DS Smith
Full Year Results Presentation
Thursday 23 June 2011
09:30 UK time

Miles Roberts

Good morning, everybody, and welcome to the announcement of our full-year results to the end of April 2011. It's not quite two months ago but it does seem a long time ago. Couple of things first. As you know, health and safety is an integral part of our business. If you look around this room you do see that there are two fire exits. We aren't expecting a fire alarm, so if there is one, follow me out. I'm joined here today, as always, by Steve, our finance director, and other members of our internal management team, but also by Peter Johnson and Jonathan Nichols, one of our non-executives. Thank you for coming.

So a year ago we stood here and said, DS Smith, we thought we'd got a company with great potential, a company where we believe we can create much more sustainable returns, less cyclicality, higher return on sales, higher return on capital and driving that dividend, the return to shareholders. We felt we had the opportunity to do that, and six months ago Steve and myself stood here and told you how we were going to do that. We're going to be focused on getting the right mix and then executing that mix in the most efficient way. That mix was about packaging and recycling and not about paper. So we told you how we were going to do that and today we're standing here with our results and just giving you a first taste of what we think we can get to, and we've set out those medium-term objectives as well. Return on sales between 6 and 8%. Volume growth above 3% per annum, and we're predominantly in Western Europe. Cash flow, 120% of our profitability, and that all important return on capital driving at consistently above 12%, towards the 12, 14% area.

So today we're going to go through our actual results and we're going to talk about our strategy, about how we're going to continue delivering value to our shareholders. So a strong performance last year, but there's more to go for. So the packaging volume was up 8%, our primary markets are the UK and France, there's 8% volume growth last year, ahead of our strategic target of 3%. The EBITDA margin up 39% to 136.1 million, or 20% excluding Otor. So momentum building into the business. And the return on capital, our primary measure, up 260 basis points to 12.7%, improve our average return on sales and asset turnover. It's the balance sheet as much as it is about the P&L. The EPS up 36% to 18.9 pence, the cash flow was very strong with a working capital improvement in the year, and on the back of that the confidence for the full-year demonstrated by a dividend increasing 41.3%, but of course that's just in line with our policy that we've already stated, of bringing the cover between two and two and a half times. Otor, the acquisition we made in September. We said it was going to be good. Then we said it was going to be very good, and now we're seeing a return on capital of 13.6% in the first eight months of ownership. The cost synergies we've upgraded once, we're upgrading them again to €13 million and they'll be delivered faster than we originally said. As I said before, there's momentum in the business so we expect to make further significant progress towards our financial objectives.

And what were some of the achievements last year? Well the volume growth, we were very pleased with that. That's our customers saying we want to work with you, DS Smith, you're starting to supply the way we want a supplier to work with us, and they've rewarded us. But then changing the nature and the structure of the group and putting the customer focus at the heart, they're easy words, but as soon as you turn more to the converting, you're thinking about the customer, you're coming away from paper and the big asset base, so you can genuinely focus on the customer's requirements, and make no apologies for it, and then charging for that service. And working as one business. So we build on the combined strength of the group, and the senior management has been enhanced. We've had a phase programme here, we've got a new head of the UK, it's a new role, new position. New head of plastics, new head of Spicers, new for us, head of France, and the divisional chief executive from Eastern Europe has come from within but he's moved into a different role. So that's been phased and planned for a much stronger, more focused management team. And success does breed success. There's a momentum in the business and I always believe this is fundamentally built on the culture of the organisation and we're seeing increased confidence. So that's the introduction, I'm going to hand you over to Steve who, as we all know, has been absolutely fundamental to achieving the results that we have.

Steve Dryden

Morning, everyone. Steve Dryden, I'm the group finance director of DS Smith. Five key themes to the results, to the financial performance I'm going to take you though: growth, cost recovery, margins, return on capital and strong cash generation. So in terms of sustainable growth, you've got revenue growth driven by both volume and pricing, and this is underpinned by our growing resilient and fast-moving consumer goods customers. These customers value the service, the quality and the innovation that we provide to them. These excellent levels of service and quality mean that we can recover our costs faster and you will see that over the last 12 months we've fully recovered our input costs in terms of the waste fibre and the paper that we purchase in. Importantly, in terms of the contractual price recovery period, and we see this as one of the biggest drivers in of the cyclicality or the volatility within our business. We actually managed to reduce this to 4 months, compared to 6 months this time last year.

We've improved our margins. Our operating margin is up 80 basis points to 5.5%, still behind our medium-term target of 6%, but a great step forward. We're now importantly making returns above our cost of capital. Our return on average capital employed is 12.7%, up 260 basis points. This is a real significant achievement for DS Smith. If you look back over the previous ten years, you'll see that only once have we managed to achieve a return on capital ahead of 12%. Finally, one of the key themes of these results is a strong cash generation. We've generated over £100 million of free cash flow, and that's actually despite growing the revenue an organic £250 million. We've managed a small working capital inflow of £7 million.

