DS Smith Interim Management Statement
13 March 2013

Speaker key

OP	Operator
MR	Miles Roberts
SD	Steve Dryden
JJ	Justin Jordan - Jeffries
KS	Kartik Swaminathan - BoAML
BD	Barry Dixon - Davy
DP	David Phillips - Citi
DO	David O'Brien - Goodbody
JW	Julian Wellington - JPMorgan

OP Good morning, ladies and gentlemen, and welcome to the DS Smith Interim Management Statement Conference Call hosted by Miles Roberts. My name is Andra and I'll be your coordinator for today's conference. For the duration of the call, you will be on listen-only; however, at the end of the call, you will have the opportunity to ask questions. If at any time you need assistance, please press star zero on your telephone keypad and you will be connected to an operator. I'm now handing you over to Miles Roberts to begin today's conference. Please go ahead, sir.

MR Good morning, everybody, and thank you very much for joining us on the call today. I'm Miles Roberts, the CEO of DS Smith, and I'm joined by Steve Dryden, our Group Finance Director. This morning we are pleased to release our Q3 IMS and I'd like to take a few minutes to run through the highlights of that statement, after which Steve and I are very pleased to take your questions.

Before getting into the detail, by way of outline, I would say that we're encouraged by another very robust quarter for DS Smith. The corrugated packaging volume delivery is fully in line with our GDP plus 1% target, led by a robust performance in the legacy DS Smith business. The economic environment in Europe remains challenging, and the profit outlook on paper is tough, and our business model remains resilient with DS Smith on track to deliver substantial year on year EPS growth. So, in terms of trading and outlook for the Group as a whole, we continue to see profit in line with expectations, a solid performance in Packaging, and a strong delivery of the previously announced synergies from the acquisition of SCA Packaging. We really are very pleased with how the integration is proceeding. Our Packaging business has continued to perform as we expected, despite the difficult European macroeconomic conditions, particularly in certain economic markets. Volume growth is in line with our GDP plus 1% medium term target, and the legacy DS Smith business has outperformed its target, whilst the SCA has been held back by our previously announced strategic decision to exit business that does not deliver attractive returns to our shareholders. The performance of Paper continues to be poor, and we still remain cautious on the profit outlook for this division with anticipated rising input costs and new capacity coming on stream later in the year. And some of the highlights from Packaging: the integration continues to proceed well and we're on track to deliver £100 million of annual cost savings and £130 million of cash savings earlier than we had previously expected. We remain on track to deliver £100 million of proceeds of surplus property and non-core businesses by the end year three, and as part of that disposal programme the three previously announced remedy disposals, as required by the European Competition Authorities, have now completed on an exit multiple of 7.7 times, raising €55 million. If you remember, we bought the SCA business on a multiple of 6 times. The timing of the completion of the remedy disposal will reduce EBITA by 2 million in the current year, and about 5 million in 2013/'14, as we said at the EBITA level. The business continues to generate strong cash flow and we expect the ratio of net debt to EBITDA to be below 2 times by 30th April 2013.

And, finally, with regard to the outlook, we continue to expect substantial year on year EPS growth, and above cost of capital returns, and the Board views the remainder of the year with confidence. Looking ahead to the new financial year, we expect the SCA packaging acquisition to deliver returns ahead of the original investment case, but we remain cautious on the outlook for our Paper business, with the recently announced paper price increases only partially offsetting the higher input prices, and expected impact of additional capacity in the European paper market. This reaffirms our strategic decision to be short in Paper, and we continue to evaluate our options to reduce this more volatile business with a view to further improving the Group's overall return on capital. Our business model remains resilient. DS Smith is very well placed to create further substantial value for our investors. We're pleased with the continuing progress on the integration of SCA and faster delivery of synergy benefits, although we are cautious on the outlook for Europe and expect the difficult market conditions, which we've seen for some time now, to persist. We continue to focus on strengthening of business and our commercial proposition across a significantly enlarged geographic footprint, and look forward at how best to work and serve our customers.

