Open briefing with M A Chaney on first quarter results

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Wesfarmers Limited recently announced an operating profit after tax before abnormals of $42.6 million for the quarter to September 30, 2000. Why was the result well ahead of your budget?

CEO Michael Chaney
It was principally because of strong performance in the Energy division, continued good performance in Hardware and Forest Products and an improvement in Rural.

The performance of the Energy division was boosted with the inclusion of revenue and profits from Curragh coal operation in Queensland, which we acquired late last financial year. Curragh performed ahead of expectations and Bengalla, our NSW coal operations, was also a little ahead of expectations.

Higher international LPG prices helped our gas export business, although Kleenheat incurred some margin squeeze domestically as a result.

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On 30 October, 2000 you announced that the Australian Railroad Group, comprising Wesfarmers and Genesee & Wyoming Inc., had been successful in its bid to acquire the Westrail Freight business for $585 million. What does Genesee & Wyoming Inc., bring to the joint venture?

CEO Michael Chaney
They operate about 20 railroad businesses in the USA. These businesses are relatively small, but Genesee & Wyoming Inc., have extensive expertise in delivering goods from A to B by rail. Genesee & Wyoming Inc. bought the South Australian rail freight operations 3 years ago and have managed to significantly increase the profits by reducing costs and increasing volumes, for example the proportion of grain transported by rail.

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Westrail was previously government owned. In what areas can it improve its services and performance?

CEO Michael Chaney
It is actually a pretty well run operation.

We have given an undertaking not to reduce employment in the first 2 years. During that time we will be able to evaluate resourcing needs. There will be some potential for cost savings, but we are looking more to revenue growth over time.

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What is Westrail's earnings history and what are the significant business risks?

CEO Michael Chaney
Westrail's earnings have reduced in the last few years, although they have stabilised more recently. Earnings declined principally because of a fall in carriage following the Asian crisis. There was a reduction in carriage of iron ore and mineral sands, which were primarily for export. The reduction in mining activity in Western Australia at that time also resulted in lower demand for mining supplies and fuel.

We believe the business risks are moderate. There is some risk related to competition because there will be an open access arrangement on the railway. The current contractual arrangements with its major customers are good. We believe competitive risk can be managed acceptably, in particular because the Australian Railroad Group owns the South Australian network.

In terms of business opportunities, there will be new investment projects commencing within Western Australia and there is also a chance to attract some business currently transported by road.

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Are there any synergies with Wesfarmers' road transport business or will they be competitors in the market place?

CEO Michael Chaney
In a sense, neither.

There are limited synergies. There is some potential for railway and road transport combinations. With regard to competition, Wesfarmers’ road transport business generally operates in different commodities and different areas than Westrail.

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The acquisition will be earnings per share positive from the outset. When do you expect Australian Railroad Group to reach your hurdle rate of return on investment?

CEO Michael Chaney
We use an internal rate of return measure in assessing what acquisition price we should pay. An internal rate of return is calculated using discounted cash flows over several years. We bid a price for Westrail that achieves an internal rate of return which is higher than our hurdle rate required on investments.

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In addition to the purchase price of $585 million, the joint venture intends to outlay up to $400 million over the next 5 years on track upgrades and the purchase of new rolling stock. Following the purchase, what will be your net debt to equity ratio?

CEO Michael Chaney
We estimate that at June 2001, our net debt to equity ratio will be about 75 percent.

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Is your long-term net debt to equity target of 40-65 percent still valid?

CEO Michael Chaney
75 per cent is above our 40-65 percent preferred range, but we are still very comfortable with it because of our strong cash flow. As an illustration, we estimate our cash interest cover in the current financial year will be over nine times. This compares to our minimum requirement of four times.

The 40-65 per cent range is a rule of thumb and we are happy to be outside that range from time to time. It is not always possible to stay within it.

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Hardware and Forest products revenue was up 22 percent, after adjusting for the change of accounting treatment of GST compared to the wholesale sales tax system. The market has been expecting a slow down in sales post GST. Did you experience any sales softness due to the GST?

CEO Michael Chaney
No. We don't seem to have suffered at all. In July, our retail sales continued to be strong.

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What about any softness in September because of the Olympics?