Stepping back, what does it mean? We've actually improve the productivity of our working capital that we deploy in this business by £24 million. The net debt to EBITDA at the end of the year, that's 1.6 times, despite the acquisition of Otor during the year. I won't cover every single number here because I do go into some depth later on but, revenue, we've grown it by £400 million or 19.5%. If you look behind the numbers, the biggest contribution is in terms of the eight months that we owned Otor, contributed just under £200 million of growth, the rest coming through on a combination of pricing and organic volume growth in packaging,

which I'll show you on the next slide. EBITDA up 24.6%, operating profit up 38.7%. Amortisation and net interest, the increases you see there purely flow from the acquisition of Otor. So profit before tax and exceptional items of 47.9%, income tax at 28.4 million, that's about 28% of the profits. It's an increase compared to last year's 26% of profits, but that's frankly because we're making more profit in France. Exceptional items, greatly reduced compared to the prior period. Again, there's the benefit of closing the pension scheme to future accrual, offset by a combination of asset impairments and restructuring actions across the group. So, finally, adjusted earnings per share, at 18.9 pence, is up 36%.

So this simple bridge really takes you on the left, from our revenue last year of £2.1 billion, to on the right, our revenue of £2.5 billion. Principle drivers are price rises. This increased revenue by £168 million. Packaging volume growth, £79 million. This represents an 8% volume increase within our packaging businesses. Office products revenue fell by £22 million. Acquisitions and some divestments, but principally the acquisition of Otor contributed £197 million of revenue growth. And, finally, foreign exchange reduced revenue by £18 million. So we finished the year with revenue of £2.5 billion.

So the same format and principle for our operating profit. Again, on the left, we started the year with £98 million of profit. On the right, we finished with £136 million. So in the first two columns you can see how we've achieved full cost recovery. We've raised our prices by £168 million to recover the cost increases, and quite a staggering set of cost increases there, at £166 million. The cost increase is from the recycled fibre and from the paper that we purchase, but also from the starch and the chemicals that we use across all of our production processes. This is an excellent result, driven by our focus on service, quality an innovation. Making sure we achieve the right price for the products that we're offering and the value that we're giving our customers. As expected, energy costs increased by £17 million, the rising price of gas, electricity and the diesel that flows through into our results during the year. The increased volume I referred to earlier improved our profits by £33 million. In terms of acquisitions and divestments, this contributed £17 million of profit growth and, importantly, behind that number, Otor contributed €21.7 million of operating profit, that's 9.4% return on sales and 13.6% in annualised return on invested capital. Translation from exchange, that reduced our packaging profit by £0.7 million, and finally office products wholesaling, or Spicers, that improved results by £3.8 million. So overall on the right, we finished the results at £136 million of operating profit.

This is an overview. I won't go through every single number, but I think the important thing to realise is that packaging makes up 80% of our profits. DS Smith is a packaging business. The key theme behind all the divisions' results is one of volume, and hence revenue growth, margin expansion, good returns on capital and improving returns on capital from as sustained focus on working capital.

So our first division, UK packaging. Grew revenues by 22%, profit by 46%, margins are up 100 basis points to 5.9% and we improved the return on average capital employed by 340 basis points to 10.3%. Great improvement, but it's still below our weighted average cost of capital, 11%. So still more work and improvement to do here. For our packaging business, top-line growth is coming from volume growth in our corrugated packaging. Great improvement in return on capital isn't just coming from profit, it's coming from sustained focus on working capital. Finally, we're investing to improve our pre-print capabilities in the UK. This is particularly as we appreciate the competitive advantage that pre-print has given Otor in its marketplace.

So for continental Europe, clearly the results are benefited by the four months ownership of Otor. We grew revenue by 69%, profits by 72%, return on sales improved to 6.6%. Return on average capital employed stepped up by 50 basis points to 12.5%, comfortably ahead of our cost of capital. Profits for the year at £39.8 million. As you will remember, Otor was acquired on 1 September. It has now been fully integrated into our business in France to form DS Smith packaging, France, and if you were to strip out Otor, revenue is actually up 13.2%. We're now investing in new capacity in France to support the expected fast moving consumer goods market growth, and we're confident that when we make these investments, we'll be able to deliver the financial returns that Otor has historically done.

Just on Otor, this is the same slide, updated, that I showed you in December. We acquired this business quickly, as I'm sure you are all aware, but we did a huge amount of commercial, operational and financial due diligence. Because of this pre-planning, there were no surprises. Business is now fully integrated, it's got growing customers and a great management team. We've continued to raise our cost synergies. When we first spoke to you about Otor in July, it was €9.3 million, today it's €13 million and, more importantly, we're going to achieve these one year earlier than we expected. In terms of delivery of the synergies, in terms of the eight months of ownership, there's €3 million of benefit there, and in terms of the coming financial year, we expect to achieve an additional €6 million of the cost synergies.

