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DS Smith 2019/20 Half Year Results Conference Transcript

Speaker Key:

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AM	Adrian Marsh
BD	Barry Dixon
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RO	Rob Chantry

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MR Hopefully everybody's ready. So firstly thank you very much everybody for your time to come here and join myself, Miles Roberts. Adrian Marsh our finance director just to present the results for the six months to the end of October. First half of our current financial year.

So firstly, we're pleased with performance. We've seen record profitability and a record margin for the group. If we split that down we've seen that Europe has grown very nicely organically. Good margin progression. And Europac has been excellent. We're very pleased with the first contribution from the Europac business and the integration etc.

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And we'll talk more about that. In the US the domestic market has remained very good for us. We've run out a bit of capacity there but we're solving that with our new plant which is now fully operational. Coming on in the beginning of November and that gives us a 30% capacity improvement.

The export market of paper in the US was poor as we expected, all about China and US. This new plant will be absorbing that back into the domestic market. The cashflow was good. Pleased with that. The plastic disposals is all on track to complete around the end of this fiscal year.

Currently very busy. We've seen November being very positive particularly on the run up to Christmas. Just in the UK we've actually seen a 40% improvement in e-commerce business in the last couple of months.

Everybody's shopping online and depending on us to get their Christmas presents delivered.

And we're looking forward to the second half. The second half of the year we're going to see an increase in our activity. We've got a positive outlook for our profitability and the year end results.

AM So thank you Miles and good morning everyone. Just before we carry on, just to clarify and I wouldn't ordinarily do this, Miles said plastics will be closing at the end of the fiscal year. You meant the calendar year. So sorry for the slight correction. I'm going to talk you through our results of the half year as usual unless otherwise explained, changes referred to are on a constant currency basis.

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I'll also be talking about the group on a continuing operations basis. So that's excluding plastics, which is treated as discontinued. So here are our financial highlights. Revenues up 3% and operating profit up 14%. I'll take you through the bridges for these key line items in a moment.

As you can see we've achieved a record margin in the middle of our target range that we upgraded when I last presented. The growth has flowed through to earnings per share up 3% on constant currency basis. Dividend per share is up 4%, broadly in line with EPS growth, reflecting our continued confidence in the business and our commitment to shareholder returns.

Our return on capital performance is reduced to 11.8%. This is below our target range, reflecting in particular the inclusion of Europac since its acquisition in January this year. As guided this acquisition is dilutive at the outset to our group target and we remain confident that it'll move into our target range as synergies are progressively delivered.

Walking through our revenue, I've split out the impact of Europac for comparison purposes. I've also noted the north-American division separately because as you'll see the drivers for us in that market have been different this period. The main component of revenue growth in the period is obviously the inclusion of Europac. And we're very pleased with how that business has been integrated and the results that it has delivered.

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Volume growth from corrugated boxes contributed £12 million reflecting the modest growth we've seen in the period. We're lower than our usual average growth. This result is delivered in the context of an overall corrugated market in Europe that was flat and relatively stable box prices.

The other volume is predominantly from paper and recycling. The decrease from sales price and mix is split around about 80% due to reductions in the selling price of paper and recycling with the balance due to reduced box prices. As you know our revenue is made up of corrugated box sales, other packaging, paper and recycling.

Corrugated box excluding North America and Europac makes up about £1.7 billion of the total with another half a billion pounds from other packaging, such as corrugated sheets, packaging services, and packaging solutions. External sales of paper and recycling, the paper for recycling was around £400 million, which mathematically will cause a reduction in revenue given the fall in paper prices.

North America is long paper so has a different dynamic to our core European business, which is short paper. Here we've seen a fall in revenue of some £39 million largely due to the sharp fall in the selling price of exported paper. Out of around 600,000 tonnes of paper we produce in North America, we utilise around 400,000 tonnes in our domestic US packaging business.

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The balance, obviously some 200,000 tonnes, is exported and sold either to our own European operations or other third parties and in common with other US businesses, whilst we've seen domestic paper and packaging profitability hold up well with relatively small reductions in domestic pricing, there's been a significant – it's around $250 a ton reduction in the price of exported paper.

As we made clear when we acquired Interstate it was fully our intention to reduce this long paper exposure by both organic growth in existing facilities, the addition of greenfield plants and or acquiring converting facilities. As you'll have seen in reception and Miles has just said, we now have our greenfield operation in Lebanon, Indiana up and running which does go a long way to resolve this.

Turning to profit, there was a contribution from the Europac acquisition including the synergies coming through at a good pace. Fully on target for our 70 million euros by 2022. The volume contribution sets out the positive from packaging which had a similar drop through to previous periods and the decrease in other volumes, which will be reflecting greater paper integration i.e. less external sales of paper and greater internal consumption within our packaging business. In Europe we've delivered good price retention in packaging as demonstrated by the net £29 million benefit between pricing and input cost falls which I'll describe in more detail on the next slide.

The £130 million is substantially all paper and recycling price reductions, which demonstrates we've again broadly absorbed all our other inflatory cost pressures within the business. To sum up what these bridges show, Europe has seen modest corrugated box volume growth at the same time as achieving very good price retention in the fact of falling paper prices of around 20%.

