

**DS Smith Interim Management Statement
Conference Call Transcript
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Speaker key

OP Operator
MR Miles Roberts
AM Adrian Marsh
BD Barry Dixon
AN Alexander Mees
CoG Catriona O'Grady
JJ Justin Jordan
DoB David O'Brien

OP Good morning, ladies and gentlemen, and welcome to the DS Smith Interim Management Statement Conference Call. For the duration of the call you will be on listen-only. However, you will have the opportunity to ask questions. If at any time you need assistance, please press the star zero on your telephone keypad and you will be connected to an operator. I will now hand you over to your host, Miles Roberts, to begin. Thank you.

MR Good morning, everybody, and thank you very much for your time to dial in this morning. I'm here with Adrian Marsh, our finance director. Before turning to questions I would just like to make a few comments by way of background. You will all have received our statement this morning and see that we continue to make good progress in growing our volumes despite the continued competitive market conditions, and we're trading fully in line with our expectations.

Encouragingly, it is further evidence that our unique offering is winning with our customers across Europe. There is ever increasing recognition by our customers of the potential and importance of recycled packaging to reduce their in-house production and distribution costs in addition to supporting their proposition at the point of sale where the final consumer is increasingly making their buying decisions. And our offer is further supported by large customers seeking to consolidate their supply chains to enable them to implement best practice consistently across their operations.

So this has led to our like for like corrugated box volumes improving in all our regions with growth accelerating ahead of last year's rate and our medium term target of GDP plus 1%. Our return on sales and return on average capital employed also continued to increase, benefitting from this organic growth, together with the synergies from the SCA packaging deal. So because of this, our outlook remains positive. Our volumes continue to grow and the board expects continued performance in line with our medium term financial targets. Very importantly, we view the remainder of the year with confidence. So I'm now very happy to take any questions people may have.

OP Thank you. Ladies and gentlemen, if you would like to ask a question, please press star one on your telephone keypad. If you change your mind and wish to withdraw your question, please press star one again, and you

will be advised when to ask your question. The first question comes from the line of Barry Dixon from Davy. Please go ahead.

BD Yes, good morning, gentlemen, it's Barry Dixon from Davy, three questions, if I could. The first one was just in terms of corrugated pricing; what are you seeing there, particularly given the volatility we've seen over the last six months on recycled containable pricing, just what's happening with corrugated pricing? You mentioned about headwinds in markets, you might just give us a sense of your own sense of which markets are performing well and which ones are proving more difficult in terms of that sort of, of that backdrop. And then finally you've had some management changes recently in terms of your packaging division. Can you maybe just talk us through the changes that you have made there and what you hope to achieve, thank you.

MR Certainly. So let's just take those in order. Raw material costs: the price of kraft and testliner has been falling until we got to August, and then we saw a stabilisation in pricing and an increase in the price of testliner in, towards the end of August. We're not totally surprised because I have to say in our corrugated business we are busy, so certainly our demand is up. We have seen an increase and it depends exactly which region, but people are talking around about €30 a ton, something like that. And we remain busy, so in terms of testliner, as I say, we never know where it's going to go. I wouldn't be surprised if there was another increase coming through but it's notoriously unpredictable, but we have seen those increases so the question obviously is what do we do about them?

Well, we remain very confident that we'll be able to pass these through to our customers in combination with mitigation. The work we're doing with our customers in reducing the total cost is really gaining traction. It's not so much about the box; it's about their whole production lines, it's about distribution through to the retailer and within the retailer, so we're able to mitigate the increased costs in many cases. But obviously in some cases there are price increases going through as well and we remain very confident that we can recover all of that, but it does seem that some prices going up. In terms of the end markets we measure ourselves against GDP. We've actually seen our weighted average for GDP increase in the last quarter over the, over last year and this is really led by the UK. Now GDP is around about the 3% mark growth in the UK.

