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Asia Pacific / Australia
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Australian research team

Greg Ward
+61 3 9280 1883
greg.ward@csfb.com

Tim Hall
+613 9280 1669
tim.hall@csfb.com

Fiona Green
+613 9280 1664
fiona.green@csfb.com

UK research team

Andrea Von Schilling
+44 20 7883 8516
andrea.vonschilling@csfb.com

Andrew Sweeting
+44 20 7883 8517
andrew.sweeting@csfb.com

Samantha Gleave
+44 20 7888 0291
samantha.gleave@csfb.com

Brambles Industries

CHEP USA—broken or damaged?

We have been monitoring the structural and operational difficulties in CHEP USA for almost two years. The issues have been the basis of our HOLD recommendation and the reason our earnings forecasts remain at the bottom of the market.

Given the importance of CHEP USA as one of the key earnings and sentiment driver for Brambles, we have detailed the issues in this report to fully inform investors so they can make a fair assessment of the potential time and cost to resolve these difficulties. We believe management will provide greater clarity on the resolution and timing of these issues in the imminent 1H02 result.

There is a growing trend amongst large retailers for a viable alternative to CHEP. Given retailers typically hold the balance of power in the supply chain, it is important to remain cognisant of this risk. We expect CHEP to maintain its dominant position, but we believe there are increasing risks of: i) best case: margin pressure; ii) worse case: CHEP will forgo market share and margins.

We continue to be strong advocates of Brambles and its core business in the medium to long term, yet remain cautious that the market's earnings may not account for the severity of the CHEP USA difficulties. Our earnings estimates are 7%, 14% and 25% below the market for FY02, FY03 and FY04, respectively. Based on CSFB estimates, Brambles is trading on a 38% premium to the Australian market, versus its historical 22.6% premium trading average. Using market consensus earnings estimates, Brambles is trading on a 21% premium.

We maintain our HOLD / Marketweight recommendation and 12-month price target of A\$9.50/£3.40.

Credit Suisse First Boston Australia Equities Limited

Participating Organisation of the Australian Stock Exchange—ABN 35 068 232 708 ACN 068 232 708

Portfolio managers detail

Ramifications to CHEP and the pallet pool: –

The potential consequences of losing control of the pallet pool include: –

- 1) A decline in asset turns / increase in dwell time for the pool;
- 2) An increase in the damage rates of the pallets, and hence increased repair costs;
- 3) Growing proportion of lost pallets;
- 4) Greater collection and transport costs resulting from pallet “leakage”;
- 5) “Black Market” pallet pool proliferation;
- 6) Increasing litigation (see *First Edition*, 21 November 2001) where there were three class actions against CHEP (now two following a settlement); and
- 7) The dilution of value incorporated in the Participating Distributor Agreement and the potential impact that will have on: –
 - Signing/converting NPDs to PDs; and
 - Maintaining current PDs agreements.

All of these ramifications have, and in our view will continue to, inhibit potential earnings growth and ROIC for the business until at least the end of FY03. What is of greater concern is that the establishment of precedents may see these difficulties remain on a more permanent basis (or at least until near full penetration when some pricing power may emerge). This may jeopardise the potential value of the CHEP USA franchise, given the expected decline in returns. The more permanent challenge we see to the mechanics and hence value of the pool is particularly reflected in ramifications 5), 6) and 7).

Key reasons for the difficulties

What has caused the difficulties.....

We believe the reasons behind the difficulties in the US pool can broadly be attributed to: –

- 1) Structural characteristics of the US Grocery and Retail Industry and the introduction of the “One-Way” Pallet Pool; and
- 2) Strategy pursued by CHEP USA.

These are discussed below: –

Structural differences

Structural dynamics inherent in the US

The differences in the structural characteristics of the US pool versus the UK pool, include: –

- The UK pool operates a “one for one bank” or “exchange” system versus the US which is a one-way system. A “One-Way” system is far more difficult to control given:
 - 1) no immediate exchange and hence no ongoing audit of the movement of pallets;
 - and 2) as the Distributors are not responsible for paying a daily hire fee, hence there

is less incentive in getting the pallet back to CHEP. With a one-way system, if control of the pool is lost, it typically has far reaching ramifications;

