DS Smith Interim Management Statement
March 10, 2011
8:15 am Greenwich Mean Time

Operator: *Welcome to the DS Smith Interim Management Statement Conference Call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session. Please note that this conference is being recorded.*

I will now turn the call over to your host, Miles Roberts. Sir, you may begin.

Miles Roberts: Good morning, everybody, and thank you for joining us today. I'm Miles Roberts, the CEO of DS Smith; and I'm joined with Steve Dryden, our Finance Director.

You will have seen our Q3 IMS, which was released to the markets earlier this morning, but let me briefly run though the highlights, which also include some key new Group efficiency targets and further benefits arising from the Otor acquisition. This is ahead of the Recycle Packaging Investor Seminar we'll be hosting this afternoon.

But firstly trading. Overall, trading in the latest period has been good, with like-for-like volume growth in corrugated packaging of 8%. This is a result of our continued focus on service, quality, and innovation, which means that we are growing strongly with our existing customers.

Profitability for the period is fully in line with expectations.

In Packaging, we're seeing strong revenue growth in the period, up 27% in the UK and 23% in Europe on a full like-for-like basis, and this has been driven by that strong volume growth that I spoke about earlier. And in addition to that, the consistent recovery of the rising of the increase in input costs, albeit with the usual delay, and this success is due to our continued focus on adding value to our customers.

In Plastics, the business is seeing like-for-like revenue of 7% and continues to see excellent volume growth, and elsewhere, trading at Spicers has been satisfactory with profitability for the division ahead of the comparable period last year through a combination of cost control and focus on margin management.

As I mentioned, we also be updating investors on Otor and new Group efficiency targets this afternoon. But in a nutshell, Otor is progressing very well. Commercial benefits of the Otor acquisition are already beginning to be realised. And in the first six months of ownership, we've exceeded our expectations and have already secured additional business equivalent to 4% of the Otor business we acquired and substantial opportunities remain. We reaffirm our previously announced cost efficiency target of €10.3 million. At the time of acquisition, this was estimated at €9.3 million.

In terms of efficiency savings in the U.K. business, we're targeting reduction in working capital of around £75 million. We're already seeing early success of this work with £30 million taken out of working capital in this financial year to date. And in procurement, we're targeting by April 2012 annual cost savings of £10 million. These two targets follow-on from the £10 million of cost efficiency savings already announced in December 2010. These demonstrate the actions that we're taking to ensure the Group achieves its financial objectives of volume growth of at least 3% per annum, that's growing ahead of GDP, a return on sales of between 6 and 8%, and a return on a capital consistently between 12 and 15%. These KPIs all represent a significant increase on historic performance.

So to conclude, we expect the year to progress in line with expectations for significant EPS growth, reflecting the continued benefit of our focus on service, quality, and innovation to our customers. Notwithstanding further input cost increases, which we're expecting the fourth quarter of the year, we look forward to the remainder of the year with confidence.

Finally, but importantly on our outlook, for the coming financial year to April 2012, the Group expects to continue to make progress towards its financial objectives we set out in December 2010.

Thank you. I'll now hand over to the operator for a question-and-answer session.

Operator: *Thank you. We will now begin the question-and-answer session. If you have a question, please press star then one on your touchtone phone. If you wish to be removed from the queue, please press the hash key or the pound sign. If you are using a speakerphone, you may need to pick up the handset first before pressing the numbers. Once again, if you have a question, please press star then one on your touchtone phone.*

Myles Allsop from UBS is online with a question.

Myles Allsop: Hi, I've got a few questions. **First of all, when you talk about making further progress towards the targets in 2012, do you expect to be within your range in 2012? If we're at, what, sort of 5% EBIT margin today, are we going to be 6-to-8% next year?**

Miles Roberts: As I said, we're making very good progress. We don't give formal forecasts for next year; however, the market consensus for us is within that range, and we're very comfortable with the expectations the City has on us.

Myles Allsop: Okay. **And then a couple of the other things you talked about in December was closing or exiting capacity and streamlining the business, is there any kind of update on those two elements?**

Miles Roberts: No. On the streamline, we've announced this and we've been very busy with that. When we have the Investor Presentation this afternoon, we'll be running through what's going to happen particularly in the U.K. to streamline our operations. And in terms of parts of the Group that will be with us or not be with us, et cetera, we just continue to work on that as we've previously announced.

Myles Allsop: **Are you confident that we will see material change over the next 12 months or have we got to keep it vague because of the uncertainty in the markets today?**

Miles Roberts: Yeah, - we put a timeframe of the next three years to get it tidied up. Let's just say, we're very comfortable with that range, and I say today we're very pleased with the progress that we're making. But as you say, things always a little but uncertain out there, but we very pleased with the progress.