When we look elsewhere in Europe, it's obviously far less rosy so the average we're getting is about 1.3%. We're seeing France and Italy, flat to slight decline; Germany pretty flat; Eastern Europe, a slight increase; Spain pretty flat. So I think this certainly worse than the ECB and other commentators were forecasting but I'm afraid it's absolutely in line with where we expected it to be. We have never expected there to be a rebound. The final consumer remains extremely price sensitive, but this is where our offer comes into play, and working with our customers to improve their sales and reduce their in-house production costs right the way through the supply cycle. And I think this is why we're seeing our volumes accelerate. And I said all our regions are in growth despite in a number of those economies, the final consumer demand actually being in decline. So we're pleased with that. It's always very uncertain how things go in the future but there's no doubt we're pleased with the reception that we are getting .

I'm not quite sure about the management changes. We make many changes all the time in our business to fit our offer to the proposition and people join the company and leave the company at any time so there's nothing that's happened with us that fuels particularly concern. We have brought two divisions together and that has changed a particular management structure but the underlying country basis, etc, and the way we report is unaffected by that change. I'm being quite straight with you, I think over the next year I wouldn't be surprised if we brought in some more people and different skills and that does necessitate a slightly different management structure. This understanding of our customers and how they're working and how we support them is becoming increasingly important and, therefore, new skills are needed all the time.

BD Thanks very much, Miles, appreciate that, thank you.

OP Thank you. The next question comes from the line of Alexander Mees from JP Morgan. Please go ahead.

AM Good morning, Miles, good morning, Adrian. Two questions please: firstly, could you comment on the performance of plastics? You've made the point that corrugated box volumes have been positive. I wonder if you can just talk about that business, particularly in light of the operational restructuring. And secondly, could you please give us some colour on where your acquisition pipeline is at, thank you.

MR Why don't I take the first one and Adrian about the acquisitions. Yes, plastics: this has been a very strong growth area for us, and makes very good margins and we have announced the creation of a number of new facilities. We are extremely excited about those, as are our customers and all of that restructuring remains on track and the construction of those facilities is all on plan and very nice they look too.

We're also creating a new display business; a new factory in Germany and the work has started on that. This is an area of the market, this is all around the point of sale and how our customers display their products, and being quite honest, we are keeping up with the demand but I can tell you it's not easy, such as the reception we're getting to our offering and our skills to our customers at the point of sale displaying in retail; we need these facilities to come on-stream as quickly as possible to really take advantage of those opportunities. So I think that's where we are; the new factories and the restructuring with that is all as expected. Adrian, do you want to talk about M&A?

AM Yes, on M&A, Alex, at any point in time there are a whole number of conversations going on. Europe is very fragmented, as you know. There're a lot of private companies there and these dialogues go on. I've been in the company a year now and there are certainly conversations that we had 12 months ago where we weren't prepared to meet value expectations - we're having the dialogues again now. So it's an intricate process and I think the important thing here is we are extremely focussed on what we will pay and our financial criteria and it's as simple as that, and if there's a prospect that meets those criteria and it fits within the business and where we're looking to grow, then we're very interested in a dialogue. If it's outside of that then we're very honest too in that respect.

We're also clearly at the advantage of having a fragmented market in Europe at the moment as well as it gives us a lot of opportunity for organic

growth too, so personally I'm not hung up on where the next acquisition target's coming from. There are a lot of dialogues. There are some that have restarted again and been closed down, and others that I'm sure we will be closing down at some point but it's not something we're prepared to rush. We don't have an ambition to buy at any cost and to grow inorganically at any cost. I think there's enough opportunity within the underlying business and no shortage, I can tell you, across my desk of areas where the business wants to invest more capital and we're just applying a very strict criterion to it all at the moment.

AM You made the comment that you're revisiting some acquisition targets that perhaps you spoke to in the past. Does that imply that in general vendor price expectations are starting to become more reasonable?

