Australian National University

ANU Student Managed Fund

Investment recommendation

Brambles Limited

ASX code: BXB

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Contents

Notes:

All dollar amounts in this report are Australian dollars.

Glossary

AAE – Active Australian Equities

ANU – The Australian National University

BXB – Brambles Ltd

CAPEX – Capital expenditure

CHEP - Commonwealth Handling Equipment Pool

EBIT – Earnings before interest and tax

EBITA – Earnings before interest, tax and amortisation

EMEA – Europe, the Middle East and Africa

FMCG – Fast-moving consumer goods

FY22 – Financial year 2022

GICS – Global Industry Classification Standard

IAC – Investment Advisory Committee

IOZ – iShares Core S&P/ASX 200 ETF

MoS – Margin of safety

OECD – The Organisation for Economic Cooperation and Development

PPP – Purchasing power parity

R&C – Risk and Compliance

SMF – ANU Student Managed Fund

WACC – Weighted average cost of capital

Portfolio recommendation

We recommend that the Student Managed Fund (SMF) **rebalance** Brambles (BXB) back to the target weighting of 10% after a review by the Active Australian Equities (AAE) team and the Risk and Compliance (R&C) team. Proceeds are to be invested into the iShares Core S&P/ASX200 ETF (IOZ). We are also placing BXB under review to determine whether a sell recommendation might be justified, or at least establish the price at which we would put forward such a recommendation to the SMF Investment Advisory Committee (IAC).

Brambles

AUSTRALIA

ASX code: BXB

Price (at 1/05/2023)	$14.28
Valuation	$13.55
- inc. franking credits	$14.80
Margin of safety (MoS)	-5.11%
- inc. franking credits	3.64%
Dividend yield (2023F)	3.0%
GICS	Transport, Air Freight & Couriers
52-week range	$9.56-$14.66
Recommendation	Rebalance to target weight
Key assumptions	
Required return on equity	7.48%
WACC	6.53%
Carbon intensity	
BXB	16.70
ASX	236.08

Two-year share price history

Investment thesis

On 17 March 2023, BXB was placed under a rebalancing review after it moved to more than 3% above its 10% target weighting in the AAE portfolio. The deviation from target stands at +3.8% at the date of this report.

The key reason for rebalancing and also placing BXB under further review is that the stock is currently trading above our valuation with a margin of safety (MoS) of -5.11%. This arises following a period of significant outperformance (see chart right), and occurs notwithstanding an updated investment outlook entailing an improved outlook that have led us to increase our forecasts.

The SMF's original investment thesis was based on BXB's strong market share in the global pallet business, cyclical exposure to the retail industry and the opportunity for margin expansion and improved asset efficiency. Since the initial purchase in May 2021, our assumptions regarding the company's positive fundamentals have been confirmed. BXB has consequently delivered a holding period return of 34.15% underpinned by:

- Guidance that revenue will exceed forecasts being released with the 1H23 interim report. This stemmed from global pallet shortages leading to pricing growth, which was only partly offset by lower volumes.
- Confirmation of strong pricing power, as demonstrated by BXB being able to pass on of input cost inflation in lumber, labour and freight costs.
- Developments pointing toward improving returns on capital, with margins increasing across all geographical segments and pointers to better capital efficiency.
- Demonstration of a disciplined approach to capital allocation through the decision not to proceed with developing plastic pallets along with Costco.

We have refreshed our forecasts and hence valuation to recognise the impact of short-term pallet scarcity, improved asset efficiency and higher contract prices. Nevertheless, the improvements have been captured in a higher share price, creating a situation where the share price is now above our valuation. This premium to valuation is sufficient in its own right to justify rebalancing.

The premium to valuation also raises the question of whether BXB may now be expensive enough to justify selling the SMF's entire position. In this respect, we consider our valuation to be based on conservative assumptions, and see further scope for further upside arising from improvements in both operational and asset efficiency. The attraction of BXB is buffered its competitive advantage in pallet pooling, especially compared to whitewood pallets; strong pricing power and the ability to pass on costs; and increased confidence in management following the decision on plastic pallets. On the other hand, BXB is trading at a premium to our valuation, and remain exposed to downside risks related to deteriorating economic conditions and some potential for competitive pressure on margins or market share. Uncertainties also exist related to currency and the scarcity of pallets, both of which could potentially impact BXB's share price either positively or negatively. Further in-depth analysis is required to weigh up these issues, and establish the share price at which a sell recommendation might be justified.

Upside to the investment case

The factors discussed below are largely responsible for the appreciation of BXB since the 1H23 financial results, and hence have been at least partially factored into the current share price. Nevertheless, we see potential for future upside if the factors identified lead to additional long-term structural improvement in the company's fundamentals.

Pricing power and ability to pass on costs

BXB has been able to successfully implement mechanisms to offset fluctuations in input costs, confirming the assumption of price leadership that underpins the investment thesis. Although input costs increased throughout 1H23, BXB has been able to not only hold margins, but improve them across all geographical locations. In 1H23, margins improved in CHEP America by +1.5%, CHEP EMEA by +0.5% and CHEP Asia-Pacific by +5.9%.

BXB's strong pricing power is partly due to the ability to pass on costs through contracts that include long-term indexation and short-term surcharge mechanisms. Such indexation has been implemented over the past three years and is now reflected in up to 80% of customer contracts. The recent cyclical rises in input prices and inventory cycle disruptions from industry wide shortages have highlighted the success of BXB's structural changes to contract pricing.

The success of BXB changing contract clauses to provide a safeguard to cyclical fluctuations has been at least partially captured in the appreciation of the share price. While we expect increases in transport and labour costs over the medium term, longer than expected pallet shortages are also forecasted by JP Morgan to continue due to slower than expected de-stocking across the industry resulting from the onset of higher pallet life cycles stemming from the pandemic. This situation presents BXB with pricing power that should allow them to weather any cost increases. It also provides potential for further upside to revenues in FY24/25.

Realisation of pricing power has both raised the baseline for forecasting and increased our confidence in future earnings. When forecasting revenue, our model accounts for the structural change in contract prices and surcharges by assuming that it will continue to offset any cyclical cost pressures. We have further assumed that current pricing and margins becomes entrenched over the long term due to the benefit of BXB's improved quality GPS trackers. The sustainability of higher contract prices is also supported by BXB's pooled pallets remaining attractively priced, with whitewood alternatives being $13.50 more expensive per unit. Meanwhile, we have applied conservative volume forecasts that allow for some potential loss of market share due to possible substitution from pooling towards whitewood alternatives in response to pallet scarcity, although the likelihood of this occurring will be limited by the differential in per unit cost.

Increased competitive advantage

BXB's 'Shaping our Future' transformation program should improve its competitive advantage over the long term. The majority of BXB's initiatives remain well on track, with the key focus areas being improving the customer experience, raising asset productivity and expanding digital and analytical capabilities. The 'Shaping our Future' transformation program is yet to see large, realised gains, so far contributing just +0.8% to EBIT. However, the success within the initial stages of the program indicates the potential for a significant long-term impact by reducing pallet losses and hence capex and increasing revenue through higher volumes. The completion of this program in 2025 should see meaningful efficiency gains that BXB should be able to capture in improved margins and so return on invested capital (ROIC) under the presence of strong pricing power. Key elements of the program are discussed below, all of which create potential to further surprise the market with the scope of efficiency improvements.

a. Customer value

In 1H23, BXB continued to rollout dynamic delivery notifications providing real time GPS locations, improving customer planning capabilities and pallet return rates. This has delivered a 1-2% net volume growth within existing customers so far, and is expected to help improve margins to above the historical average.

b. Digital transformation

In 1H23, 660,000 pallets were tagged, with the company on track to reach 1 million tagged pallets over FY23. Tagging should support a significant reduction in pallet loss and improvement in customer experience. Since the implementation of the five-year program, uncompensated pallets have decreased by 30%. This will ultimately reduce maintenance capex on lost pallets. Our valuation assumes this initiative will provide long-term benefit for margins.

c. Asset efficiency and network productivity

The nine new integrated repair cells introduced so far in FY23 have improved the recovery and remanufacturing process, thus contributing to better asset efficiency. The impact of these repair cells was evident in 1H23, when an additional five million pallets were made available compared to an additional four million during 1H22. With current industry wide pallet shortages, which is assumed to continue longer than initially expected into FY24, the ability to recover pallets has become more important to BXB's competitive advantage in the market. BXB plans to introduce an additional 14 new repair cells by the end of FY23, which should further boost capital efficiency.

