Australian National University

Student Managed Fund

ANU Student Managed Fund

Investment Recommendation - Brambles Limited

Analysts: Max Burrows and Felix Jones

This Version: 18/05/21 (FINAL)

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Table of Contents

Glossary

AAE – Active Australian Equities

APAC – Asia-Pacific

AUD – Australian dollar

BXB – Brambles Limited

BV – Book Value

CD – Consumer Discretionary

CEO – Chief Executive Officer

CHEP – Commonwealth Handling and Equipment Pool

DCF – Discounted Cash Flow

EBITA – Earnings Before Interest, Tax and Amortisation

EMEA – Europe, Middle East and Africa

ESG - Environmental, Social and Governance

EUR – Euro

FC – Franking Credits

FCF – Free Cash Flow

FY – Financial Year

GW – Goodwill

HFG – Hoover Ferguson Group

IC – Invested Capital

IOZ – IShares Core S&P/ASX 200 ETF

IPS – Investment Policy Statement

NOPLAT – Net Operating Profit Less Adjusted Taxes

PV – Present Value

ROIC – Return On Invested Capital

RPCs – Reusable Plastic Containers

SMF – Student Managed Fund

SRI – Socially Responsible Investing

USD – United States dollar

WACC – Weighted Average Cost of Capital

Portfolio Recommendation

We recommend establishing a 10% weighting of Brambles Limited (BXB) in the Active Australian Equity (AAE) portfolio, funded by reducing holdings in the iShares Core S&P/ASX200 ETF (IOZ).

Investment Thesis

BXB presents potential for strong returns as a mature industrial business trading at a reasonable valuation. Our base case valuation of $12.69 implies a Margin of Safety (MoS) of 18.8% excluding franking credits (FCs). We believe this is an attractive MoS considering the defensive nature of the business.

BXB operates through its Commonwealth Handling and Equipment Pool (CHEP) segments in the Americas, Europe, Middle East and Africa (EMEA) and the Asia-Pacific (APAC). CHEP rents wooden pallets, reusable plastic containers (RPCs) and automotive containers to clients primarily in the Consumer Staples industry.

The main considerations underpinning this recommendation are:

- BXB has a strong competitive advantage in the pallets business, particularly in the APAC region. New entrants to the sector are unlikely.
- BXB provides attractive cyclical exposure to the retail industry, with a revenue base that is largely insulated from any disruption from growth in e-commerce.
- Current management has a strong record of demerging less productive business divisions, including Kegstar (2020), IFCO (2018), CHEP Recycled (2018), the Hoover Ferguson Group (HFG) Joint Venture (JV) (2018) and CHEP Aerospace (2016). These divestments both increase return on invested capital (ROIC) and establish a focused business.
- BXB's revenue is diversified geographically, providing an attractive compliment to the predominantly Australian businesses held by the Student Managed Fund (SMF).
- Key uncertainties include exchange rate sensitivity, BXB's strategy in plastic pallets, the outcome of CHEP Americas' Automation Program, and a possibility of margin pressure if customer buying power increase under the rise of e-commerce.
- Scenario analysis is undertaken to gauge sensitivity to these uncertainties (see Appendix E). We assess the risks associated with a value-destroying push into plastic pallets and pricing pressures. Both scenarios result in valuations including FCs near the current share price, suggesting that the recommendation is somewhat resilient to these two risks. An upside scenario to capture greater efficacy from the automation program points to upside potential in the valuation, with MoS increasing by 22% to 48% including FCs.
- We also estimate exchange rate sensitivities (see Appendix G). While exchange rates are difficult to forecast over the short-medium term, the fact that the Australian dollar (AUD) currently trades at 14% above purchasing power parity (PPP) of 0.68 versus the US Dollar (USD) provides some comfort from a long-term perspective. Our valuation would be 13% higher with the AUD/USD at 0.68.

Brambles

AUSTRALIA

ASX code: BXB

Price (at 17/05/2021) A$10.68

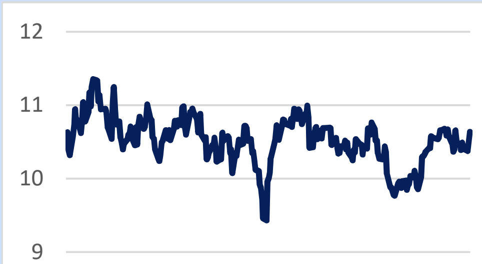
Valuation	A$12.69
- Inc. Franking Credits	A$13.51
Margin of Safety	18.8%
- Inc. Franking Credits	26.5%
Dividend Yield (2021F)	2.05%
- Inc. Franking Credits	2.31%
GICS	Industrials – Commercial and Professional Services
52-Week Range	A$9.54-A$11.78

Recommendation
A 10% weighting of BXB in the AAE portfolio, funded by reducing holdings in the iShares Core S&P/ASX200 ETF (IOZ).

Key Assumptions	
Required Return on Equity	5.68%
WACC	5.17%

Carbon Intensity	
BXB	13.2
ASX200	201.0

1 Year Share Price History



Main Considerations

Strong competitive advantage within the pallets industry

A strong competitive advantage is core to our confidence in BXB as an investment that aligns with the SMF's long-term objectives. BXB has a first-mover advantage in the pallets industry, where CHEP is a leading player in all of its markets globally. Market share is estimated at 55%, 25% and 70% in the Americas, EMEA and APAC regions, respectively. While efficiency benefits on account of scale seem largely to have been realised in developed markets, there remains room for gains in emerging markets across all of CHEP's segments. Although scale alone is not always the most sustainable of competitive advantages, the importance of network effects to the company's share-and-reuse business model underlies its relative strength. CHEP has a more expansive network of service centres than key competitors, providing a cost advantage relative to the market. This cost advantage is of particular importance due to limited pricing power in the pallets industry. Many major retailers, including BXB clients, seek to have multiple pallet suppliers at any given time to minimise supply-chain concentration risk. This strategy of diversification places both a floor and a ceiling on market share while limiting pricing power, independent of BXB's strong competitive position within the industry.

In assessing the ability of BXB to maintain its competitive advantage, it is important to consider the threat of new entrants to the pallets industry. Potential new entrants include retailers such as Costco and Walmart or e-commerce companies such as Amazon seeking vertical integration. We believe that this threat is of low probability, given the limits to pricing power and concentration in the industry. This is evidenced by Costco's approach to developing plastic pallets, in which they are conducting trials with multiple suppliers (including BXB) rather than developing the pallets themselves. This suggests that retailers are not necessarily seeking to disrupt the pallets industry, even though the relative incumbency advantage of the pallet providers is fragile. Furthermore, pallets are a fractional cost to such companies, relative to other out-sourced elements of the supply-chain such as shipping and transportation. Even if vertical integration is a priority for retailers and traditionally asset-light e-commerce companies, we do not see the pallet industry as being top of their list.