Plastic packaging shows more modest revenue growth of 4.7%, but actually if you were to exclude the full-year effect of last year where we disposed of a business called Demes which was a plastic pallet management business, you'd actually find that underlying revenue growth was up 11% and underlying operating profit growth is 8.6%. This business is now generating consistently high margins and high returns on capital. We've had some good commercial success in the year, both in our bag-in-box solutions and also our proprietary mobile pallet solution for retail use. In office products wholesaling or as the brand is known, Spicers, reported revenue fell to £715 million, but in constant currency, revenue was broadly flat. Operating profit: £25.2 million, it was up 17.8%. Return on sales improved by 60 basis points to 3.5%, return on capital employed grew by 450 basis points. This was due to a continued focus throughout the whole of the year on working capital. Strong profit performance: profits are up by £3.8 million, and it's really coming from the areas that we identified and spoke to you about in December. We strengthened the management team and we focused on cost savings and margin improvement. This is what's driven the strong performance. And the same themes as in prior years, you know, great, strong growing business on the continent, find the UK more challenging. When we spoke to you in December, we said we needed to focus on creating a strong management team, improving profit, improving working capital, and this is what we've done.

Free cash flow per share up 21.4%. When you look behind this you can see the big drivers of improvement. Obviously the profit we've talked about. Look at the working capital. Compared to last year, the improvement's £10 million. We've actually managed an inflow in the year of 7.6 million. There's been a huge amount of work to do this because you've got to make sure that organically when we grow this business, there's no use just putting some of the benefits of that into working capital, we've got to look to drive working capital down, and that's what we've done. There's a slide at the back for the growth in revenue, and compare it to the working capital, the actual productivity is £24 million of benefit. 'Other' increased by £13.3 million. This is really, as we announced in December, we made an additional payment into the pension scheme, which is part of the process by which we've closed the pension

scheme to future accrual from 30 April 2011. Capital expenditure: £66 million, it's up £14 million. Obviously includes eight months of the acquisition of Otor in there, which is increasing the capital expenditure, but what's important is we're looking to invest in our packaging business where we see some good growth opportunities, and behind that £66 million, there's about £20 million of what I would call growth capital expenditure.

Cash tax is running significantly behind the charge on the income statement as we obtained some of the benefit of the losses that we acquired as part of the Otor acquisition. Interest payment is running below that charged on the income statement but, again, that's purely just timing of when we make our interest payments based on some of the loans that we took on to help finance the Otor acquisition. So free cash flow of £100.7 million, up £23.9 million compared to last year. Dividends, that really reflects the step-up in the cash returns to shareholders as we implement the new dividend policy that we announce in December. Acquisitions, the sterling equivalent of the €247 million we announced for the purchase of Otor, offset by some small disposals with the cash coming in during the year. The Otor acquisition was partly financed by a 10% share placing. Foreign exchange movements increased the value of our debt by £14.5 million as the euro moved. So net debt at the end of the year increased by £111.5 million. So, overall, free cash flow per share, 23.8p, up 21% compared to last year.

Really just to reconcile the movement in net debt to you. Start of the year, again on the left, at £240 million. Finished the year on the right at £351 million. What this really demonstrates, graphically, is how we used the organic free cash flow to part-fund the acquisition of Otor and then what flows through from that is the profit and the earnings benefit of that acquisition. In terms of facilities. We've got plenty of headroom, headroom of £305 million on £727 million of facilities, and those facilities run through... £709 million of those runs through to November 2012. Net debt to EBITDA, 1.6. Interest cover at 7.6 times. Plenty of headroom and increasing headroom against our covenants.

I'll just put some technical details in terms of... of the analysts, in terms of them doing their models for next year. So delivering on... you know, we committed to you when we spoke to you in March in terms of the detail behind the targets that we're working on. So first one was UK efficiency. We said we'd achieve a £10 million run rate by the end of April 2014 to structurally reduce our costs. And the projects that Gary outlined when he spoke to you in March, they're on track, and we're confident that we will achieve at least £3 million of this in this financial year, namely 2011/12. Second, in terms of procurement, we said we'd be at a £10 million run rate by the end of this financial year. Again, the projects, the initiatives we spoke about last time, they're on track, and we can see the delivery of £3 million in operating expenditure and £3 million in capex will be achieved in this financial year. Thirdly, the cost synergies, as I outlined previously, for Otor, £9.3 million originally, £13 million now, one year earlier. Finally, in terms of working capital, our targets to get it from 8% to 5% by April 2014. As you can see here, that will make a £75 million benefit, £24 million delivered from the first year.

