 June 2018 is summarised below:

**COLES – PRO FORMA SUMMARISED HISTORICAL CASH FLOW ($ MILLIONS)**

| | YEAR ENDED 30 JUNE | | |
|---|---|---|---|
| | 2016 PRO FORMA | 2017 PRO FORMA | 2018 PRO FORMA |
| **EBITDA** | **2,390** | **2,165** | **2,061** |
| Change in working capital and other adjustments | (54) | (113) | 172 |
| **Operating cash flow before interest and tax** | **2,336** | **2,052** | **2,233** |
| Capital expenditure (net) | (643) | (558) | (549) |
| **Operating cash flow before interest and tax and after net capital expenditure** | **1,693** | **1,494** | **1,684** |

Source: Scheme Booklet and Grant Samuel analysis

The pro forma historical cash flow for Coles has been prepared on the same basis as the pro forma historical financial performance set out in Section 5.3.2 of this report, except that it:

- removes Coles' share of net profit after tax from its 50% interest in *flybuys* (as this is a non-cash item) and recognises dividends arising from this investment as part of other adjustments; and
- has been presented before investing activities (other than net capital expenditure), financing activities, taxation and dividends on the basis that the periods presented do not reflect Coles' corporate and operating structure, financing facilities, tax arrangements and capital structure following the Demerger. As a result, the pro forma cash realisation ratio is not able to be calculated.

While it is not able to be calculated from the pro forma financial information provided, Coles is expected to have a strong cash realisation ratio (the pro forma cash realisation ratio for FY18 would be 111% assuming net interest of $80 million (based on average net debt of $2 billion at 4.18%[60]) and tax at 30%, and net interest and tax expense equivalent to net interest and tax paid[61]).

### 5.3.5 Directors and Management

Coles' board will comprise eight directors:

- one non-executive director, David Cheesewright, who will be Wesfarmers' nominee on the Coles board;
- six non-executive directors (independent of Wesfarmers), being James Graham AM (Chairman), Jacqueline Chow, Richard Freudenstein, Abi Cleland, Wendy Stops and Zlatko Todorcevski; and
- one executive director (Managing Director, Steven Cain).

In addition, Archie Norman will step down as Deputy Chairman of Coles and adviser to the Wesfarmers board to become an adviser to the new Coles board.

The senior management of Coles will comprise Coles' existing senior management team. Steven Cain (who commenced as CEO of Coles on 17 September 2018) will continue as CEO, Leah Weckert will continue as CFO and Greg Davis will continue as COO. The existing operational team is to remain in place. Further details of the board and senior management of Coles are set out in Section 2.10 of the Scheme Booklet.

### 5.3.6 Capital Structure and Ownership

On implementation of the Demerger, Coles will have approximately 1,333.9 million shares on issue. Wesfarmers shareholders will collectively hold 85% of the shares on issue and Wesfarmers will hold 15%. Other than the Wesfarmers shareholding, Coles will have a relatively open share register. Wesfarmers will be the only substantial shareholder.

Coles will also establish an Equity Incentive Plan to assist in the motivation, retention and reward of certain employees. The plan provides flexibility for Coles to grant rights, options and/or restricted shares as incentives subject to the satisfaction of performance rights and/or service conditions. Shortly after listing, Coles intends to:

- make a long term incentive grant of restricted shares under the plan to the Coles Managing Director (Steven Cain), CFO (Leah Weckert) and select members of the senior management team;
- make an offer of restricted shares under the plan to senior managers in the business; and
- offer eligible employees the opportunity to acquire Coles shares as an award (subject to eligibility or performance criteria) or by salary sacrifice.

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60 Equivalent to Wesfarmers' FY18 effective interest rate.

61 This calculation has been shown for illustrative purposes only, to assist Wesfarmers shareholders to understand the impact of the Demerger on the cash realisation ratio. The calculation does not purport to reflect the actual cash realisation ratio for Coles if it had operated as a standalone entity during FY18.

# 6 Evaluation of the Demerger

## 6.1 Approach to Evaluation

Wesfarmers shareholders are being asked to split their current investment into two parts, a shareholding in Wesfarmers post Demerger and a separate shareholding in Coles.

The transaction is a "clean" split in so far as there is no change in the underlying economic interest of each shareholder (except for ineligible overseas shareholders and selling shareholders). They will, in aggregate, continue to own 100% of the Coles business, but in a different form, with 85% held directly and 15% owned indirectly through their ongoing shareholding in Wesfarmers. There is:

- no purchase or sale of equity in either Coles or Wesfarmers to third parties;
- no value leakage to third parties from either entity; and
- not expected to be any adverse tax consequences for the separate entities and for the vast majority of Wesfarmers shareholders (see Section 6.6).

Accordingly, the Demerger is definitionally fair as shareholders (except ineligible overseas shareholders) will hold exactly the same underlying economic interests in the Coles business before and after the Demerger is implemented. Evaluation of whether the Demerger is in the best interests of shareholders therefore involves weighing up the advantages and disadvantages of the Demerger for shareholders. This involves judgements about the advantages and benefits such as shareholder flexibility and management focus weighed against the disadvantages, costs and risks such as reduced scale, duplicated operating costs and transaction costs, rather than analysis of quantifiable financial or other verifiable factors.

## 6.2 Background to the Demerger

### 6.2.1 Wesfarmers Prior to the Acquisition of Coles Group

Since listing on the ASX in 1984, Wesfarmers has operated as a diversified conglomerate, undertaking investments, acquisitions and divestments across a range of industries, with the primary objective of delivering a satisfactory return to shareholders. The measure used to assess satisfactory returns has always been TSR, with a target to deliver superior returns relative to the broader Australian market index.

The growth strategies employed by Wesfarmers to achieve this objective have consistently been to:

- strengthen existing businesses through operating excellence and satisfying customer needs;
- secure growth opportunities through entrepreneurial initiative;
- renew the portfolio through value adding transactions; and
- ensure sustainability though responsible long-term management.

As a conglomerate, Wesfarmers has always operated a decentralised business model, where each division in the group has a strong management capability and is responsible for strategy development and execution as well as day-to-day operational performance.

Examples of acquisitions and divestments that have delivered strong returns over time include:

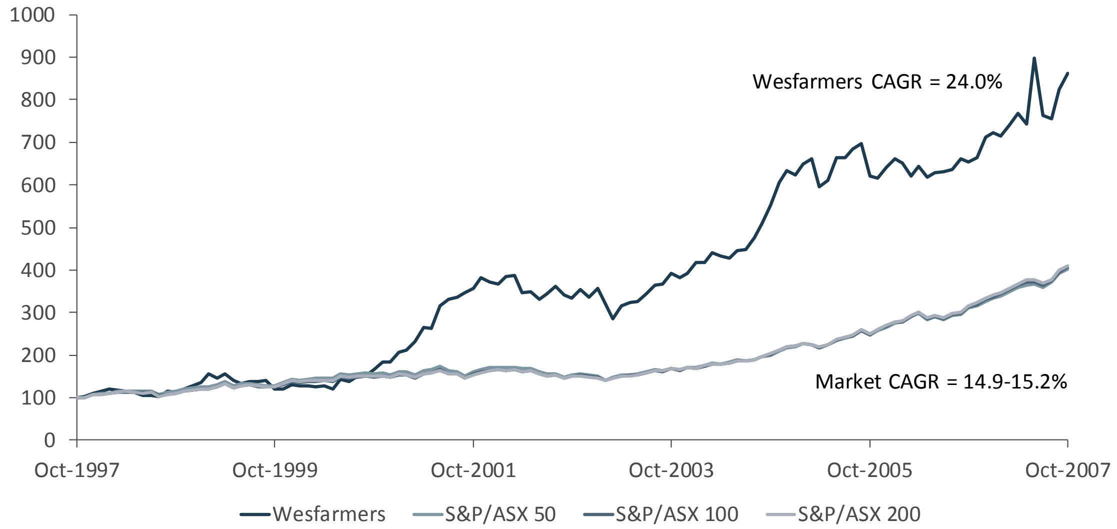
- CSBP Limited ("CSBP"), in which an initial interest was acquired in 1977 and 100% control achieved in 1986. Under Wesfarmers' ownership, CSBP became a major producer of industrial chemicals while continuing to be Western Australia's leading fertiliser supplier;
- Curragh coal mine, which underwent a major expansion program following its acquisition for $200 million in 2000 and subsequently benefited from the resources boom (although it was also adversely impacted by low commodity prices and unfavourable exchange rate movements following the end of the resources boom);

- the $2.7 billion cash and scrip takeover of Howard Smith Limited ("Howard Smith") in 2001, where the BBC Hardware chain was consolidated with Bunnings ANZ to create the largest participant in the Australian hardware sector, and Howards Smith's distribution business, Blackwoods, led to the formation of WIS; and
- the 2003 sale of Wesfarmers' foundation rural services business, Landmark, for $825 million, generating significant value for shareholders.

Wesfarmers' success at achieving its objective is illustrated by the differential between Wesfarmers' TSR and various market accumulation indices over the ten-year period from October 1997 to October 2007:

**WESFARMERS TOTAL SHAREHOLDER RETURN VS MARKET ACCUMULATION INDICES**

**OCTOBER 1997 TO OCTOBER 2007**




Source: Bloomberg, IRESS

Over this decade, Wesfarmers delivered average annual TSR of 24%, compared to an average annual return for the broader Australian market (as measured by the S&P/ASX 100 accumulation index[62]) of 15%, an average outperformance of 9% per annum.

## 6.2.2 Coles Group Acquisition and Turnaround

**Coles Group Acquisition**

Wesfarmers acquired Coles Group in November 2007 in a cash and scrip takeover valued at $19.3 billion. It was a transformational acquisition for Wesfarmers:

- three new divisions were created (Coles food and liquor, Kmart and Target), with Officeworks initially combining with Bunnings ANZ in the Home Improvement and Office Supplies Division;
- earnings almost doubled, with FY07 EBIT increasing from $1.3 billion to $2.5 billion on a pro forma basis;
- the proportion of earnings from retail businesses increased from 39% to 66% (on a pro forma basis), making Wesfarmers one of Australia's largest retailers;
- it became one of Australia's largest listed companies with a market capitalisation of more than $30 billion. Former Coles Group shareholders accounted for approximately 44% of Wesfarmers' issued shares; and

[62] The average annual return for the S&P/ASX 50 accumulation index and the S&P/ASX 200 accumulation index over this period were similar to that of the S&P/ASX 100 accumulation index at 14.9% and 15.2% respectively.

- debt increased substantially, with acquisition debt of $8.1 billion increasing Wesfarmers total debt to $11.5 billion and net debt to $11.0 million (representing a book gearing ratio of almost 70% and pro forma interest cover of 4.2 times).

At the time of acquisition, Coles Group's businesses, (other than Target) were performing poorly. In particular, the earnings of Coles Supermarkets had fallen significantly in FY07 due to a variety of factors, including general deterioration in the customer offer, continued competitive pressure and management issues as well as a poorly executed conversion of the *Bi-Lo* chain to the *Coles* brand and a problematic implementation of a new centrally-managed range system across the supermarket network. Based on a comparison to domestic and international peers, the potential for a turnaround in performance in the medium term was substantial. The Coles Group had commenced group-wide initiatives to support further growth through business simplification (cost savings) and a transformation initiative focused on improving Coles Group's supply chain and IT. However, significant structural change was required to turn the businesses around.

The board of Wesfarmers believed that the acquisition of Coles Group was consistent with Wesfarmers' strategy in that it would provide a significant opportunity to add shareholder value over time by combining:

- Coles Group's significant retail brand platform, extensive non-replicable store network and established market position in sectors with high barriers to entry; with
- Wesfarmers' decentralised business model, financial discipline and execution capabilities, including Wesfarmers' considerable retail experience gained through more than ten years' ownership of Bunnings ANZ.

The board of Wesfarmers also believed that a change of ownership would provide the catalyst required for the transformation of Coles Group and an improvement in performance. Wesfarmers ownership would provide an "umbrella" of protection, with access to the capital required and the ability to execute the turnaround in Coles Group's performance over the medium term without the distractions of being a listed company and, in particular, the pressure to deliver short term returns.

The timing of the acquisition of Coles Group coincided with the global financial crisis. Ongoing volatility in global debt capital markets resulted in a $4 billion bridging loan used to finance the acquisition being replaced in part by a $2.5 billion equity raising (underwritten entitlement offer) in April/May 2008 at a substantial discount of ~20% to Wesfarmers' share price at the time. A second equity raising of $2.8 billion (comprising a partially underwritten entitlement offer at a discount of ~17% to Wesfarmers' share price at the time and a placement) was completed in January/February 2009 to reduce Wesfarmers' debt to a conservative gearing level and a debt maturity profile considered by the board to be appropriate for the prevailing uncertain economic times.

**Transformation of Coles Group**

Wesfarmers transformation of Coles Group included:

- restructuring the previously centralised functions to create autonomous retail divisions;
- completing commercial reviews including a review of Kmart;
- appointing new management teams;
- a cultural shift to a strong performance focus;
- continuing the simplification (cost reduction) program, targeting cost savings through overhead reductions of $385 million per annum on an annualised basis by late FY09;
- continuing the transformation initiative around supply chain re-engineering (procurement, information technology ("IT") and supply chain infrastructure and processes), with benefits of approximately $540 million to be achieved on an annualised basis by late FY13; and

- restoring sales momentum through a focus on the customer (implementing a stronger customer proposition around value and convenience as well as new store rollouts, increased store refurbishments and maintenance).

At the time of acquisition, it was expected that a sustained turnaround for Coles Group, particularly the Coles business (including Supermarkets, Liquor and Convenience), would take up to five years.

### The Coles Business

Since 2009, more than $9 billion of capital has been invested in Coles:

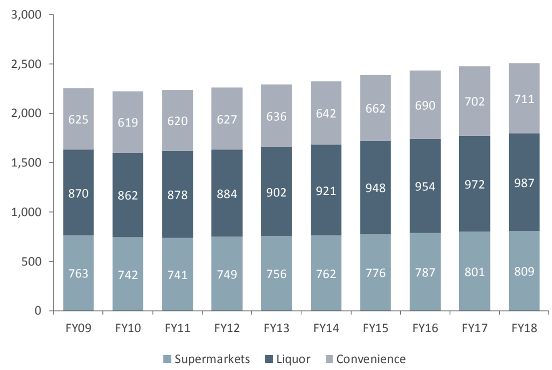
- 184 new supermarkets have opened, 134 supermarkets have been closed or relocated and 43 supermarkets have been rebranded;
- 90% of the supermarket network has been renewed as part of a refurbishment program focused on fresh, bakery, deli and meat; and
- omni-channel capabilities have been established with 1,000 "click & collect" sites operational at the end of FY18.

