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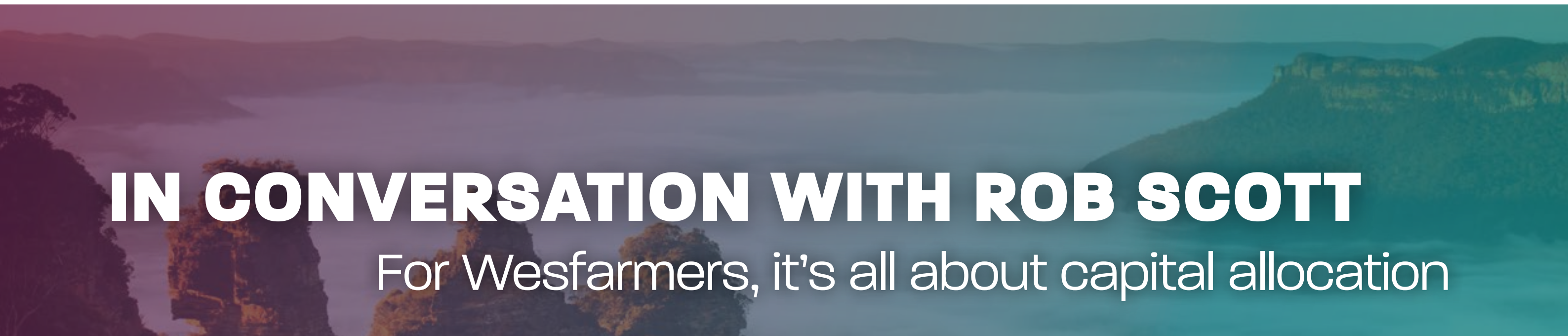

IN CONVERSATION WITH ROB SCOTT

For Wesfarmers, it's all about capital allocation

Rob Scott, Managing Director and Chief Executive of Wesfarmers

Emma Fisher, Portfolio Manager & Head of Research

Rob Scott, Managing Director and Chief Executive of Wesfarmers, spoke with Emma Fisher, Portfolio Manager of the Airlie Australian Share Fund, about his first decisions in charge, why he demerged Coles, why the conglomerate model works for Wesfarmers when it has mostly failed elsewhere, how the company approaches capital allocation, what he looks for in acquisitions, and why he made 'entrepreneurial spirit' a Wesfarmers value.

Q: Tell us about the person in charge of Wesfarmers, even how you won a silver medal for rowing at the Atlanta Olympics.

A: I grew up in Western Australia. My parents were teachers and I got dragged around the regional areas of the state. Having to cope with change became a formative experience for me. My father was a physical education teacher so sport became a big part of my life. I didn't row at school but I participated at a rowing club and liked the teamwork and the physical demands. Being tall with a big lung capacity, I had some capability but I'm an underachiever compared with my wife who won a gold medal in water polo.

Q: What skills do you use as CEO that were fostered during your sporting career?

A: This might sound like a bit of a cliché but many attributes within high-performance sport – the determination, discipline, teamwork and resilience – are important in all aspects of life. The thing I missed most when I stopped professional sport was being with people who every day were trying to be the best in the world. It's inspiring to be surrounded by that sense of ambition. Most athletes don't become the best in the world but it's an addictive thing to be part of. When I finished serious sport, I wanted to associate with people who wanted to do something special. That's what attracted me to Wesfarmers.

Q: You started your business career at Wesfarmers. Could you talk us through the journey to the top?

A: I started as a graduate in Perth in a financial role in the corporate centre in 1992 just after the Barcelona Olympics. At the time, I wanted to row at the Atlanta Olympics. But to do so, I needed some flexibility with my career. Fortunately, Michael Chaney, the CEO of Wesfarmers at the time, gave me the flexibility to pursue rowing. I finished my professional year studies in accounting and did other post-graduate work while training for the Olympics. But, for rowing, I had to move to Sydney where I joined Ernst & Young and then moved into investment banking. In 2004, now in Hong Kong with one child, my wife and I wanted to move back to Australia. I rang Wesfarmers and asked if I could return and the company said yes. I have found many people inspiring throughout my career. At Wesfarmers I've been fortunate to observe some great leaders. Trevor Eastwood, Chaney and Richard Goyder had unique capabilities. I've picked up aspects of what each did well and tried to incorporate those attributes in how I work.

> **"We encourage our divisions to think openly about how they can invest, improve efficiency, strengthen theircompetitive positions and create new revenue streams."**

Q: The share price was stagnating when you took charge of Wesfarmers in 2017. What decisions did you take in your first year that led to a higher share price?

A: As a conglomerate intent on delivering satisfactory returns to shareholders, we had to focus on capital allocation. Our goal is to deliver top-quartile shareholder returns over the long term. It was obvious we couldn't do that with the portfolio of assets I inherited. Thus the decisions to exit our Bunnings investment in the UK and to demerge Coles. They were not easy decisions because it's unusual for big companies to shrink to greatness.