So last December, and again in March, we talked you through our medium-term, strategic financial targets for DS Smith. We believe it's important that you recognise, these are medium-term targets, but also that we test ourselves when we report about the progress that we're making towards them. In terms of volume growth, to be greater than 3%. Well, if we focus on fast moving consumer goods, packaging, and with the customers that are winning, we can exceed that. And in the first... in terms of last year, as delivered 8% volume growth in

packaging. If we look at the EBITDA margin, we wanted to be between 6 and 8%. This financial year we just reported, 5.5%. We're getting there. Not quite at the 6%, but we are reporting an 80 basis points improvement on last year. Return on average capital employed, we want to be in a range of between 12 and 15%. We're at 12.7%, so we're in the range. So that's a 260 basis points improvement on last year, but it's not just coming from the profit side, it's also coming from better management and focus on our balance sheet. Looking at operating cash flow to operating profit, how much cash are we generating? We want to be generating 120%. We're actually, in terms of the financial year we just reported, at 125%, so good underlying cash generation. Finally, net debt to EBITDA. We want to be at or below 2. We're at 1.6, so we are in the range here, but you can see how DS Smith's organic cash flow is enabling us to invest and develop growth for the future. And on that point, this is a medium-term target, and for the right opportunity, we would be prepared to go beyond this, but we're going beyond it in the confidence that DS Smith's cash generation will bring us back towards that target quickly.

Miles Roberts

Thanks, Steve, that's tremendous. So who's DS Smith? What are we? We're about recycled packaging for consumer goods. So why recycle? Well, it's simply the most environmentally-sustainable option for our customers. And consumer goods, why consumer goods? Because of the consistency of the demand, and that demand not just in terms of volume but also in the exacting quality, service and strive for innovative products that our customers expect from us, and that means consistent margin growth and consistency of profits. So that's why we're focused on recycled packaging for consumer goods. But let's just step back and, you know, the fundamentals in business are often... come back to the business model. And you can see here the hoarding that's going up across vast numbers of Tesco stores. Drive into Tesco and they immediately start to promote themselves by using the name DS Smith. It's true. That's the way I look at it anyway. Here's one of their signs, and what Tesco is saying here, you can see the closed loop, DS Smith, we're very long in fibre, we collect vastly more fibre than we actually need, and the reason for that is it's working with the retailer to promote the use of recycled packaging. We want them to use more so we showed them the benefits to drive the demand from retailers. So we own that relationship. It's not just the trading, it's an ownership of that relationship. And not only does it allow us to drive the demand, it gives them the security of supply of fibre. And in an environment where raw materials are becoming scarcer, I believe that's a critical success factor for our shareholders.

And then we take it to paper. There's nothing wrong in paper, unless you're a shareholder. It is cyclical. It is very cyclical. And therefore we are extremely short in paper. We produce less than half the paper we need for our packaging. And then we are long in box. The conversion, the design, the production, the printing, the cut at the supply. It's capital light. It's growing nicely. It's got high margins. I believe that is a very attractive model for shareholders. So in DS Smith, we are very long in fibre, very short in paper and long in the conversion. It's a different business model to many of our competitors.

And I said when I started we wanted to create a business that's consistent GDP plus growth growing ahead of the economy, less cyclicality, higher margins, producing returns consistently above our cost of capital, and we set out how we're going to do that. And our figures we've outlined in terms of some of the achievements in the last year, I do always come back to the culture and the team in the organisation. I believe that is a fundamental part of that, we have strengthened the management and we're getting everybody in DS Smith

increasing confidence, thinking of the customer, and when it works it breeds confidence and therefore you get momentum into the company. You start achieving above what you expected to achieve. That's how you delight shareholders. And we've grown packaging. Otor has virtually no paper, so we've changed the shift, the mix of the business. And we've reduced our contractual price review points to four months. So we're happy not having the long-term contracts because we haven't got the long-term assets. So it makes us far more flexible in recovering and, as Steve said, fully recovering the raw material cost increases last year. And we have been looking at the way we're structured and putting in group-wide customer management and procurement. The cost save is all coming through and the UK business, under our new divisional chief executive, Gary Saunders, restructured, rebranded and doing much better.

So why are we confident that the success last year is going to flow through into the current year and get us towards those strategic financial objectives that Steve outlined earlier. The first point of this is you have to be growing above GDP growth. We do have the revenue synergies from Otor, we outlined them at our previous announcements. In the first six months we have secured an additional 4% of Otor's revenues from new business from our existing customers. In the first six months, signed up and starting to be delivered. That will be delivered into the current year. And we are investing to increase capacity in high quality packaging. Our capacity is becoming tight as these volume increases come on, but as Steve has said, we will maintain the capital discipline and they're very capital light in the conversion. Using our existing technology, our existing systems, just more capacity going into our existing footprint to drive for growth. And innovation, the roll-out of R-Flute®. It's a registered trademark. It's our trademark. We are the only supplier of that product, a product that takes over 20% out of the distribution cost of our FMCG companies for their packaging. We are the only supplier. And expanding the footprint of recycling. We've set up operations now in Eastern Europe and we're starting to trade.

And let's just look at R-Flute®. This has been a major success in the UK. It has been customer led. Customers such as Danone, Kronenbourg, more importantly... just importantly, coming to Proctors. They're now... all the new packaging is in this format. We're building it into Europe. We've put it into two sites now in Europe. We are delighted with the demand that's coming from that and we will put it into our remaining sites in Poland over the course of the coming year.