AM I think as always, it's impossible to say. If you were to ask me, my instinct is yes because across Europe, at the moment, realistically, if you're not able to support certainly the big multinational FMCG customers on a Pan European basis, it's becoming an increasingly difficult market to operate in. There's a very limited number of companies at the moment that are able to make that offer so I think there is a change within the industry; certainly the way we operate is very different from the way we operated three or four years ago so I suspect that will have a gradual resonation over time. We've seen a situation, in one of the countries we operate in, with company becoming insolvent. I think it's a difficult market in Europe and if you're not able to operate on the Pan European basis, it's increasingly difficult. That, there's no doubt about.

AM Thank you very much.

OP Thank you. The next question comes from the line of Catriona O'Grady from UBS. Please go ahead.

COG Morning Miles, morning Adrian. I've just got three questions, if I may, and some of them build on Barry and Alex's questions. Firstly, you flagged the completion of the Scandinavian foam business disposal. When you look across your products and your plant portfolio, and this is notwithstanding the kind of paper potential disposals, do you have any more opportunities where you could dispose of non-core products? Second question is around M&A - so I see that you've completed the acquisition of a small plastics plant in Croatia. Can you just give a bit of background to why you did that alongside your organic investment, and is plastics an area where you could do larger acquisitions or is the focus more going to be on organic investment? And finally, if we look at end industry trends, can you give us some colour around how volumes have trended in your industrial customers, as well as your FMCG customers? Thanks.

MR Okay, so if we split the questions up, if I take the volumes, our outlook on plastics in terms of organics and acquisition and what's possible there, and you want to pick up on the non-core stuff and where we are there, and there is a bit more coming. Yes, so just in terms of the volumes, what's really happening here is we're trying to expand the perimeter of the corrugated markets, so our offering to our customers is showing how corrugated can increase their sales, and we've got some simply outstanding examples with our biggest customers using our packaging and not using it, trialling it in different stores: in convenience stores and then not in convenience stores, in the hypers and not in the hypers, in the

supers and not in the supers, so you can start to really show how this is affecting their sales.

There's also the question of the whole supply chain, taking cost out at every opportunity whether it's their line speeds, distribution costs, etc. So we're finding generally, of all of our large customers who are under intense pressure in Europe from the retailer and from the consumer to enhance their offering, we're finding what we're able to do. We are getting much more traction and voice in their operations. One of the very, very largest companies, I'm seeing tomorrow and talking about how we can enhance their sales.

I think it's just that sort of reception that has been possible, when they look at their businesses. So when we look across Europe, in terms of volumes we see all the regions in growth, it's particularly strong in regions that historically we have been strong with regard to Eastern Europe and the areas of the old SCA business where we continue to roll our proposition out. But equally we've seen a pick-up in the UK. We're seeing supermarkets in the UK put more shelf packaging in stores, and this is all extending the perimeter of our offering so we remain very pleased with that.

With plastics: plastics is very interesting business, and what we're trying to do there is grow that bag in box concept because of its environmental credentials. It goes in the cardboard box, the bag goes in a box, it's allowed to, allowing the transportation of liquids. It's in a cube therefore the transportation costs are lower. There are some various acquisition opportunities there but we're very disciplined on price.

We're a quoted group. We're here to make the return on capital. That is why we're here. That is our purpose. The way we do it is by enhancing our propositions to our customers, etc. That's the reason we're there, we remain very disciplined. If we can't buy those businesses at sensible pricing, then we have organic opportunities. We have a significant expansion in our plastics business organically. A small business has come to us, which is good. Personally I think that remains a very fragmented market. We are talking to a number of people there. We very much hope that they will, we can then conclude some of those discussions at sensible prices, but we do have a number of opportunities.

Some of you remember we built a factory in Thailand. That factory's virtually full now, and with our customers, and we've got another decision to make out in the Far East on how we grow that. So it is a good area for us. There are acquisition opportunities but there're also organic as well, and we'll make the right decision that's best for our shareholders. The non-core business, Adrian?