Improved confidence in management

As our original investment thesis assumed minimal adoption of plastic pallets, our valuation has not been impacted by the announcement that BXB will not participate in Costco's plastic pallets initiative. Importantly, the decision to not proceed with the initiative has boosted our confidence that management will make value-accretive decisions.

Despite conducting extensive trials and developing an industry-leading plastic pallet over the past three years, BXB decided not to participate further in this initiative as the returns were below its hurdle ROIC of 15%. The issue was that the efficiencies of plastic pallets are not large enough to cover their higher cost, which is four times greater than wooden pallets. Further, Costco and BXB could not agree on commercial terms whereby Costco would pay a price premium to enable BXB to meet a 15% return. BXB thus demonstrated a disciplined approach to capital allocation by not pursuing a project that would have diluted its return on capital. During BXB's press release to confirm their withdrawal from the agreement in 2022, management pledged to support Costco with future business initiatives in order to retain their long-standing relationship. While Costco may still look to transition to plastic pallets, the likelihood, timing and magnitude is unknown. The transition is anticipated to not take place in the foreseeable future.

Downside to the investment case

Whilst we believe there remains residual upside potential that has not been fully incorporated into the BXB price, this needs to be weighed against potential for downside.

Deteriorating economic conditions

Demand for pallets is linked to economic growth, and the outlook for trading conditions has deteriorated across most of BXB's key markets, in large part due to monetary policy tightening. According to IMF predictions released in April 2023, GDP growth forecasted to slow from 2022 into 2023 and 2024 in the USA from 2.1% to 1.6% then 1.1%, in Europe from 3.5% to 0.8% then 1.4% and in Australia from 3.7% to 1.6% then 1.7%; although it is projected to rise in China from 3.0% to 5.2% then 4.5%. This will more than likely lead to a slowdown in consumer demand, particularly in retail trade, resulting in lower pallet and container volumes. Our valuation assumes that recent pallet price increases are structural and hence sustainable. The main risk is that they prove to be cyclical in nature, and unwind as economies and hence pallet demand weakens. On the other hand, we have been conservative in terms of volume levels, which we assume remain constant thus factoring in destocking and lower consumer demand.

Competitive pressures

BXB operates in a competitive market. Competitors include Loscam, which also uses pooled pallets, and GMA which is one of the leading distributers of whitewood pallets. Maintaining BXB's competitive position is critical for sustaining margins and future cash flow generation. Within the fast-moving consumer goods (FMCG) industry, BXB's competitive advantage comes from:

1. Efficient logistics in providing and repairing pallets, allowing them to earn strong margins while offering competitive prices;
2. Higher quality pallet offerings in terms of materials and repair locations and GPS locators;
3. Increased customer experience through its GPS locators, which assists customers to plan daily production activities.

An erosion in BXB's competitive advantages could reduce either their pricing advantage and/or volumes. The risk in this regard relates to competitors making technological and material advancements or emulating BXB's efficiency strategies and programs to improve their network efficiencies and quality of their pallets. If BXB's relative advantage disappears, two possibilities emerge. First, their product could be substituted, with any loss of share to competitors slowing volume growth and causing the pallet pool to become unbalanced. Second, BXB may be required to reduce prices and hence margins to compete.

Another possibility is that competitors compete aggressively for business notwithstanding facing a competitive disadvantage. Our forecasts assume ongoing price growth will offset any underlying cost inflation and maintain or grow margins, with BXB's recent changes in pricing contracts to add indexation clauses and surcharges as important mechanisms to insulate and stabilise gross margins. However, the question remains whether this assumed stability is sustainable over the long run if competition heightens. It is possible that competitors may target BXB clients at the end of their contracts, offering them more favourable terms and forcing BXB to compete on pricing. We believe this is unlikely due to BXB's strong market position. For instance, BXB's EBIT margin sits at 11.3% compared to its closest competitor Sankyu with EBIT margins at 6.6%, which limits potential for the latter to compete on pricing.

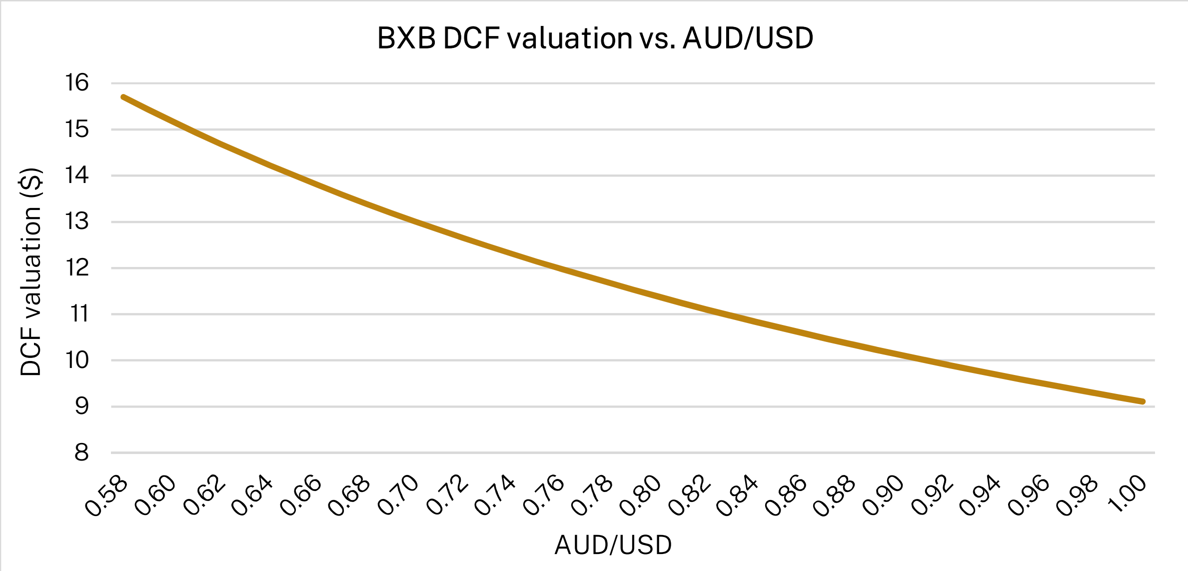
Our projections for revenue growth and margins assume some potential loss of market share to allow for the possibility of a modest contraction in BXB's competitive advantage or some degree of competitive pressures. Nevertheless, the risk exists that competitors are able to close the gaps to a greater extent, or compete more aggressively, than we have assumed.

Uncertainties

Currency

With 92.92% of revenue and hence the majority of its cash flows sourced from outside Australia, BXB's valuation is quite sensitive to currency fluctuations (see chart over). The portion of BXB's total revenue derived from the US has continued to increase over time. In 1H23, the US revenue portion increased to 56.6% up from 53% from 2022. This implies a greater exposure to fluctuations in the USD then in previous years and is evidenced by the tendency for the share price to respond to AUD/USD movements. Meanwhile, the Euro exposure has decreased as the EMEA portion of revenue has decreased. Currency effects were evident in 1H23, as revenue growth was dampened by depreciation in the USD relative to the AUD and Euro.

Currency is a source of volatility, and as such may provide both upside and downside to BXB's valuation. The AUD/USD at 0.664 sits below purchasing power parity (PPP) of 0.695 according to the OECD, leaving a difference from long-term value on this measure or -4.5%. While this raises the likelihood of an upward adjustment in the exchange rate that could amount to reduction in BXB's valuation in AUD terms, the difference is not large. In summary, we see currency as a more a source of uncertainty than as an important consideration for the investment case.