The paper price fall is reflected both in the tailwind to input costs and also fall in revenue and profitability for our external paper sales. However, as we're net short of paper in Europe, the overall impact is still positive. The reduction in packaging prices is in the order 1-2% which is a testament to the quality of our service and the value we add to our customers across Europe.

Europac continues to deliver well and we're fully on track for the synergies targeted. I'm particularly pleased to report that their packaging operations, which were loss making at the time we bought it, are now profitable as we've integrated our pricing processes and customer management with their operations.

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Whilst this way of working integration was volume negative but profit enhancing in the first quarter, it is now both volume positive and profit enhancing in the second quarter. The US business has performed exceptionally well since acquisition as a result of stronger than expected volume growth last year and a very stable paper price environment in 2018/19.

The first half of this year has seen volume growth reduced as we've become capacity constrained in packaging as we fully utilise the existing plants and also as I've mentioned there was a significant reduction in the export price of paper, which impacted us through our long paper position.

To repeat myself, the commissioning of our new greenfield site in Lebanon does start to solve these issues. Particularly our need for capacity to support further growth and by reducing our long paper position. I mean the one slight upside in the low export price of paper in North America is the benefit that that's had in our European paper sourcing operation which supplies our European packaging business.

The amount of the start-up cost in the first half for Lebanon is relatively small with most of the £15 million we guided falling into the second half.

Our overall margin performance is definitely a highlight for me in the period. Margins for the group as a whole have improved 100 basis points to the mid-point of our upgraded 10 to 12% range, which we raised last June.

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However, there are clearly some variations within that. The driver behind those segments that have improved versus those that have declined principally comes down the amount of paper versus packaging produced in the region. The regions where we have most of our paper capacity, that is North America and North Europe, are noticeably down to our paper short regions of South and East Europe.

Clearly our overall group margin reflects our net short paper strategy and the strength of our predominantly FMCG packaging business, which has demonstrated the strength and resilience of our business model. Cashflows continue to be good. EBITDA increase mainly reflect in the inclusion of Europac.

As expected there's been an increase in capex with the inclusion of Europac and the additional expenditure in North America on the Indiana greenfield. As I described at the full year our intention is to hold factoring balances at or under £500 million and whilst we didn't achieve that at the full year because of the inclusion of Europac factoring, the balance at the half year is now £475 million.

The working capital outflow is largely driven by reduction in creditors due to lower paper prices, which would've been partially offset by similar but smaller reduction in the value of paper inventories. However, inventories are being held at levels higher than we'd normally have to accommodate any Brexit disruption and once that's settled we'd expect them to return to normalised levels.

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The reduction in sold receivables has been largely offset through changes to commercial arrangements with our customers. Moving to net debt, we've remained broadly unchanged from the year end with free cashflow and the proceeds of the remedy disposals covering dividends and exceptionals. Given the currency matching of our debt to cashflow we've also seen a negative impact on debt coming from FX. Although this is offset in free cashflow.

Please note that the net debt as reported now includes an element for lease obligations under IFRS 16 of £242 million. In line with the guidance we gave at the full year in June. This increase doesn't impact our financing gearing ratio which is reported on the basis of our banking covenant calculations, which are on a frozen GAAP basis.

That said the ratio wouldn't have materially changed due to a similar increase in EBITDA driven by IFRS 16. In the second half of the year we expect the proceeds of the disposal of plastics of around £400 million net of costs. There'll also be the settlement of the exercise of half of the put option of the 20% stake in Interstate resources retained by the regional seller for about £90 million.

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Taking both into account, at the year-end we expect our reported gearing to be around two times. We expect the group to continue de-gearing through ongoing cashflow and during this half we also further extended the liquidity profile or duration of our debt by issuing a seven-year Euro bond at a fixed interest rate of 87 and a half basis points.

So overall we made progress in relation to our medium term targets. Volume was below our GDP plus one target but nonetheless represents a further gain in market share and Miles will talk more about the drivers for our volume growth and our expectation for the second half later in his presentation.

As I already mentioned our return on sales achieved a record margin in the period and goes to describe how the business is managed and the benefit of our international footprint. As discussed earlier, ROACE was impacted by the initial dilute of impact of our recent acquisitions and by 20 basis points due to IFRS 16.

So on a pre-IFRS 16 basis it would've been 12% at the bottom end of our target range. Net debt as discussed earlier and cashflow was discussed earlier and cashflow still remains strong. Technical guidance I think is pretty much unchanged although the sharper eyes will spot there's a slight increase in interest to 88 million and that just reflects where we are now with fixed interest rates and certainty of what the charge will be for the year.

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Otherwise I'm pretty sure everything is as you last saw it and clearly I'll just draw your attention as sterling is strengthening and who knows what will happen post-election. There is an FX headwind to us as the sterling strengthens given the large amount of our business is outside of the UK.

And finally, we continue to be very proud of our track record and the progress in this year continues to add to the upward trajectory both in EPS and dividends per share. I'd now like to hand back to Miles who'll talk more about the drivers behind our resilient and growing business.

MR Great, well thank you very much Adrian for that and taking us through the financials for the half year. But what's really been happening in that half year? What is the background to the market? I've put a few highlights here about starting with some of that political uncertainty.

And sitting where we are today we don't expect that political uncertainty to subside certainly during the second half. We'll wait to see what happens in the UK. We'll wait to see what happens between China and in the US but it's not likely to be solved in the near future.