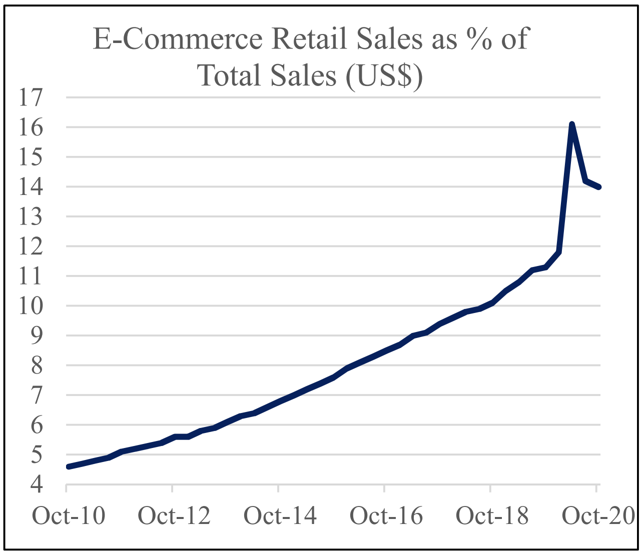
Improved returns on invested capital after demerging non-core businesses

BXB's current executive team, particularly Chief Executive Officer (CEO) Graham Chipchase, have a strong record in demerging less productive businesses from the group. Whilst many of these businesses were successful, their lack of maturity meant they were more capital intensive and drained cash flow generated by the CHEP segments. These actions include:

- Reducing BXB's stake in keg management business Kegstar from 100% to 15% in early 2021.
- The sale of IFCO, the company's US-based RPC business in 2018 for A$3.52 billion.
- The sale of a 50% interest in the HFG JV, an oil and gas containers business, to JV partner First Reserve in 2018 for US$37 million consideration and the repayment of a US$150 million shareholder loan.
- Divestment of recycled whitewood pallets business, CHEP Recycled, for A$147.2 million in 2017.
- Offloading of CHEP Aerospace Solutions, which provided pooling, management and maintenance of unit load devices (ULD) to EQT Infrastructure, for A$175 million in 2016.

Proceeds from these divestments have allowed BXB to undergo a combination of initiatives, including a significant capital management programme, reduction of the debt to equity ratio to just under 15%, payment of a $0.29/share special dividend and initiation of an A$2.4 billion share buy-back programme (discussed below). These strategic divestments also leave BXB better positioned to create value for shareholders by focusing the operations on the core CHEP businesses.

Exposure to retail sector, with insulation from e-commerce



BXB provides attractive exposure to the retail sector, without committing the Fund to a strong view on the future of e-commerce. BXB's management believes that its value proposition is unchanged by the e-commerce trend, with CEO Graham Chipchase noting "at the moment we are a bit ambivalent about whether it is online or bricks and mortar". One possibility is that e-commerce leads to industry concentration within the retail sector, which could be a long-term headwind for suppliers in the pallets industry through increasing the market power of buyers. Our base case valuation recognises that potential for buyer concentration places a ceiling on BXB's margins and profitability. The e-commerce trend remains a source of uncertainty and therefore is considered more deeply in scenario analysis.

Inflationary pressures on margins hedged by contract terms

BXB's ability to secure its operating margins is largely a result of its ability to implement mechanisms to offset the impact of fluctuations in input prices. BXB's three main costs are lumber, wages and transport costs. BXB is able to offset movements in the prices of these inputs through long-term indexation and short-term surcharge mechanisms in its customer contracts. Such indexation has been implemented in the past three years, and now is reflected in 75-80% of contracts. The efficacy of such indexation strategies is reflected in the FY20 accounts, with BXB's capex-to-sales ratio decreasing to 20.7% from 23.1% despite lumber prices increasing by close to 9%. This outcome would not be expected without indexation, noting that lumber accounts for approximately 45% of all costs for CHEP Americas. The importance of this indexation should be further demonstrated in FY21, with average lumber prices rising for the period by close to 130%. Management have indicated that, while the increase in lumber costs is set to persist throughout the second half of FY21, they expect the widespread implementation of contract surcharging to recover the associated costs.

Another way by which BXB seeks to reduce cost pressures upon margins is through investing in their own lumber procurement program. The program involves investment in sawmills, which currently supply approximately 40% of CHEP's lumber. This reduces the company's exposure to fluctuations in lumber pricing while providing both a better yield and scale advantages.

Geographic diversification enhances BXB's defensive nature

BXB generates over 90% of its revenues outside of Australia, despite being founded in Newcastle and listed on the Australian Securities Exchange (ASX). The pallets industry is closely linked to the broader economy, given that growth mainly takes the form of increased volumes within existing contracts. This means that revenue growth varies with economic activity across BXB's regions. Not only does this diversification increase the resilience of BXB's group revenue and earnings, but the exposure to overseas economies provides diversification within the AAE and broader SMF portfolio, which is focused on Australian-based assets.

Socially Responsible Investing (SRI) Highlights

An SRI review by the SMF Risk and Compliance (R&C) team has determined that an investment in BXB would satisfy the SMF SRI Policy. BXB's pallet-based operations do not generate revenue from any industries on the exclusion list, and adding would reduce the carbon intensity of the Fund's active stock positions. Further, R&C has detected no signs of the company causing any significant social injury.

Given BXB's low carbon intensity score of 13.2, its addition would improve the carbon intensity of active positions held within the AAE portfolio from 78.3% below the ASX200 to 81.4% below. By taking us further beyond our 30% minimum improvement threshold, it would also expand the investable universe through enabling consideration of companies with a greater range of carbon intensity scores.

BXB is an ESG leader. It received the maximum AAA rating from MSCI ESG Ratings, which ranked the company in the top 4% within the Commercial Services & Supplies industry globally. It is in the 96th percentile in its industry category on the Dow Jones Sustainability Index, and was rated the #1 most sustainable international company by Barron's in 2021. A list of specific achievements that support BXB's impressive ESG rating are outlined in Appendix D.

We have identified two ESG-related concerns. First, CHEP Americas saw a 39.26% increase in employee turnover in FY20. This is a high number relative to CHEP EMEA (6.21%) and CHEP Asia-Pacific (9.81%). The high turnover in America is likely due to the roll-out of automation to replace workers. Since 2018, 39 sites have been automated, with a goal to automate 50 additional plants by FY22 according to the 1H21 results presentation. R&C believe that the benefits of automation for society outweigh the social harm of job losses. We consider high employee turnover to be a watch point, rather than a major concern.

Second, BXB is exposed to the impacts of climate change and deforestation in relation to raw material supply. Rapid climate change can affect tree growth and mortality rates, and excessive deforestation can deplete the supply of lumber thus impacting its price and availability. BXB source 100% of timber from sustainable forests and plant two trees for every one they use. While R&C are satisfied with BXB's efforts to mitigate deforestation and climate change related effects, third parties may not employ the same risk management. Therefore, BXB's raw material supply may be impacted in the long-term.