And the markets. Corrugated, recycled packaging is growing ahead of GDP. We show here GDP growth in Western Europe in the blue graph, about 2%. Corrugated is growing at 3%. It's the product of choice. It's recycled. Consumers want it. Our customers want it so it's growing ahead of that market. And of course, DS Smith, with the work we're doing, last year we grew ahead of our strategic objective, an absolutely super 8% last year. So the market's growing. And how do we drive out margins, getting to that 6 to 8% return on sales. 5.5% last year, 4.7% the year before. We're going to improve, firstly, the gross margin management. We've now installed the systems and the processes for understanding our margins of all of our products. The information is there, that has allowed us to target our price increases, and we're using that information to drive our gross margin management. Improving the mix of business, going more towards the higher end. We have been exiting lower margin business quite aggressively in that 8%. There's quite a loss of business which has been low value and commoditised. You're not getting the right return on the assets, therefore we don't want to do it. It's a disciplined approach to capital utilisation. And the cost save, I think Steve's outlined a lot of these. We've got the UK coming through as we bring the divisions together. We've

got procurement starting, where we've made a very good progress there, and then we have the Otor synergies, a further €6 million in the current year, and we leave further cost savings to come in 2012/13. And of course, underlying all of this is the operational gearingWhen that volume comes through, you can imagine what happens to that bottom line in terms of the return on sales from the improved gearing.

And underpinned, to delight your shareholders, you have to delight your customers. Simple graph here. On-time, in-full. You'll see us reporting this consistently. We've gone up from 94% to 96%; it's not good enough. That's industry leading but it's not where Proctors are at 99% and that's where we have to drive towards. So a very good improvement last year, but more to go for. And how do you drive these margins, again? You've got to protect your innovation. So simple facts, we bought Otor, comes with 50 patents. You can't supply what they make because it's patented. Ten licences and six new patents licensed in the current year. So there are patents behind this. The product here, it says it's all about the taste. Find that rather a bit of a shame; should say it's all about the packaging, but they didn't want that. All patented. You can't copy it. 100% of their supply within DS Smith.

Driving strategic change by reducing... next about how do we reduce the cyclicality? The FMCG business to a now circa 70% of our packaging is into the FMCG sector. We are overweight here and we're very happy to be. Continued work on reducing the price review period. It's now four months. And as we've announced today, reducing our UK paper manufacturing base. We've announced the closure of a site in the northwest. So reducing the cyclicality. Our primary measure is this return on capital. How do we deliver this 12 to 15%? A lot of it's around the balance sheet. It's around capital discipline. When you invest in organic growth and bolt on acquisitions. We're looking for good returns there. We've delivered them in Otor. But internally when we manage our capital expenditure, it's about strategic investment of capital. It's not just a straight, what return do we get on it? It's got to be aligned to our strategy. So you get the combined effects of that asset with the rest of the group. So you start to get enhanced returns by investing strategically, not just any proposal, depending on payback. And as Steve said, we've set out our targets on working capital and we can see those improvements continuing to flow through. And opportunities to grow further. This is our existing footprint. In the UK and France we're clearly the leader in consumer goods, corrugate packaging. We put very good footprints elsewhere but we're underweight there. We are growing, there are clearly opportunities for us there. Backed with – as you'll see on the left-hand side of the graph in front of you – you'll see how the consumption of corrugated in central and Eastern Europe is only about 60% of what it is in Western Europe, but of course the Western European retailers are going there. So the Tescos, the Carrefours, the Ocean etc. they're moving into these areas, they're driving the growth of corrugated so over the coming years we'll see Western Europe continuing to grow but Central and Eastern Europe growing more aggressively to catch up, and it will catch up.

And if we just look at our competitive landscape. We put central and Western Europe here, there's still a lot of fragmentation of privately owned businesses, and this is something we've very conscious of. How do we look to grow, expand our footprint in a highly fragmented market, where the retailers and our customers are taking share? How can we make sure we get to the size to match our customers? And as you can see on this simple graph, between roughly 50 to 60% of the market is really much more modestly sized businesses, many of them privately owned, some in VC hands. So plenty of opportunity to look at those.

So, summary and outlook. It has been a year of change. We've been very clear about the strategic direction of the company, what we're trying to achieve. I think the delivery has been strong. Against the background of very significantly increasing raw material cost. I'm sure you probably heard of other companies with difficulty, being disciplined on the pricing and disciplined on charging for it and that's why you're seeing the results that are coming through. The momentum's continuing. We have started this year very well. We haven't seen any drop-off in continuing volume growth and we expect to make further significant progress towards our financial objectives, and the confidence of the board behind that has led to a 41% increase in our dividend, but I have to say, it's just in line with the dividend policy we've established.

Thank you very much, everybody, for listening to Steve and myself. Now we're very happy to take any questions anybody may have.