- Further, by operating a bank or exchange system, repairs and transport costs are lower than a one-way system, as pallets that do not need inspection and repairs are not returned to the CHEP depot. Under a one-way system, all pallets are returned, inspected and if necessary, repaired;
- Similarly, because of the significantly larger geographic mass and population spread of the US versus the relatively smaller UK or the highly concentrated (east coast) Australian markets, we expect greater transport costs and lower pallet turns from greater dwell times on the back of trucks etc;
- Another difference between the US and the UK markets is that the inventory turns (hence potential CHEP margins) of the major US retailers are significantly lower to those in the UK;
- The relative size of the large US retailers, and the US' proliferation of Warehouse Clubs and Mega "Category Killer" Stores, which ultimately translates into an enormous number of DCs to which CHEP has to fill with non revenue generating, but depreciating pallets to effectively penetrate the markets (relevant largely when there is an imbalance between the proportion of inbound pallets to pallets in the DC);
- The speed in which CHEP had to roll-out Wal-Mart, the largest Retailer in the US (and the world), when the pool was in its relative infancy;
- The relative negotiating power of these large US retailers / distributors, as evidenced by their ability to fill DCs quicker than inbound volumes, as well as ability to use pallets in the secondary circuit; and
- Unlike Australia and Europe, the US market had a well-established pallet recycling industry upon CHEP's entry. Thus, the US market is highly fragmented with a large number of entrepreneurial pallet recycling companies who are highly protective of their own franchises.

Potential ramifications: –

- 1) Decline in asset turns;
- 2) Increase in dwell times; and
- 3) An increase in the damage rates of the pallets, and hence increased repair costs.

Given many investors extrapolate the UK margins (these are the only filed reliable accounts {others are of holding companies etc with transfer pricing}) to calculate the potential earnings and returns of other markets, we err on the side of caution that the high UK margins and returns may be an exception.

We believe these seven points are largely a cost of doing business in the US and to its credit, a function of CHEP's successful growth. Hence, while we argue below the US pool has operational difficulties, which may be resolved over time, it is also important to recognise the US market is different.

Strategy

In our view, the strategy pursued by CHEP USA in recent years has contributed to the operational and structural difficulties.

Management changes at CHEP USA

Whilst we recognise the significant sales growth of CHEP over recent years, this has been at the expense of margins and returns, a scenario that may have not needed to occur given the US business has limited competition.

We believe CHEP USA has had increasing business risk due to limited pallet pooling management expertise. The original management group, which established CHEP USA in 1990, has left since the current senior management team was introduced in August 1995. Of the personnel that held the top 25 positions (Directors and above) in CHEP USA in 1995, only three remain in the organisation. The main areas where CHEP USA has had difficulties, in our view: –

A difficult environment

Customer focus suggested to be slipping—CHEP too dominant?

We believe that with CHEP's culture in transition, some issues have emerged in an industry with a well developed network with long standing relationships, particularly given the relative infant position CHEP is in. We believe, as a consequence of a change in CHEP's focus, that customer service levels and operational efficiency of the pool has deteriorated.

We expect this will improve as Brambles Group management addresses the CHEP US issues.

Ramifications: a proliferation of lost pallets, an increased size of the black market pool and the current litigation.

The cost of winning Wal-Mart

Wal-Mart contract was essential but was it too big too quick?

CHEP signed the agreement with Wal-Mart in 1998 and it was a major win for CHEP (Brambles share price spiked on this announcement). This essentially meant CHEP had secured the largest Retailer in the US to "endorse" (see letter over) the use of the CHEP pallet to its suppliers (1500+). Having Wal-Mart as its largest advocate is and should continue to be the backbone to CHEP's success in the US. While CHEP pushes upstream into new suppliers' manufacturing processes, it is likely to ultimately see that product sent downstream into other new large retail chains yet to convert (endorse) to the CHEP program (convert the distributor to a PD). From there, CHEP again pushes upstream signing-on new manufacturers that are not suppliers to Wal-Mart, and so on.

The difficulties arising as a consequence of offering such to Wal-Mart can either be seen as structural (the cost of winning Wal-Mart and penetrating the US market) or operational (did CHEP USA ensure sufficient control measures?). We are not aware whether the Distributor agreement Wal-Mart signed did include the standard prohibiting clause of "misuse", defined in the Distributor agreements as any use other than to carry "the original load" (we assume it did). Regardless of whether it is structural or operational that delivered this situation, we consider it the key reason behind CHEP USA's fall in margins, and now fall in EBIT contribution.

