PALLET MANAGEMENT SYSTEMS INC
Form 10-K
October 12, 2001

U.S. SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended June 30, 2001

Commission file number 000-24405

Pallet Management Systems, Inc.
(Exact name of registrant as specified in its charter)

Florida	59-2197020
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification Number)
2855 University Drive, Suite 510 Coral Springs, Florida	33065
(Address of Principal Executive Offices)	(Zip Code)

Registrant's Telephone Number, Including Area Code: (954) 340-1290

Securities registered pursuant to Section 12(b) of the Act:
None

Securities registered pursuant to Section 12(g) of the Act:
Common Stock

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes X No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-B is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [ ]

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the Company is $1,836,927 based on the closing price of $ 0.72 per share as of October 5, 2001.

As of October 5, 2001, there were 4,065,612 shares of the issuer's Common Stock, $.01 par value, outstanding.

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FORWARD-LOOKING STATEMENTS

Pallet Management Systems, Inc. ("Pallet Management," or the "Company") cautions readers that certain important factors may affect Pallet Management's actual results and could cause such results to differ materially from any forward-looking statements which may be deemed to have been made in this Report or which are otherwise made by or on behalf of Pallet Management. For this purpose, any statements contained in this Report that are not statements of historical fact may be deemed to be forward-looking statements. Without limiting the generality of the foregoing, words such as "may," "expect," "believe," "anticipate," "intend," "could," "estimate," or "continue" or the negative other variations thereof or comparable terminology are intended to identify forward-looking statements. Pallet Management is also subject to risks detailed herein (see Item 6, "Risk Factors") or detailed from time to time in Pallet Management's filings with the Securities and Exchange Commission.

PART I

Item 1. Business.

Introduction

Pallet Management is the first pallet company in the United States to become publicly traded in the estimated $6 billion pallet industry. The Company is a leader in total solutions for pallet and other transport packaging requirements and offers a wide variety of products and services, from pallet manufacturing, to reverse distribution of transport packaging assets. The primary users of Pallet Management's services are companies from various industries, including steel and metal; chemical and fluid; paper and fiber, pallet rental, and printing.

The Company is a leader in reducing product distribution costs for major manufacturers and distributors by providing value-added transport packaging products and logistical services. As one of the largest pallet manufacturing companies in the United States, Pallet Management has expanded its line of business to include related transport packaging, logistical and repair services. With two related lines of business, manufacturing and services, Pallet Management primarily manufactures wood pallets, which are the base of most transport packaging assets. Services related to transport packaging, which are focused on reducing customer distribution costs, include transport packaging retrieval, repair, recycling, sorting, warehousing, reverse distribution, tracking, logistics and value-added information services.

A significant portion of Pallet Management's current business is the sale of pallets and services to CHEP, which is part of the international CHEP organization that manages the world's largest pallet rental pool. CHEP service spans 38 countries across six continents controlling more than 160 million pallets and 34 million containers, primarily focused on the retail, grocery and automotive industries.

Pallet Management's business strategy is to manufacture and service pallets as well as other supply chain assets for niche markets. Manufacturing operations complement expansion of the Company's related transport packaging services that should increase gross margins. All of Pallet Management's products and services are designed to assist its customers in reducing the cost per trip for shipments of their goods.

In order to fulfill the increasing demand for transport packaging management services, Pallet Management plans to expand its service offerings and its network of facilities by opening company-owned facilities as well as entering into affiliations with other pallet and logistics companies in strategic locations. These additional locations will provide local retrieval, repair, sortation, storage and recycling services for Pallet Management's national customers. Pallet Management also plans to be able to accelerate its internal growth by marketing expanded value-added information services to new and existing customers through the use of PalletNetTM, its proprietary software application process for the tracking and management of transport packaging assets.

Industry Overview

Pallet Industry

A pallet is a platform, usually made of wood and assembled with metal nails, that is used for storing and shipping goods. Pallets allow goods to be transported or warehoused economically by providing a foundation for forklifts and vertical storage. Pallets are used in virtually all U.S. industries where products are physically distributed, including the automotive, chemical, consumer products, grocery, produce and food production, paper and forest products, retail, and steel and metals industries. Without pallets, shipping by air, land and sea would be severely hampered. Pallets come in a wide range of shapes and sizes. Although pallets are primarily made of wood, they may also be made from steel, plastic, cardboard, molded wood fiber and other materials to satisfy smaller niche markets. It is estimated by industry sources that there are over 7 pallets for each person in the United States, and Pallet Management believes that there are over 1,000 different sizes and specifications of pallets used in North America. The grocery industry, however, which accounts for approximately one-third of the all new pallets produced in the United States, uses a standard size 48 x 40-inch pallet referred to as a GMA pallet. Other industries utilize unique specifications that are appropriate for their particular needs. According to a survey conducted by the National Wooden Pallet and Container Association ("NWPCA"), 91% of pallet users reported using wood pallets, with just 5% or less using plastic, a combination of wood and plastic, or other material. The wooden pallet has traditionally been the basis for the design of storage racks, warehouse storage areas, forklifts, docks and containers used in shipping goods.

Many pallets are not durable enough for multiple trips. The manufacturing capacity for the standard GMA pallet is in excess of demand and unless one is manufacturing a top quality durable pallet for a customer who wants to use their pallets for multiple trips, the margins are very small. Standard GMA pallets weigh approximately 45 lbs. and are designed to hold 1,500 pounds of goods. Since CHEP has a pool of 48 x 40-inch pallets that are continually reused, it demands a higher quality, better-engineered pallet, which is more durable. A CHEP pallet weighs approximately 60 lbs., and is engineered to hold 2,800 pounds of goods.

Based on information supplied by industry sources, Pallet Management estimates that the U.S. pallet industry currently generates revenues of approximately $6 billion, and it is served by approximately 3,600 companies, most of which are small, privately-held entities. These companies are generally operating in only one location and serving customers within a limited geographic region. The industry is generally composed of companies that manufacture new pallets and companies that repair and recycle pallets. The U.S. Forest Service estimates that 475 million new wood pallets are produced annually, 300 million wood pallets are repaired and sent back into circulation, and 175 million wood pallets are sent to landfills.

The pallet industry, a generally mature industry, has experienced significant changes during the past several years. These changes are due, among other factors, to the focus by Fortune 1000 businesses on improving the efficiency of their supply chain, manufacturing, and distribution systems. This focus has caused many of these businesses to attempt to reduce significantly the number of vendors serving them in order to simplify their procurement and product distribution processes. It has also prompted large manufacturers and distributors to outsource key elements of those processes that are not within their core competencies and to develop just-in-time procurement, manufacturing, and distribution systems. With the adoption of these systems, expedited product movement has become increasingly important and the demand for a high quality source of pallets has increased. Palletized freight facilitates movement through the supply chain by reducing costly loading and unloading delays at distribution centers and warehouse facilities. As a result, there has been an increased demand for high-quality pallets in an attempt to decrease the cost per trip by reducing product damage during shipping and storage, and increasing the number of trips for which pallets can be used.

The broad changes affecting the U.S. industry have created significant demand for higher quality pallets distributed through an efficient, more sophisticated system. Environmental and cost concerns have also accelerated the trend toward increased reuse or "recycling" of pallets and certain other transport packing materials, further increasing the importance of the quality of newly manufactured pallets. In recognition of these trends, CHEP has established an international system that provides high-quality pallets to customers worldwide. CHEP is owned by Brambles Industries Limited (BIL), an Australian publicly-held corporation that outsources its pallet manufacturing and some of its repair operations. During the fiscal year ending June 30, 2001, approximately 86% of Pallet Management's revenues and a significant percentage of Pallet Management's growth were attributable to CHEP. While Pallet Management expects to continue to build its relationship with CHEP, additional growth is anticipated to diversify revenues into other areas.

CHEP's pallet leasing system represents a significant change in the U.S. grocery and retail pallet market. CHEP leases high quality, standardized and easily identifiable (all CHEP pallets are painted blue) 48" by 40" pallets, primarily for use by grocery and consumer product manufacturers. CHEP pallets are manufactured to strict specifications by vendors, including Pallet Management, that have been selected based on their ability to provide large volumes of high quality pallets manufactured to CHEP specifications in a timely manner.

Due to the high cost of plastics and other materials, wood is the preferred and "more environmentally conscious" material (a renewable resource) for pallets. Wood pallets are also generally stronger, more repairable, and less expensive than comparable plastic pallets. Plastic pallets currently have a limited market in "closed loop" systems where system leakage is minimal and where the pallets can be tracked and retrieved for reuse.

Third Party Logistics Industry

As manufacturers and retailers continue to drive down the costs of distribution, they will continue to look to third party logistics companies to handle supply chain systems. It is estimated that about 7%, or approximately $40 billion, of relevant logistic costs are currently managed by third party logistics companies. Within the next 3 to 5 years, this sector could capture 10% to 15% of the available market. Third party logistics companies include outsourcing companies that manage portions of a company's supply chain. Outsourcing supply chain management gives companies a competitive edge and drives profitability up. The third party logistics industry is expected to experience an annual growth rate of about 20%, driven primarily by the continued outsourcing of specific supply chain logistics functions. Management believes that this industry will eventually be ready for consolidation, as customers will want third-party logistic companies to increase their scope of service offerings on a global level.

Reverse Distribution, a sub-industry of the logistics industry, is estimated to have grown from $4.6 billion in 1997 to over $7.7 billion in 2000 in the United States. It is rapidly growing and becoming more diverse and complex as its importance to the supply chain becomes more evident. Reverse Distribution is defined as the opposite of direct distribution. It is moving products back up the supply chain to the original manufacturer. The increasing importance of reverse distribution in the market place is a key factor in the dramatic changes taking place in the pallet industry.

Until recently, pallet manufacturers were focused on producing the cheapest pallet for their customers, who considered their packaging material an expense. Manufacturers and distributors are now discovering that the lowest cost per trip (the ultimate goal) for their packaging material is realized when high quality packaging is utilized and subsequently returned for re-use in a reverse distribution system. Viewing packaging material as an asset instead of an expense requires a reverse distribution system to return their packaging assets. Pallet Management is aggressively pursuing this market as a specialist in reverse distribution for packaging material assets.

Growth Strategy

Pallet Management's goal is to become a leading national provider of pallets and related transport packaging services by continuing to expand its existing operations and seeking strategic acquisitions. Pallet Management believes that a significant market opportunity exists for a company that can consistently offer high-quality pallets and related value-added services to large pallet users in the U.S. Pallet Management believes that its management's experience, industry reputation, and existing customer base will provide the Company with a significant competitive advantage as it pursues its growth strategy. Elements of its strategy include:

- CHEP
- Specifically Engineered Niche Market Manufacturing
- Reverse Distribution Services
- Acquisitions

CHEP

CHEP is the world's largest pallet pooling company with a pallet pool worth over $2 billion consisting of over 160 million pallets. CHEP markets to the grocery, retail, and automotive industries, where large volumes of standard size pallets can be contained in a closed loop-system. Based on published

information, CHEP has a market share of 88% of all leased pallets worldwide and dominates 90% of the markets in which they operate. CHEP is by far the largest participant in the U.S. pallet industry and does not have a significant pallet-pooling competitor. CHEP service spans 38 countries across six continents controlling more than 160 million pallets and 34 million containers. Effective August 2001, CHEP announced being wholly owned by Brambles Industries, Ltd.

As a result of entering into a series of multi-year manufacturing agreements with CHEP to produce specially engineered grocery pallets in strategic locations, Pallet Management opened a new manufacturing facility in Rogersville, Alabama, in September 1998, another manufacturing facility in Bolingbrook, Illinois, just outside Chicago, in April 1999, and a third manufacturing facility in Plainfield, Indiana, just outside Indianapolis, in August 1999. Pallet Management has invested over $4.2 million in "state-of the art" pallet manufacturing equipment for these facilities, including a new $1.5 million "Vanderloo" nailing machine system custom made for Pallet Management in Holland and installed at the Company's Plainfield, Indiana facility.

The Rogersville, Alabama contract expired on September 7th, 2001 and was not renewed. The Bolingbrook, Illinois contract expires on April 30, 2002. A third contract, for Plainfield, Indiana does not expire until Fiscal Year 2003. The Company anticipates that the Bolingbrook, Illinois contract will not be renewed. The volume of business that is currently produced out of the Bolingbrook, Illinois facility may be extended beyond the end of the contract. Should the contract for Bolingbrook, Illinois not be renewed or the business not be extended, the Company may not be able to meet current cash needs and may not be profitable. The Company continues to work with CHEP regarding future opportunities.

In addition to pallet manufacturing, Pallet Management also offers to CHEP Reverse Distribution Services. Pallet Management has a facility which sorts, repairs, warehouses and returns pallets to the CHEP pallet pool.

Pallet Management has had a business relationship with CHEP for over ten years and CHEP is expected to be Pallet Management's largest customer for the next several years, during which Pallet Management will support CHEP's projected growth. While Pallet Management is continuously developing its CHEP relationship, it is continuing to aggressively pursue other areas of growth.

Specifically Engineered Niche Market Manufacturing

Many manufacturers require specially engineered pallets to transport their goods. Pallet Management targets these markets due to the limited number of pallet manufacturers that can produce specialized pallets, the established reputation of Pallet Management in the industry for being a high quality pallet manufacturer, and the higher profit margins realized in the production of these pallets.

Niche market pallets are uniquely engineered to transport a specific product and are not universally used like the standard GMA or CHEP pallet. Examples of niche pallets Pallet Management builds include those for the metals and fibers industries. These types of pallets are specially engineered by Pallet Management by using PDS (Pallet Design System), a system developed by Virginia Tech's Pallet Laboratory in conjunction with the National Wooden Pallet and Container Association.

Most niche market pallets cost more than high volume grocery pallets and yield high margins due to their uniqueness and strict specifications, which are required for automated warehousing operations. Pallet Management is aggressively marketing its experience and expertise in this area, as it believes that large manufacturing companies will always have a demand for specially engineered pallets to transport certain kinds of goods.

Reverse Distribution Services

As large manufacturers have focused more of their attention on reducing distribution costs, Pallet Management has expanded the marketing of its Reverse Distribution Services. Reverse Distribution is the systematic retrieval, sortation, repair, warehouse and return of pallets and other packaging material that creates closed-loop return systems between the manufacturer, their customers, and their vendors. Pallet Management's customers own the pallets or containers that are loaded with their products for transport. Large manufacturing companies often make sizable investments in specially engineered and heavy-duty pallets. Pallet Management can recover, sort, repair, warehouse and return a niche pallet to a customer for significantly less than the cost of a new pallet, thereby eliminating or reducing some of its customers' distribution expenses. At the same time, Pallet Management generates greater margins than when a new pallet is built. The key to successfully implementing a large-scale reverse distribution program is to have an integrated network that encompasses information, retrieval, and logistics capabilities. Pallet Management is actively seeking strategic relationships to more fully develop its nationwide reverse distribution network.