Questions and Answers

Donal O'Neill– Goodbody Stockbrokers

First of all, congratulations on a fantastic set of results. A couple of questions from me. In terms of the shutdown of the 95,000 tons of capacity in the UK, is there any kind of timeline on that and what sort of costs might be associated with that? Second of all, in terms of capital expenditure, two things there: can you give us any indication of what sort of tangible things you're looking at in terms of investing capacity, what sort of tonnage you might be looking at? And also you mentioned in the report that you're looking at some proprietary consultations on the recycling business in central and Eastern Europe, and what the strategy is there currently and what the timeline of that might be.

Do you want to take the first bit, Steve, about the closure and the cost, etc, and then I'll come to about where we're making investments in the future and the recycling.

Yes, Donal, on the closure, that's obviously something that we're announcing today, both obviously to the stock market but also explaining to our employees. In terms of the timeline, that will be phased over the next 12 months, but it's important that we are actually able to start a consultation on the process. The cost: you have to figure in a cash cost of about £3 million. And in terms of the capex is... it's not new tonnage. We may change, reconfigure, but it's not new tonnage on the market. The majority of our capex is going, currently, into packaging, mostly the corrugated packaging, and there we're looking at the ability to print out boxes better, make them faster and make them more complicated, delivering what our customers are requesting of us.

I think for all of that, as Steve outlined earlier, you know, the capex is being very tightly controlled and really aligned to strategic objectives. And we've talked about some of the individual projects in there. We are expanding pre-print, our pre-print capabilities. The thing about pre-print is that you print the packaging before you make it into a box, into corrugated. So you print on the sheet of paper, then you make it into corrugated. And the beauty of that is when you print, you print onto a hard surface and therefore you can use very light paper. Typically at Otor, the same strength of box because Otor are the leader in pre-print, using about 25% less paper than the equivalent post-print. Of course, because we're light in paper, we don't want to sell paper, it's not in our interest to because we're so light in it. So our objectives are aligned with our customers, to save paper. It's so simple but that's where we

are. So we're looking at expanding that pre-print footprint, and the technology we're putting in is unrivalled in Europe. All built on that expertise we have in Otor. And we talked about recycling. We have set up operations there in Eastern Europe. It's not about just trading in the market; this is about getting relationship with the retailer. So you're not only getting access to the fibre, but you're driving the use of recycled corrugated packaging. It's very important to us to be able to talk to the retailer and promote the use of it, show how it allows them to hit their environmental credentials, allows them to take out cost from their operations. That's why we're doing it, that's why we set it up, that's why we haven't made a big acquisition in this area because our business model is pretty unique in this area. So we started trading... we started, sorry, to set up the operations and I think we'll make very good progress this year. But the capital employed in that is minimal because it's all about our systems and processes and expertise, which we've already developed, so it's very modest capital investment. In fact, it's virtually non-existent, the capital investment.

Actually, the question is on capex there, it's important to see the link with procurement, in the sense... because we're quite clear on what our strategy is now. You know, we know what type of machines we're going to be buying over the next 12, 18 months. So it's no longer going to a supplier saying, I want a machine for location X. It's actually far more of, I need three machines, going into these three locations, in this phased timing. That obviously puts our procurement team in a far stronger position. So in terms of capital expenditure efficiency, I think we're getting far more now for what we're spending.

Ross Gilardi – Merrill Lynch

Steve, you mentioned that in terms of your net debt to EBITDA you'd be willing to go above the targeted two times for the right acquisition. Can you give us just a little bit better feel for what we're talking about. I mean, would you be willing to do another Otor sized acquisition or would you be willing to do something even larger than that?

Yes, I think... of course, when you're buying, we're typically buying... the thing with the Otor type acquisitions, very consistent return on sales, you know, great cash flow profile, good market positions. So you're not just putting out debt, you're also buying – as long as you do your due diligence, which we expect we will do properly – you're buying, you know, a strong, secure cash flow profile. So going up to two and a half times, or even above, I think the key criteria is... there's quite a few of our relationship banks here as well in the audience, a key criteria to me is how quick can we get that down? And in a sense, that's an assessment of the earnings and the cash generation of the business, but also part of the due diligence, looking at things like the working capital and the capex profile. So one of the things that... in terms of out of Otor, you know, we have actually... their previous owners had a reputation for being tight on cash but we've extracted cash out of Otor's working capital, you know, just by focusing on why you're holding so much stock in these areas, looking at your receivables, looking at payables. So to me, it's not so much saying it's X times EBITDA going up to... frankly, it's what are we buying and how quick can we see over the first 12, 18 months paying that debt back down towards two.

Okay, thank you. And in terms of your return on capital objectives of getting to the 15%. You're at 12.7% this year, but that of course includes office products wholesaling, so I think without that you've shown your release around 11.5%. So is the target lower without Spicers and, I guess, more importantly, how long do you think it takes to just get the packaging business itself well into that 12% to 15% range?