Steve and I are now very happy to take any questions you have, and I would remind you that our pre close up date is due in about seven or eight weeks now, on 24 April, and we'll give you a fuller update on the full year to April 2013 then. Thank you. Operator, if you would take over now for questions.

OP Thank you. Ladies and gentlemen, if you would like to ask a question, please press star one on your telephone keypads. If you change your mind and wish to withdraw your question, please press star one again. You will be advised when to ask your question. The first question comes from the line of Justin Jordan from Jeffries. Please go ahead.

JJ Good morning, gentlemen. I'm just trying to get a little bit more clarity on what you're talking about in terms of the announced paper price increase is only partially offset by higher input costs and expected impact of additional capacity. I'm assuming you're referring to the consensual EUR60 a ton that most producers seem to have certainly announced if not fully implemented for Testliner. Can you just remind us your short position in Testliner as a proportion of overall production, as it were? And effectively, what we're talking about is higher input costs for you and obviously a time lag in recovering that through higher corrugated prices at the other end. Is that effectively what you're talking about?

MR Yes. What happens with Paper is that the profitability is really a function of supply and demand, and it's therefore, if it's an industry issue and paper can move around Europe, and, indeed, across continents relatively easily, so we always feel we have very, very little pricing power in this business. And the returns on capital from this business are very poor. Therefore, traditionally, DS Smith has only made about 40% to 45% of the paper that the packaging needs, and that's why our return on capital is so much more consistent and higher than the industry norms. Now, what's happened recently is the profitability of paper has been so poor there has been some cost-driven, not demand but cost-driven price rises, price announcements over the last year, of which very few have actually succeeded. At the moment, there is a current price increase, and indeed, some of it is, at the moment, is sticking. But, of course, you've got an increase in raw material costs as well increasing fibre and energy, etc, and the history of these price increases is when new capacity comes on stream, it tends to undermine that. So yes, we can see increases have come through. That may raise the price of paper. But raw material costs are increasing. And all we're saying is, we just remain very cautious on the outlook for profitability. If the price increases do stick and raw materials come off, then it may get better. But I'll be quite honest; we're still a very large producer and until we see a sustained increase in pricing and profitability that's demand-led, we're certainly not calling it into our result, and we'll wait to see. It's just very, very early days.

JJ Thank you. Can you just share with us what sort of pricing momentum, if any, you have in Corrugated? Obviously, I'm fully aware of the raw material testliner price increase for you and how that affects your business, and equally what we're seeing in OCC, but in terms of the end customer or corrugated prices, are they flat? What's happening on those?

MR Yes. I mean, we have done a lot of work in DS Smith. Because of our short paper position it means that we have to be in a position where we can pass on, either way, changes in raw material costs. And obviously raw material for us is paper. So, in the old DS Smith business, we typically had about a three month lag between changes in input costs and change in the price of a box. It's not in every contract, but that's the average that we have across the business. And, indeed, over the last few years we have routinely recovered increases, and we've passed reductions back to our customers. Because we're not trying to second guess the paper cycle, because we're short in paper. And the reason we're short is because it doesn't produce its cost to capital. With paper prices going up, you'll start to see, although there is a lag, you'll start to see box prices going up. Traditionally, if you look over the last few years, we've always recovered every penny within that time period. The challenge for us is converting the SCA business, which has been more like six months, down to three months in the contract period, and that's something which we're well on with, and just changing customers over. One of the things we found, actually, was that customers were generally pretty okay with that. It wasn't a huge issue because I think they can just see that there's no point in trying to second guess the paper cycle. But we do have more work to do on the SCA business, and I think that will probably take, would you say, Steve, another year to get that fully in place in terms of the contract period?

SD Yes, well, it took DS Smith 18 months to get it down, so yes, probably another year for SCA.

MR Yes, something like that.

JJ Thanks. Can I just have one follow up question? Obviously, you are a major euro revenue and profit generator at this point, and just bearing in mind the movement we've seen in sterling/euro in the last few weeks and months is pretty dramatic. Can you remind us of the sensitivity of the business, and can you also just remind us of what hedging, if any, you have in place in terms of managing that sensitivity. Or should we fully reflect the changes in currency movements into the modelling assumptions going forward?

