# Wesfarmers Gearing Ready to Pounce

## Coles Demerger Opens up New Possibilities, but Stops Short of Materially Adding to Underlying Value.

**Morningstar Equity Research**
29 May 2018

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### Executive Summary

Wesfarmers' management is significantly altering the group's DNA with the proposed demerger of grocer Coles, closing sometime in fiscal 2019 if approved by shareholders. There are aspects to like in the demerger, which will separate Coles from the core Bunnings home improvement retail stores. The two businesses—accounting for about two thirds of group EBIT—have very different growth prospects, and the split will provide the residual group with a greater capacity to engage in impactful M&A transactions given the smaller size and stronger balance sheet of Wesfarmers post-demerger. However, we can't see a material value uplift, as we don't expect the cash flows generated by the existing businesses to be enhanced by simply splitting them apart. Although limited upside potential to our fair value estimate of Wesfarmers exists in the order of 4% on our preliminary assessment, it is mainly from a lower cost of equity for Coles than for Wesfarmers today. Pending firm capital structures and the finalisation of our moat ratings for the new entities, we reiterate our fair value estimate of AUD 37.50 per current Wesfarmers share. In our base case, we continue to expect Bunnings to grow strongly in Australia and New Zealand, but we believe the market is much more optimistic on Bunnings' prospects and is pricing it close to perfection.


### Key Takeaways

- Our preliminary fair value estimates for Wesfarmers post-demerger and Coles are AUD 27.50 and AUD 14.35, respectively, based on Wesfarmers' current share count. Once adjusted for Wesfarmers' planned 20% remaining ownership in Coles, Wesfarmers post-demerger's fair value estimate is AUD 24.60, and the combined preliminary fair value is AUD 38.95, only 4% above our current AUD 37.50 consolidated fair value estimate.
- All else equal, to justify the current share price of Wesfarmers today, Bunnings' EBIT margins in Australia and New Zealand would have to expand to 17.2% in 2027 from 11.6% in fiscal 2017. Our base-case EBIT margin forecast is markedly lower at 12.4% in fiscal 2027, as we expect Bunnings to fuel its market share grab by passing on efficiency gains to its customers through lower prices.
- The demerger of Coles would leave Wesfarmers post-demerger with an undergeared balance sheet, ideal to fund acquisitions or returning excess cash to shareholders. Acquisition risk is always inherent in an investment in Wesfarmers, demonstrated by the recent acquisition challenges of U.K.'s Homebase. Nonetheless, the demerger would boost the war chest and increase the scope for a sizable transaction.

### Companies Mentioned

| Name/Ticker | Economic Moat | Currency | Fair Value Estimate | Current Price | Uncertainty Rating | Morningstar Rating | Market Cap(Bil) |
|---|---|---|---|---|---|---|---|
| Wesfarmers WES | Narrow | AUD | 37.50 | 45.52 | Medium | ★★ | 51.61 |
| Woolworths WOW | Narrow | AUD | 23.50 | 28.98 | Medium | ★★ | 37.72 |


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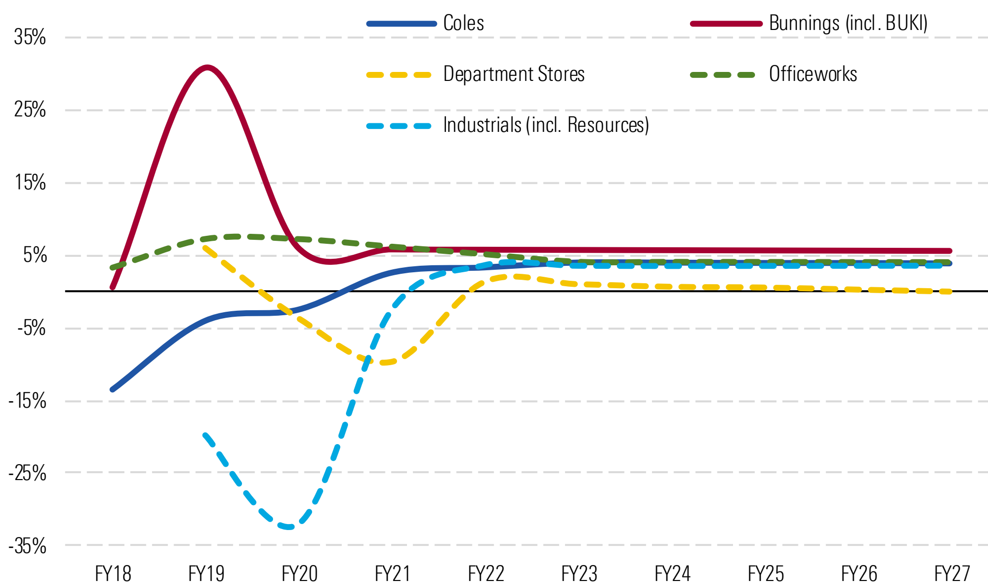
**Demerger Unlikely to Improve Operations but Provides Optionality for Management and Investors**

We don't expect the value of the sum of Wesfarmers' split parts, which we refer to as Wesfarmers post-demerger and Coles, will be materially larger than the combined entity, or Wesfarmers today. Wesfarmers' individual businesses are already run by largely autonomous management teams and capital within the group is allocated to the investments promising the highest return on capital. It is unlikely the individual businesses within Wesfarmers post-demerger will be managed differently, or capital to be allocated more effectively, once Coles is separated. Certainly, the competitive environment in which the segments operate doesn't change, as no further consolidation or fragmentation of the market results from the demerger. Hence, we maintain our outlook on the sales and earnings trajectories of the existing segments.

However, there are still positive aspects of the demerger. First, the restructure splits the highly profitable and rapidly growing Bunnings home improvement chain from the slow-growing Coles supermarkets, which face fierce competition and declining EBIT margins. By separating the two largest businesses of the Wesfarmers portfolio, investors are provided with a clearer choice between growth-focused and defensive investment propositions.

**Exhibit 1** Bunnings Exhibits the Highest Long-Term EBIT Growth Potential, While Department Stores Lag




Source: Morningstar estimates
Note: Near-term EBIT growth is distorted at Bunnings by the BUKI divestment, at Department Stores by a turnaround in Target, and at Industrials by the sale of the Curragh coal mine.

