DEVELOPING A ROBUST CAPITAL MANAGEMENT FRAMEWORK

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Capital Management Strategic Pillars

Seek to increase shareholder value through the following objectives:

1. **Maintain Financial Strength & Flexibility**
2. **Provide for Sustainable Investment**
3. **Offer Strong Returns to Shareholders**
4. **Optimise Cost of Capital, Funding & Liquidity Costs**

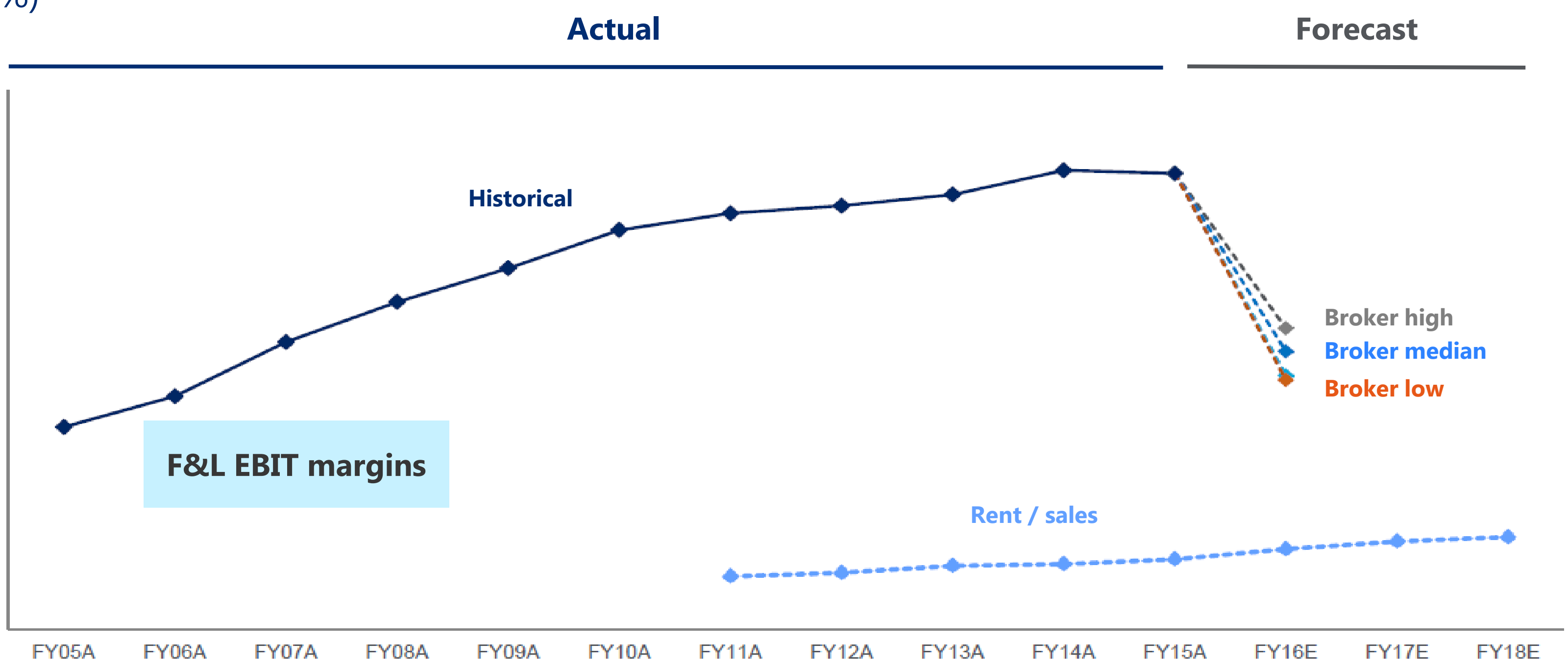
Maintain Financial Strength & Flexibility

- Determine your financial risk appetite
  - Ability to withstand market shocks
  - Ensure no competitive disadvantage
  - Adjust for industry and competitive threats
  - Regardless of the measures, the objective is to take advantage of strategic opportunities, target a level of financial flexibility to withstand operating volatility, maintain a safe buffer to debt covenants and to provide the widest access to low cost funding
  - Can use target rating metrics as a proxy for risk appetite