Myles Allsop: Okay. **And then with the Otor and the synergies, €10 million, you revised them up in December, do they include the additional revenues? I presume that's not part of that.**

Miles Roberts: No, the €10.3m is purely cost. We are very comfortable with that. And on the revenue, this is business that we've actually won. This isn't about future opportunities. It's done. It's sealed, but it isn't in those like-for-like numbers because of volume growth because it's only just starting to come in. But again, we'll be running through a lot more detail of this this afternoon when Jean-Marie Paultes, the MD of Packaging France, will be presenting just exactly how this has arisen.

Myles Allsop: Okay. **And with the procurement savings, these new £10 million procurement savings, have you set up this central team? Is that already starting to come through or is this something that's in the process of about to start?**

Miles Roberts: There are people today in our head office. We have an interim head of procurement. He's been with us for a number of months. He has a procurement team behind him that's being recruited. This afternoon Steve Dryden will take people through the detail of some of the successes. This is a very exciting area for us.

Myles Allsop: Okay. **So it's actually, the process is already rolling in terms of delivering on it?**

Miles Roberts: They are there and we will give examples of exactly what has been achieved, and we're very pleased with that.

Myles Allsop: Okay. And maybe one last question and then I'll let some other people get on it. **On the energy cost side, I mean obviously that's been an issue for DS Smith in the past, could you give us a sense of as what we should be concerned about, and what degree of your energy cost is hedged, what the step-up we're likely to see in 2012? Just give us a sense of that risk.**

Miles Roberts: It's just energy costs, distribution costs, raw material costs are rising significantly. I think the very important thing… But I'll come back and talk more about that. But ultimately this is something that affects everybody. The key to success is that you add value to your customers. If you're just commoditised, it's going to be very difficult. And looking over the next few years, the companies that really add value to their customer base will be the ones who can secure the price increases they need. It is a key focus for us and whilst we don't like the input cost inflation, today we are - - we're very comfortable with the city's numbers because we are consistently recovering because of our focus on added value.

I'll ask Steve to comment in on the energy costs. They are significant, but I would ask our investors to keep that in their minds. It's about cost recovery consistently because we add value, and that is exactly where it is with us today.

Steve Dryden: I think the history you're referring to is when DS Smith came out of a multi-year fixed price contract that was below the market and there was a significant step up. We're not in those sorts of contractual arrangements now. Hedging which helps reduce the volatility of the energy costs. In terms of next year's cost increases, Myles, could be if I looked at the price today and compare it to this year's costs, you could be looking at about nearly a £10 million increase. But actually that's potential cost pressures. That's one of the lower categories of cost increases we face. There's obviously cost increases on the fibre we buy, the paper we buy. And again, it comes back to that we got to recover those costs as quickly as we can. I think IMS demonstrates in terms of the revenue growth and the price - - the volume growth we give, you can work out what the price increases are. You can see that we are out there quickly to recover these cost increases and that's the same - - probably exactly the same next year.

Myles Allsop: Okay, thanks.

Operator: Ross Gilardi from Merrill Lynch is online with a question.

Ross Gilardi: Good morning. I just had a few questions. **I don't know if you're able to do this, but you seem to be getting 15-to-20% year-on-year pricing growth in your Packaging business if you back out the 8% like-for-like on volumes. Is there any way that you can characterise that pricing increase in terms of how much of it is coming from just the typical cost push versus where you're actually getting paid additionally for service and product differentiation?**

Miles Roberts: Yes it's very interesting. We look at the very strong volume growth, it is where we're growing with our large customers who are very demanding, and there's no doubt we are getting a mix benefit as we focus more on that and less on some of the other commodity areas. So we are getting an improvement there, but we are also fully recovering our input costs, so we do have a slight double benefit. But we need that to get our stated targets of 6-to-8% margin, and we're very comfortable with that. If you look at the Otor revenue synergies, I think this is such an important point for investors, this is where some very large customers of ours have said, "Okay, now Otor's part of you, we would like you to supply our factories in the regions you now work in." So this is where they consider us to be a supplier of choice. And the reason they do is because we're adding value to them, and that again has quite a significant margin benefit for us because of their added value, so we are improving the mix at the same time as recovering costs to enable us to hit those financial targets that we spoke about.

Ross Gilardi: Okay, thank you, that's very helpful. **And then on Plastics, you made the point in the IMS that Spicers was running ahead of last year on profitability despite the sluggish conditions in the UK. You didn't make any comments on Plastics in terms of profits, but you did cite 7% like-for-like growth, so presumably Plastics is also running ahead of last year?**

Miles Roberts: Oh yes it is, very much so. All parts of the Group are. The fact that the expectations the City has, that's what they're expecting and that's exactly what's happening.

