DS Smith - 04.03.2020

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Participants

Miles Roberts – Group Chief Executive, DS Smith

Adrian Marsh – Group Finance Director, DS Smith

Miles Roberts: Hi, good morning everybody, and firstly thank you very much for joining us today. I'm Miles Roberts, the CEO of DS Smith, and I'm here as always going by Adrian Marsh, our CFO. Our statement today covers the trading period since the 1st of November. So trading continues to progress well despite some of the macro economic uncertainty. Our group like-for-like corrugated box volume growth has increased during the second half of our financial year fully as expected, with particularly good performances in Iberia, Eastern Europe and the UK. It's also been very pleasing to see the ex-Europac packaging operations performing so well and our leading FMCG and ecommerce businesses growing strongly over the important Christmas period, although some countries with exposure to export led markets, including Germany do continue to be subdued. Our North American business, so we're pleased with the initial - very pleased with the initial customer reaction and operational progress from our new box plant in Indiana which opened in November.

Our domestic US basis remains robust, although the negative impact of lower US paper export prices remains ongoing due to reduced demand from China. However, our increasing packaging capacity in the new site will progressively reduce our exposure to that market. We've continued to focus on pricing, cost and cash, with limited box price erosion, testament to our resilient business model and strong customer offering, and we expect to deliver a margin in the full year in line with that achieved in the first half. I'm pleased to say that we recently completed a sale of the plastics division. This reinforces our commitment to fibre-based packaging solutions for our customers. The net cash proceeds of approximately £400 million have been used to reduce financial leverage. In summary then, the Group has delivered a robust performance during the period, a challenging environment. Our sustainable packaging offering, including the replacement of plastics is becoming ever more important to our FMCG and ecommerce customers and we continue to gain market share.

With regard to coronavirus, whilst we continue to monitor events and work closely with all our suppliers and customers, we have not to date seen any material impact on our business. Our production is spread over 200 sites across Europe and North America and we have a diverse customer base. And as such we believe we have a robust business model albeit we're not immune to the event of a widespread macro-economic slowdown. So despite continued uncertainty in this environment, our focus on pricing discipline, enhanced cost and efficiency programs and cash generation support our expectation of further good progress in the year. Thank you. And now myself, and Adrian are very happy to take any questions people have.

Alexander Berglund: Thank you very much. Good morning. Three questions from my side. The first one is on container board. Did you get anything on your recycle containerboard hike in February and if not, how is it looking into March? My second question is on your potential containerboard disposals. I wonder if you can give an update on the progress here and if there's any challenge you can give a range of the size of these disposals, either in value, tons or EBITDA contribution. And my final question, if you do get a cash inflow from these potential disposals, will you use stock mainly for the leveraging or would you look to further expand your downstream capacity in addition to what you're already doing now in the near term? Those were my questions. Thank you.

Miles Roberts: All right. Thanks very much. Yeah, some containerboard, looking at March, we're looking at plus €30 to €40 on containerboard I think it's pretty clear now. Prices are going up and that's what we are paying. But that's really coming through in, as I said in March. If we look at some disposals, as we said, we're looking to reduce our paper exposure, particularly in and around Central Europe. There's work ongoing there. It's exactly where we expected it to be. We said we would come back over this year and explain exactly what we want to do, et cetera and that's progressing pretty much as we expected. Now look, any disposal proceeds from this, as we said, we're looking at about 10% of our paper, our capacity could be maybe a bit more from that, but it's in that range. And any proceeds that come in would initially be used to reduce leverage. I think with plastics, as we said here, we're going to be around two times with the plastics proceeds. And indeed the cash flow just reduces that slightly further again.

Alexander Berglund (Bank of America): Thank you very much. Just maybe a follow up on the containerboard side. Given you said 30 to 40 on recycled, are you seeing anything on the virgin side or generally in the market you've seen a potential for virgin container board to increase as well in March?

Miles Roberts: No, absolutely yeah, both are going up.

Adrian Marsh: Yeah. It's quite tight in the market.

Miles Roberts: Stock is tight, demand is fine. Yeah, the stocks are tight. And yeah, so we've seen that pretty much across the board. Yeah, absolutely. Absolutely.

Alexander Berglund: Thank you very much.

