FINANCIAL REVIEW

NEWS WEBSITE OF THE YEAR

The following is an article written by Senior Companies Reporter Sue Mitchell which appeared on the Australian Financial Review website on 31st May 2018.

British home improvement expert Steve Collinge knew from day one Wesfarmers' foray into the £40 billion market would eventually end in tears. The first alarm bells rang within weeks of Wesfarmers' $705 million acquisition of struggling hardware chain Homebase from the Home Retail Group in February 2016. Wesfarmers replaced almost the entire Homebase board and sacked more than 140 staff from Homebase's head office in Milton Keynes. Almost overnight, hundreds of years of British home improvement and general retail expertise walked out the door.

"They wanted a total transformation and anything to do with the old business was seen as bad," Mr Collinge, a 30-year veteran of the UK home improvement market, told The Australian Financial Review. "They wanted everybody out of the way so they could steamroll what they believed would be something like a Costco or Ikea point of difference to the UK market.

"The reality was they were launching into the UK a B&Q [Britain's largest home improvement chain] from 1998 – they were delivering what British consumers had seen at B&Q 20 years ago. It was so old-hat, so old-fashioned." By the spring of 2016, Bunnings UK and Ireland (BUKI) had started removing popular products such as Laura Ashley pillows and Habitat picture frames – which had helped Homebase differentiate itself from rivals – and reducing prices to compete with B&Q.

"In a 12-week period, prices fell by as much as 20 per cent across more than 10,000 lines," said Mr Collinge, a former ICI Dulux sales and marketing director who now runs a DIY consultancy, Insight Retail Group, which tracks prices across the entire home improvement sector. Wesfarmers studied the UK market for two years before making its move and spent six months walking stores and speaking to suppliers as part of its due diligence before agreeing to pay £340 million ($705 million) for Homebase and committing another $1 billion to convert the 240-store chain into the British version of Bunnings.

But Mr Collinge says Wesfarmers' due diligence apparently failed to pick up the fact that concessions such as Laura Ashley and Habitat were generating rental income of almost £25 million a year and accounted for much of Homebase's annual £25 million profit.

"They removed some of the key reasons for people to shop," said Mr Collinge, who started analysing Wesfarmers' strategy in fortnightly blogs and quickly became a key source of information for Wesfarmers investors and analysts. "[Homebase's] target market was predominantly women who went there for a different shopping experience – [suddenly] they had no reason to go anymore, they stopped coming," he said. Bunnings then replaced Homebase's range of aspirational kitchens with a cheap and cheerful range of flat-pack kitchens modelled on Bunnings' Kit & Kaboodle range and removing installation services.

Kit & Kaboodle is a popular choice for Australian holiday homes and granny flats but the new range didn't appeal to homeowners in Wimbledon, Ruislip or Stoke on Trent. "This misunderstanding of the complexity of the UK kitchen business … had a devastating impact on the kitchen and bathroom business," Mr Collinge wrote in one of his blogs, estimating the change cost Homebase between £60 million and £80 million in annual sales. As kitchen and bathroom sales tanked, so too did demand for related products such as sinks, taps and tiles, wiping off another £20 million to £30 million in annual sales.

By the time the first new-format Bunnings store opened in February 2017, Homebase was losing $48 million on sales of $1.03 billion, but Wesfarmers chief executive Richard Goyder reassured analysts and investors, saying he was happy with the progress. Mr Collinge claims that when the first new-format Bunnings stores opened Wesfarmers took its eye off the Homebase stores, where sales were falling at an alarming rate. "It was a copy and paste of Bunnings [in Australia] and there was very little effort to differentiate it in any way or tailor it to the local market," he said.

"These Bunnings stores from day one were hugely unprofitable because they were price matching B&Q, dropping prices in some cases by another 10 or 15 per cent. They had to be lowest in the market." By August 2017 it was obvious to all that Wesfarmers had a serious problem in the UK. BUKI lost $89 million on sales of $2.07 billion in the year ending June and Mr Goyder admitted for the first time that the pace of change had taken a toll. By February 2018 BUKI's half-year losses had blown out to $165 million, prompting new Wesfarmers chief Rob Scott to announce a strategic review, the retirement of BUKI boss, Bunnings veteran Peter Davis, and flag $1.02 billion in writedowns and provisions. Former Bunnings managing director John Gillam, another architect of the UK expansion, had resigned in December 2016.