Second, we expect sales and earnings volatility between Bunnings and Coles to differ over the cycle. Coles is a consumer staples retailer with relatively defensive consumer demand, commanding

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a lower cost of equity than consumer discretionary retail or commodity businesses such as Bunnings and WesCEF, respectively. Therefore, splitting Coles' inherently less volatile income stream from the riskier Wesfarmers businesses offers investors the opportunity to fine tune their exposure according to their appetite for risk.
Third, management is targeting a lower investment grade credit rating for Coles than for Wesfarmers today, which we expect to result in Wesfarmers post-merger to be underleveraged. This opens the door for capital management. In the absence of a material corporate deal, we anticipate share buybacks or special dividends to benefit shareholders in Wesfarmers post-demerger. Also, Wesfarmers post-demerger would be able to look at a wider range of potential acquisitions. At only about two thirds the size of Wesfarmers today, smaller acquisitions could still make a meaningful impact to the group’s earnings profile.

Negatives are the one-off costs of the demerger and any ongoing expenses arising from the listing a new entity, such as ASX and auditing fees. Also, we expect the less-diversified Wesfarmers post-demerger to exhibit higher earnings volatility than Wesfarmers today, as it loses the more reliable earnings and cash flow from Coles. Bunnings will account for about half of EBIT after the demerger and is exposed to external factors such as the housing market and household discretionary income growth.

Similarly, Wesfarmers’ discount department stores segment is facing increasingly fierce competition and we expect it to be confronted with loss of market share and margin pressure as a result. Independent of the demerger, an investment in Wesfarmers always brings risks and opportunities arising from portfolio management, and investors must implicitly trust that management can identify, and has access to, better targets than they do. The recent challenges that have arisen from the Bunnings in the U.K. and Ireland, or BUKI, transaction highlights not every deal is necessarily a slam dunk for the conglomerate.

On balance, we support the decision to demerge. By spitting out the lower-than-average returns on the capital of Coles, the demerger would lift the return on capital of the residual group. It would also increase the universe of potential transactions large enough to move the dial for Wesfarmers post-demerger. Investors which were invested in Wesfarmers for exposure to either Bunnings or Coles would be able to allocate their funds with more precision. However, until the demerger is finalised, investors in Wesfarmers remain fully exposed to the performance of Coles as well as the businesses of Wesfarmers post-demerger.

However, we don't expect a material valuation uplift from this transaction. We see the combined individual valuations of the two businesses at AUD 38.95 per share, only 4% higher than our unchanged fair value estimate for Wesfarmers today of AUD 37.50. Shares are significantly overvalued at current prices. We have calculated preliminary fair value estimates for Coles and Wesfarmers post-demerger, at AUD 14.35 and AUD 27.50, respectively, subject to the finalisation of the firms' capital structures and the final determination of the Morningstar moat ratings on the stocks. The preliminary fair value estimate of Wesfarmers post-demerger includes the value of the

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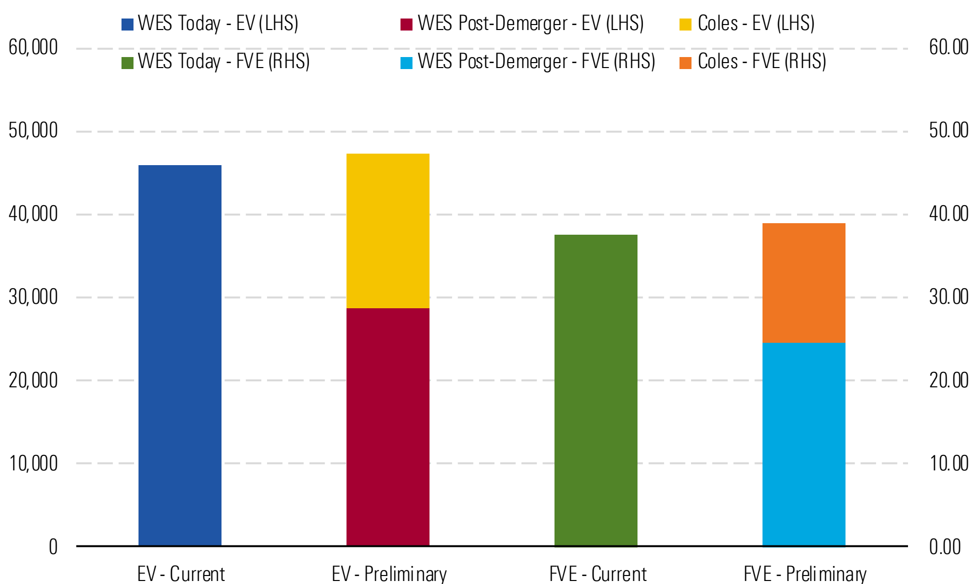
20% ownership in Coles we expect the conglomerate to retain. After adjusting for the AUD 2.90 per share this stake adds, we estimate Wesfarmers post-demerger's valuation would be AUD 24.60, based solely on its operating assets.

Our initial discounted cash flow valuations are based on our pro forma financials for Wesfarmers post-demerger and Coles, the analysis of the competitive standing of the businesses against their peers, as well as our preliminary estimate of the cost of equity for Coles. The slight difference between our unchanged fair value estimate for Wesfarmers today and the sum of the indicative valuations of Wesfarmers post-demerger and Coles is mainly driven by the lower weighted average cost of capital, or WACC, anticipated for Coles. Importantly, our preliminary analysis ignores additional costs associated with the demerger, both one-off and ongoing. These costs would detract from our implied fair value estimates, but we expect them to be immaterial in relation to the enterprise values of Wesfarmers post-demerger and Coles.

**Exhibit 2** The Fair Value Estimate of Wesfarmers Doesn't Move Much After the Demerger




Source: Morningstar estimates
Notes: Wesfarmers post-demerger's enterprise value estimate excludes 20% retained ownership in Coles.
The fair value estimate of Wesfarmers post-demerger excludes its 20% stake in Coles, to adjust for double counting.

We believe we are more cautious than the market on the earnings outlook for Bunnings. All else equal, to justify the current share price of Wesfarmers today, Bunnings' EBIT margins in Australia and New Zealand would have to expand by almost 600 basis points to 17.2% in 2027 from 11.6% in fiscal 2017, while at the same time expanding its market share in Australia to our base-case forecast of 24% from 20% over that period. This is 480 basis points or 39% higher than our base-case EBIT margin forecast for Bunnings at 12.4% in fiscal 2027, as we expect Bunnings to fuel its market share grab by passing on efficiency gains to its customers through lower prices.

