PORTLAND INVESTMENT COUNSEL™

Overview & Investment Thesis:

- Given the much diversified nature of Wesfarmers businesses and the defensive nature of some of its largest divisions, the stock, in our view, has good downside protection; while preserving excellent exposure to critical growth sectors of the Australian economy, as well as to growth in China and North Asia.
- While it was initially meant to be one of the leading businesses of Western Australia, with the addition of Coles, its scope became truly national. In addition, its coal production is mainly exported to North Asian countries, as well as some other Asian and European countries, and the company maintains a significant presence in New Zealand through Lumley New Zealand (insurance) and through its hardware, industrial and safety businesses.

- Wesfarmers' business prowess has been proven throughout time through a history of acquisitions and successful turn-arounds:
    - In 1984, while the farmers' cooperative was still the largest shareholder, Wesfarmers Ltd. went public and in the same year acquired CSBP & Farmer, a fertilizer manufacturer and distributor - the largest Australian corporate takeover at the time;
    - In 1989 Wesfarmers acquired Western Collieries (now Premier), a coal mining business. In the 1990s, the Company added Bengalla mine in New South Wales to its coal portfolio and in 2000 acquired Curragh mine in Queensland and further expanded it, in 2003;
    - In 1994 Wesfarmers acquired Bunnings to initiate a presence in the hardware and forest products business. It has since been expanded and is now Australia's leading supplier of home improvements and building supplies, following the acquisition of Howard Smith's BBC and Hardwarehouse as well as an expansion into New Zealand.;
    - The insurance business grew through the merger of Wesfarmers and Federation Insurance in 1991 to form Wesfarmers Federation Insurance (recently re-branded WFI), one of the largest rural insurers in Australia. The business was further strengthened by the addition of Lumley Insurance Australian and NZ business, as well as the insurance broking business of OAMPS (orginally Oil Agents Mutual Provident Society) and Crombie Lockwood Holdings.

- The 2007 acquisition of Coles Group added a number of previously underperforming businesses - Coles (food, beverage and convenience), Kmart (discount department stores) and Officeworks (officeware) - to the list of Wesfarmers' turnaround challenges and bought a dominant market share of the Australian retail space.
    - In addition, Target (department stores) came to strengthen Wesfarmers' operations with robust growth and and EBIT margin of 9.4% in 2009 and 10% in 2010. New management has been brought in at Coles (Ian McLeod, former CEO of Halfords in U.K.) and at Kmart and significant changes have been made at all levels of management in the acquired divisions, with a focus on the decentralization of the operations;
    - In less than three years since the acquisition, significant improvements have been achieved at Coles in terms of top line growth (exceeding A$30 bn for the first time during the fiscal year ending June 30, 2010) and operational efficiency with latest results showing an expansion of the EBIT margin from about 2.8% in 2008 to 3.7% in 2010;
    - Given Coles' operating margin was at about half the level of its major competitor, Woolworth, at the time of the acquisition, we believe there is still significant up-side for the division.

- Most of the existing divisions exhibit operational strength and resilience in the face of adverse economic conditions:
    - Bunnings (hardware) posted a strong 7.3% like-for-like cash sales growth;
    - Coles grew 5% in like-for-like food and liquor sales for the 2010 fiscal year;
    - The non-retail divisions experienced EBIT progression with the exception of the resources division, influenced by a much weaker bulk commodities pricing environment in the year ended June 30.

- While preserving a solid balance sheet, the company has achieved a progressive dividend policy over most of the last decade (with the exception of the last couple of years when its dividend has been reduced with the purpose of enhancing financial flexibility in a tough environment); the current announced A$1.25 dividend is higher than the A$1.10 dividend announced in 2009 and is yielding almost 4%.

Business Description:

Founded in 1914, Wesfarmers' initial scope and purpose was the provision of services and merchandise to Western Australia's rural community, specifically: wool and wheat merchandising, grain and fruit exporting, oil distribution and a public radio station. Now with over 200,000 employees and a shareholder base of more than 450,000, Wesfarmers is one of Australia's largest companies. The acquisition of Coles in the fall of 2007 delivered a retail footprint un-matched by any other competitor on the continent. Wesfarmers Limited engages in the following businesses: food and beverage, convenience and fuel retailing, department store and discount department store retailing, hardware and officeware retailing, insurance, coal mining, gas processing and distribution, industrial and safety product distribution and chemicals and fertilizers manufacturing. The company is headquartered in Perth, Australia.