Maintain Financial Strength & Flexibility

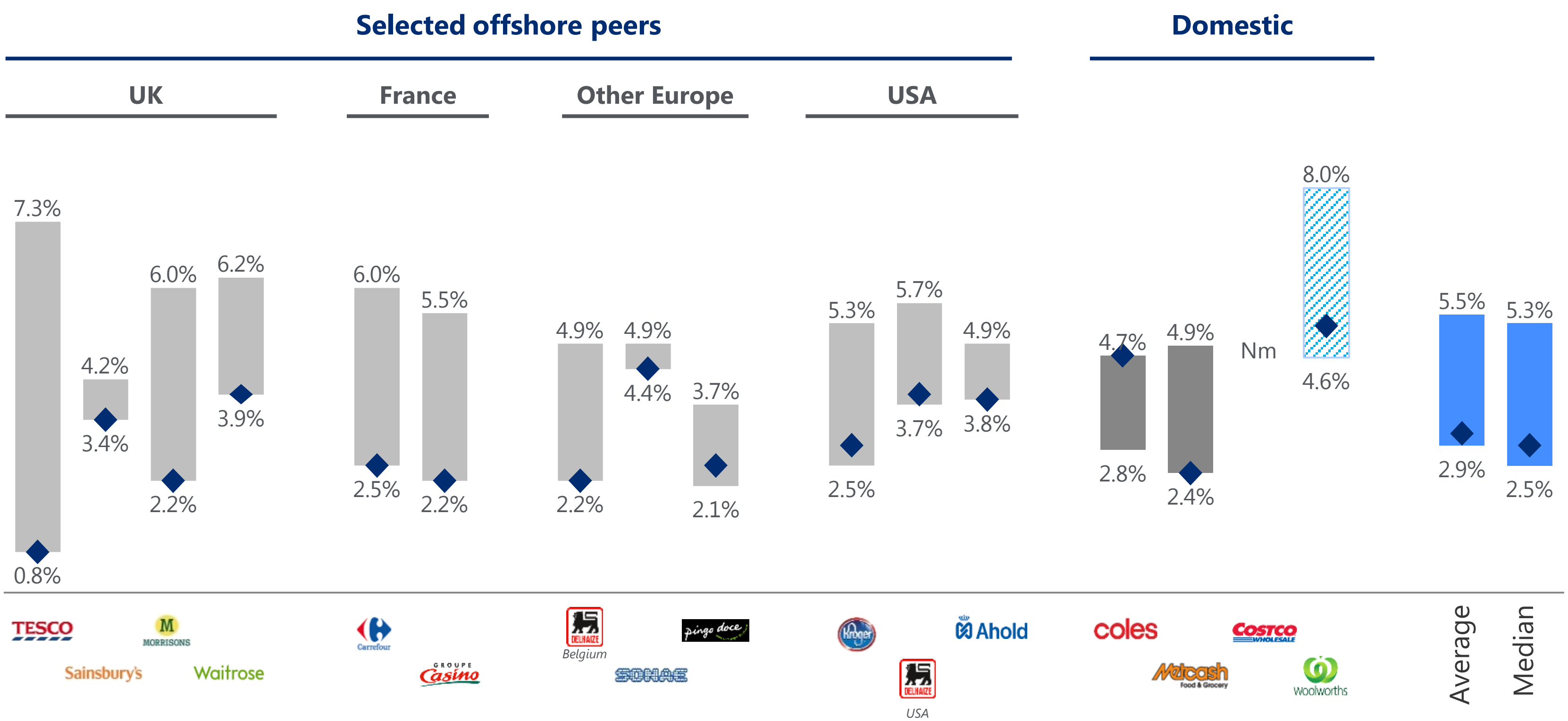
Margin deterioration analysis—things can change quickly

Food & Liquor EBIT margins
(%)



Maintain Financial Strength & Flexibility

Margin deterioration analysis



◆ Current EBIT margin (%)

■ Historical EBIT margin range (%)

Maintain Financial Strength & Flexibility

Cross Industry Examples

- Qantas
  - Overlapped earnings shocks – early 90's recession, Gulf War I and II, SARS, September 11, GFC and grounding of fleet.
- AMP
  - Life insurance strain, bank contagion, GFC (equity and interest rate shocks)
- Santos/Origin
  - Falling oil prices and investment
- Financial institutions
  - GFC
- Rio Tinto, BHP
  - Commodity price corrections over the past three years

Maintain Financial Strength & Flexibility

Summary Conclusions

- Understand your corporate strategy and align your financial risk appetite accordingly
- Know your business and where you fit in locally and globally
- Be a student of history (use this in stress tests)
- Don’t always rely on earnings strength, look to strong balance sheet measures

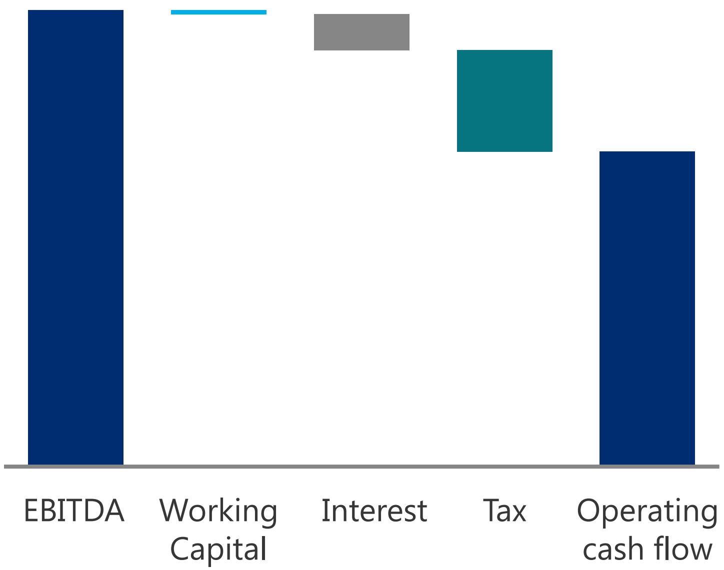
Provide for Sustainable Levels of Investment & Growth