Overall, R&C have determined that BXB's above average management of ESG issues, in particular its focus on sustainable sourcing of timber and its attempts to mitigate Scope 3 emissions, outweigh any areas of concern. BXB is considered as fully compliant with the SMF's and University's SRI Policies.

Valuation Summary and Model Overview

Our Discounted Cash Flow (DCF) model of BXB's operations values the shares at $12.69 excluding FCs and $13.51 including FCs. The current price of $10.68 sits at a substantial discount to the valuation, with a MoS of 18.82% excluding FCs and 26.49% including FCs. Our recommendation to include BXB in the portfolio is underpinned by this valuation, combined with the defensive nature of BXB's cash flows due to its competitive advantage and geographic diversification.

Revenue forecasts are derived through two methods that assess both macroeconomic and industry variables. Method one forecasts sales by segment relative to total retail trade in the primary market of the CHEP segment (US for Americas, EU for EMEA and Australia for APAC). This is then adjusted in the US by the total inventory to sales ratio, an indicator for short-term demand in the sector. Method two adopts a global perspective by building a revenue forecast that bases market size on growth in world GDP and manufacturing output (noting that pallet usage is related to the latter), and then applying a BXB market share. Final revenue forecasts are then formulated through taking an average of the two methods.

Due to the distinct geographic regions, we have chosen to project forward by first converting FY20 earnings into a combination of USD, Euro (EUR) and AUD at the average spot rate for the fiscal year. This establishes a forecasting base in local currencies. The projected earnings stream for EMEA and APAC is subsequently converted back into USD at current spot rates in order to generate a USD valuation. Our final valuation in AUD is derived through converting the USD valuation at the AUD/USD spot rate (currently 0.78).

The base case scenario assumes continued economic recovery following the pandemic, with no major shocks impacting on our key drivers. Group revenue is forecast to grow 7.45% through FY21, driven by strong growth in the APAC sector of 21% resulting from recent contract wins for the supply of RPCs. After FY25, revenue growth is forecast to trend to a modest level of 3.04% reflecting the mature nature of the business with sales largely driven by volume growth.

Margins are forecast to gradually increase to a peak of 20.16% in FY25. This largely reflects expected benefits from automation, reducing the repair and maintenance costs associated with conventional systems. Further, we believe BXB's implementation of surcharge mechanisms will assist in hedging cost pressures and contribute to increased margins over the period. Having implemented such mechanisms across 75-80% of all supplier contracts, we expect further completion over the coming years. We assume slowly declining margins after FY25 due to competitive pressures arising from customer consolidation.

ROIC (including goodwill) is forecasted to rise to 17.81% in FY25, and then decline to 16.53% over the remaining forecast period. In addition to improving margins, the increase is also supported by some improvement in capital efficiency between FY21 and FY25 due to declining rates of capital expenditure in the Americas and EMEA sectors, driven by the projected completion of the automation program.

A weighted average cost of capital (WACC) of 5.17% has been applied. This reflects a reduction in the baseline target equity return used by the AAE team, from 7.25% to 5.68%. The latter represents an estimate of the expected return on the benchmark S&P/ASX200 ETF (i.e. IOZ), based on the Asset Allocation team's median domestic equity market forecasts. The expected market return amounts to a required return hurdle that sets the baseline cost of equity, to which the AAE team applies further adjustments for industry risk buckets, confidence in modelling and leverage to arrive at a cost of equity and hence WACC for a specific company.

Previously the SMF employed a baseline target equity return of 7.25%, comprising the sum of the 4.5% distribution rate, assumed inflation of 2.5% and a small 0.5% premium to acknowledge the relative risk of investing in equities. This hurdle reflected the return required to achieve the objective of maintaining the real value of the Fund and its distributions. The team was finding that a 7.25% baseline return made it extremely difficult to find suitable stocks with a sufficient MoS, given that the overall Australian equity market seems to be priced for returns well below this target. Furthermore, the AAE component of the SMF portfolio is structured so that any capital not invested in individual stocks is instead invested in IOZ. Whilst we still aim to achieve an absolute return target, consideration thus also needs to be given to the returns offered by potential stocks relative to investing in IOZ. To choose to remain in IOZ rather than invest actively in a stock implies that the index is a more attractive opportunity for the Fund. If both the stock and the market are priced for returns below the 7.25% target, the relevant question is which option gets closer to the target return.

To provide context, the tables below compare our BXB valuation under the previous and revised baseline market return hurdle rates. Under the 7.25% hurdle, BXB offers a negative MoS of -1.54% including franking credits. At the revised 5.68% hurdle rate, the MoS is +26.49%. These estimates suggest that BXB comes close to delivering a 7.25% required return (after allowance for risk adjustments); while being considerably more attractive than retaining an investment in IOZ, which in turn seems even less likely to deliver on the 7.25% required return.

7.25% Hurdle	
WACC	**6.38%**
Current Price	$10.68
AUD Valuation	$9.88
Franking Credits	$0.64
MoS (exc. FC)	-7.49%
MoS (inc. FC)	-1.54%

5.68% Hurdle	
WACC	**5.17%**
Current Price	$10.68
AUD Valuation	$12.69
Franking Credits	$0.82
MoS (exc. FC)	18.82%
MoS (inc. FC)	26.49%

The cost of debt is calculated through deriving an implied credit spread, assessing BXB's FY20 interest expense and their current debt. Such calculations led to an after-tax cost of debt of 2.66%. We have assumed a target capital ratio in estimating WACC of Equity/Debt of 0.3, equating to an equity ratio of 77%.

Appendix A: Valuation Summary

Share Price (17/05/21)	$10.68
Base Case Valuation, ex. FC	$12.69
Base Case Valuation, inc. FC	$13.51
Margin of Safety, inc. FC	26.49%
Required Return on Equity	5.68%
Cost of Debt	2.66%
Target Capital Ratio (MV Equity/BV Debt)	0.3
WACC	5.17%