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Achieving EBIT margins at those levels isn't an impossible feat, but we think it's too optimistic to incorporate in our base case. As a comparison, we estimate a midcycle EBIT margin of 16% for Home Depot, the most profitable hardware retailer in Morningstar's coverage universe and the market leader in the U.S., with a market share of around 25%. However, Home Depot owns most of its stores and only spends 1.0% of its sales on rent. Conversely, we estimate Bunnings in Australia and New Zealand's, or BANZ's, rental expense to sales were 4.4% in fiscal 2017. Adjusting for these differences, EBIT before rent, or EBITR, margins for Home Depot and Bunnings were strikingly similar in fiscal 2017, at 15.6% and 15.9%, respectively. We estimate this relation to remain relatively steady with EBITR margins for Home Depots and BANZ at 17.0% and 16.8% in fiscal 2027, respectively. We forecast Home Depot's sales to grow at an average rate of only 3.8% over the next decade. This compares with our average sales growth estimate for Bunnings of 6.5% over the same period, during which we forecast the Australian hardware and garden supplies market will grow by 4.4 % on average.

For hardware retailers Lowe's and Kingfisher, we estimate midcycle EBIT margins of 11.0% and 7.0%, respectively, but coupled with even slower sales growth than Home Depot, at average rates of 2.7% and 1.5% over our forecast period, respectively. The discrepancy in EBIT margins of Home Depot and Lowe's are largely due to the latter's lower sales productivity per square foot, while gross margins are similar for both U.S. chains.

Our preliminary fair value estimates place Coles and Wesfarmers post-demerger in the mid-range of the price/earnings, or P/E, and fair value estimate/earnings, or FVE/E, multiples of their international peers covered by Morningstar.

Woolworths' FVE/E is higher than Coles' mainly due a material turnaround of Big W expected over the medium term. The discount department store reported an operating loss of AUD 151 million in fiscal 2017, but we expect Big W to revert to operating profits in fiscal 2019 and its EBIT margins to improve to long-term levels of 2% by 2020.

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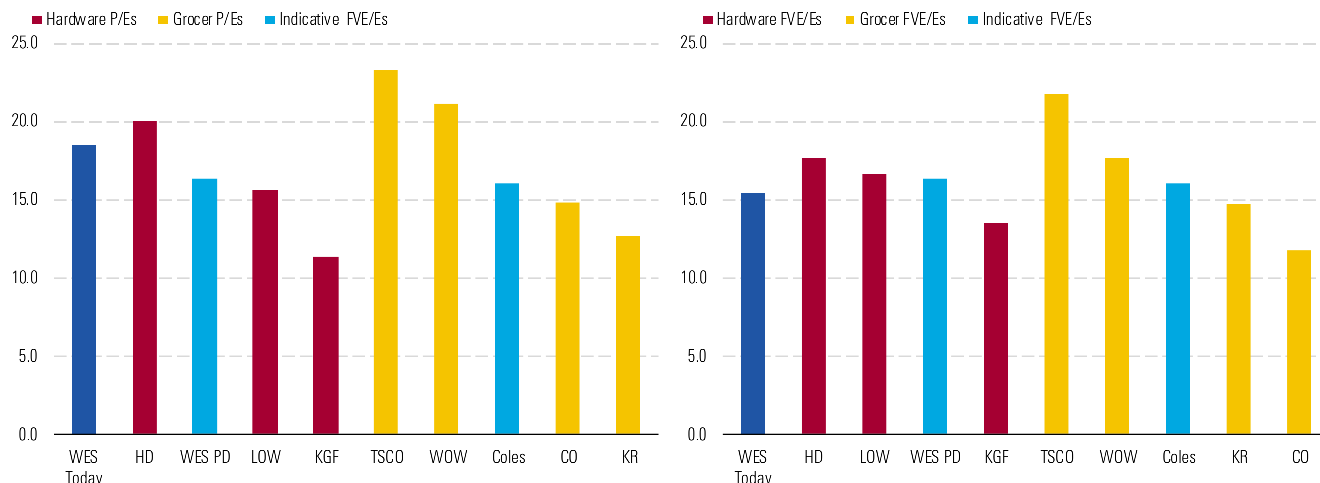
**Exhibit 3** Wesfarmers Today's P/E Is Greater than Wesfarmers Post-Demerger's and Coles' indicative FVE/Es - and its Shares Screen as Expensive




Source: Morningstar estimates

We estimate a demerged Coles will have a lower WACC than Wesfarmers today, as we expect the grocer's preliminary cost of equity, or COE, to be below average at 7.5%, due to its defensive nature as a consumer staples retailer. This aligns with Woolworths' COE of 7.5%. Wesfarmers today has an average COE at 9.0%. We estimate Coles' preliminary WACC at 7.0% versus Wesfarmers today's at 8.5%, and Woolworths' at 7.2%.

We expect Wesfarmers post-demerger's preliminary COE to remain average. Home improvement and department store sales are mostly discretionary and much more susceptible to the economic cycle, and therefore should display a higher beta than grocers. Further, Wesfarmers' chemical, energy and fertiliser businesses are price takers and earnings largely depend on volatile commodity prices.

In the absence of corporate activity and capital management, we anticipate Wesfarmers post-demerger will have lower gearing than Wesfarmers today. The higher equity weighting versus cheaper debt in the capital structure results in a higher preliminary WACC for Wesfarmers post-demerger, at 8.7%.