Industry Growth Drivers/Trends:

- The fate of the retail divisions - whether it is the turn-around grocery giant Coles or the well performing hardware leader Bunnings - are tightly linked to the Australian consumer and to the fate of the Australian economy as a whole.
- Australia experienced 17 solid years of economic expansion; the first negative growth numbers were reported in Q4 of 2008 and were followed by positive growth in the first two quarters of 2009 (technically Australia has not suffered a recession). Sustained reforms, low inflation, a housing boom and increasingly strong ties with China have been the main drivers of growth.
- Wesfarmers' cyclical businesses have exhibited resilience in front of the adverse economic conditions. More recently, as the government stimulus programs targeted at encouraging domestic consumption are being wound-down and the interest rate has been raised, the growth prospects of Westfarmers' retail businesses have tempered, yet nevertheless, we believe are still high when compared with those of other developed countries counterparts.
- The resources and industrial divisions have been particularly hard hit by the economic down-turn, with the price of coal down 40-50% in the first half of fiscal 2010, and demand for chemical inputs, fertilizers and LNG dwindling. As the year progressed, the pricing of both metallurgical and thermal coal improved, providing good outlook for the resources division short term profitability. Similarly, other industrial divisions, including energy, fertilizers, chemicals and safety have now improved growth prospects, as outlined in the latest company reporting.
- Westfarmers' mining operations are amongst the most cost efficient in the country and its strong operational practices resulted in the scaling back of production to eliminate the marginally inefficient quantities of coal. On the basis of a conservatively assumed long-run coking (metallurgical) coal price of USD 150/ton, below today's relatively low levels of USD 250/ton, the mining operations of Wesfarmers remain profitable, and so are potentially responsible for 10-15% of the group EBIT going forward.
- The chemicals, fertilizers and energy businesses, currently priced at very low levels, hold the potential of increased earnings in a stronger trading environment.

Competitive Advantages:

- The largest retail footprint in Australia, with dominant positions in the hardware/home improvement retail and department store retail markets.
- A strong managerial team with demonstrated capabilities in a variety of turn-around and other commercial projects.
- One of the lowest cost coal producers in Australia and worldwide, strategically positioned to take advantage of the pick-up in demand in Asian markets.

Competitors:

- **Food and Beverage**: Woolworth, Metcash, Aldi.
- **Department Stores**: Woolworth, specialty stores.
- **Hardware**: Danks Group (Woolworth), Mitre10.
- **Coal**: BHP Billiton, Rio Tinto, Felix Resources.
- **Insurance**: Insurance Australia Group, QBE Insurance Group, Suncorp-Metway.
- **Industrial/Energy**: Emeco Holdings, Bradken, Nufarm, Incitec Pivot, Austral Pacific Energy, AGL Energy.

Barriers to Entry:

- **Economies of scale**: The size of the retail business and power of distribution, allows it to obtain significant economies of scale and optimize distribution operations which could deter new entrants/competitors in prime retail locations.
- **Initial capital outlays**: Most of the industrial operations involving Wesfarmers require significant initial capital outlays which could be difficult to muster by a new entrant; in addition overcapacity and the prospect of reduced demand would act as a strong deterrent.

Customers:

- Wesfarmers' businesses cater to a varied array of customers, from a single governmental utility in the case of Premier coal mines to millions of consumers walking in their stores.
- Given the widely diversified character of the Wesfarmers portfolio business there is no significant exposure to any single customer at the group level.

Officers and Directors:

Leadership team: Non-Executive Independent Chairman of the Board, Robert Every (64); Group Managing Director, Richard Goyder (49); Finance Director, Terry Bowen (42); Director-Industrial Divisions, Keith Gordon; Managing Director-Coles Division, Ian McLeod (50).