Pallet Management is forming the majority of its reverse distribution network through the utilization of the over 3,600 existing pallet manufacturers and recyclers across the United States, as well as creating its own facilities. Many of the smaller pallet companies are looking for an affiliation with a national company as they lack the ability to market their company beyond a limited geographic region, customers demand more diverse geographical services, and CHEP continues to impact the grocery pallet market. Pallet Management believes that many of these companies have excess capacity and are willing to affiliate with Pallet Management on a fee-for-service basis.

During the fiscal year 2000, the Company launched PalletNetTM, a web-based tracking and information system that manages the flow of pallets and other shipping platforms and containers throughout industrial supply chains. As part of the Company's strategy to use the Internet to enhance customer service, PalletNet provides reverse distribution with a single source national contact. This service is supported by leading edge technology that enables users to improve asset control and reduce cost and waste from their supply chain.

PalletNetTM is a browser-based user interface combined with three levels of security management, which delivers safe and unlimited access to customers. Customers can view exactly where their shipping platforms and containers are in their supply chain at any given moment. The system also offers a full range of personalization options, so each company can configure PalletNetTM to their operations. In addition, PalletNetTM has the capacity to use bar codes and integrate radio frequency identification ("RFID") tags to track individual pallets and the equipment transported on them.

These additional services provide the Company's customers the flexibility to meet almost any industrial needs in terms of reverse distribution and transport packaging, and an even higher level of customer service and improved supply chain efficiency.

Acquisitions

Pallet Management intends to pursue acquisitions within its existing markets and new markets to increase its market penetration, as well as to provide a broader range of services to existing customers in those markets. These potential acquisitions will primarily involve transport services businesses and smaller pallet companies whose operations can be incorporated into Pallet Management's existing operations without a significant increase in infrastructure, as well as those that will provide Pallet Management with the ability to service new customers or existing customers in new locations. Pallet Management does not currently plan to acquire any significant additional manufacturing capacity and does not have any current agreements or understandings for any acquisitions. The consideration for such acquisitions, if consummated, could consist of cash, debt, equity or any combination thereof.

Current Operations

Manufacturing

- High volume, high quality CHEP grocery pallet manufacturing
- Low volume, specially engineered niche pallet manufacturing

Services

- Reverse Distribution Services
- Retrieval, sort, repair, warehouse and return services
- Other Products

Manufacturing. The manufacturing process for new pallets at each of Pallet Management's facilities is generally the most capital intensive part of the business, with the majority of assembly and construction being automated. New pallets are manufactured from an assortment of wood products, varying in type and quality, with construction specifications determined by the pallet's end user. Pallet Management believes that approximately 70% of the wood used in new pallets manufactured in North America consists of hardwood (including oak, poplar, alder and gum), with the balance consisting of pine or other softwoods.

Pallet Management utilizes sawing equipment, which cuts large wood sections to specification. The Company also purchases a vast quantity of pre-cut lumber from outside vendors for pallet manufacturing. The cut wood is then transported to assembly points where employees load the stringers ("runners") or blocks and deck boards into nailing machines which nail the pallets together. A typical nailing machine produces 1500 - 2,000 pallets per 8-hour shift with three to ten employees. After construction is completed, pallets are prepared for shipment or storage.

All the high volume CHEP pallets and most of the lower volume specifically engineered niche pallets are manufactured on automated nailing machines. More customized or smaller niche pallet orders may be manufactured by hand on assembly tables utilizing two laborers with pneumatic nailers. Pallet Management typically manufactures pallets upon receipt of customer orders and does not generally maintain significant finished goods inventory. At the Company's Plainfield and Bolingbrook locations, finished goods inventory may build to approximately $1,500,000 when demand softens. This is done to level out production and hold manufacturing costs down.

Services. Reducing the cost of product distribution in the supply chain is the focus of Pallet Management's value-added services. Retrieval, sortation, repair, warehouse and return services enable the customer to better utilize their packaging assets. Besides being environmentally friendly, a properly repaired used pallet will provide the customer significant savings over having to buy a new pallet. Pallet Management initiates the retrieval or purchase of used pallets from a variety of sources. The condition and size of these pallets vary greatly. Once obtained, the pallets are sorted by size, condition and potential customer. Pallets that can be repaired have their damaged boards replaced with salvaged boards or boards from new stock inventory at the facility. Pallets that cannot be repaired are dismantled and the salvageable boards are recovered for use in repairing and building other pallets. Pallet Management sells the remaining damaged boards to be ground into wood fiber, which is used as landscaping mulch, fuel, animal bedding, gardening material and other goods. Despite recent increases in levels of automation, pallet return operations remain a labor-intensive process.

Other Products and Services. Pallet Management functions as a wholesale distributor of other returnable transport packaging such as plastic and metal pallets; collapsible plastic bulk boxes; wood, plastic, and metal slave pallets; wooden boxes and crates; and various other products. Due to lack of demand, sales of pallets made from materials other than wood are minimal.

Marketing and Distribution

Pallet Management uses its internal sales force in marketing its products and services. With services being the primary focus of all marketing efforts, Pallet Management seeks to efficiently serve large numbers of customers across diverse markets and industries to provide a stable and diversified base for ongoing sales of services and products.

Pallet Management has many customers that are Fortune 1000 companies, including Honeywell, CHEP, DuPont, IAMS, Mitsubishi, Monsanto and Scotts Company, as well as various governmental agencies.

During the fiscal year ended June 30, 2001, CHEP accounted for approximately 86% of Pallet Management's revenues. No other single customer accounted for 10% or more of Pallet Management's revenues. Pallet Management enters into contracts with CHEP on a facility by facility basis, and the terms of such contracts vary in accordance with the service to be provided. The Company's depot/repair agreement with CHEP is not finalized for fiscal year 2002. The Company has continued its depot/repair business with CHEP while this contract is being completed. Manufacturing contracts are on a multi-year basis and have varying minimum pallet purchase requirements for each facility. All of the CHEP contracts prohibit Pallet Management from engaging the corresponding

facilities to compete with CHEP during the term of the agreement and for up to three years thereafter in the pallet leasing business and from repairing pallets for other pallet leasing companies.

Suppliers

Pallet Management believes that there is an adequate supply of raw material components for pallet production. The primary raw materials are hardwood, softwood, used lumber, used pallets and nails. Pallet Management has several principal suppliers, which are rotated depending on availability. During the fiscal year ended June 30, 2001, Pallet Management purchased lumber and plywood from over 50 vendors. The three largest suppliers accounted for approximately 29%, 22% and 5 % of the lumber purchases. During the fiscal year ended June 30, 2001, Pallet Management purchased approximately 4.4% of its lumber from Clary Lumber Company, Inc., a North Carolina corporation ("Clary"), at prices comparable to vendors other than Clary. Clary is owned by John C. Lucy, Jr., a significant shareholder and former Director of Pallet Management, and his son, John C. Lucy III, who is Pallet Management's CEO. See Item 13, "Certain Relationships and Related Transactions." Pallet Management expects its percentage of purchases from Clary to decrease in the future as Pallet

Management's lumber demands increase outside of Clary's geographic supply areas. Pallet Management does not believe that the loss of any vendor would materially adversely affect its financial condition or results of operations. Pallet Management intends to continue to pursue a strategy of purchasing from alternative sources of lumber.

Pallet Management's sales prices are closely related to the changing costs and availability of lumber. While Pallet Management believes that it will benefit from strong relationships with multiple lumber suppliers, there can be no assurance that Pallet Management will be able to secure adequate lumber supplies in the future. Lumber supplies and costs are affected by many factors outside Pallet Management's control, including governmental regulation of logging on public lands, lumber agreements between Canada and the U.S., and competition from other industries that use similar grades and types of lumber. In addition, adverse weather conditions may affect Pallet Management's ability to obtain adequate supplies of lumber at a reasonable cost. Pallet Management is also able to buy low quality lumber and upgrade such lumber at its own plants. Though Pallet Management has studied the broad use of alternative materials for the manufacture of pallets, such as plastic, it believes that there is not currently an available alternative raw material that possesses the tensile strength, recyclability and low cost of wood. Pallet Management continues to evaluate alternatives to wood and is receptive to their future use in pallet production.

Competition

Pallet Management believes that the principal competitive factors in the pallet industry are price, quality of services and reliability. With over 3,600 industry participants, the pallet manufacturing industry has been and is expected to remain extremely fragmented and highly competitive. While there are several companies which have attempted to establish national pallet operations, most of Pallet Management's competitors are small, privately held companies that operate in only one location and serve customers within a limited geographic region. Pallet Management does not directly compete against many of these companies to a large extent due to its concentration on CHEP and specialty pallets, which are not made by most of its competitors, although they may at any time attempt to compete directly with Pallet Management. New pallet manufacturers can typically service up to a 300-mile radius, although recyclers

rarely market beyond a 100-mile radius. Pallet Management believes that it will have a competitive advantage as it expands its national network of facilities, thus benefiting from economies of scale while interfacing with customers' nationwide distribution systems.

Competition is often intense and Pallet Management faces most of its competition from other manufacturers. Pallet rental systems compete with new pallet sales to the grocery and wholesales distribution industries, and may expand into other industries in the future. Pallet Management does not compete to any significant extent with pallet rental systems in the grocery industry and intends to focus on industries and products in which pallet rental systems are not competitive.

In addition, pallet manufacturing and recycling operations are not highly capital intensive and the barriers to entry in such businesses are minimal. Certain other smaller competitors may have lower overhead costs and, consequently, may be able to manufacture or recycle pallets at lower costs than Pallet Management. Other companies with significantly greater capital and other resources than Pallet Management (including CHEP) may enter or expand their operations in the pallet manufacturing and recycling businesses in the future, changing the competitive dynamics of the industry. While Pallet Management estimates, based on industry sources, that non-wooden pallets currently account for less than 10% of the pallet market, there can be no assurance that Pallet Management will not face increasing competition from pallets fabricated from non-wooden components in the future. Pallet Management does not believe that non-wooden pallets will be widely used until it is demonstrated that they replicate the strength of wood pallets and until their cost decreases from their current levels, which are well above the cost of similar wood pallets.

Employees

As of June 30, 2001, Pallet Management had 263 employees. This includes production workers who work on new and recycled pallets, clerical personnel, logistical and computer personnel, facility management personnel, regional management personnel, sales force, customer service personnel, administrative personnel, and executive personnel.

Item 2. Properties

Facilities: Pallet Management currently has 5 facilities in 4 states.

Bolingbrook, Illinois - Manufacturing Plant: This facility opened in April 1999 at 335 Crossroads Suite B, Bolingbrook, Illinois in a 110,000-sq.-ft. facility with a 5-year lease ending February 2004. The facility employed 29 people as of June 30, 2001.

Lawrenceville, Virginia - Manufacturing Plant: Located at 10324 Liberty Road, Lawrenceville, Virginia, new pallet manufacturing is performed at this Company-owned facility using automated equipment. This facility's primary production is specifically engineered niche pallets and cutting lumber to size for pallet production at this facility and shipment to other company facilities. In addition, pallet recycling and repair services are performed at this location, which has 60,000 sq. ft. of manufacturing buildings located on 70 acres, a 3,000-sq.-ft. office building and employed 117 people as of June 30, 2001.

Plainfield Indiana - Manufacturing Plant: This facility opened at 6030 Gateway Dr., Plainfield, Indiana, in August 1999 in a 130,000-sq.-ft. facility with a 5-year lease ending September 2004. As of June 30, 2001 there were 54 people employed at this facility, which manufactures pallets on high-speed automated manufacturing lines.

Petersburg, Virginia - Repair Depot: Located at 1925 Puddledock Road, Petersburg, Virginia, this facility processes, repairs, and stores all types of pallets. It contains a 40,000-sq.-ft. warehouse on eight acres of Company-owned, mortgage-free property. As of June 30, 2001 there were 27 people employed at this facility, which contains "state of the art" automated sorting and repair equipment.

Rogersville, Alabama - Manufacturing Plant: Located at 120 Industrial Park Road, Rogersville, Alabama, this facility opened in September 1998 in a 25,500-sq.-ft. facility on seven acres with a three-year lease terminating September 2001. This lease was extended for 6 months beginning in September 2001 and is renewable for 6 month increments. The facility employed 23 people as of June 30, 2001. It employs 2 people currently as we anticipate closing this facility.

Corporate and Regional Offices: Corporate and regional offices are located at the following addresses.

2900 Highwoods Blvd., Suite 200, Raleigh, North Carolina - Regional Offices - Three year lease expiring September 2002.

2855 University Blvd, Suite 510, Coral Springs, Florida - Corporate Headquarters - Five year lease expiring in October 2005.

Item 3. Legal Proceedings

None.

Item 4. Submission of Matters to a Vote of Security Holders

None.

PART II

Item 5. Market for Registrants Common Equity and Related Stockholder Matters

Pallet Management's Common Stock is quoted on the OTC Bulletin Board under the symbol PALT. The following table sets forth the average of the high and low bid prices of the Pallet Management's Common Stock as reported on the OTC Bulletin Board for each quarter from June 28, 1999 through June 30, 2001. The quotations are over-the-market quotations and, accordingly, reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not represent actual transactions.

	High Bid
FISCAL 2000	
June 27 , 1999 through September 25, 1999	6 1/4
September 26, 1999 through December 25, 1999	4
December 26, 1999 through March 25, 2000	5 5/8
March 26, 2000 through June 24, 2000	4 3/4
FISCAL 2001	
June 25, 2000 through September 30, 2000	3 7/8
October 1, 2000 through December 30, 2000	3 1/16
December 31, 2000 through March 31, 2001	3 3/32
April 1, 2001 through June 30, 2001	1 7/10

As of September 21, 2001, there were 65 holders of record of the Company's Common Stock. All stock data and per share amounts have been restated to give effect to the one-for-four reverse stock split in February 1998.

The quotations in the foregoing table represent prices between dealers and do not include retail markup, markdown, or commissions paid and may not represent actual transactions. Such quotations are not necessarily representative of actual transactions or of the value of the Company's securities.

Dividend Policy

Pallet Management has not paid any cash dividends on its Common Stock since its inception. Pallet Management presently intends to retain future earnings, if any, to finance the expansion of its business and does not anticipate that any cash dividends will be paid in the foreseeable future. Future dividend policy will depend on Pallet Management's earnings, capital requirements, expansion plans, financial condition and other relevant factors.

Recent Sales of Unregistered Securities

None.

Item 6. Selected Financial Data.

	Fiscal Years Ended		
	30-Jun-01	24-Jun-00	26-Jun-99
Net Sales	$ 72,167,233	$ 62,445,175	$ 38,744,129
Income (loss) from continuing operations	$ 302,984	$ (2,249,967)	$ 537,529
Income (loss) from continuing operations per share	$ 0.08	$ (0.57)	$ 0.15
Total Assets	$ 12,879,737	$ 13,350,996	$ 10,205,006
Long-term debt	$ 5,576,663	$ 5,597,490	$ 3,119,578
Cash dividends per share	$ --	$ --	$ --

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operation

Fifty-third Week in Fiscal Year 2001

Comparisons of fiscal year 2001 to fiscal year 2000 are affected by an additional week of results in the 2001 reporting year. Because our fiscal year ends on the last Saturday in June, a fifty-third week is added every 5 or 6 years. The fifty-third week increased 2001 net sales by an estimated $1.3 million and net income by an estimated $6 thousand.