- How much capital is required to protect your business franchise?
  - Determine available funding through following cash
  - Understand maintenance vs growth capital requirement
  - Ageing of assets versus financial capacity
  - What are competitors doing (e.g. Amazon 100% re-investment)
  - Dividends are an out working not a driver of capital requirements

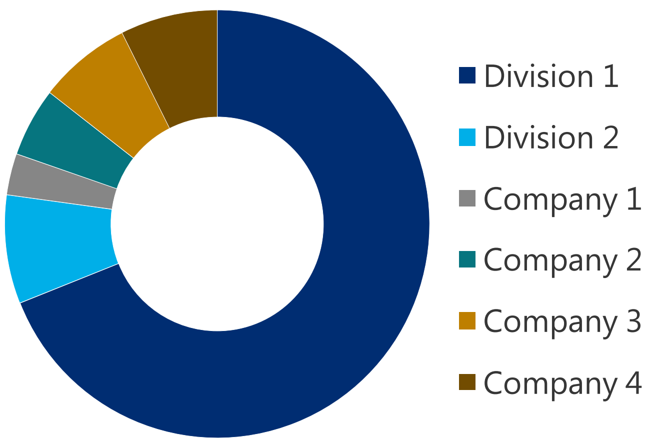
Provide for Sustainable Levels of Investment & Growth

Available funding analysis

Annual available funding (for dividends and capex)

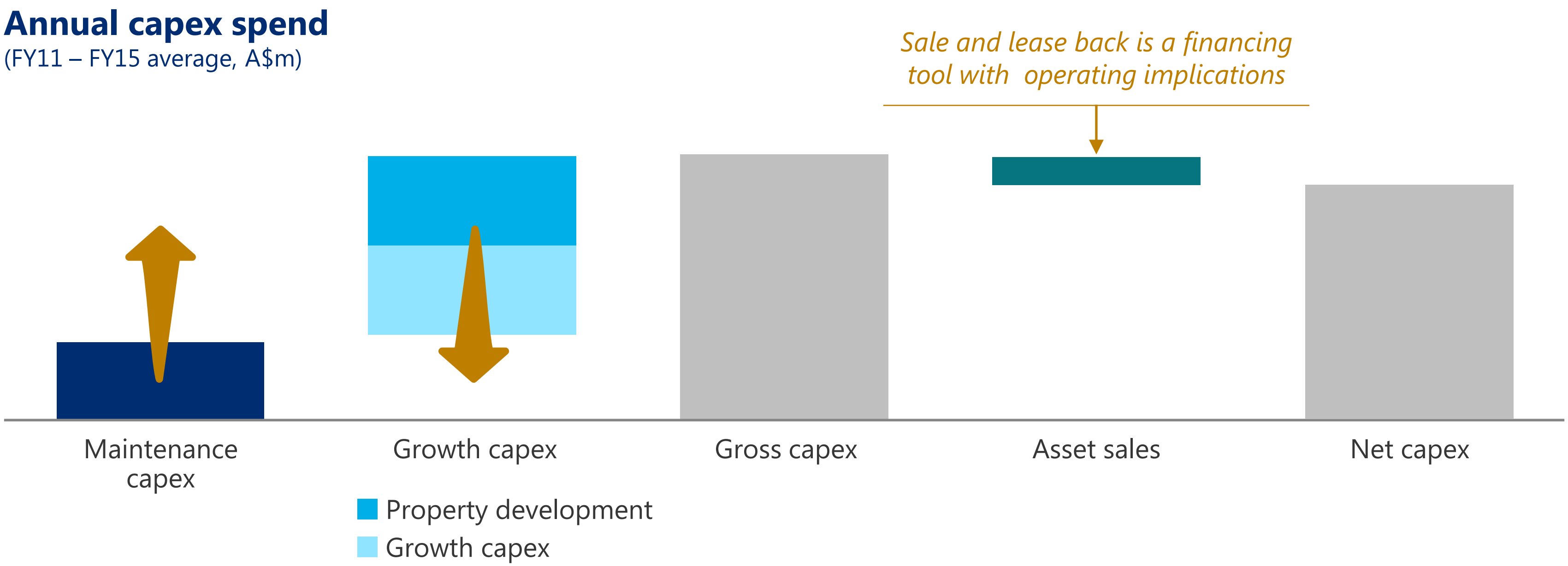


Annual available funding by division or company



Provide for Sustainable Levels of Investment & Growth

Group capex analysis—maintenance versus growth



Provide for Sustainable Levels of Investment & Growth

Growth capex analysis

Develop heuristics on growth versus maintenance

Required spend to grow asset base

Net asset base	
+ Depreciation	
= Gross asset base	
+ NPV of operating leases	
= Total asset base	
Required spend to grow asset base by 1%	