Wesfarmers successfully turned around Coles, achieving solid growth in EBIT (from FY09 to FY16) through a combination of sales and market share growth and margin improvement:

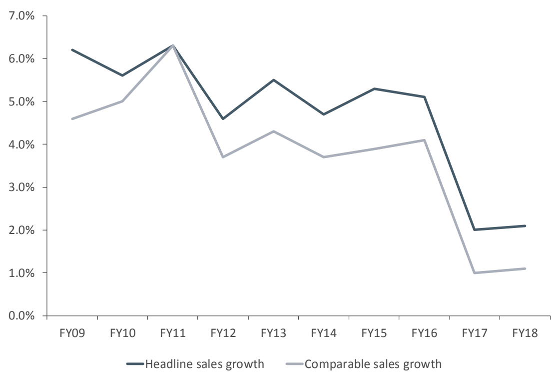
**COLES FOOD AND LIQUOR BUSINESS – TURNAROUND IN PERFORMANCE**

**FY09 TO FY18**

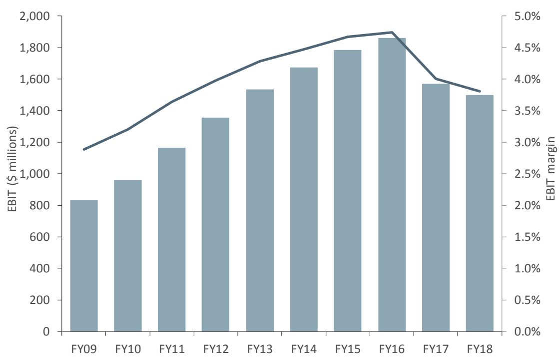
**NUMBER OF STORES**



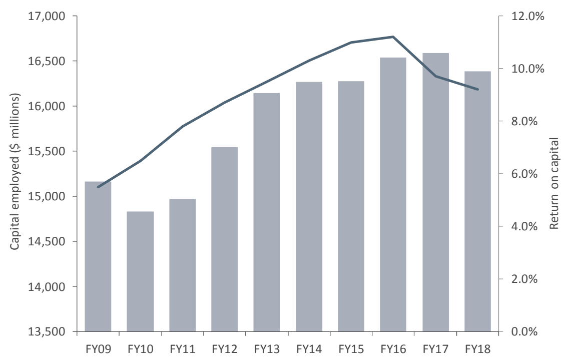

**SALES GROWTH**




**EBIT[63] AND EBIT MARGIN**




**CAPITAL EMPLOYED AND RETURN ON CAPITAL**




Source: Wesfarmers

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63 EBIT is shown before significant items but includes earnings from the Coles credit card business in FY16 and FY17 (prior to its sale in February 2017).

Under Wesfarmers, Coles strengthened its position as a leading Australian retailer delivering long term sales and earnings growth and returns. While performance declined in FY17 and FY18, this has reflected a period of intense competition. In particular, Woolworths' large investment in price and service during FY16 and FY17 required Coles to respond with an accelerated investment in the customer offer, impacting sales revenue and margins. However, there has been some improvement in the second half of FY18, with comparable sales growth of 1.8% and price deflation of 0.6% in the fourth quarter of FY18 (compared to sales growth of 1.1% and price deflation of 1.2% for FY18 overall). Even allowing for the decline in EBIT In FY17 and FY18, Coles has achieved average annual growth in EBIT of 6.8%, reflecting above market sales growth and an improvement in EBIT margins (which have increased from 2.9% in FY09, peaked at 4.7% in FY15 and FY16 and were 4.0% in FY17 and 3.8% in FY18). Return on capital has more than doubled from 5.5% in FY09 to its peak of 11.2% in FY16 and was 9.2% in FY18.

### Impact on Wesfarmers

Following the acquisition of Coles Group, Wesfarmers remained committed to its primary objective of providing a satisfactory return to shareholders over the long term and continued to believe that the diversified conglomerate model provided the best opportunity to achieve this objective. The group continued to actively manage its portfolio of businesses and make changes to its portfolio where this was consistent with improving long term returns to shareholders. Despite the substantial retail weighting in Wesfarmers' overall business portfolio, Wesfarmers continued to make acquisitions outside the retail sector although:

- no material acquisitions were made for a period of more than six years as Wesfarmers focused on the turnaround of Coles Group and responded to the global financial crisis; and
- acquisitions were on a much smaller scale.

Key acquisitions and divestments since the acquisition of Coles Group are summarised below:

**WESFARMERS – ACQUISITIONS AND DIVESTMENTS AFTER COLES GROUP**

| | DATE | ACQUISITION PRICE (MILLIONS) | SALE PRICE (MILLIONS) | PRE TAX PROFIT/(LOSS) ON SALE (MILLIONS) |
|---|---|---|---|---|
| **Acquisitions** | | | | |
| MDL 162 (adjacent to Curragh coal mine) | January 2014 | $70 | | |
| Workwear Group | December 2014 | $180 | | |
| 50% interest in Coles credit card joint venture | May 2015 | nd[64] | | |
| 13.5% interest in Quadrant Energy | June 2015 | US$100 | | |
| Homebase (BUKI) | February 2016 | £340 | | |
| **Divestments** | | | | |
| Energy Generation (enGen) | August 2011 | | $101 | $40 |
| Premier Coal | December 2011 | | $297 | $90 |
| 40% interest in Air Liquide WA | December 2013 | | nd | $95 |
| Insurance division | June 2014 | | $2,855 | $1,040 |
| Kleenheat east coast gas distribution operations | February 2015 | | nd | $14 |
| Coles credit card business | February 2017 | | $947[65] | - |
| Curragh coal mine | March 2018 | | $700[66] | $120 |
| BUKI | June 2018 | | nominal[67] | $(375) |

64 nd = not disclosed.

65 Gross value of receivables.

66 Wesfarmers will also participate in a value share mechanism under which it will receive 25% of Curragh's export coal revenue generated above a realised metallurgical coal price of $US145 per tonne, paid quarterly over a period of two years.

67 Wesfarmers will also participate in a value share mechanism whereby it is entitled to 20% of any equity distributions from the business.

**WESFARMERS – ACQUISITIONS AND DIVESTMENTS AFTER COLES GROUP (CONT)**

| | DATE | ACQUISITION PRICE (MILLIONS) | SALE PRICE (MILLIONS) | PRE TAX PROFIT/(LOSS) ON SALE (MILLIONS) |
|---|---|---|---|---|
| 40% interest in Bengalla joint venture | August 2018[68] | | $860 | $670-680 |
| Kmart Tyre and Auto Service business | August 2018[69] | | $350 | $270-275 |
| 13.2% interest in Quadrant Energy | August 2018[70] | | US$170 | US$98 |

Source: Wesfarmers

Not all of Wesfarmers acquisitions have been successful in achieving Wesfarmers' primary objective of satisfactory returns to shareholders over the long term. The BUKI acquisition, in particular, has been acknowledged as being poorly executed, underestimating the importance of local management and compounded by the deterioration in the United Kingdom retail sector.

On the other hand, other Wesfarmers businesses have performed extremely well:

- an initial 9.7% interest in Bunnings Limited (then a publicly listed company) was acquired in 1987 and a takeover to achieve full control was completed in 1994. Wesfarmers was initially attracted to the forest and timber business, but it was the hardware business and the growing "do-it-yourself" market that became the cornerstone of growth over the past 24 years. Bunnings ANZ has grown (organically and through the acquisition of Howard Smith and its BBC hardware chain) to become the largest participant in the Australian home improvement sector, with an estimated market share of 20%. In FY18, Bunnings ANZ reported an EBIT of $1.5 billion and equalled Coles as Wesfarmers' largest contributor to earnings, achieving sales growth of 8.9%, an EBIT margin of 12.0% and a return on capital of 49.4%. Over the past ten years, sales and EBIT have grown at an average of 9% and 10% per annum respectively, EBIT margins have consistently been in the range 11-12% and return on capital has increased from 26 to 49%;
- the sale of Wesfarmers' insurance division, which was built over a number of years through organic growth and acquisition prior to its sale in FY14, generated a pre-tax profit on sale of $1.0 billion. The sale of the business was consistent with Wesfarmers' focus on disciplined portfolio management having regard to the long-term interests of its shareholders; and
- the investment in the Curragh coal mine, which delivered an after tax internal rate of return of approximately 49% per annum over its 17 year life, prior to its divestment in March 2018.

### 6.2.3 Wesfarmers Today

**Coles Turnaround Complete**

The turnaround of Coles has been completed and Coles is a mature business generating substantial cash flows. Future growth in Coles will be driven by:

- market growth (a function of population growth, consumption growth and food price inflation/deflation). Average market growth has been 4.0% per annum over the past ten years and 3.7% per annum over the past five years[71]. Market growth is expected to remain at around 3-4% per annum (on average) but could be lower if food price deflation continues at recent levels; and

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68 Announced on 7 August 2018. Expected to complete in the fourth quarter of 2018. Profit on sale subject to completion adjustments.

69 Announced on 12 August 2018. Expected to complete in the first quarter of FY19. Profit on sale subject to completion adjustments.

70 Announced on 22 August 2018. Expected to complete in the second or third quarter of FY19.

71 Source: Australian Bureau of Statistics 8501.0 - Retail Trade, Australia, May 2018 (Total Turnover, Food Retailing, Original). Food retailing includes supermarket and grocery stores and non-petrol sales (convenience stores) of selected fuel retailing, liquor retailing and other specialised food retailing (fresh meat, fish and poultry, fruit and vegetable, other).

- competition and its impact on market share, margins and earnings. The Australian supermarket industry is extremely competitive among both the incumbent major participants (Coles and Woolworths) as well as more recent entrants (*ALDI* and Costco Wholesale Corporation ("Costco"), along with the potential entry of German-based grocery chain *Kaufland* and the threat of *AmazonFresh*). In addition to competing on price and customer offer, there is also the potential for a focus on sales growth and market share to result in additional store space (i.e. new store rollouts) exceeding market growth. As evidenced by Coles' performance in FY17 and FY18, the actions of competitors, particularly Woolworths, can have a significant impact on Coles' performance.

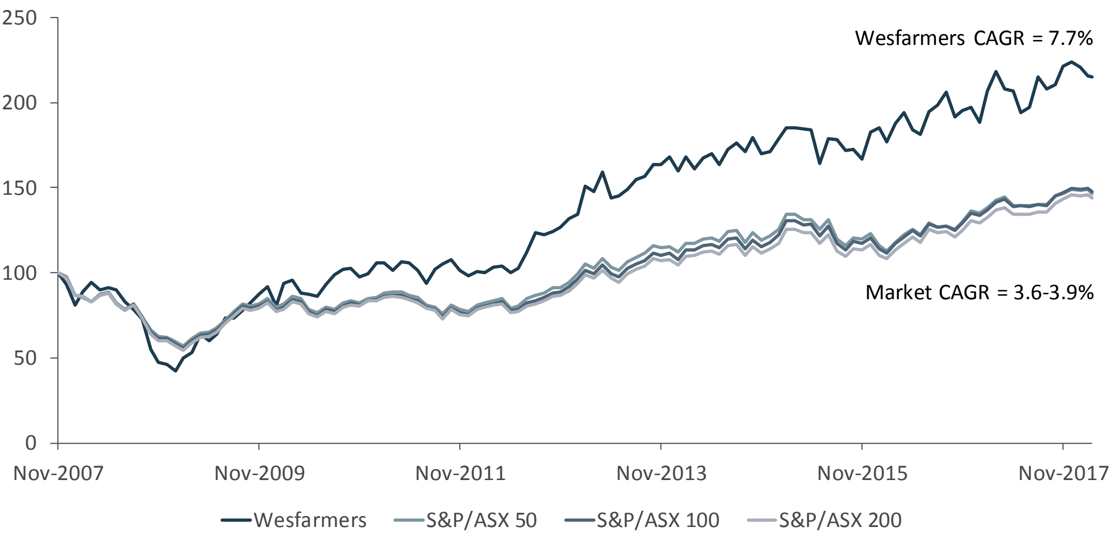
As a result, while Wesfarmers expects that Coles will return to positive earnings growth in FY19 and beyond, future growth will be more moderate compared to the strong turnaround growth achieved over the past ten years (average annual EBIT growth of 6.8%). While there are competitive and structural risks, Coles is a strong competitor with an established brand, an extensive store network and opportunities for growth through ongoing improvements in its cost structure. On the assumption that Coles is able to maintain its market share and margins at current levels, future growth would be expected to be limited to estimated market growth of around 3-4% per annum.

**Impact of Coles on Wesfarmers**

The acquisition of Coles Group strengthened Wesfarmers' position as a diversified conglomerate. Wesfarmers has delivered strong returns to Wesfarmers' shareholders in the ten years following the acquisition:

**WESFARMERS TOTAL SHAREHOLDER RETURN VS MARKET ACCUMULATION INDICES**

**30 NOVEMBER 2007 TO 15 MARCH 2018**



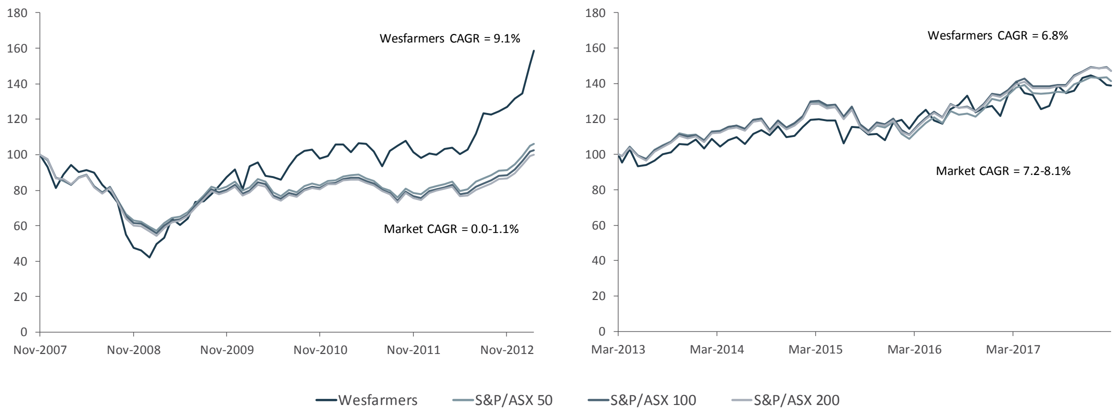

Source: Bloomberg, IRESS

From the acquisition of Coles Group in November 2007 to announcement of the Demerger, Wesfarmers delivered average annual TSR of 7.7% compared to an average annual return for the broader Australian market (as measured by the S&P/ASX 100 accumulation index[72]) of 3.9%, an average outperformance of 3.8% per annum. However, the majority of this outperformance was achieved over the first five years following the acquisition of Coles Group, when the impact of the turnaround was greatest. Over the subsequent five years, Wesfarmers has generally performed in line with the broader Australian market:

72 The average annual return for the S&P/ASX 50 accumulation index and the S&P/ASX 200 accumulation index over this period were similar to that of the S&P/ASX 100 accumulation index at 3.8% and 3.6% respectively.