Cautionary Statements

The following discussion and analysis should be read in conjunction with Pallet Management's Consolidated Financial Statements and the Notes thereto included in Part II, Item 8 of this Report.

The following discussion regarding Pallet Management and its business and operations contains "forward-looking statements" within the meaning of Private Securities Litigation Reform Act 1995. These statements consist of any statement other than a recitation of historical fact and can be identified by the use of forward-looking terminology such as "may," "expect," "anticipate," "estimate" or "continue" or the negative thereof or other variations thereon or comparable terminology. The reader is cautioned that all forward-looking statements are necessarily speculative and there are certain risks and uncertainties that could cause actual events or results to differ materially from those referred to in such forward looking statements, including the limited history of profitable operations, dependence on a key customer, competition, risks related to acquisitions, difficulties in managing growth, dependence on key personnel and other risk factors discussed in this report. See "Risk Factors." Pallet Management does not have a policy of updating or revising forward-looking statements and thus it should not be assumed that silence by management of the Pallet Management over time means that actual events are bearing out as estimated in such forward looking statements.

Results of Operations

General

We have grown to be one of the largest pallet companies in the estimated $6 billion U.S. pallet industry, by providing value-added products and services to our customers. Our customer base has remained stable as our sales have grown to $72,167,233 for the year ending June 30, 2001.

The majority of our revenues have traditionally been generated from providing high quality, specially engineered pallets to manufacturers, wholesalers and distributors. As supply chain logistics have become increasingly complex, our existing customers as well as prospective customers are seeking new ways to streamline distribution and reduce costs, which is opening a huge service-orientated market for us.

With this shift in focus toward services and cost efficiency, we are providing "state of the art" logistical services known as reverse distribution. Reverse distribution is simply defined as maximizing the use of transport packaging, the base of which is the pallet, by reusing assets to reduce the overall cost per trip.

This shift in focus toward supply chain efficiency by our customer base is by far our industry's most dramatic shift in focus and provides the most opportunity for our company. Driven mainly by economics, reusable packaging in a Reverse Distribution system also has environmental marketing benefits.

As this market of Reverse Distribution is just starting to be created, the economic advantages to companies that are implementing it are huge; thus the demand is overwhelming. We are working diligently as an industry leader in this area, as the growth potential continues to unfold.

Reverse logistics, a sub-industry of the logistics industry, is growing rapidly and is estimated to have reached $7.7 billion. The third-party logistics industry is estimated to be in excess of $35 billion and growing rapidly as companies are discovering the benefits of outsourcing their logistical demands.

The Company has two lines of revenue, manufacturing and services:

Manufacturing: Our Company has two primary categories of manufacturing:

CHEP grocery pallets and specifically engineered niche market pallets. The Company has multi-year contracts to manufacture high quality grocery pallets for CHEP, the world's largest pallet rental pool. The Company has three manufacturing facilities, which currently produce CHEP pallets. During the next 12 months, our contracts with CHEP at two of our facilities will expire. In Rogersville, Alabama, our contract expires on September 7th, 2001. The Company is currently winding down operations and anticipates closing the facility in fiscal year 2002. In Bolingbrook, Illinois, our contract expires on April 30th, 2002.

Pallets that are uniquely engineered to transport a specific product are classified as niche market pallets. Besides CHEP, our company's customer base is primarily composed of customers who require niche pallets. Niche pallets are lower volume and higher margin than CHEP pallets.

Pallet Management functions as a wholesale distributor of other various returnable transport packaging such as plastic and metal pallets; collapsible plastic bulk boxes; wood, plastic, and metal slave pallets; wooden boxes and crates; and various other products. Due to lack of demand, sales of pallets made from materials other than wood are minimal.

Services: Our company provides a variety of retrieval, sortation, repair, warehouse and return services that enable our customers to better utilize their packaging assets. Besides being environmentally friendly, a properly repaired used pallet will provide the customer significant savings over having to buy a new pallet. Pallet users currently discard a large portion of new pallets after one use. The condition and size of these pallets vary greatly. The pallets are sorted and repaired as needed, placed in storage and made available for return to service. Pallets that can be repaired have their damaged boards replaced with salvaged boards or boards from new stock inventoried at the facility. Pallets that cannot be repaired are dismantled and the salvageable boards are recovered for use in repairing and building other pallets. Pallet Management sells the remaining damaged boards to be ground into wood fiber, which is used as landscaping mulch, fuel, animal bedding, gardening material and other items. Despite recent increases in levels of automation, pallet return operations remain a labor-intensive process.

As part of the Company's strategy to use the Internet to improve the effectiveness of its service offerings, it developed PalletNetTM , a service brand providing a logistics and information system that manages the flow of shipping platforms and containers throughout industrial supply chains (excluding the grocery industry). PalletNetTM creates a closed loop delivery, recovery and recycling system, which enables customers to treat pallets as assets rather than expendables. The principal services PalletNetTM offers include reverse distribution, single source national contracts, high quality shipping platforms and transport packaging, recovery, repair, recycling and export packaging. These physical activities are supported by leading edge technology that enables users to improve shipping asset controls and reduce cost and waste from the supply chain, while reducing inventories and enhancing customer satisfaction. By coupling PalletNetTM with the Internet, the Company is creating value for the customer through substantially lower costs and improved efficiencies. The PalletNetTM Application is a browser-based user interface combined with three levels of security management which delivers unlimited, safe access to customers who can view exactly where their shipping platforms and containers are in the supply chain at any given moment. The system also offers a full range of personalization options, so each company can configure PalletNetTM to their operations. In addition, PalletNetTM has the capacity to use either bar codes or radio frequency identification tags to track individual pallets and the equipment transported on them. These new, "state of the art", logistics and information system capabilities provide customers and Pallet Management the technical support requirements to manage an efficient reverse distribution operation and management of valuable transport packaging from any location in which they can access the Internet.

In order to fulfill the increasing demand for transport management services, Pallet Management plans to expand its service offerings and service revenues by hiring additional key sales personnel during this fiscal year. Though expanding sales of services will not require any significant capital expenditures other than possibly additional computer equipment and application, it will increase SG&A as a percentage of sales until newly hired sales personnel are trained. In addition, the cycle for completing a sale of services is significantly longer than that for selling manufactured pallets. We anticipate that service will become a greater percent of net sales as we expand our sales personnel.

Discussion of fiscal year 2001

Fiscal year 2001 was characterized as a year of restructuring for our company as we evolved from a "Start-Up" phase company to an "Entrepreneurial Expansion and Professional Management" company. This transition started in April 2000 when the shareholders elected a new Board of Directors. The Board then enacted a shift in management authority and responsibilities.

During the first half of fiscal year 2001, ending December 2000, we focused on turning our operations around to become a profitable manufacturing company. Our most visible achievement included completing three profitable quarters in which we earned over $300,000, as compared to a loss of over $3,500,000 for the three-quarters ending December 1999. In addition, we installed new "state of the art" pallet manufacturing equipment as we grew to be one of the largest pallet producing companies in the industry.

At the same time, we made enormous strides in streamlining our management structure, developing an understanding of job functions and creating a corporate culture far more focused and disciplined than we had at the

beginning of this fiscal year. As a result, our company has become a far better place to work because all of our employees now have an understanding of what is expected of each of them and the challenges we face.

During the third quarter of this fiscal year we faced the challenge of a declining economic environment and orders from our major customer became sluggish and erratic. We were fortunate to have in place our new management structure that was able to react and control expenses to minimize losses during that period.

The fourth quarter presented a whole new set of challenges as pine lumber prices spiraled up with an unprecedented increase of approximately 30% during the month of May. This increase squeezed us in the middle of our vendors who passed the price increase on to us weekly and customers to whom we could not pass the increase on to until the end of the month. By the time May ended, the price for pine was dropping back to normal levels again. Though the price of lumber historically fluctuates, these fluctuations generally correct themselves over time. As a result of this recent sharp increase, we restructured our purchasing methods to minimize the negative impact if a dramatic price increase occurs again. Despite this dramatic change in lumber pricing, our operations were still able to show a profit for the quarter, which we credit to our improved corporate operations restructuring.

When we started restructuring our company this fiscal year, we wanted to create a strong and focused leadership team that can carry our company's potential forward. Our company is now structured into six departments: Operations, Finance, Human Resources, Information Technology, Sales & Marketing, and Administrative. Each department is run by a Director who reports to the President of the company.

The previous management group committed considerable amounts of company assets to servicing a single customer. Our current management team has recognized that this dependency on a single customer should be reduced. Contracts with this customer are coming to an end, with the first ending September 7th, 2001 for our Rogersville facility, and the second ending April 30th, 2002 for our Bolingbrook facility. We have already been notified that the Rogersville, Alabama contract will not be renewed and we are working hard to address the impact of this situation. During the third and fourth quarters, we aggressively sought to purchase several acquisition targets and create strategic partnerships, none of which materialized during the fiscal year due to various circumstances, though we are still actively pursuing such transactions.

June 30, 2001 vs. June 24, 2000

For the year ended June 30, 2001, net sales increased 16% to $72,167,233 from $62,445,175 for the prior year. This increase was due mainly to an increase in new pallet sales, which accounted for 97% of net revenues, as opposed to 92% of net revenues the previous year. New pallet sales increased due to sales to one customer, which accounted for 86% of our sales. Sales other than new pallet sales, comprised principally of service, accounted for 3% of net revenues, as opposed to 8% of net revenues the previous year. These sales dropped from approximately $4,996,000 in fiscal year 2000 to approximately $2,047,000 in fiscal year 2001. The decrease is a result of closing the Lakeland facility in fiscal year 2000, and a reduction in the order rate on services experienced in our third quarter.

Cost of sales for 2001 was $67,035,408 or 93% of net sales, as compared to $59,097,842 or 95% of net sales for 2000. This decrease in cost of sales in relation to net sales, is due to becoming more efficient in production throughout fiscal year 2001. In addition, we focused on cost control and reduced spending. Efficiencies were gained in the plants by reducing machine down time and by planning production during periods of reduced demand. By leveling our production, we held down additional costs in our facilities and contributed to the cost of sales percent decrease noted above. By decreasing down time, we were able to produce more product without adding additional labor costs, which also reduced our cost per unit.

Selling, general and administrative expenses were $4,320,719 or 6.0% of net sales in 2001, as compared to $4,899,091 or 7.8% of net sales in 2000. This decrease is primarily due to increased sales volume and cost control. Reductions were made in many areas including travel, entertainment, legal and salaries. Our corporate structure during the year became more streamlined as we set our management team in place and focused on placing controls in place while developing new sales opportunities.

Net interest expense decreased to $528,078 in 2001 from $545,119 in 2000. This decrease came as a result of improved cash management. We changed our approach on borrowing from our revolver loan to reduce the average outstanding balance on a daily basis. We borrowed $1,031,000 in fiscal year 2001 for our new Vanderloo nailing machine, which was installed in our Plainfield, Indiana facility. By increasing our borrowings, we incurred more interest expense, which offset the savings realized from our improved cash management policies and procedures. Additionally, we were helped during the year by declining interest rates that contributed to reduce expenses.

Net income for 2001 was $302,984 compared to a net loss of $2,249,967 in 2000. This was an improvement of over $2.5 million and signified a turnaround to profitability. For a discussion of the loss for year 2000, see `June 24, 2000 vs. June 26, 1999' below. During 2001 manufacturing operations made many improvements which led to our profitable year. Among those improvements were significant reductions to machine downtime, process engineering to eliminate costs from our manufacturing lines and reductions in staffing where appropriate. During November we began planning for a slow down from our major customer in January. We were prepared for and minimized losses during a slow third quarter and when sales started coming back up in April, we were prepared to meet all of our customer expectations. May saw the largest increase to pine lumber prices in recent history of nearly 30% and contributed greatly to losses during that month as we could not pass this cost increase on to our customers. We continued to meet our customer demands and worked with our vendors on gaining price reductions to counteract the May pine lumber price increases seen in May so that our profitability for June would be maximized. During the course of this fiscal year, we reorganized the business structure of the company by creating distinct departments, which had clear lines of responsibility and authority. We also hired a completely new senior management team. During the transition of reorganizing, we relied upon outside consultants to fill some senior management positions until the new management team was in place. Consultants were utilized primarily for manufacturing operations, Human Resources, Marketing, Materials, Systems and Logistics. The company expects to reduce expenditures on consultants materially during fiscal year 2002. The total expenditures made during the course of fiscal year 2001 for these consultants were $515,000.

For a discussion of fiscal year 2000 net income, please refer to June 24, 2000 vs. June 26, 1999 below.

June 24, 2000 vs. June 26, 1999

For the year ended June 24, 2000, net sales increased 61% to $62,445,175 from $38,744,129 for the prior year. This increase was due mainly to an increase in new pallet sales, which accounted for 92% of net revenues, as opposed to 77% of net revenues the previous year. The increase in new pallet sales resulted from a significant increase from one major customer, which accounted for approximately 83% and 75% of 2000 and 1999 net sales respectively. Sales other than new pallet sales, comprised principally of service, accounted for 8% of net revenues, as opposed to 23% of net revenues the previous year. These sales dropped from approximately $8,911,000 in fiscal year 1999 to approximately $4,996,000 in fiscal year 2000. The decrease is a result of selling the Ocala facility and closing the Orlando facility at the end of fiscal year 1999, and closing the Lakeland facility in fiscal year 2000.

Cost of sales for 2000 was $59,097,842 or 95% of net sales, as compared to $35,012,585 or 90% of net sales for 1999. This increase reflects the higher expenses associated with the opening of a new facility in Indiana in the first quarter of fiscal year 2000, which did not recognize significant sales until the end of the second quarter. In addition, the Company lost sales at its Lawrenceville facility as CHEP sales were shifted to other facilities. The Company was unable to reduce costs commensurate with the decrease in sales. The Company also experienced operational problems and a significant theft at its Bolingbrook, Illinois facility, which opened during the third quarter of the previous fiscal year. See Liquidity and Capital Resources. Other costs remained consistent as lumber prices remained stable. The Company hopes to recognize efficiencies in fiscal 2001 with larger production runs and improved management structure. For the fourth quarter of fiscal 2000, cost of sales were equal to 90% of the Company's revenues, as the gross profit increased by $1,885,000 during the fourth quarter of the fiscal year.

Selling, general and administrative expenses were $4,899,091 or 7.8% of net sales in 1999, as compared to $2,944,355 or 7.6% of net sales in 1999. This dollar increase was a result of additional administrative costs related to the sales volume increase and expenses related to expanding the Reverse Distribution business and investments in the PalletNet web page and PalletNetTM.

Net interest expense increased to $545,119 in 2000 from $299,019 in 1999. This increase resulted from increased borrowing related to increased sales volume, as well as to sustain operations. This increase in sales volume required increased purchasing of raw materials for production, which in turn increased the average borrowing base and the related interest expense.

