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HD **Goyder weighs next move as pressure mounts for a deal**

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Cover Story

Will investors give the Wesfarmers chief the time he needs? Elizabeth Knight reports.

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Crown Towers, the hotel at James Packer's glitzy Melbourne casino, seemed a slightly incongruous venue to host the two-yearly Wesfarmers' management retreat last week. The message delivered to the 400-strong team by its boss, Richard Goyder, was even more eyebrow raising. "Be bold. You can make mistakes - but not many."

There are a few hallmarks that define the century-old Western Australian company that evolved out of a farmers co-operative - discipline, patience and caution. These characteristics equally define Goyder - a smart, deliberate yet mild-mannered executive from rural WA, with an aversion to hubris.

Inciting the team to be bold and innovate may seem counter-intuitive. Says Goyder: "If you want to have innovation ... you've got to have an environment where you accept that mistakes happen. In my career I've made my share of mistakes and haven't been crucified."

When Goyder stands before investors at the end of this financial year he may deliver what some will consider an unthinkable result - a fall in Wesfarmers' underlying earnings. At least, this is what many analysts are now factoring into their forecasts. This may well be Goyder's biggest challenge and he may be punished by the market.

So, with this result on the horizon, why is it that Wesfarmers' share price is trading at levels reserved usually for companies with significant growth prospects? And another big question - will the notoriously impatient and avarice-driven investment community allow Wesfarmers the time it needs to write a new growth chapter?

Goyder is in an unenviable position. In part a victim of its own success in transforming into a conglomerate powerhouse, Wesfarmers sits on the horns of a dilemma - satisfy the sharemarket's thirst for growth, risk pulling the wrong trigger and blowing up long-term shareholder returns - versus attracting criticism for a lack of activity.

Goyder and his predecessors have followed an assiduous, almost Warren Buffett-like, investment formula of buying businesses with potential on the cheap, teamed with a private-equity like model of parachuting in superior management to restructure the operations.

Patience is a virtue in most walks of life but in investment circles it has its detractors.

Yes, Wesfarmers' earnings in all likelihood will go backwards this year. This is not because its main businesses are underperforming (although some are) but because it has recently sold a major asset - the insurance division that was earning more than $220 million.

The $3 billion plus price tag it received for this business unit was yet another example of the company's genius in selling assets at the right point in the cycle and for stellar returns. But it has left an earnings hole.

And the Wesfarmers beast needs to be fed to grow. Its shareholders, which include many small retail investors, expect new acquisitions so it can churn - albeit slowly - the businesses it brings into the fold. It wants the company to weave its magic, to use its management strengths to buy potential, reap the rewards from operational improvements and ultimately achieve hefty capital profits on their sale.

Wesfarmers is now a $50 billion enterprise with an investment appetite to match. Relatively small, bolt-on acquisitions, such as the recently announced King Gee and Hard Yakka workwear, won't move the dial. It needs another business the size of Coles - its last major acquisition, the biggest in its history, which it bought for $20.7 billion in 2007.

It's a tall order.

There is a fine line between the pressure on the troops to take risks - to "be bold"- and to secure returns in a company that prides itself on being clinical in its approach to investment.

History has shown that Wesfarmers' management has been ruthless in punishing those that cannot achieve outcomes. One need look no further than three changes to the top management of discount department store chain Target as a result of poor performance (however, Wesfarmers appears unwilling or unable to stomach jettisoning Target from its stable of assets).

Goyder's response to investor pressure is, "We don't fret about it." More accurately, he doesn't get antsy about the (lack of) speed taken to source new assets. But he concedes that others within Wesfarmers might.

"I think shareholders are happy with the fact that we just gave them $1.10 per share," he says, which was part of the $1.1 billion in capital that the company has just returned to its investors. And if the recent share price response is an accurate guide, he is right about that.

Indeed, Macquarie strategists suggested recently that the dividend largesse showered on investors by some big companies in 2014 may have been designed to distract shareholders from the growth challenges facing their businesses. Wesfarmers, Telstra and the Commonwealth Bank were singled out in this regard.

Citi analyst Craig Woolford suggested that despite low single-digit earnings growth in 2014, shareholders had been captivated by the prospect of the capital return - noting that on the day of Wesfarmers' latest results announcement the market capitalisation rose $1.9 billion - significantly more than the $1.1 billion capital return.

The trouble for Wesfarmers is that the glow from its generous dividend will fade and shareholders will be looking for the next hit. But with the excess cash within Wesfarmers already distributed, the source will need to be an improved profit.

