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Research Update:

DS Smith Plc Outlook Revised To Negative On Higher Leverage; 'BBB-' Ratings Affirmed

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Overview

- DS Smith's adjusted leverage is higher than we had anticipated following increased acquisition activity. There is also uncertainty around timings for DS Smith's potential divestments, and a weaker-than-expected working capital position.
- We are revising our outlook on DS Smith to negative from stable.
- We are affirming our 'BBB-' long-term issuer credit rating and senior unsecured debt ratings, as well as our 'A-3' short-term rating on the company.
- The negative outlook reflects that despite our belief that management has a credible plan to deleverage the business and bring credit metrics back in line with the current rating over the next 12-24 months, we forecast execution risk relating to this and the possibility of sustained higher leverage.

Rating Action

On June 18, 2018, S&P Global Ratings revised its outlook on U.K.-based DS Smith Plc to negative from stable. At the same time, we affirmed our 'BBB-/A-3' long- and short-term issuer credit ratings and our 'BBB-' senior unsecured debt issue ratings on the company.

Rationale

The outlook revision follows the publication of DS Smith's results for the financial year ended April 30, 2018 (FY2018), which showed higher-than-expected financial leverage. At 3.6x, S&P Global Ratings-adjusted debt to EBITDA has increased year-on-year due to more acquisition activity than we anticipated, and a weaker-than-expected adjusted working capital position. The outlook revision also reflects the expected effect of the Europac acquisition and uncertainties regarding the possible disposal of non-core assets.

Our 'BBB-' long-term issuer credit rating is supported by DS Smith's strong underlying cash generative operations, management's strong track record of successfully integrating acquisitions, and a financial policy that should enable DS Smith to bring credit metrics back in line with the current rating level within the next 12-24 months. We understand that the company plans to reduce leverage via the possible disposal of non-core assets. This and additional working capital savings would reduce leverage to below 3.0x by end-FY2019.

We continue to assess DS Smith's business risk profile as satisfactory on the back of its strong market shares, economies of scale, and proximity to customers.

Our base-case scenario assumes:

- Revenue growth of around 13% in FY2019, primarily from acquisitions, but also from price increases, and exports boosted by the depreciation of pound sterling. We also expect organic growth of 2%-3% as we expect packaging and paper volumes to increase due to economic growth and e-commerce.
- A slight improvement in EBITDA margins as DS Smith integrates Europac, continues with efficiency measures, and moves toward higher-margin products, with a lower share of paper and recycling sales.
- The completion of the acquisition of Europac in FY2019, financed via debt (euro-equivalent of around £645 million) and equity (£1.02 billion). No acquisitions thereafter.
- Annual capital expenditure (capex) of around £330 million.
- Annual dividends of around £190 million-£200 million.

Based on these assumptions, we arrive at the following credit measures:

- S&P Global Ratings-adjusted debt to EBITDA of 3.6x for FY2019 and 2.7x for FY2020.
- Adjusted funds from operations (FFO) to debt of 20% for FY2019 and around 25% for FY2020.

Liquidity

We assess DS Smith's liquidity as strong. We expect the group's liquidity sources to exceed uses by more than 1.5x over the next 24 months, supported by healthy cash balances and full availability under its committed revolving credit facility (RCF). In addition, any issuance under DS Smith's euro medium-term note program would further extend the group's debt maturity profile and support our liquidity assessment.

Principal liquidity sources are:

- Our assumption of £195 million of cash on balance sheet that we consider as unrestricted as of end-FY2018;
- Our assumption of ongoing access to an undrawn RCF of £800 million;
- Our forecast unadjusted FFO of £550 million-£600 million; and
- Any proceeds from non-core asset sales would further boost liquidity.

Principal liquidity uses are:

- Acquisition spend of about £1.7 billion (primarily Europac) in FY2019. We expect this to be funded with the recently announced share issuance of £1.02 billion and a new unsecured debt issuance of €740 million (around £645 million).
- Up to £50 million in working capital outflows in FY2019 due to the expected effect of the Europac acquisitions and limited working capital outflows thereafter.
- Annual capex of around £330 million.
- Debt amortization of £150 million-£200 million.
- Annual dividends of around £190 million-£200 million

Covenant Analysis

DS Smith has covenants on its RCF, the tightest of which is reported debt to EBITDA of less than 3.25x. We expect the group to meet this covenant with adequate headroom.

Outlook

The negative outlook reflects the uncertainties over timing and the implementation of management's action plan to reduce leverage and the possibility that we could downgrade DS Smith Plc if it is unable to reduce financial leverage to a level we consider commensurate with the 'BBB-' rating.

Downside scenario

We could consider a downgrade if DS Smith's credit metrics did not recover over the next 12-24 months, notably if debt to EBITDA remained above 3.0x and FFO to debt stayed below 30%. We could lower the rating if DS Smith experiences delays or additional costs in implementing the measures (including non-core asset sales) to reduce leverage to below 3.0x. We could also lower the rating if the integration of Europac resulted in lower-than-expected EBITDA improvements. Credit metrics could also be hit by higher debt-funded acquisitions or shareholder returns.

Upside scenario

We could revise the outlook to stable if we believe DS Smith will be able to improve credit metrics to levels we consider commensurate with the rating on a sustainable basis. This could happen following a successful execution of possible business and non-core asset disposals, combined with continuing successful integration of its recent acquisitions.

Ratings Score Snapshot

Issuer Credit Rating: BBB-/Negative/A-3

Business risk: Satisfactory

- Country risk: Low
- Industry risk: Intermediate
- Competitive position: Satisfactory

Financial risk: Intermediate

- Cash flow/Leverage: Intermediate

Anchor: bbb-

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Strong (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - Industrials: Key Credit Factors For The Containers And Packaging Industry, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013

- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed; Outlook Action

	To	From
DS Smith Plc		
Corporate Credit Rating	BBB-/Negative/A-3	BBB-/Stable/A-3
Senior Unsecured	BBB-	BBB-

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