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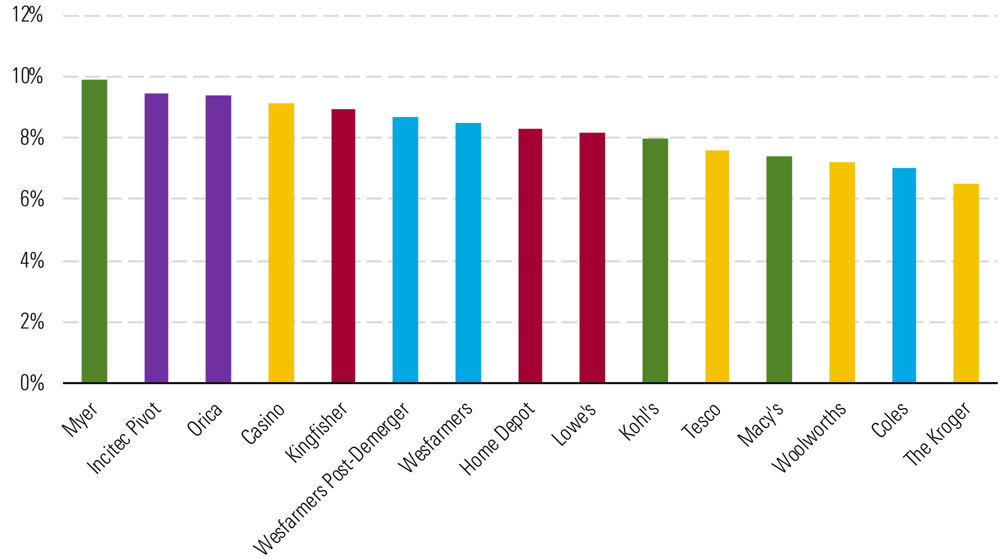
**Exhibit 4** Indicative WACCs of Wesfarmers Post-Demerger and Coles are Comparable With Peers




Source: Morningstar estimates

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**Wesfarmers Post-Demerger Underleveraged Without M&A or Capital Management**

We expect detail on the capital structures of Coles and Wesfarmers post-demerger to be clarified at Wesfarmers' full-year results in August 2018. Management is currently working with the rating agencies to determine the appropriate level of gearing and credit rating for the two entities. In the interim, we endeavoured to create pro forma balance sheets for Coles and Wesfarmers post-demerger, primarily to calculate a discounted cash flow-driven fair value estimate based on differentiated preliminary views on moat on cost of capital. However, the pro forma capital structures also provide a preliminary glance at the returns on capital of Coles and Wesfarmers post-demerger.

**Exhibit 5** Preliminary Split of WES Today's Fiscal 2017 Balance Sheet Between Coles and WES Post-Demerger

| **Pro-forma balance sheets (fiscal year end 2017)** | **Coles** | **WES Post-Demerger** | **WES Today** |
|---|---|---|---|
| Cash | 615 | 398 | 1,013 |
| Inventory | 2,658 | 3,872 | 6,530 |
| Accounts receivable | 537 | 1,096 | 1,633 |
| Other | 0 | 491 | 491 |
| Total current assets | 3,810 | 5,857 | 9,667 |
| | | | |
| Net property, plant and equipment | 4,011 | 5,429 | 9,440 |
| Intangible assets | 2,962 | 1,614 | 4,576 |
| Goodwill | 10,375 | 3,985 | 14,360 |
| Other, including provisions* | 595 | 4,202 | 2,072 |
| Total non-current assets | 17,944 | 15,229 | 30,448 |
| Total assets | 21,754 | 21,086 | 40,115 |
| | | | |
| Current liabilities ex-short term debt | 4,245 | 4,825 | 9,070 |
| Short term debt | 924 | 423 | 1,347 |
| Total current liabilities | 5,169 | 5,248 | 10,417 |
| | | | |
| Long term debt | 2,362 | 1,704 | 4,066 |
| Other long term liabilities | 595 | 1,096 | 1,691 |
| Total non-current liabilities | 2,957 | 2,800 | 5,757 |
| Total liabilities | 8,126 | 8,048 | 16,174 |
| | | | |
| Equity* | 13,629 | 13,038 | 23,941 |

Source: Morningstar estimates, Wesfarmers

Notes: We assume goodwill ascribed to Coles within Wesfarmers Today is transfer to Coles as a standalone entity.

*Other non-current assets and Equity of WES post-demerger include an estimated 20% stake in Coles valued at its equity of AUD 13,629 million.

Wesfarmers announced it is targeting an investment grade rating of BBB+ or BBB by Standard & Poor's for Coles, markedly lower than the current A- credit rating of Wesfarmers today, but in line with Woolworths' BBB credit rating. Coles and Woolworths would be close peers, despite Woolworths operating a more profitable liquor business and group results including the discount

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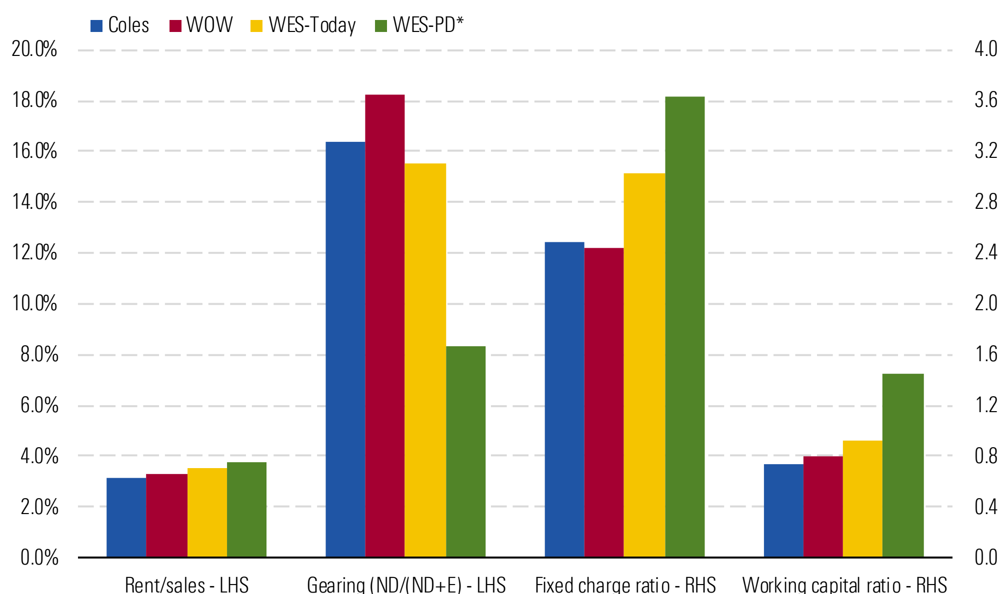
departments store Big W. However, Big W contributes only a relatively small part of the group's profits, detracting 6% from total group EBIT in fiscal 2017.