Q: What were the lessons from the Bunnings UK investment?

A: The UK venture was about rolling out the Bunnings model in the UK by taking over a UK hardware business. The idea that Bunnings could be successful in the UK was probably correct but we approached it in the wrong way. We bought a business that had many flaws and we were retrofitting the Bunnings model into this broken business. We too quickly removed the management who knew how the business worked and put in our team who lacked UK knowledge and experience.

Q: Airlie generally supports divestments and spinoffs because, even though they shrink a business, they often unlock value. What did the demerger with Coles achieve for Wesfarmers?

A: Spinoffs often make sense because they refocus management and can provide greater access to capital. These reasons, however, didn't apply with the Coles spinoff because we already had a disciplined and capable management team that had access to capital and had incentives to drive the performance. But the critical issues for us were that supermarkets are capital-intensive and complex businesses and their growth outlook was only moderate. Our concern was we had more than 60% of our capital deployed to a business that was only expected to generate modest returns. It was hard to see how we could deliver top-quartile shareholder returns. Another problem was that running a supermarket chain such as Coles is relentless. Our corporate team was probably spending 70% to 80% of its time on Coles. Spinning off the supermarket chain freed capital and the leadership team in ways that we thought would prove more rewarding to shareholders.

Q: Now that Coles is gone, how do you split your time?

A: The two most important types of decisions a CEO makes are around capital allocation and leadership. A lot of my focus now is engaging with the managing directors of each of our businesses on the strategic focus within the business and thinking about capital-allocation opportunities. Now more than half of my time is focused on growth and opportunities whereas four years ago 90% of my time was caught up with fixing things.

Q: Conglomerates have chequered histories. They were a glamorous business model in the 1970s but not since. How does Wesfarmers regard its conglomerate business model? Why are businesses better off within the Wesfarmers stable?

A: Conglomerates that have struggled have provided useful lessons. One is they have often proven poor allocators of capital. They've often pursued growth for the sake of growth rather than to boost shareholder returns. Another lesson is they've often had centralised decision-making that disempowered their operating businesses. These bloated corporate offices tended to create too much complexity for the business units. We try to avoid these pitfalls. We have a lean corporate office and are disciplined around capital allocation. We have a strong focus on returns rather than on growth for the sake of growth. We have this autonomy model that empowers our divisional teams. Importantly, we shelter our operating businesses from the distractions of capital markets so they can best do what they do. In many ways, our business model provides us with a competitive advantage. Our business leaders often say how they like doing their jobs but they'd hate to do mine. That's great. The leaders running our divisions spend their time running Bunnings and Kmart knowing they have a long-term shareholder behind them.

Q: A large part of your role is capital allocation. How, from a cultural perspective, do you manage competitive tensions between business units for capital, while maintaining this culture where everyone is focused on the long term.

A: Our approach is to think that capital is unlimited but investment opportunities are limited. We don't adopt a capital-rationing approach. We don't set capital budgets for the year and tell managers to spend it or lose it. With many companies, one of the problems is people think that capital budgets are locked in stone and if they don't spend the capital they're going to lose it. The right approach is to question whether capital will generate appropriate returns to shareholders. We encourage our divisions to think openly about how they can invest, improve efficiency, strengthen their competitive positions and create new revenue streams. Some of the projects that divisions initiate get developed in a collaborative way by others. Take, for example, our recent investment in lithium. That was a collaborative process between our chemicals team in our fertiliser division and our central business-development team.

Q: What do you think makes a great business?

A: When we invest in businesses, we always start with value. We ask: Are we confident that if we allocate capital to this opportunity it will deliver a better return than our cost of capital over the next five to 10 years? We're always focused on the competitive

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position; what will give a business the ability to deliver superior returns? We're pragmatic about what might add value to a business, what we can do with the business that others can't. We analyse a business's reputation around environmental, social and governance issues. If a business promised good returns but compromised our corporate reputation we'd be concerned about that.

Q: How do you bring together a team? What are you looking for in the senior people that you hire?

A: The leadership team in Wesfarmers has developed a good balance between divisional autonomy and coming together on strategic issues. This has especially been our approach during the pandemic. On many occasions, the leadership team has come together to make some big calls such as committing to pay our staff through Melbourne's long lockdown and offering paid pandemic leave for our staff, including casual staff.

Q: The best management teams can articulate their values. What are the Wesfarmers values?

A: We have a number of core values. We focus on accountability and openness, which are crucial given our divisional autonomy model. We define openness as bad news flowing faster than good news. Another crucial value is integrity. Every business talks about integrity as a value. For us, it's about what we do day to day and how we deal with problems that arise. And finally, there's 'entrepreneurial spirit'. I changed the value of 'boldness' to entrepreneurial spirit because it has greater meaning within the company. Wesfarmers has been around since 1914 and it's always had an entrepreneurial streak. As we get bigger, I want everyone to keep that spirit. Some of the best examples of entrepreneurial spirit occur in our Bunnings and Kmart stores rather than in head office.

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