AM Yes, on the non-core side we have, might have described it briefly at the results presentation, so we have a process where we go through as a board and we look at the strategic plan for the group; currently going through that process or we've just started that process again now. Last year, that identified the foams business as not sitting logically within us as a core business and we executed a plan to dispose of that. As it stands at the moment there's nothing specific, part of which is because we haven't concluded the process, but there's nothing at the moment that obviously, to my mind, without having been through it, sits as non-core.

That said, there will, of course, be a number of areas that if we, if having gone through the process, we can't see them adding value to the portfolio any further or having a value potentially higher somewhere else where we can liberate cash, we will look at that and that process will go through. And occasionally we'll get an inbound enquiry over a specific asset or combination of assets, and again we will always look at that and if the value proposal being offered meets the criteria then of course we follow that seriously. But it is part of the corporate plan process which we take the board through and that, we've literally only just started that again for the next three years now, but in terms of the recent plans they've been successfully executed.

CoG That's great, thank you.

AM Okay.

OP Thank you. The next question comes from the line of Justin Jordan from Jefferies. Please go ahead.

JJ Thank you. Good morning, everyone. Sorry, Miles, you talked earlier about 30 Euros of pricing achieved on testliner and further potentially to come. Can you comment specifically on kraft liner because according to RISI, €30 a tonne has been implemented by the producers from September onwards. I'm just thinking about the impact on your business as one of the largest market purchasers of kraft liner in Europe, and just specifically have you seen any impact from September onwards on new orders and your feeling on the kraft liner price as well as the testliner price going forward?

MR You're absolutely right on test. We've seen about 30 and let's see what happens the next month but it may well go up. We haven't seen it on kraft. As you know, we are probably Europe's largest purchaser of it, I think almost certainly on the open market, and we have a programme of systematically replacing kraft with testliner, which our customers are increasingly willing to embrace. It's actually very strong, the conversion. I think there has been chatter about increases. We haven't paid any increases and we will be heavily resisting any so we haven't had any, we're not expecting any but it is notoriously volatile. We'll just have to see. But that's where we are at the moment. But in terms of September we certainly haven't paid anything to date.

JJ Thank you. Just one follow-up question, and I guess for Adrian really on technical guidance, you mentioned in the statement about your contribution schedule for the pension fund is unchanged, and I'm assuming that's the 15 million per annum cash contribution you're referring to.

AM Yes.

JJ Are there any other changes to the technical guidance from what you gave us back in the 26th June?

AM No, that is as is. You've obviously got the detailed currency breakdown so you can look at the translation impact, and clearly we referred to the Euro but we have provided a much more detailed analysis currency by currency; I'd obviously encourage you to look at that. I think that's as

good a ready reckoner as we can think of but no, nothing else has changed.

JJ Thanks Adrian.

OP Thank you. The next question comes from the line of David O'Brien from Goodbody. Please go ahead.

DoB Hey, folks, just a couple of questions from me, and apologise if you've touched on them already, but firstly, just against the backdrop of I suppose economies not improving a whole lot since May and DS Smith's volumes now up nearly 2.5, 3%, what are the drivers behind this split between, firstly, volume levels but also corrugated pricing. Are you being a little bit more competitive on that front? And just on the point I suppose you're talking about reducing your kraft liner consumption - maybe you can give us an idea what total tonnage of kraft liner you purchased in 2014, versus maybe three years ago to give us an idea what that switch has been like.

MR Well, just on the kraft, we used to buy about, the combined business about 800,000 tons a year on the open market. Last year we reduced that by over 100,000 tons, about... exactly what time period you're looking at but more like 120 over the last 12 months, and we see very good opportunities to reduce that even further.

DoB Is there a floor, you think, on how low you can get that tonnage reduced?

