6 November 2018

DS Smith Pre-Close Trading Statement Conference Call

Speaker Key:

MR	Miles Roberts
AM	Adrian Marsh
DO	David O'Brien
BD	Barry Dixon
CH	Cole Hathorn

MR Good morning, everybody. Thank you very much for joining us today. I'm Miles Roberts, the CEO of DS Smith, and I'm joined by Adrian Marsh, our CFO. Our trading update released this morning relates to the six-month period ending on 31 October 2018. So, overall, the business continues to perform in line with our expectations with business trends consistent with our trading update in September. We expect the return on sales and adjusted operating profit in the first half to be materially ahead of a comparable period, following recovery of increased input costs early in the year and good volume growth from our very highly resilient FMCG-focused business.

The integration of interstate resources continues to go very well with major customers now procuring from us in both Europe and the US. And as we discussed in detail at our recent capital markets day, we remain highly focused on cash management and anticipate cash flow from operations to be significantly ahead of the prior period. The previously announced strategic review of our plastics business is also going well.

The regulatory process for the proposed acquisition of Europac continues to be in line with our expectations with completion of the acquisition expected by the end of this calendar year. This is a timetable we anticipated from the outset. We look forward to completing this acquisition, an excellent business with excellent people, which will expand our position in the very important growth market in Iberia.

So, overall, we have a highly resilient business with our short paper business model focused on value-added packaging for our FMCG customers. We continue to see strong customer support for our innovative sustainable packaging, responding to the dynamic retail environment. We expect good ongoing volume and market share growth and view the future with confidence. I would now like to invite any questions anybody may have, and Adrian or myself will certainly try to answer them, thank you.

DO Good morning, guys. Just a couple of questions from me, please. Firstly, just on volume performance, some of your peers have noted a slight softening of volume across Europe in the last couple of months. Could you give us some colour on your own experiences and maybe any differences you see in regional performance across Europe, and also any differences across different industries that you're serving. Secondly, just on your comment on the recovery of higher input costs, if we go back over the last four halves and just using your EBITA bridges that you give in your presentation, your price cost has been a headwind for, probably, four of those periods consecutively now. So, when we see that in December when we get that presentation, are we likely to see that upturn positive now, just given the catch-up on corrugated pricing versus container board?

MR Absolutely. Well, look, just starting with the first question on the volumes, now, I said, we're very focused in the FMCG sector and this has always proved to be very resilient. Basically, people, consumers don't stop eating and drinking, and we continue to take very strong share in that market for a number of reasons, such as our big customers continue to consolidate their supply chain, the environmental debates, etc. So, when we look at our volume overall, it remains very robust. In fact, Q2 is pretty much the same as… well, we haven't got Q2 numbers yet, but we expect it to show a similar trait to Q1. And indeed, we've talked previously—we think it's always between about 3 and 5%, and we are very likely to be in that range. All our regions are in growth. People have asked us a lot about the UK because clearly, the market and the economy is under some significant pressure there.

We continue to grow quite nicely, but then we aren't focused in the areas that are probably seeing more negative impact from Brexit. So, overall, we continue to grow regionally. I think, it's pretty consistent, and that remains our outlook, I have to say, for the second half of the year; a good, solid, underlying volume growth, which falls to the bottom line very nicely, as you've seen in our bridges. And on those higher input costs, you're absolutely right, David: because it takes us three–four months to recover increasing paper prices, given paper prices have been rising pretty consistently for most of those four periods, there's always been a lag. Obviously, you get the other side of that when paper prices go down; obviously, that acts as quite a tailwind for our business, particularly as we still have to buy a lot of paper externally. Have to say, over that period, it's been pretty clear that our margins have either stayed the same or been increasing, but we're very clear; we've always said to everybody, we will recover the paper cost increases. The last increase in paper was really coming through in February, so that's, what, eight/nine months ago. And you'll see in this half, we're saying that we've fully recovered, where we sit today, those last increases, so you should certainly see that in our bridge at the half-year, and we'll see what happens with paper prices going forwards. We're very pleased with our position there. We've done what we said we were going to do.

DO That's very helpful, thanks. If I could just follow up on one comment, are you seeing any softness in paper prices that could perhaps help margin performance into the second half of 2019?