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You've all seen the economy. The general economies have weakened but they do appear to be stable at this slightly lower level. We've seen probably about half a percent come off GDP. Raw material costs have been volatile, it's partly driven by FX.

We've seen sterling being quite volatile. We've seen between the euro and the dollar as well there's been some volatility there. But also we've seen energy costs come down a bit. We've seen fibre costs, the OCC cost, that's been quite volatile underneath the market and equally some of the chemicals.

But all of that's been dealt with with our hedging strategies etc. and our very well developed procurement function. So broadly wait to see what happens on the economic side. The economy's weak and stable, some volatility in pricing, but we can deal with all of that.

And of course what we've all seen is the way our customers and our final consumers are really changing. Look at the amount of publicity that's currently being given to the whole environmental debate. And about the current COP25 and all the leaders going there, just the publicity of some of the world leaders who won't be there.

This is really changing. It's changing how we're shopping, how we feel about the environment, about the role of packaging in that and we have to solve that. It's no longer good enough just to say we make a recycled product. We have to show as a company how we are actually recycling.

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Our customers are expecting us to show that and as a net recycler that means we pick up and we recycle more than we produce. This is something that's becoming more important to our customers and the final consumer. We're seeing the sophistication of packaging solutions growing. I'll talk more about that in a later slide but this is where we thrive. This is where we really start to give more differentiation to our product and to our customers.

And as I say with that whole environment, we're pleased with the first half results. So how is it being delivered? Sustainable, value-added solutions, we've continued to gain market share in a flat market. I'll talk more about our box price discipline. But if you look at what we're trying to do in that differentiation, why have we been able to drive pricing in packaging?

We've always said we're a packaging-led business. We have a short paper position. We're showing when prices, when raw material costs have been increasing, how we've been able to recover that. Now we're showing how we're able to hold on to our pricing with the solutions that we've developed.

Is that market changing in the degree of importance of our packaging to our customers? Europac integration as you know this is a key feature of DS Smith, how we integrate. We're talking more about that integration. But one which we're very pleased with and you can see that in the financial results produced in the first half.

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And obviously about North America, we'll talk more about that later. Just on that Indiana site and what's really happening in that very exciting US market. So firstly about our sustainable packaging solutions, let's just look at that environment. We have seen a whole range of the way our customers are talking to us.

No longer can I put a label on the product that says this is recyclable? They're saying to us well where does that fibre come from? What is your supply chain? This is where the differentiation is coming from our customers, why they're focusing on a fewer customers.

Sorry, fewer suppliers. A smaller group of suppliers. They can really understand where are you getting your product from. We talk about fibre origins, the pulp you can use, where does that pulp come from? What is the policy of growing trees? Replanting trees? What is your policy on soil quality and maintaining the quality of soil? Are we cutting down the northern forest or actually are we restocking the supply of wood in the markets in which we're taking the fibre?

What are the sorts of trees that you are planting? Are they indigenous? How does that affect the local community? All of these things about driving into not the efficiency but the effectiveness of sustainability of your supply chain.

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We've put down let's say here we've done an enormous amount of work with them, with Greenpeace, with the communities in which we are harvesting just to show about the strength of the business model and about recyclability. It's an easy word but it’s no longer can the product be recycled. You have to demonstrate to us that that particular box can be recycled easily.

Can it be recycled in country? So you don’t have to send it overseas. How easy is it to break down that product such that it can be transported to be recycled easily to avoid the carbon footprint of the transportation? All of these things come into what our customers are asking us to do.

If you look at the hard to recycle, it says this product can be recycled but how has it become contaminated in its use? We talk about pizza boxes. Well pizza boxes with grease we can deal with. Pizza boxes that still have half an uneaten pizza in there, that’s more difficult so how do we work that customer to communicate with the consumer to take out that uneaten pizza?

With coffee cups, how we’ve been able to work in what is a very difficult product to recycle so the position we are in today where we can recycle all of the UK’s two and a half billion coffee cups that we use per annum. Enough to go round the world a number of times. That’s just coffee cups that people are buying.

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Previously all of it went to landfill. So working with customers like Costa Coffee as to how we can generate a different product but then recycle it as well. And of course about plastic replacement. The topic of the day is going to be the topic of the future and this is what we’ve been doing in one area. If we look at plastic replacement, as you know we published a report last year.

A report that we produced with an independent consultancy. There are copies available here but I know we distributed it widely. This is just looking at a simple thing about supermarket aisles and this is what consumers see. This highly visible. So the retailers and our customers want to show to the consumer the improvements being made and we’ve identified there is an immediate opportunity to take out 70 billion units of plastic that are currently used in the Europe’s retail aisles.

How we can replace that today with corrugated solutions. And we’ve developed those solutions. If we look at fresh produce or punnets currently there are 27 billion plastic units that are used on retailers shelves. They can be replace by corrugated. If we look at the packaging of meat, fish and cheese, 44 billion units per annum in Europe.

Less than 7% of those are recycled. So every year of that 70 billion, 63 billion typically end up going to land field and we’re showing how we can replace and we’ve developed over 650 designs for this, 400 into retail, 100 in e-commerce and 150 into B2B and here are some of them.