MR There is a floor we think we can go to, and it's significantly less than we are using today, so we see opportunities to take quite a considerable amount of kraft out again. I have to say the momentum's actually coming, a lot of it not just with us in the design of the packaging; actually from my customers as well. We have a number of our customers saying we just don't want kraft paper; we want recycled paper. Just as a very small anecdote, I had some product delivered to my house at the weekend from Amazon and John Lewis on line, and over both boxes, stamped all over them, it says this is all made from recycled paper; not just underneath, on the back, under a flap, but right on the front. This is the consumer proposition and we're seeing that gain some traction so we think certainly our business a considerable way to go.

DoB Follow-up on that one if I could: what are the general ramifications of the industry as a whole and if we're going to see reduced kraft liner in the overall industry, and how does that play then to the quality of recycled fibre in Europe as a whole?

MR We are one company. I think we're able to replace the kraft with all our design expertise. Whether other companies can or not, I have absolutely no idea. But that's something we work really hard on and I think we've got some outstanding design capabilities in this area. So, look, we are 14%; there's another 86% of the market that may or may not be using more or less kraft. I think, secondly, in terms of we often get this question about what does it mean for testliner, etc. What we're finding is that we can lightweight and lightweight and lightweight testliner, so again we're taking more fibre out there as well, so the actual amount of fibre consumption, we've got less kraft coming in but we are significantly lightweighting our boxes.

But also the fibre comes from many sources. One source is OCC but there're many other sources, and as you know, we have the lead in recycling business in Europe and there we access fibre from many, many sources, not just OCC and it's up to us to ensure we're increasing the recovery rates, not just of OCC but of all those grades to keep the integrity of testliner going. Time will tell as to how things move but that's certainly how we see the immediate outlook.

DoB And then just on the drivers behind your corrugated volume increase is split between maybe more competitive pricing and increased service levels?

MR Yes, our margins are going up, as we said, and our return on capital. I think we are working with our customers. A lot of the propositions are increasingly turning to the total supply cycle cost, so how can we ensure that their line run speeds are working better? It's not in every case but this is becoming more important to our customers all the time, so as long as we can demonstrate cost reduction or sales increases to their business, then we're able to include that in the value of our overall proposition. Costs are going up in paper. They do have to be recovered. We feel confident we can do that. But there will obviously be some impact on pricing, but we feel pretty confident about that.

So at the moment we've got the volumes going up but our return on sales is going up, and our return on capital is because of the enhanced offering, and this is an area needs to be built more and more and more on. Our customers are more open to this than they've been, I think, for years. Also the pressure the consumer is putting on them. We work with another very large FMCGM. We've managed to increase their sales through a better presentation of their products and we've been trialling this for a number of months and they said to us we've increased our sales by more in the last few months in that trial than we have in the previous five years. And that just shows where the consumer is but this is the value of our proposition. It's the point of sale and what we can do there.

AM I think it's a little bit misleading to think , if you're working to reduce the fibre content and you're lightweighting and you look to mitigate the price rise, to think that means you've being competitive on price. I think what it means is you've been very innovative in terms of solution, so our cost base is still going to be our cost base; our margins are still going to be our margins. And as Miles said, we can improve those. It's not because we've been overly competitive on what we're charging for that. I think what it says is that we're working much harder in order to reduce the costs that go into the final goods and that gets recognised, so I think you need to be a little bit careful about drawing a conclusion that if you're increasing volume you must be competitive on price, ie, overly competitive on price.

MR If you're a small guy in Europe, if you're a small regional player in Europe in corrugated, it's tough, and I think it's going to get tougher; without the design of the economies of scale it's tough and I can't see that getting any better.

DoB That's great, thanks very much.

OP We currently have no more questions coming through.

MR Well, look, just a last comment from us: thank you, everybody for your time. In summary, we know the end consumer's difficult, the end markets are challenging but we feel our proposition is working. We've been working with our customers to enhance their sales and reduce costs, and on the back of that everything's in line with our expectations and we look forward to the rest of the year. But thank you very much, everybody, for your time.

AM Thank you.