Management flagged a fixed charges ratio of 2.6 or higher as a key criterion in achieving an investment grade rating. We allocate 61% of Wesfarmers today's debt and cash to Coles, based on the current distribution of capital employed within the group. Hence, we estimate Coles to carry interest bearing debt of AUD 3.3 billion, with a pro forma interest expense of around AUD 160 million based on a cost of debt of 5%. We estimate Coles' rental payments at about AUD 1,240 million, which together with the interest expense equates to fixed financial obligations of approximately AUD 1,400 million. Coles reported an EBITDA of AUD 2,256 million in fiscal 2017, resulting in a pro forma EBITDA plus rent, or EBITDAR, of around AUD 3,500 million. All up, this leaves Coles' pro forma fixed charges ratio, or EBITDAR/fixed financial obligations, at 2.5, just short of management's initial target of 2.6, but in line with Woolworths at 2.5. Lower total debt, a lower cost of debt, and lower actual rental payments, or a combination of these could lift the fixed charges ratio to the required target level. We estimate Coles' pro forma equity at about AUD 13,600 million, based on reported capital employed in Coles of AUD 16,586 million in fiscal 2017, and our estimate of around AUD 3,000 million in noncurrent liabilities.

**Exhibit 6** We Anticipate Coles' and Woolworths' Balance Sheets to Be Similarly Geared




Source: Morningstar
Note: *We modelled pro forma financials for Wesfarmers post-demerger only from fiscal 2018. All other figures are fiscal 2017.

Our preliminary pro forma debt metrics and rent estimates for Coles are broadly in line with those of supermarket giant Woolworths. We harmonised the midcycle inventory days, receivable days, and payable days for Coles with those of Woolworths. Both companies have negative working capital

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with working capital ratios, or current assets divided by current liabilities, of 0.74 for Coles and 0.79 for Woolworths, respectively.

Coles' pro forma gearing and fixed charge cover ratio are lower than Wesfarmers today's. Conversely, Wesfarmers post-demerger's preliminary debt metrics are much improved on Wesfarmers today. We expect the firm would have scope to consider capital management and distribute excess cash to shareholders as the balance sheet, in the absence of a near-term acquisition.

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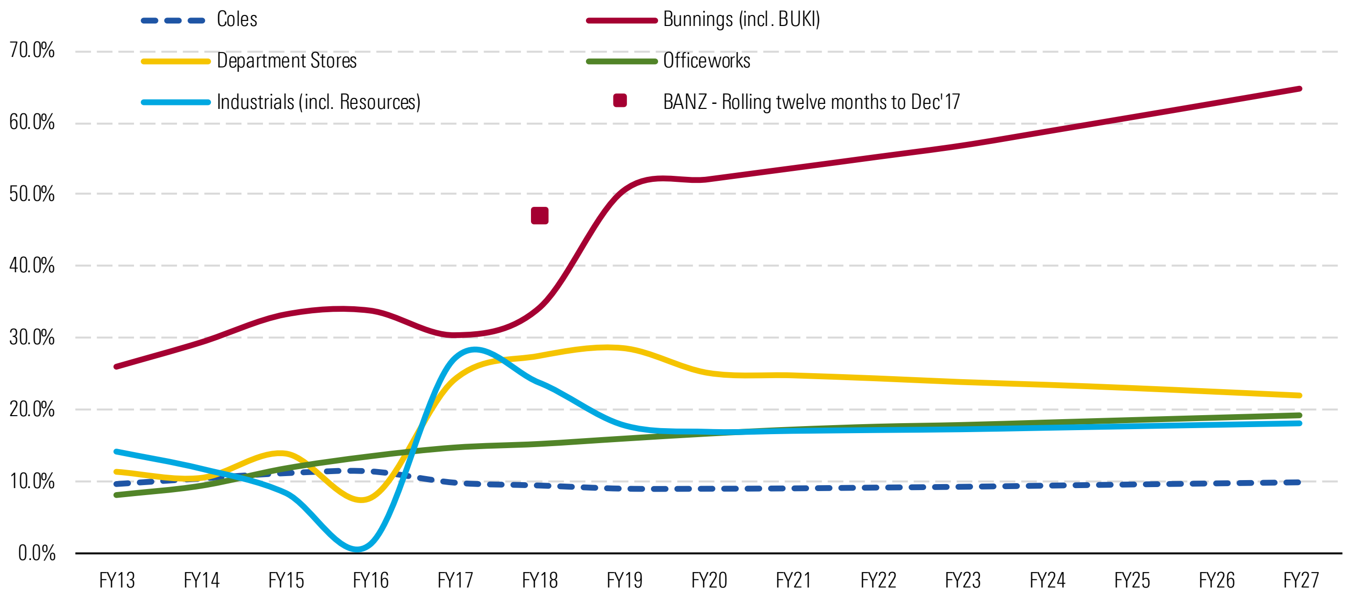
**Bunnings and Coles at Different Ends of Return on Capital and Growth Spectrums**

Wesfarmers' stated primary objective is to deliver satisfactory total returns to its shareholders, or TSR, relative to the broader Australian market index. However, the share price doesn't necessarily always reflect the underlying value of the business and is affected by a number of factors outside of management's control, such as market sentiment. Over the longer term, the growth in the underlying value of the portfolio should be the key driver of share prices and TSR. Therefore, management focuses on growing its key internal performance indicators, return on equity, or ROE, at the group level and return on capital, or ROC, at the divisional level, to achieve its primary financial objective.

In this context, it only takes a quick glance at the ROC of Wesfarmers' individual business segments to understand why management decided to demerge Coles—it is simply a drag on the group's performance. In relative terms, Coles' ROC hasn't grown much in recent years, increasing by some 170 basis points between fiscal years 2013 and 2016. Then, it actually went backwards in fiscal 2017—decreasing by 150 basis points in a single year, almost retuning to its fiscal 2013 level of 9.5%. The lower ROC reflects declining EBIT margins in the segment. These tightened by some 60 basis points in fiscal 2017, due to fierce competition among Australia's supermarket chains.