Mr Collinge was not surprised when Mr Scott announced on Friday that Wesfarmers had struck a deal to sell Homebase to US debt specialist Hilco Capital for a nominal sum, believed to be £1. Wesfarmers will book further losses of about $400 million in pension liabilities and transaction costs, taking total losses and writedowns to more than $1.7 billion. But crucially the deal enables Wesfarmers to avoid almost $2 billion in lease obligations if it had decided to pull the plug. Mr Scott, who was not involved in the decision to enter the UK, has been quick to admit that Wesfarmers made mistakes in strategy and execution and much of the damage was "self-inflicted".

"The initial strategy was to rapidly reset the Homebase business to facilitate conversion to Bunnings," Mr Scott said in February. "(But) the pace and nature of this change was not well received by Homebase customers and significant management change led to loss of local knowledge."

His mea culpa has helped mollify angry investors, but questions remain over how Wesfarmers, which prides itself on its disciplined approach to investment and allocation of capital, could have got it so wrong. Chairman Michael Chaney this week defended the due diligence process but said that, with hindsight, Wesfarmers would have done things differently. "It was a very thorough investment investigation," Mr Chaney told the Financial Review.

"They spent six months visiting stores and talking to suppliers and customers and they came up with a very thorough analysis of the model and the business and what they would do about it," he said. "With hindsight, as you've heard from Rob Scott, some of the things we have done we would have done differently. "We removed 40 per cent of the products because they weren't suitable in our view but customers were looking for them. With hindsight we might have tested the concept in a small number of Homebase stores and seen how they had gone." Mr Chaney also regrets the decision to remove Homebase's senior management team.

"We were of the view they weren't of the standard we required – what we missed out on was some local knowledge on things like seasonality," he said. "If you were making an investment again you'd think twice about that. "We had in Bunnings one of the worlds' great retail teams and you tend to back proposals that they come up with." The problem for Mr Scott, who is searching for new sources of growth after demerging Coles and selling the bulk of the coal assets, is that investors will be more sceptical about future acquisitions, particularly offshore expansion.

As former Wesfarmers executives face losing long-term incentives or handing back bonuses, shareholders are also demanding the board take responsibility and adopt a more conservative approach to future investment proposals. "The board needs to be more accountable and at least know ... enough to ask the right questions of management," said Argo Investments managing director Jason Beddow.

Mr Chaney confirmed long-term incentives would not vest for several senior executives as a result of the BUKI impairments and the penalties would be revealed in Wesfarmers' 2018 remuneration report. However, he ruled out changes to Wesfarmers' approach to evaluating investments or its return hurdles.

"I'd hope the board doesn't need to change the way it sees things," he said. "We have had long-standing methods of evaluating projects and I don't think they will change. But there are lessons to be learned by everyone." After negotiating a better than expected exit from the UK, Wesfarmers is keen to put the BUKI debacle behind it as quickly as possible and rebuild its credibility with investors.

But Mr Collinge says there is more pain to come for 12,000 Homebase staff, some of whom will lose their jobs. He expects Hilco to close or sell at least 60 Homebase stores shortly its takes control on July 1 to retailers such as B&Q owner Kingfisher, Travis Perkins, discounter B&M Retail, The Range and where planning permission allows even Aldi and Lidl.

He fears the remaining business may be put into administration, mirroring Hilco's involvement in the demise of the UK's third largest home improvement chain, Focus DIY, which found itself in an almost identical position in 2011. "Wesfarmers are going to walk away, things will move on in the UK and they'll get away with it and their reputation in Australia and New Zealand will be intact," said Mr Collinge. **"But over here I'm gunning for them ... they wrecked this business,"** he said.

"I want people to be aware of what's really gone on here and for people not to think this is just another example of the retail Armageddon that is happening in the UK at the moment. It's not – this is very, very poor management decision making and poor execution."

Source: Australian Financial Review