**WESFARMERS TOTAL SHAREHOLDER RETURN VS MARKET ACCUMULATION INDICES**

**30 NOVEMBER 2007 TO 15 MARCH 2013** | **18 MARCH 2013 TO 15 MARCH 2018**




Source: Source: Bloomberg, IRESS

From the acquisition of Coles in November 2007 to 15 March 2013, Wesfarmers delivered average annual TSR of 9.1% compared to an average annual return for the broader Australian market (as measured by the S&P/ASX 100 accumulation index[73]) of 0.5%, an average outperformance of 8.6% per annum. In contrast, over the five years prior to announcement of the Demerger, Wesfarmers' average annual TSR at 6.8% was below the average annual return for the broader Australian market (as measured by the S&P/ASX 100 accumulation index[74]) of 8.1%.

The lack of outperformance by Wesfarmers over the past five years can in part be attributed to Coles:

- the size of Coles relative to other businesses in Wesfarmers' portfolio which creates challenges for the diversified conglomerate model because:
  - Coles represents a large proportion of earnings (32%) and capital employed (64%) and therefore has a significant impact on Wesfarmers' earnings growth and return on capital, regardless of the performance of Wesfarmers' other businesses. Conversely, any outperformance by smaller businesses in the portfolio has less impact on Wesfarmers' overall performance. While the underperformance of other portfolio businesses such as BUKI and Target would have also had an impact on Wesfarmers' TSR over the past five years, these two businesses have collectively represented only (2)-7% of earnings (before non-recurring items) and 9-12% of capital employed over the period to FY17[24];
  - Coles requires a disproportionate amount of corporate head office resources and focus. Although Coles has its own management and divisional board of directors responsible for strategy development and execution and operational performance, a significant proportion of corporate head office management time is spent on Coles-related investor relations, governance and compliance matters; and
  - it reduces the pool of acquisition targets that would have a meaningful impact on Wesfarmers' earnings and return on capital (i.e. acquisitions would need to be extremely large to have any material impact); and
- in recent years, Coles has not achieved earnings growth at a level that supports superior TSR for Wesfarmers relative to the broader Australian market. To achieve superior TSR, earnings need to grow at a faster rate than the market, which generally requires high single digit earnings growth over the long term. In this context, the turnaround of Coles has been very successful (~12% average per

[73] The average annual return for the S&P/ASX 50 accumulation index and the S&P/ASX 200 accumulation index over this period were similar to that of the S&P/ASX 100 accumulation index at 1.1% and 0.0% respectively.

[74] The average annual return for the S&P/ASX 50 accumulation index and the S&P/ASX 200 accumulation index over this period were similar to that of the S&P/ASX 100 accumulation index at 7.2% and 8.0% respectively.

annum growth in EBIT up to FY16). However, the business is now in a position where maintaining this level of growth will be difficult. The Coles business, while operationally sound, is mature. EBIT margins fell by around 70 basis points in FY17 to 4.0% (a level not seen since FY12) and fell a further 20 basis points to 3.8% in FY18, due to intense competition in the Australian supermarket sector. There is no indication that the level of competition will subside (and there is the possibility of an increase in competition from further new entrants). While Wesfarmers expects Coles to achieve moderate earnings growth from FY19, Wesfarmers' target of superior TSR requires a consistently higher level of growth over the long term.

Coles' return on capital peaked at 11.2% in FY16 (albeit having more than doubled from 5.5% in FY09) but went backwards in FY17, decreasing by 150 basis points to 9.7% and falling by a further 50 basis points to 9.2% in FY18, below its FY13 return on capital of 9.5%. The decline in Coles' return on capital in FY17 and FY18 has not had as great an impact on Wesfarmers' overall return on capital, which increased from around 10% to 12% in FY17 due to the impact of impairments in Target and the Resources business in the prior year and to 17% in FY18 as a result of very strong results from Wesfarmers' other portfolio businesses.

## 6.3 Rationale for and Benefits of the Demerger

### 6.3.1 Decision to Divest Coles

The decision to divest Coles followed a review of the Wesfarmers portfolio of businesses and an assessment of the composition of capital employed required to support higher levels of future growth and superior TSR over the long term.

To deliver superior TSR over the long term, Wesfarmers identified that it needed to:

- continue to invest in portfolio businesses where capital investment opportunities exceed return requirements;
- acquire or divest portfolio businesses where this is estimated to increase long term shareholder value; and
- manage its balance sheet to achieve an appropriate risk profile, optimise its cost of capital and have the flexibility to take advantage of opportunities as they arise.

As a result, the Wesfarmers board came to the conclusion that Wesfarmers would be better able to achieve its objective if Coles was no longer part of the Wesfarmers portfolio of businesses.

The decision to divest Coles and not Wesfarmers' other retail businesses that were acquired as part of the Coles Group acquisition in 2007 (Kmart, Target and Officeworks) and/or Bunnings ANZ has been justified by Wesfarmers on the basis that the divestment of Coles has the greatest impact on EBIT, EBIT growth and return on capital. Coles is a substantial and mature business with a moderate growth profile. The turnaround of Coles has been achieved and the value that Wesfarmers' ownership provided as an "umbrella" of protection during the transformation period is no longer necessary.

In contrast, Wesfarmers' other retail businesses are either:

- expected to continue to deliver strong growth and increasing returns to shareholders while requiring a relatively small capital allocation (Kmart, Bunnings ANZ). Kmart, in particular, has been transformed into a deep discount department store specialising in homewares and apparel. It is a niche participant with a differentiated offering in the department store sector and has moved away from categories most exposed to digital disruption (such as consumer electronics, books, music etc.); or
- relatively small in terms of earnings and capital employed (Officeworks) and/or in the midst of a turnaround (Target) that would be a distraction in any divestment. Target also offers the potential for earnings growth and return on capital upside as its turnaround is completed.

Furthermore, there are limited synergies between supermarkets and the other retail businesses.

### 6.3.2 Alternatives

Having made the decision to "divest" Coles, a number of alternative divestment methods were available to Wesfarmers. These included:

- trade sale (to a global supermarket operator or to private equity);
- IPO (of 100% or with retention of a cornerstone interest); or
- demerger (of 100% or with a retained interest).

While it is inevitable that any proposal will involve some compromises and drawbacks, the board and management of Wesfarmers have considered each of these alternatives and determined that the Demerger is the most effective means of achieving its objectives.

A trade sale would have its attractions, particularly if there was an acquirer that could extract significant synergies, but:

- there are no obvious acquirers of Coles. It is a very substantial business. The current median broker valuation of Coles is in excess of $20 billion (enterprise value):
  - few global supermarket operators would have the financial capacity to acquire Coles (for cash rather than equity) and any synergies with their existing businesses would be limited;
  - the largest global supermarket operators that might have the necessary financial capacity (such as Walmart Inc. ("Walmart")), may have some interest, but are facing increasing competitive pressures and declining margins in their existing businesses and acquisitions have focused on brands, e-commerce and logistics. Furthermore, offshore acquisitions in the supermarket sector have largely been unsuccessful in the past; and
  - a private equity funded acquisition of this scale would require a consortium of private equity funds and would be heavily leveraged, increasing execution risk and the ability to maximise the acquisition price;
- Wesfarmers believes that there is further opportunity to improve the performance of Coles. It would be difficult for Wesfarmers to get any value for this potential upside in a trade sale;
- a trade sale process would be protracted and disruptive and there would be no certainty of success. A failed trade sale process could have an adverse impact on the Coles business; and
- a trade sale would crystallise a significant capital gains tax liability for Wesfarmers.

In any event, there is no impediment to a trade sale taking place either before or after the Demerger. Coles will have an open register except for Wesfarmers' 15% interest so an interested party could make a takeover offer or other change of control proposal. Since announcement of the Demerger, Wesfarmers has not received any approaches from trade or financial investors in relation to an acquisition of Coles.

An IPO would have the advantage of creating a shareholder base of "natural holders" but would also have a number of drawbacks:

- the pricing would invariably be based on current earnings and would represent a portfolio price. Moreover, the pricing of a public issue would normally reflect a discount to the expected post issue trading price;
- the size of an IPO of Coles would be challenging for equity markets. The largest Australian IPO in the past ten years was the $5.7 billion IPO of Medibank Private Limited in November 2014. There is no certainty that a 100% IPO would be able to be completed and Wesfarmers would be exposed to the vagaries of market conditions.

  A staged exit, where there was an initial partial IPO of Coles with Wesfarmers retaining a cornerstone interest, followed by one or more sell downs over a period of time, could solve some of these issues but:

- it would likely mean that Wesfarmers would remain exposed to Coles for several more years (depending on any escrow period). It would not achieve a quick, clean exit;
- the exposure to market conditions would remain, arising at the time of each sell down; and
- pricing at each stage would inevitably reflect some discount and the fact that Wesfarmers was a known seller would create the perception of an overhang that could adversely affect trading in Coles shares;

- an IPO would crystallise a significant capital gains tax liability for Wesfarmers; and
- an IPO would arguably result in an inefficient recycling of capital as:
  - most Wesfarmers shareholders would also be natural holders of Coles shares given that Coles is such a significant part of Wesfarmers; and
  - neither business has a critical need for the capital that would come with an IPO:
    - Wesfarmers post Demerger will have a conservative capital structure, expecting to retain its existing investment grade credit rating and with ample capacity to fund growth opportunities; and
    - Coles will be established with a prudent capital structure consistent with a strong investment grade credit rating. The business generates significant amounts of cash to fund dividend payments and has sufficient headroom in its debt facilities to fund its capital expenditure requirements (including the additional requirements relating to store refurbishments, expansion of digital capabilities and improvements in the supply chain) in the near future.

  Consequently, the capital raised through an IPO would be likely to be returned to Wesfarmers shareholders in the form of special dividends and/or capital returns (after allowing for tax leakage).

The key attractions of a demerger are that:

- it provides more certainty compared to the other options. The outcome is largely in the control of Wesfarmers;
- Wesfarmers shareholders are provided with the opportunity to retain exposure to the upside potential from any improvement in the performance of Coles and/or corporate activity. As a result of Wesfarmers' retaining a 15% interest in Coles, Wesfarmers will also benefit from this upside potential;
- it provides shareholders with ownership of Coles at its market value and, to the extent that shareholders wish to sell their Coles shares, they will receive the full market price (less brokerage) on sale and will (in general) have the flexibility to choose when to sell; and
- demerger tax relief should be available to Wesfarmers shareholders, deferring any tax payable until they sell any of their Coles shares (see Section 6.6.2).

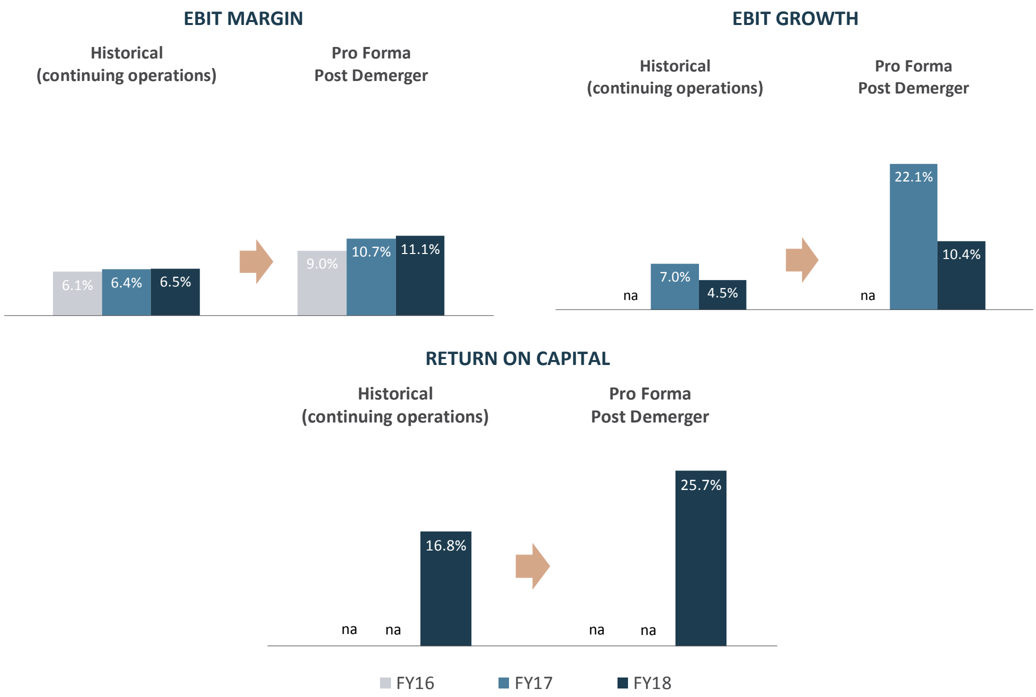
Wesfarmers has decided to retain a 15% interest in Coles to demonstrate its confidence in Coles and to provide alignment of interests in relation to the *flybuys* joint venture and the development of its data and digital capabilities. The advantages and disadvantages of Wesfarmers' retention of an interest in Coles are discussed in Section 6.3.4 of this report.

### 6.3.3 Wesfarmers post Demerger

The demerger of Coles will re-establish Wesfarmers as an industrial conglomerate (rather than a diversified retailer) that is better positioned to create shareholder value over the long term. The Demerger will:

- refocus Wesfarmers' on the growing, higher return businesses in its portfolio, in particular, Bunnings ANZ and Kmart. On a pro forma basis, the EBIT margin, EBIT growth and return on capital for Wesfarmers post Demerger are significantly higher than for Wesfarmers in its current form:

**WESFARMERS VS WESFARMERS POST DEMERGER**



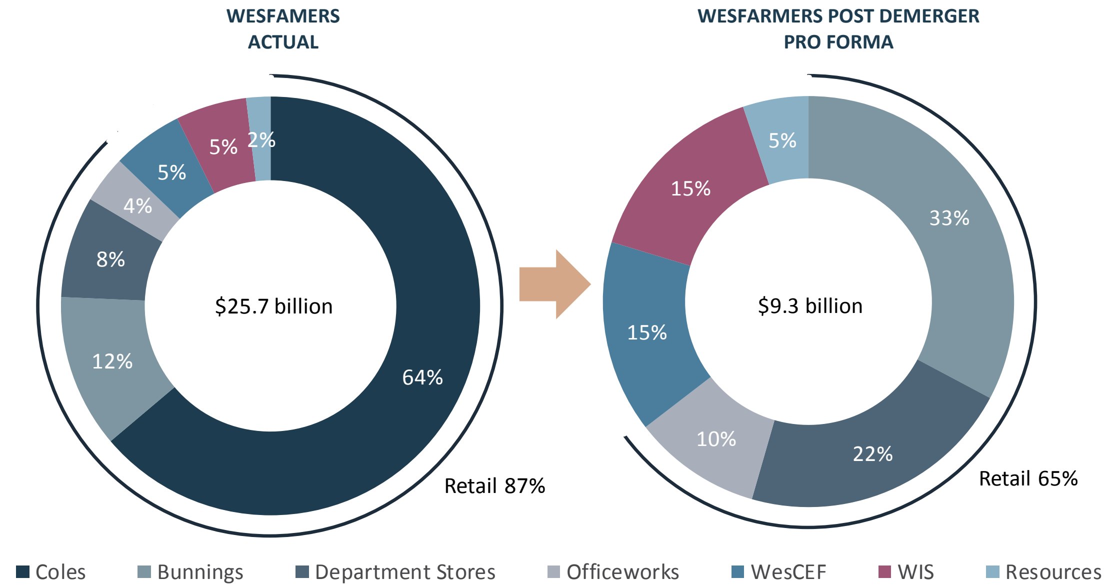

Source: Wesfarmers and Scheme Booklet

Importantly, Wesfarmers post Demerger's pro forma EBIT growth over the period from FY16 to FY18 has been in the low to high double digits (10-22%), above the level of growth necessary over the long term to enable Wesfarmers post Demerger to generate superior TSR relative to the broader Australian market (of high single digit EBIT growth); and

- reduce capital employed, so that successful growth initiatives in the remaining portfolio businesses and through acquisition will have a greater impact on returns:

**CAPITAL EMPLOYED[75]**

**ROLLING 12 MONTHS TO JUNE 2018**




Source: Wesfarmers and Scheme Booklet

Wesfarmers post Demerger remains substantially a retail business. Capital employed in retail businesses falls from 87% to 65% on a pro forma basis[75], albeit in the non-food rather than the food sector. Retail businesses contribute 77% of FY18 EBIT on a pro forma basis[75], with Bunnings ANZ representing 50% of group EBIT.