Justin Jordan (Exane) : Thank you and good morning everyone. I'm sorry to labour the issue of the moment, but just on coronavirus. According to your 2019 annual report, DS Smith had some 11% of revenues from Italy. Can you update us on just the extra measures that I'm sure you're taking at the moment, I mean particularly in Europe and box plants in Northern Italy just to keep employees and customers safe?

Miles Roberts: Oh, absolutely. I mean our primary focus is obviously on our employees. I mean, we have very well worked procedures in the event of these sorts of events, although they're obviously adapted to this particular coronavirus. We're very much following the guidance of the World Health Organization. We are working with our unions and employee representatives again there. So really all the measures that the World Health Authority has put out are the ones that we're following with a few extra precautions as well. I mean, I have to say, with our customers and talking to them to date, we haven't really noticed any particular change. We're not saying we're immune from anything because who knows what's going to happen. You look at some of the forecasts and for general economic slowdown, et cetera, and of course we would have to assess that. But we do have a number of plants. We are able to move production around, move from middle Italy up to northern Italy if that was the case. Food and drink, et cetera, we're servicing. So at the moment it's been okay, but as you can imagine, we're watching it very, very carefully indeed.

Adrian Marsh: I mean we've got a task force on it Justin, all staff are advised on the precautions to take. Provision is made for relevant hygiene precautions at all of the plants. And as Miles said, one of the advantages of us and similar types of businesses to us is you do have a fragmented manufacturing base. So we're not concentrated in one specific area. But we had a board meeting yesterday. It was one of the top issues on the agenda, just how prepared are we and what are we doing.

Justin Jordan: Sure. Okay. I appreciate you've got a large mass of FMCG customers, but I know you've also got some luxury brands as customers. Just specifically for those luxury brands, are they seeing a downturn in activity in particularly sales to Asian customers?

Miles Roberts: Yes. I mean we do have some luxuries. Our packaging is of the very highest quality you can get in Europe and therefore we do work for and some of these big customers, we're actually exclusive to them. They only want to work with us as you can imagine. But yes, in the Chinese market there has been an effect. We were talking to one particular ultra-premium sells a lot of sort of high end spirits, et cetera, and of course people aren't going to bars and clubs in parts of China and that has hit their production, their demand. And that obviously comes on to us. I should say these are relatively modest volumes. Not everybody is consuming sort of ultra-luxury products all the time as you can imagine. And today China is one market out of many markets in the world, but it is having an effect.

But really for us it is minimal as these customers who are still very, very important is obviously a very modest amount of overall demand. But we're watching the situation very, very carefully. I mean, interesting, some of our customers are actually increasing their demand because there's more of a focus on them. So we’ve got one company, a very important customer actually based in Italy that makes all the hygiene products so you can imagine that their orders have ballooned and within that part of our diverse customer base, focusing very much on these sorts of customers. So as one's gone down, the others go up. But as I said, we're really just seeing what happens, just in terms of overall demand we think we are reasonably resilient, but it's uncertain.

Adrian Marsh: I think the most obvious thing in the moment, Justin, when you look at it from a general business perspective, and again, will be no different to anyone in this respect is what it's doing to two global shipping rates at the moment, where you're seeing containers are being stockpiled effectively in China because no one's collecting them. And I just think we need to play out over time what that will do for not only our logistics costs but anyone's, and you can see it. I mean, the shipping rates are definitely rising. And clearly on packaging you don't move a lot by that route. However, you see opportunities, people in distribution. I mean, their cost base is going up.

Justin Jordan: Yeah. Good point Adrian. Just one follow-up question. I guess Miles, in December you talked about box prices for contractual customers being, I think it was down two to 4% at that point. Here we are now three months later. Where are those sort of contracted box prices conversations currently?

Miles Roberts: I mean, look, I think one of the things which we've always - what we try to do as an organization in building our capability of our customer is about the value add setting the serves, the quality, the innovation, the security supply, try to show how we demonstrate why we've been able to increase our value add and therefore our margins. And the box price erosion has - it has been coming through. But really we are a year on, we talked about 2% before, we're talking about 3% now from where we were around that.

Adrian Marsh: Definitely we're trending into that range, Justin. I mean, the unknown at the moment is the paper price rise is just going through which one would anticipate starts to put a ceiling on that. But it's certainly no different than how we described it before when Miles gave the range. That was an anticipation of where it would get to and we're seeing it sort of middle moving through that range.