Net loss for 2000 was $2,249,967 compared to a profit of $537,529 in 1999. During the first three quarters of fiscal year 2000, the Company underwent a reorganization of management in which management positions were eliminated and substantial charges were incurred totaling approximately $725,000. Of this amount, costs included in selling, general and administrative consisted of $32,000 for legal and accounting expenses related to a postponed equity offering and the Nelson Company transaction, $67,000 for closing the Cary, North Carolina, and Richmond, Virginia offices and $192,000 for custom software which is outdated and no longer used. Costs included in other expenses or in cost of goods sold consisted of $77,000 for equipment at the Bolingbrook, Illinois facility that is not economically efficient, and $325,000 related to the closing of the Lakeland, Florida facility. Included in interest expense is $72,000 in costs relating to costs of obtaining the National Bank of Canada loan, which

were amortized over the life of the loan. During the fourth quarter of fiscal 2000, the Company focused on cost control while assembling a core management team to oversee the operations of the Company which produced a fourth quarter net income of $47,800.

Liquidity and Capital Resources

We had $226,126 of cash on hand at June 30, 2001, compared to $577,052 at the beginning of fiscal year 2001. Net cash provided from operating activities was $1,414,843 for the year. We purchased a Vanderloo nailing machine for our Plainfield, Indiana facility for approximately $1,400,000 and capitalized our PalletNetTM software for approximately $270,000. Cash provided by operations in accounts receivable and inventory is $347,000. This is primarily due to initiatives to reduce accounts receivable and inventory by $129,000 and $218,000, respectively. We focused on reducing our on-hand supply of inventory in our Plainfield, Indiana, Bolingbrook, Illinois and Rogersville, Alabama from 7 days of supply on-hand to approximately 3 days of supply on-hand. In addition, we concentrated on utilizing our lumber at our Lawrenceville, Virginia facility that had been aging past 3 months. Both of these efforts led to the reduction of inventory on hand. For Accounts Receivable, we concentrated on accounts which were in excess of 30 days past due and began new collection methods to reduce our Accounts Receivable balances by fiscal year end.

We decreased our borrowings from LaSalle Business Credit, Inc. by $ 710,000 during the fiscal year ended June 30, 2001. This decrease was made up of a reduced revolver borrowing base plus principal payments on our term and real estate loans of $1,741,000 born from effective cash management offset by the addition to the capital loan for a portion of the Vanderloo Nailing Machine of $1,031,000.

In the third quarter of fiscal 2000, the company secured $9,609,000 in financing from LaSalle Business Credit, Inc. This new funding replaced the previous $10,000,000 from the National Bank of Canada. The new credit facility has more favorable terms than the previous agreement with the National Bank of Canada, with additional availability for real estate. The new facility bears interest at a rate of prime for the revolver, and prime plus one quarter to one half for the term loans.

In mid-September, 1999 the Company discovered a theft at its Bolingbrook facility, estimated to be $640,000, consisting of raw material, work in process and finished goods. This loss has been included in cost of goods sold over a time frame, which included a portion of fiscal year 1999 and 2000.

Pallet Management intends to pursue expansion and acquisition plans, which may include the opening of additional facilities as well as the acquisition of additional facilities or companies. The success and timing of any such plans and required capital expenditures cannot be reasonably estimated at this time and the Company has no current arrangements with respect to any such acquisition or expansion. Funding for these plans and for ongoing operations could be a combination of issuance of additional equity, working capital, additional borrowings, and profits from operations. Pallet Management cannot make any assurances that such funding would become available for such plans.

Management believes that existing cash on hand, cash provided by future operations and services, additional borrowings under its current line of credit,

and a net working capital of $2,319,000 as of June 30, 2001, will be sufficient to finance its operations and expected working capital and capital expenditure requirements for at least the next twelve months.

Risk Factors

Limited History of Profitable Operations

The Company reported a net income of $302,984 for the fiscal year ended June 30, 2001, a net loss of $2,249,967 for the fiscal year ended June 24, 2000, a net income of $537,529 for the fiscal year ended June 26, 1999, net income of $191,627 for the fiscal year ended June 27, 1998 and a net loss of $882,977 for the fiscal year ended June 30, 1997. The Company cannot guarantee that it will sustain growth, that it will continue to be profitable or that it will maintain sufficient revenues for profitability. The Company cannot guarantee that it will sustain or increase profitability on a quarterly or annual basis in the future.

Dependence on Key Customer

The Company currently depends on CHEP for a material portion of its business. During the fiscal year ended June 30, 2001, approximately 86% of the Company's revenues and a significant percentage of its growth were attributable to CHEP. The Company expects that the revenues from CHEP may account for up to 80% of its revenues and will continue to be a material portion of its business for the next fiscal year until the Company can diversify its customer base. In addition, CHEP is the predominant customer of certain of the Company's facilities. If CHEP were to materially decrease its purchase of pallets and services from the Company for any reason, the Company's financial condition and results of operations would be materially adversely affected. The Company has entered into separate agreements with CHEP for each facility that performs CHEP manufacturing, repair or depot services. The Company cannot guarantee that CHEP will not terminate its existing agreements with the Company, and does not anticipate that CHEP will renew its existing agreements with the Company.

During the next 12 months, our contracts with CHEP at two of our facilities will expire. In Rogersville, Alabama, our contract expires on September 7th, 2001. The Company is currently winding down operations and anticipates closing the facility in fiscal year 2002. In Bolingbrook, Illinois, our contract expires on April 30th, 2002.

Supply and Demand for Lumber

Pallet prices are closely related to the market price of lumber, the principal raw material used in the manufacture and repair of wooden pallets. If lumber prices increase sharply, the Company may not be able to pass this increase on to its customers. The Company has attempted to index the sale prices of its pallets based on its lumber costs, although the Company has not always been able to do so.

The price of lumber has been volatile in recent years due to factors beyond the Company's control, including:

- weather and other natural events,
- governmental regulation of logging on public lands,

- lumber agreements between Canada and the U.S., and
- competition from other industries that use similar grades and types of lumber.

Although the Company typically buys its lumber in the open market, the Company purchased approximately 55% of its lumber from 3 suppliers in fiscal 2000. However, the Company might be unable to purchase adequate lumber supplies to meet its needs. To the extent the Company encounters adverse lumber prices or is unable to procure adequate supplies of lumber, the Company's financial condition and results of operations could be materially adversely affected. The Company purchased approximately 4.4% of its lumber from a related company, Clary Lumber Company, Inc., a North Carolina corporation. See Item 13, "Certain Relationships and Related Transactions."

Competition from Other Companies

There are over 3,600 companies that manufacture pallets or provide pallet recycling services. Many of these are small companies that concentrate on the grocery and retail businesses in which the Company does not generally compete, although they might at any time attempt to compete directly with the Company. The Company generally services specialty markets and other services in which there are not as many competitors. CHEP's pallet rental system competes with new pallet sales to the grocery and wholesale distribution industries, and may expand into other industries in the future.

Pallet manufacturing and recycling operations are not highly capital intensive, and the barriers to entry in these businesses are minimal. Smaller competitors might have lower overhead costs and consequently, may be able to manufacture or recycle pallets at lower costs than the Company. Other companies with significantly greater capital and other resources than the Company (including CHEP) might enter or expand their operations in the pallet manufacturing and recycling businesses in the future, which could change the competitive dynamics of the industry. The Company has competed in the past and will continue to compete with lumber mills for sales of new pallets.

Potential Increase in Debt and Interest Expense

On March 31, 2000, the Company established a $9,609,000 borrowing facility with LaSalle Business Credit, Inc., of which approximately $5,732,000 is outstanding. The Company placed into service a Vanderloo pallet nailing machine, which was financed by LaSalle Business Credit as part of the original borrowing facility. The funding for this machine was done in two parts, first in July 2000 for $411,000 and then in February 2001 for $620,000.

The Company uses the borrowing facility to finance receivables, inventory, and real estate as well as for various other corporate purposes including the purchase of new equipment. Thus, the Company's debt and interest expense may be substantially higher in the future, which could limit the Company's flexibility. In addition, this bank has a lien on substantially all of the Company's assets.

The Company increased its debt during the year ended June 30, 2001 by financing the Vanderloo pallet nailing machine with LaSalle as part of the original borrowing facility. We may finance up to $400,000 in additional equipment in the next 12 months. The current facility allows for this capital increase. If interest rates were raised by 100 basis points, given our outstanding debt, the additional interest expense would be approximately $60,000.

Potential Risks Related to Acquisitions

One of the Company's growth strategies is to acquire additional pallet manufacturing and recycling companies to increase the Company's revenues and markets. Acquisitions involve a number of risks, including:

- adverse short-term effects on the Company's operating results;
- difficulties in successfully integrating and managing additional businesses;
- diversion of management's attention;
- dependence on retention, hiring and training of key personnel;
- loss of existing or anticipated customers of the acquired companies;
- unanticipated problems or legal liabilities; and
- amortization of acquired intangible assets.

Some or all of these risks could have a material adverse effect on the Company's financial condition or results of operations. In addition, to the extent that consolidation becomes more prevalent in the industry, the prices for attractive acquisition candidates might increase and the number of attractive acquisition candidates might decrease. The Company cannot guarantee that it will be able to acquire additional businesses or successfully integrate and manage such additional businesses.

Potential Problems in Financing Acquisitions

The Company might potentially issue additional shares of its Common Stock as partial consideration for future acquisitions. If the Common Stock does not maintain a sufficient valuation or potential acquisition candidates are unwilling to accept Common Stock as part of the consideration for the sale of their businesses, the Company might be required to use more cash or bank financing, if available, in order to complete acquisitions. If the Company does not have sufficient cash resources or borrowing availability, the Company's growth could be limited unless the Company is able to obtain additional capital through future debt or equity financing. The Company does not currently have sufficient availability under its current facility to finance any additional acquisitions. Using cash to complete acquisitions and finance internal growth could substantially limit the Company's financial flexibility. Using debt could result in financial covenants that limit the Company's operations and financial flexibility. The Company might be unable to obtain financing if and when needed on acceptable terms. As a result, the Company might be unable to pursue its acquisition strategy successfully.

Transactions With Affiliates

For fiscal 2001, the Company purchased approximately $2,285,000 or 4.4% of its lumber supply from Clary Lumber Company, Inc., a North Carolina corporation ("Clary"), which is owned by the family of John C. Lucy, Jr., a principal shareholder and former Director of Pallet Management. John C. Lucy, III, Mr. Lucy's son, is Pallet Management's Chief Executive Officer and is also President and a minority shareholder of Clary. After procedures were performed

by the Company's auditors during the current fiscal year as it related to purchases for fiscal year 2000, at the request of the Company, the Company believes that these transactions were made at prices comparable to vendors other than Clary in the ordinary course of business. The Company expects to purchase less than 4.4% of its lumber from Clary for the foreseeable future.

Volatility of Stock Price

The trading price of the Company's Common Stock has been, and in the future is expected to be, volatile. The Company expects to experience further market fluctuations as a result of a number of factors, including:

- current and anticipated results of operations;
- changes in the Company's business, operations or financial results;
- general market and economic conditions;
- competition;
- the low number of shares outstanding;
- low trading volume;
- the number of market makers in the Company's stock;
- lumber prices; and
- other factors.

Difficulties in Obtaining New Sales

In the last year, the Company has brought in key personnel to sustain current sales and then focus on new sales. New sales will be required to sustain current operations in all of our facilities if our major customer should not renew our contracts. We anticipate closing the Rogersville, Alabama facility as the contract has not been renewed. Should the Company not be able to obtain adequate new sales we might be unable to:

- successfully implement its business strategy;
- generate sufficient cash flow from operations;
- manage its costs; and
- successfully manage continued growth.

The failure to obtain new sales might have a material adverse effect on the Company's business, financial condition and results of operations.

Dependence on Key Personnel

The Company materially depends upon the services of the following individuals:

- John C. Lucy, III, Chief Executive Officer
- Zachary M. Richardson, President
- Marc Steinberg, Vice President of Finance, Secretary and Treasurer
- Ellen Chambers, Director of Information Technologies
- Mike Sawdy, Director of Manufacturing Operations
- B. French Speece, Director of Sales and Marketing

The Company has five-year employment agreements with Messrs. Lucy and Richardson that expire October 2003. In addition, the Company currently has Key-man insurance in the amount of $1,000,000 for Messrs. Lucy and Richardson. The Company would be adversely affected by the loss of the services of any of the above-mentioned individuals.

No Dividend Payments

The Company has never paid any cash dividends on its Common Stock and does not anticipate paying cash dividends on its Common Stock in the foreseeable future. The future payment of dividends is directly dependent upon the Company's future earnings, capital requirements, financial requirements and other factors to be determined by the Company's Board of Directors. For the foreseeable future, it is anticipated that earnings, if any, which may be generated from the Company's operations will be used to finance the Company's growth.

Vulnerable Stock Price

If the Company's stockholders sell substantial amounts of their Common Stock (including shares issued upon the exercise of outstanding options), the market price of the Company's Common Stock could fall. As of September 21, 2001 the Company had outstanding 4,065,612 shares of Common Stock, of which 3,070,150 shares are freely tradable in the public market, and of which 995,462 shares are "restricted securities" under the Securities Act of 1933, as amended (the "Securities Act"). The Company's officers, directors and employees own options to purchase up to 1,667,405 additional shares of Common Stock.

Restricted securities may only be sold pursuant to an effective registration statement under the Securities Act or in compliance with Rule 144 under the Securities Act or other exemption from registration. Rule 144 provides that a person holding restricted securities for a period of one year may sell such securities during any three-month period, subject to certain exceptions, in limited amounts. Rule 144 also permits, under certain circumstances, the sale of shares without any quantity limitations by a person who is not our affiliate and who has held the shares for a two year holding period. No predictions can be made as to the effect, if any, that market sales of such shares or the availability of such shares for future sale will have on the market price of the Common Stock prevailing from time to time.

Potential Issuance of Preferred Stock

The Company's Articles of Incorporation authorize 7,500,000 shares of preferred stock, none of which are issued and outstanding as of the date hereof. As provided in the Company's Articles of Incorporation, preferred stock may be issued by resolutions of the Company's Board of Directors from time to time without any action of the stockholders. These resolutions may authorize issuance of the preferred stock and set dividend and liquidation preferences, voting rights, conversion privileges, redemption terms and other privileges and rights.

Accordingly, the Company's Board of Directors may, without stockholder approval, issue preferred stock with dividend, liquidation, conversion, voting or other rights which could adversely affect the voting power or the rights of the holders of the Company's Common Stock. The preferred stock could be utilized, under certain circumstances, as a method of discouraging, delaying or preventing a change in control of Pallet Management.