Well, if you actually look across the divisions there, you'll actually see continental Europe is in 12 to 15% and packaging is comfortably at the upper end of that range. So it's really about the UK business. we improved the return on capital there by 340 basis points to 10.3%, so we're still below. But you can see there some of the things we're talking about – UK efficiency and procurement – so those are all the things that will get us there, plus there's still opportunities in terms of the working capital. So if just looking at the... if we had just a packaging business, of course we'd have to relook at those targets, and you could equally argue, perhaps the margin guidance should move as well. but, you know, at the end of the day, our cost of capital is 11%; we're here to beat that. So having a 12% range and upwards is still quite appropriate for a packaging business.

Obviously you're trying to reduce the cyclicality and, over time, reduce exposure to paper. Do you care about the paper cycle anymore? Does it matter to your business, particularly, now that you've gotten the contracts shrunk to four months instead of six months?

Do we care about it? We've always got to be aware of it because it's a driver of pricing with our customers. But are we fixated on it? Is that we think about? Absolutely not. We're far more thinking about how much can we charge for what we're offering and what's the reasons and the service we offer, rather than saying, our cost is X. So, yes, it's important, but it's not... we're not focused absolutely on it. Frankly, I just as much think about what's happening on energy, what's happening on starches and what's happening on chemicals. It's another input that we have to manage commercially with our customers.

Not to put words in your mouth, but I would assume you think you can still do 12 to 15% even at the bottom of the paper cycle, going forward.

That is the range that we're giving. So it's quite important to think of the structure of our business as well on this. We're obviously long in box, short in paper. So clearly, you know, in terms of our business performance at the minute with rising costs, if you were the reverse, you'd find yourself actually with more benefit. So the bottom of the paper cycle isn't so much of a concern to us when we're focused just on box.

Thank you.

Harry Philips – Evolution

Several questions, please. In terms of the additional investment you say you're going to make at Kemsley in the context of the switch over for 95,000 tons, how big an investment is that? Does any of the tonnage actually move to Kemsley or is it a net out of 95? Secondly, in terms of R-Flute® penetration, could you give an idea maybe of where you are in terms of penetration in that particular product? And then lastly maybe, and hopefully a very simple one, in terms of dividend, should we expect the dividend cover to move into the proposed dividend cover range this year? Please.

I think I'll take the first one. We're not going out with specific numbers, frankly because we've still got procurement working on them for them to come down. We're investing, in terms of paper, in line with depreciation. Be phased over the next two, three years. It's more that we're moving into more speciality products that actually it's not the paper, it's actually that our packaging business needs the type of products because that's what our customers are

asking for, rather than necessarily investing in however many tons of paper here. It'll be closing out of one site but investing into another, but it will actually be displacing some of the more commodity grades that that site manufactures. So we actually see this as strengthening Kemsley's position in the marketplace.

Richard, we've kept Kemsley because in the UK there's no independent capacity. That's why we've got it. If you're going to keep an asset, then... which is supplying the packaging, then it has to produce fit for purpose papers, or else it become a millstone. And there is a net reduction in tonnage closing. Some grades that are produced, we're not going to produce and the investment's going elsewhere Steve. So it's all in line with depreciation. It's specific to our packaging business. It's not paper for its own sake; it's specific to the packaging, and in time we'll talk more about that. But it's absolutely the right thing to do. You talked about the dividend. The policy we have is very clear. Moved from last year, the cover was three. This current dividend is... so the year 2010/2011, we're 2.9 times covered. The earnings are up considerably but we're still outside of the range of between 2 and 2.5 through the cycle. So there's clearly more to go for. The exact timing of how we get there, you know, we put it up 41% so we're not being shy about it, but that will be a decision the board will make over the coming years. But we've very clear policy. We view it as the primary return to shareholders, built on the back of a sustainable business model, driving the return on capital which produces cash. That's what it does. So investors should have more confidence in the business model, aligned with a very clear strategy on dividend. But we'll make the decision in... well, the board will make the decision.

And then just on R-Flute® penetration.

If our competitors hears they would... it's been extremely good. It's been extremely good. We're absolutely delighted. You see, it's so interesting because behind that it's a new grade; nobody else produces it. And the take-up has been super. So, again, people think of packaging and think, well, it's the same stuff, A, B, C, D and all the rest, all the different flutes have been out there for the last 55 years. But as soon as something new that adds value to our customers, they change. And it's that speed of change that drives that margins, you know, it's as simple as that. They have to have new products and they want their whole supply team to support it. so I'm actually more encouraged by the speed of response from Proctor, from Kraft, from Unilever, from Reckitts, from Coke, all of our major customers suddenly switching into it because of what it does for their supply base. We sell less paper but, of course, we don't mind selling less paper because we're short in paper.

Markus Almerud – Morgan Stanley

A couple of questions. First, on cost, where have you seen cost going after... I mean, in the past couple of months have the cost pressures abated somewhat? We've seen the paper... the recycled cost has abated in the past month maybe, but what about the other cost items? And then on the acquisitions, is your priority to make medium-sized acquisitions, the Otor kind of acquisitions, or also bolt-on acquisitions, and what region are you focusing on, is it Western Europe or is it central and Eastern Europe?