Corporate Governance:

- **10 member board** – of which 8 are independent and the functions of chairman and managing director are separated.
- The Company scores at the top of the scale (8.5) in the Governance Metrics International (GMI) Overall Global rating and also well above average in the Institutional Shareholder Services Corporate Governance Quotient (ISS CGQ) Index (89.7) and ISS CGQ Industry (90.4).
- Wesfarmers accounts for about 1% of Australia's total greenhouse emissions. Each division has emission reduction targets, with the Insurance group aiming at becoming carbon neutral by 2009/2010 and Bunnings sooner than 2015 through energy efficiency measures and the use of offsets. The Resources division managed to reduce its greenhouse gas emissions, water and energy used in a record production year. The company as a group reduced its energy usage in 2009 over 2008 and reported flat growth in water usage.
- Wesfarmers is one of the 19 Australian companies that are members of the Dow Jones Sustainability Index (DJSI) World.
- The Company as a group has issued a sustainability report since 1998 and the reports are audited by independent consulting firms.
- Westfarmers' top 7 executives were paid a total remuneration equivalent to 1.03% of the 2009 operating profit.

Ownership:

Insiders own 0.27% of outstanding shares. Institutions own 15.86% of outstanding shares. Notable holders include: Capital World Investors 2.7% , Colonial First State Asset Management 2.1%, QIC Ltd. 1.22%, Blackrock Institutional Trust 1.1%, Norges Bank Investment Management 0.9%.

Capital Allocation/Uses:

Wesfarmers' main objective of achieving a satisfactory return to the shareholders, shapes its capital allocation policy:

- Capital expenditure for 2010 was A$1.7bn higher than the A$1.5bn expenditure for 2009 and it was driven by continued investment in Coles refurbishment and Bunnings new stores roll-outs. For 2011, A$2.2 to 2.4bn will be spent in capital expenditure commitments, mainly for refurbishments at Coles and on financing Currah and Bengalla (subject to board approval) mines expansion.
- Wesfarmers enjoys a continuous improvement in its operating cash flow (CFO), reaching the level of A$3,327m in 2010. CFO's last 5 year CAGR is 28.9%.
- For the last couple of years, the Company's main use of cash was to pay down debt following the acquisition of Coles (A$6.6B paid to the shareholders of Coles in 2007 and 2008).
- A A$10B syndicated facility was arranged in the fall of 2007 with the purpose of primarily financing the cash component of the acquisition of Coles. A$7.3B of the syndicated loan has already been repaid of which A$2.2 million was repaid in 2010.
- Wesfarmers raised A$4.5B of share capital in early 2009 through a very successful entitlement/rights offer. The proceeds was mainly used to pay down debt and enhance liquidity. During fiscal 2010, the group raised a A$500m domestic bond and a EUR 500m medium term note (MTN).
- An A$1.25 fully franked dividend announced for 2010, is yielding 3.94% as of August 23, 2010.

Business Segments:

	Revenues (%)		Operating Profit (%)	
Business Mix	2009	2010	2009	2010
Coles	56.5	57.9	27.0	33.5
Home Improvement & Office Supplies	14.0	15.1	23.5	28.0
Kmart	7.8	7.8	3.5	6.8
Target	7.4	7.4	11.6	13.3
Insurance	3.4	3.3	3.0	4.3
Resources	4.7	2.7	29.7	5.8
Industrial & Safety	2.5	2.5	3.7	3.9
Chemical & Fertilizers	2.3	2.0	1.7	4.2
Energy	1.2	1.2	2.4	3.6
Other	0.2	0.1	(6.1)	(3.2)

Financial Statement Summary: (AUD MM, years ended June 30)

Income Statement	2006	2007	2008	2009	2010
Total Revenue	8,859	8,818	9,666	33,301	50,641
Normalized EBIT	1,309	1,216	2,150	2,958	2,746
Net Income, continuing ops	869	782	1,050	1,614	1,614
Fully Diluted EPS, continuing ops	2.16	1.92	1.71	1.73	1.40
ROE	33.55%	23.58%	9.69%	7.49%	6.40%
Balance Sheet					
Net Debt	1,453	4,904	7,921	3,042	2,648
Common Equity	3,166	3,503	19,590	24,252	24,694
Net Debt: Common Equity	45.89%	140.00%	40.43%	12.54%	10.72%

Key Profitability Ratios and Figures:

Y/E June 30	2007	2008	2009	2010
Operating Margin	11.3%	6.4%	5.8%	5.3%
Interest Coverage	2.7x	3.5x	3.5x	5.6x
Return on Equity, continuing ops	23.58%	9.69%	7.49%	6.40%
S&P Credit Rating	A-	BBB+	BBB+	BBB+

Sourced from Thomson Reuters, Company Filings, PIC.

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