SD Justin, Steve here. The previous guidance we gave still holds at a PBT level, one euro cent is £1 million at translation. Then on the hedge, we don't hedge translation. And frankly, most of the goods and services that we supply we tend to find that we are invoicing and receiving payment within that one currency. There's very few cross border. There are some kraft import. That might be in dollars and we'll hedge that forward. But predominantly, yes, recover a limited amount of transaction. But we don’t cover the translation side.

JJ So it's really the translational impact, which you think might…?

SD Yes, that's right. But the contra I'd say about the movements in exchange rate, I do think some of them do reflect relative GDPs, and if GDP is a bit weaker, obviously our target for growth is GDP plus 1%. And in particular in the last quarter, in terms of what we're reporting here, GDP across the markets that we operate in, and weighted by the revenue of that, of the markets, is minus 0.4%.

JJ Thank you very much.

OP The next question comes from the line of Kartik Swaminathan from BoAML. Please go ahead.

KS Hi, gentlemen. Thanks for taking my question. First question was whether you could provide us with a little bit of colour as to the other initiatives beyond the synergy programme that we've been hearing about in trade publications and, most significantly, what you're doing on the UK recycling side. And secondly, if you could also very quickly do a quick run through of how trading is going across the continent, with respect to your different geographic regions, please.

MR Maybe if I just take the second question first, because it all impinges on the recycling. Different markets. What we've seen is, overall, GDP in Europe fell last year, and indeed the final quarter wasn't a great period for GDP growth. We've seen the UK pretty flat. France has always been flat, but there's no doubt that, over the last six months, the economy has just suffered from a bit of a lack of confidence, and that's pulled economic activity down slightly. There's the well-publicised reduction in Germany as well, and Italy and Spain remain difficult and Eastern Europe moving forward. In current trading, again the UK remain flat; I think France is difficult. Italy is difficult and Spain is. But Germany is certainly picking up and Eastern Europe is reasonably… maintains its strong momentum. So if I characterise last year, it's sort of flat first half - this is calendar year. Coming off of this in the second half, obviously, a few changes in governments had an effect there. And, at the moment, some of those economies are perhaps slightly more positive but generally UK, France, Italy not a lot of change from the second half of last year. This is why, as a Group, we position ourselves so strongly in FMCG. And I have to say the overall business in volumes grew quite nicely. We continue to outperform our target of GDP plus 1%. SCA was slightly below the target but with a strategic exit from low margin business as we've announced. So overall our volumes continue to grow despite the very difficult backdrop. I think that with our real focus on the right segments in the market, that's customer segmentation and category segmentation, we're getting better at this all the time. And this is very much where we feel a lot of value can come from the SCA acquisition, enabling us to segment customer and categories much more finely and put much greater emphasis and resource and capability behind those customers. And, in fact, that's part of the reason why we continue to grow, because it's working. And you can really see that in the legacy DS Smith business, and we can start to see it in the SCA packaging. But that is against a very uncertain economic outlook. I certainly don't expect Europe to be picking up in 2013. That's probably pessimistic, but I just can't see what's going to trigger it. We're just not seeing it. So we are cautious on the European economy there for 2013. But it's quite interesting.

You mentioned about recycling. As you know, we focus very much on recycled packaging. I don't particularly want to sell kraft papers. We feel that's not a long term future for Europe for the customer, and what we're finding is our ability to recycle with our recycling arm working with our customers, the big retailers; working with our final customers, you can see people want to use more recycled. They don't want to use kraft. And we're seeing a very nice rate of conversion from kraft going into recycled now, and we think this is going to continue for some time. New qualities of recycle, particularly in white tops coming on, which has traditionally been a strong point for kraft. We think that rate of conversion will increase. And our recycling arm is a major part of that in making sure that Europe is able to capture as much of the lost fibre as possible. In terms of the UK, our recycling business there has done well and continues to. It works, as you know, with all the major retailers. We're in specialised vehicles where we go and collect the refuse, and we work with them as to how to use more corrugated. And we're pleased with that. Our challenge is to get the same UK model onto the continent. We're working on that. It's in our plans always; it's going to take a little while. In Eastern Europe it's coming along very nicely. Good operations there. But still we're looking to get into France and Italy. But our plans are well developed there and we'll obviously update you as soon as we have something really major to announce. It's challenging but we're very focused on getting a strong foothold there.