Scarcity of pallets

In 1H23, pallet prices across all markets stood above historic levels. While this is partly due to cost pressures being passed through into prices, it also reflects a shortage of pallets caused by increased inventories among retailers and changes in the customer supply chain that lengthened the pallet cycle. Pallet supply remains tight overall despite pallet scarcity being eased by the current de-stocking environment and an additional five to six million pallets being returned to the pool. BXB argues that their pool remains below normal levels by two to three million pallets, raising the possibility that pricing tail winds will remain supportive in the short term before having a lesser effect on revenue over the medium-to-long-term.

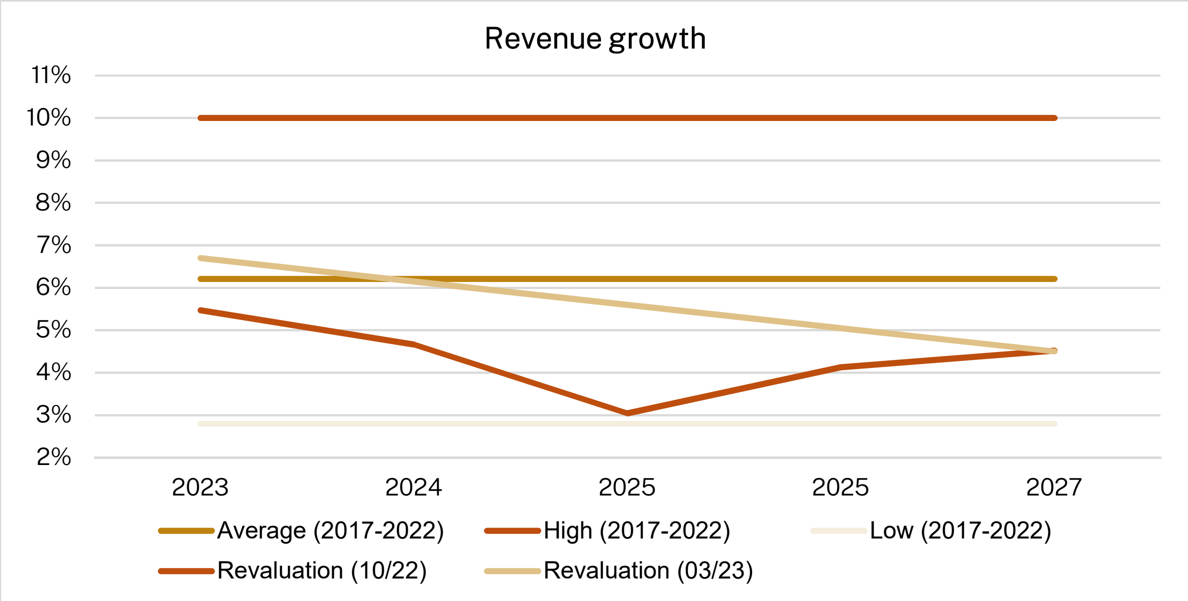
Pallet scarcity has helped to provide improvements to contract prices that we have assumed is largely structural. We also see the higher prices as more appropriately reflecting the benefit of BXB's improved quality GPS tracker pallet and the risk of pallet damage or loss. Nevertheless, there is some uncertainty over the extent to which the increase in pallet prices and volumes will be sustained once pallet availability improves. We estimate revenue growth on the assumption any price increase stems from improvements in the quality of BXB's products rather than scarcity of pallets, with volumes remaining relatively flat. While consider this set of assumption to be conservative given BXB is a market leader in terms of quality, there is scope for effects of reduced pallet scarcity to go either way.

Key model updates

Revenue growth

Increased pallet pricing has allowed BXB and the industry to increase revenue per unit, although price increases have occurred along with some decline in pallet trading volumes. The 1H23 interim result reported revenue growth of 6.7%, with the price effect outweighing the volume effect. Further, revenue growth exceeded both market expectations and the SMF forecasts in our previous revaluations, with BXB able to pass on in full the rising costs in timber, transport and labour to users of its CHEP pallets, crates and containers. We adjusted our full-year revenue growth forecasts up to 6.7% accordingly, thus raising the baseline for forecasting. Other contributions to the upward revision in the revenue stream include continued scarcity of pallets, increased contract prices and confirmation of BXB's competitive advantage.

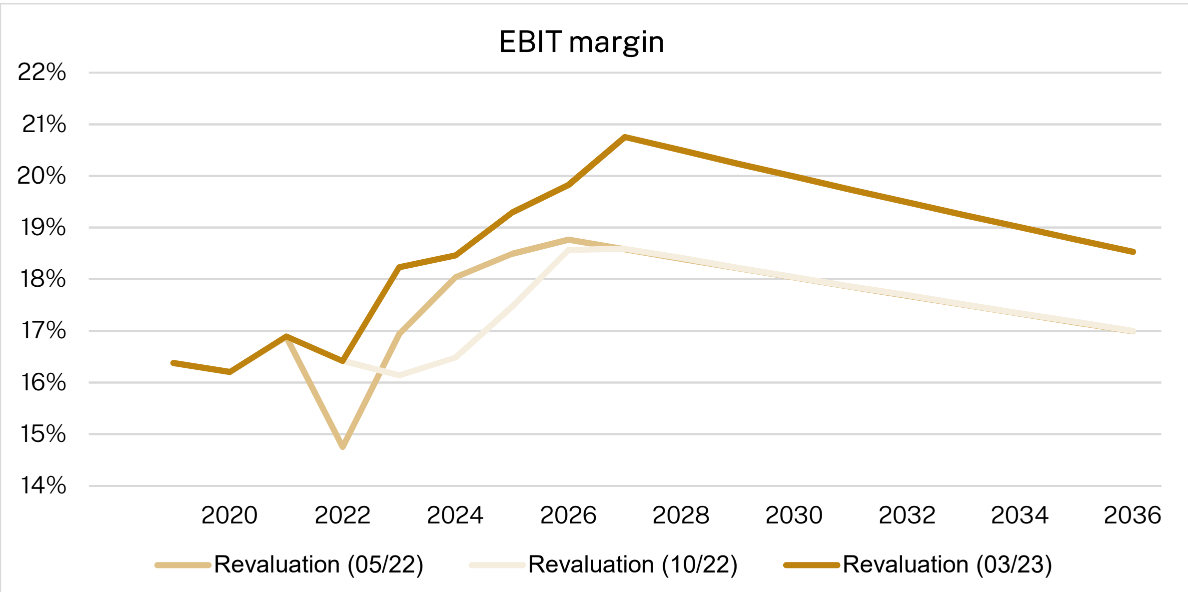
We assume revenue growth will trend towards 4.5% in FY27, a +0.25% increase from previous revaluations. This level remains in-between the FY17-FY22 average and the FY17-FY22 low, as seen in the graph over. We consider this a conservative forecast with volumes anticipated to remain constant along with higher prices reflecting BXB's improved quality of pallets due to GPS trackers and reduced rate of pallet loss. Our forecasts sit in the lower half of BXB's historical revenue growth range, thus incorporating the risks of deteriorating economic conditions and potential loss of future market share.