- 1) Allowing retailers to fill its DCs at a faster rate than inbound volumes—Wal-Mart currently has 55 DCs in the US, and is adding an average of 8-9 DCs per annum as the successful retailer continues to take market share. The quality of CHEP pallets

and the lack of control of the one-way pallet pool system has encouraged US retailers, such as Wal-Mart, to accelerate the filling of its DCs with CHEP pallets as reliable storing platforms. In the UK market, retailers also have their DCs full of CHEP pallets, however these were filled at the same rate as its inbound conversion rate, hence the pallets maintained similar asset turns to the retailer. In the case of the US, Wal-Mart is filling its DCs at a faster rate than the inbound volumes, leading to CHEP's asset turns being lower than the retailer's and hence seeing margins and returns fall. We believe this practise is likely to continue until i) all Wal-Mart DCs are penetrated with CHEP pallets (currently estimated to be approximately 80% full ii) CHEP adopts a more rigid pricing regime to discourage this practise (considered unlikely); and/or iii) CHEP and Wal-Mart terminate the contract (considered highly unlikely).

- 2) Secondary Circuit Use—The other difficulty with the Wal-Mart contract is that CHEP has agreed for Wal-Mart to send "order picked" pallets to the store level, known as the secondary circuit. Under the terms of a normal Distributor Agreement, this represents "misuse", again something that didn't occur in the UK pool. The consequence of such is that it lowers asset turns (adds a minimum of 7 unpaid days to an approximate 67-day paid cycle time), as well as increases the damage rate to pallets, due to the use of more damaging equipment such as hand jacks.

Unfortunately, in the case of Wal-Mart, the pallets are staying at the store level significantly longer than the 7 days, sometimes for months, as Wal-Mart uses CHEP pallets as display platforms in its stores, and often, in its garden departments.

Ramifications: Reduces the asset turns and increases the damage rate (from the usual 20% to an estimated 60%) and repair costs.

- 3) Leakage of the pool to NPDs—in launching the Accelerated Volume Program (AVP) in 1997, CHEP didn't appear to ensure that it had the necessary controls and sales representatives to; 1) prevent Manufacturers from sending pallets to NPDs; and / or 2) follow the pallets and product downstream and then signing up the NPDs. This has resulted in an estimated 20% of the pallet pool being sent to NPDs, distributors who have don't have a contract with CHEP, and hence comply with the care of the assets.

Ramifications: There are several ramifications including: i) reduced asset turns; ii) increased damage rate, iii) increase in lost pallets, iv) greater collection and transport costs, v) "Black Market" pallet pool; vi) litigation; and vii) the dilution of value incorporated in the Participating Distributor Agreement.

It is important to note that an element of these issues also exist in other markets, but most important is that they are not of the magnitude of the US, particularly given the US's relative immaturity and low penetration. Based on discussions with industry experts that have operated in markets outside of the US, we believe these issues are more material than usual.

For readers seeking for a more detailed discussion please read the following section.

Detailed discussion

The difficulties defined....

In the following section, we describe in detail the structural and operational difficulties we see as described by "loss of control of the pallet pool": –

- 1) CHEP having to stockpile a considerable number distribution centres in the US (DCs)—a structural problem (cost of doing business in the US);
- 2) Large retailers / distributors' inappropriate use of the pallet pool in the secondary circuit—a structural and operational problem; and
- 3) A growing proportion of leakage in the pool (estimated by management to be 20%) as pallets are being sent to non-participating distributors (NPDs)—an operational problem.