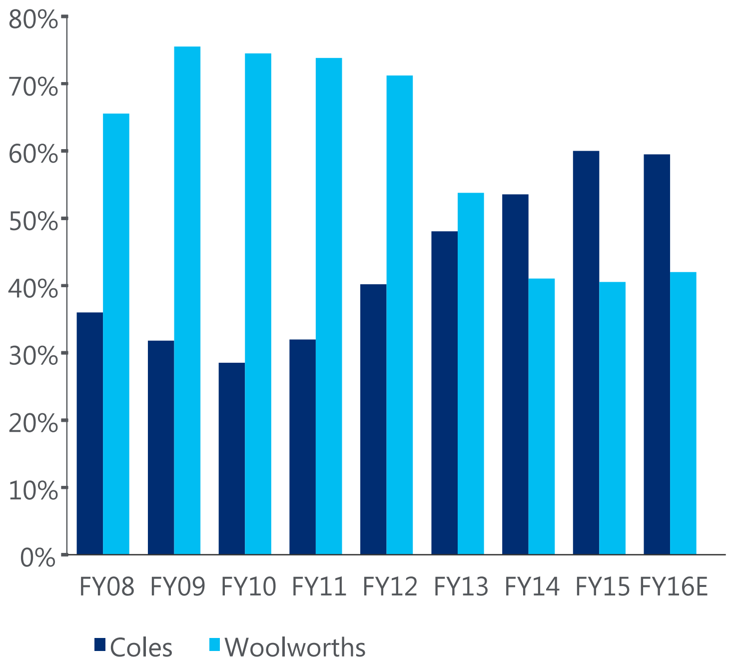
Asset base growth sensitivity (gross assets)

Asset base growth	Required spend (rounded)
1%	$350m
2%	$700m
3%	$1,050m
4%	$1,400m
5%	$1,750m
6%	$2,100m
7%	$2,450m
8%	$2,800m

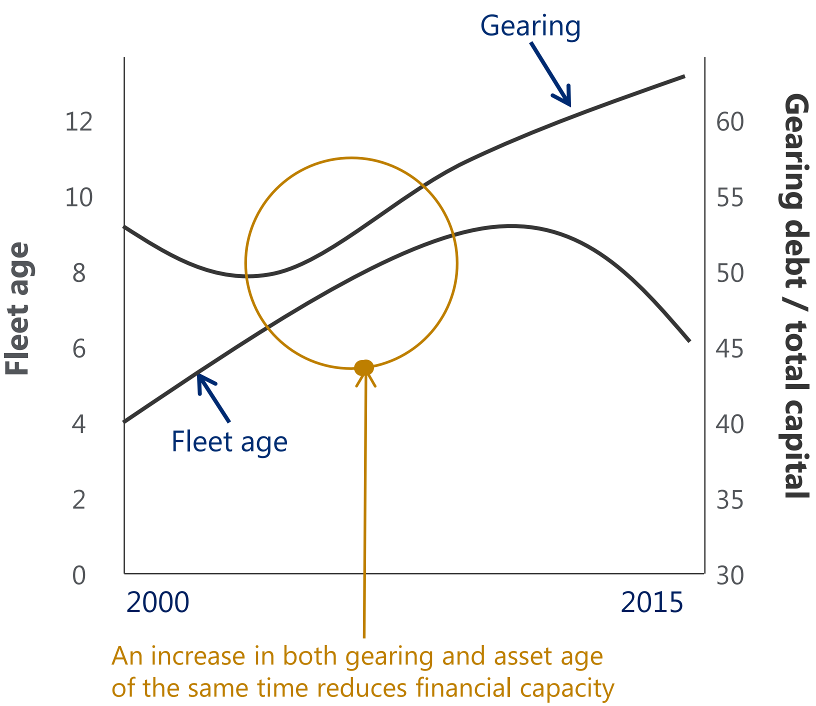
Provide for Sustainable Levels of Investment & Growth

Understand asset age

Coles v Woolworths proportion of supermarket fleet <5 years old
(%)



Estimated cost p.a. to reduce fleet age airlines versus – fleet age versus gearing
($m)