Appendix B: Key Financial Summary

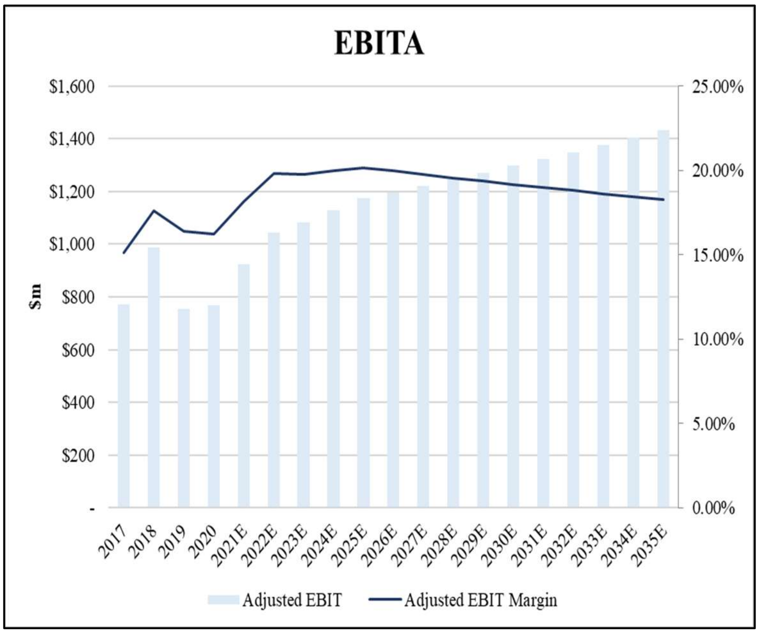
Financial Year	**2019(A)**	**2020(A)**	**2021(E)**	**2022(E)**	**2023(E)**	**2024(E)**	**2025(E)**
Total Revenue	4595	4734	5086	5300	5504	5683	5856
Revenue Growth	17.89%	3.01%	7.45%	4.20%	3.86%	3.25%	3.04%
EBITA	753	767	925	1051	1086	1131	1174
EBITA Margins	16.38%	16.20%	18.18%	19.82%	19.75%	19.96%	20.16%
NOPLAT	264	514	805	729	733	780	849
NOPLAT Margin	5.74%	10.86%	15.81%	13.73%	13.34%	13.77%	14.57%
Invested Capital (ex. Goodwill)	4609	4698	4328	4420	4582	4763	4794
Invested Capital (inc. Goodwill)	4895	4958	4594	4666	4825	5010	5034
ROIC (ex. Goodwill)	4.53%	11.15%	17.13%	16.84%	16.59%	17.01%	17.81%
ROIC (inc. Goodwill)	3.86%	10.50%	16.23%	15.87%	15.71%	16.16%	16.93%
FCF (inc. Goodwill)	2215	452	1168	657	573	594	825
IC Turnover (ex. Goodwill)	0.88x	1.02x	1.13x	1.21x	1.22x	1.21x	1.22x

Financial Year	**2026(E)**	**2027(E)**	**2028(E)**	**2029(E)**	**2030(E)**	**2031(E)**
Total Revenue	6034	6218	6407	6602	6803	7010
Revenue Growth	3.04%	3.04%	3.04%	3.04%	3.04%	3.04%
EBITA	1198	1222	1247	1272	1298	1324
EBITA Margins	19.96%	19.76%	19.56%	19.37%	19.18%	18.99%
NOPLAT	833	850	867	885	903	921
NOPLAT Margin	13.87%	13.74%	13.60%	13.46%	13.33%	13.20%
Invested Capital (ex. Goodwill)	4939	5089	5243	5402	5566	5735
Invested Capital (inc. Goodwill)	5179	5329	5483	5642	5806	5975
ROIC (ex. Goodwill)	17.37%	17.20%	17.03%	16.86%	16.69%	16.53%
ROIC (inc. Goodwill)	16.54%	16.40%	16.26%	16.12%	15.98%	15.84%
FCF (inc. Goodwill)	687	700	712	725	738	751
IC Turnover (ex. Goodwill)	1.24x	1.24x	1.24x	1.24x	1.24x	1.24x

Appendix C: Key Valuation Driver Charts

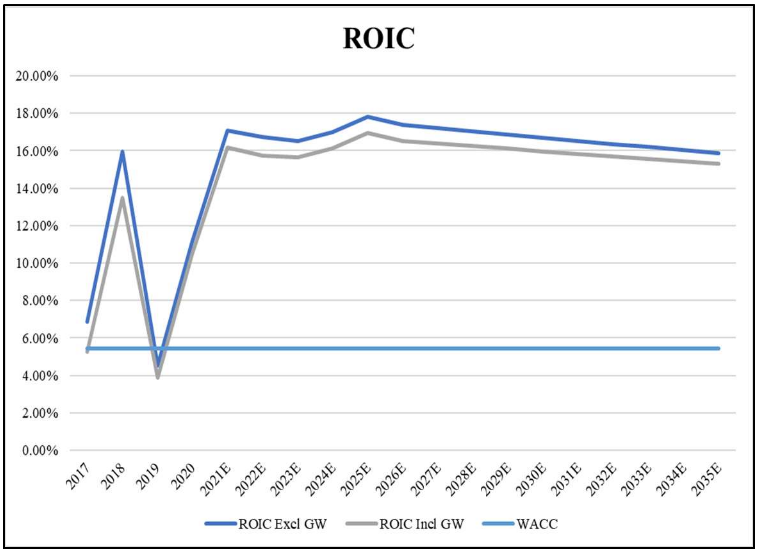
Earnings before interest, tax and amortisation (EBITA)

EBITA is forecasted to increase 20.5% from FY20 to FY21, primarily due to the reduction in pricing pressures faced throughout the pandemic. The reduction of such pressures is primarily due to normalisation of pricing inflationary pressures alongside the efficacy of BXB's surcharge mechanism programs. The US automation program targets 2% margin improvement over the 1HFY18 base, and is forecast to be achieved in FY22. Whilst the program has delivered some improvement on CHEP Americas' operating margins already, these have been somewhat offset by input cost pressures. Following FY25, we have forecast earning margins to decrease. This conservatively allows for declining pricing power due to the consolidation of its customer base, for which the likelihood and effects are open to debate.



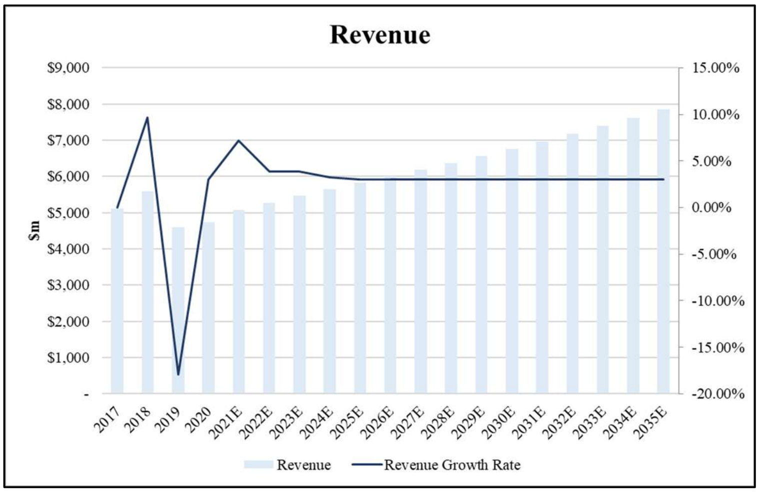
Return on Investment Capital (ROIC)

ROIC is forecasted to increase to 17.13% in FY21, recovering from the observed lows experienced in FY19. From FY21, we expect ROIC to steadily increase until FY25, and subsequently decline to the end of the forecast horizon in FY31. The increase up to FY25 is partly driven by the gains from automation and an element of easing cost pressures. Specifically, the implementation of the automation program should increase margins through reducing repair and maintenance costs, while also enhancing capital efficiency. Management's history of successfully demerging less productive and more capital intensive businesses supports ROIC moving to a higher level than seen previously.