Miles Roberts: We are quite pleased seeing this volume increase, which we talked about really coming through in the second half as well as we've just repositioned our sales a little bit. Today we are pleased with the margin and I have to say and also the volumes coming through in the quarter.

Justin Jordan: Okay. Thank you. Just one final thing for me, Adrian, look, I know I've given you a hard time in the case and so over the last seven years, but clearly best wishes on your imminent move to William Hill.

Adrian Marsh: Thank you very much Justin. I've never noticed the hard time you've ever given me.

David O'Brien (Goodbody): Hey guys, how are you? Thanks for taking the call. And if I could just start on box price again. Sorry. You did give the range of one to 2% for total pricing in the first half. If you're saying that 3% number now, is that the year to date or is that what happened in Q3, just to be clear?

Adrian Marsh: Yeah, so the one to two was what we experienced. Miles gave a view on the contract. He said the indices where we knew they would start biting and we thought the range would be more like the three to four going forward. First half is exactly as we said. Second half, you can say that the run rate is closer to where the middle of that range is so around the 3%. There's obviously been an increase in Q3 and Q4 remains unknown. I mean at this stage, I mean with paper prices going up, our anticipation at this stage is no further significant erosion. So the retention has been very good.

David O'Brien: Okay. If in terms of you notice a step up in corrugated volumes, can you quantify what type of growth are you seeing at the moment where the improvement is coming from? Maybe a on a sector basis and also, has there been any evolution about that growth you're saying that there's been a pretty good November, December, Christmas periods, like from January onwards, how demand trended into March. And that another one from me just you do note your margin is going to be stable and sequentially into the second half. How does margin look year on year and on organic basis? And if I could tie that into your guidance for further progress in the year, should we be looking at organic profit was down in the first half? Should that be flat a little bit in the second half?

Miles Roberts: If we - just taking the volumes first. In the first half we noted how we had had a difficult period in industrial volumes, typically some markets like Germany and we've also noted how whilst we can obviously chase that volume, we felt that we were just going to focus, continue to focus the group in much more resilient categories. And we have a number of opportunities to really grow there as you can imagine, with our product development, service quality, etc. And therefore it caused the volumes in the first half to be a little bit lower than we would normally expect. But we did say that we will be recovering into the second half. We could see the timing of new awards coming through slices we position our business. We could see the Europac business where we'd had a negative growth or we had a decline in the first period as we were working through the pricing changes. And then we started to see an improvement with the ex-Europac packaging. They're now firmly in growth.

In the US as well, we'd run at full capacity. We've got the new Lebanon site. We can clearly see that coming on. We're very pleased with how that's gone. So all of that means in the second half in that case, this is building, we're looking at a higher run rate. Now for the - if we look at the second half, I think we'll be around about the sort of maybe one and a half to 2%, something like that in terms of second half growth, bringing the whole year up into, again, that sort of difficult to really say precisely, but it seems to make one to two, something like that. But we're just clearly seeing the run rate improvement. Indeed, that run rate is improving during the second half. It's really as we've repositioned. As I said, what we are pleased about is the margins. And if we look at the second half, the second half traditionally is a little bit quieter than the first half for a number of reasons. Of course the January period, which traditionally is a little bit quieter after New Year.

But even so, we're seeing the margins come through. Now we do have the Europac business, but clearly in the second half of last year we had a good period of the Europac business. So just in the first half, if you look at our European business, we're seeing the margins improve organically in the core business. In the US, the US domestic business continues to go well. We're pleased with that. We are bringing paper back onto the US mainland that used to be sold in China. But just as we come in here, we still sell paper to China. The market remains subdued, it is not particularly better or worse. It's just remains subdued in terms of pricing, which affected us in the first half. Very broadly, all the things that we talked about margin retention, about growing our volumes, about bring the paper back on domestically and disposing the plastics, those are things we talked about the half year. Where we are today, we're absolutely all on track with those new, and some of them are being completed as well.

David O'Brien: Great, thanks very much.

Miles Roberts: No, thank you. Thank you David.

Barry: Yes. Good morning gentlemen. A couple of questions from me. Just in terms of OCC costs, you might just give us a sense as to what's happening there. There were some talk of an increase or some evidence of an increase earlier in the year. And then just in the context of what's going on in terms of logistics and transport costs, what's happening on that front. And then secondly on the container board price increases. I mean, you talk about that as far as the weakness in the US export prices. How realistic is it do you think that European price increases can be maintained in an environment where US export prices to Europe continue to fall? Thanks.