Antitakeover Effects in Our Charter Documents and Under Florida Law

Certain provisions of our Articles and Bylaws may be deemed to have antitakeover effects and may delay, defer or prevent a hostile takeover, including prohibition of shareholder action by written consent and advance notice requirements for shareholder proposals and director nominations In addition, Florida has enacted legislation that may deter or hinder takeovers of Florida corporations. The Florida Control Share Act generally provides that shares acquired in excess of certain specified thresholds will not have any voting rights unless such voting rights are approved by a majority of the corporation's disinterested shareholders. The Florida Affiliated Transactions Act generally requires supermajority approval by disinterested shareholders of certain specified transactions between a public corporation and holders of more than 10% of the outstanding voting shares of the corporation (or their affiliates).

Item 7A. Quantitative and Qualitative Disclosures About Market Risk.

None.

Item 8. Financial Statements and Supplementary Data.

The financial statements are attached at the end of this document.

Item 9. Changes In and Disagreements With Accountants on Accounting and Financial Disclosure.

None.

PART III

Item 10. Directors and Executive Officers of Registrant.

The following table sets forth the names, ages and positions held with respect to each Director and Executive Officer of the Company.

Name	Age	Position

Zachary M. Richardson	46	President and Director
John C. Lucy, III	43	Chief Executive Officer
Marc S. Steinberg	39	Vice President of Finance, T Secretary
Philip D. Feltman	81	Director
Ronald D. Shindler	54	Chairman of the Board
Alan P. Sklar	62	Director
Robert L. Steiler	53	Director

Directors and Officers

ZACHARY M. RICHARDSON has been President of the Company since 1994, when Pallet Recycling Technologies, Inc. (PRTI), which he founded in 1991, was acquired by the Company in a reverse acquisition. From June 1995, when the Company was acquired by Abell Industries and controlled by the Lucy family, until July 2000, Mr. Richardson's areas of responsibility were confined to investor relations and financial reporting. Beginning July 2000, Mr. Richardson assumed executive responsibility for all departments, except New Business Development, of the Company. Mr. Richardson has been a Director since May 2001 and from 1994 until April 2000, when he voluntarily resigned from that position. Mr. Richardson has been involved in the pallet industry since 1991, with over 25 years of management and sales experience. After graduating from Franklin and Marshall College in 1977, he was commissioned in the United States Navy and designated a Naval Aviator. On active duty for eight years he maintained his reserve status in the Navy until his retirement from the reserves in 1997. Mr. Richardson is an active member of the NWPCA and has served on the association's Recyclers Council Executive Committee, which deals with national issues related to pallet recycling.

JOHN C. LUCY, III has served as Chief Executive Officer of the Company since 1995. In addition to being CEO of the Company, he is President of Clary Lumber, a hardwood lumber sawmill located in Gaston, North Carolina (see Item 13, "Certain Relationships and Related Transactions"), and is also Vice-President of Blacksburg Enterprises, Inc., which operates a food service franchise in Blacksburg, Virginia. From 1995 through 1999, Mr. Lucy served the Company as both CEO and Chairman of the Board. Mr. Lucy has also been actively involved in the National Wooden Pallet and Container Association ("NWPCA"), where he served for two years as Chairman of the Military Packing Task Force, and for three years as Chairman of the Research Steering Committee. Mr. Lucy graduated from Virginia Tech with a Bachelor of Science degree in business.

MARC S. STEINBERG joined the Company in July 2000 as its Corporate Controller and became the Vice President of Finance in May 2001. Mr. Steinberg was also appointed Treasurer and Secretary effective August 2000. Mr. Steinberg has worked in the field of accounting for the past 18 years, and has extensive experience in the manufacturing industry. Prior to joining the Company, Mr.

Steinberg served as the controller for the transportation and education subsidiaries of TFG Corporation. Prior to that, Mr. Steinberg served as the controller of RTP Corp. (an electronics equipment manufacturer), controller for Mederer Corporation (a candy manufacturer), and cost accounting manager for Sensormatic Electronics Corp. (an electronics equipment manufacturer). Mr. Steinberg has a CPA license, a CMA license and is certified in Production and Inventory Management. Mr. Steinberg graduated from the University of Florida in 1984 with a Bachelors degree in Accounting.

PHILIP D. FELTMAN was elected a Director of the Company on April 27, 2000. Mr. Feltman has over 50 years of management experience starting in 1947 when he established a drug store chain in Manchester Connecticut. He and several friends later went on to found Ames Department Stores, which became a major chain of discount department stores. He left Ames in 1978 to found K & F Industries, Inc., a foreign auto parts importer. Mr. Feltman went on to participate in the concept, construction, and development of Villas Tacul, a resort in Cancun, Mexico, and was part of its management team. In addition, Mr. Feltman was President of Feltman Enterprises Inc., an investment management company which wholly owned New Nurses, a medical personnel pool; a director of Royalpar Inc., a public company; and President of Pequot Spring Water Company. Currently, Mr. Feltman is an active partner in FW Enterprises, which owns office buildings and apartments; a principal in Travacon Inc., a full service travel agency located in West Hartford, Connecticut; and a principal in F & R Associates, Inc., a builder of high quality homes in the Westbrook area of Connecticut. With a Bachelor of Science degree from the University of Connecticut, College of Pharmacy, in 1943 he served in the European Theater of Operations with the 4th Armored Division, Third Army. Mr. Feltman has also been involved with many charitable causes for many years.

RONALD D. SHINDLER was elected as a Director of the Company in April 2000 and became Chairman of the Board in March 2001. He has been a shareholder of Fowler, White, Burnett, Hurley, Banick & Strickroot, a Miami, Florida law firm, since 1989. He also served as a Vice President and Senior Counsel for Drexel Burnham Lambert Incorporated from 1979 to 1987, as well as managed a large brokerage office. Mr. Shindler's firm serves as one of the Company's outside counsel. He received his B.A. degree from the University of Pennsylvania, his law degree from Boston University and a Master of Law in taxation from New York University. Mr. Shindler specializes in securities law.

ALAN P. SKLAR was appointed a Director for the Company in August 2000. Mr. Sklar has been a CPA for 40 years. Mr. Sklar founded the Chicago CPA and management consulting firm, Gleeson, Sklar, Sawyers & Cumpata LLP in 1967, and is presently a senior partner in the firm, where he primarily consults with middle market manufacturers and distributors. Mr. Sklar serves as an advisor to the board for many of his firm's clients. Mr. Sklar also serves on the board of directors of several non-profit business related organizations, and is former president of the International Group of Accounting Firms. Mr. Sklar is a graduate of Northwestern University.

ROBERT L. STEILER was elected as a Director of the Company in April 2000. He has been a principal of Lewis Management Group, a consulting firm specializing in business strategy, business development, manufacturing operations and logistics, since its founding in 1990. Mr. Steiler's firm has served as a manufacturing consultant to the Company since his election to the Board. See Item 13, "Certain Relationships and Related Transactions." Prior to founding the Lewis Management Group, Mr. Steiler was associated with KPMG Peat Marwick from 1988 to 1990. Earlier in his career he was Vice President of Materials with Stone Management Corporation, a large consumer goods company, where he directed the material management functions and a highly sophisticated computer-controlled picking and storage system. He was also Vice President of Materials for SmithKline Beecham, a Fortune 100 pharmaceutical company. Mr. Steiler graduated from St. John's University with an MBA in Management.

Significant Employees

ELLEN M. CHAMBERS joined the Company in March 1999, as Controller and became the Director of Information Technologies in March 2000. Ms. Chambers previously acted as Information Systems Coordinator for AIDS Community Services, Inc. She also served as Operations Manager at Advanced Logic Technologies, Inc., a company specializing in custom CAD/CAM design. Ms. Chambers has extensive experience in both accounting and systems development, design and implementation, and has worked in the accounting and information technology fields for over 12 years. Ms. Chambers graduated from the University of Buffalo with a B.S. in Accounting, Finance and Management Information Systems, as well as an MBA in Management Information Systems and Management Science/Statistics.

B. FRENCH SPEECE, JR. joined the Company in July 2001 as its Director of Sales & Marketing. Mr. Speece brings over 25 years of sales and marketing experience ranging from industrial products and electronics equipment to reverse distribution services and an in depth knowledge of customer service. For the past 4 years, Mr. Speece managed the global sales marketing and customer service functions at OPW Engineered Systems in Ohio. Prior to that, Mr. Speece worked for 17 years for Eastman Kodak where he managed the sales and marketing efforts as well as created systems for reverse distribution services for companies such as Apple Computer and Palm Computing. Mr. Speece graduated from the University of Virginia in 1973 with a B.A. degree in Economics.

MICHAEL W. SAWDY joined the Company in June, 2001 as its Director of Operations. Mr. Sawdy has worked in the fields of Operations and International Logistics for the past 23 years. Prior to joining the Company, Mr. Sawdy was employed by International Paper Company in several positions, most recently as the Director of Manufacturing in the Automotive Systems Group. Prior employment responsibilities included exportation of 200,000 Chrysler vehicles annually as the Export Logistics Manager for a division of Circle International, and packaging and logistics for Chrysler Austria of automotive components for assembly as Facility Manager for F.X. Coughlin Company. Mr. Sawdy's prior affiliations include the Warehousing Education and Research Council, as well as the American Production and Inventory Control Society.

Compliance with Section 16(a) of the Securities Exchange Act of 1934

To the Company's knowledge, based solely on a review of the copies of such reports furnished to the Company and on representations that no other reports were required, there were no reports required under Section 16(a) of the Securities Exchange Act of 1934, which were not timely filed during fiscal 2001.

Item 11. Executive Compensation.

The following table summarizes all compensation paid by the Company in each of the last three fiscal years for the Company's executive officers currently serving as such whose annual compensation exceeded $100,000.

Annual Compensation

Name and Principal Position	Year	Salary($)(1)	Bonus($)	Other($)(2
Zachary M. Richardson,	2001	170,878	0	83,200(3)
President	2000	161,114	0	59,900(4)
	1999	119,000	0	13,200
John C. Lucy, III	2001	172,262	0	14,348(5)
Chief Executive Officer	2000	161,451	0	16,800(6)
	1999	119,000	0	25,200

(1) Includes medical insurance reimbursements.
(2) Includes car allowances and other miscellaneous benefits.
(3) Includes $13,200 for car allowances. Also, Mr. Richardson sold his home at the request of the Company and incurred expenses in connection with this sale. In fiscal year 2001, the Company reimbursed Mr. Richardson $70,000 for his out of pocket costs.
(4) Includes $13,200 for car allowances and $16,800 for reimbursement of income taxes paid. Also, as noted in footnote 3 above, Mr. Richardson sold his home at the request of the Company and incurred expenses in connection with this sale. In fiscal year 2000, the Company reimbursed Mr. Richardson for closing costs in connection with this sale, which totaled $29,900.
(5) Includes $13,200 for car allowances and other miscellaneous benefits, and $1,148 for payment of Mr. Lucy's Guardian Life policy.
(6) Includes $13,200 for car allowances and other miscellaneous benefits, and $3,600 for reimbursement of closing costs incurred in connection with the purchase of Mr. Lucy's home.

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The following table sets forth information concerning individual grants of stock options made during the fiscal year ended June 30, 2001 to each of the Named Executive Officers:

OPTION GRANTS IN LAST FISCAL YEAR

Name	Number of Shares Underlying Options Granted(#)	% of Total Options Granted to Employees in Fiscal Year	Exercise or Bas Price ($/Share)
Zachary M. Richardson	40,556 (1)	34%	2.25
John C. Lucy, III	40,556 (1)	34%	2.25

(1) Options to purchase 8,111 shares vest each year, beginning July 1, 2001 and continuing through July 1, 2005.

AGGREGATED OPTION EXERCISES IN LAST FISCAL YEAR AND FY-END OPTION VALUES

Name	Shares Acquired On Exercise (#)	Value Realized ($)	Number Of Securities Underlying Unexercised Options at FY-End (#) Exercisable/ Unexercisable	Exerc
Zachary M. Richardson	0	0	529,426/76,819	
John C. Lucy, III	0	0	523,394/76,819	

Compensation of Directors

Starting in fiscal year 2001, the Chairman of the Board is paid a monthly retainer of $1,000 and all other directors are paid a monthly retainer of $500. The directors are paid $1,000 per board meeting day and $500 per teleconference meeting plus all related business expenses. All audit committee members are paid $250 per quarter. All directors are granted 30,000 ten-year options when they are appointed or elected to the board and may be granted additional options for each additional year they are on the board at the then market value. These options vest over two years at fifty percent per year and when services are terminated, all unexercised options are forfeited. See also "Stock Option Plans."

Employment Agreements

In November 1998, the Company entered into five-year employment agreements (the "Employment Agreements") with Zachary M. Richardson and John C. Lucy, III. Pursuant to the terms of these Employment Agreements, each executive is entitled to receive (i) annual base compensation of $156,000, with increases

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in future years by the percentage increase of the Consumer Price Index and (ii) a bonus up to 100% of base salary based on the increase in pretax earnings per share over the prior year. For the year ending June 30, 2001, Mr. Lucy and Mr. Richardson have agreed to waive the bonus with no other effect on the existing employment agreement. The Employment Agreements also provide for annual grants of common stock options commencing in fiscal 2000 equal to 1% of the then outstanding number of common shares at an exercise price of fair market value at date of grant, and the granting of 150,000 stock appreciation rights that vest only upon a "Change of Control" as defined in the Employment Agreements.

During the term of the Employment Agreements, should there be a Change of Control of the Company as that term is defined therein, the Company, at its sole option, may terminate the Employment Agreements upon 30 days prior written notice and thereafter will be obligated to pay the executives the balance of the compensation payable under the Employment Agreements, had they not been terminated prior to their expiration, together with an additional sum equal to 299% of Executives' annual base compensation. The Employment Agreements also contain non-competition and confidentiality provisions.

Stock Option Plans

Pallet Management has adopted two combined stock option and appreciation rights plans (the "Plans") to attract and to induce officers, directors and key employees of the Company to remain with the Company. The Plans provide for options which qualify as incentive stock options under Section 422(a) of the Internal Revenue Code of 1986, as amended (the "Code"), as well as nonstatutory options. No more than fifteen percent (15%) of the Common Stock outstanding will be reserved for issuance upon exercise of options to be granted from time-to-time. The 1997 Omnibus Stock Option Plan (the "1997 Plan") was approved in August, 1997. Pallet Management's 1998 Omnibus Stock Option Plan (the "1998 Plan") became effective on September 1, 1998. An aggregate of 250,000 shares is reserved for issuance under the 1997 Plan and 1,000,000 shares are reserved for issuance under the 1998 Plan.

As of September 21, 2001, an aggregate of 6,394 options were outstanding under the 1997 Plan with an exercise price of $2.00, and an aggregate of 519,669 options were outstanding under the 1998 Plan with exercise prices ranging from $2.25 to $5.25. These options generally vest over a five-year period and expire ten years from date of grant. From 1997 through 2001, the Company granted Messrs. Lucy, III and Richardson options to acquire an aggregate of 600,215 and 606,247 shares, respectively. See Item 12, "Security Ownership of Certain Beneficial Owners and Management."

The Plans provide for a combined stock option and appreciation rights plan. The Plans provide for options which will qualify as incentive stock options under Section 422(a) of the Internal Revenue Code of 1986, as amended, as well as for options which do not so qualify. Incentive Awards may be granted under the Plans in the form of Options, Stock Appreciation Rights, Restricted Stock, and Performance Awards.