However, the reduced size and substantial balance sheet capacity of Wesfarmers post Demerger should make it a more nimble business. Wesfarmers post Demerger will be able to consider a broader universe of growth opportunities (both organic and inorganic) which, if successfully executed, will have a greater impact on shareholder returns.

Wesfarmers is agnostic as to where its capital is allocated. Its focus is on achieving strong returns, rather than portfolio composition or scale. While Wesfarmers post Demerger will have a less concentrated exposure to retail, this is not a driver of Wesfarmers' strategy.

While there is no guarantee that past performance on a pro forma basis is indicative of future performance, the Demerger better positions Wesfarmers to achieve the growth necessary to meet its objective of generating satisfactory returns for shareholders over the long term.

While Wesfarmers post Demerger will have a portfolio of cash generative businesses with good momentum and leading positions in growing markets, the short to medium term outlook for Wesfarmers is arguably more subdued than in prior years, with Bunnings ANZ and Kmart dependent on consumer discretionary spending and exposed to the economic cycle and the WesCEF businesses being price takers in competitive markets with earnings dependent on volatile commodity prices. As a result, Wesfarmers post Demerger may need to turn to business expansion/extension or acquisitions to generate the necessary levels of growth. Acquisitions carry with them the associated execution risk (as demonstrated by the experience with recent acquisitions such as BUKI).

### 6.3.4 Investments in *flybuys* and Coles

Following the Demerger, Wesfarmers will retain a:

- 50% interest in *flybuys* (with Coles retaining the other 50% interest); and
- 15% interest in Coles and have one representative on the board of Coles[76].

In a typical demerger, it would be expected that a loyalty program such as *flybuys*, which is integral to Coles' Supermarkets business, would be demerged with Coles. However, Wesfarmers' diversified conglomerate model and its focus on growing, high return businesses provide a strong rationale for investing in *flybuys* as a separate business:

- Wesfarmers will retain a strong retail exposure and will have an opportunity, with Coles as its joint venture partner, to further develop the *flybuys* loyalty offer, which will benefit its remaining retail divisions and Coles. Data and digital are increasingly important capabilities for all retail businesses to remain competitive. A number of opportunities linked to *flybuys* are under consideration which are expected to:
  - deliver greater value to retail customers;
  - enable more informed business decision-making in relation to, for example, product range and purchasing, targeted marketing and store location and layout; and

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75 Calculated on a rolling monthly basis and before taking into account the capital invested in, and the share of net profit after tax from, Wesfarmers' 15% interest in Coles and its 50% interest in *flybuys* (which are treated as associates and as part of "other" activities). Including the 15% interest in Coles in these calculations would increase the pro forma capital employed in retail businesses from 65% to 70% but would only increase the pro forma EBIT contribution from retail businesses from 77% to 78%.

76 Under a Relationship Deed entered into between Wesfarmers and Coles, Wesfarmers will be entitled to appoint one person as a director to the Coles board for as long as it retains a shareholding of at least 10% of Coles.

   - create new revenue streams.

  Wesfarmers' ongoing investment in *flybuys* will assist it in successfully taking advantage of these opportunities;

- it is consistent with Wesfarmers' data and analytics strategy as it:
   - enhances its data analytics capabilities; and
   - forms a substantial basis from which Wesfarmers will be able to grow its presence in the data and digital sector; and
- it meets Wesfarmers' objective of investing in growing businesses.

The rationale for Wesfarmers retaining a 15% interest in Coles is less obvious, albeit Wesfarmers does have a history of holding large minority interests in businesses for long periods of time. One example is BWP Trust, in which Wesfarmers has held a ~25% interest since its listing on the ASX in September 1998. BWP Trust owns the majority of properties tenanted by Bunnings ANZ and a wholly owned subsidiary of Wesfarmers is the responsible entity for the trust.

Wesfarmers' stated rationale for retaining a 15% interest in Coles is that it:

- provides alignment of interests, particularly in relation to *flybuys* and the development of data and digital capabilities; and
- demonstrates to the market Wesfarmers' confidence in the demerged Coles. This is regarded as important for retail shareholders, who hold approximately 50% of Wesfarmers' issued shares.

The 15% interest in Coles should provide Wesfarmers with a "voice" at board meetings, particularly in relation to *flybuys*, as well as insight into Coles' thinking in relation to *flybuys*. Wesfarmers will be able to be an advocate for the broader scope for *flybuys* to the Coles board and may also be able to ameliorate any tensions that might arise in the *flybuys* joint venture as a result of it having a better understanding of Coles' position and strategy. However, in Grant Samuel's view, the investment in Coles is not essential:

- *flybuys* is a very small (albeit high growth) part of the Wesfarmers business post Demerger. The 15% interest in Coles represents a significant amount of capital (~$2.3 billion or around 19% of capital employed) tied up in a relatively low growth business over which Wesfarmers will have limited direct influence; and
- there is no certainty that the investment or representation on the board would, on its own, solve any significant issues that might arise in the *flybuys* joint venture. The success of *flybuys* will depend more on the *flybuys* board and management interactions between it, Coles and Wesfarmers.

Furthermore, cash flows from the investment in Coles will be in the form of dividends received twice per year with Wesfarmers having limited influence over the dividend policy and will result in lower return on capital and return on equity relative to a full demerger of Coles.

While Coles will be a liquid investment listed on the ASX:

- the Wesfarmers investment in Coles could create a potential overhang if Wesfarmers was perceived either as a seller or not a long term holder of the interest. In this regard, Wesfarmers has indicated that it does not regard its investment in Coles as a short term investment (although as part of its objective to provide satisfactory returns to shareholders, has also stated that all of its businesses/investments are for sale at the right price); and
- the relatively large size of Wesfarmers' shareholding (as Coles' largest shareholder) may mean that it is difficult to sell quickly or in one line and may restrict the price at which Wesfarmers is able to sell its interest.

### 6.3.5 Other Benefits of the Demerger

**Shareholder Flexibility**

Immediately following the Demerger, Wesfarmers shareholders (except ineligible overseas shareholders and selling shareholders) will retain the same economic exposure to Wesfarmers' businesses, but will hold it through two separate investments:

- shares in Coles, which will provide direct ownership of, and a pure exposure to, Coles' Supermarkets, Liquor and Convenience businesses (including a 50% interest in *flybuys*); and
- shares in Wesfarmers, which will provide exposure to 15% of the Coles business, together with all of Wesfarmers' other businesses (Bunnings ANZ, Kmart, Target, Officeworks, WesCEF, WIS, Resources and its non-controlling investments, including a 50% interest in *flybuys*). Shareholders' interests will not change (including the number of shares held) from their current interest except that Wesfarmers shares will now provide only a limited direct exposure (15%) to Coles. The 15% interest in Coles and the retained 50% interest in *flybuys* will be treated as equity accounted investments along with Wesfarmers' existing non-controlling interests in BWP Trust, Gresham Partners and Wespine.

This arrangement will provide shareholders with increased flexibility to manage their exposures to the respective businesses as they see fit. The Demerger will enable shareholders to retain their existing ownership of Coles and provide the opportunity to increase or decrease that exposure by trading Coles shares. Shareholders attracted to Coles' defensive investment characteristics and strong cash generation to support dividend payments could increase their exposure to Coles if they wished. Alternatively, they could decrease their exposure to the Coles business by selling Coles shares if they were more attracted to the higher growth prospects (and higher risk) of Wesfarmers post Demerger.

The ability to make a more precise targeted investment into the demerged Coles and Wesfarmers businesses (or adjust allocations between these businesses) should be attractive to shareholders, certainly compared to the current structure where they are locked into the relativities implicitly set by 100% ownership.

**Increased Capacity to Focus on Wesfarmers post Demerger Businesses**

Despite Wesfarmers' autonomous management model, the size, public profile and turnaround of Coles has demanded a significant commitment of time and resources by the Wesfarmers' board and corporate head office i.e. it has consumed significant management "bandwidth". As a result, there has been less capacity to pursue other opportunities.

The Demerger will increase the capacity of the Wesfarmers' board and corporate management to focus solely on the growing businesses in the portfolio and new opportunities. In particular, it will eliminate the need for board and corporate head office management resources to be devoted to Coles.

In Grant Samuel's opinion, this benefit is real but is not directly measurable and will only be manifested in performance measures over the medium and longer term.

The demerger of Coles may also increase investor and analyst awareness and understanding of Wesfarmers' remaining businesses. At present, these businesses receive relatively little attention in meetings with investors or analysts.

**Streamlined Decision Making for Coles**

The Demerger will result in simplification of Coles' decision making processes for significant initiatives. While Coles operates on an autonomous basis, at present, certain significant decisions (e.g. large capital expenditure, long tenure agreements) involve all of Coles and Wesfarmers management (including Wesfarmers' business development team), the Coles divisional board and the Wesfarmers board. Inevitably, this results in longer decision making processes for significant initiatives and the potential for second guessing of those "on the ground". The Demerger should therefore lead to greater speed of decision making for significant initiatives which will be important in the highly competitive retail supermarket sector.

**More Targeted and Flexible Staff Incentives for Coles**

Under the current Wesfarmers incentive scheme, Wesfarmers' executives are already rewarded for achieving objectives for which they are accountable and responsible. Under Wesfarmers' KEEPP, the granting of equity incentives is based on divisional financial measures (EBIT, return on capital, store sales growth and transaction growth) (60%) and divisional strategic measures (40%). However, only the Coles CEO is entitled to participate in the KEEPP. Management and staff below the CEO are able to receive grants of Wesfarmers shares (subject to a time lock).

As a standalone listed company:

- incentives will be able to be offered to a wider range of executives (i.e. below CEO level) and store managers; and
- there will be stronger alignment between executive/store manager performance and the value of shares provided as incentives because Coles will be able to offer equity in a pure Coles business rather than the diversified Wesfarmers' business (albeit given Coles' relative size, Wesfarmers shares are often regarded as a proxy for Coles).

### 6.3.6 Other Considerations

The rationale for the Demerger is not conventional. It is specific to Wesfarmers and is driven by the desire to reposition Wesfarmers as a diversified industrial conglomerate focused on providing satisfactory returns to shareholders. The Demerger is not being driven by the expectation of a market re-rating or by some of the other typical benefits of demergers.

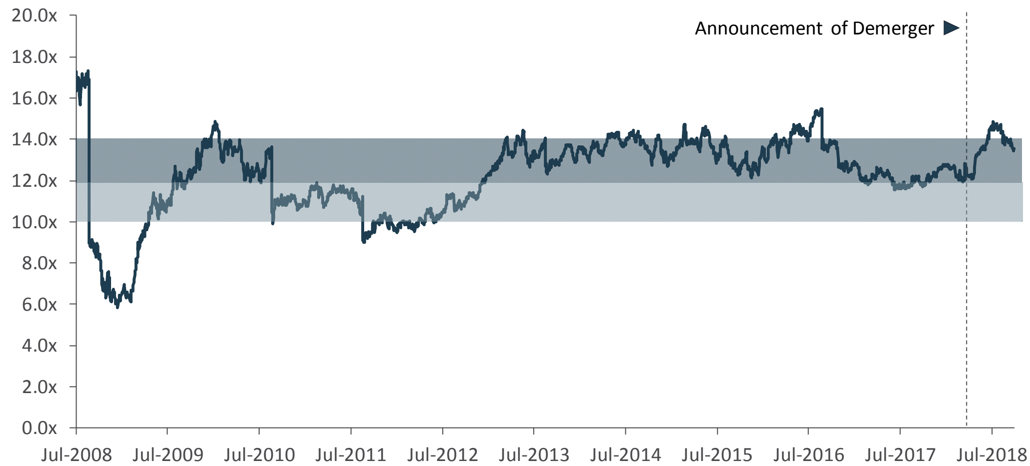
**Sharemarket Re-Rating**

The case for any short-term market re-rating is not strong:

- there does not appear to be any material mis-pricing of Wesfarmers shares:
  - Wesfarmers is currently trading broadly in line with its long term average trading multiples:

**WESFARMERS – FORWARD EBIT TRADING MULTIPLE**

**JULY 2008 TO SEPTEMBER 2018**




Source: S&P Global Market Intelligence

Over the past ten years, Wesfarmers has consistently traded in the range 10-14 times forward EBIT (other than for a short period of time during the global financial crisis). Over the past six years, the range has been even tighter at around 12-14 times forward EBIT. While there has been an increase in Wesfarmers' forward EBIT trading multiple since announcement of the Demerger (to as high as 15 times), this has been in the context of a general rise in equities markets (the S&P/ASX 200 has increased by 5% over the same period) as well as company specific factors that did not necessarily impact forward earnings forecasts at the time, such as the exit from BUKI on better than expected terms (announced on 25 May 2018 and completed on 2 June 2018), the annual strategy briefing day held on 7 June 2018 and the announcement of Wesfarmers' FY18 results on 15 August 2018;

- broker "sum of the parts" valuations for Wesfarmers on announcement of the Demerger were generally in line with the trading range for Wesfarmers' shares at the time:

**WESFARMERS – BROKER VALUATIONS**

**ON ANNOUNCEMENT OF DEMERGER (16 MARCH 2018)[77]**

| | BROKER VALUATIONS[78] ($ MILLIONS) | | |
|---|---|---|---|
| | LOW | MEDIAN | HIGH |
| Coles | 18,995 | | 20,063 |
| Bunnings ANZ | 18,674 | | 22,868 |
| Department stores | 7,255 | | 8,138 |
| Officeworks | 904 | | 2,110 |
| Industrials | 4,533 | | 5,471 |
| Corporate and other | (2,840) | | 396 |
| **Enterprise value** | **47,521** | **51,026** | **59,046** |
| Net borrowings | (3,579) | (3,964) | (3,720) |
| **Equity value** | **43,942** | **47,062** | **55,326** |
| **Equity value per share** | **$38.75** | **$41.51** | **$48.70** |