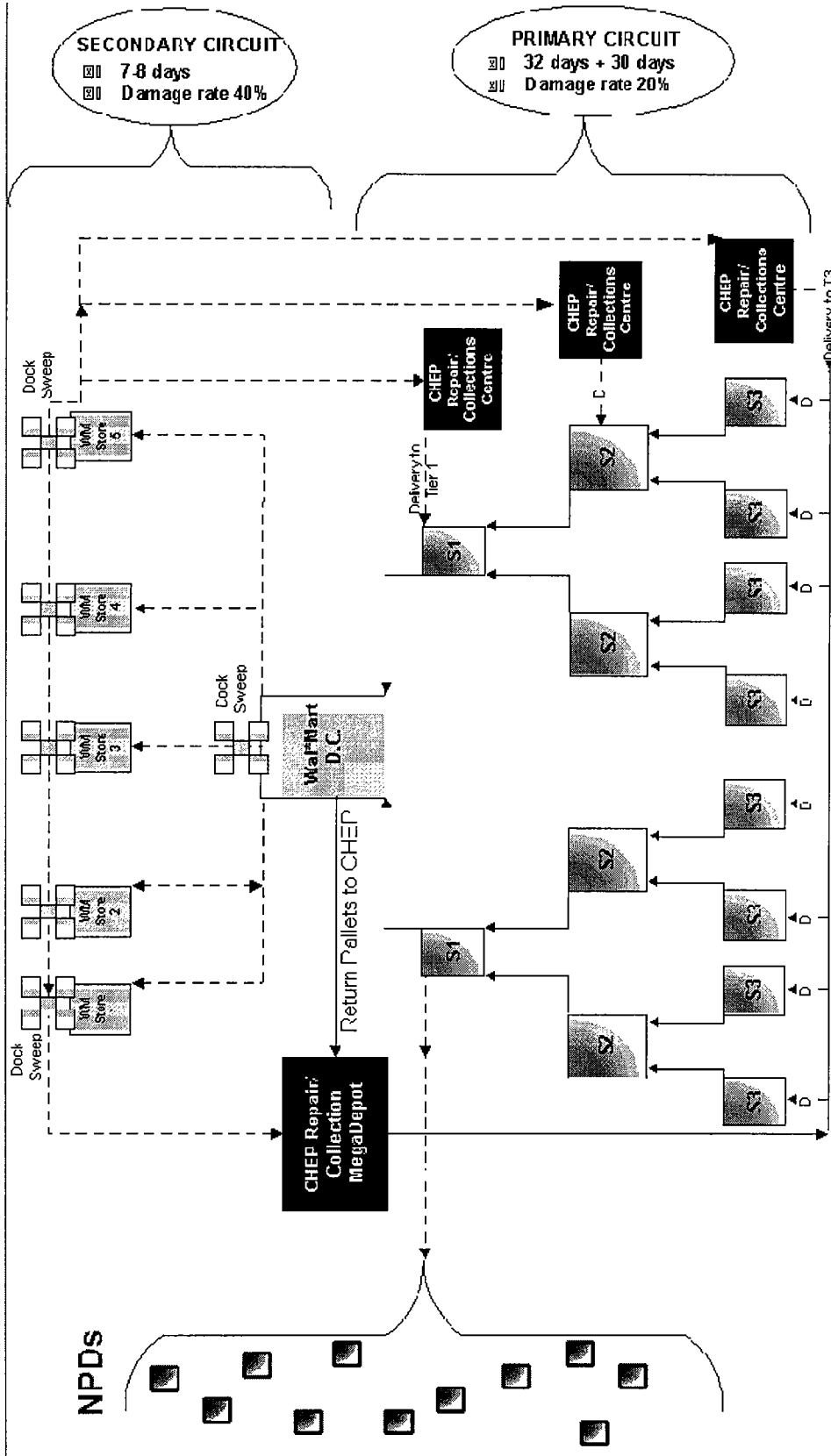
In each of these difficulties, we provide background and a description of the problem, the short to medium term implications, the potential longer term franchise value impact, and finally we discuss the steps management are taking to address these, and the likely issues it may encounter.

Large retailers / distributors' inappropriate use of the pallet pool

Inappropriate use by large retailers/distributors

Background—In attempting to describe this issue, we thought it appropriate to first explain our understanding of how the CHEP US one-way system is intended to work, the dynamics of the supply chain and the differences in the primary and secondary circuits.

Figure 3: The CHEP supply chain circuits



Source: CSFB.

The one-way CHEP pallet pool in theory

Please refer to the preceding diagram for the following discussion.

A CHEP pallet is "issued" to a supplier / Manufacturer (S3 – or S1 and S2, depending on the deepness of penetration). That supplier pays an issue/delivery fee (US\$1.70) and a daily hire fee (US3.5 cents a day). Once the S3 supplier has a load on the pallet and sends the pallet to the next leg in the supply chain, then the pallet is transferred off S3's account (and onto S2) and hence is free of any liability or daily rental fee. Once on account, S2 commences paying the daily hire fee until it is transferred to S1. The same occurs for S2 to S1 and S1 to the retailer's DC.

(As an example, let's assume S1 is a Manufacturer of empty tin cans, which he sends to S2. S2 is a speciality Tomato soup kitchen and fills the empty cans with soup, seals them and then sends these to S1, who is Campbell's. Campbell's then places a label on the cans, packages them in a Campbell's corrugated box and then on sends the full pallet load of labelled tomato soup cans to Wal-Mart.)

The final fee in the manufacturing cycle is that of a transfer fee. S1, as the final supplier before sending their product to Wal-Mart, is also responsible for paying a transfer fee (US\$1.07). This transfer fee is in fact S1 paying CHEP for the daily hire fee for the time the Retailer is expected to keep the pallet in its DC (generally 30-45 days based on average inventory turns of retailers in the respective markets). So in the case of the US\$1.07 in the US, Campbell's is paying for Wal-Mart's daily hire fee of US3.5 cents for 30 days while downstream under its original load. The supply chain movement from S3 to the retailer's DC is what is called the "Primary Circuit", and on average takes around 35 days.