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These are being used now. They show up there on the top left about things like the plant pots. You know in the UK, 450 million plastic plant pots are sent to land field per annum. That’s just the UK, which is about 15% of the European operations. So if you scale that up and you see the billions of units that are going there, we've developed the solution that can replace that with a fibre base solution.

It's currently being sold now. It's out there and we aim to replace a substantial part, certainly starting in the UK. If you look up in the top right you've got our solution to the packaging of meat, fish and cheese. That's now available and is now being rolled out and that takes out about 90% of the packaging of the plastic packaging that's previously been used.

That's 44 billion units of plastic currently going to landfill and we can replace that. If you go into Waitrose you'll see that those plastic punnets that are used for grapes, well they're no longer plastic punnets they're now a DS Smith solution. That's on sale now from a retailer that's very keen to show how they're improving the environmental debate.

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But I think what's very important whilst we've done the work, I think that the work we've been doing with a lot of governments whether it's in the UK or really across the EU, we're going to see this legislation coming forward now that's going to push this further. Today generally plastic is cheaper, it's a lower cost solution to our customers and the retailer than corrugated.

Because nobody has to pay, well the consumer doesn't have to pay, for the clean-up of the plastic. But this is being the playing field we expect to be levelled over the coming one and two years. We expect to see progressive taxation come through. We've done a lot of work here with governments, with the EU.

We're encouraged by their consultation documents. We're encouraged by some of the initial bans they've put on. And we think that whilst we can all fill this, what could really drive further growth into DS Smith, into our industry, is some of this progressive taxation which we expect to come on over the next one to two years. We've already seen those consultation documents out there.

It's great to have the design but here again we show our design centres, this is the route to market, how do we get it out there. We've got a selection. We've got design centres everywhere across Europe. We're building them in the US as well. It's been a particular feature of DS Smith over many years. Nine Impact Centres, 36 PackRight Centres where customers can go.

We're having now about between 5 and 600 meetings a year. These are extensive meetings with retailers. That is all of the major retailers coming and the big brands often they'll come together as to how they solve these problems. We can see the barrier. I think the taxation will be a big opportunity for us but it's also how we work to get those solutions.

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And it's working. It was just a very recent example in the last couple of weeks. Retailer Morrisons we've been working with them and some of their own label suppliers and now you're going to see for example all of their bacon, a big category in the UK, all of that all on shelf is all being replaced with corrugated trays and presentation solutions coming out of plastics.

So we can see that opportunity. Now things like that so plastic replacement is why when we look at our volume, why we're winning with our customers. The volume growth with our multinational contracts is up 6%. FMCG is up 3% again on top of last year and on top of the previous year.

So we're really gaining share in our core category. Industrial customers have been impacted by the macro-economic downturn and we are very, very selective about the margin. We do not have an integrated model with packaging and paper. We don't want to sell at a margin we don't have to.

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We don't have to fill the supply chain. We have a short paper position. So we just buy less paper. That allows us to be choosy on the margin. And that pricing discipline you've seen it in our core markets. How we've held onto it. It's been a particular feature of us recovering on the way up and maintaining that value that we're offering.

And there is a trade-off with some volume and we've seen it in some of the industrial markets. But in H1 due to first either timing of some particular contracts, just the timing first half second half we can now see those new contracts coming in.

We can see that in Indiana the start of that facility where we have been capacity constrained in the US and significantly capacity constrained, that is now online. And if we look at Europac, when we took that over, the packaging business, the pricing wasn't where we wanted it to be so we had negative growth in Europac in the first period of when we bought it and in Q1 of this financial year.

But Q2 is strongly positive and that's a typical feature of us as we get the pricing and the commercial excellence installed. The impact on volume up until the end of Q1 but Q2 it's now largely positive. Those three give us real confidence in the outlook for volume. If we look at Europac it's really quite encouraging performance. We know the economic background that we have faced but in the first half, we've made a return on capital of over 8% in that first six months period.

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Despite all those economic headwinds, we're very pleased with this. How has it come? On the packaging side that commercial excellence. It is now strongly profitable, the packaging business. And that's not just because of the lower paper price. That's the commercial excellence coming in and driving that operational excellence. We said it was a major opportunity for us and we're delighted to see that coming through.

We've seen the winning of new contracts, particularly coming in Q2, are now coming into our Q3. In terms of the synergies, again we've upgraded from 50 to 70 million. You'll see on the slide which Adrian presented, you'll see the synergy produced, we are well on track for that and we're very pleased the PACE programme is absolutely unique in Iberia.

And the way we're rolling that out, using performance based packaging, going to our customers, that's why we're now getting the growth and we're getting the financial returns that we expect. It's gone very well indeed. As I said before, in integration it's really one of our best.

In terms of our US operations, the domestic market remains very good for us. We haven't been able to keep up with the demand from our customers. We've known about that so we've built a new facility and my goodness, what a facility it is. Absolutely state of the art.

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It's a facility that doesn't exist in the US. In terms of its capability to supply performance-based packaging, to supply the right solutions we have in Europe for things like e-commerce for our big FMCG customers. It's working very well for us but it does have a long paper position. We've always been very open about that.

Long paper position and we export some of that paper. We have to close that out and there's a number of programmes that one is we've bought a business, CCC, the Corrugated Container Corporation in 2018. Secondly, opened this new site. The new site increases our packaging capacity by over 30%.