Source: Broker's reports and Grant Samuel analysis

There is evidence that diversified conglomerates often trade at a discount to the identifiable market value of their portfolio businesses (known as the "conglomerate discount"). The quantum of the discount and the reasons for it vary from case to case and typically relate to disadvantages in relation to resource allocation, management focus, decision making and incentives. However, the conglomerate discount does not appear to apply to Wesfarmers. The median broker "sum of the parts" valuation for Wesfarmers at the time of announcement of the Demerger ($41.51) was generally in line with the then trading range of $40.29-42.65; and

- the increase in Wesfarmers' share price immediately following announcement of the Demerger was not sustained:

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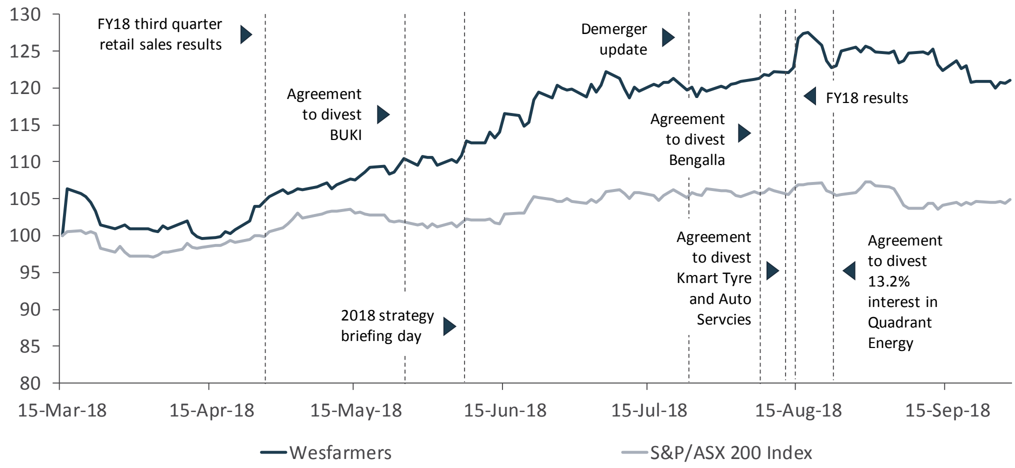
77 6 of the 10 brokers following Wesfarmers when the Demerger was announced published research on or around 16 March 2018 that included "sum of the parts" valuations and have been used in the analysis. The valuations are not presented on a consistent basis as they reflect each broker's approach to analysis of Wesfarmers. In this analysis, Grant Samuel has attempted to present the valuations on a consistent basis, however, some inconsistencies may exist (e.g. in relation to the treatment of BUKI).

78 Grant Samuel's analysis of low, high and median broker valuations is based on enterprise value. As a result, median values for each business have not been shown (as they do not add to the median enterprise value).

**WESFARMERS VS S&P/ASX 200 INDEX**

**15 MARCH 2018 TO 28 SEPTEMBER 2018**



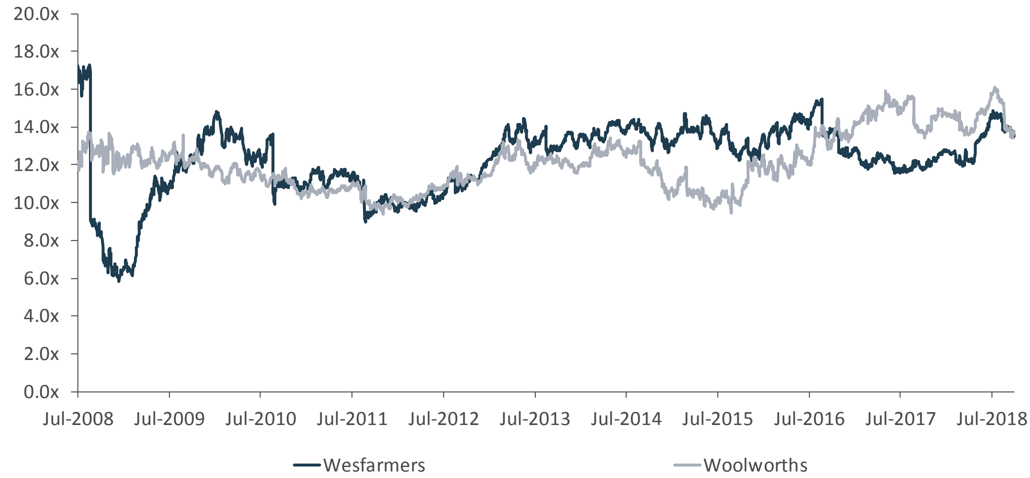

Source: IRESS

Following announcement of the Demerger on 16 March 2018, Wesfarmers' share price increased by over 6% to close at $43.80. However, over the following weeks (while the market as a whole was relatively flat), all of this gain was lost, with the share price reverting to pre-announcement levels by mid-April 2018. While Wesfarmers shares have subsequently outperformed the S&P/ASX 200 index substantially, it is difficult to isolate the extent to which this outperformance might be related to the Demerger given other significant announcements over this period. In particular, it is likely that there would have been a positive share price reaction to the announcements of FY18 third quarter sales results on 26 April 2018 that showed growing sales momentum for Coles' food and liquor business, the agreement to divest BUKI on better than expected terms on 25 May 2018 and the 2018 strategy briefing day held on 7 June 2018. The share price also reacted very positively to the release of Wesfarmers' FY18 results on 15 August 2018 (increasing by $1.61 or 3.2% on the day of announcement);

- the trading multiples for a separately listed Coles would not be expected to be materially different to Wesfarmers' trading multiples as Wesfarmers is currently rated by the market largely based on the Coles business due to its relative size and high profile:
  - Coles' closest competitor and ASX listed peer, Woolworths, provides value parameters against which a separately listed Coles would be benchmarked (albeit Woolworths has a stronger liquor offering but also includes the underperforming BIG W discount department store business). The forward EBIT trading multiples for Wesfarmers and Woolworths over the past ten years are shown in the chart below:

**WESFARMERS AND WOOLWORTHS FORWARD EBIT TRADING MULTPLES**

**JULY 2008 TO SEPTEMBER 2018**




Source: S&P Global Market Intelligence

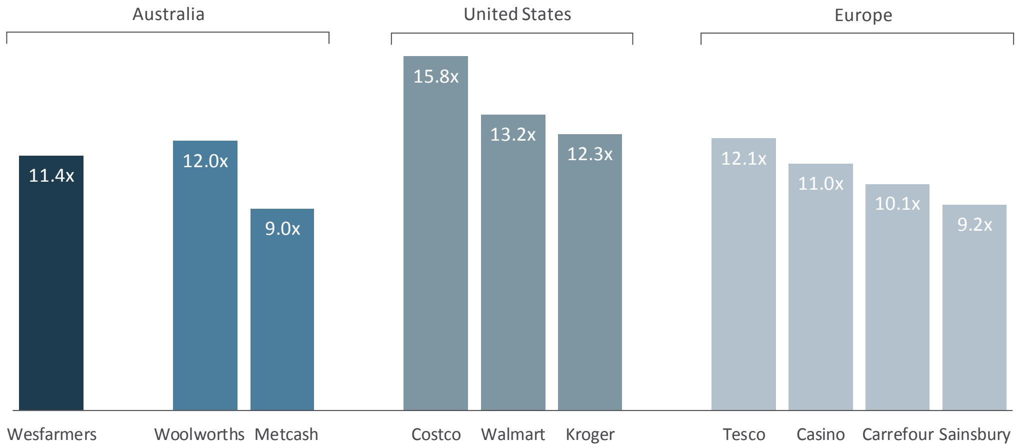
Over the past ten years, the forward EBIT trading multiples for Wesfarmers and Woolworths have been reasonably consistent, other than for a short period of time during the global financial crisis when Wesfarmers' share price was severely impacted by several factors, including increased debt levels associated with the acquisition of Coles, a dilutive $2.8 billion equity capital raising and a reduction in dividends.

The periods of Wesfarmers' relative outperformance (from mid-2013 to late-2015) and underperformance (from late-2016 to mid-2018), coincided with relative strength of the Coles and Woolworths customer offerings (and as a result, sales and EBIT growth) over these periods. The gap between the Wesfarmers and Woolworths forward EBIT trading multiples has largely closed following Wesfarmers' announcement of its FY18 third quarter sales results on 26 April 2018; and

- a review of the values attributed to Coles in the six "sum of the parts" valuations used in the broker valuations analysis above indicates that brokers adopted multiples in the range 11.6-14.4 times (median 12.2 times) to apply to their FY19 EBIT forecasts for Coles. These multiples are not dissimilar to the trading multiples of listed companies comparable to Coles immediately prior to announcement of the Demerger:

**COLES - COMPARABLE COMPANY FORECAST FY19 EBIT MULTIPLES**

**AS AT 15 MARCH 2018**




Source: S&P Global Market Intelligence

The forecast FY19 EBIT trading multiple for Woolworths at 12.0 times is consistent with the range for Coles adopted by brokers of 11.6-14.4 times, and almost identical to the median of 12.2 times. It is also only a slight premium to the trading multiple for Wesfarmers prior to announcement of the Demerger. The forecast trading multiple for Metcash Limited ("Metcash") is less relevant due to its significantly smaller size and its operation as a lower margin (~2% EBIT margin) wholesale distribution and marketing company across food, liquor, hardware and automotive parts and accessories (supplying independent supermarkets in Australia). Metcash's trading multiples have fallen further following announcement of the loss of a major customer at the end of May 2018.

The forecast trading multiples for the selected comparable international listed companies indicate that the United States companies are trading at slightly higher multiples and the European companies are trading at slightly lower multiples. The supermarket sector in the United States and Europe is more competitive than it is in Australia, with the dominant market position of Coles and Woolworths more entrenched compared to global peers. As a result, the global peers tend to have lower EBIT margins (despite owning rather than leasing the majority of their properties).

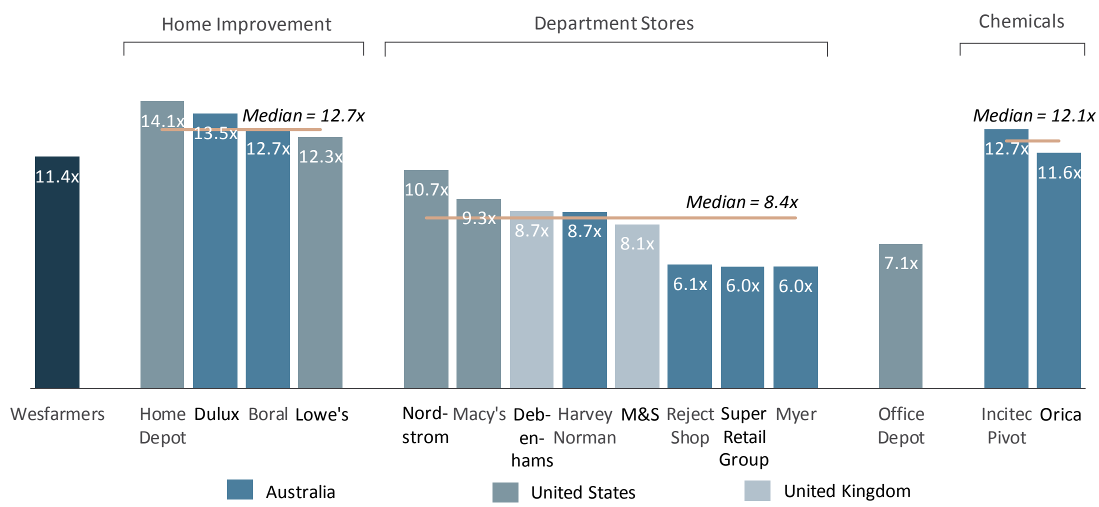
The higher multiples for United States companies, particularly Costco and Walmart, would in part reflect their considerably larger size, multi-national operations and strong bargaining power and, in the case of Costco, its warehouse style stores and membership-based model with lower prices and fewer product lines. In relation to the European companies, the relatively lower trading multiples for Groupe Casino ("Casino") and J Sainsbury plc ("Sainsbury") may reflect their considerably smaller size relative to Coles. In contrast, Carrefour SA ("Carrefour"), which is a similar size to Coles, is at the start of a five-year transformation announced in January 2018 (following two profit downgrades and a loss in FY17) and the forecast turnaround in earnings is not yet reflected in its share price; and

- Wesfarmers post Demerger will retain many of its current characteristics in that it:
  - will continue to disclose performance by business division;
  - will be followed by a broad investor and analyst market;
  - will have a strong balance sheet and the ability to act when opportunities arise; and
  - is expected to retain its existing investment grade credit rating and high dividend payout ratio.

Wesfarmers has historically traded broadly in line with domestic and international retail peers (refer to the charts above), reflecting the fact that retail represents around 80% of earnings and 90% of broker "sum of the parts" valuations. Wesfarmers post Demerger will still be primarily a retail business, with Bunnings ANZ, Kmart, Target and Officeworks representing around 70% of earnings and 80% of broker "sum of the parts" valuations. As a result, domestic and international retail peers will remain a relevant benchmark. A comparison of Wesfarmers' FY19 forecast EBIT multiple to the FY19 forecast EBIT multiples of domestic and international home improvement, department store, office supplies and chemicals businesses is shown in the chart below:

**WESFARMERS POST DEMERGER - COMPARABLE COMPANY FORECAST FY19 EBIT MULTIPLES**

**AS AT 15 MARCH 2018**




Source: S&P Global Market Intelligence

While it is difficult to draw any definitive conclusions given the diversified nature of Wesfarmers' business activities, there is nothing to suggest that Wesfarmers was trading materially out of line with other (non-supermarket) domestic and international peers prior to announcement of the Demerger, particularly taking into account the heavy weighting towards Bunnings ANZ (where comparable companies were trading at a relatively higher median FY19 EBIT multiple of 12.7 times), offset by the exposure to Department Stores and Officeworks (where comparable companies were trading at relatively lower median FY19 EBIT multiples in the range 7.1-8.4 times).

The impact of higher earnings growth and return on capital for Wesfarmers post Demerger is likely to be offset by an increase in volatility (i.e. greater exposure to consumer discretionary rather than defensive consumer staples retail) and an increase in risk due to the increased weighting of underperforming businesses (e.g. Target and Blackwoods).

There may be the potential for some re-rating of Wesfarmers shares following the Demerger, but this is only likely to be achieved over time as Wesfarmers executes on its strategy and the market and analysts turn their attention to Wesfarmers' other businesses.

### Typical Advantages of Demergers

As a result of the:

- relative size of Coles as the largest of Wesfarmers' portfolio of businesses (representing 32% of FY18 EBIT and 64% of capital employed for the rolling 12 months to 30 June 2018); and
- nature of Wesfarmers as a diversified conglomerate, where:

- each business, including Coles, is operated on an autonomous basis with its own management responsible for strategy development and execution as well as day-to-day operational performance; and
- capital is allocated to the portfolio businesses or investments based on the ability to achieve long term value creation,

many of the typical advantages and benefits of demergers (set out in Section 4 of this report) do not apply.