Ross Gilardi: Okay, thank you. **And then could you just give us some comments on the management changes that you announced for Spicers the other day.**

Miles Roberts: With Spicers, we've been clear what we wanted to do here to improve the performance of the business. It is on service. It is on margin management. It is on cost. And for that, we are having a slight reorganisation of our management, and we have very recently brought in a new head of Spicers to give this further leadership. All of his details are on the website. He joins us previously from Corporate Express Europe. He's got many, many years of experience in office products, and I think he'll certainly be able to support the business in its ongoing improvement in profitability. We're very pleased with that recruitment and we think the shareholders will see it in the results over the coming year.

Ross Gilardi: Very good. **And then just lastly, Miles, could you comment on your efforts to shorten the contract periods and the lags and passing along pricing, because I imagine - - I mean certainly there's a lot of cost pressure on recovered paper right now, but I would imagine that's helping and feeding some of your confidence for the rest of the year.**

Miles Roberts: Absolutely. I think this is really one of our key ambitions is to reduce the cyclicality in the business and one of the causes of cyclicality in the past has been these very long contracts, fixed price contracts, that can run for six months, nine months, 12 months. And when you have all this raw material volatility, it just causes havoc with the returns, so we have been systematically reducing our exposure to these long contracts as they come up for renewal. We've been working on this for a number of months now, and we have made quite a significant improvement in reducing the contract length. I believe that was the right thing to do 10 months ago. I was absolutely convinced of it six months ago, and now I'm very pleased we've been doing it because it has meant that despite significant increases in costs, we are able to recover this, albeit there is a lag. You'll never be instantaneous, but we'd like to get it more from where we started about six months down towards our target of three months.

Ross Gilardi: **And where are you now do you think? Have you got it down to four months yet?**

Miles Roberts: No, it's made good progress towards that, but we're not at four yet. We're sort of between that four and five month period, but it's improved quite a long. We're getting the benefit of it now.

Ross Gilardi: Thank you very much.

Miles Roberts: Not at all.

Operator: *Myles Allsop from UBS is back online with a question.*

Myles Allsop: **Yeah, just couple of questions on the corrugated cycle. Can you give us a sense where industry testliner inventories are today?**

Miles Roberts: Generally they are pretty low. The Germaneconomy has been picking up very strongly and by and large it's been quite demand for testliner, so stocks remain at a low - - at historic low level. But I have to say it's more or less a position. It has been for perhaps the last six/eight months. So we're not seeing a further reduction, but stocks are less than they have been historically. It's quite interesting where this has actually just improved inventory management with the paper manufacturers or whether it is that they've just been able to rebuild stocks. It's a bit of better inventory management, but that's just a personal view.

Myles Allsop: Yeah. **And in terms of demand, you're saying you grew 8%. How does that split between the U.K. and Continent, and what is the market growth in the U.K. and Continent?**

Miles Roberts: I mean that 8% is pretty consistent I'll say across the Group. We have historically enjoyed very strong growth in Eastern Europe, and that's continued. Growth in the U.K. has been around 8%, as it has been in France, and the overall market has grown at about 2-to-2.5%. So corrugated continues to grow ahead of GDP, but we really have grown quite significantly ahead of that with our existing customers. Pretty much as we've said taking share from other formats as people want recycle packaging. The customer preference is not to use new virgin material, paper from cut down trees basically. They don't want that. Our offering on innovation, on service, et cetera, I have to say is being very well received by our customer base.

Myles Allsop: **That's pretty punchy kind of growth versus the market. I mean is there a threat do you think that the Smurfit Kappa's, and the others look to take back that market share, or do you feel - - and sort of compete on price, I guess, or do you feel that the market is going to readjust to the new DS Smith, I guess?**

Miles Roberts: We're not growing volume with price. We're seeking to add value and if our competitors align themselves with our value, then I perceive they'll be able to compete more. But I have to say, we're growing our existing customers. We're not trawling the market, et cetera. This is working with the likes of Procter, with Danone, and with Kraft, et cetera, and we're very pleased with the progress we made with them. We will be outlining a lot more about this this afternoon about exactly what we have been doing and how we've been approaching these customers and really trying to understand the value that they add. We've talked about R- flute in the past, we are absolutely delighted with the reception this is getting in the marketplace. We are the only supplier of that product in Europe. There is nobody else who does it. We are the only supplier who has a closed loop model in the U.K., France, et cetera. And again, we'll be outlining more about that.

Myles Allsop: Okay. **And on the testliner pricing, we saw €40 go through on the Continent in February; I think the U.K. is pushing in March. Are you pretty confident in that increase?**

Miles Roberts: Yes we are. We're seeing continued increase in raw material costs. Personally I think we're going to see this for a while . So we are confident of those increases. They certainly are sticking. But I'm afraid we're going to see more of this coming. Your questions earlier on input cost pressures I'm afraid I think aren't going to go away.