That site on its own will take over half our export volumes and we'll see ongoing growth in that business. The plant has opened. Here is a picture of a week ago. It's in Indiana and it's been snowing quite heavily there. It's just outside Indianapolis. As I said it's a state-of-the-art. It's produced a third increase in capacity.

And we're now delivering, it is now working for these customers. And there are other customers. European customers. Where we've sold on the same basis as we supply Europe. We can't put them on the slide because they won't allow us to put it on there but I can assure you they're there and the initial start-up is very, very encouraging.

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So there is a video outside about it. We continue to strengthen our business model. How do we show that no matter what the environment as we've shown over many years we can continue to drive profitable growth, continue to drive the margin. Well it is about that FMCG focus. Value-added innovation led will lead this market and with our increasing, our ongoing focus and innovation it's driving more value.

Maintaining our long recycling position this has always been important to our customers but it's increasingly important. We are a net recycler and it's being valued by our end customers. Increasing our short paper position it is right for our business. We've seen the volatility in paper. Therefore it is right to have a short position.

We are creating that in the US with the opening of the new site and we continue to review our European paper footprint which as we said previously we expect to be concluded this financial year. So the outlook, drives and growth are good. There's volatility in the market but it's volatility we can deal with.

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Our differentiation means that we're able to take advantage of those main trends. And we're seeing, we expect H2 volumes to be ahead of H1 just on the top etc. and we have a positive outlook for the second half. We expect further growth in the year in our profitability. Thank you.

BD Thanks very much. It's Barry Dixon from Davy. A couple of questions please. Just in terms of the volume growth, Miles, you've talked about pricing discipline and we've seen the impact and I think we've heard that message from you now for some time. Can you talk a little bit about that and the context of your ambitions to grow ahead of the market and how important pricing discipline is to you now in terms of that trade-off between margin protection?

Second question is on the profitability of Europac and just trying to get a sense of the impact of falling paper prices versus your I suppose self-help in terms of getting rid of low margin contracts as to how that has contributed and how you would expect that to roll out going forward? And maybe how much of each of those have contributed to the decline and the profitability of Europac since you acquired it?

And then if just in terms of your organic volume growth into the second half of the year, you're optimistic on that. If you exclude that sort of Europac impact and the impact of Indiana, what kind of underlying organic growth do you think the business can generate in the second half of the year? Thank you.

MR Well taking the first point about what is the volume. In the first half, I think the markets were weaker than we originally expected. In the underlying economies there was quite a bit of volatility. Probably a little bit more than we thought. We are very picky on pricing. We always have been. We want to grow in our core categories.

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There's some other categories here that we don't think are long-term value drivers for us. We are very disciplined on prices in some markets and we can really see the effect. Like I say to everybody, we could have had two or two and a half percent progress, not a problem at all, it's really not a problem.

Obviously we have to buy the paper. That market is there. It's all in the volatile sort of section and we can absolutely see that. And when we see how we can build volume; sometimes there are just short-term impacts. Last half of the year we grew 3.2%.

We've grown 0.7% as a group now. It's better in Europe because we've got the lack of capacity in the US. So we've got a big comparative. We've grown again. We could've grown more however it's just some of the timing of contracts and we want to grow value and margin in our core category. Not just chase some of the other things.

So I really don't have a particular concern about that. We've been here before and sometimes it's worked out it's been a little bit quieter. I really don't have a concern. The core value if we look at the profitability of our core group of customers, the line to service quality and innovation we can see over years that margin increasing and that has maintained the same.

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Take out the paper cycle etc. we can see what they're valuing and that's what we need to drive more into. And I think you'll see that in the second half. As I said we do have this issue about Europac having nothing the first quarter and growing strongly now. That's what we expect.

The US as you said will see Indiana come on and so far it's been open four weeks but it does look good. Seems to be working quite well. The quality's good and the service is coming out as we expect so we're pleased with that. We're very pleased. In terms of Europac, we're very pleased with that first performance.

As you know that business when we took it in it had more paper than it had packaging so it's been more exposed to that cycle. You can see from the results that actually the performance of the business has been extremely strong. Synergies are coming through. We've upgraded the amount of synergies has been very good.

But the packaging performance as we've always said this is an area that goes above the synergy target. It's about the commercial excellence and how we drive value into our packaging offering. Ultimately if we're going to create a successful business we really have to differentiate in the packaging then that's what we need, that's what we need to get and we've always felt that we'll get that by offering something that other people can't, which is about the pan-European supply but about the solutions that we're giving them as well.

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Showing how it adds more value to our customers. We've seen that come through over the years. Look at that margin. It's 11%. It used to be below 5%. Constantly driving that value and I think now is a further test for raw material costs are down – how much can we hold onto? How much of this is really going to be valued by our customers? Just as it was a year ago when we saw the increase in raw materials.

We recovered all of that. So when we go into Europac, yes we've had the low paper price, very good synergy, good integration, we're pleased with the packaging performance. Sort of a last reminder on that one when we bought it it was making about minus 1% return.

Our business in the same region was making about 8 or 9% return and we wanted to get it to that margin and we are well on track. If you take out the

US and look at the organic growth in Europe we're just below 0.9 if you look just at the Europac business etc. Some of this other stuff I think we'll have underlying of 1.2, 1.3 something like that.