Provide for Sustainable Levels of Investment & Growth

Conclusions

- Understand growth and asset age heuristics
  - Total growth, gross assets (plus Cap op lease), x growth rate and what is required for each % growth
- The company requires around c.$Xm of capital p.a. to stay in business and protect its franchise aging and from competitive deterioration
  - Depreciation (economic, accounting, inflation adjusted)
  - Measures of asset age and target age
  - Re-invest for technology change and customer requirements
- What is your target asset age (to achieve your strategic and customer requirements)?
- Does your balance sheet capacity match your capital requirements?
  - E.g. Age of assets versus balance sheet capacity

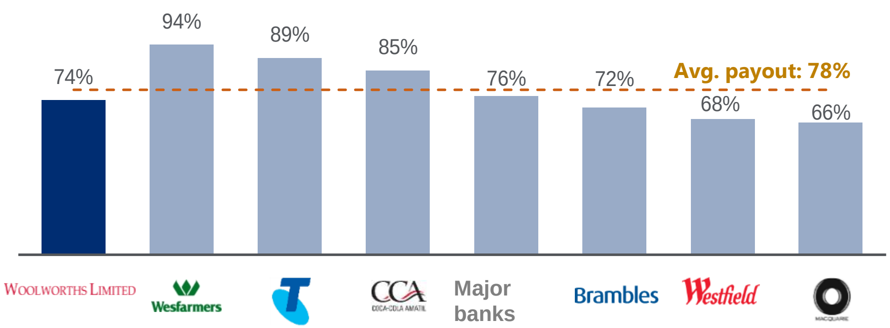
Offer Strong Returns to Shareholders

Market Expectations

Payout ratio relative to peers

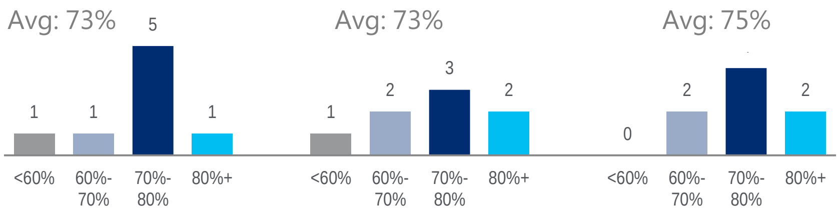
FY16 div yield: **Avg. div yield: 4.8%**

4.3%	4.9%	5.6%	5.1%	6.6%	3.5%	3.4%	5.6%



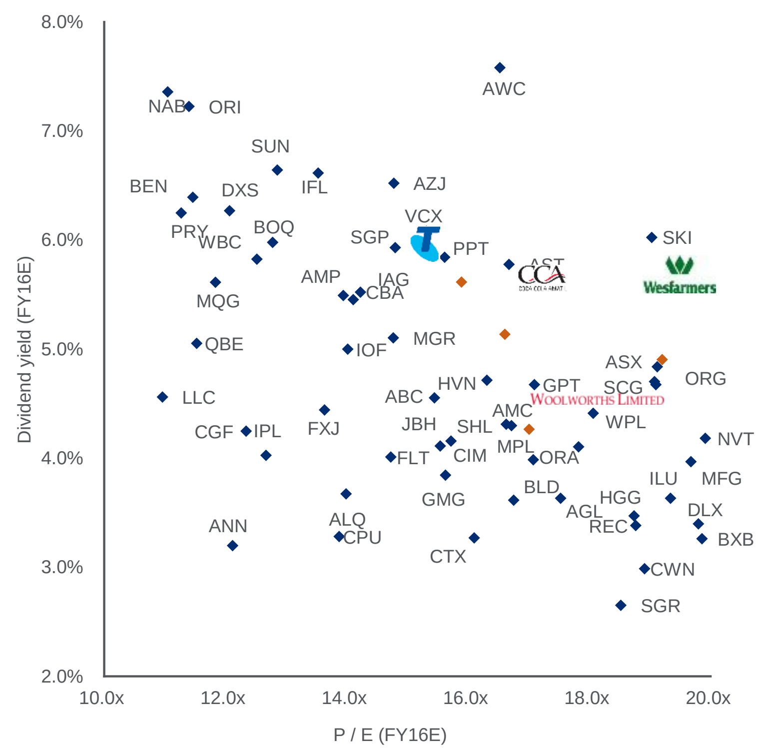
Consensus payout ratio

FY16E:	FY17E:	FY18E:
Max: 95%	Max: 93%	Max: 89%
Min: 50%	Min: 50%	Min: 69%
Avg: 73%	Avg: 73%	Avg: 75%



Dividend yield vs. valuation

ASX 100 industrials (P / E range of 10.0 – 20.0x)