The Demerger does not result in any substantial improvement for Coles in terms of:

- transparency. Wesfarmers has reported Coles as a separate segment since its acquisition in FY08. A significant amount of information on Coles is already disclosed by Wesfarmers, including:
  - revenue split between food and liquor and convenience; and
  - key financial metrics such as comparable sales growth (quarterly), price inflation/(deflation), store numbers and movements, and sales and EBIT per square metre and per store (albeit some information, such as Coles' food and liquor EBIT margin, has not been disclosed in recent years).

  While a separately listed Coles will inevitably provide more information (and with greater granularity), the market already has access to sufficient information to enable assessment of Coles' performance and outlook (and comparison to its peers);
- access to capital. Under Wesfarmers' current structure, there is no shortage of capital for any of the businesses in the portfolio, including Coles. Wesfarmers has:
  - strong cash flow generation across the group with a cash realisation ratio in excess of 100%;
  - conservative leverage, with book gearing at 30 June 2018 of around 16% and interest cover of around 30 times;
  - ample headroom of ~$3.1 billion under its bank loan facilities (as at 30 June 2018); and
  - the ability to raise equity if necessary:
    - the equity markets have not been accessed since January/February 2009; and
    - through its active dividend reinvestment plan (although this has generally had relatively low take up due to its 0% discount and there has been no take up since March 2017).

  The ability to apply capital is limited only by opportunity, rather than through the rationing of a limited amount of capital among the portfolio businesses.

  While Coles' capital expenditure has declined over the past five years, this reflects the cyclical nature of store renewals (i.e. the timing of previous renewals (there was a large renewal program in the initial years of the Coles turnaround) and the timing needs to be right in terms of lease expiry etc) and does not reflect any withholding of capital by Wesfarmers. Coles' share of group capital expenditure has consistently been in the range 40-48%;
- strategic, operational and financial flexibility:
  - Coles already has a divisional board and management focussed solely on developing and optimising the performance of the Coles business and pursuing its own strategic and operational priorities;
  - while Coles is being established with its own capital structure and will have a higher level of borrowings and higher gearing than Wesfarmers post Demerger and will set its own dividend policy:
    - the level of borrowings reflects Coles' defensive characteristics and strong and stable cash generation, which provide greater debt servicing capacity (despite the need for continued investment in the customer offer);

- Coles' debt facilities allow for the ~20% increase in gross capital expenditure (to around $1 billion) forecast for FY19 (and for capital expenditure to remain at that level in the medium term);
- Coles' pro forma credit metrics (other than its book gearing) compare favourably with those of its main competitor, Woolworths, with pro forma FY18 interest cover of 24.7 times[79] (compared to 23.7 times for Woolworths). Book gearing will be higher at 65% (compared to 11% for Woolworths) but this reflects in part Coles' lower intangible assets as a result of the derecognition of goodwill and intangible assets associated with Wesfarmers' acquisition of Coles in 2008. As at 30 June 2018, Coles' intangible assets represented 38% of pro forma capital employed whereas Woolworths' intangible assets represented 54% of capital employed; and
- Coles' dividend payments will reflect its performance and funding requirements, but it is expected that dividends declared by Coles and Wesfarmers post Demerger for FY19 will be broadly equivalent to the dividends that Wesfarmers would otherwise have declared in the absence of the Demerger; and

- focus and scrutiny. As a result of its size and autonomous management, Coles is already subject to considerable focus and scrutiny as part of Wesfarmers:
  - it has an extremely high public profile as one of Australia's leading supermarket chains;
  - it is the subject of focussed research by analysts as Wesfarmers' largest portfolio business; and
  - there is regular interaction between Coles' CEO and analysts and institutional investors. The Coles' CEO is part of the investor roadshows and a considerable portion of these meetings is devoted to Coles.

  While there will be additional focus and scrutiny through higher levels of financial disclosure, standalone Coles roadshows/investor meetings and the requirement to hold annual general meetings, any additional pressure on Coles management is likely to be minimal.

Being a separate listed company will inevitably involve some changes to transparency, access to capital, strategic, operational and financial flexibility and focus and scrutiny for Coles. However, any impact is likely to be incremental rather than transformational.

The Demerger is also unlikely to result in any increase in takeover potential for the demerged entities. Coles and Wesfarmers post Demerger will be substantial entities, and both will be amongst the 30 largest companies listed on the ASX. The size of both entities will be a deterrent to any takeover, as will Wesfarmers' conglomerate nature. While a greater focus on, and higher profile of, the remaining businesses in Wesfarmers' portfolio may elicit interest from potential purchasers, any increased interest in the portfolio businesses as a direct result of the Demerger is likely to be minimal.

## 6.4 Disadvantages, Costs and Risks of the Demerger

Due to the unusual rationale for the Demerger, a number of disadvantages usually associated with demergers do not apply. The Demerger is unlikely to have any material impact, for Coles or Wesfarmers post Demerger, on:

- market liquidity:
  - Coles and Wesfarmers post Demerger will be substantial listed companies, with both amongst the 30 largest companies listed on the ASX;

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[79] Coles' Pro forma FY18 interest cover has been estimated by Grant Samuel assuming pro forma average net borrowings of $2 billion and an interest rate of 4.18% (equivalent to Wesfarmers' FY18 effective interest rate). This calculation has been shown for illustrative purposes only, to assist Wesfarmers shareholders to understand the impact of the Demerger on credit metrics. The calculations do not purport to reflect the actual credit metrics for Coles if it had operated as a standalone entity during FY18.

  - for index tracking or benchmarked investors, Wesfarmers post Demerger and Coles will both be included in all relevant indices (S&P/ASX 50, S&P/ASX 100 and, most importantly, the S&P/ASX 200), even after allowing for Wesfarmers' 15% retained interest in Coles which would not be part of the free float. Consequently, the proportionate exposure of these investors to Wesfarmers prior to the Demerger will be the same as their proportionate exposure to Coles and Wesfarmers post Demerger; and
  - there may be some short-term impacts, but the net effect is likely to be minimal. For example:
    - selling by holders of small parcels of Coles shares, although the share sale facility made available to Wesfarmers shareholders holding 160 or fewer shares will allow these Coles shares to be placed with investors in a more structured manner that should minimise any impact on the Coles share price;
    - selling by Coles shareholders who are not attracted to its lower growth, lower return on capital profile. However, given the substantial proportion of Wesfarmers represented by Coles (32% of EBIT and 64% of capital employed), it is likely that most shareholders invest in Wesfarmers for exposure to supermarkets, so any selling is likely to be limited; and
    - buying from investors more attracted to Coles (yield focused investors or active retail managers) and Wesfarmers post Demerger (growth focused investors); and
- vulnerability to external shocks. The Demerger will result in two smaller and less diversified companies than Wesfarmers. Definitionally, this means that each will be individually less able to readily absorb the financial and business impact of significant adverse events as the events will have a greater relative impact. These adverse events might include, for example, disappointing outcomes from the strategies to increase Coles comparable sales growth and grow EBIT (store refurbishment, digital expansion, increased range and penetration of private label products) or failure by Wesfarmers to deliver the planned turnaround in underperforming businesses (e.g. Target, Blackwoods). However:
  - Coles and Wesfarmers will both be very substantial businesses. Coles has pro forma FY18 revenue of $39.3 billion and pro forma FY18 EBIT of $1.4 billion and Wesfarmers post Demerger has pro forma FY18 revenue of $27.5 billion and pro forma FY18 EBIT of $3.0 billion;
  - Coles operates in the consumer staples retail sector, which has defensive investment characteristics and is less volatile than other retail and market sectors. It is therefore less prone (although not exempt from) shock events;
  - Wesfarmers will remain a diversified conglomerate with exposure to a portfolio of businesses that should result in reduced risk and volatility in overall returns relative to market conditions;
  - while Coles will have relatively high pro forma FY18 book gearing of around 65%, Wesfarmers post Demerger will have reasonably modest levels of financial leverage with a pro forma FY18 book gearing ratio of around 17% and both Coles and Wesfarmers will have conservative interest cover ratios (of around 25 times[79] for Coles and 20 times for Wesfarmers post Demerger); and
  - both Coles and Wesfarmers should have ready access to equity markets to raise additional equity capital if necessary.

However, there are a number of disadvantages that do apply:

**Single Focus of Coles**

Coles will be standalone company focused on the supermarkets, liquor and convenience sectors of the retail industry in Australia. As a listed company, it will be subject to pressure to deliver short term returns. It will no longer have access to the Wesfarmers protective "umbrella" that provided access to capital and the ability to make medium term decisions without the distractions of being a listed company. However:

- having achieved the turnaround in Coles' performance, it is arguable that there is no longer any need for the "umbrella" of protection; and

- in any event, Coles' management and performance has been the focus of investors and analysts even as part of Wesfarmers.

**Lack of Track Record**

Coles will be a new standalone company with a new board of directors including six recently appointed non-executive directors. The relationships between the new board and Coles management and the relationships within the board itself are untested and, inevitably, there is a risk that it does not work as planned. In addition:

- Coles' new CEO, Steven Cain, has only been recently appointed and commenced in mid-September 2018 and the relationship between the new CEO and the new board and management is untested; and
- the CFO, Leah Weckert has only been in the role since March 2018 and does not have previous experience in this role in a publicly listed company (although she has held various positions in Coles over the past eight years).

However:

- the board will have continuity and experience with the business through the appointment of James Graham as Chairman. James Graham was a non-executive director on the Wesfarmers' board for 20 years prior to his resignation in July 2018 and his tenure includes the entire period Wesfarmers' has owned Coles. While some investors have raised concerns about James Graham's independence (he is also Chairman of, and a shareholder in, Gresham Partners, which is 50% owned by Wesfarmers and which has provided corporate advisory services to Wesfarmers), he knows the Coles business well and should be able to assist Coles in making a smooth transition from a Wesfarmers business unit to a standalone listed company;
- Archie Norman will become an adviser to the Coles board (although he will step down as deputy chairman of Coles). Archie Norman has extensive retail experience and knows the Coles business well;
- Steven Cain has extensive local and international retail experience, including with Kingfisher plc and supermarket chain Asda as well as his prior role as CEO of Supermarkets and Convenience at Metcash. He was also Managing Director of food, liquor and fuel at Coles Myer for a short period in 2003-2004 and advised Wesfarmers on its takeover of Coles Group in 2007. In addition, John Durkan, the current CEO, will remain in an advisory role until FY19 or FY20 to ensure a seamless transition to the new CEO; and
- most other key members of the Coles senior operational management team have been with Coles for some time (at least four, and up to 25, years).

Any organisational change involves some degree of risk. However, change is a regular part of corporate development and any negative impact is unlikely to be material.

**One-off Transaction and Implementation Costs**

Wesfarmers has estimated the total transaction and implementation costs of the Demerger to be approximately $148 million (before tax). These costs include advisers' fees, restructure costs (including stamp duty and other taxes), establishment fees for debt facilities, fees associated with the ASX listing of Coles and other costs. Approximately $65 million of the total costs will have been incurred prior to the Wesfarmers shareholders' meeting to vote on the Demerger. Therefore, the additional costs to be incurred if the Demerger proceeds are approximately $83 million.

It is expected that all of the transaction costs will be incurred and paid for by Wesfarmers.

While the quantum of the one-off transaction costs associated with the Demerger is significant, they are not material relative to Wesfarmers' assets and market capitalisation. Total one-off transaction costs represent around 0.25% of Wesfarmers' current market capitalisation.

In addition, Coles is expected to incur approximately $25 million in separation costs to set up new systems and processes to allow it to operate as an independent entity. There may also be additional separation costs incurred by Coles and/or Wesfarmers at the expiry of the Transitional Services Agreement in the process of establishing systems or services to replace the transitional services. These costs are uncertain and have not been included in the one-off transaction and implementation costs.

**Incremental Operating Costs**

The Demerger will result in loss of the financial benefits of operating Coles and Wesfarmers under a single corporate structure. These benefits are largely derived from operating a corporate head office and the central provision of a number of administrative functions.

Although Coles already operates independently in many respects, it currently shares corporate overheads, shared services and costs related to being an ASX listed company. While certain services will be covered by a Transitional Services Agreement for a period of time, ultimately Coles and Wesfarmers will have to support these overheads from their own resources (except for those services that Coles will continue to provide to Kmart, Target and Officeworks under ongoing contractual agreements which are on terms and pricing consistent with the existing arrangements).

Following the Demerger, additional operating costs will be incurred in relation to:

- Coles establishing its own corporate office functions. The support services provided by Wesfarmers' corporate office to Coles include legal (although a substantial legal division already exists within Coles), company secretarial, external reporting, internal audit, tax, treasury, investor relations, insurance and statutory reporting. Coles will also incur additional costs related to being an ASX listed company such as directors fees, other board costs, ASX listing fees, share registry costs, annual general meeting costs and preparation of annual reports. Wesfarmers estimates the incremental cost to Coles will be approximately $38 million per annum, although they will be partially offset by $10 million of operating costs previously incurred by Coles that will be incurred by *flybuys* post the Demerger; and
- restructuring group wide arrangements that currently rely on Coles' presence within Wesfarmers, including self-insurance costs and internal audit costs. Coles is self-insured for workers' compensation insurance either under a Wesfarmers licence or a Coles licence. Coles will need to move to its own self-insurance licence where it currently operates under a Wesfarmers licence. Wesfarmers estimates that the costs transferred from Wesfarmers to Coles will be approximately $28 million per annum.

The impact of these net incremental costs (totalling $56 million) is reflected in the pro forma financial performance for Coles set out in Section 5 of this report. These costs collectively represent approximately 4% of Coles' pro forma FY18 EBIT (and just over 1% of the combined EBIT of Coles and Wesfarmers post Demerger).

*flybuys* will also incur incremental standalone operating costs of $10 million per annum and both Coles and Wesfarmers post Demerger will reflect their share of these costs in the share of profits of equity accounted associates and joint ventures. The impact of these incremental costs is also reflected in the pro forma financial performance for Coles set out in Section 5.3.2 of this report.

Any incremental costs for Wesfarmers have not been reflected in the pro forma financial performance for Wesfarmers post Demerger on the basis that they are not material.

In addition, Coles is a smaller business than Wesfarmers. All other things being equal, its reduced scale and diversity and its expected credit rating would definitionally mean that it will incur higher interest margins than Wesfarmers would have incurred in the same circumstances. It is not straightforward to isolate the impact because the funding strategies, the timing of accessing the debt markets and the markets accessed are different. Coles is putting in place a reasonably vanilla funding structure comprising bank debt, while Wesfarmers has a diversified funding mix including capital markets debt (domestic, Euro and United States bonds) as well as bank debt.

Coles has received very attractive proposals from the banks and it expects to pay margins on its debt facilities that are not materially different to those that Wesfarmers is currently paying. Nevertheless, in Grant Samuel's view, if Wesfarmers had sought a similar quantum of bank debt today, it would have been able to secure margins that were in the order of 15 basis points lower. Based on $2 billion of average net borrowings, this indicates that the Demerger would result in additional borrowing costs of $3 million per annum. This is immaterial in the context of Coles' FY18 pro forma profit before tax.

Just as important as interest cost are the other terms of the facilities (in particular financial and other covenants) as these can have a significant impact on financial flexibility. The key covenants of the Coles bank facilities contain financial covenants and undertakings that are customary for facilities of this nature including financial covenants, provision of information, negative pledge and restrictions on subsidiary indebtedness and disposals of assets.