The markets are about flat so we're still taking share… But FMCG is plus 3%. You know this is just where we're focusing. We need to come more overweight. We're going to see I think at the moment still industrial has been quite volatile. It seems to be reasonably flat at the moment.

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Hence again it gives us confidence about volumes in H2. Should be there. Very recent results they are.

JJ Thank you it's Justin Jordan from Exane. I've got three different questions. Firstly just on slide five the revenue development bridge that you've given us, thank you for this. You talk about plus 12 of the corrugated volume contribution so this is the 0.7% organic volume growth and so I appreciate Adrian you've given a little bit on this but I just want to… Sorry I wasn't quite listening to what you said.

For that maths to work in the 0.7% organic growth, that would imply that the denominator of that calculation would be something like 1.7 billion sterling?

AM That's exactly what I said, yes.

JJ Yes can you just walk us through the 1.3 billion or so other revenue? What's in there please?

AM So you've got 1.7 is corrugated box.

JJ Sorry is that… Sorry to interrupt. Is that just Europe or is that group including US?

AM It's excluding Europac and excluding North America.

JJ So the 0.7% organic volume growth then excludes the US and excludes North America?

00:49:07

AM I mean if it's helpful Justin afterwards Hugo and Rachel can take you through the logistics of that model it's not a problem but it was what I said it's 1.7 is excluding Europac and North America. You've then got about half a billion from other packaging which is sheet, which is packaging services, packaging solutions, separate businesses.

Then you've got about 400 million from external sales of paper and recycling and then you'll have Europac. Then you'll have North America. And we can take you through the splits on those if it helps.

JJ And so what was the organic volume growth including the US and Europac please?

AM So the organic growth…

JJ The organic box volume growth including the US and including Europac then please. Okay take out Europac because it wasn't there the year prior but US was.

AM So you're talking about revenue?

JJ No, you said…

AM Box volume?

JJ Yes, box volume with 70 basis points excluding the US. Because Europac wasn't there in the prior year but excluding the US, which was there in the prior year, what was the organic box volume growth please.

00:50:14

AM I'm struggling to work out… Do you understand what the question is?

JJ Okay you had Interstate since 2017. So it is in the prior year comparator. You're calling our organic box volume growth on 0.7% excluding the US. I'm asking you please…

MR No that includes the US. That's the whole market. Our overall volume.

JJ Including the US?

MR That's the overall like for like for the group as a whole.

JJ Okay, thank you for clarifying. And just on Europac specifically in your annual report you talk about the fact that if you'd owned it for the year 2019 it would've generated revenues of 780 million sterling and EBITA of 130 million. In the first six months of ownership it's generated EBITA of 44 million sterling. Can you explain to us why that's fallen so dramatically year by year?

AM Have you included the synergies in your 44, Justin?

JJ Frankly even if you include the synergies it's down, Adrian.

00:51:13

AM So including the synergies it's 61 sterling EBITA. So what were you going back to?

JJ So in note 30 of your 2019 annual report, you say that if you'd owned it for a full year to April 2019 revenues of 780 million sterling and EBITA of 130 million sterling. So even with synergies the profit of that business has gone backwards in the first year of ownership.

AM Yes.

JJ Can you help us understand that please?

AM It's a long paper business. Paper prices are down 20%. I'm wondering whether there's anything in the question I'm not seeing.

JJ I'm just trying to clarify that essentially Europac's gone backwards since you bought it both in revenue…

AM Paper price in Europe is down 20% since we bought it.

JJ Okay and just in terms of your EBITA bridge on supply six, so if you exclude Europac and synergies your EBITA would've been 290 million. Giving you a margin of 10%. So the margin improvement year per year is entirely down to Europac.

00:52:34

AM Europac is margin enhancing. It would be. It's a big kraft business. We said that at the start. The reason why we increased our targets, there's a mathematical increase in margin through the acquisition of Europac which is what [overtalking].

JJ But I just want to clarify that the underlying organic…

AM But your maths, if you've calculated that I'm not going to doubt your maths, Justin.

JJ Sure but just clarifying that the organic margin improvement year per year is zero. It's entirely down to Europac the 110 basis points margin improvement?

AM Europac is margin enhancing to the business as a whole. That's a mathematical fact. The reason why we increased our margin targets. There are other synergies that Europac has generated within the business and there are other things outside the business as we shifted volumes around so I don't think you can be so precise but I can categorically say the inclusion of Europac within our business increases mathematically on margin, which is the reason why we raised our targets.

JJ Fantastic. Just one final question sorry for Miles actually, back on September 4th at the AGM event on the call, you talked about on that point box prices on index volumes being down 1 to 3% at that point. That was three months ago. Can you just update us where you are in terms of box prices on index contracts today please?

00:53:53

MR Yes, so if we look at half on half we've seen on a comparative that box prices are down 1 to 2 per cent depending on the category.

JJ Sorry, specifically on the index contract which you referred to on September 4th? On September 4th you referred to your index contracts pricing being down 1 to 3%, what is that today please?

MR On the index deals it's going to be more than that. You can probably add another percent to that.

JJ So we're somewhere about 2 to 4 right now then?

MR In terms of the index contracts that's right. If we look at our business, 40% is on index. 60% is on what we call freely negotiated. What we've seen is on the index they move up and down so therefore we'd have seen further erosion in those but on the freely negotiated they're as we expect, we've seen much more resilience.