Myles Allsop: Okay. **And then I guess you're going to push for another corrugated increase in four to five months' time. Is that the way we should be thinking about this?**

Miles Roberts: We will always seek to be paid for the value that we add. That is what we are. That's what we are fixed on, adding value to our customers and obviously getting paid for it for our shareholders, and that will always be the case frankly whatever the price of testliner runs up or down.

Myles Allsop: Okay. **And then one last question on plastics and polymer costs. I mean how big a risk is that? How big a squeeze is that? I mean what percentage of your contracts are pass-through?**

Miles Roberts: That's a very good question. Again, we're doing quite a bit work here on plastics and shortening those contracts. We do have some old contracts where there are longer-term periods, but those are all being wound down. Polymer prices have been increasing. We've got a big US business. The increase in the US has actually been more modest than elsewhere. Polymers generally are probably up 25-to-30% for that certain of region. We have a significant number of contracts where it's a straight pass-through; and on the longer-term contracts, we are exiting those and shortening them. We have been for a while, so the City's expecting a good increase in the profitability of plastics, and we're very comfortable with that forecast.

Myles Allsop: **What percentage of the business is pass-through? Is it sort of 80% or 50%, I forget?**

Steve Dryden: Probably 50.

Miles Roberts: Yeah, I was going to say about 50% is just straight pass-through. It's actually very interesting. Some of our most demanding customers, the real world class organisations, typically it's our straight cost pass-through and we've been able to achieve that by really working on the service and the quality, et cetera. We have some absolutely outstanding practice there. And with the very significant growth we're getting, we'll be aligned in the business more towards those very demanding customers. But frankly we make the margin (inaudible) pass-through.

Myles Allsop: Okay. Thank you.

Miles Roberts: Not at all.

Operator: Ross Gilardi from Merrill Lynch is back online with a question.

Ross Gilardi: Yeah, I just had one follow-up. **There was a story the other day about some of the cereal manufacturers actually rethinking recycled cardboard as the sort of substrate of choice and that one of them in particular had already made a change, and I know you've got the Dorset cereals business, which you've highlighted many times before, but could you comment on that trend at all, and do you look at that as a threat or an opportunity?**

Miles Roberts: That's a great question, Ross. I have ot to be very clear about this. This issue which the story of the BBC ran, it's a very well understood issue. The UK Food Standard Association investigated it fully in 2003 and DS Smith was part of that, so we understand the issue very well, and this affects carton board. Now we supply corrugated and it's not carton board. Carton board is used much more in countries like Germany. It is made far more from old newspapers, and basically we don't supply that. We do corrugated. It's the outer case there. It's the tray that the products slides onto the shelf with. It's not the carton that the cereal fits into, so basically it's referring to something that isn't our business.

Ross Gilardi: Okay. **So you wouldn't necessarily see, though, opportunity to gain share from the cereal companies that are dropping corrugated or dropping carton board, excuse me, and looking to use, for example, corrugated instead with... Is that...**

Miles Roberts: Longer-term, there's certainly some opportunities there, but it's not our primary focus today.

Ross Gilardi: Got it. Thanks very much.

Miles Roberts: Not at all.

Operator: As a reminder, if you have a question, please press star then one on your touchtone phone.

Wayne Gerry from Investec is online with a question.

Wayne Gerry: Most of my questions got addressed earlier, but just one. **Could you give some colour, Miles, on the performance of the RTP part of the Plastics division?**

Miles Roberts: The RTP, returnable transit packaging.

Wayne Gerry: Yes

Miles Roberts: Yes, within the Plastics' numbers, RTP has less than the volume from the revenue growth that we've seen elsewhere. It can be quite a lumpy business, and that part of it certainly hasn't performed where the rest of Plastics has. Volumes have just been a little bit more erratic. It's not a huge part of our business.

Wayne Gerry: **But that erratic performance is more due to the fact there's more of a capital purchase and therefore it's line with the market conditions rather than anything particular to the business?**

Miles Roberts: That's absolutely right.

Wayne Gerry: Right, okay.

Miles Roberts: That's right.

Wayne Gerry: Great. Thanks very much.

Miles Roberts: Not at all.

Operator: As a reminder, if you have a question, please press star/one on your touchtone phone. We have no further questions at this time.

Miles Roberts: Well thank you very much, everybody, for your time to listen in. But just to conclude, basically we've had a strong last few months. The last four months have been very good, and we've highlighted our 8% like-for-like volume growth. Otor's going very well, both in terms of cost synergies and these additional business wins. Group profitability is fully in line with expectations, and the full year is on track to deliver significant EPS growth and this is supported by 10 million of new procurement savings and £75 million worth of new working capital savings. And the outlook for the coming year is for DS Smith to make good progress towards its stated financial objectives. Thank you very much, everybody, for your time this morning.

Operator: Thank you, ladies and gentlemen. This concludes today's conference. Thank you for participating. You may now disconnect.