Goyder holds the line.

"We are all right with getting smaller for the right reasons," he says.

But what will these same investors think this time next year, assuming Wesfarmers is carrying the same bunch of assets and there is no sign of growth - other than from existing business?

At what point will the diehard Wesfarmers groupies begin to get fractious? And will Goyder's renowned patience be enough to reassure its investors?

Shareholders generally pay for next year's growth rather than look at five-year growth horizons.

Goyder and his team are some of the highest-paid executives in the country, and with that level of reward comes serious expectations.

One high-profile investment banking analyst noted last week that the market will not reward Goyder for being patient but rather expects his team to be able to find the next acquisition sooner rather than later.

"We are not paying big pay packets and a hefty share price premium for management to be disciplined," he says.

The 20-strong team of merger and acquisitions experts that reside inside the Wesfarmers head office in Perth are a significant part of the $114 million head office cost that the company bears. That includes the $4.8 million that former Coles supermarkets boss Ian McLeod now pockets to lead the globe-scouring exercise to find new businesses to add to the Wesfarmers stable of assets.

In size, this team is the equivalent to that contained in a small to medium-size investment bank. "We are not paying for all this capability for limited outcomes," another investor notes.

Goyder takes a different view. He thinks his job includes the stamina, confidence and discipline to bide his time and not make a mistake. A large part of his job is not getting it wrong rather than just getting it right.

"Our licence to operate as a conglomerate depends on the ability to buy value-creating assets," he says.

In his defence, corporate Australia is littered with poor acquisitions that new management teams needed to clean up (often before they embark on their own mistakes, which others need to clean up - and the cycle goes on).

For example, we are now witnessing the demerger of BHP Billiton into two companies - roughly speaking, one that contained many of the old BHP assets, and Newco, which will contain most of the Billiton assets acquired 13 years ago.

But in an investment world focused on shorter-term horizons the Wesfarmers approach to patience is not in harmony with at least some of its investors.

Goyder still vividly remembers the period between 1994 and 2000 in which the company's wallet remained firmly closed - a time during which he says Wesfarmers was being constantly criticised for being "always the bridesmaid and never the bride".

In a sense he wears this ability to weather investor pressure as a badge of honour. But this kind of acquisition drought won't be tolerated for too long.

"It is to be expected that Wesfarmers would look at replacing the earnings from the insurance business through acquisitions or expansions ... a key problem is that there does not look to us to be readily available opportunity for Wesfarmers - that would generate an acceptable return on investment within a reasonable time frame," said Bank of America Merrill Lynch analyst David Errington in a note to investors in March.

So what could be on Wesfarmers' shopping list?

There has been plenty of speculation that Wesfarmers, having potentially outgrown Australia, may choose an offshore business as its next target.

"Inevitably we are looking offshore, but we recognise there are greater risks and we have to be more patient," says Goyder.

He says Wesfarmers has to build its own capabilities and networks to better understand the opportunities and be able to take advantage of them.

Over the past five years Wesfarmers has hired a bunch of international management talent, particularly through its retail operations such as with McLeod, who are being used to target and assess offshore opportunities.

"The trouble with retail offshore is that it's pretty tough. You go to Beijing and you are competing against the best in the world, so you've got to bring something to the table."

Goyder is not writing off investment in international retail but one gets the vibe that the options being investigated may not involve a pure retail model.

"Ian [McLeod] is looking at a lot of opportunities at the moment to leverage food ... we are probably the second biggest aggregator of food in Australia so is there an opportunity to look at that into new markets ... it doesn't have to be retail market it could be more direct.

"Ian's been to China several times and he's been to the Middle East.

"There is appeal in some sectors where there is clearly unstoppable growth momentum like food, water, energy. These possess more tailwinds than headwinds."

Over the past years companies that have been on top of the rumoured tyre-kicking pile include AGL, Origin, Orica and Healthscope. But all have reportedly been consigned to the dust bin.

Another approach to investment for Wesfarmers (with its obsession with value) has been the counter-cyclical play. It's a point of similarity with Buffett's Berkshire Hathaway. (Goyder confesses to being a fan rather than a disciple).

From an Australian perspective the biggest potential in this vein must sit in the resources sector. But one gains the impression from Goyder that this is probably a no-fly zone. Not only is the **company**'s **coal** business struggling, thanks to the commodity's flagging price, but according to Goyder, "We have stamped on our foreheads 'Don't buy anything that isn't in the lowest quartile of the cost curve'."