No more than 50,000 common shares may be allocated to Incentive Awards and no more than 300,000 common shares may be allocated to Non-Incentive Awards granted to any one employee during a single calendar year.

All present and future employees of the Company or of any parent or subsidiary of the Company ("Employee") and any person retained to provide services to the Company (other than as an Employee, a member of the Board of Directors or a member of the board of directors of any subsidiary or parent of the Company), and who is selected by the committee, is eligible to receive Incentive Awards under the Plan.

All present and future Non-Employee Directors are eligible to receive Non-Statutory Options under the Plan. Non-Employee Directors shall not be entitled to receive any other form of Incentive Award under the Plan.

The exercise price of shares of Company Stock covered by an Incentive Stock Option cannot be less than 100% of the fair market value of such shares on the date of grant; provided that if an Incentive Stock Option is granted to an Employee who, at the time of the grant, is a 10% Shareholder, then the exercise price of the shares covered by the Incentive Stock Option will not less than 110% of the fair market value of such shares on the date of grant. The exercise price of Nonstatutory Stock Options will not be less than 85% of fair market value of such shares on the date of grant.

Whenever the Board of Directors of the Company (the "Board") deems it appropriate, Stock Appreciation Rights may be granted in connection with all or any part of an Option, either concurrently with the grant of the Option or, if the Option is a Nonstatutory Stock Option, by an amendment to the Option at any time thereafter during the term of the Option. Stock Appreciation Rights may be exercised in whole or in part at such times and under such conditions as may be specified by the Committee in the participant's stock option agreement.

The Board may terminate or amend the Plans in such respects as it shall deem advisable. The Board may unilaterally amend the Plans and Incentive Awards as it deems appropriate to ensure compliance with Rule 16b-3 and to cause Incentive Awards to meet the requirements of the Code, including Code section 422, and regulations thereunder.

Accelerated Options

In August 1997, the Company jointly granted 1,000,000 options to Messrs. Richardson and Lucy to re-allocate to other members of the Company's management. Messrs. Richardson and Lucy immediately re-allocated approximately one-third of these options to other members of the Company's management. If an employee terminated employment with the company, for any reason or no reason, the options allocated to them would immediately revert back to Messrs. Richardson and Lucy. The options provided that vesting would accelerate if the Company achieved specified income before taxes, depreciation, amortization and certain other charges at different measurement dates, which milestones were determined based on management's internal projections through fiscal 1999. All three milestones were met and the options vested according to the accelerated schedule. The options expire in August 2002. See Item 12, "Security Ownership of Certain Beneficial Owners and Management."

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The following table summarizes the terms of these vested but unexercised options:

Name	Exercise Price	Vested	Expiration Date
Zachary M. Richardson	$1.50	172,412	August 20, 2002
	$1.75	128,613	
	$2.25	135,400	
John C. Lucy, III	$1.50	172,412	August 20, 2002
	$1.75	128,613	
	$2.25	135,400	
Other Employees	$1.50	55,175	August 20, 2002
	$1.75	42,775	
	$2.25	29,200	
		1,000,000	

Compensation Committee Interlocks and Insider Participation in Compensation Decisions

The Company created its Compensation Committee during fiscal 2001. Philip D. Feltman, as Chairman, and Robert L. Steiler served on during fiscal 2001, and currently comprise, the Board's Compensation Committee. Mr. Steiler is also the sole owner of a company that provides consulting services to the

Company for compensation. See "Item 13, Certain Relationships and Related Transactions." Mr. Steiler abstains from voting on issues concerning such compensation.

Board Compensation Committee Report on Executive Compensation

General Compensation Policy. The three principal components of the Compensation Committee's executive compensation are salary, bonus and stock options. The components are designed to facilitate fulfillment of the compensation objectives of the Compensation Committee, which objectives include (i) attracting and retaining competent management, (ii) recognizing individual initiative and achievement, (iii) rewarding management for short and long term accomplishments and (iv) aligning management compensation with the achievement of the Company's goals and performance.

The Compensation Committee endorses the position that equity ownership by management is beneficial in aligning management's and shareholders' interest in the enhancement of shareholder value. Base salaries for new management employees are determined initially by evaluating the responsibilities of the position held and the experience of the individual, and by reference to the competitive marketplace for managerial talent, including a comparison of base salaries for comparable position at similar companies of comparable sales and capitalization. Annual salary adjustments are determined by evaluating (i) the performance of and responsibilities assumed by the executive, (ii) the competitive marketplace and (iii) the performance of the Company. The Compensation Committee does not utilize any specific formula to determine compensation based on Company performance.

The Compensation Committee periodically reviews the Company's existing management compensation programs on an ongoing basis, including (i) meetings with the President to consider and set mutually agreeable performance standards and goals for members of senior management and/or the Company, as appropriate or as otherwise required pursuant to any such officer's employment agreement and (ii) modifications to such compensation programs as appropriate, to ensure alignment with the philosophy and established standards and goals of the Compensation Committee.

Compensation of President and Chief Executive Officer. The Company has entered into employment agreements with both Mr. Zachary M. Richardson, its President, and Mr. John C. Lucy, III, its Chief Executive Officer. Each of their employment agreements provide for bonuses of up to 100% of base salary based on the increase in pretax earnings per share over the prior year. See "Employment Agreements." Aside from Company performance, other factors which influence the compensation paid to Messrs. Richardson and Lucy include executive responsibilities and performance, and compensation levels at comparable companies.

Philip D. Feltman, Chairman
Robert L. Steiler

Performance Graph

COMPARE CUMULATIVE TOTAL RETURN
AMONG PALLET MANAGEMENT SYSTEMS, INC.,
NASDAQ MARKET INDEX AND SIC CODE INDEX

[Graph Omitted]

	1996	1997	1998	1999	2000
Pallet Management Systems, Inc.	100.00	70.00	430.00	210.00	125.00
SIC Code Index	100.00	144.49	151.84	114.39	85.48
NASDAQ Market Index	100.00	120.46	159.68	223.77	336.71

Assumes $100 invested on July 1, 1996
Assumes Dividend Reinvested
Fiscal Year Ending June 30, 2001

Item 12. Security Ownership of Certain Beneficial Owners and Management

The following table sets forth, as of the close of business on October 5, 2001 (a) the name, and number of shares of each person known by the Company to be the beneficial owner of more than 5% of the Company's Common Stock and (b) the number of shares of Common Stock owned by each director and all officers and directors as a group, together with their respective percentage holdings of such shares:

Name and Address of Beneficial Owner(1)	Amount of Beneficial Ownership of Stock	Percent of Class Outstanding
Zachary M. Richardson	710,629(2)	15.5%
John C. Lucy, III	705,491(3)	15.4%
Marc S. Steinberg	11,500(4)	*
Philip D. Feltman	37,600(5)	*
Ronald D. Shindler	15,000(6)	*
Robert L. Steiler	26,000(7)	*
Alan P. Sklar	20,000 (8)	*
All Officers and Directors as a Group (seven persons)	1,526,220(9)	29.4%
D.L. Cromwell Group (10)	621,729 (11)	15.3%
John C. Lucy Jr. (12)	675,696 (13)	15.9%

* Less than 1%

(1) The address of director and officers listed above, except for Mr. John C. Lucy, III, is 2855 N. University Drive - Suite 510, Coral Springs, Florida 33065. The address for Mr. John C. Lucy, III is 2900 Highwood Blvd. Suite 200, Raleigh, North Carolina 27604.

(2) This figure includes 181,203 shares owned of record by Mr. Richardson and options to acquire 529,426 shares, which options are exercisable within 60 days from the date hereof. It excludes options to acquire 76,819 shares, which options are not exercisable within 60 days from the date hereof.

(3) This figure includes 182,097 shares owned of record by Mr. Lucy and his children and options to acquire 523,394 shares, which options are exercisable within 60 days from the date hereof. This figure excludes options to acquire 76,819 shares, which options are not exercisable within 60 days from the date hereof. This figure also excludes beneficial ownership of Mr. Lucy Jr., the father of Mr. Lucy III. Together, Mr. Lucy III and Mr. Lucy Jr. (including Clary, see footnote 10 below) own 682,793 shares of record and options and warrants to acquire 698,394 shares, which options and warrants are exercisable within 60 days from the date hereof, or 29.0% of the Company.

(4) This figure includes 0 shares owned of record by Mr. Steinberg and options to acquire 11,500 shares, which options are exercisable within 60 days from the date hereof. It excludes options to acquire 6,000 shares, which options are not exercisable within 60 days from the date hereof.

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(5) This figure includes 22,600 shares owned of record by Mr. Feltman and options to acquire 15,000 shares, which options are exercisable within 60 days from the date hereof. It excludes options to acquire 15,000 shares, which options are not exercisable within 60 days from the date hereof.

(6) This figure includes 0 shares owned of record by Mr. Shindler and options to acquire 15,000 shares, which options are exercisable within 60 days from the date hereof. It excludes options to acquire 15,000 shares, which options are not exercisable within 60 days from the date hereof.

(7) This figure includes 1,000 shares owned of record by Mr. Steiler and options to acquire 25,000 shares, which options are exercisable within 60 days from the date hereof. It excludes options to acquire 25,000 shares, which options are not exercisable within 60 days from the date hereof.

(8) This figure includes 5,000 shares owned of record by Mr. Sklar and options to acquire 15,000 shares, which options are exercisable within 60 days from the date hereof. It excludes options to acquire 15,000 shares, which options are not exercisable within 60 days from the date hereof.

(9) This figure includes 391,900 shares owned of record by the Company's directors and executive officers as a group, and options to acquire 1,134,320 shares as a group, which options are exercisable within 60

days from the date hereof. This figure excludes options to acquire 229,638 shares as a group, which options are not exercisable within 60 days from the date hereof.

(10) The "D.L. Cromwell Group" consists of D.L. Cromwell LLC, a Florida limited liability company ("Cromwell"), David Davidson ("Davidson") and Lloyd Beirne ("Beirne"), as well as Lawrence and Connie Loscalzo (the "Loscalzos"). Cromwell is a holding company for D.L. Cromwell Investments, Inc., a registered broker-dealer engaged in the securities business. Davidson and Beirne might be deemed to control Cromwell. The Loscalzos are individuals and clients of D.L. Cromwell Investments, Inc. Although Cromwell and the Loscalzos do not jointly own any securities of the Company, they would likely act as a group in voting their shares of the Company's common stock. The address of Cromwell and Messrs. Davidson and Beirne is 1200 North Federal Highway, Boca Raton, Florida 33432. The address of the Loscalzos is 1 Bouton Point, Lloyd Harbor, New York 11743. The information disclosed by the Company about Cromwell and the Loscalzos is based upon a Schedule 13D jointly filed by Cromwell and the Loscalzos with the United States Securities and Exchange Commission on October 3, 2001.

(11) To be read in conjunction with footnote (10) above, Cromwell individually owns 321,229 shares of the Company's common stock, or 7.9% of the Company, and the Loscalzos individually own 300,500 shares of the Company's common stock, or 7.4% of the Company. Although Cromwell and the Loscalzos do not jointly own any securities of the Company, they would likely act as a group in voting their shares of the Company's common stock.

(12) The address of Mr. John C. Lucy, Jr. is 4755 Liberty Road, Dolphin, Virginia 23843.

(13) This figure includes 450,696 shares owned of record by Mr. Lucy Jr., the father of Mr. Lucy III, and options to acquire 125,000 shares, which options are exercisable within 60 days from the date hereof. This figure also includes 50,000 shares owned of record by Clary Lumber Company, Inc., a North Carolina corporation ("Clary"), and warrants to acquire 50,000 shares, which warrants are exercisable within 60 days

from the date hereof. Mr. Lucy Jr. owns two-thirds of Clary, with the other one-third ownership shared between Mr. Lucy III and his sister. This figure does not include beneficial ownership of Mr. Lucy III. Together, Mr. Lucy Jr. (including Clary) and Mr. Lucy III own 682,793 shares of record and options and warrants to acquire 698,394 shares, which options and warrants are exercisable within 60 days from the date hereof, or 29.0% of the Company.

Item 13. Certain Relationships and Related Transactions

The Lewis Management Group ("LMG"), a firm that provides manufacturing consulting services to the Company, is partially owned by Robert L. Steiler, a Director of the Company. Under a consulting agreement between LMG and the Company, the Company paid LMG $25,000 per month from July 2000 through November 2000 and the Company paid LMG or Mr. Steiler directly for continued consulting services $5,000 per month from December 2000 through June 2001. The total amount paid by the Company to LMG and Mr. Steiler for consulting services, inclusive of expenses, was $162,483 during fiscal year 2001.

The Lewis Management Group ("LMG") employed Mr. Ed Carr. Mr. Ed Carr acted in the capacity for the Company as the Director of Manufacturing Operations from July 2000 until June 2001. The Company began paying Integrated Consulting Associates, Inc., which is Mr. Carr's consulting company, for his consulting services directly beginning in December 2000 at the rate of $20,000 per month. The total amount paid by the Company to Integrated Consulting Associates, Inc., inclusive of expenses, was $147,065 during fiscal year 2001. Mr. Carr also received warrants for 10,000 shares on May 17, 2001 with a $3.09 exercise price. The company discontinued Mr. Carr's consulting services in August 2001.

Clary Lumber Company, Inc., a North Carolina corporation ("Clary"), which is owned by the family of John C. Lucy, Jr., a principal shareholder and former Director of Pallet Management, and his son, John C. Lucy III, who is Pallet Management's CEO, sold $2,285,000, $2,633,000 and $2,359,000 of pallets and lumber to the Company during the fiscal years 2001, 2000 and 1999, respectively. Lumber purchases from Clary amounted to 4.4%, 5.6% and 8% of the Company's lumber purchases for fiscal years 2001, 2000 and 1999, respectively. After procedures were performed by the Company's auditors at the request of the Company for fiscal year 2000, the Company believes that these transactions were made at prices comparable to vendors other than Clary in the ordinary course of business.

PART IV

Item 14. Exhibits, Financial Statement Schedules, and Reports on Form 8-K

(a) Exhibits and Financial Statements and Schedules
  (1) Financial Statements and Schedules:
      See Attached.
  (2) Exhibits:
      See Exhibit Index.

(b) Reports on Form 8-K
    None.