**Exhibit 7** Divisional Returns on Capital - Coles Is the Weakest Link in a Portfolio Focused on Growing ROC




Source: Morningstar estimates, Wesfarmers
Note: ROC=EBIT/capital employed

The competitive tension in groceries remains high and we expect Coles' EBIT margins to decline further in the near term, falling about 40 basis points to 3.7% by fiscal 2019, and linger around this

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level in the long term[1]. Aldi is established in Australia and is here to stay. The supermarket discounter has structurally disrupted the previous duopoly of Coles and Woolworths, hindering a return to the super-profits the major chains had garnered relative other international markets. Costco and newcomer Kaufland are also eyeing a piece of the action by introducing alternative shopping formats to the Australian consumer, but we expect both chains to mainly compete on price. Corresponding with tightening EBIT margins, we also expect Coles' ROC to decline until fiscal 2019, to 8.9% from 9.7% in fiscal 2017.

Hands down, BANZ is the crown jewel in Wesfarmers' portfolio. Our sales growth and EBIT margin estimates for the business, as well as ROC forecasts—in absolute and growth terms—are second to none in the conglomerate's stable. The business is by far the largest player in the Australian home improvement sector, with an estimated market share of 20%, well ahead of the number two, Metcash's Independent Hardware Group network, at 4%. We forecast Bunnings to increase its market share to 24% of the Australian home improvement market by fiscal 2027—similar to Home Depot's U.S. market share today—fueled by 7% average sales growth in Australia and New Zealand over the next decade.

Bunnings' growth wasn't significantly slowed by the Masters Home Improvement joint venture competitor, albeit against the backdrop of an Australian housing sector going from strength to strength. Masters, owned by Woolworths and Lowe's, closed its last stores in December 2016, five years after it opened its first location and after years of losses. The exit of Masters manifested Bunnings' market-dominant position. However, Bunnings remains exposed to external factors such as housing turnover, value and formation, as well as renovation activity and household disposable income.

We estimate Bunnings' ROC to grow to 70% by fiscal 2027, including the European Bunnings business which we forecast to be profitable from fiscal 2021. This may sound optimistic, but BANZ already returned 47.0% on capital in the 12 months to December 2017, when excluding BUKI's negative ROC of 22.0% in the same period, and was up some mouth-watering 800 basis points from BANZ's ROC of 39.0% in the 12 months to December 2016.

The industrials and department stores segments' ROC benefited considerably from higher coal prices and better performance at Target in fiscal 2017 but were also boosted by significant write-downs. In fiscal 2016, the Target discount department store and the Curragh coal mine were impaired by AUD 1,266 million and AUD 850 million, respectively, both pretax. In fiscal 2017, Target was impaired by another AUD 304 million, pretax. In fiscal 2018, after only just being acquired in February 2016, BUKI was initially impaired and written down by AUD 861 million, pretax, and subsequently sold. Concurrently, Wesfarmers announced a further pretax impairment on Target of AUD 306 million, due to difficult trading conditions in the first half of fiscal 2018 and the poor internal outlook for the discount department store.

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1 For further detail, please refer to our special report "Aldi's Presence Makes a Return to Duopoly-Like Margins Unlikely" published November 29, 2016.

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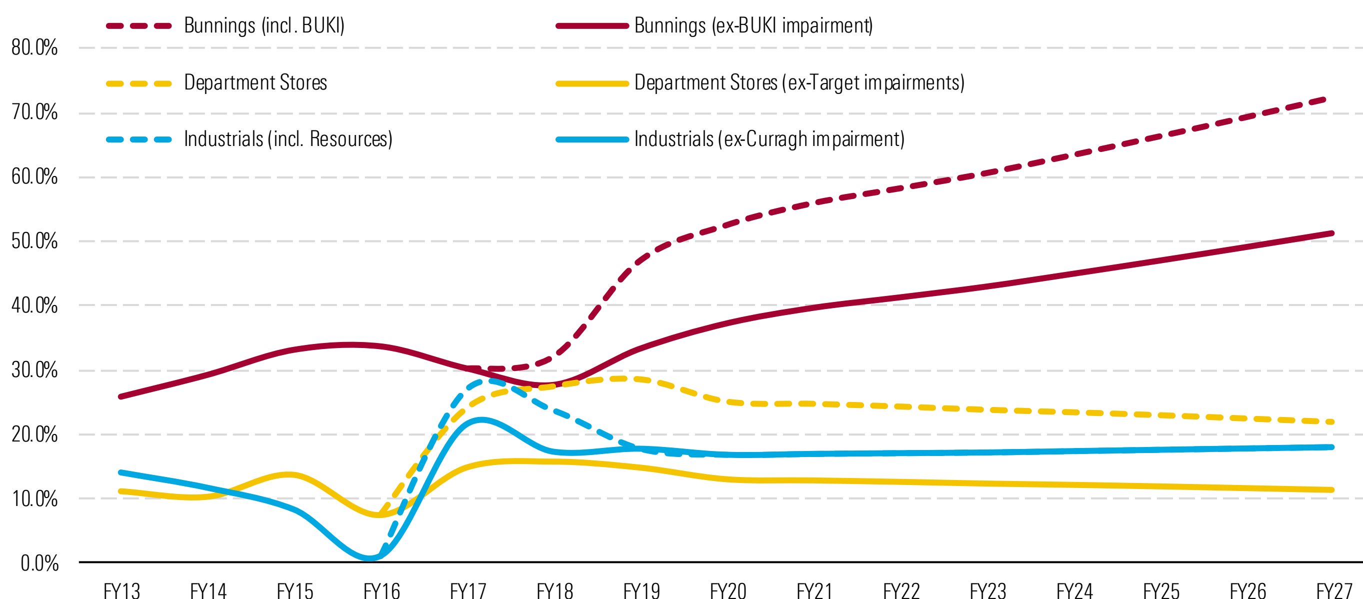
**Exhibit 8** Adjusted Divisional Returns on Capital - Constant Denominators Convey More Muted Returns for Department Stores and Industrials




Source: Morningstar estimates, Wesfarmers
Note: ROC=EBIT/capital employed

On our ROC analysis, the next largest drag on returns after BUKI are the department stores. Despite our forecast for Kmart's sales to increase by 2% annually on average over the next decade, we expect Kmart's EBIT margins to decrease as Amazon Australia gains momentum and competition intensifies. Together with declining sales at Target, which are an average of 3% over the same period, our outlook for the department store segment is muted and we anticipate Wesfarmers will withdraw from this structurally challenged sector over the medium term—at the very least divesting the weaker Target chain.