**Transition and Implementation Risks**

Any separation of two organisations is a complicated exercise at an operational level. There are inevitably risks relating to implementation of the Demerger, including:

- delays and increased costs in achieving legal and practical separation of the businesses, including a full support service capacity for Coles;
- failure to obtain any third party consents required as a result of triggering change of control clauses in supplier or service contracts or property leases;
- disruption and management distraction during the implementation period that affects the performance of Coles; and
- retention of key management personnel.

Grant Samuel does not regard these risks as being outside the normal risks of any corporate restructuring transaction. In any event:

- Coles is already established as a separate, autonomous business with its own premises. The operational separation largely relates to corporate office functions, shared infrastructure and the restructuring of group wide arrangements and there is a dedicated transaction team to isolate these activities from the operation of the core business;
- Coles and Wesfarmers have assessed the need to obtain consents from key suppliers and lessors and have begun the process of contacting the relevant counterparties; and
- there is a detailed Transitional Services Agreement which provides for the sharing of support services for a period post the Demerger. This should facilitate the smooth establishment of standalone support services capacity at Coles over time.

**Ongoing Risks from Joint Ownership of *flybuys***

*flybuys* is a successful and fundamental part of Coles' strategy in terms of marketing and sales and it is operated as an integral part of Coles' business (even though it is currently jointly owned by Coles and Wesfarmers).

Under the Demerger, *flybuys* will be a separate joint venture, 50% owned by Coles and 50% owned by Wesfarmers. The relationship between Coles and Wesfarmers as joint owners of *flybuys* will be set out in a shareholders' agreement and the ongoing commercial relationship between *flybuys* and Coles will be set out in a participation agreement. While these new agreements contain provisions to protect the existing *flybuys* business, and Coles management believes that these arrangements will be effective, there is always the risk that as a separate, standalone business that is jointly owned by two separate, publicly listed companies, the relationship between *flybuys* and Coles could change, particularly over time.

## 6.5 Other Matters

### 6.5.1 Dividends

Following implementation of the Demerger, the level of dividends paid will be a matter for the boards of each company. In this context:

- there will be no change to Wesfarmers' dividend policy which will continue to consider earnings, cash flows, franking credits and credit metrics. Over the past five years, this policy has resulted in Wesfarmers paying around 90% of NPAT before significant items as dividends (with the dividend payout ratio ranging from 88% to 93%);
- Coles currently intends to follow a dividend policy which is the same as Wesfarmers' current dividend policy and is expected to deliver a payout ratio ranging from 80% to 90%; and
- Wesfarmers has stated that it expects the combined dividends declared by Coles and Wesfarmers for FY19 to be broadly equivalent to the dividends that Wesfarmers would have declared in the absence of the Demerger (including in relation to franking).

However:

- the absolute level of profits from which Wesfarmers will be able to pay dividends will be reduced, given its ownership of only 15% of Coles and a Coles dividend payout ratio of less than 100% of profits;
- it is estimated that, in aggregate, Coles will incur incremental corporate and operating costs of $56 million if the Demerger proceeds; and
- the extent to which any dividend paid by Coles can be franked will depend on Coles' franking account balance, which immediately following the Demerger will be nil and will depend on the amount of Australian income tax paid by Coles.

### 6.5.2 Ineligible Overseas Shareholders

Ineligible overseas shareholders will not be entitled to receive Coles shares under the Demerger. The Coles shares that would otherwise have been distributed to them will be transferred to a sale agent and sold on the ASX on their behalf and they will receive the net proceeds (free of any brokerage costs or stamp duty). Ineligible overseas shareholders may also be required to pay tax on any profit on that disposal (in their country of residence). However:

- the Coles shares will be sold for market value;
- they can acquire Coles shares through the ASX following listing if they wish to retain (or increase) their exposure to the Coles business; and
- shareholders representing less than 0.05% of Wesfarmers' issued capital are expected to be impacted by these provisions.

## 6.6 Taxation Issues

### 6.6.1 Corporate Taxation

The Demerger is not expected to result in any capital gains tax ("CGT") or income tax liability for Wesfarmers[80].

Wesfarmers has Australian carried forward income tax losses and Australian carried forward capital losses. These losses are expected to be preserved within Wesfarmers post Demerger. Coles will have no Australian carried forward income tax losses or Australian carried forward capital losses at the time of exit from the Wesfarmers income tax consolidated group.

Following the Demerger, Wesfarmers will remain the head company of the Wesfarmers post Demerger Australian income tax consolidated group and Coles will exit Wesfarmers' Australian income tax consolidated group. A decision as to whether Coles will form a new Australian income tax consolidated group will be made after completion of the Demerger.

### 6.6.2 Tax Consequences for Australian Resident Shareholders

The Demerger is not expected to give rise to any adverse tax consequences for shareholders who are residents of Australia for income tax purposes and hold Wesfarmers shares on capital account (and are not subject to the Taxation of Financial Arrangements rules in relation to their Wesfarmers shares).

Wesfarmers has applied to the Australian Taxation Office ("ATO") for a class ruling to confirm the Australian income tax consequences of the Demerger for Australian resident shareholders. Wesfarmers has received a draft of the class ruling which sets out the ATO's preliminary views. In summary, it is expected that:

- Australian resident shareholders who hold Wesfarmers shares on capital account should generally be eligible for demerger tax relief to defer any capital gain that arises in relation to the capital reduction; and
- the demerger dividend (i.e. the difference between the fair value of Coles shares and the amount of the capital reduction) will not be assessable to Australian resident shareholders.

For Australian resident shareholders who hold their shares on capital account and elect to obtain demerger tax relief, the tax consequences of the Demerger are expected to be as follows:

- any capital gain that arises in relation to the capital reduction will be disregarded;
- the existing cost base of their Wesfarmers shares will be apportioned between the Wesfarmers post Demerger shares and Coles shares on the basis of market values immediately following the Demerger; and
- the CGT status of Wesfarmers post Demerger shares and Coles shares will be the same as the status of the shareholder's Wesfarmers shares. If the Wesfarmers shares were pre-CGT shares (i.e. acquired before 20 September 1985), the Wesfarmers post Demerger shares and Coles shares will be treated as pre-CGT shares.

For Australian resident shareholders who hold their shares on capital account and do not elect to obtain demerger tax relief, the CGT consequences are expected to be similar to shareholders who elect to obtain demerger tax relief except that:

- if the Wesfarmers shares were post-CGT shares (i.e. acquired on or after 20 September 1985), the cost base of the Wesfarmers shares must be reduced by the amount of the capital reduction and, to the

80 To the extent the internal restructuring prior to the Demerger results in stamp duty (or similar) liabilities, these amounts have been allowed for in the estimate of one-off transaction costs (see Section 6.4).

extent that the capital reduction amount exceeds the cost base, will realise a capital gain. Any capital gain may be eligible for the CGT discount concession; and

- if the Wesfarmers shares were pre-CGT shares (i.e. acquired before 20 September 1985), the Coles shares will be treated as having been acquired on the implementation date of the Demerger and will be post-CGT shares.

### 6.6.3 Disclaimer

The analysis set out above outlines that major tax consequences for Australian resident shareholders of the Demerger and should be viewed as indicative only. It does not purport to represent formal advice regarding the taxation consequences of the Demerger for shareholders. Further details of the taxation consequences of the Demerger are set out in Section 5 of the Scheme Booklet. In any event, the tax consequences for shareholders will depend upon their individual circumstances. If in any doubt, shareholders should consult their own professional adviser.

The non-Australian taxation implications for non-Australian resident Wesfarmers shareholders will depend on the country of domicile of the shareholder. Non-Australian residents should seek their own taxation advice in relation to the taxation consequences of the Demerger.

## 6.7 Summary and Conclusion

In some circumstances, there is a clear case for a demerger because the relevant businesses are in completely different industries or there is some "hidden" value that will emerge through re-rating by the market of the separate companies. This is not the situation with Wesfarmers. However, Wesfarmers' portfolio of businesses has evolved over the past ten years to the point where it makes sense to separate Coles from the rest of Wesfarmers given the size of Coles and the differing investment characteristics and growth profile of Coles and Wesfarmers' other businesses.

The main driver for the demerger of Coles is to put Wesfarmers in a better position to be able to achieve its longstanding primary objective to deliver satisfactory returns to shareholders over the long term, where satisfactory returns are defined as superior TSR compared to the broader Australian market.

In recent years, Wesfarmers has generally performed in line with broader Australian market indices and has struggled to achieve any outperformance. The reasons for this have been twofold:

- successful completion of the turnaround of Coles under the Wesfarmers' protective "umbrella" following the acquisition of Coles Group in November 2007. Through the turnaround period, Coles generated very high returns (average annual EBIT growth of ~12% over the period from FY09 to FY16). However, EBIT has declined in the past two years (albeit primarily due to the actions of a key competitor) and future growth would be expected to be limited to estimated market growth (of 3-4% per annum). Coles is no longer in a position to achieve the earnings growth required for superior TSR relative to the broader Australian market (i.e. high single digits over the long term); and
- the size of Coles relative to the other businesses in Wesfarmers' portfolio. As at 30 June 2018, the capital investment in Coles was $16.4 billion, or 64% of Wesfarmers' total capital employed. In contrast, it generated 32% of Wesfarmers' EBIT in FY18 and its return on capital was 9.2%. Coles' relative size means that its performance overshadows that of the other businesses in Wesfarmers' portfolio (i.e. outperformance by businesses such as Bunnings ANZ and Kmart have had much less impact on Wesfarmers' overall EBIT growth and return on equity).

Wesfarmers has always believed that the diversified conglomerate model and active management of its portfolio of businesses provides the best opportunity to achieve its primary objective, and it has a long track record of success. Consequently, the Wesfarmers board determined that Wesfarmers would be better able to achieve its primary objective if Coles was no longer part of the Wesfarmers' portfolio of businesses.

The primary advantage of the Demerger is its attraction relative to alternative divestment methods such as trade sale or IPO. A trade sale would be challenging to execute. There are few, obvious, qualified buyers and it would be difficult to get value for the potential upside in the performance of Coles. A trade sale process would be protracted and would have no certainty of success. Importantly, the process and outcome would not be within Wesfarmers' control and an unsuccessful process could have a material adverse impact on the Coles business. A 100% IPO of Coles is highly unlikely to be achievable. A staged exit, with progressive sell downs over time, is more realistic, but would be wholly dependent on market conditions and pricing at each stage would inevitably reflect some discount. Both a trade sale and an IPO would crystallise a significant capital gains tax liability for Wesfarmers.

In contrast, the Demerger:

- can be executed relatively quickly and with a higher degree of certainty;
- allows Wesfarmers shareholders to retain exposure to any upside from improved performance of Coles; and
- is expected to provide Wesfarmers shareholders with demerger tax relief, enabling them to defer any tax payable until the sale of their Coles shares.

The retention of a 50% interest in *flybuys* by Wesfarmers fits with its diversified conglomerate model and its focus on growing, high return businesses. It provides the opportunity to improve the loyalty offer across Wesfarmers' remaining retail brands and is consistent with its data and analytics strategy.

The rationale for Wesfarmers retention of a 15% interest in Coles is less obvious. The Wesfarmers board believes that the investment will provide alignment of interests (in relation to *flybuys* and the development of data and digital capabilities), and retention of the 15% shareholding is a sign of confidence in Coles as a standalone business but, in Grant Samuel's view, it is not essential. The investment represents a substantial capital commitment (~$2.3 billion or 19% of Wesfarmers' total capital employed), tied up in a relatively low growth business over which Wesfarmers will have limited influence. There is also no certainty that the investment or representation on the board of Coles would, on its own, resolve any significant issues that might arise in the *flybuys* joint venture. Cash flow from the investment will be in the form of dividends and will result in a lower return on equity than for a full demerger of Coles. While Coles will be a liquid investment listed on the ASX, the Wesfarmers 15% shareholding could create a potential overhang and the relatively large size of the shareholding may make it difficult to sell quickly or in one line (and may restrict the sale price).

The Demerger essentially returns Wesfarmers to its pre-Coles diversified conglomerate structure and will better position Wesfarmers to create shareholder value over the long term by:

- refocusing Wesfarmers on the growing, higher return businesses in its portfolio, in particular, Bunnings ANZ and Kmart; and
- reducing capital employed, so that successful growth initiatives in the remaining portfolio businesses and through acquisition will have a greater impact on returns.

In this regard, the Demerger will have an immediate impact on earnings growth (increasing it from low single digits to double digits on a pro forma basis) and return on capital (from 16.8% to in excess of 25% on a pro forma basis). However, this benefit, at least on a pro forma basis, is largely perception, as, from an existing Wesfarmers shareholder point of view, the combined return from Wesfarmers post Demerger and Coles is no different to the return generated by Wesfarmers in the absence of the Demerger.

The Demerger will have other benefits:

- shareholders will have greater flexibility to manage their exposures to the respective businesses as they see fit;

- Wesfarmers' board and corporate management will have increased capacity or "bandwidth" after the Demerger to focus solely on the growing businesses in the portfolio (as will investors and analysts) and new opportunities;
- Coles' decision making processes for significant initiatives (e.g. major capital expenditure, long term agreements) will be simplified; and
- staff incentives will be able to be offered to a wider range of Coles employees and there will be stronger alignment between employee performance and the value of shares.

At the same time, there are a number of disadvantages, costs and risks:

- Coles will be a standalone listed company subject to the pressure to deliver short term returns (although the Coles business is subject to much of this pressure in the existing Wesfarmers structure) and will no longer have access to Wesfarmers' protective "umbrella";
- Coles will have a new board of directors and a new CEO and the relationships between the board and Coles management and within the board itself are untested;
- there will be one-off transaction and implementation costs of around $148 million, $65 million of which will have been incurred prior to the Wesfarmers' shareholder meeting to vote on the Demerger as well as net incremental operating costs for Coles estimated at $56 million per annum[81]; and
- there will be risks associated with implementation of the Demerger and from joint ownership of the *flybuys* joint venture.

While these negative aspects of the Demerger cannot be disregarded, each of the disadvantages has mitigating factors, the costs are not material in the overall context of the demerged entities and the risks are not outside the normal risks of any corporate restructuring transaction.

The critical question is whether shareholders are likely to realise greater value over time if the Demerger is implemented than if Wesfarmers' current structure is maintained. The evaluation is essentially subjective. While the benefits are real, they are largely not quantifiable or testable and some are a matter of perception, at least initially. However, in Grant Samuel's view, the demerger of Coles is sensible in the circumstances. The key outcome of the Demerger is that Wesfarmers is re-established as an industrial conglomerate that is better positioned to generate satisfactory returns to shareholders over the long term. The benefits of the Demerger are not individually compelling but collectively are meaningful and outweigh the disadvantages, costs and risks. While implementation of the Demerger is not a guarantee of future performance, on balance, shareholders are ultimately likely to be better off if the Demerger proceeds.

Accordingly, in Grant Samuel's opinion, the Demerger is in the best interests of Wesfarmers shareholders.