JJ Okay. And just thinking about that when we think about the second half, I just want to clarify, on the 15 million of cost for the start-up that you've guided to for April 2020. I know you said a modest about in H1. How much was that please, Adrian?

00:55:21

AM Low single digit.

JJ Okay so you've got that headwind in the second half and you've got clearly the impact of falling box prices. So I appreciate you've got hopefully an acceleration of volume growth, but how does the profit in the second half be greater than the first half?

MR Okay so as we've said so you've got the opening of Indiana. So you've got the start-up losses but then you've got the volume incoming and bringing the paper back from the offshore market. You've got the ongoing volume growth. You've got the ongoing efficiency in the business but if you take your maths previously you said the 1.7, take another percent off, that's 17. So you can see how we can easily offset that with the other factors that I've said.

JJ But you've previously said 1% of box prices is something like 30-40 million…

MR No I'm using your maths.

JJ Sure but what I'm saying is look unfortunately the maths of negative box prices in the second half and first half is going to more than overwhelm the volume growth.

MR No, no I'm using your maths and your figures that you've just given and of course if you look at those indices as I said that only applies to the box volume which the box revenue which you've just highlighted.

JJ Okay we'll see what the outcome is. Thanks, Miles.

00:56:40

MR Yes, we will.

DO Thank you. David O'Brien from Goodbody. If I could unfortunately go back to box prices please. Maybe some more colour you can give us. What is the point to point from the start of the quarter? What's the exit rate of box price decline? So one to two is the average but even from the Q1 commentary you gave us it seemed like the box was reasonably stable at that stage. So it implies that your Q2 has seen a more material step down. I'm just trying to get a sense of what the trajectory for the second half is like.

AM So if we look at Q1, we said that we've seen some erosion. I mean if you go over from 12 months ago we're talking one to two percent. These are I think by any standards that has been a very good price retention. Basically the phasing on the big contracts is it's all on averages so there isn't any particular acceleration or deceleration on that.

It's really quite mathematical. It's just taking averages. As the average comes down then it's sort of passed through. We look at all of the types of contracts we have with the big customers and when they're coming through and again sometimes there's a bit about a quarter end, quarter start etc. but it's not particularly phased from one point, from one quarter to the next because it's all on indexation. It hasn't materially changed.

DO Sorry to follow up on Justin again but on a negotiated side of them you were pointing to kind of a flat pricing environment when we spoke at AGM.

00:58:20

AM That's right. We have seen some but overall it continues to be very resilient. And I'm sure we do expect for there to be further erosion on the box pricing side if paper prices stay where they are. Now we'd have to see where they go into the new year but if everything stays the same then you will see more erosion there.

And we've just talked about if we had the one to two percent over 12 months go, if you apply that to where we are today going forward, I'm just saying if that was the case you can see how we should be able to deal with that with our ongoing efficiency and volume growth etc. etc.

DO In terms of the US and the bridge of profitability, can you give us a sense of what the final part of Interstate's synergies is in that profit bridge and also CCC?

AM It's very small.

DO It's very small and what about this small acquisition?

AM More likely it'll be negligible. It's substantially all Europac in that number.

00:59:19

DO No sorry specifically on the US part of the bridge there's no contribution from CCC?

AM Not that we could easily tease out because we'd move volume around. So the acquisition was absorbed into the footprint so we've shifted volumes from legacy Interstate to it. So if I teased it out the performance of the acquisitions been through the roof but that's been a sort of false performance because we've moved volume in there from other plants as we've tried to free up capacity.

So we haven't look at it per say like that. However, clearly the fact it's cutting up our paper rather than going to the export market is in of itself a positive in that paper price environment.

DO What type of returning capital do you see for the investments in North America at the moment?

AM I think if we look at it in terms of you know on an averaging basis since we've owned it, I mean last year it was through the roof returns, this year it's lower than that on an average basis it's achieving above the group cost of capital, which is where we said it would get to. It's just happened to be last year it was a phenomenal performance from where the paper pricing environment was.

01:00:35

And this year it's lower. It's still ahead of cost of capital. It's still value enhancing but you have to look at it or I feel you have to look at it on an averaging basis. So over the period, you can't just take short term. And that's the issue. I mean the reason why we always want to be short paper is to reduce your exposure to the cyclicality. You can just see it in a commoditised product. You do get exposed to the cycle.

DO And two quick final ones if I could. The non-recourse factoring is now down to 475. You want to get it below 500. Is that going to stay around there?

AM Yes, exactly.

DO Not much lower. Perfect. And in terms of the paper cycle itself, you know, prices continue to erode despite your sales and number of periods trying to increase prices mid-2019 we have a large mill coming on maybe before the end of the year or at least the start, two more in the second half of the year. How concerned are you about the paper cycle? The ability to absorb your capacity and quantify what's supplied what you see for 2020 calendar?

AM I think the unknown at the moment as it is every year is Christmas downtime. I mean I know we're taking some additional. We've been running our plants hot for the last few years. So we've got a lot of maintenance to do over Christmas. I don't know how else that translates but inventory levels are at sensible levels now.

If you go through Christmas with similar levels and you see the corrugated volume that we've certainly been seeing in the last couple of months across Europe continuing then there's a strong pull.