Just in terms of raw material cost, you always get short-term fluctuations. It's very important for a business to think not just about the short but the medium and long-term. And it's true, over the last six weeks I'd say that some of our input costs have... well, the rate of increase has reduced. Not seeing any great reductions, we're just seeing that incredible growth in cost,

it's just levelled off for the last six weeks. It's very important that we don't just think about now, we think about the next six months, next year, 18 months and two years, and we certainly are very firm in the camp that we will see a resumption of the increase in raw material cost over the next one, two, three years. So to get our business model, to make sure it's resilient to that pressure that comes on. So it has flattened off. It's.. but we expect it to increase in the future. The only question is when, really. Is it six months, is it a year? Don't know. But I have to say, you know, it's not a huge... the issue is about recovering it or getting your... just being made sure you are recovering the added value. It's so much more of an issue if you're in a commodity because it starts to affect everything. You know, if you're commoditised, you've got little value added, we're looking to be paid for the value add, which is much higher. That return on Otor, 9.4%, that shows the value add. That shows what it's adding and therefore you're able to charge for the cost pass through. One of our major customers, we've now virtually just got a straight cost pass through. There is a lag, it is three months, but the costs are what they are. It's the added value that they want and it's getting under the skin of those customers. I do apologise, you asked another question and in my enthusiasm I forgot what it was. It was on bolt-on acquisitions, wasn't it?

It's quite... you can see how fragmented the chart is, and there's a range in there. There's Otor type of opportunities and bigger, there's an awful lot of private businesses in the markets where we are currently, both in terms of Western and central and Eastern Europe. And we see actually a plan where we can do organic investments. There's certain investments where we can put down, for a relatively modest investment, the new corrugated facility. And we get excellent returns in some of the markets we're operating from that sort of organic investment. You can see bolt-ons where we can... we may have three sites in the country, you can see we've put a fourth one in. So there's a bolt-on, and then there's the Otor sized acquisitions and slightly larger as well. So there's an interesting mix. There is organic development through capex and new locations, bolt-on opportunities, sort of, building a network and, finally, there's the Otor type and larger acquisition opportunities.

And both in central and Eastern Europe and Western Europe?

Absolutely. Because if you understand the market and you're focusing on the FMCG goods sector, and almost some of our customers are dragging us saying, can you come to here and help because we like what you supply us in France or Poland, you know. You're starting to build up, develop a real understanding of the market that you can serve and hence your confidence to invest in that specific location.

Thank you.

Hector Forsythe – Oriel

Three questions for you. You've done remarkably well in reducing the pass-through of costs down from six months to four months, but clearly it's a bit of a journey; how far do you think you can get that or how short a time do you think you can do that? Second question: you made a note in the presentation that round-about 70% of turnover is with FMCG groups, can you talk about where that's come from and where you think you can get that over the coming few years? And a minor one at the end: on the UK paper asset that you're closing, can you just give an indication of contribution or otherwise that that business made last year?

The contract period, this is when we can talk about pricing, and so much of it is about how they view your product and the value-add that you're giving to them, and the more you give them, the more they're happy to see the cost reduce the contract period of the price negotiation. When you're more commoditised then you tend to want it... they want it longer because then it's just, you know, who's got it right about the forecast in terms of future cost. So we actually see the price negotiation, I think the optimum would be three months. You start pushing it less than that and it can become... it can have other consequences. So there is... I think we can get it towards the three months. It's actually where Otor is. I think going less than that, for various reasons, isn't particularly advantageous to our shareholders. So somewhere round-about that three months. We're about four, it's come down from six, and as we add more value I think we'll get closer and closer to that three. And on the FMCG, it is 70%, and overall FMCG in our principle markets, it's more 57, 56% of the market. So we're well ahead of that. Otor's about 82%, so they're very, very heavily exposed to it. I think we can drive that 70, perhaps get it up to 75%, something like that. But then you... it's not a question of whether it's more to go for, it's a question of whether or not you actually want it, because there is an element of FMCG which is just brown box and that's not really what we're interested in. So I think we can push it a bit further, more up to about 75%. It's slightly less in Eastern Europe but it's of that sort of number. So another... improving the mix as the total increase as well. You can see that it's really quite exciting growth for us in that area.

Yes, just on the paper asset. I guess the accounts would say it's making a small positive contribution, it's not significant. But the reality is that commercial, in terms of the pricing and resources, frankly, are largely based at Kemsley anyway. So we're not exiting a loss making site, we're just... in a sense, we're trying to build a stronger business at Kemsley and we're looking to exit a site that, frankly, would need far more investment and capital commitment into there than actually we're putting into Kemsley.

Okay, thank you very much.

Closing Comments

Well, the time's pushing on, everybody has got busy days. Thank you very much, everybody, for sparing the time to come and see us and listening to our presentation, and the next update will be at the AGM in September where we'll release another trading update or so. I look forward to talking to many of you at that time. Thank you, everybody.