CEO Michael Chaney
The Olympics had no noticeable impact either. That was pleasing because we have noticed, for example, when there is a big football game on a Saturday afternoon on television in Western Australia, our sales can be significantly affected.

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What level of growth do you plan for warehouse stores in the current financial year and in which year will the rate of growth slow?

CEO Michael Chaney
We expect to open 10 stores this year and around 15 in FY2002. We are forecasting 10-15 per annum thereafter.

Time will tell how long that sort of rollout will continue. My feeling is that we may achieve 10 years of that level of new warehouse store growth because we have potential for more in-fill warehouse stores, the smaller format, as well as the larger ones.

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Coal recorded a profit contribution which was above expectations. Since you acquired Curragh coal operations in June 2000, what has been the experience with spot coal prices?

CEO Michael Chaney
Curragh's coal is all sold under contract, but obviously the level of spot prices would ultimately impact on contract price negotiations. Spot prices are also important for Bengalla because some of its coal is sold in spot markets.

In the last year, spot prices have moved up towards contract prices in the high US$20s per tonne. The coal industry view is that contract prices should increase in the next round of price negotiations, which take effect from 1 April 2001.

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With spot coal prices stronger and the exchange rate lower, are you ahead of expectations on this investment?

CEO Michael Chaney
Yes, we are quite a bit ahead of expectations. We try to be conservative in our project analysis of new acquisitions. The production levels are above budget and the coal quality mix is more favourable so that our average US dollar sales price is higher. We have also received an additional $1 million in EBIT for the quarter because of the lower Australian dollar.

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Has there been any progress on negotiating cheaper freight rates for Curragh coal operations?

CEO Michael Chaney
We have extended our existing contract until mid 2001 to give us the opportunity to negotiate the best possible rate.

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In the quarterly report you announced you had been granted an additional mining lease known as Curragh East. Will this enable you to increase Curragh's output in the medium term or will it just have the impact of extending the Curragh operation's mine life?

CEO Michael Chaney
It was part of our original plan to lift production from 4.5 to 5.5 million tonnes over the next few years and acquiring Curragh East will enable us to do that.

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The commissioning of the LP gas extraction plant expansion at Kwinana is scheduled to be completed by early calendar 2001. What financial impact will this have on Wesfarmers?

CEO Michael Chaney
It should add a couple of million dollars in EBIT and about 35,000 tonnes to extracted LPG volumes in the second half of the year.

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Fertiliser sales tonnages in the quarter were significantly above the corresponding three months last year due to the late break to the season in Western Australia. Did the increase in the first quarter sales tonnages offset the weakness in the June quarter last financial year?

CEO Michael Chaney
It did, but the increased sales were all at very low margins. Last year we under priced some of our fertilisers, particularly urea. The main increase in volume in the September quarter was from urea sales, so the impact on profit was not great.

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Commodity fertiliser prices were depressed last financial year due to intense competition. Has the market stabilised and what is the current trend in fertiliser prices?

CEO Michael Chaney
There has been a reasonable increase in international prices and margins have improved. Urea prices rose about 30 percent early in the financial year, although they have come off a little recently. We have managed to put through two price increases.

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Operating revenue of the Rural and Insurance division was up 15 percent because of higher sales in merchandise and strong wool and livestock prices. What is driving wool and livestock prices higher and can they be sustained?

CEO Michael Chaney
The main positive factor for both is the low Australian dollar.

At around current levels of the Australian dollar, cattle prices in Australia are expected to remain firm despite some weakness in the Japanese market and high levels of beef production in the U.S.

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Since July, you have been pursuing the merger of Wesfarmers Dalgety with IAMA Limited. What is the current state of play?

CEO Michael Chaney
The IAMA board is currently considering a merger proposal put by us last week. They apparently received a proposal from Futuris at the same time.

The main issue is there is a litigation action brought by Futuris, which has now been deferred for hearing until the 8th January. In the meantime, the IAMA board is considering the merger proposals.

Our view remains that it makes sense merging Wesfarmers Dalgety and IAMA. In the event that does not occur, Wesfarmers Dalgety should continue to be a profitable and growing business.

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Do you expect to reach your new target of a 16 percent return on shareholders' funds for the full year ending June 30, 2001?

CEO Michael Chaney
Yes.

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Thank you Michael. We look forward to the next Open Briefing with Wesfarmers.