Miles Roberts: Right. So just on that, for us we're saying that the US in terms of our US business has continued to export to China. It hasn't gotten any better or worse.

Adrian Marsh: Yeah, I was just going to interrupt him. I mean, I think it's fair to say we were expecting at Christmas time export process to China would be getting better, which they were showing signs of until the coronavirus.

Miles Roberts: Remained the same.

Adrian Marsh: But going up into Europe at the moment.

Miles Roberts: Yeah. I was coming on to say containaboard prices into China the second half is pretty much as we saw in the first half. Prices of export from the US into Europe has gone up for kraft, and that's effective for this month. The big sort of unknown is what's happening in China because you've probably noticed this affects OCC as well. OCC prices in Europe over December and January fell and they fell because the import into China just wasn't happening so there was an excess of supply. Recently we've actually seen an increase in demand from China because the domestic collections in China are obviously struggling with all their restrictions on gatherings and transportation, et cetera. I mean, it's really some statistics about how 300 million people in China are displaced. And they haven't come back from after the Chinese New Year is incredible. And obviously this affects municipal collections, etc.

So we've actually seen an increase in demand from China for OCC. It's too early to quote it, far too early, but also some indications on paper have been actually quite positive, but we're not quoting it, this is really just as we're seeing things on a weekly basis and it all comes from this sort of restrictions on mobility in China. We've also seen a relaxation in some of the import tariffs, et cetera on OCC from the US, they've been lifted from China. So there's clearly something going on. China is looking sort of to pull from Europe and the US with their sort of domestic production capacity and collection being down. We also hear things about very low stocks in China because they've been used, the supply chain there is looking a little bit bare. So everybody can have their own views on it. At the moment, demand seems to be increasing because of our sort of existing resilience and manufacturing base. But it's too early to tell. So OCC down in the first December, January, more demand coming from China, a little bit on pricing there. We've seen in a few places starting to age up. US cross exports in Europe up, US pricing into China flat first half, second half. However, we are seeing some signs of demand but it's too early to quote it.

Adrian Marsh: And then the data is so unreliable. I mean I heard something yesterday saying half the paper machines are shut in China. I don't know whether that's true or not

Miles Roberts: Our people that are out there permanently saying that certainly the OCC collections are affected and there is quite a bit of downtime on the mills in China at the moment.

Barry Dixon (Davy): And just to follow on from that Miles, so the increased demand for - is there increased demand for container board from China as well as for OCC given that depth? We're hearing that the plants are running at 50% capacity. And maybe just a trick you want to follow on is that, are you seeing good demand for your paper moves in Europe and could Chinese buyers be potential buyers of those?

Miles Roberts: Yeah, I mean look, all that we can say is what we see and it's very difficult to get a sort of industry wide information there. However, if we're sitting inside and we are not quoting it, this is literally these things are moving very quickly. We are seeing there is an increased demand for OCC from China and there's a lot of interest in taking more paper from the US and from Europe. That's just what we see from the people we interact with. Although we do have quite a big network into there. It's interesting what you say on the paper, there is obviously interest from a number of sources and as you're saying, Chinese buyers have been looking to get more capacity in pulping and paper, particularly pulping in Europe and in the US because of their import restrictions on OCC. That's been a long-term trend and that remains the case today. We can see interest in there as they turn over, they look to close the gap between their demand for OCC and paper and basically their domestic collection rate od OCC, which has plateaued for a while now. And there's a gap and I'm not surprised to see the increase in demand as they seek to close that gap.

Adrian Marsh: Yeah. But really, this is not reliable data. It's a problem, David. I mean, you go from one day to the next, you can get totally different views on what you think is happening, but the reality is we don't know.

Barry: Perfect. Thank you.

Cole Hathorn (Jefferies): Good morning. Adrian, a question for you on the integration that you've done for paper within Europe. Could you just give a little bit of colour of how that's kind of helped the margins bringing kind of more paper internally within DS Smith? And then secondly, I'm just trying to get some more colour on the difference between your US and European businesses from a box pricing perspective. You've always talked about Europe, 40% indexed and the various other items to support pricing, whereas in the US it's always been more of a correlation with the paper price. And I was just wondering if you could give a little bit of colour on the differences you see between price mechanisms in the US versus Europe at the moment.