Removing Coles from the portfolio has a positive effect and on Wesfarmers' ROE, a key metric management relies on to assess the financial performance of the group. We estimate Wesfarmers' fiscal 2018 ROE to increase by some 390 basis points to 16.1% following the demerger of Coles. The strong growth of Bunnings is the key driver of continuing, gradual growth in ROE over the next 10 years.

At Coles, we don't expect material gains from operating leverage with average sales growth of 3% to fiscal 2027, and we expect any efficiency gains are reinvested into price cutting and services, particularly in expanding the online channel. We forecast Coles' EBIT margins in food to hover at sustainable levels of 4% in the long run.

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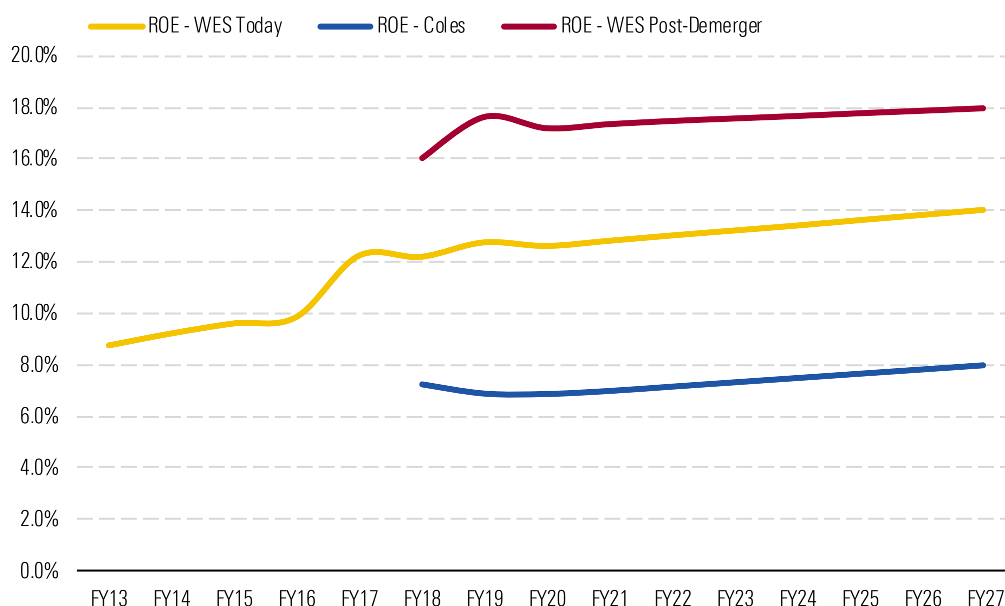
**Exhibit 9** The Coles Demerger Materially Lifts Wesfarmers' ROE




Source: Morningstar estimates, Wesfarmers
Note: We assume goodwill ascribed to Coles within Wesfarmers Today will transfer to Coles as a standalone entity.

At Morningstar, return on invested capital, or ROIC, is our preferred metric in comparing the profitability of companies. Just like ROE, it considers debt, but adjusts for differences in financial gearing. Further, we include capitalised operating leases in our ROIC calculation, which generally present significant financial obligations for traditional retailers.

We expect companies with a durable competitive edge, or an economic moat, to consistently earn an economic profit, that is, their ROIC is consistently greater than their WACC. Wesfarmers today and Wesfarmers post-demerger display ROICs higher than their respective WACC, as do Coles and Woolworths. Wesfarmers' ROIC increases from demerging the lower returning Coles business, strengthening its economic profits. This is an indicator that the overall competitive strength of Wesfarmers also increases with the demerger.

Wesfarmers today has a narrow economic moat sourced from cost advantages due to its significant scale, and the difficult-to-replicate store locations of its Coles and Bunnings businesses, which we estimate will account for 65% of earnings in fiscal 2018. It took Aldi nearly two decades to roll out a store network of close to 500 stores, and create the scale required to run an efficient logistics infrastructure. Masters' challenges in competing with Bunnings were partly due to its much smaller scale, but also its inferior sites across most of its store network. For instance, Bunnings put its hand up to secure only up to 11 of the 63 Masters sites after its competitor ceased operations. BANZ currently operates some 360 stores in Australia and New Zealand.

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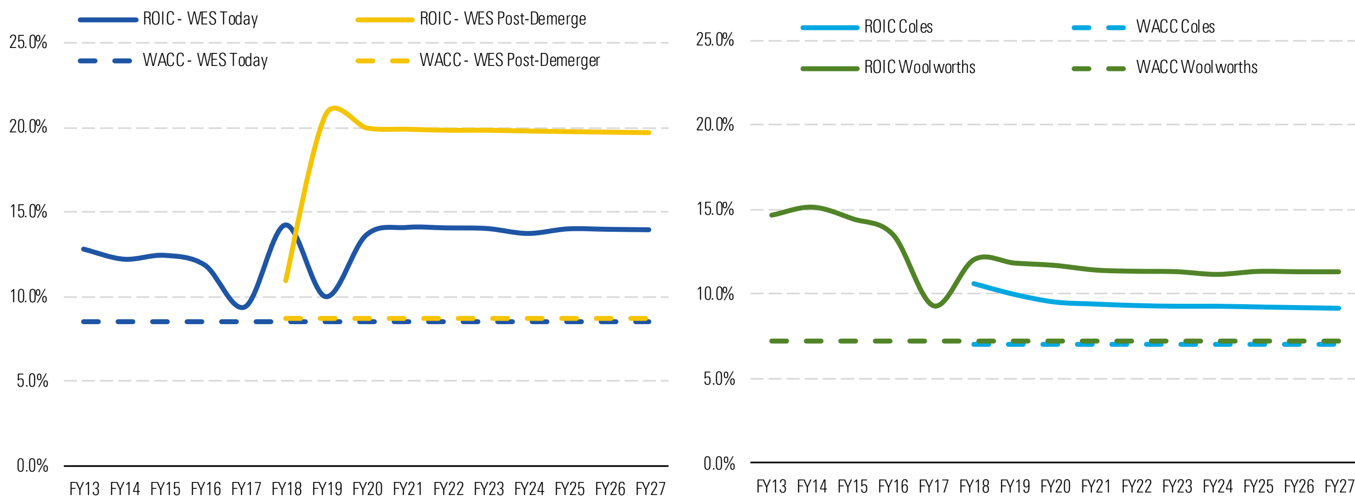
**Exhibit 10** Robust Economic Profits Point to the Presence of Economic Moats for Wesfarmers Post-Demerger and Coles