SD I think the news items that you've seen Kartik, that you refer to, is we're effectively implementing our synergy plan. Part of our overall synergy plan is in recycling and some of that's in the UK, where we do have overlaps of depots. So we are removing that duplication and selling any surplus that's there. Also, certain parts of the business we inherited that we don't feel the margins and the returns are attractive, so we're looking commercially to either improve those terms or we're not doing that work. And I think that's what you've seen in the press, Kartik.

KS And sorry, just to follow up very quickly, how do you see that feeding through into your overall target? Would that be a kind of marginal bonus on where you see trading conditions now, and how that can support profitability, or is that too small to really factor in?

SD No, sorry, when you look at our cost synergies, Kartik, they are broken out by country, by business, by manager, and specifically there is a section in there for recycling. There's a section subset in there for recycling UK and that's what is being implemented. So what you're seeing coming through in your news feeds is just us implementing on the synergy delivery plan.

KS Okay, understood.

OP The next question comes from the line of Barry Dixon from Davy. Please go ahead.

BD Good morning, gentlemen, a couple of questions, please. Just in terms of the completion accounts, could you give us some colour in terms of how negotiations are going around that? And also, do you have a date when you expect that to be completed? And the second question is in terms of the new capacity that you've talked about coming on stream in container board. Does that refer to the Stora plant in Poland and the VPK plant, or are there other stuff that you're seeing? Thank you.

MR Normally, on the completion accounts, the truth is it's all going according to the SPA, as we always expect. There are some issues, which we are in discussion about. By their size these go through a very prescribed process and we are going through that process fully as the SPA requires. As soon as we have something, we'll come back and tell the market, but we haven't assumed any recovery, anything at all in our accounts or our announcements. But it's always going to take a little while because there's a prescribed process. And in terms of the capacity, testliner, we have mentioned two mills are coming on stream in 2013. More capacity. As you know, we've got plenty of, ready supplies in the market, and indeed we hear rumours of further capacity, but they are only rumours that we're hearing and the only real firm announcements are the ones that you've just mentioned. I think those two. You got 450 in the UK. I think you got about another 700,000 tons coming on stream in Europe in 2013.

BD Thank you.

OP The next question comes from the line of David Phillips from Citi. Please go ahead.

DP Good morning, everybody. You've covered a couple of the ones I was going to ask. I was just going to come back to revenue synergy, something we've talked about in the past. Previously you said let's wait until June/July. Is that still the same scale that you will go into more detail on revenues?

MR Yes, absolutely. We're going to hold an investor day in the first half of the financial year. We've got to get a date out. It's going to be in the autumn, something like that, and we'll come back. I think we really want to… It's not just a few vague things. We want to really give people a sense of the segmentation and what we're going to be doing, etc, and we'll come back and outline a lot more of that. But I would argue quite strongly; you've seen us consistently grow volumes throughout the last few years, profitable volumes. You can see our margins and our return on capital; it isn't running around the market trying to buy volume. It's profitable growth. So what we're doing we feel is working, but we will be coming back in the autumn to talk a lot more about it.

DP Would you characterise the top 30 customers? With the growth rates and volumes that you're seeing there, would you put a figure on that? Is it a high single digit?

MR Well, the last time we actually published a number in our top 20 customers, which was last financial year, I think we said our revenue growth there was 13% year on year. And the volume growth wasn't far behind that. That was the last figure we gave in legacy DS Smith business. I think the volume growth there was about 7% year on year. That's the last time we published a figure, which was on last year's results, was it, Steve?

SD Yes.

MR Yes, last year's results. So it's been very strong.

DP Similar level maintained?

MR Well, we've got the SCA business and everything we say has to be audited, etc, and gone through and checked on where it is, so that is one of the reasons we haven't been saying things. But it won't be at that same level because, obviously, we're getting SCA people on board with everything else we do, so the combined Group will certainly be lower than that but it is better than the Group average, which is already ahead of GDP, etc.