Adrian Marsh: Okay. In terms of the way the integration will affect margin, it's purely mathematical in as far as if we're not selling paper into the external market, rather using it internally, increasing our integration level, then you simply are reducing the revenue line by the effect of not having to have the gross up of a sale and a purchase. And we have been increasing - I mean, not massively, but we have been increasing integration levels in the last six to nine months, probably. In fact, probably over nine to 12 probably. And we can change that at any point in time. We're still - our model is to be short paper but where you have capacity to make it is not always where you need it. And hence we have the make, buy, sell decisions and we operate that quite effectively and we buy the papers we need in the open market and we sell into the open market.

Where prices are volatile, economically you look to integrate more, particularly when they're volatile on the downside. And we will manage economically to optimize our results. The effect of that will simply be that you do have an improvement of margin when you take your profit compared to your revenue line because the revenue line will have come down by that in the same way as with where we sell OCC into the open market. If the price of OCC has come down, that has a net effective of reducing our revenue, but the profitability may have stayed exactly the same. However, mathematically, a couple of basis points, potential improvement of margin for example. So it's a very mathematical trend. And you can see that and you can work that through. In terms of box pricing in Europe and the States, I'm sure Miles can give a more definitive answer on that. But it does operate quite differently.

In the States it's still marked to market. So if the price of paper moves, classically the price of a box will move with a relatively short lag, maybe one to two months. And it's set on and they tend to get fixed based on paper weekly prices of paper. So if paper comes off $10 a ton, then likely box prices could classically follow as you're talking about a market that's largely made up of standard brown boxes. Now going forward, one would expect over a period of time and it may be a significant period of time that it will follow more like in Europe where you're selling on value and you're selling on innovation and you're selling on service. Most of these you get more into the shelf ready areas and the high print areas, your ability to retain prices and manage prices is much greater as we're seeing in Europe. But at the moment US is marked to market very quickly. Europe which was that probably even when I started seven years ago, we're just seeing is a lot less so now as the market is consolidated as the type of packaging and the value of the packaging is increased, is less driven, entirely dislocated from the price of paper. Miles do you have anything to add to that? That's what we see and I dare say, if you talk to big competitors, they'll probably say the same, it's certainly what we've seen.

Cole: Great. Thanks very much Adrian. The comments on the box process very much echo what Smurfit were saying recently. So appreciate that. And then just one follow-up on cost inflation that you're seeing at the moment or deflation. Is there anything that you can call out there or any programs that you got in place to kind of take out extra costs where you can?

Adrian Marsh: Yeah, absolutely. So if you park the individual element of paper and OCC and you know those as well, if not better than me, where they'd be moving. If you then look into what cost drivers one will have as a business outside of those two, I mean, labour will inflate every year. If you're in Europe, you're pretty much tied into, and a lot of countries that have mandatory inflationary price, labour cost rises. So you can pick a number, but you can say on average you're inflating your labour base by 3% a year roughly, roughly if you do nothing else. Other costs that we've had, logistics have gone up, energy has gone down. Starch has gone up and it's come down and its full costs go up again, who really knows. All we can do is try and optimize our efficiency and we've always done that. That's never changed.

I think it would be fairly honest of me to say we've stepped up our efforts this year, particularly as we've seen paper prices coming down. We've absolutely looked at every single line of optimizing efficiency and we've got a number of programs in place to deliver on that over the next two to three years in the same way as we've had in the past. Obviously through some of the acquisitions, we've grown the business and we've got opportunities there to improve their operational efficiency. But in a way, there's no stone that doesn't get turned within the business. Within the UK, which is a very successful part of our operations, we're consistently driving operational efficiencies there. We've got a very, very strong procurement function that delivered a number of benefits over the years. They're tasked with driving, not only the price that we buy raw materials and various direct and indirect costs, but also the volume. I mean, how people are consuming particularly on indirects. And I've always said since I've been here, one of the biggest advantages of having a company where you've got a large number of fragmented operations is there's always opportunities for improvement and they continue to be so.

Cole: Great. Thank you very much.

Miles Roberts: Well, thank you very much everybody for your time this morning. Just a note that trading, we've seen the increase in volumes, we're seeing the effects on our full year on the margins and we look forward to the rest of the year to continue making good progress. Thank you very much for your time.