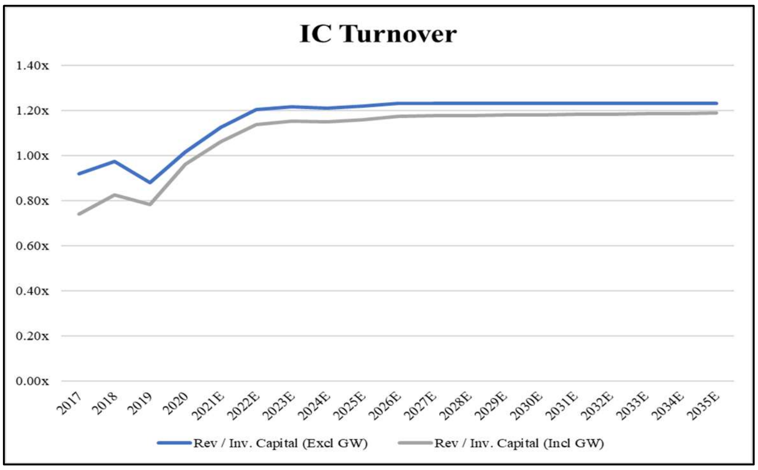
Revenue

Revenue growth is forecast to peak in FY21 at 7.45%. This is largely driven by a strong performance in the APAC sector, which is set to experience a 21% increase from FY20 due to the realisation of a major RPC contract with Coles. Over the next 5 years, we expect CHEP Americas revenue growth to lag behind CHEP EMEA due to fewer opportunities for expansion. Given the defensive nature of BXB's revenue, and its link to the performance of volume growth in the broader economy, we have forecast modest revenue growth after FY25 of 3.04%.



Invested Capital (IC) Turnover

IC turnover is forecast to peak in FY26, subsequently stabilising over the remainder of our forecast period at 1.24x. The increase over the next few years is driven by the impact of the automation programs, which should allow for capital expenditure to reduce as revenue grows concurrently.



Appendix D: SRI Highlights

BXB's impressive ESG rating has been supported by the following achievements:

- Decrease in Scope 1 & 2 Emissions from 120,760 tons in 2016 to 58,390 tons in 2020.
- Circular operating model that reduces waste and pollution throughout the supply chain, supporting a regenerative future.
- 100% of timber being sourced from certified sustainable forests. BXB have also committed to growing two trees for every one that they use.
- Zero timber product waste and less than 0.1% of plastic product waste being sent to landfill.
- Commitment to decarbonizing supply chains via leveraging the best available low and zero carbon products, thus addressing Scope 3 emissions arising from outsourced service centres and transportation of pallets. These attempts to mitigate Scope 3 emissions exceed industry standards.
- Decrease of 61% in the injury frequency rate between 2015 and 2020.
- Company policies set in alignment with the UN's Sustainable Development Goals.
- Women comprise 31% of the Board and management positions, with a target of 40% for 2025.
- Corporate governance in compliance with all relevant legislation. This includes Board members that have a diverse skillset and extensive experience in supply chain operations, and Director remuneration being tied to ESG outcomes such as safety and asset protection.

Appendix E: Scenario Analysis

Upside Scenario, Driven by Widespread Automation

Our base case forecasts assume benefits from completion of the automation program within the Americas region. We test an upside scenario that allows for those benefits to achieve greater efficacy, while concurrently considering the potential for further automation across geographic regions. We also allow for higher revenue growth than assumed in the base case.

BXB may have scope to further enhance operational effectiveness through the widespread implementation of plant automation. The automation process allows for defects to be identified, therefore reducing pallet variation while concurrently reducing the costs associated with human capital. With reference to the Americas region, over 39 sites have been automated to date with a further 50 set for automation. The adoption of the automation programs so far has been observed to have a direct impact on operational effectiveness. In FY19, Brambles spent $460 million on replacing lost, broken or poor-quality pallets across CHEP Americas division. Citi estimates that with every ~1% improvement in the pallet replacement rate Brambles are able to generate an additional $40m in cash flows due to a reduction in repair costs.

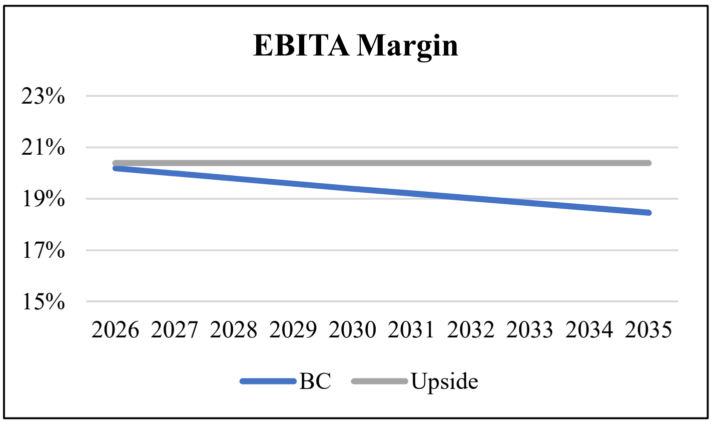
Revenue

Our upside valuation forecasts a steady increase in group revenue up to and including 2025, being driven by the effective rollout of the vaccine and the accompanying positive sentiment. Our base case forecasts for revenue are below both management and market consensus, as well as nominal GDP, such that upside remains quite feasible. Our upside valuation maintains revenue increasing at 3.6% from 2025, compared to the 3.04% growth rate under our base case valuation.

Revenue Growth	FY21	FY22	FY23	FY24	FY25
Base Case:	7.45%	4.20%	3.86%	3.25%	3.04%
Upside Scenario:	7.7%	4.7%	4.6%	4.1%	3.6%

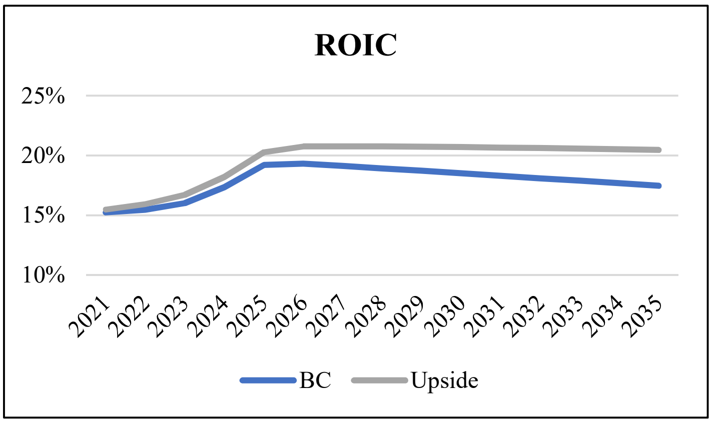
EBITA Margin

Our upside valuation assumes Brambles can maintain stable EBITA margins from FY26 onwards, whereas our base case assumed that margins trended lower. This allows for increased efficiency related to reduced operational expenditure stimulated by the automation program. As our base case considers the effects of pricing pressures upon the reduction in margins from FY26, stability in our upside scenarios is derived through the automation program serving to offset any pricing pressures resulting from a consolidating customer base.