Once in the retailer's DC, the distributor / retailer often breaks down the pallet and builds "order picked pallets" or "rainbow pallets" appropriate for store use. That is, each store is unlikely to require the quantity of a full pallet of Tomato soup, hence in the DC, the Distributor / Retailer will build a pallet of soup, scouring pads, coffee, vegemite, VB, baked beans etc. Importantly, in the UK these mixed pallets sent down the 'Secondary Circuit' to the retailers' stores are stacked on "white" pallets or packed in roll-cages, and are not built and sent on CHEP pallets (unless the retailer pays for such).

Figure 4: "Rainbow" or "order picked" pallet (on plastic) in the secondary circuit (store)



Source: CSFB.

Under the terms of the Distributors Agreement in the US and the UK (Australia allows secondary circuit use) the CHEP pallets are required to be sent from the Retailer's DC back to CHEP, not downstream to the store level. *(If UK retailers want to use the pallet to send to the Secondary Circuit, the Retailer would need a separate contract and have to pay for its use.)* This is what is termed the Retailer's "First Free Use", where the pallet is only intended to be in the DC under its original load for 30 days or so, giving the Retailer adequate time to break down the pallet and order pick the pallet into smaller consignments as required.

At no point does the Retailer pay CHEP for the use of the pallet while in its DC, however the Retailer is responsible for care of the pallet and the cost of returning the pallet to CHEP, after its first free use in the DC. Once the pallet is returned to CHEP, CHEP will inspect and, if required, repair the pallet, then store it in the depot until a supplier / manufacturer requests it for another cycle. In all, the process is expected to take approximately 65 days or so (excluding transport, repair and depot storage dwell time), allowing an efficient pool to generate 5-6 (4-5 including dwell times) pallet trips/asset turns per annum in the FMCG channel (lower asset turns in the other three major channels). This would result in US\$4.10 (US\$1.70 + 35*3.5c + US\$1.07 {30*3.5c} + \$0.10 Admin fee) per pallet per turn, US\$22.55/pallet pa based on 5.5 turns pa or US\$16.81/pallet pa based on 4.1x (includes 21 days dwell time for repairs, storage and transport—refer Figure 12).

The US experience

The US 'one-way' system—In essence, the process detailed above is currently in existence up until when the pallet reaches the retailers DC. In this primary circuit, it is likely the pool is very efficient and generating the desired 5-6 pallet turns per annum, given Suppliers tend not to hoard pallets as they are paying a daily hire fee. What is occurring at the Distributor's or Retailer's DC is where we believe the system is breaking down. These issues are most evident in the Wal-Mart circuit, given it is the largest

CHEP pallets dormant on
the racking of DCs

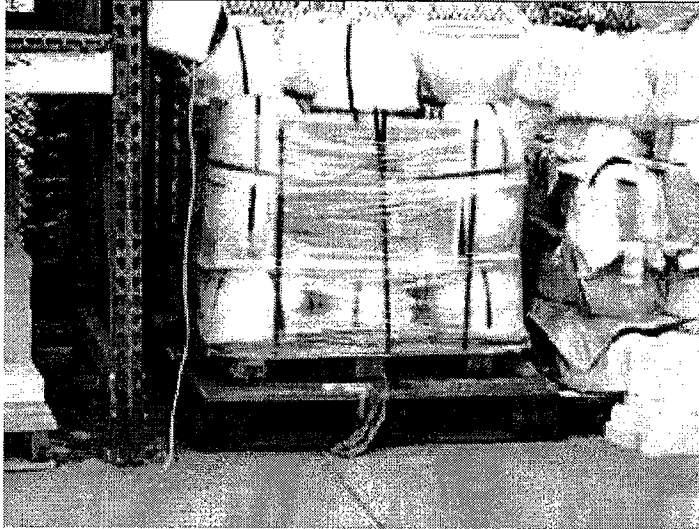
Retailer CHEP has penetrated. The difficulties we see arising with Wal-Mart can be broken into two factors: –

Wal-Mart filling its DCs

The decline in asset turns while Wal-Mart fills up its DC racking with CHEP pallets.