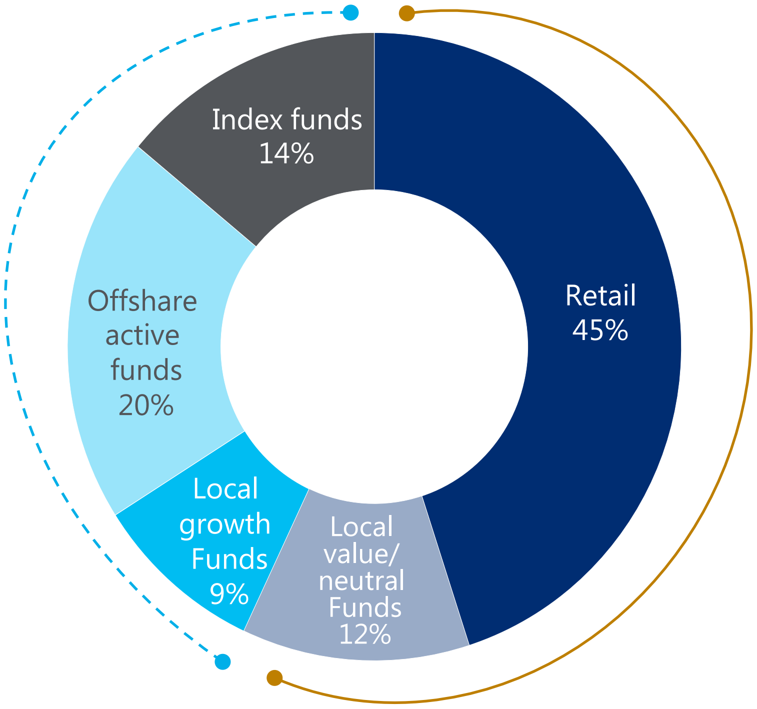


Offer Strong Returns to Shareholders

Understand who your shareholders are

- Who are you shareholders?
- Do they want growth, dividends, franking credits?
- If you change your dividend policy or payout what will happen?
- Make tough decisions if you need to