Margins

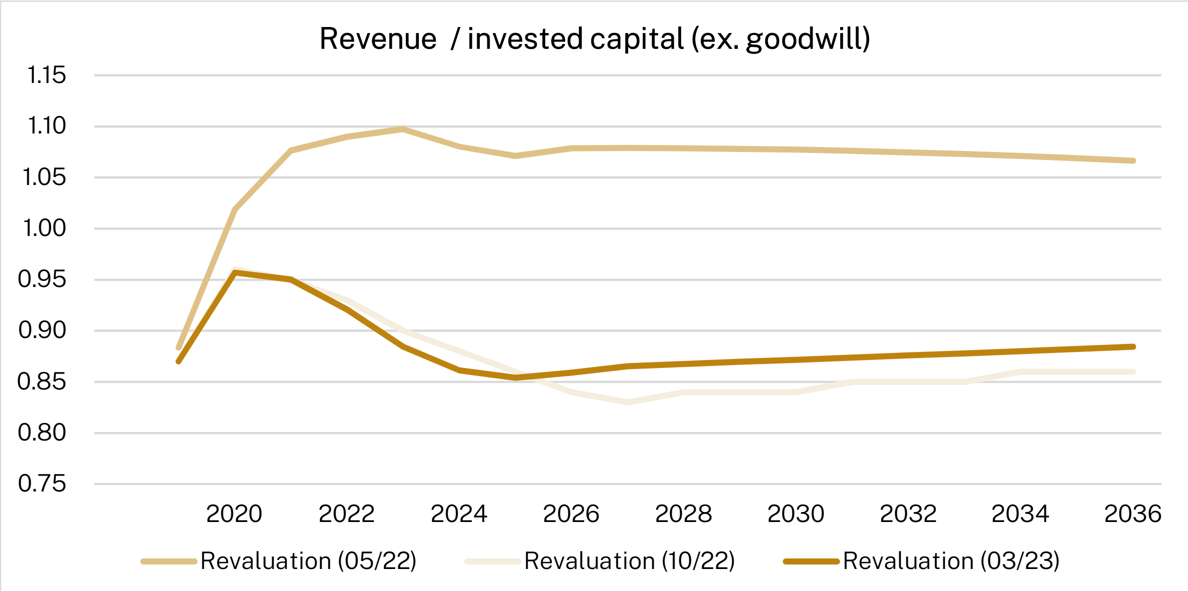
Sensitivity analysis (see Appendix 1) finds that operating margin assumptions have a material effect on the final DCF valuation, most notably for the Americas region and to a lesser extent EMEA. Since the previous revaluation, BXB's 1H23 report revealed a major increase in operating margins across all regions. Operating margins for 1H23 were higher than all years since FY16 in the Americas; the highest since 2018 in EMEA, and only 2.48% lower than the seven-year high; and the highest in the past seven years in Asia-Pacific. Margins during 2021-22 of 16.89% were at the highest since FY16, and jumped further to 17.40% in 1H23. Efficiency improvements through the 'Shaping our Future' transformation program are yet to generate significant benefits, with further gains expected when the program completes in FY25. We have responded by adjusting our operating margin forecasts upward to reflect current operating performance, with EBIT margins expected to peak at 20.75% in FY27. See Appendix 2 for segment margin forecasts.

EBIT margins are expected to decline from FY28 to 18.5%, which conservatively allows for some erosion in BXB's strong competitive advantage over the medium-long term. This considers the emergence of new technology from competitors, whitewood becoming more competitive and competitors adopting similar programs to the 'Shaping our Future' program thus improving their efficiency. This is consistent with the October FY22 revaluation.



Improvements in capital intensity

Another major driver of our valuation is capital efficiency. Our forecasts anticipate a gradual decline in the ration of capital expenditure (CAPEX) to revenue each year. Again, assumptions for America and EMEA have the most pronounced effect on the valuation (see Appendix 3). Across all segments, our forecasts assume that maintenance CAPEX is expected to rise slowly (see Appendix 4). The combination of conservative revenue assumptions coupled with conservative CAPEX assumptions result in a marginal improvement in the ratio of revenue to invested capital relative to the October 2022 revaluation (see chart below).



a. Maintenance CAPEX (see Appendix 4)

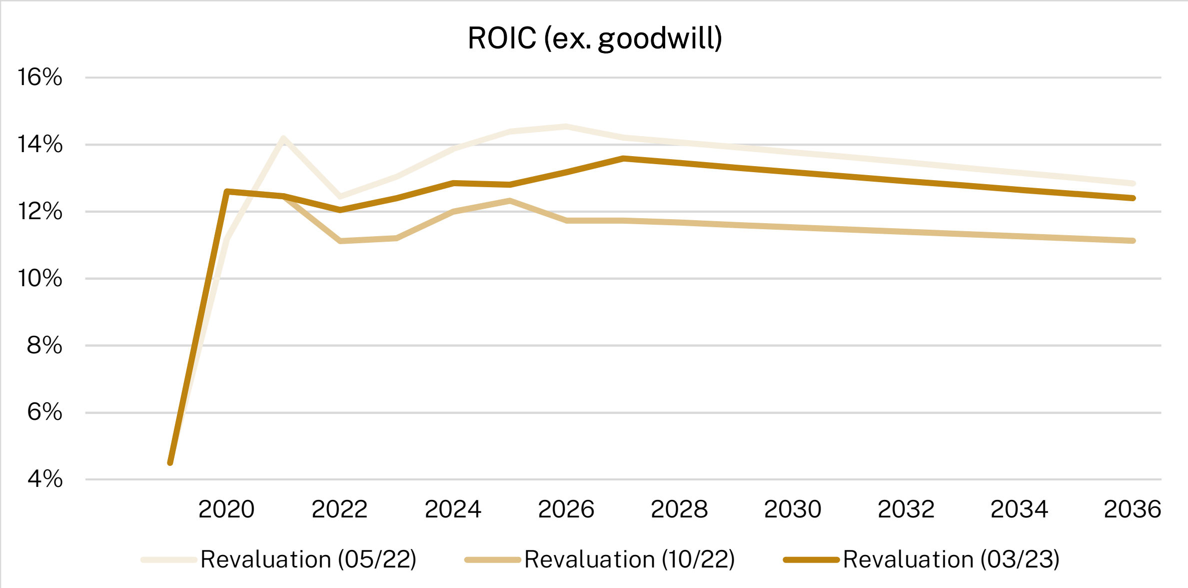
BXB is a capital-intensive business, with pallet expenditure accounting for the vast majority of CAPEX. Historically around 10% of BXB's pallet pool needs to be replaced annually due to damage or loss. During 1H23, elevated lumber prices boosted the cost of replacing pallets. However, this was offset by improved pallet return rates with approximately five to six million pallets returned to the pool. The returned pallets can be redeployed to existing customers or allow BXB to service pent-up demand, thus reducing the requirement for expenditure on additional pallets. Asset efficiency is further improved through the implementation of new digital capabilities such as machine learning and automation. BXB has also developed over 20 advanced analytic tools to improve collections and loss reduction. In 1H23, maintenance CAPEX has been significantly below the past average in all regions. Our forecast assumes that maintenance CAPEX will increase at slower rate compared to previous years.

b. Further investment (see Appendix 5)

BXB continually needs to invest in new pallets to grow and service new customers, especially with the scarcity of pallets. The need to acquire pallets currently sits below historic levels across all segments as a consequence of improved pallet retention rates due to efficiency initiatives. Our valuation assumes that CAPEX/revenue in each region returns to historical averages over the long term, to reflect the possibility of weakened future pallet retention and the need to maintain BXB's competitive advantage as competitors adopt efficient technology and programs.

c. ROIC

BXB's forecasted ROIC has increased relative to the October 2022 revaluation. Improvements to operating efficiency and margins imply that a higher level of returns can be extracted from a given dollar of invested capital.