As mentioned above, a CHEP pallet is only expected to be in a DC for approximately 30 days. Once the original load has been broken down at the DC, the CHEP pallet is required to be sent back to CHEP. However, CHEP pallets are stronger, more robust pallets and are less prone to breaking, slipping, bending etc than the inferior white pallets, particularly when on racking with heavy loads such as soup cans. In an effort to reduce product damage and avoid expensive Occupational Health and Safety costs (OHS) from accidents, Wal-Mart is storing the loaded products on the DC racking with CHEP pallets on a more permanent basis. This will include those pallets being sent on CHEP, or, where product is inbound on white pallets, Wal-Mart is transferring the load from a white pallet onto a blue pallet, or in some cases, placing the white pallet on the racking, with a reinforcing CHEP pallet underneath. These are called 'slave pallets'.

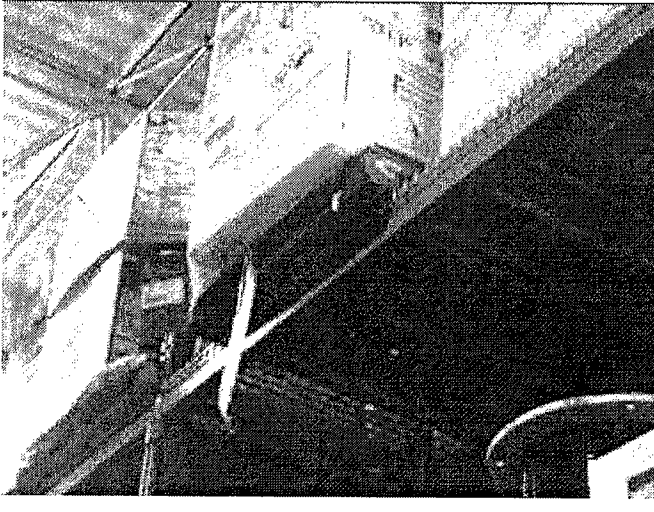
Figure 5: A 'Slave pallet'—white pallet placed onto a supporting CHEP pallet.



*This was taken in a Home Depot store, highlighting HD is now filling its secondary circuit like WM.
Source: CSFB.*

In this case, CHEP pallets are supporting product of non-customers while sitting in a Wal-Mart / Home Depot DC or store. The impact of pallets sitting on racking or in stores beyond the allocated and paid for 30 days (up-to indefinitely) is that asset turns and hence margins fall.

Figure 6: Filling the Home Depot DCs with "Blue"



Source: CSFB.

Figure 7: Not all product is palletised



Source: CSFB.

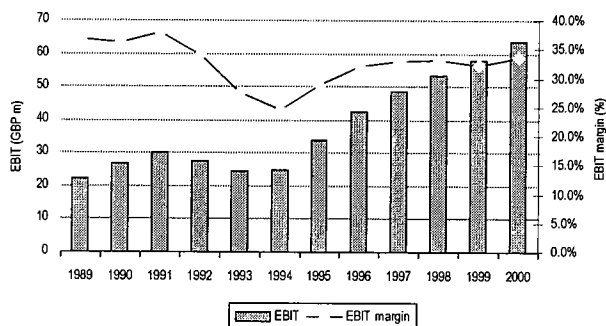
Tesco (UK) also has its DCs full of CHEP pallets. However, these were filled slowly through natural attrition as CHEP penetrated deeper into the supply chain, and eventually converted the majority of Tesco's suppliers. If the proportion of blue to white pallets on a retailers DC racking is equal to that of the proportion of blue to white coming inbound into the DC, then there is no impact to margins, as the pallets are turning at the same rate as the retailers inventories. The problem only arises when CHEP pallets become free of their original load and are reused for storing product coming in on white. Essentially, in the case of the US, CHEP pallets are going into Wal-Mart's DCs, but they are not yet coming out.

The reason this has been exacerbated in Wal-Mart's case is:

- The different market structure of the US versus the UK. The UK system is an exchange or bank system, where if a supplier sends Tesco a pallet, Tesco has to give one in return. So in this regard, in the early stages Tesco did not have the opportunity to hold onto the CHEP pallets and swap the product from a white pallet onto a CHEP pallet for storage on its racking. In contrast, Wal-Mart has effectively filled the DCs almost immediately.