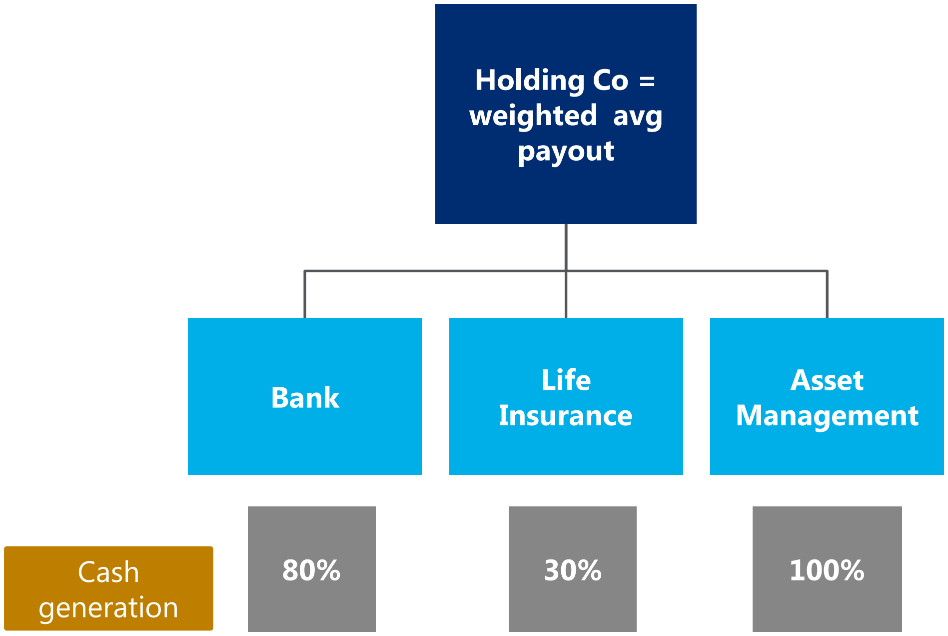
Register Analysis



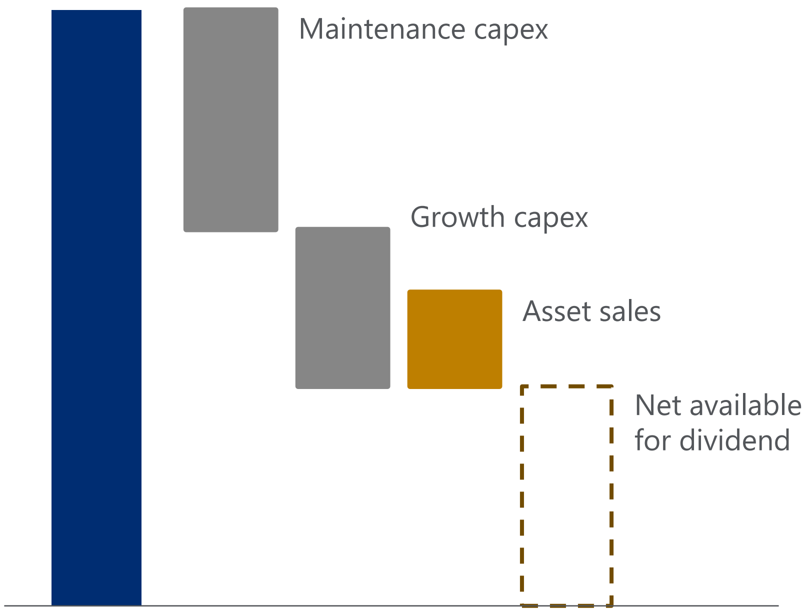
Offer Strong Returns to Shareholders

Is the payout ratio sustainable? Forecasts should also be stress tested

Financial services example



Operating cash flow



Offer Strong Returns to Shareholders

- Do DRP's make sense?
  - Distribute franking credits
  - Cover one-offs / catch up (aging)
  - No reliance in longer term

Offer Strong Returns to Shareholders

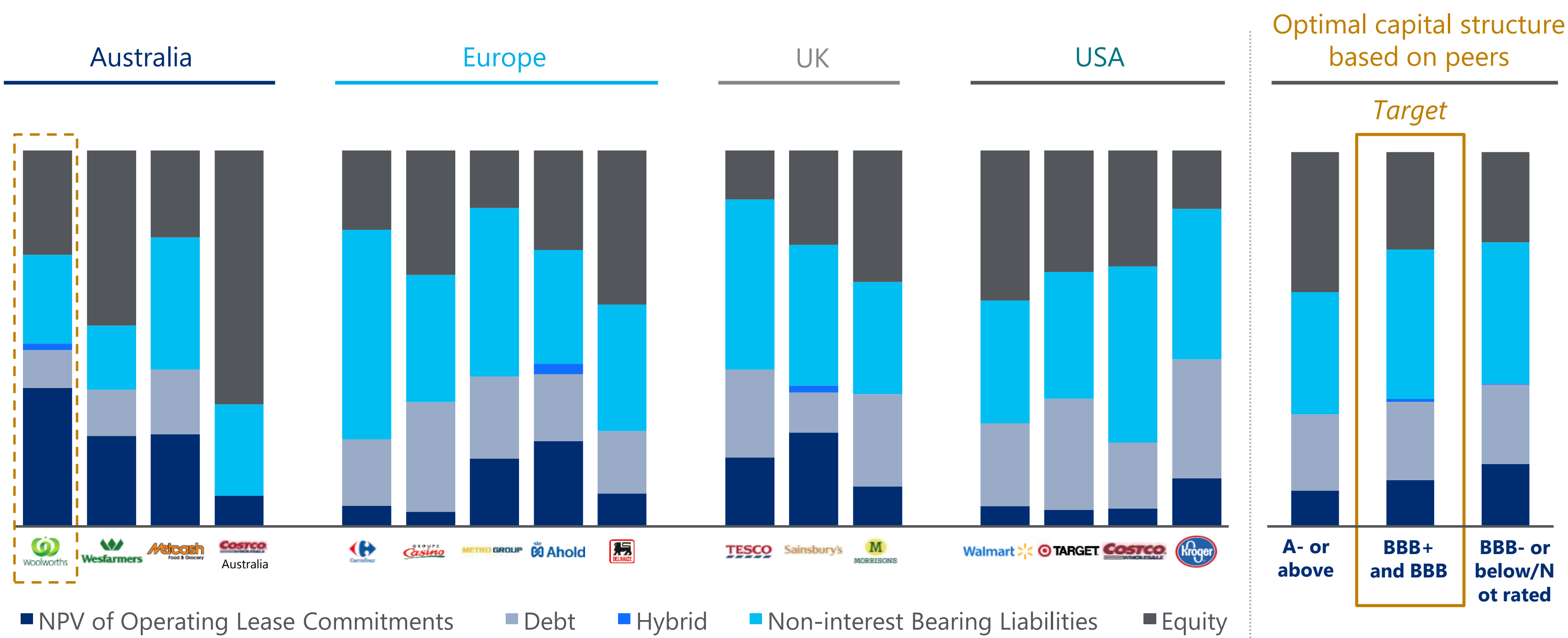
- Is your dividend sustainable given cash generated by the business?
- What are market expectations / peers offering?
- What are shareholders expecting?
- Franking credits distributed?
- Can you be competitive?
  - e.g. sustainable re-investment to remain competitive, alignment to strategy
- Growth versus yield trade-off
- Have the hard conversation if you need to cut dividends

OPTIMISE COST OF CAPITAL, FUNDING COSTS & LIQUIDITY

Optimise Cost of Capital, Funding Costs & Liquidity

Optimal capital structure—peer comparison

Look at debt, operating leases, hybrid, non interest bearing liabilities & equity