Conclusion and recommendation

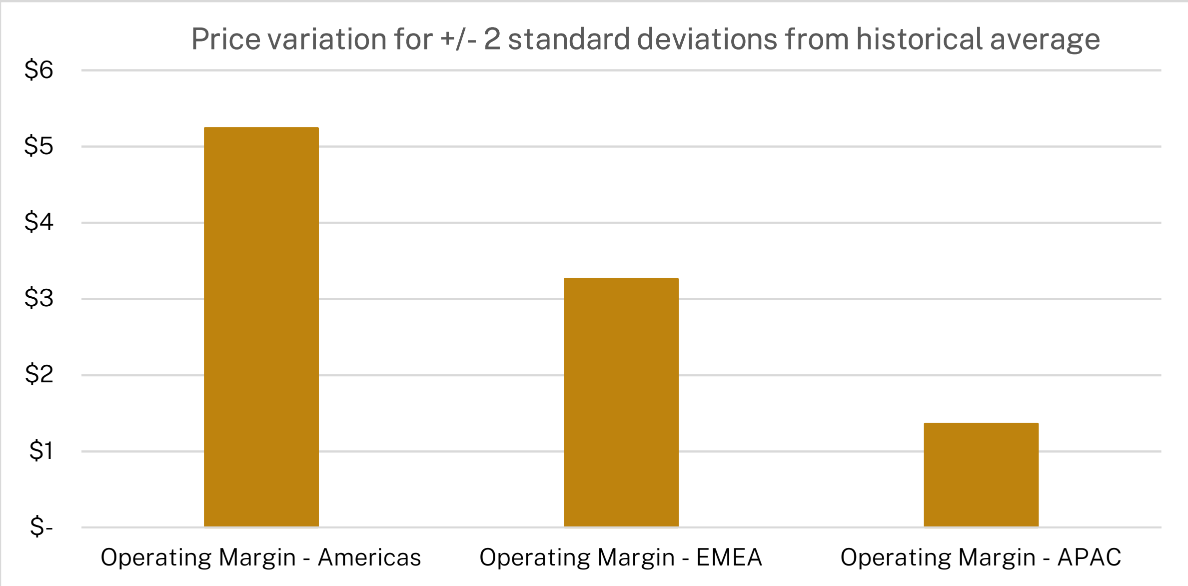
Outperformance by BXB has triggered the rebalancing procedure and led to an opportunity for the AAE team to revisit the investment case. While the underlying fundamentals of BXB are still intact and have improved in terms of both operational and asset efficiency, the MoS now stands at -5.11% excluding franking credits (+3.86% including franking credits). We consider our valuation to be based on conservative assumptions, and we still see potential for additional upside as compared to the downside risk. Nevertheless, with BXB trading above our valuation we do not see sufficient reason to remain above the endorsed 10% target weight. As such, we recommend rebalancing back to target and investing the proceeds into the iShares Core S&P/ASX200 ETF (IOZ). We are also planning to undertake further review of BXB to consider whether a recommendation to sell the remainder might be justified, or at least establish a price at which a sell recommendation might be worth putting to the SMF IAC.

Revised BXB valuation at (1/05/23)

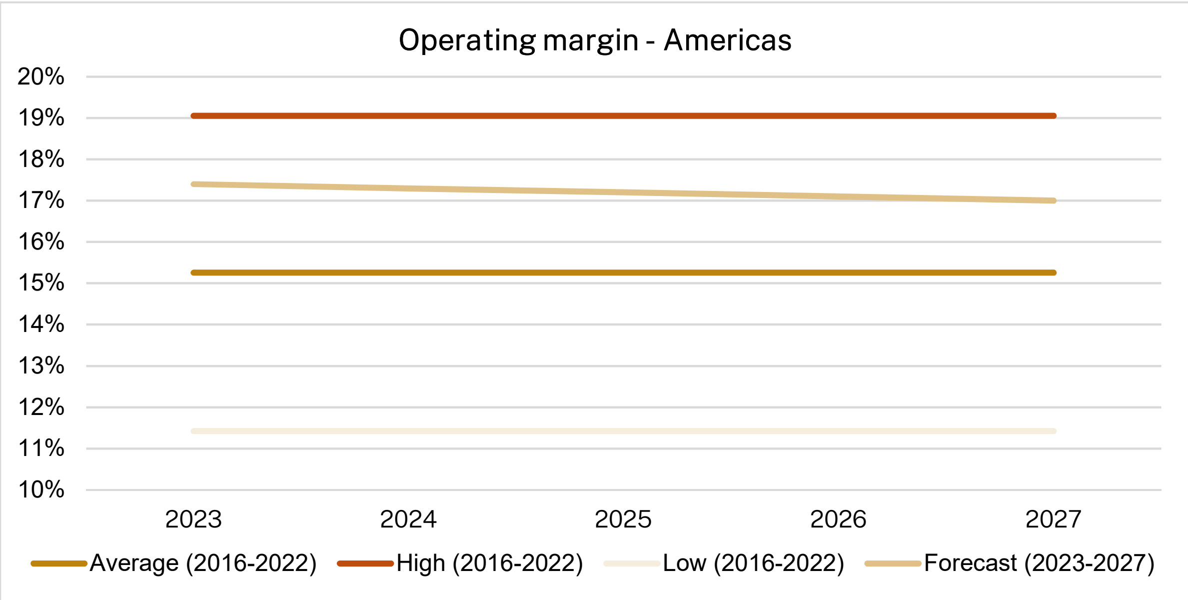
Valuation ex. franking credits	$13.55
Franking credits	$1.25
Valuation inc. franking credits	$14.80
Current share price	$14.28
MoS ex. franking	-5.11%
MoS inc. franking	3.64%