ROIC

Our upside valuation assumes Brambles can maintain stable rates of ROIC following FY25. The ability to maintain consistent ROIC within our upside is largely driven by the automation program, allowing for increased pallet life and hence significantly lower rates of capital expenditure, in addition to better margins.



Resulting Valuation

Our upside valuation results in a share price of $14.49 including FC's, reflecting a MoS of 48.32%. As our base case assumptions with regards to revenue growth and EBITA margins adopt a level of conservatism, we believe that our upside valuation remains a feasible valuation. Further, our upside valuation considers the increased efficacy of the automation program in maintaining EBITA margins from 2026 onwards, which may result from further automation across geographic regions. While management has expressed no commitment to undertake automation across all segments, we believe such a scenario is plausible given the observed benefits upon operations.

	Base Case	Upside Case
Share Price (17/05/2021)	$10.68	$10.68
Base Case Valuation, inc. FC	$13.51	$14.49
Margin of Safety, inc. FC	26.49%	48.32%
Required Return on Equity	5.68%	5.68%
WACC	5.17%	5.17%

Plastic Pallets Scenario

BXB currently predominately services customers through the distribution of wooden pallets. The widespread uptake of plastic pallets could serve as a potential risk, by both decreasing demand for wooden pallets and requiring BXB to incur significant capital expenditure to switch to plastic pallets to retain customers, thus depressing ROIC. Plastic pallets provide benefits to customers as they possess increased durability and are safer to transport. These benefits, however, come at significant additional cost. Customers can expect to pay $70 for plastic pallets, compared to $20 for wooden. As per UBS analyst Matt Ryan, less than 5% of American pallet customers would be willing to pay the observed premium. As such, we believe the likelihood of customers moving from wooden to plastic pallets is low.

Further, demand for plastic pallets within the industry is currently being driven largely in isolation by one retailer, Costco. Costco are currently under the process of transitioning towards an all-plastic pallet pool and are undertaking a trial with CHEP Americas. Costco's observed transition away from wooden pallets is primarily due to health and safety concerns, as opposed to being driven by a financial motive. As such, the observed uptake of plastic pallets largely reflects the uniqueness of Costco's business model, rather than the likelihood of widespread adoption across the market. Within our base case scenario, we have assumed a gradual and minimal adoption of plastic pallets, providing no meaningful impact upon our valuation.

One concern within the market (suggested to us by a fund manager) is that BXB may push ahead with expansion into plastic pallets, despite the risk that the move will result in a reduction in ROIC. As such, we have analysed a scenario whereby expansion into plastic pallets occurs and destroys value, through assessing the associated impacts upon revenues, capital expenditure and the resulting ROIC.

In considering this scenario, it gives us some comfort that management have stated that any decision towards widespread adoption will be subject to strict financial and return criteria. In any event, under circumstances whereby plastic pallet demand turned out to be strong, BXB would be well-placed given its trial with Costco. Further, plastic pallets have proved to be more susceptible to automation, creating less equipment blockages.

Revenue

For the scenario where management pursues expansion into plastic pallets, we have assumed increased revenue from FY22 to FY25, driven by new and relatively inelastic demand and the significantly higher prices charged for plastic pallets. We expect some growth in the plastic pallets business to come from existing wooden pallets customers, such as Costco, thus moderating the increase in revenue growth.

Revenue Growth	FY21	FY22	FY23	FY24	FY25
Base Case:	7.45%	4.20%	3.86%	3.25%	3.04%
Plastic Uptake:	7.50%	4.30%	4.15%	3.55%	3.21%

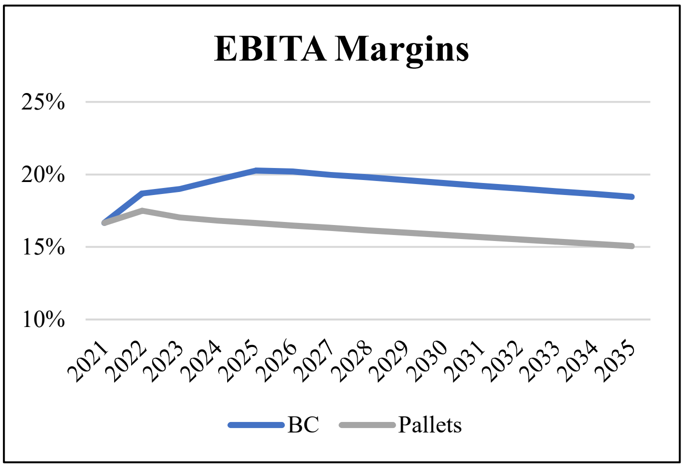
Capital Expenditure

The transition into plastic pallets would involve Brambles making widespread changes across both their plant and supply chain, reflected in an increase in group capital expenditure up to FY25.

Capex Growth	FY21	FY22	FY23	FY24	FY25
Base Case:	11.2%	3.8%	4.9%	2.3%	1.3%
Plastic Uptake:	18.3%	5.3%	6.7%	4.3%	3.9%

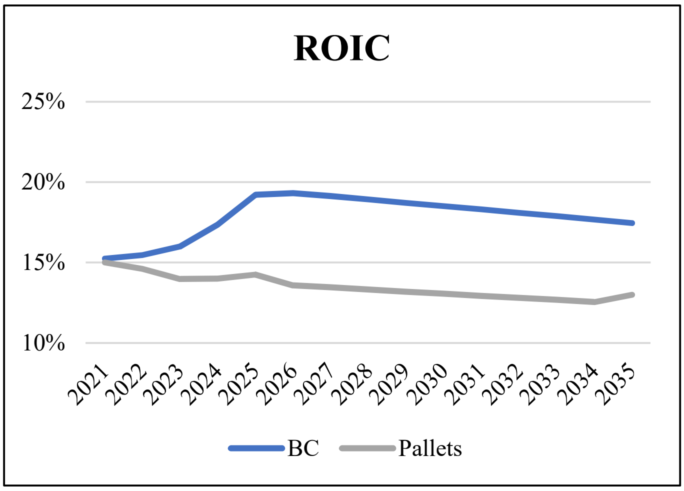
EBITA Margins

Under the scenario whereby plastic pallets are pursued, we have forecast reduced EBITA margins over the period. This could arise because either the higher purchase price inhibits demand, or limits to the price that the market will bear relative to costs.



ROIC

The increase in capital expenditure and lower margins under the plastic pallets scenario sees ROIC decline over the forecast period.