Moody's and S&P Credit Ratings

Baa2	A3	-	-	Baa1	-	Baa3	Baa2	Baa3	Ba1	-	Baa3	Aa2	A2	A1	Baa2
BBB	A-	-	-	BBB+	BBB-	BBB-	BBB	BBB	BB+	-	-	AA	A	A+	BBB

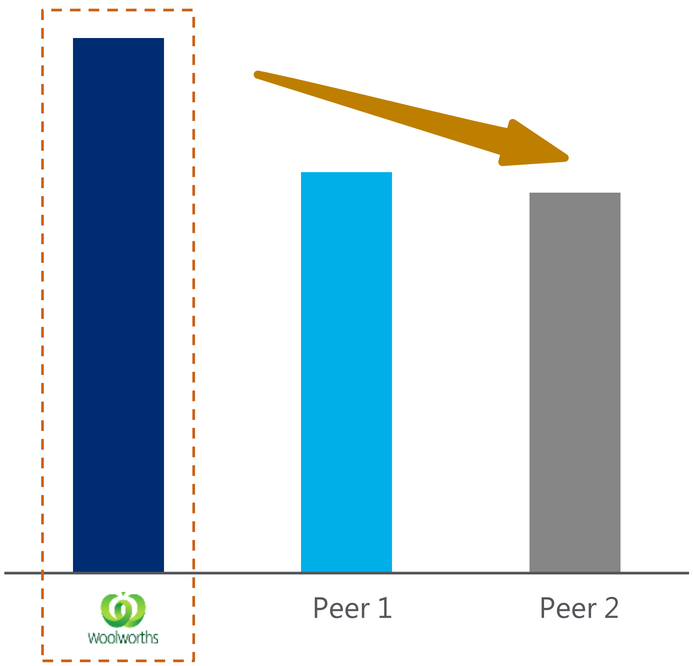
Number of Companies

4	4	6

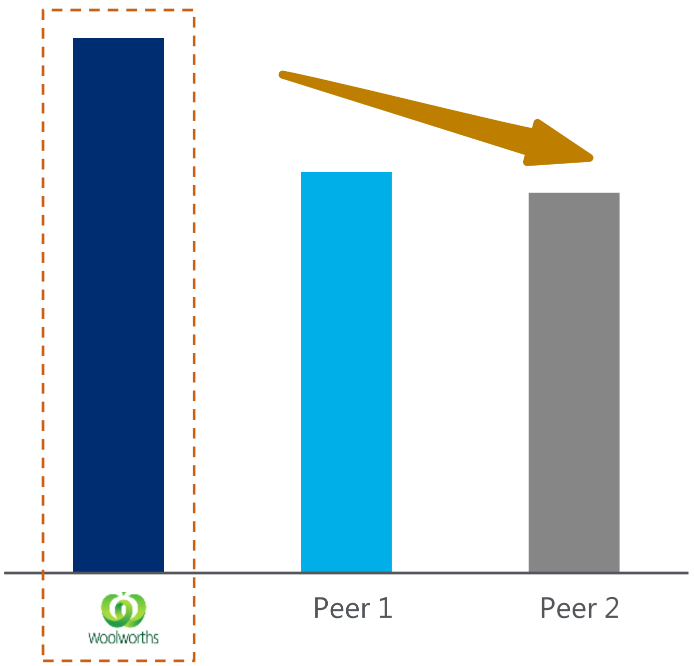
Optimise Cost of Capital, Funding Costs & Liquidity

Lease liability and debt duration relative to peers and target

Average lease duration (years)



Average debt duration (years)



Optimise Cost of Capital, Funding Costs & Liquidity

Liquidity

- Months of business disruption coverage (e.g. 3, 6 months+)
- Ensure refinance in place 12 months out
- Know if your business w/c positive or negative, under different conditions and determine operating leverage (stress test)
- Be opportunistic but remember markets are volatile and cannot always be relied upon (GFC was a learning event)

Capital Management Summary

Increase shareholder value through:

Pillar	Key principles
1 **Maintain financial strength and flexibility**	▪ Target a financial risk profile consistent with your strategy and your risk appetite (credit rating) ▪ Provides an appropriate level of financial flexibility to withstand operating volatility, maintain a safe buffer to debt covenants, take advantage of opportunities and obtain the widest access to funding markets
2 **Provide for sustainable levels of investment & growth**	▪ Invest to remain attractive to customers, protect your franchise from ageing and to deliver an appropriate level of growth
3 **Offers strong returns to shareholders**	▪ Understand shareholders expectations of sustainable returns via dividends that are supported by free cash flow after required investment. In addition, franking credits should be distributed to the maximum extent possible
4 **Optimise the cost of capital, and deliver an efficient funding plan**	▪ Target a capital structure that is relevant and competitive for your industry ▪ Optimise non-interest bearing liabilities and working capital to provide additional low cost funding and stress test ▪ Include all forms of off balance sheet funding in your capital structure analysis and compare debt duration