Source: Morningstar

Morningstar ascribes narrow moat ratings to Woolworths and Kroger, sourced from cost advantages and intangible assets. Woolworths, like Coles, is a fully integrated supermarket, and has an additional cost advantage over independent retailers, including those within the IGA network, but also over smaller greengrocers which have been feeling the pinch recently. For Woolworths, we consider a narrow moat rating to be more appropriate than wide. Aldi is expected to continue expanding its network while improving and broadening its product range over the next decade. Further, there is the latent threat of new entrants to the Australian discount and online channels, but this is unlikely to have a material impact in the foreseeable future. Contrary to this, Tesco lacks an economic moat despite its scale and market-leading position in the U.K., as the market is more fragmented and discounters Aldi and Lidl continue to disrupt the traditional major super market chains.

Our preliminary quantitative ROIC study on Coles, and the similar qualitative metrics to narrow-moat Woolworths, such as its store footprint and size, point towards the presence of an economic moat for Coles. We estimate Coles' and Woolworths' current market share of Australian food and liquor retailing at 38% and 27%, respectively. However, our final determination regarding Coles' moat rating is subject to the performance of a granular review of its business model once there is clarity on its financial structure.

We anticipate Wesfarmers post-demerger to generate greater ROE and ROIC than Wesfarmers today does. The core Bunnings business accounted for 44% of pro forma group EBIT in fiscal 2017. Its strong sales growth and gradually improving EBIT margins, especially against the less profitable business segments, sees Bunnings' EBIT contribution to Wesfarmers post-demerger EBIT rising to 66% by fiscal 2027.

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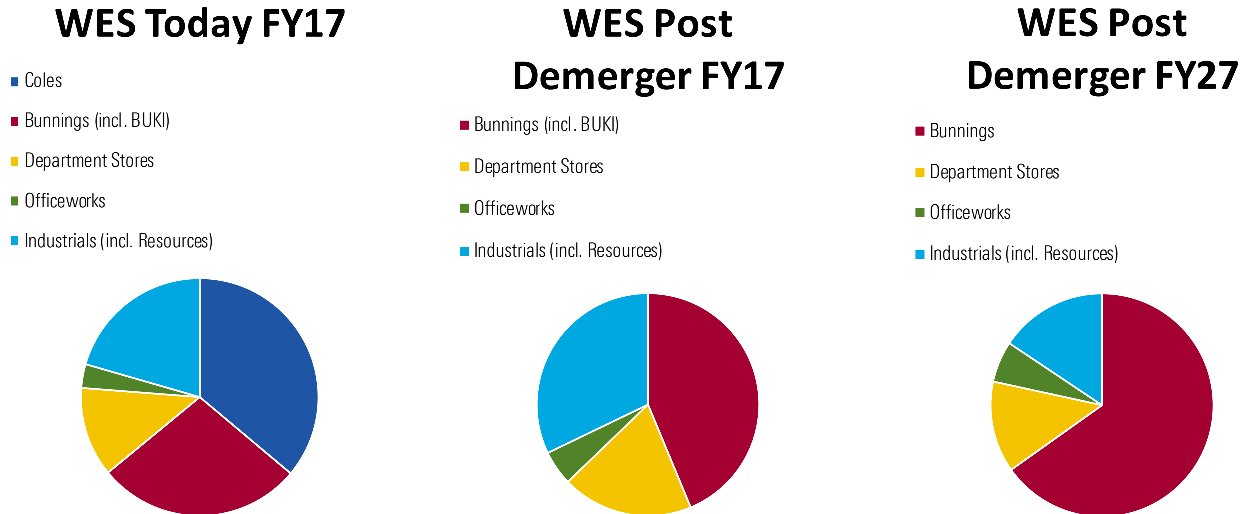
**Exhibit 11** We Expect the Standout Bunnings Business to Increase its Weighting in the Conglomerates Portfolio




Source: Morningstar estimates, Wesfarmers

Qualitatively and quantitatively, Bunnings exhibits strong evidence of cost advantages and intangible assets that would be typical of a narrow or even possibly a wide moat company. For instance, U.S.-listed hardware retailers Home Depot and Lowe's have wide economic moats, while U.K.-listed Kingfisher has a narrow moat. The moat sources of all three peers are cost advantages and intangible assets.

The remaining business segments of Wesfarmers post-demerger, except for Officeworks presenting a mere 5% of group EBIT, largely manufacture commoditised products and are price takers, or are exposed to fierce global competition from online and new entrants. There is little evidence of the presence of an economic moat in the department stores and industrials segments. Again, our final determination is subject to a review by the Morningstar Economic Moat Committee.

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**Exhibit 12** Scale in Hardware and Grocery Retailing Creates Buying Power and Logistic Efficiencies

| Sector | Company | Morningstar Moat Rating | Moat Source | Moat Trend |
|---|---|---|---|---|
| Diversified | Wesfarmers | Narrow | Cost Advantage, Intangible Assets | Negative |
| | | | | |
| Home Improvement | Home Depot | Wide | Cost Advantage, Intangible Assets | Stable |
| Home Improvement | Lowe's | Wide | Cost Advantage, Intangible Assets | Stable |
| Home Improvement | Kingfisher | Narrow | Cost Advantage, Intangible Assets | Stable |
| | | | | |
| Department Store | Myer | None | Cost Advantage | Negative |
| Department Store | Macy's | None | | Stable |
| Department Store | Kohl's | None | Cost Advantage | Negative |
| | | | | |
| Chemicals | Orica | None | | Stable |
| Chemicals | Incitec Pivot | None | | Stable |
| | | | | |
| Diversified | Wesfarmers Post-Demerger | na | Cost Advantage, Intangible Assets | na |
| | | | | |
| Grocer | Woolworths | Narrow | Cost Advantage, Intangible Assets | Negative |
| Grocer | The Kroger | Narrow | Cost Advantage, Intangible Assets | Stable |
| Grocer | Tesco | None | | Stable |
| Grocer | Casino | None | Cost Advantage | Negative |
| | | | | |
| Grocer | Coles | na | Cost Advantage, Intangible Assets | na |

Source: Morningstar

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