Exhibit Index

Exhibit No.	Description
3.1	Articles of Incorporation. (2)
3.2	Amendment to Articles of Incorporation filed June 7, 1985. (2)
3.3	Amendment to Articles of Incorporation filed July 10,1985. (2)
3.4	Amendment to Articles of Incorporation filed October 12, 1994. (2)
3.5	Amendment to Articles of Incorporation filed November 21, 1994. (2)
3.6	Amendment to Articles of Incorporation filed February 3, 1998. (3)
3.7	Amended and Restated By-Laws. (2)

4.1 Specimen Certificate of Common Stock. (2)

10.1 1997 Omnibus Stock Plan. (4)*

10.2 Employment Agreement between the Company and John C. Lucy, III. (6)*

10.3 Employment Agreement between the Company and Zachary M. Richardson. (6)*

10.5 1998 Omnibus Stock Plan. (5)*

21.1 Subsidiaries (2)

(1) Incorporated by reference to the Registrant's Current Report on Form 8-K dated August 18,1999.
(2) Incorporated by reference to the Registrant's Annual Report on Form 10-KSB for the fiscal year ended June 30, 1996.
(3) Incorporated by reference to the Registrant's Registration Statement on Form SB-2 (file number 46245).
(4) Incorporated by referenced to the Annual Report on Form 10-K for the fiscal year ended June 30, 1998.
(5) Incorporated by reference to the Registrant's Proxy Statement filed November 30, 1998.
(6) Incorporated by reference to the Registrant's Quarterly Report on Form 10-QSB for the period ended December 26, 1998.

*Management compensation plan or arrangement

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this Annual Report on Form 10-K to be signed on its behalf by the undersigned, thereunto duly authorized.

PALLET MANAGEMENT SYSTEMS, INC.

Date: October 12, 2001

By: /s/ John C. Lucy III

John C. Lucy III, CEO

In accordance with the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated:

Signature	Title
/s/ Zachary M. Richardson	President and Director

Zachary M. Richardson

/s/ John C. Lucy, III John C. Lucy, III	Chief Executive Officer
/s/ Marc S. Steinberg Marc S. Steinberg	Vice President of Finance, Secretary and Treasurer (Principal Financial and Accounting Officer)
Philip D. Feltman	Director
/s/ Alan P. Sklar Alan P. Sklar	Director
/s/ Ronald D. Shindler Ronald D. Shindler	Director
/s/ Robert S. Steiler Robert S. Steiler	Director

PALLET MANAGEMENT SYSTEMS, INC.

AND SUBSIDIARIES

FINANCIAL STATEMENTS

JUNE 30, 2001

REPORT OF INDEPENDENT CERTIFIED
PUBLIC ACCOUNTANTS

Board of Directors and Stockholders
Pallet Management Systems, Inc.

We have audited the accompanying consolidated balance sheet of Pallet Management Systems, Inc. and Subsidiaries as of June 30, 2001 and June 24, 2000, and the related consolidated statements of operations, stockholders' equity and cash flows for the years ended June 30, 2001 (53 weeks), June 24, 2000 (52 weeks) and June 26, 1999 (52 weeks). These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Pallet Management Systems, Inc. and Subsidiaries as of June 30, 2001 and June 24, 2000, and the results of their operations and their cash flows for the years ended June 30, 2001 (53 weeks), June 24, 2000 (52 weeks) and June 26, 1999 (52 weeks), in conformity with accounting principles generally accepted in the United States. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

KAUFMAN, ROSSIN & CO.

Miami, Florida
August 24, 2001

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Pallet Management Systems, Inc. and Subsidiaries

CONSOLIDATED BALANCE SHEET

June 30, 2001 and June 24, 2000

	2001
ASSETS	
CURRENT ASSETS	
Cash	$ 232,
Accounts receivable, net of allowance for doubtful accounts of $156,655 and $100,436	4,614,
Inventories	2,041,
Prepaid expenses	258,
Total current assets	7,147,
Property, plant and equipment - net	5,640,
Other assets	91,

Total assets	$ 12,879,

LIABILITIES AND STOCKHOLDERS' EQUITY

CURRENT LIABILITIES	
Current maturities of long-term debt	$ 420,
Current portion of capital lease obligations	111,
Accounts payable, including $17,392 and $108,923 to a related party	3,039,
Accrued liabilities	509,
Total current liabilities	4,081,
LONG-TERM LIABILITIES	
Long-term debt	5,420,
Capital lease obligations	156,
Total long-term liabilities	5,576,
Total liabilities	9,658,
COMMITMENTS AND CONTINGENCIES	
STOCKHOLDERS' EQUITY	
Preferred stock, authorized 7,500,000 shares at $.001 par value; no shares issued and outstanding	
Common stock, authorized 100,000,000 shares at $.001 par value; issued and outstanding 4,065,612 shares	4,
Additional paid-in capital	7,269,
Accumulated deficit	(3,776,
Notes receivable from stockholders	(276,
Total stockholders' equity	3,221,
Total liabilities and stockholders' equity	$ 12,879,

The accompanying notes are an integral part of these statements.

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Pallet Management Systems, Inc. and Subsidiaries

CONSOLIDATED STATEMENTS OF OPERATIONS

Years Ended June 30, 2001 (53 Weeks), June 24, 2000 (52 Weeks)
and June 26, 1999 (52 Weeks)

	2001	2000

Net sales	$ 72,167,233	$ 62,445,175
Cost of goods sold, including approximately $2,455,000, $2,633,000 and $2,359,000 from a related party	67,035,408	59,097,842
Gross profit	5,131,825	3,347,333
OPERATING EXPENSES		
Provision for bad debts	142,134	95,436
Selling, general and administrative	4,178,585	4,803,655
Total operating expenses	4,320,719	4,899,091
Operating income (loss)	811,106	(1,551,758)
Other income (expense)		
Other income	41,655	84,629
Interest expense	(528,078)	(551,444)
Other expense	(21,699)	(231,394)
Other income (expense)	(508,122)	(698,209)
Income (loss) before income taxes	302,984	(2,249,967)
Income taxes	-	-
Net income (loss)	$ 302,984	$ (2,249,967)
Earnings (loss) per common share:		
Basic	$ 0.07	$ (0.57)
Diluted	$ 0.07	$ (0.57)
Shares used in computing earnings (loss) per common share:		
Basic	4,065,612	3,981,199
Diluted	4,258,484	3,981,199

The accompanying notes are an integral part of these statements.

Pallet Management Systems, Inc. and Subsidiaries

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

Years Ended June 30, 2001 (53 Weeks), June 24, 2000 (52 Weeks)
and June 26, 1999 (52 Weeks)

	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital
Balance at June 27, 1998	2,342,034	$ 2,342	$ 4,526,340
Exercise of options and warrants	1,575,578	1,576	2,302,364
Options issued for services	-	-	130,000
Unrealized loss on available-for-sale investments	-	-	-
Net income	-	-	-
Balance at June 26, 1999	3,917,612	3,918	6,958,704
Exercise of options	138,000	138	275,862
Common stock issued for services	10,000	10	34,990
Sale of investments	-	-	-
Net loss	-	-	-
Balance at June 24, 2000	4,065,612	4,066	7,269,556
Net income	-	-	-
Balance at June 30, 2001	4,065,612	$ 4,066	$ 7,269,556

[restubbed table]

	Accumulated Deficit	Accumulated Other Comprehensive Income (1)	Total
Balance at June 27, 1998	$ (2,366,718)	$ 13,477	$ 2,175,441

Exercise of options and warrants	-	-	2,303,940
Options issued for services	-	-	130,000
Unrealized loss on available-for-sale investments	-	(2,993)	(2,993)
Net income	537,529	-	537,529
Balance at June 26, 1999	(1,829,189)	10,484	5,143,917
Exercise of options	-	-	-
Common stock issued for services	-	-	35,000
Sale of investments	-	(10,484)	(10,484)
Net loss	(2,249,967)	-	(2,249,967)
Balance at June 24, 2000	(4,079,156)	-	2,918,466
Net income	302,984	-	302,984
Balance at June 30, 2001	$ 3,776,172)	$ -	$ 3,221,450

(1) Consisting of unrealized gains on available-for-sale securities.

The accompanying notes are an integral part of these statements.

Pallet Management Systems, Inc. and Subsidiaries

CONSOLIDATED STATEMENTS OF CASH FLOWS

Years Ended June 30, 2001 (53 Weeks), June 24, 2000 (52 Weeks) and June 26, 1999 (52 Weeks)

	2001	2000
Cash flows from operating activities:		
Net income (loss)	$ 302,984	$ (2,249,
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	654,133	602,
Issuance of common stock and options for services	-	35,
Loss on disposal of property, plant and equipment	2,876	226,
Bad debt expense	142,134	95,

(Increase) decrease in operating assets:		
Accounts receivable	128,556	(2,328,
Inventories	217,621	(392,
Prepaid expenses	(21,281)	(81,
Other assets	12,596	12,
Increase (decrease) in operating liabilities:		
Accounts payable	279,349	1,636,
Accrued liabilities	(304,125)	300,
Deferred income taxes	-	
Net cash provided by (used in) operating activities	1,414,843	(2,142,
Cash flows from investing activities:		
Purchase of fixed assets	(905,805)	(1,119,
Proceeds from sale of property, plant and equipment	-	221,
Net cash used in investing activities	(905,805)	(897,
Cash flows from financing activities:		
Proceeds (repayments) under line of credit, net	(1,342,305)	1,837,
Proceeds from lenders	1,170,264	3,631,
Repayments to lenders	(681,414)	(2,113,
Exercise of options and warrants	-	
Net cash provided by (used in) financing activities	(853,455)	3,355,
Increase (decrease) in cash	(344,417)	314,
Cash at beginning of period	577,052	262,
Cash at end of period	$ 232,635	$ 577,
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest	$ 498,344	$ 512,
Income taxes	$ -	$

Schedule of non-cash investing and financing activities:

Capital lease obligations of $103,988, $78,896 and $191,024 were incurred during the years ended June 30, 2001, June 24, 2000 and June 26, 1999, respectively.

During the year ended June 30, 2001, $880,479 of deposits on machinery and software costs were transferred to property and equipment.

In January 2000, stockholders of the Company issued notes receivable to the Company in the aggregate amount of $276,000 for the exercise of stock options.

The accompanying notes are an integral part of these statements.

Pallet Management Systems, Inc. and Subsidiaries

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2001 (53 Weeks), June 24, 2000 (52 Weeks) and June 26, 1999 (52 Weeks)

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A summary of the Company's significant accounting policies consistently applied in the preparation of the accompanying consolidated financial statements follows:

1. Nature of Operations

Pallet Management Systems, Inc. and Subsidiaries (the "Company"/"Pallet") is principally engaged in the manufacture and repair of wooden pallets in Virginia, Alabama, Illinois and Indiana. The Company's revenues are derived primarily from the sale of new and used pallets. The Company's fiscal year ends on the Saturday closest to June 30. Fiscal year 2001 included 53 weeks and fiscal years 2000 and 1999 included 52 weeks.

2. Principles of Consolidation

The accompanying consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries Pallet Recycling Technology, Inc. ("PRTI"), Abell Lumber, Inc. ("Abell"), Pallet Systems-Lakeland, FL, Inc., Pallet Management Systems of Alabama, Inc., Pallet Management Systems of Illinois, Inc. and Pallet Management Systems of Indiana, Inc. Intercompany balances and transactions are eliminated in consolidation.

3. Accounts Receivable

Trade receivable accounts are principally comprised of amounts due from large distributors, national retail chains and major manufacturers. The Company evaluates each account receivable balance to establish an estimate for uncollectible accounts.

4. Inventories

Inventories, consisting of raw materials, work in process, and finished goods, are stated at the lower of cost or market. Cost is determined by the first-in, first-out method and includes costs of materials, direct and indirect labor and overhead attributable to production.

5. Property, Plant and Equipment

Property, plant and equipment are stated at cost, net of accumulated depreciation. Major renewals and improvements are capitalized. Repairs and maintenance are expensed as incurred. Depreciation is computed by using the straight-line method over the expected useful lives of the related assets which are as follows:

	Years
Machinery and equipment	5 - 15

Vehicles	5 - 10
Buildings and improvements	7 - 40
Furniture and equipment	5 - 10

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

6. Estimates

In preparing financial statements in accordance with accounting principles generally accepted in the United States, management makes estimates and assumptions that affect the reported amounts and disclosures of assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

The Company has recorded deferred tax assets of approximately $1,297,689 and $1,433,000 at June 30, 2001 and June 24, 2000, respectively, which are completely offset by valuation allowances. Realization of the deferred tax asset is dependent on generating sufficient taxable income in the future. The amount of the deferred tax asset considered realizable could change in the near term if estimates of future taxable income are modified.

7. Income Taxes

The Company accounts for income taxes under the liability method. Deferred tax assets and liabilities are recognized for future tax consequences attributable to differences between the financial statements carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled.

8. Earnings (Loss) Per Share

Basic earnings (loss) per common share is computed using the weighted average number of shares outstanding during the period. Diluted earnings (loss) per common and common equivalent share is computed using the weighted average number of shares outstanding during the period adjusted for incremental shares attributed to outstanding options and warrants to purchase common stock of 192,872 and 1,206,569 for the years ended June 30, 2001 and June 26, 1999, respectively. For the year ended June 24, 2000, outstanding stock options and warrants were not considered in the calculation of diluted earnings (loss) per common and common equivalent share as their effect would have been antidilutive. Securities that could potentially dilute basic earnings per share in the future consist of 1,596,721 options to purchase common stock discussed in Note M, and 142,935 warrants outstanding to purchase common stock at $2.00 per share. The warrants expire December 31, 2001.

9. Financial Instruments

Statement of Financial Accounting Standards No. 107 requires disclosure of the estimated fair value of financial instruments. The carrying values of cash, accounts receivable and accounts payable approximate fair value due to the short-term maturities of these instruments. The carrying value of debt approximates fair value due to the length of the maturities, the interest rates being tied to market indices and/or due to the interest rates not being significantly different from the current market rates available or offered to the Company.

Pallet Management Systems, Inc. and Subsidiaries

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

June 30, 2001 (53 Weeks), June 24, 2000 (52 Weeks) and June 26, 1999 (52 Weeks)

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

10. Stock Options (SFAS 123)

Options granted to employees under the Company's Stock Option Plan are accounted for by using the intrinsic method under APB Opinion 25, Accounting for Stock Issued to Employees (APB 25). In October 1995, the Financial Accounting Standards Board issued Statement No. 123, Accounting for Stock-Based Compensation (SFAS 123), which defines a fair value based method of accounting for stock options. The accounting standards prescribed by SFAS 123 are optional and the Company has continued to account for stock options under the intrinsic value method specified in APB 25. Pro forma disclosures of net earnings and earnings per share have been made in accordance with SFAS 123.

11. Concentration of Credit

The Company, from time to time, maintained deposits at financial institutions in excess of federally insured limits. The Company is currently monitoring amounts on deposit at the financial institutions.

12. Comprehensive Income

Comprehensive income is not reported in the accompanying consolidated financial statements as it is not materially different from net income.