MR I think, where we are, we're seeing that paper prices have certainly been flat for the last five months, something like that. There are always some ups and downs; there are a few ups on some certain grades, and clearly on some other grades, there are also some downs, but these are the normal ebb and flow of business at the moment. It's very difficult to predict. As I said, there are always some local ups and downs and that's what we continue to see. Demand remains quite robust; we're certainly seeing that. I think, we'll know a lot more as we get towards Christmas and everybody starts thinking about 2019. So, demand remains pretty strong. I have to say, I've just returned from the US this morning, and my goodness me, is it busy there. We're seeing very strong demand indeed, and pricing seems very robust indeed, very robust. So, overall, we're okay with the position but we'll know a lot more towards the end of the year.

DO That's very helpful, Miles. Thanks very much.

MR Not at all.

BD Yes, good morning, Miles; morning, Adrian. Just following up on that, Miles, I think, in September, you talked about volume growth at 4%. When you say the Q2 volumes are similar to Q1, and sorry to be labouring the point, but are we talking about the 4%, or has it dipped below that 4% in Q2? Secondly, just in terms of OCC costs, and again, lots of chat around about what's happening on OCC costs, and, obviously, it's a big input to costs for a lot of companies, including yourselves, any thoughts in terms of what you're seeing there, particularly given the size of your recycling business in the UK, and the exposure, I suppose, to China, if you're seeing anything on that side?

And then, just finally, in terms of other costs, again, hearing talk about labour cost pressures, other raw material cost pressures, transport, etc, just your thoughts around that and the ability to recover those non-raw material cost increases, in terms of corrugated prices? Thank you.

MR So, firstly, just on the volumes, we've said, between 3 and 5%, I think, is exactly what we said at the update in September. We didn't say it was 4%. We just said, between 3 and 5, and we continue to see the volumes in there. The 3% is where we've been, pretty much, historically. Last year, we did have an absolutely bumper year of 5%. So, we still sit within that range, and it's really based on that FMCG… it's just so consistent, how it works.

With the OCC cost, as you know, there's been quite a bit of volatility here, not just in headline price, but also in the different grades of OCC. There was a lot of talk a while ago about China and what China are going to do. Well, China are rigorously enforcing their import restrictions on poor quality fibre, and poor quality of any refuse, really. I think, you've seen it in many sectors, and this continues to pull down the overall cost of OCC. We've seen, really, the overall cost staying pretty static. Now, some of the higher grades have been going up, but some of the lower grades have been coming down. And as you know, as you referred to, Barry, we've got a very, very substantial recycling business. There are quite a few local regional differences, not just across Europe, but into the US as well. So, how we source, we're able to use far more mixed papers.

We've got very flexible production techniques/skills in this area that really allow us to manage those costs. So, we haven't seen any great increases. Again, we'll see at the new year, when all the licenses are coming out, but I wouldn't be surprised if the current position stays as it is. There seems to be no let-up in what China's doing. And in terms of the other cost pressures, you're absolutely right: there's some cost inflation coming through. Some areas, there's a bit more in energy; as you know, we get constant wage increases. Really, across Europe, we're averaging about just over 2%. There's still quite high unemployment in quite a few places in Europe; if you go into Spain, Germany, Italy, the southern states, there's still a lot of quite high structural unemployment. I was looking—unemployment in France is still well over 9%, and equally in Spain. So, there are some pressures there.

To be honest, with you, we view these costs as just part of our ongoing management. They've always been there; we've always had these sorts of issues to deal with, and the way we have historically dealt with them, and indeed, continue to deal with them is through that continuous improvement in the way that we're operating. We've got good underlying volume growth. There's a lot of work we can do with efficiency. We're seeing the synergies come through from our acquisitions, but also in our core business as well. As we've become bigger, we're more able to compare and contrast across the business. So, there are pressures there, but these are the pressures that we're here to deal with on a day-to-day basis, and we're not seeing any huge overall increase. There are, obviously, local things, a bit of transport, regionally, we can get some energy, but equally, there are some other costs that have moderated, so it doesn't give us any particular cause for concern. It's just part of the day job really.

BD Okay. Thanks very much, guys. Well done.

MR Thanks, Barry.

CH Morning, Miles. Could you give us a little bit more colour on your new box plant expansion? So, I believe, you've secured a location for a new box plant in the US, as well as Poland, and just give us a little bit more colour as to how those regions are going?