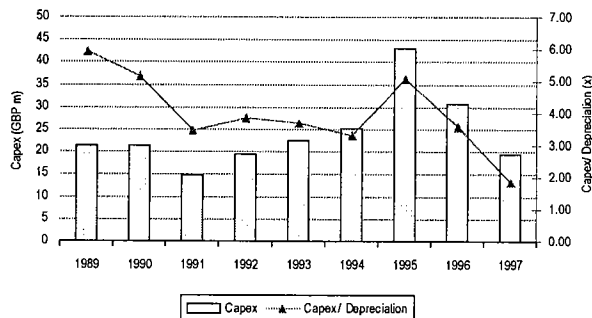
Why didn't CHEP use the same exchange system as the UK? The problems associated with the UK exchange system is that once the pallet is removed from its "original load" the pallet returns up the supply chain for re-use, without going back to CHEP for repairs. In the UK, it is the responsibility of customers to exchange damaged pallets at a CHEP depot for new pallets. This can result in the quality of the pallet pool deteriorating, and rather than having a smooth cycle of repair costs, can tend to be lumpy at the expense of earnings—one of the suggested reasons behind the decline in UK margins between 1992-1994 (refer Figure 8 and 9 over).

Figure 8: CHEP UK—EBIT & EBIT margin (%)



Source: Company data, CSFB estimates.

Figure 9: CHEP UK—Capex profile



Source: Company data, CSFB estimates.

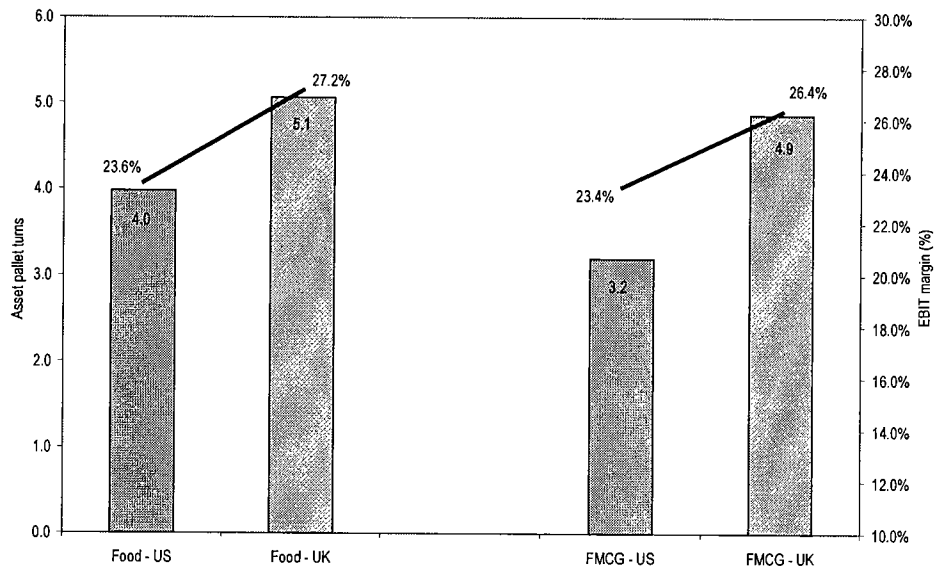
One of the findings of the US Grocery Industry Pallet Subcommittee study in 1989 was that the US Grocery Industry demanded a higher quality pallet, and that quality must be maintained. To add to this, CHEP conducted significant market research which showed that the UK's 'one-for-one' exchange system would be uneconomical for the US due to i) greater distances; and ii) differing distribution density—truck may deliver a loaded pallet but geographic breadth may force the truck to continue to another Retailer/ DC, thus preventing the return of empty pallets to the Manufacturer. As a result, CHEP decided to launch a "One-Way" Pallet Pool System (following experience in France), so that at the end of the circuit, the pallet would be returned to CHEP for repairs.

As being evidenced now, while being a positive resolution for its customers, a one-way pooling system does have implications for CHEP; i) there are increased dwell times and greater transportation and inspection / repair costs (at times pallets are returned and inspected when they don't have damage); and ii) reduced control once the pallet arrives at the Distributor. That is, as the pallet ceases generating revenue (or costs to those that hold it) once it leaves the hands of the last supplier (with no exchange of a pallet), it is more difficult to control such downstream. Hence there is greater scope for Distributors (both Participating and Non Participating) to inappropriately use the system. This is the current experience.

Other factors that have contributed to the difficulties at Wal-Mart include: –

- Geographic difference—The geographic spread and population mass of the US versus the relatively smaller/UK, and related to such the size of Wal-Mart and the significant number of stores, and more importantly, the number of DCs;
- Differing Inventory Turns of the UK versus the US—for similar reasons to that mentioned above, the US Retailers have lower inventory turns than their UK counterparts. As a consequence, the CHEP US margins may not reach those reported in the UK. Figure 10 illustrates the potential CHEP asset turns and margins based on the differing inventory turns of the major food and FMCG retailers in the US and UK.