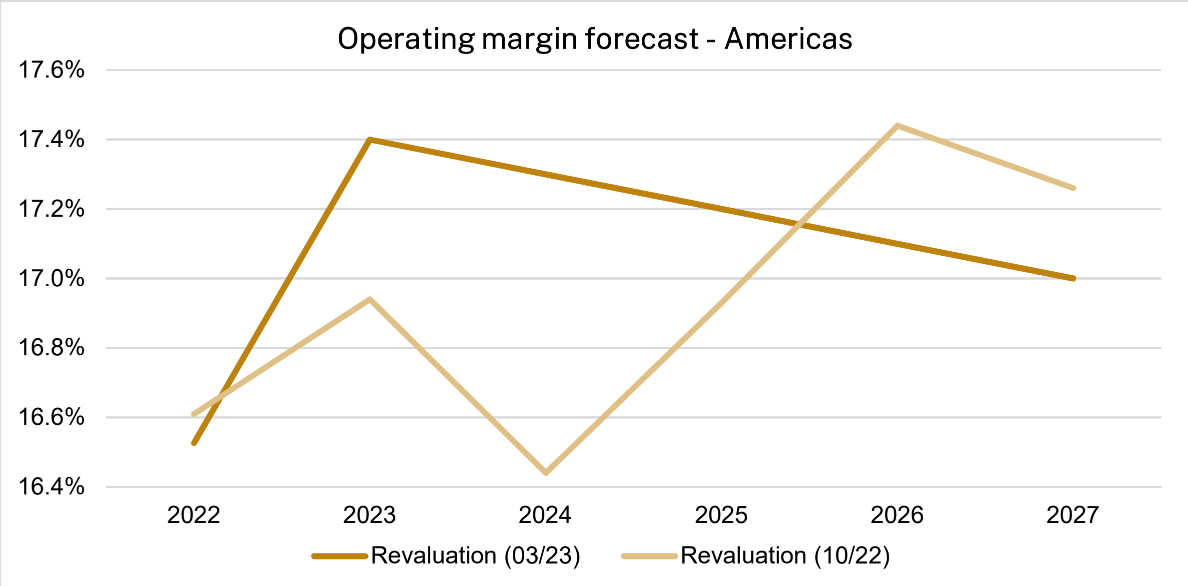
Appendix

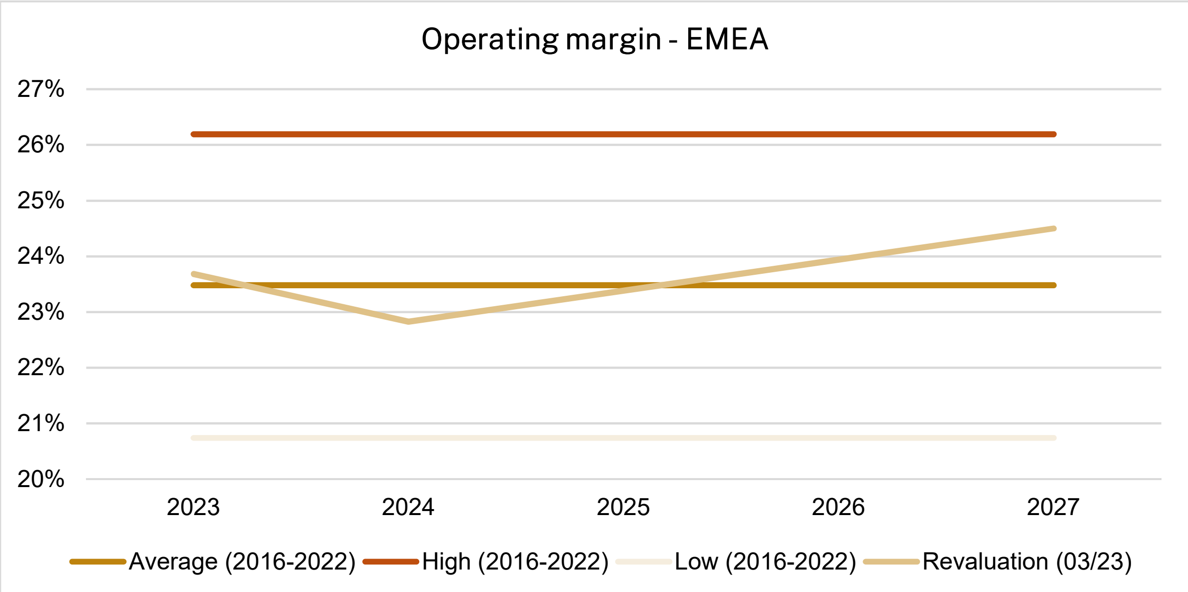
Appendix 1

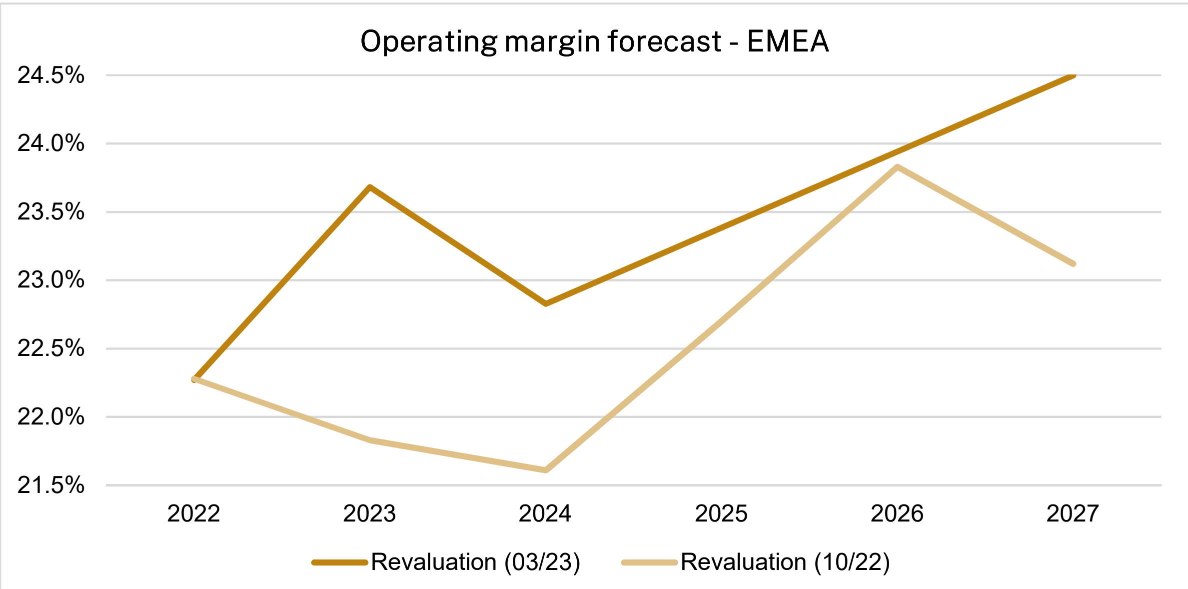


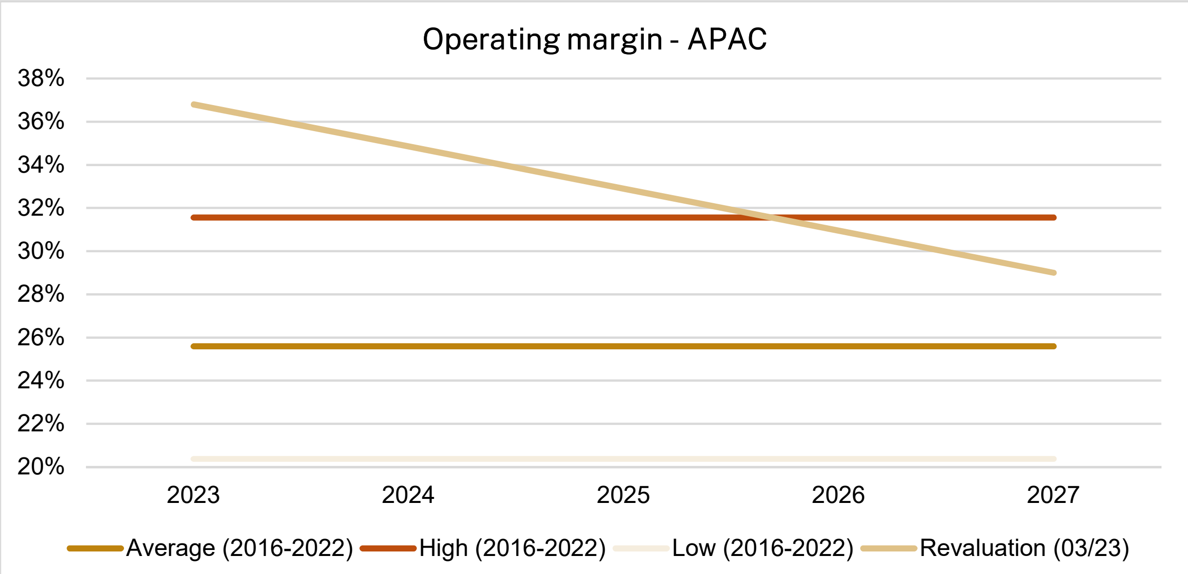
Appendix 2



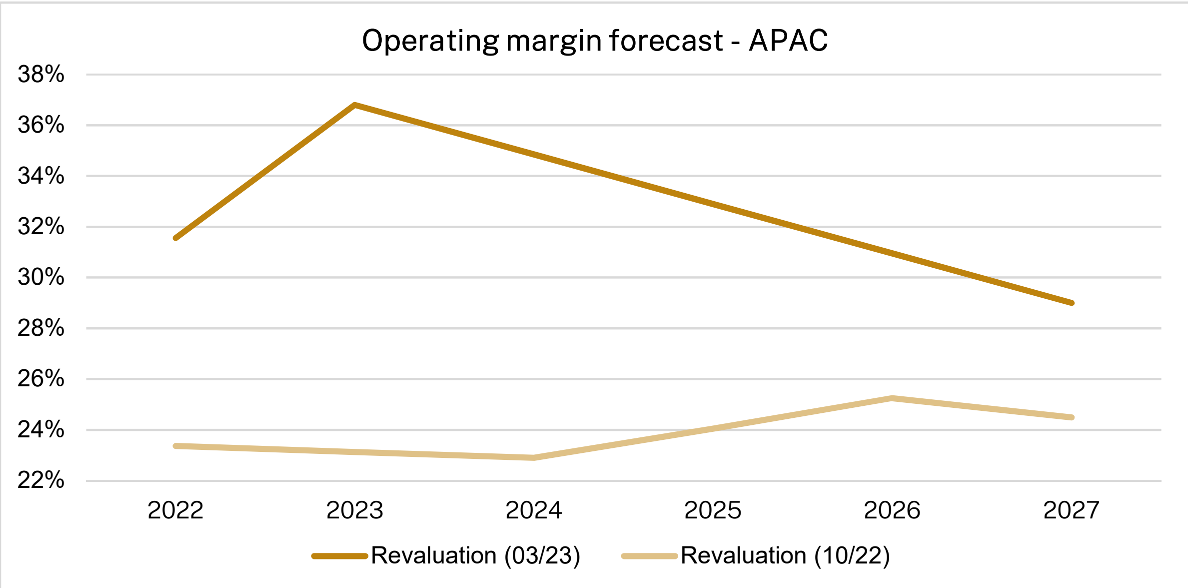

Operating margin forecast - Americas
17.6%
17.4%
17.2%
17.0%
16.8%
16.6%
16.4%
2022
2023
2024
2025
2026
2027
Revaluation (03/23)
Revaluation (10/22)