01:02:11

If you see a very erratic production cycle over Christmas, people not managing downtime to when the consumption is and you see high inventories going into the new year, you'll see a difference in our area. So I think time will play out on that. We have no visibility. We know what we're doing. We know where our inventories are and where our demand is and we're confident on that basis.

MR We have seen the inventory has fallen. We've seen production actually falling in Europe over the last few months and you know we know what we're doing, we'll see what the industry does. But actually, I think we genuinely are surprised. Surprised that paper came down a bit. Now OCC came down at the same time so is it just sort of a crossed paths on the OCC into the paper? We were surprised that it came down given what we're seeing in our activity.

And we've seen capacity come out. So we will just have to see and it's up, it's down, we never know. How we drive a value in packaging is obviously where we're focused. It's a lot tighter than it used to be, even at the moment. It feels tighter. If we look at what we're selling then actually the order looks pretty good from our mills.

01:03:35

AM We've seen this morning that a small Italian 50,000 tonnes have just gone bankrupt in Italy. So you don't see things will shut, things will open, things will go, I don't know what happens but in the end if demand continues for corrugated in Europe at the levels we're seeing having started the year with Europe as a whole for DS Smith, for Europe as a whole in negative territory getting stronger through the year to where it's exiting, seems to be exiting Europe.

If that carries through that's a different scenario and we've seen this in previous years. Things turn on a sixpence because actually you know the supply and the demand is pretty well balanced. So you only need demand to be slightly stronger than supply and prices go up and vice versa and we've seen that now consistently in my six or seven years here.

DO You've given us your net short position. What are the gross…? In terms of gross tonnage you're selling externally, to understand your revenue bridge a little bit better, what is the amount of tonnage you're actually selling into the open market?

MR At the current rate external we're probably selling about 1.3 million tonnes, something like that. Roughly. It does move around. Again we run a very dynamic model to what we sell externally, what we've produced internally, so you can see the top line move as we use more of our internal we sell the paper and it's a very dynamic model. We do not have an integration target.

01:05:18

We do not say that we should be 50%, 70%, 100%. We supply our packaging customers with a paper that's right for them. For their solution. We make it or buy it, that is a separate discussion. So it does move around a bit. And at the moment it's probably about 1.3 million. In the past it's probably been as high as 1.7 million, something like that.

AM For interest I think Paul one of the other analysts was saying this morning if you integrated all of your internal volume you wouldn't have had the drop in revenue. So our focus is on profitability and return so we're less driven by the revenue line, more driven by the profit line. But he's absolutely right, that would've been the case. Revenue is off four or five percent simply driven by paper prices. If we'd integrated you wouldn't have seen that.

DO Thank you.

AM Anymore questions?

RO Thank you, Rob Chantry, Berenberg. Could you talk a bit about the structural paper position in the US specifically I think you called out 200,000 tonnes. How much of that was sold to DS Smith Europe versus external market? And then the second part of that would be obviously you've got the big Indiana facility coming on that absorbs half of that, is there anymore appetite to do anymore large greenfield opportunities in there?

01:06:45

MR Absolutely. So look, in America as we said we had about 200,000 tonnes, European tonnes of paper. In effect that's a long position. If that is sold externally we in effect get the upside of that into Europe. Paper prices have come down there on the input so we get the benefit of that.

You can say and that's why the box prices have dropped because we're having to pay less for that paper but it's effectively the lower cost that comes in elsewhere in the group. The reason it's been effected is because the US has been exporting a lot to China. The US market. And of course all the sort of trade disputes between the US and China has effected the whole flow of paper from the US into China.

And that has effected pricing and therefore we've seen a lot more of American products coming into Europe. We do expect that to change in time. We expect when these current trade disputes are resolved then we think the flow of paper between the States and China will pick up again.

So it's a temporary position but it has been running for probably about a year now. When we look at that long position, the 200,000 tonnes as I say we bought CCC, we have another 130,000 tonnes eventually at a full run rate for the new factory. We want to build a much bigger position in the US. Another similar factory would actually mean that we're net short in the US.

01:08:32

We have plans to do that. We know where we'll go, how we'll go, with which customers we'll go, but today we focus on really getting that factory up and running properly. Not just because of the return on capital of that. Because it makes a statement into the US.

It is giving our customers what they've told us they want and we want to prove that. We want them to really come onboard and we've been very pleased with the response of those customers. I think we'll know over the next six months how well that's really come on and then I think that will unlock further opportunity for us in the US.

We have no issue in the medium term about the long paper. We knew it. We know how to deal with it. If it goes as we expect we think that's going to become a short position. If you look at the profitability of our US domestic business it is some of the highest in the group. It is very, very good.

The stability of the market in the US has been much better than Europe and we need more exposed there. It's just because we haven't matured our model there. That's what it's about. It's just a timing issue. How we can get hold of the greater margins in the US with our big customers who are currently giving us more work there. And we can see it in our results. So I think let's give it six months and I think we'll be talking then about our further opportunities. It's really very exciting. Very exciting indeed.

01:10:06

I'm very conscious of people's time. We've gone over an hour. If there aren't any other sort of burning questions for the whole audience of course Adrian and myself and Hugo and Rachel are here for some time. If you have any questions but just to say thank you very much for your time today. We do much appreciate it and once again, just pleased with our results but positive on the second half. Thank you very much.

AM Thank you.

01:10:33