Figure 10: Asset turn—US vs UK retailers



Source: CSFB estimates.

- The speed in which the Wal-Mart (supplier) rollout has occurred in its relative infancy—Wal-Mart officially commenced endorsing the receipt of CHEP in 1998 (started trialing in October 1995), and was the major breakthrough for CHEP, almost underpinning its success. With Wal-Mart strongly advocating the receipt of CHEP pallets (see Wal-Mart letter below), CHEP's penetration of Manufacturers was unprecedented. It is estimated more than 600 of Wal-Mart's 1,500-2,000 (30%) suppliers are now using CHEP. Brambles management estimates the Wal-Mart circuit now represents more than a third of the US pool, and estimates Wal-Mart itself is only 30% penetrated, hence it is likely Wal-Mart will soon grow to be even a greater proportion of the US pool. In contrast to the US, the first major UK Retailer to endorse the CHEP pallet pool was Tesco in 1995, but at that point, it is estimated CHEP was some 65% penetrated in the FMCG channel;

A letter from Wal-Mart to Suppliers:

Figure 11: Wal-Mart letter advocating its suppliers should use CHEP

WAL★MART

CORPORATE OFFICES
702 N.W. 5TH STREET
BENTONVILLE, AR 72716

TO: Wal-Mart Suppliers
From: Robert F. Connolly
Subject: CHEP Pallets
Date: September 20, 1999

In an effort to improve supply chain-shipping efficiencies, Wal-Mart has chosen CHEP as the preferred provider for platforms to be used to deliver merchandise to our distribution centers and stores. I have been asked by our distribution centers to contact you to gain your support to convert incoming merchandise to CHEP pallets.

Attached is a letter from CHEP that gives a general outline of the benefits the CHEP program will bring to your organization.

Wal-Mart is eager to get out of the costly inefficient practices of pallet exchange, one way pallets, slip sheets and floor loads. It is our expectation that suppliers will convert to the CHEP program, as this solution will improve supply chain efficiencies for all involved parties. We believe that there will be a reduction in supply chain costs by using the CHEP program. This is truly the right thing to do for our business relationship and Wal-Mart, Inc.

Robert F. Connolly
Executive Vice President
Merchandising and Sales

Source: Wal-Mart.

- The relative pricing power of Wal-Mart, and the importance of winning that first big Retailer. We believe this is best illustrated by the fact that Wal-Mart has been allowed to use the pallets in the secondary circuit, from the DC to the store: –

Filling the pipeline of the top US retailers

Figure 12 is a spreadsheet of a mock US CHEP pallet pool market, servicing the major US food and broadline retailers. This has been created to highlight the impact to margins based on; i) the retailers inventory turns; ii) the mix between "Inbound" penetration versus DC/Store penetration of CHEP pallets and; iii) the absolute level of penetration.

Inventory Turns – The inventory turns are reported turns as at FY00 for the listed retailers. Assuming constant manufacturing cycle times, the speed in which a retailer turns its stock should have minimal bearing to CHEP's EBITDA margins, providing the pool is operating efficiently (refer all food retailers have relatively constant 36-37% margins while Broadline have relatively constant 38-40%). However, inventory turns will influence EBIT margins, reflecting that depreciation is a fixed cost of \$2 per annum, but is spread over the number of cycles (asset turns) the pallet does over the year.

The mix between Inbound penetration versus DC/Store penetration of CHEP pallets – In Figure 12, we have included management's estimates that CHEP penetration of product inbound to Wal-Mart DC's is approximately 30%, while the proportion of CHEP pallets inside Wal-Mart's DCs, according to industry sources, is approximately 80%. This is the basis of the difficulties discussed above, namely Wal-Mart filling its DC's at a faster rate than CHEP's natural penetration of Wal-Mart's suppliers. Like inventory turns, there is no impact to EBITDA margins due to the variable cost nature of running a pallet pool. However, we have added a column which adjusts EBIT margins to take into account the depreciation charge for the additional pallets sitting dormant in Wal-Mart's DCs and stores (i.e. when there is an imbalance). The sensitivity under this scenario is significantly more material, as margins fall from 39.4% to 18.0%.

This model also suggests to us that the impact of September 11 and the subsequent "de-stocking" by retailers would have had a far greater earnings impact on CHEP in the Wal-Mart channel than any other retailer. We believe if Wal-Mart did not have such a large imbalance between Inbound vs. DC, then the de-stocking issue would not have been as material for Brambles.

The absolute level of penetration – The penetration of a retailer's product has little impact on margins (except spreading a small amount of overheads), but does obviously assist in volumes.