Resulting Valuation

The plastic pallets uptake scenario results in a valuation of $9.98 including FCs and a MoS of -0.34%. While such analysis suggests that a push into plastic pallets by BXB could lead to significant downside relative to the base case, the valuation including FCs still comes out at around current share. This suggests that the case for holding BXB would not be undermined by BXB expanding into plastic pallets. We also believe that such a scenario remains unlikely due to management's commitment to only pursue expansion under strict financial criteria. Further, as the current demand for plastic pallets is largely being driven in isolation by retailer Costco, there remains no certainty as to the widespread adoption across the industry.

	Base Case	Plastic Pallets
Share Price (17/05/2021)	$10.68	$10.68
Valuation, inc. FC	$13.51	$9.98
Margin of Safety, inc. FC	26.49%	-0.34%
Required Return on Equity	5.68%	5.68%
WACC	5.17%	5.17%

Pricing Pressure Resulting from Rise of E-Commerce

The e-commerce supply chain from dock or factory to distribution centre is significantly shorter than the traditional retail supply chain from dock or factory to warehouse to retail store. The revenue base for BXB may be reduced if a greater number of BXB clients require pallets over this shorter e-commerce supply chain. However, this would likely also lead to improved asset turnover and efficiency, increasing revenue on a per pallet basis. Therefore, under this scenario we forecast revenue to decline but to do so proportionately with capital expenditure in the long-run.

More important than the nature of the supply chain is the presence of network effects in driving the growth of e-commerce, which has multiple implications. First, it may lead to a more consolidated retail industry as existing players have the capacity to increase market share. If BXB's customers become increasingly concentrated relative to the pallets industry, this could reduce the company's pricing power and place pressure on operating margins. Second, it would increase the price sensitivity of retailers themselves, as a network-driven market pushes companies away from differentiation and towards cost leadership as a strategic focus. This is because in a market defined by network-effects, the driving concern is not so much profit as market share, as the willingness to pay for future customers is driven by the number of existing users. The combination of customers becoming more concentrated and price sensitive could compound the impact on profit margins. We assume that the retreat in operating margins would be most acute in CHEP Americas originally, where e-commerce is more established, but would have meaningful impacts on margins across all CHEP segments.

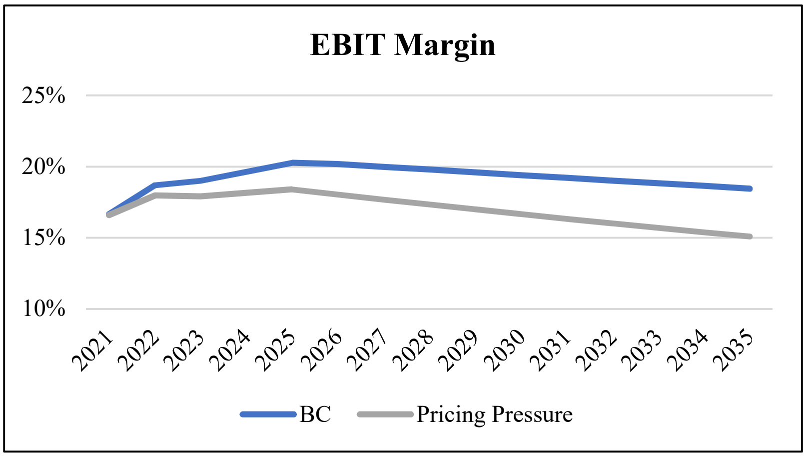
Revenue

We have assumed that the rise of e-commerce deteriorates BXB's revenue through shortening the supply chain and shrinking the size of the global pallets industry. As a greater proportion of BXB clients require contracts covering a smaller number of pallets and over a shorter time frame, a ceiling is placed on volume growth within existing contracts. This decrease would occur industry-wide: we model no changes to market-share assumptions under this scenario.

Revenue Growth	FY21	FY22	FY23	FY24	FY25
Base Case:	7.45%	4.20%	3.86%	3.25%	3.04%
Pricing Pressure:	6.0%	3.2%	3.2%	2.7%	2.5%

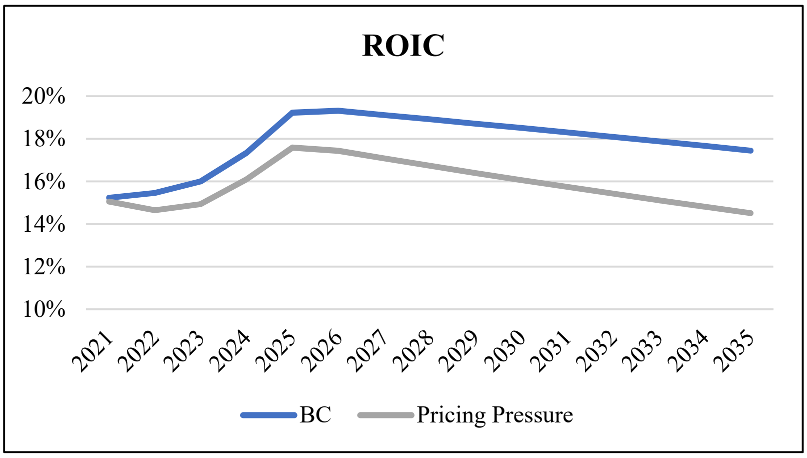
EBIT Margin

The greatest threat posed from the rise of e-commerce is a potential decrease in operating margins. The consolidation of retail would significantly reduce the pricing power of the pallets industry, where retail consolidation is unlikely to be matched. As such, we have modelled margins to decrease after FY25.



ROIC

Due to the reduction in margins, ROIC tracks below our base case, peaking in FY25 at 17.6% and subsequently declining throughout our forecasts.



Resulting Valuation

The pricing pressure scenario results in a valuation of $10.72 including FCs and a MoS of 0.01%. Due to the rapid uptake of e-commerce, we believe that consolidation within the customer base is a likely outcome. The main question is to what extent this will impact on margins. The scenario allows more a more substantial impact than the modest effects assumed under the base case. Notwithstanding a significant reduction, the resulting valuation is still around the current share price with FCs are included. Our analysis suggests that the case for holding BXB is somewhat resilient to a reduction in pricing power.

	Base Case	**E-Commerce Scenario**
Share Price (17/05/2021)	$10.68	$10.68
Valuation, inc. FC	$13.51	$10.72
Margin of Safety, inc. FC	26.49%	0.01%
Required Return on Equity	5.68%	5.68%
WACC	5.17%	5.17%

Appendix F: Risk Matrix and Guide

Risk Matrix

Investment Risk

Nature: Failure to generate sufficient returns to maintain the real value of funds invested over the long run.