NOTE B - INVENTORIES

Inventories consisted of the following:

	June 30, 2001	June 24, 2000
Raw materials	$ 1,333,846	$ 1,408,008
Work in process	454,991	549,858
Finished goods	252,652	301,244
	$ 2,041,489	$ 2,259,110

Pallet Management Systems, Inc. and Subsidiaries

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

June 30, 2001 (53 Weeks), June 24, 2000 (52 Weeks) and June 26, 1999 (52 Weeks)

NOTE C - PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment consisted of the following:

	June 30, 2001	June 24, 2000
Machinery and equipment	$ 6,654,079	$ 5,087,856
Building and improvements	1,623,000	1,623,000
Vehicles	541,709	575,160
Furniture and equipment	795,588	519,233
Land	136,044	136,044
	9,750,420	7,941,293
Less: accumulated depreciation and amortization	4,110,065	3,534,201
	$ 5,640,355	$ 4,407,092

Depreciation and amortization expense was $654,133, $602,230 and $524,371 in 2001, 2000 and 1999, respectively, and is included in "cost of goods sold" and "selling, general and administrative" expenses in the accompanying consolidated financial statements. Property, plant and equipment at June 30, 2001 and June 24, 2000 included assets recorded under capital leases and related accumulated amortization of approximately $467,000 and $104,000, and $363,000 and $61,000, respectively. Amortization expense related to assets under capital leases was approximately, $43,000, $38,000 and $23,000 in 2001, 2000 and 1999, respectively.

NOTE D - OTHER ASSETS

Other assets consisted of the following:

	June 30, 2001	June 24, 2000
Deposits on machinery	$ -	$ 647,213
Software costs - in process	-	233,266
Security deposits	84,463	97,059
Other	7,325	7,325

	$ 91,788	$ 984,863

Pallet Management Systems, Inc. and Subsidiaries

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

June 30, 2001 (53 Weeks), June 24, 2000 (52 Weeks) and June 26, 1999 (52 Weeks)

NOTE E - INCOME TAXES

The income tax benefit consisted of the following:

	Years Ended		
	June 30, 2001	June 24, 2000	
Current:			
Federal	$ -	$ -	$
State	-	-	
	-	-	
Deferred:			
Federal	(123,107)	(759,622)	
State	(11,952)	(80,784)	
Change in valuation allowance	135,059	840,406	
	-	-	
	$ -	$ -	$

Deferred income taxes were recognized in the consolidated balance sheets due to the tax effect of temporary differences and loss carryforwards as follows:

	June 30, 2001	June 24, 2000
Deferred tax assets:		
Net operating loss carryforwards	$ 1,678,315	$ 1,657,639
Other	106,590	87,317

	1,784,905	1,744,956
Deferred tax liabilities:		
Depreciation	487,216	312,208
Net deferred tax asset	1,297,689	1,432,748
Less valuation allowance	1,297,689	1,432,748
	$ -	$ -

The major elements contributing to the difference between the income tax benefit and the amount computed by applying the federal statutory tax rate to income (loss) before income taxes are as follows:

	Years Ended		
	June 30, 2001	June 24, 2000	
Statutory rate	$ 103,015	$ (764,989)	$
State income taxes	11,962	(80,784)	
Change in valuation allowance	(135,059)	840,406	
Permanent differences and other	20,082	5,367	
	$ -	$ -	$

NOTE E - INCOME TAXES - Continued

As of June 30, 2001, the Company had net operating loss carryforwards of approximately $4,460,044 which expire in various years through June 2021. Approximately $976,000 of these net operating losses are subject to substantial restrictions imposed under the change in ownership and separate return limitation year rules.

NOTE F - LONG-TERM DEBT

	2001
$5,000,000 revolving credit agreement with a bank. Interest is paid monthly	

at the bank's prime rate or at the borrower's election LIBOR plus 2.75%. As of June 30, 2001 interest was being charged at 6.75%, the bank's prime rate. The line is collateralized by substantially all the assets of the Company, and expires in March 2003 at which time all principal and accrued interest is due. Advances are based on 85% of eligible accounts receivable and 55% of eligible inventories, as defined, less certain other outstanding obligations.	$ 1,904,40
Bank note payable in monthly installments of approximately $21,000 plus interest at the bank's prime rate plus .25% or at the borrower's election LIBOR plus 3.0%, through March 2003. As of June 30, 2001 interest was being charged at 7.00%, the bank's prime rate plus .25%. The note is collateralized by substantially all the assets of the Company.	1,517,50
Bank note payable in monthly installments of $11,567 plus interest at the bank's prime rate plus .25% or at the borrower's election LIBOR plus 3.00%, through March 2003. As of June 30, 2001 interest was being charged at 7.00%, the bank's prime rate plus .25%. The note is collateralized by substantially all the assets of the Company.	1,226,06
Bank note payable in monthly installments of $17,188 plus interest at the bank's prime rate plus .25% or at the borrower's election LIBOR plus 3.00%, through March 2003. As of June 30, 2001 interest was being charged at 7.00%, the bank's prime rate plus .25%. The note is collateralized by substantially all the assets of the Company.	1,031,29
Industrialized development notes payable in quarterly installments of $3,381, including interest at 5.25%, maturing October 2017 and uncollateralized.	145,71
Notes payable in monthly installments of $440 to $3,343, including interest ranging from 8% to 16%, collateralized by equipment and vehicles, maturing at various dates through February 2002.	15,62
Note payable in monthly installments of $594, including interest of 16%, collateralized by equipment and vehicles, maturing in May 2001.	
Total debt	5,840,60
Less: current maturities of long-term debt	420,34
Long-term debt	$ 5,420,26

Pallet Management Systems, Inc. and Subsidiaries

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

June 30, 2001 (53 Weeks), June 24, 2000 (52 Weeks) and June 26, 1999 (52 Weeks)

NOTE F - LONG-TERM DEBT - Continued

The revolving credit agreement and bank notes payable are subject to certain restrictive covenants including, but not limited to, minimum tangible net worth and interest and debt service coverage ratios, as defined. The agreement also provides restrictions as to the payment of dividends.

Interest expense for the years ended June 30, 2001, June 24, 2000 and June 26, 1999 amounted to $528,078, $551,444 and $332,818, respectively, and is included in other expense in the accompanying consolidated statements of income.

Scheduled maturities of long-term debt for years subsequent to June 30, 2001 are as follows:

2002	$ 420,344
2003	5,286,417
2004	6,427
2005	6,781
2006	7,155
Thereafter	113,481
	$ 5,840,605

NOTE G - CAPITAL LEASE OBLIGATIONS

Minimum future annual lease payments under capital leases as of June 30, 2001, in the aggregate, are as follows:

2002	$ 130,770
2003	120,010
2004	46,927
Total minimum future lease payments	297,707
Less: imputed interest	29,543
Present value of future minimum lease payments	268,164
Less: current portion of capital lease obligations	111,762
Long-term portion of capital lease obligations	$ 156,402

NOTE H - ACCRUED LIABILITIES

Accrued liabilities consisted of the following:

	June 30, 2001	June 24, 2000
Accrued compensation	$ 154,998	$ 217,627
Other accrued liabilities	354,954	596,450

$ 509,952	$ 814,077

Pallet Management Systems, Inc. and Subsidiaries

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

June 30, 2001 (53 Weeks), June 24, 2000 (52 Weeks) and June 26, 1999 (52 Weeks)

NOTE I - COMMITMENTS

1. Operating Leases

The Company leases manufacturing facilities, office space, equipment and vehicles under non-cancelable operating leases. The following is a schedule, by years, of the minimum rental commitments remaining on leased property and equipment:

2002	$ 1,023,439
2003	964,187
2004	719,140
2005	88,230
2006	22,285
Total	$ 2,817,281

Total rent expense was approximately $999,000, $1,030,000 and $530,000 for the years ended June 30, 2001, June 24, 2000 and June 26, 1999, respectively.

NOTE J - RELATED PARTY TRANSACTIONS

The Company paid approximately $76,000 during the year ended June 26, 1999, to Clary Lumber Co. (Clary), an entity owned by an officer and former directors of the Company, for compensation of certain employees who perform services for both Clary and the Company.

The Company purchased approximately $2,455,000, $2,633,000 and $2,359,000 of lumber and pallets from Clary during the years ended June 30, 2001, June 24, 2000 and June 26, 1999, respectively. Lumber purchases from Clary amounted to approximately 4%, 6% and 8% of the Company's lumber purchases for the years ended June 30, 2001, June 24, 2000 and June 26, 1999, respectively.

NOTE K - EMPLOYMENT AND CONSULTING AGREEMENTS

The Company has employment agreements with two senior executives that provide for, among other things, annual compensation totaling $312,000, a bonus based on diluted earnings per share, stock appreciation rights to vest upon a change of control, as defined, and stock options to be granted annually. The agreements are cancellable by the Company upon 30 days written notice to the executives and payment of requisite compensation and expire on

October 31, 2003.

NOTE L - STOCKHOLDERS' EQUITY

In January 2000, the Company loaned two officers an aggregate of $276,000 to exercise options to purchase an aggregate of 138,000 shares of common stock. The loans bear interest at 5% per annum, with interest payment due annually and principal due the earlier of January 12, 2003 or upon registering the shares and are collateralized by mature shares of stock previously owned by the stockholders. The loans receivable are recorded as a separate component of stockholders' equity in the accompanying balance sheet.

NOTE M - STOCK BASED COMPENSATION

In April 1997 and September 1998, the Company established Stock Option Plans which authorize the Company to issue options to employees, directors and outside consultants of the Company. The issuance and form of the options shall be at the discretion of the Company's board of directors, except that the exercise price may not be less than 85% of the fair market value at the time of grant. The options vest over a four year period and expire in ten years or three months after separation of service, whichever occurs earlier.

The Company has elected to follow Accounting Principles Board Opinion No. 25 "Accounting for Stock Issued to Employees" (APB 25") in accounting for its employees stock options. Under APB 25, because the exercise price of the Company's employee stock options issued was greater than the market price of the underlying stock on the date of grant, no compensation expense was recognized.

Statement of Financial Accounting Standards No. 123 "Accounting for Stock-based Compensation," ("SFAS No. 123") requires the Company to provide proforma information regarding net income (loss) and earnings (loss) per common share as if compensation cost for the Company's Stock Option plan had been determined in accordance with the fair value based method prescribed in SFAS No. 123. The Company estimated the fair value of each stock option on the date of grant by using the Black-Scholes pricing model with the following assumptions: expected volatility of 75%; expected life of the option of 75% of the stated life for 10 year options and the stated life for all others; no dividends; and a risk free interest rate of approximately 4%.

Under the accounting provisions of SFAS No. 123, the Company's net income (loss) and basic and diluted earnings (loss) per common share for the years ended June 30, 2001, June 24, 2000 and June 26, 1999 would have been approximately $6,000, $0.00 and $0.00, ($2,497,000), ($0.63) and ($0.63) and $294,000, $.08 and $.06, respectively.

A summary of the Company's stock option activity, and related information for the years ended June 30, 2001, June 24, 2000 and June 26, 1999, is as follows:

	# of	Weighted Average

	Options	Exercise Price
Outstanding June 27, 1998	1,231,107	$ 1.84
Granted	322,780	5.20
Exercised	-	-
Forfeited	6,701	2.00
Outstanding June 26, 1999	1,547,186	$ 2.56
Granted	240,709	4.06
Exercised	138,000	2.00
Forfeited	307,696	3.66
Outstanding June 24, 2000	1,342,199	$ 2.63

NOTE M - STOCK BASED COMPENSATION (Continued)

Granted	360,657	2.47
Exercised	-	-
Forfeited	106,135	4.30
Outstanding June 30, 2001	1,596,721	$ 2.48
Exercisable at June 30, 2001	1,194,516	$ 2.20

The weighted-average fair value of options granted during the years ended June 30, 2001, June 24, 2000 and June 26, 1999 was $1.36, $2.84 and $1.87, respectively.

Exercise prices for options outstanding as of June 30, 2001 ranged from $1.50 to $5.25. The weighted average remaining contractual life of these options is as follows:

Exercise Price	# of Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life
$1.50 - $3.01	1,336,039	$1.97	3.17
$5.00 - $5.25	260,682	$5.10	7.54

NOTE N - SIGNIFICANT CUSTOMERS

The Company entered into three multi-year manufacturing agreements each covering a specific operating location with a significant customer, which provide for, among other things, minimum purchase commitments. The agreements are for initial terms expiring during 2001 through 2003 and automatically continue in effect from year to year for successive one year renewal terms unless cancelled in writing by either party at least 180 days prior to the expiration date. The contracts with the Illinois and Indiana facilities expire in April 2002 and March 2003, respectively. The Illinois and Indiana facilities accounted for approximately $19,600,000 and $26,300,000, respectively in net revenues for the year ended June 30, 2001.

The Company has received notification from the significant customer of their intent to cancel the contract with the Alabama facility effective September 2001. The Company is currently winding-down operations at the Alabama facility and anticipates closing the facility in fiscal year 2002. For the year ended June 30, 2001, the Alabama facility accounted for approximately $14,900,000 in net revenues.

Sales to this significant customer represented approximately 86%, 83% and 75% of net sales for the years ended June 30, 2001, June 24, 2000 and June 26, 1999, respectively. At June 30, 2001 and June 24, 2000 two customers accounted for approximately 88% and 80% of trade accounts receivable, respectively, with one customer accounting for approximately 78% and 66%, respectively.

NOTE O - PENSION AND PROFIT SHARING PLAN

The Company has a salary reduction / profit-sharing plan under the provisions of Section 401(k) of the Internal Revenue Code. The Plan covers all full-time employees who have completed one year of service with the Company. The Company's contributions to the plan are made at the discretion of the Board of Directors and amounted to approximately $50,000, $40,000 and $23,000 for the years ended June 30, 2001, June 24, 2000 and June 26, 1999, respectively.

NOTE P - CONTINGENCY

In June 1999, the Company was named as a co-defendant in a lawsuit whereby the plaintiff is alleging damages of up to $300,000 related to lost income from a facility formerly leased to the Company in Jessup, Maryland. Management believes the claim is without merit and intends to vigorously contest the claim. The outcome of the action as well as the extent of the Company's liability, if any, can not be determined at this time.

NOTE Q - QUARTERLY FINANCIAL INFORMATION (UNAUDITED)

Quarterly financial information for the years ended June 30, 2001 and June 24, 2000 is summarized below (in thousands except per share amounts):

	First Quarter		Second Quarter		Third Quarter	
2001						
Net sales	$	19,474	$	21,610	$	12,374	$
Gross profit		1,240		1,603		781	
Net income (loss)		55		256		(104)	
Basic earnings (loss) per common share		0.01		0.06		(0.03)	
Diluted earnings (loss) per common share		0.01		0.06		(0.03)	
2000							
Net sales	$	12,278	$	17,817	$	14,155	$
Gross profit		(215)		900		778	
Net income (loss)		(1,697)		(423)		(178)	
Basic earnings (loss) per common share		(0.43)		(0.11)		(0.04)	
Diluted earnings (loss) per common share		(0.43)		(0.11)		(0.04)	

Pallet Management Systems, Inc. and Subsidiaries

SCHEDULE II - VALUATION AND QUALIFY ACCOUNTS

Years Ended June 30, 2001 (53 Weeks), June 24, 2000 (52 Weeks) and June 26, 1999 (52 Weeks)

	Balance Beginning of Year		Charged to Costs and Expenses		Deducti
Allowance for doubtful accounts:					
June 30, 2001	$	100,436	$	142,134	$ (8
June 24, 2000		5,000		95,436	
June 26, 1999		15,000		6,857	(1