Operating margin - EMEA
27%
26%
25%
24%
23%
22%
21%
20%
2023
2024
2025
2026
2027
Average (2016-2022)
High (2016-2022)
Low (2016-2022)
Revaluation (03/23)


Operating margin forecast - EMEA
24.5%
24.0%
23.5%
23.0%
22.5%
22.0%
21.5%
2022
2023
2024
2025
2026
2027
Revaluation (03/23)
Revaluation (10/22)

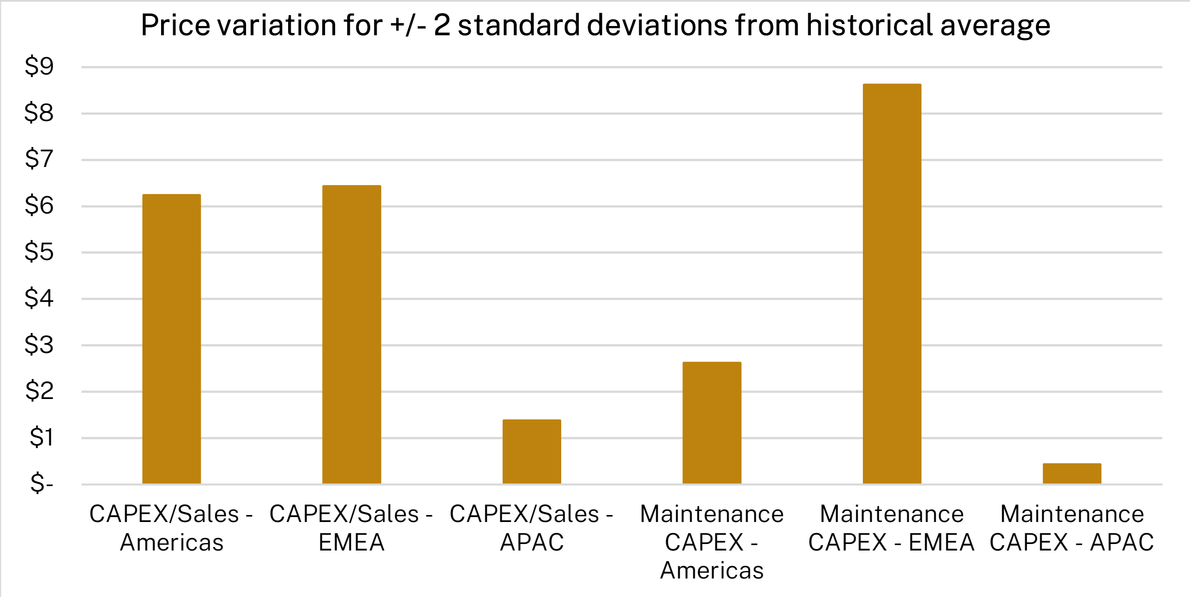


Operating margin - APAC
38%
36%
34%
32%
30%
28%
26%
24%
22%
20%
2023
2024
2025
2026
2027
Average (2016-2022)
High (2016-2022)
Low (2016-2022)
Revaluation (03/23)

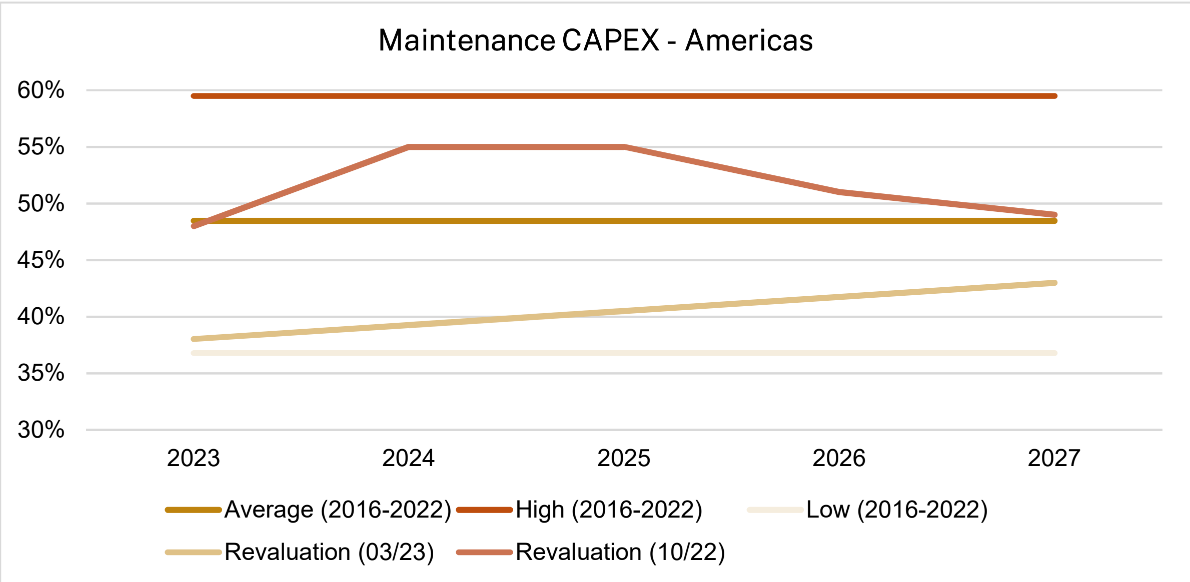


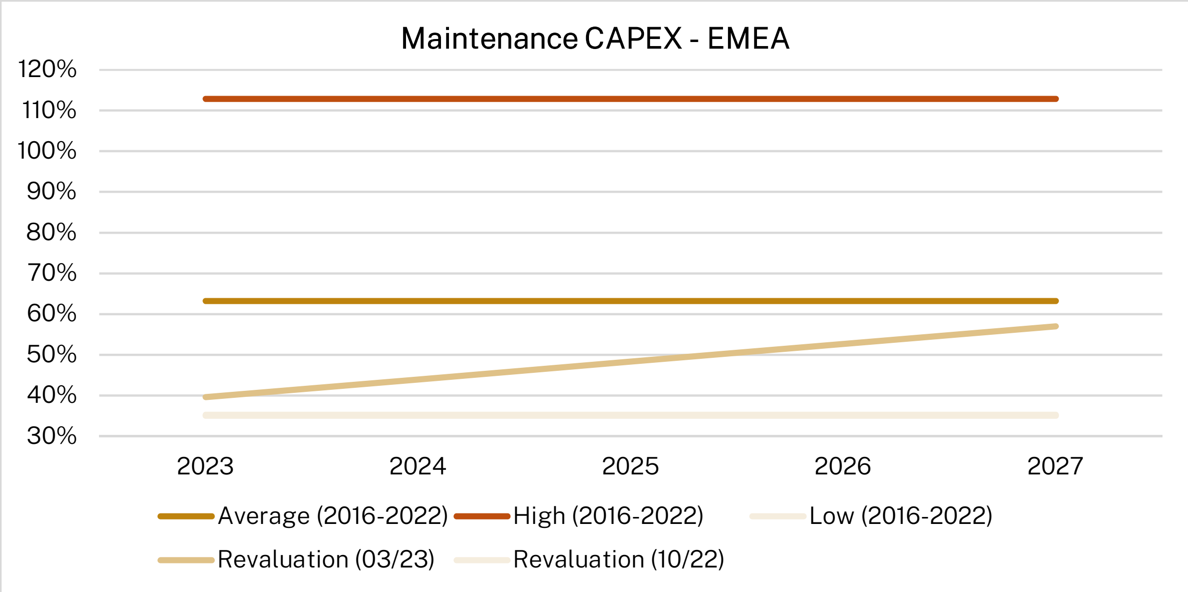
Operating margin forecast - APAC
38%
36%
34%
32%
30%
28%
26%
24%
22%
2022
2023
2024
2025
2026
2027
Revaluation (03/23)
Revaluation (10/22)