Subsets of Investment Risk	**BXB Exposure**	**Risk Matrix**		
		Consequence	**Likelihood**	**Risk Rating Level**
Macro-Economic Risk	- Over 80% of revenue is derived from the consumer staples sector, which is defensive with relatively stable long-term demand. - Timber is a key input for BXB. Recent lumber inflation may persist in the long-term, increasing the cost of inputs which would decrease BXB's margins. BXB has introduced cost indexation clauses in customer contracts to pass some of the cost on to customers. Additionally, BXB produces lumber through CHEP South Africa's forestry and milling division (40% of supply in FY18).	MODERATE	UNLIKELY	LOW
Permanent Loss of Demand	- Sticky customers. - Market-leading position and global scale create high barriers to entry. - Network advantage created by pooled pallet solutions and tracking the pallet pool across the world. - Increased competition in the form of customers in-sourcing pallet production is unlikely as pallets represent a small portion of operating costs for retailers (i.e. not significant enough to justify vertical integration). - Potential switch to plastic pallets may increase capital expenditure and decrease demand, with plastic pallets costing \$70 compared to \$20 for traditional wood pallets. - Disruption via the entrance of a large, aggressive competitor (e.g. Amazon) is possible as the ROIC (excl. goodwill) of 11.4% represents an attractive opportunity for companies with sufficient scale to overcome the barriers to entry and keep costs low. - Significant loss of demand from a new entrant is unlikely given BXB's scale and relationships with customers.	MODERATE	UNLIKELY	LOW
Structural Industry Changes	- The rise of e-commerce threatens to reduce the size of the supply chain as goods are distributed direct to consumers. E-commerce may also lead to more industry consolidation, which would negatively impact BXB's pricing power. - Digital disruption may enable competitors to improve efficiency and decrease prices. BXB is developing digital solutions to effectively manage equipment losses and asset efficiency. BXB aims to achieve 85% automation in CHEP Americas by FY21.	MODERATE	LIKELY	HIGH

Cash Flow Risk	- Core business has a history of generating positive free cash flow. - As BXB operations are capital intensive, any unexpected and sustained increase in capital expenditure, with costs not being passed on to customers, may lead to a permanent reduction in cash flow generation. - These increases could be caused by the introduction of plastic pallets, increases in input costs or a failure to meet quality standards.	MODERATE	UNLIKELY	LOW
Leverage Risk	- BBB+ credit rating from S&P, Baa1 from Moody's. - Long-term Net Debt/Earnings Before Interest, Tax, Depreciation and Amortisation ratio target < 2.0.	MINOR	UNLIKELY	LOW
Currency Risk	- Around 90% of BXB's revenues and operating earnings are generated outside of Australia. - Revenues are reported in USD; however, the company operates in currencies such as the AUD, Euro, Latin American currencies, and the South African rand. - As an ASX listed company, all valuations will be in AUD. Therefore, any fluctuations in the AUD will impact the value of all future cash flows. - Fluctuations in the AUD are extremely likely over the long-term, as the AUD has traded between ~50 and ~110 cents over recent decades. - BXB has negative price sensitivity and will benefit from a weakening AUD. - Evidence suggests that currencies fluctuate around purchasing power parity (PPP) over the long-term. The AUD is currently above PPP, which implies that currency fluctuations are likely to generate upside to our valuation. - To mitigate currency risk, BXB generates income and incurs expenses in its local currencies of operation, so that currency impacts only relate to translation of free cash flows attributable to investors. - Foreign exchange hedging is used when a transaction exposure exceeds certain thresholds. BXB also raises debt in currencies where there are matching assets to avoid mismatch between the asset and debt base.	MODERATE	LIKELY	HIGH

Common Investment Risk

Nature: Risk exposures across all assets that may lead to a loss at the portfolio level.

Subsets of Common Investment Risk:	BXB Exposure	Risk Matrix		
		Consequence	Likelihood	Risk Rating Level
Concentration Risk	- In light of the planned sale of BIN, BXB would be the only active holding in the GICS Industrials sector. - SHL also has significant operations in the US and Europe. However, other active AAE holdings derive most of their revenue from Australia.	MODERATE	UNLIKELY	LOW

Reputational Risk

Nature: SMF activities that give rise to an adverse public opinion about ANU or CBE. This may result from adverse media attention, either solicited or unsolicited, or due to the violation of the ANU SRI policy.

Reputational Risk	BXB Exposure	Risk Matrix		
		Consequence	Likelihood	Risk Rating Level
Reputational Risk	- BXB is an ESG leader with policies that are aligned with the UN's Sustainable Development Goals. - BXB has no recent controversies that may give rise to reputational risk.	MAJOR	UNLIKELY	MEDIUM

Risk Matrix Guide

		Consequence		
		Minor	Moderate	Major
Likelihood	Unlikely	Low	Low	Medium
	Possible	Low	Medium	High
	Likely	Medium	High	High

Risk Category	Developments that can prevent, impede or delay the achievement of our objectives (primarily meeting the target return).
Risk Description	Describes the nature of the risk category.
Description	Describes the risk specific to the investment.
Risk Rating Level	The risk matrix indicates a risk rating based on the likelihood and consequences of a risk. There are 3 different levels for each.

Likelihood	**Criteria**	**Description**
Unlikely	Not expected to occur in most circumstances	• Sufficient controls are in place to limit the occurrences of this risk • May occur once every 3 years
Possible	Might occur occasionally	• May or may not occur, even with the controls in place • May occur once per year
Likely	Will probably occur in most circumstances	• Circumstances expected to occur that will give rise to the risk, which will be challenging to control • May occur several times a year

Consequence	**Description**
Minor	• Minor delays in achieving objectives and limited impact on the overall portfolio • The consequence can be easily controlled by the risk owner
Moderate	• Moderate delays in achieving key objectives and some impact on the overall portfolio • Program/activity/fund team subject to unplanned review or changed ways of operation • Moderate community sensitivity resulting in limited adverse publicity or criticism • Limited dissatisfaction of key stakeholders, moderately damaging SMF's reputation
Major	• Major delays in achieving key objectives and/or significant adverse impact on the portfolio • Threaten the survival or continued effective functioning of the SMF • Major community sensitivity, resulting in significant adverse publicity or criticism • Significant dissatisfaction of key stakeholders, significantly damaging SMF's reputation and relationshi ps

Appendix G: Foreign Exchange Valuation Impacts

The graph below plots the sensitivity of our base case valuation to the AUD/USD exchange rate. The estimates may overstate the actual sensitivity to the extent there is a positive correlation between EUR/USD and AUD/USD. This is because any negative translation effect of a lower USD may be somewhat offset by higher revenue and earnings from CHEP EMEA if accompanied by a stronger EUR.

Our base case MoS is resilient enough to withstand an appreciation in the AUD/USD to around 0.95. Furthermore, the valuation would benefit from decreases in the exchange rate. In this regard, we note that the AUD/USD is currently trading above its long-term value as measured by Purchasing Power Parity (PPP), which stands at around 0.68 according to the OECD (see https://data.oecd.org/conversion/purchasing-power-parities-ppp.htm). With the AUD currently trading 14% above this benchmark, arguably currency sensitivity offers more upside than downside from a long-term perspective. The valuation at an exchange rate of 0.68 is 13% higher at $14.28.