The next question being asked in some circles is whether Goyder has the board's mandate to launch the **company** to its next stage - or whether it is time to renew management. Goyder started as chief executive in July 2005, after a stint as chief financial officer, and has been on the Wesfarmers board for well over a decade.

But speaking to Fairfax Media at the chairman's lounge in Sydney this week, on his way to the B20 meeting in Cairns this weekend, Goyder appeared pretty comfortable that he will **lead** the **company** for some time yet.

Indeed, he thinks that the investment that Wesfarmers has made in allowing him to **lead** the B20 group will open valuable networking opportunities.

"The one thing I would like when I leave is for the table to be set in terms of the group going forward. That is good succession plans and a growth platform in front [of us].

"There are plenty of times when people ask questions and challenge us but I think one of the biggest challenges is not to be intimidated by the pressure. It's one of the good things about being in the role for a while. It's harder as a new CEO to maintain the discipline under pressure."

There is no doubt that Wesfarmers is on a mission to find growth. But how long it has to achieve this outcome is hotly debated.

Some argue that the time is ripe for acquisitions, given the cost of debt is at historical lows.

While this does potentially increase the competition for assets, Goyder argues that the mountain of cheap finance does not alter the fundamentals of what will produce a return.

"In terms of **M**&A we can make a whole bunch of things stack up. We can gear up the balance sheet [but in doing so] you can destroy shareholder value."

Errington's investor note from April appears to support Goyder's sentiment. "After QE [quantitative easing] for the past couple of years, asset prices are high ... and any **company** reinvesting or buying assets to generate growth are paying very high prices in the majority of cases.

"The latent firepower in earnings from future reinvestment from an ungeared balance sheet no longer exists in our view ... causing derating for companies such as Wesfarmers."

And what about using Wesfarmers highly priced **equity** as the currency for future **acquisition**? According to Goyder, the same rules apply. Cheap currency doesn't enhance the value of a **purchase**.

"'You can't just think from the point of view of the current shareholders but also need to consider future shareholders.

"You can't just look at the current arbitrage [between Wesfarmers share price and that of a lesser-valued **company**]."

Despite these laudable protestations it was the lure of cheap debt that in part motivated Wesfarmers' most infamous corporate play - the 2007 **acquisition** of the Coles Group, which included the supermarket businesses Kmart, Target and Officeworks.

It was the classic corporate move that didn't go to plan. While the Coles business met the Wesfarmers criteria of containing clapped out, mismanaged assets with plenty of upside, the **acquisition** was ultimately costly.

The GFC intervened, debt became expensive and Wesfarmers needed to raise precious and expensive capital to get the deal across the line. It cost the group some reputation and for five years crimped its ability to meet its hurdles on return on **equity**.

It was in the wake of the Coles deal that Wesfarmers adopted a new performance metric - total shareholder returns.

Ultimately it has become a textbook success in turning around a business and the defining point of Goyder's career.

But had it not been for a boom in the earnings of Wesfarmers**coal** business in the early years after its foray into Coles, history would not have been as kind to the Western Australian conglomerate.

Ironically, the earnings transformation of the retail assets are now shouldering the poor performance of the **coal** business.

While there is an expectation that group earnings will fall this year, the assets that remain in the portfolio are expected to see their earnings grow - in particular the flagship Coles supermarkets group.

Having smashed arch-rival Woolworths on most growth measures over the past three years, Coles is expected to make gains but not at the same rate.

However, its transformation, along with the hardware juggernaut Bunnings, will continue to dominate the positive returns posted by Wesfarmers.

The ongoing stellar growth by Bunnings has been achieved in the face of Woolworths contesting the home improvement space through the introduction of its (now) troubled Masters brand.

The irony is that the invasion by Masters has not managed to crimp Bunnings' positive performance but has instead placed pressure on the Woolworths group's return on capital.

But investing significantly more in retail in Australia would be difficult for Wesfarmers - given the size and the breadth of its current retail portfolio and the competition regulator's intense scrutiny of both Coles and Woolworths.

Wesfarmers, it seems, has outgrown its ability to score easy runs.

Co-operative turned conglomerate

All about Wesfarmers

200,000 staff

500,000 shareholders

An estimated 50 per cent of shares held by retail investors

Coles food, liquor and petrol generate 42% of earnings

Began as a WA farmers co-operative in 1914

|(81)> Floated in 1984.

CO wsfrm : Wesfarmers Ltd

IN i8396 : Diversified Holding Companies | ibcs : Business/Consumer Services

RE austr : Australia | apacz : Asia Pacific | ausnz : Australia/Oceania

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