Appendix 3

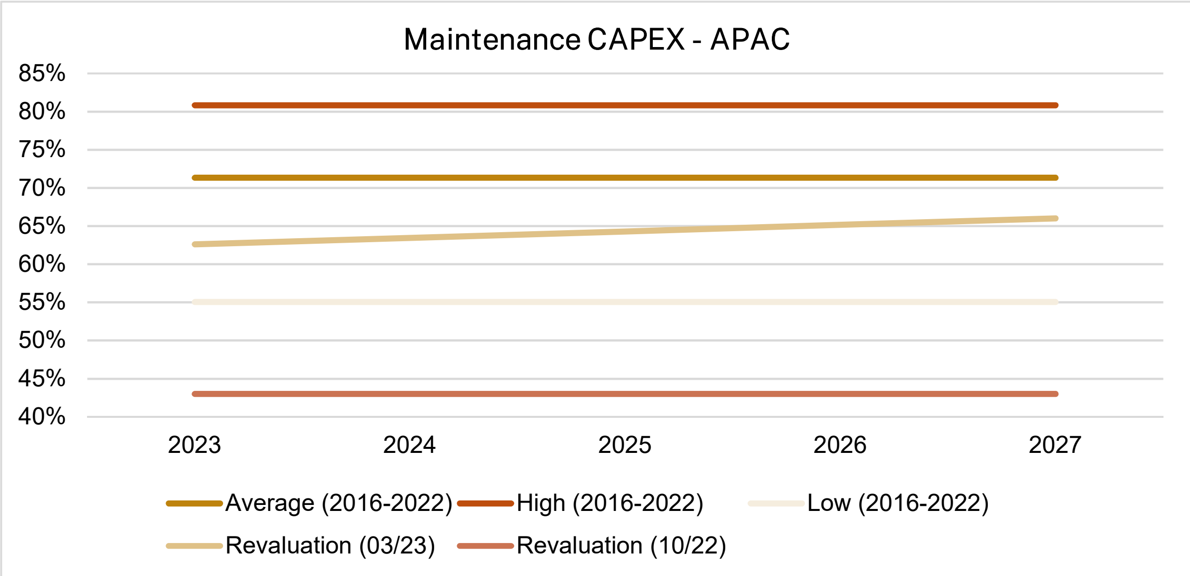


Appendix 4



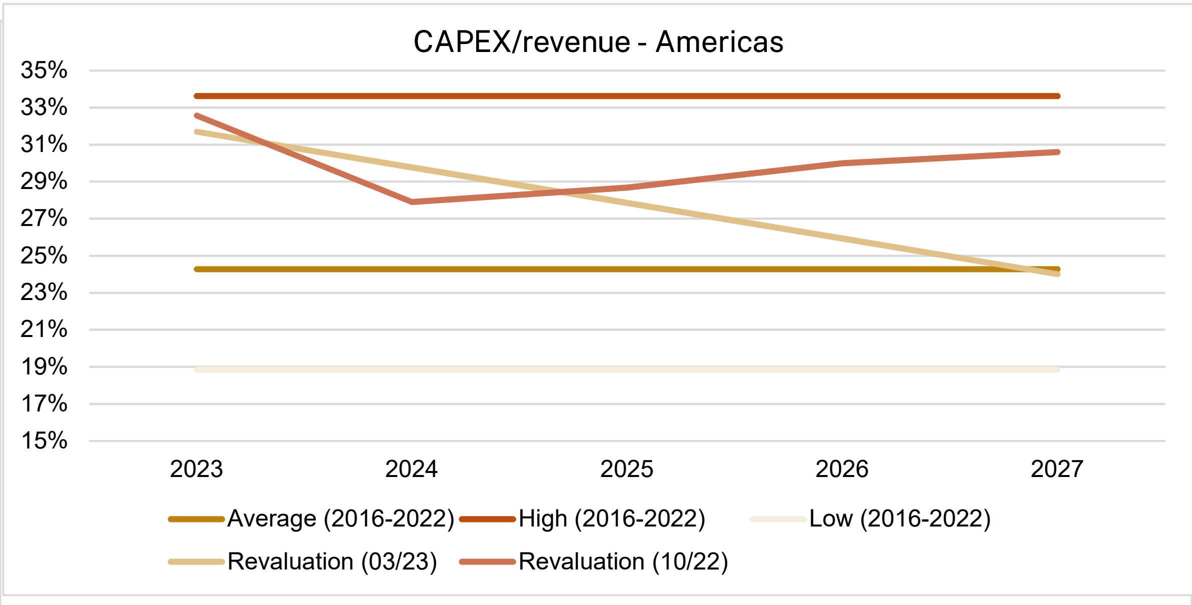


Maintenance CAPEX - EMEA
120%
110%
100%
90%
80%
70%
60%
50%
40%
30%
2023
2024
2025
2026
2027
Average (2016-2022)
High (2016-2022)
Low (2016-2022)
Revaluation (03/23)
Revaluation (10/22)

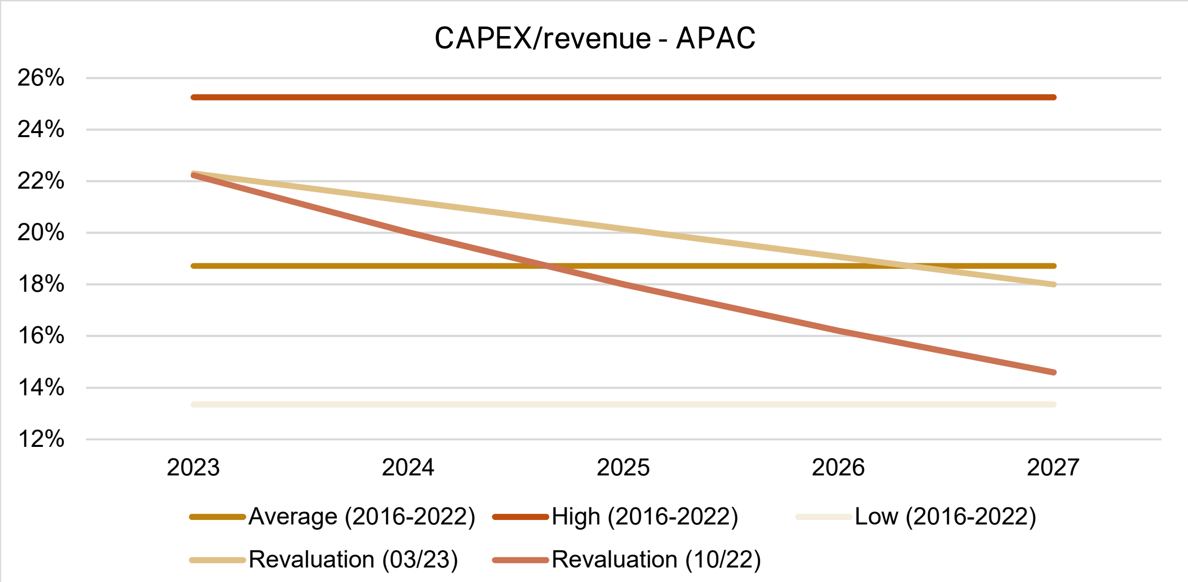


Maintenance CAPEX - APAC
85%
80%
75%
70%
65%
60%
55%
50%
45%
40%
2023
2024
2025
2026
2027
Average (2016-2022)
High (2016-2022)
Low (2016-2022)
Revaluation (03/23)
Revaluation (10/22)

Appendix 5



CAPEX/revenue - Americas
35%
33%
31%
29%
27%
25%
23%
21%
19%
17%
15%
2023
2024
2025
2026
2027
Average (2016-2022)
High (2016-2022)
Low (2016-2022)
Revaluation (03/23)
Revaluation (10/22)



Contact details

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