DP Great. Just a small division for you, but Plastics was growing quite nicely historically and you've not mentioned it. Is that still showing the same high levels of growth or has there been a bit of a tail off in recent months?

MR No. Plastics we're very pleased with. The Bag-in-Box - we're the second largest in the world. We're behind a US privately owned business, and we're absolutely delighted with that. That continues to go very well as it has done over the last few years. We opened a new site, we've got more capacity coming on, and it ties in so nicely with the Corrugated. Driving the growth of the Bag-in-Box, that's what we're really about and that's why we've got such a strong market share. And that continues to do very well.

DP Thank you. And just finally, just coming back to currency and the euro. At what point should I start thinking about the switch from the euro being an insulating factor to a helpful factor, something that can actually boost maybe not 2013 but 2014 levels. Is it a case of another quarter of rates where they are and we can be thinking about trying to factor through that one million per euro cent in forecasts, or is it still an insulating trend for now?

MR I think, as I said earlier, David, I think you've got to take the two things. I think you've got to take the exchange rate and also what's happening on GDP and what's your growth assumptions. As you know, our medium term target is GDP plus 1%, and we've achieved that in the last quarter in terms of this IMS, so I think you've got to think on those two. But yes, I think the exchange rate has taken a step down. I'd probably wait another quarter before you start thinking about whether you're going to feed that through or not. At the same time consider as well GDP, and hence our relative growth levels.

DP Understood. Thank you very much

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

DO Just one question from me. You noted in the statement that you're going to evaluate the strategic options to reduce your paper exposure. I'm just wondering is there any underlying assumption of paper disposals in your 100 million disposal target that you outlined for synergies for SCA?

MR No, there isn't. There's no assumption there in the 100 million. That's purely the remedy disposal plus other surplus assets, property, etc, that we are currently disposing of. So that will be the subject of a completely separate announcement, if and when we make that decision. And then obviously the disposal number can change. But there's nothing in there.

DO That's fine. Thank you.

MR Is there one last question?

OP The last question comes from the line of Hector… from Julian Wellington from JPMorgan. Please go ahead.

JW Morning, Miles. Morning, Steve. Two questions from me, if I may. Firstly, you've mentioned about the packaging growth in Europe being in line with GDP plus 1%. I just wondered if you could talk about the trend in industrial packaging versus FMCG and how that's been going. And then, secondly, on the businesses that you've been de-emphasising in SCA, the ones you talk about, the lower margin ones, could you touch on what maybe the tonnages are or what the quantum of that is, and if possible which geographies they're in, please? Thank you.

MR When we took the business over, there're some parts that haven't done, and we don't think will make the cost of capital, and we said it'd be up to 4% of turnover. That's what we said at the time of the acquisition, and that was in our statement there, and nothing has changed on that. Sometimes these have slightly longer term natures, but that is gradually coming out and that is broadly what's held the ex-SCA growth back. But we did say it'd be up to 4% of the SCA turnover over, I guess, the first couple of years. Then secondly, if we look at the growth, it hasn't really changed from our half year numbers where the economies were overall in decline, we're still growing, and there we have seen the FMCG really grow quite a bit stronger than our average, and Industrial was more or less at the GDP level. So you can see there's quite a strong outperformance in FMCG and that's back to our segmentation, about where we're really focusing customers and categories. And this is what we will outline a lot more at our investor day because it has been so strong and I think we need to outline to people how it's been successful and why and how we see that going forward and how we want to continue to strengthen our position in that market. And for the last quarter, those volumes have been pretty much the same; FMCG very strong and Industrial at or around GDP level.

JW Very good. Thank you very much.

MR And it's still that state. Well, can I just say to everybody thank you very much for your time this morning. We do appreciate it. And as a final few words, the economic environment in Europe remains challenging. The outlook for Paper, I think, will remain pretty much as it has. It's going to be tough. But our business model remains resilient and DS Smith is on track to deliver substantial year on year growth as the Board considers the rest of the year with confidence. Thank you very much for your time, gentlemen.

OP Thank you for joining today's conference call.