MR Yes we're responding to our customers, our demand, and since entering the US, we've had absolutely tremendous demand from our customers. And indeed, we announced some time ago, but recently entered into an agreement where a new factory will be built by a developer, etc. This is in Indiana. It's very close to a number of our customers. We're going to use the sort of technology that they want us to see. And again, all the costs and the timing of that are all within the guidance that we've previously given shareholders. And again, we've said, the cash flow in the business is doing very well, and that, obviously, includes all the capex expenditure. So, we're quite excited about that. I have to say, we've had a fabulous reception from the state as well, who've been very supportive of this. It brings some jobs to an area where we’re seeing our customers grow quite rapidly, but most importantly, they want this performance-based packaging helping them have the right sort of packaging for on-shelf display. It’s using our existing technology in Europe. We couldn’t find somebody to buy in that region with the technology that we need, so we’re really quite excited about that, really building on the success of the Interstate acquisition.

Again, in Poland—we’ve announced this previously—our Eastern European business has been booming, it really has, for quite a few years; we enjoy phenomenal success there. And Poland is one of those countries; go back a few years; we had one factory then two, then three. Now it’s over six, and we are extremely short of capacity now to meet our customer’s demands. So, we are closing in on, again, having a plant built, which we’ll lease afterwards, again, using our existing technology, but really built on the success that we’ve enjoyed there. So, two very exciting projects, but I have to say, with very, very attractive paybacks on them as well, very attractive financial returns.

CH And then just a quick comment on margins; you talked about your margins being materially ahead of last years as you benefit from higher box prices offsetting paper costs. As we look for the full year, do you expect margins to be even higher then as you get the full benefit of higher box prices as well as the benefit from acquisitions? Is that how we should be thinking about it?

MR Look, we’re very comfortable with full-year guidance, very comfortable with that indeed, and, I think, people are broadly expecting margins to come up pretty strongly, and as I said, we’re very comfortable with those expectations. We’ve enjoyed many years of increasing margins. Last year, the margin was flat with the previous years. We had a lot of input cost. You can see the additional input cost that we had. As I say, we’re now recovering them, plus we’ve got our volume growth. We should expect to see our margins climbing, and that’s exactly what we’re seeing.

CH Well, I don't know if maybe this is one for Adrian, but is there a level where paper prices get implemented into box prices? Is there a threshold I should be thinking about? So, even if there is a €20–a-ton moving container board prices, does it actually trigger anything in your box prices, or do we need a more significant amount to trigger box price changes?

MR Adrian, do you want to cover?

AM Yes, thanks. In terms of indices, every contract will be constructed slightly differently. You’ve got the ones that will run through on a quarterly index, ones that will run through on a shorter time frame.. They’ll all have a level of movement, in which to expect triggers. But, I think, it’s reasonable to assume that a small marginal move in the price doesn’t impact the indices at all. They do rely, on the way up and on the way down, on significant movements. And the €10/20 you’re alluding to is unlikely to be significant within our overall box business across Europe. And again, within that, every country is slightly different, so it’s quite hard to be too prescriptive, but on small movements upwards and downwards, it's unlikely to have a material impact on index-based contracts.

MR No, I expect that's absolutely right.

CH Great. Thank you for your clarity.

MR These board changes make no difference.

CH Miles, just one last follow-up on the Europac acquisition: Is there a more detailed timeline that you can give us for the completion besides the end of Q4? Should we be right in thinking that it should be December timeframe?

MR Yes, the reason we haven't given a more definitive timetable is, it's partly outside of our control. It requires various paths, etc, but December is where it's looking like. The competition authorities, we expect to announce the results of their review next week. That timetable is all in accordance with our expectations at the time of the announcement of the acquisition, and the engagement with them has been very good and very thorough, and all the discussion with them, very much in line with our expectations. With CNMV, which is a Spanish regulatory authority, their timetable is a little undefined, but again, we've had a good contact with them, to date. So, we'll wait and see, but all that process has gone very well, so we are expecting it to be in December. It's unlikely that it will be at the end of this month.

CH Okay, great. Thank you.

MR Well, thank you, once again, everybody, for your time. We do appreciate that, and just to say, we expect to see ongoing good growth of our business, market share gains and we view the future with confidence. Thank you very much.