## 6.8 Shareholder Decision

Grant Samuel has been engaged to prepare an independent expert's report setting out whether in its opinion the Demerger is in the best interests of shareholders and to state reasons for that opinion. Grant Samuel has not been engaged to provide a recommendation to shareholders in relation to the Demerger, the responsibility for which lies with the directors of Wesfarmers.

In any event, the decision whether to vote for or against the Demerger is a matter for individual shareholders based on each shareholder's views as to value and business strategy, their expectations about future economic and market conditions and their particular circumstances including risk profile, liquidity preference, investment strategy, portfolio structure and tax position. In particular, taxation consequences may vary from shareholder to shareholder. If in any doubt as to the action they should take in relation to the Demerger, shareholders should consult their own professional adviser.

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81 Although $28 million of these operating costs are transferred from Wesfarmers and therefore do not represent a reduction in earnings of the combined businesses.

Similarly, it is a matter for individual shareholders as to whether to buy, hold or sell shares in Wesfarmers (pre or post the Demerger) or Coles. These are investment decisions upon which Grant Samuel does not offer an opinion and they are independent of a decision on whether to vote for or against the Demerger. Shareholders should consult their own professional adviser in this regard.

## 7 Impact on Wesfarmers' Ability to Pay its Creditors

The Demerger will result in the splitting of Wesfarmers into two separate companies. Existing creditors of Wesfarmers (and its subsidiaries) will either continue as creditors of Wesfarmers post Demerger (and its subsidiaries) or become creditors of Coles (and its subsidiaries).

If the Demerger is approved, Wesfarmers will undertake a capital reduction and declare a demerger dividend (together, the distribution amount). The distribution amount will be applied on behalf of shareholders as payment for Coles shares. The distribution amount will be calculated as the volume weighted average price of Coles shares on the ASX over the first five trading days after the scheme becomes effective, multiplied by the number of Wesfarmers shares on issue. The capital reduction amount will be calculated by reference to the market values of Coles and Wesfarmers immediately after implementation of the Demerger and Wesfarmers share capital account immediately prior to implementation of the Demerger[82] and the dividend amount will be the distribution amount less the capital reduction amount.

The capital reduction will be effected by the issue of Coles shares to Wesfarmers shareholders. The capital reduction will result in a reduction in Wesfarmers' shareholders' funds and future earnings will be reduced by removal of the contribution from the Coles businesses (other than dividends received by Wesfarmers in relation to its 15% interest in Coles).

Grant Samuel has been requested to express an opinion as to whether the capital reduction will materially prejudice Wesfarmers' ability to pay its creditors. Given the capital reduction and demerger dividend will effectively occur concurrently and both are fundamental aspects of the Demerger, it is difficult to assess whether the capital reduction by itself will materially prejudice Wesfarmers' ability to pay its creditors. Accordingly, Grant Samuel has assessed the impact of the capital return by considering whether the payment of the capital return and demerger dividend will materially prejudice Wesfarmers' ability to pay its existing creditors.

By definition, any reduction in the equity base of a company disadvantages creditors as it reduces the company's capacity to meet the claims of creditors. The important test in this analysis is the relative position of Wesfarmers prior to the Demerger compared to the positions of Wesfarmers and Coles if the Demerger is implemented. As creditors will have formed their own views about whether to extend credit to Wesfarmers on the basis of Wesfarmers' existing investment parameters, and assuming that they have been comfortable to extend credit on this basis, the issue is whether the position changes materially as a result of the Demerger.

In Grant Samuel's opinion, existing Wesfarmers creditors will not be materially prejudiced by the capital reduction for the following reasons:

- Wesfarmers Limited and certain of its controlled entities (including most of its Australian operating subsidiaries) are parties to a deed of cross guarantee under which each company guarantees the debts of the others. As part of the Demerger, a Revocation Deed was lodged with ASIC on 2 July 2018 to revoke the guarantee in respect of Coles subsidiaries (i.e. the deed of guarantee will continue in effect for Wesfarmers post Demerger). The revocation will take effect six months after the date of lodgement (2 January 2019). It is intended that Coles will establish its own deed of cross guarantee. The consequences of this arrangement are that:
    - creditors of any Wesfarmers entity that is subject to the deed of cross guarantee currently have an effective exposure to the overall financial health of the Wesfarmers group rather than the individual entity to which they have provided credit (in effect they are all creditors of Wesfarmers Limited);

82 Based on the formula (Coles market value/(Wesfarmers market value + Coles market value)) x Wesfarmers share capital account.

- creditors of entities that are not part of the deed of cross guarantee group will continue to depend entirely on the financial health of that individual entity. The capital reduction has no impact on the capital base or other financial attributes of these entities (as it occurs at the Wesfarmers Limited level);
- most trade creditors are short term in nature (i.e. repayable within 60 days at any point in time) and accordingly:
  - in respect of any credit exposure as at the implementation date (expected to be 28 November 2018) they will be covered by the existing deed of cross guarantee as the revocation does not become effective until 2 January 2019. Therefore, they will continue to have access to all of the resources of the current Wesfarmers deed of cross guarantee group (i.e. there is no change to their risk profile) until this time. In this context, it is important to note that the capital reduction is non-cash, so there is no net outflow of cash (except for transaction and implementation costs) from the combined Coles and Wesfarmers group as a consequence of the Demerger; and
  - they will have the opportunity to reassess for themselves whether they wish to continue to grant credit to Wesfarmers post Demerger or Coles; and
- existing creditors with an exposure (to relevant entities) that extends beyond 2 January 2019 (i.e. not repayable until after that date) will end up with a risk exposure to either Wesfarmers post Demerger or Coles (depending on where the individual entity with which they have contracted sits). As both Wesfarmers post Demerger and Coles will have deeds of cross guarantee, that exposure is to the overall financial health of each group rather than the individual entity;

- in terms of the overall financial robustness and risk profile of Wesfarmers post Demerger and Coles:
  - Wesfarmers post Demerger and Coles will still each be of a meaningful size:

**IMPACT OF DEMERGER ON KEY FINANCIAL PARAMETERS ($ MILLIONS)**

| YEAR ENDED/AS AT 30 JUNE 2018 | WESFARMERS ACTUAL | WESFARMERS' CONTINUING OPERATIONS | WESFARMERS POST DEMERGER PRO FORMA | COLES PRO FORMA |
|---|---|---|---|---|
| ***Financial Performance*** | | | | |
| Revenue | 69,878 | 66,883 | 27,495 | 39,288 |
| EBITDA | 5,571 | 5,565 | 3,584 | 2,068 |
| EBIT | 4,288 | 4,367 | 3,037 | 1,414 |
| ***Financial Position*** | | | | |
| Total assets | 36,933 | 36,933 | 19,522 | 9,539 |
| Net borrowings | 3,580 | 3,580 | 1,725 | 1,905 |
| Net assets | 22,754 | 22,754 | 10,012 | 2,935 |

Source: Wesfarmers and Grant Samuel analysis

  - Wesfarmers post Demerger will have less leverage in its capital structure than Coles (and Wesfarmers), while Coles will have higher leverage than Wesfarmers (and Wesfarmers post Demerger), at least initially:

**IMPACT OF DEMERGER ON LIQUIDITY AND LEVERAGE METRICS[83] ($ MILLIONS)**

| YEAR ENDED/AS AT 30 JUNE 2018 | WESFARMERS ACTUAL | WESFARMERS CONTINUING OPERATIONS | WESFARMERS POST DEMERGER PRO FORMA | COLES PRO FORMA |
|---|---|---|---|---|
| Gearing | 15.7% | 15.7% | 17.2% | 64.9% |
| Debt cover (net financial debt/EBITDA) | 0.6x | 0.6x | 0.5x | 0.9x |
| Fixed charges cover | 3.0x | 3.0x | 3.8x | 2.9x |
| Interest cover | 30.4x | 30.4x | 19.6x | 24.7x |

Source: Wesfarmers and Grant Samuel analysis

Wesfarmers post Demerger will initially have a relatively conservative gearing level. The allocation of debt to Coles and the deconsolidation of Coles' lease liabilities results in steady or improved group credit metrics for Wesfarmers post Demerger. Coles will be more highly geared and will have higher debt cover than Wesfarmers post Demerger and will also have higher book gearing than Woolworths (11.3% as at 30 June 2018). However, pro forma interest cover for both Wesfarmers post Demerger and Coles is very conservative (and, in the case of Coles, above Woolworths' FY18 interest cover of 23.7 times). Coles also has more conservative fixed charges cover than Woolworths (at 3.1 times compared to 1.1 times); and

- Wesfarmers has an investment grade credit rating of A-/Stable/A-2 from Standard & Poor's and A3/Stable/P-2 from Moody's. Wesfarmers is expected to retain its current investment grade credit rating following the Demerger, albeit the target metrics for these ratings are expected to be more restrictive.

  The standalone credit ratings for Coles are also expected to support a strong investment grade credit rating;

- following the Demerger, Coles is expected to have committed bank facilities totalling $4.0 billion from a group of domestic and international banks. The providers of these new facilities have made their own judgements as to the financial risk of Coles in full knowledge of its financial position as a standalone entity. The funding commitments of these parties suggest that the financial leverage of Coles is reasonable;
- Wesfarmers' existing bank facilities (which are all unsecured and therefore rank equally with other creditors) will remain in place. These lenders are not required to approve the Demerger, but is should be noted that a number of existing lenders to Wesfarmers have agreed to participate in the new facilities for Coles. It is reasonable to assume that these banks are comfortable with the risks attached to their existing exposure to Wesfarmers (and therefore their ongoing exposure to Wesfarmers post Demerger);
- Coles and Wesfarmers are both cash generative businesses:
  - Coles is a leading Australian retailer with a strong market share operating in a mature industry. It exhibits defensive characteristics (e.g. an earnings profile that is resilient through economic cycles and with relatively high barriers to entry); and
  - Wesfarmers post Demerger will own a growth focused portfolio of businesses, weighted towards Bunnings ANZ and Kmart;

[83] The liquidity metrics for Coles have been calculated by Grant Samuel assuming average net borrowings of $2 billion, an effective interest rate of 4.18% (equivalent to Wesfarmers' FY18 effective interest rate), an effective tax rate of 30% and minimum lease payments of $1.2 billion. These calculations have been shown for illustrative purposes only, to assist Wesfarmers shareholders to understand the impact of the Demerger on liquidity and leverage metrics. The calculations do not purport to reflect the actual liquidity and leverage metrics for Coles if it had operated as a standalone entity during FY18.

- as substantial listed companies, Wesfarmers' post Demerger and Coles would, if necessary, have access to the public equity markets to fund creditor payments (although there is absolutely no indication that this might be required); and
- the directors of Wesfarmers have stated that in their opinion, the Demerger and in particular, the capital reduction, will not materially prejudice Wesfarmers' ability to pay its creditors.

Grant Samuel makes no warranty, express or implied, as to the potential recoverability of existing or contingent debts owed by Wesfarmers at the date of this report or at any subsequent time. Grant Samuel's opinion relates only to the impact of the Demerger on Wesfarmers' ability to pays its existing creditors. Future creditors must rely on their own investigations of the financial positions of Wesfarmers post Demerger and Coles.

# 8 Qualifications, Declarations and Consents

## 8.1 Qualifications

The Grant Samuel group of companies provide corporate advisory services in relation to mergers and acquisitions, capital raisings, debt raisings, corporate restructurings and financial matters generally. The primary activity of Grant Samuel & Associates Pty Limited is the preparation of corporate and business valuations and the provision of independent advice and expert's reports in connection with mergers and acquisitions, takeovers and capital reconstructions. Since inception in 1988, Grant Samuel and its related companies have prepared more than 550 public independent expert and appraisal reports.

The persons responsible for preparing this report on behalf of Grant Samuel are Jaye Gardner BCom LLB (Hons) CA SF Fin GAICD and Stephen Wilson MCom (Hons) CA SF Fin. Each has a significant number of years of experience in relevant corporate advisory matters and both are representatives of Grant Samuel pursuant to its Australian Financial Services Licence under Part 7.6 of the Corporations Act.

## 8.2 Disclaimers

It is not intended that this report should be used or relied upon for any purpose other than as an expression of Grant Samuel's opinion as to whether the Demerger is in the best interests of shareholders. Grant Samuel expressly disclaims any liability to any Wesfarmers shareholder who relies or purports to rely on the report for any other purpose and to any other party who relies or purports to rely on the report for any purpose whatsoever.

Grant Samuel has had no involvement in the preparation of the Scheme Booklet issued by Wesfarmers and has not verified or approved any of the contents of the Scheme Booklet. Grant Samuel does not accept any responsibility for the contents of the Scheme Booklet (except for this report).

Grant Samuel has had no involvement in Wesfarmers' due diligence investigation in relation to the Scheme Booklet and does not accept any responsibility for the completeness or reliability of the process which is the responsibility of Wesfarmers.

## 8.3 Independence

Grant Samuel and its related entities do not have at the date of this report, and have not had within the previous two years, any business or professional relationship with Wesfarmers or any financial or other interest that could reasonably be regarded as capable of affecting its ability to provide an unbiased opinion in relation to the Demerger.

Grant Samuel had no part in the formulation of the Demerger. Its only role has been the preparation of this report.

Grant Samuel will receive a fixed fee of $1.5 million for the preparation of this report. This fee is not contingent on the conclusions reached or the outcome of the Demerger. Grant Samuel's out of pocket expenses in relation to the preparation of the report will be reimbursed. Grant Samuel will receive no other benefit for the preparation of this report.

Grant Samuel considers itself to be independent in terms of Regulatory Guide 112 issued by the ASIC on 30 March 2011.

## 8.4 Declarations

Wesfarmers has agreed that it will indemnify Grant Samuel and its employees and officers in respect of any liability suffered or incurred as a result of or in connection with the preparation of the report. This indemnity will not apply in respect of the proportion of any liability found by a court to be primarily caused by any conduct involving gross negligence or wilful misconduct by Grant Samuel. Wesfarmers has also agreed to indemnify Grant Samuel and its employees and officers for time spent and reasonable legal costs and expenses incurred in relation to any inquiry or proceeding initiated by any person. Any claims by Wesfarmers are limited to an amount equal to the fees paid to Grant Samuel. Where Grant Samuel or its employees and officers are found to have been grossly negligent or engaged in wilful misconduct Grant Samuel shall bear the proportion of such costs caused by its action.

Advance drafts of this report were provided to Wesfarmers and its advisers. Certain changes were made to the drafting of the report as a result of the circulation of the draft reports. There was no alteration to the methodology, evaluation or conclusions as a result of issuing the drafts.

## 8.5 Consents

Grant Samuel consents to the issuing of this report in the form and context in which it is to be included in the Scheme Booklet to be sent to shareholders of Wesfarmers. Neither the whole nor any part of this report nor any reference thereto may be included in any other document without the prior written consent of Grant Samuel as to the form and context in which it appears.

## 8.6 Other

Grant Samuel has prepared a Financial Services Guide as required by the Corporations Act. The Financial Services Guide is set out at the beginning of this report.

**GRANT SAMUEL & ASSOCIATES PTY LIMITED**

5 October 2018

Grant Samuel & Associates