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DS Smith Q1 AGM Trading Statement Conference Call Transcript

Speaker Key:

MR	Miles Roberts
AM	Adrian Marsh
ALM	Alexander Mees
BD	Barry Dixon
JJ	Justin Jordan
LK	Lars Kjellberg
DO	David O'Brien
MD	Mikael Doepel
CH	Cole Hathorn
OP	Operator

00:00:03

OP Hello, and welcome to the DS Smith Q1 AGM trading statement. My name is Jess and I'll be your coordinator for today's event. For the duration of the call, your lines will be on listen only. However, there will be an opportunity to ask questions. And this can be done by pressing star one to register your question at any time. If you need assistance at any point, please press star zero on your telephone keypad and you will be connected to an operator. I will now hand you over to your host, Miles Roberts, to begin todays' call. Thank you.

MR Good morning everybody. And firstly, thank you very much for joining us on this call today. I'm Miles Roberts, the Chief Executive, and I'm joined here by Adrian Marsh, our CFO. Our statement today covers our trading period since 1 May 2019. And overall, the business continues to progress well despite the as-expected continued macroeconomic uncertainty. And our expectations for overall financial performance remain unchanged.

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Our excellent customer engagement and differentiators of scale, service, quality and innovation, have enabled strong pricing discipline. This combined with ongoing operating cost efficiencies and focus on cash generation, together with new business wins in Europe and in the US, gives us confidence in our resilient business model.

Despite the ongoing subdued volumes in some markets, in particular those economies with significant export-led exposure, including Germany, we continue to win with our customers and, as such, we expect an improving trend in our volumes through this financial year, as we previously indicated.

Strategically, we completed the remedy disposals in June. Our paper optimisation review continues, and we continue to expect completion of the disposal of our plastics division before the end of this calendar year. The Europac integration and the synergy delivery are progressing very well, with excellent customer and employee engagement.

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The construction of our new state-of-the-art greenfield packaging plant in Indiana, which will enhance our capability in the US by around one third of our capacity and reduce our long paper position, is fully on track, and production is expected to start this calendar year.

So in summary, the underlying drivers of demand for sustainable corrugated packaging remain strong and our leading offerings for highly resilient FMCG and e-commerce customers give us confidence of volume and market share growth. Whilst volatility in the macroeconomic environment and input costs remains, our focus on pricing discipline, margin progression, enhanced cost and efficiency improvements with cash generation support our expectation of further good progress in the year. Thank you. I'd now like to open the lines to questions for myself and Adrian. Thank you.

OP If you would like to ask a question, please press star one on your telephone keypads. Please ensure your line is unmuted locally as you will then be advised when to ask your question. And we do have a few questions in the queue. And the first question comes from the line of Alexander Mees from JP Morgan. Please go ahead.

00:03:50

ALM Good morning. Thanks for taking my questions. Just I wonder if you could give us a little bit more colour on how you see Europac integrating. It's obviously reasonably early days. There are some positive comments in your statement. But I just wonder how it compares to what you'd expected to see at this stage.

And then secondly, I wonder if you could just comment on your expectations for where pricing is likely to go. You mentioned pricing discipline, also some new tenders. Does this mean that we ought to be able to see stability in pricing going forward, or ought we to be more conscious of the possibility that they could come down?

MR No, thanks Alex. Firstly, with Europac and the integration, we are very pleased with this indeed. As I said, the customer and employee reaction has been excellent. We have, at the full year, raised our synergy targets from €50 million cost synergies to 70 and, as I say, we are performing very well against that revised target. It's certainly given us quite a bit of new capacity in these markets. It's capacity that we are now starting to utilise.

The packaging business there has been challenged for quite a long time, but we're now seeing growth coming through into that business that they haven't seen before, and we're seeing a good positive customer reaction. So overall, we remain very pleased with this. As I say, all of our new colleagues and our customers are really supporting us there. So overall, very good.

You asked about pricing. And here, we have seen, I'd say, probably better retention than we originally thought. Yes, there are indices starting to move; it's as expected – the price of paper has been flat now for some time. As some of these indices start to move, that's really on about 40% of our business.

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In terms of our customers where we don't have these automatic mechanisms, just to say our service and quality is absolutely excellent and we're getting good recognition for that. And overall, we're very pleased with how we've been able to retain pricing. Looking forward, obviously, we will see some erosion of our pricing because of the index deals but I have to say, on the others, we are very encouraged with our pricing; our pricing has held up, very much so.

ALM Thanks Miles. And best of luck for the rest of the half.

MR Thank you. Cheers Alex.

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

BD Morning Miles. Morning Adrian. Miles, you might just give us a bit more colour on the volume environment. And you cite some subdued volumes in some markets like Germany. So maybe just a little bit more colour around the various regions.

And also particularly interested in your thoughts around volume demand on the FMCG side versus the industrial side. And I suppose very specifically, is it that industrial side that you're seeing most of the weakness? And then, can you characterise what kind of volume growth you're seeing on the FMCG side?

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And not to push you too much on the pricing side, but there has been this expectation that we'll see some price weakness in the second half of this year. And again, maybe your thoughts around the scale of that price decline as we head towards the end of the year. Thank you.

MR Yes, absolutely. Well, look, overall market conditions remain pretty much unchanged from when we talked about it at the full year. We have seen some markets have been more subdued. We do call out Germany. It's got a big export-led manufacturing market. And it remains subdued. It does. It isn't exporting as it has. You've seen it in their overall GDP figures. And that falls through into the overall market demand.

But I think it's pretty much unchanged from where we were at the time of the full year. Hence, our assertion that our expectations for our financial performance for this year remain unchanged. There is still some uncertainty. I have to say, we've got this situation in the UK.

The UK is about 10% of our business. It's not the biggest part. But goodness knows what's happening at the moment or what will happen at the end of October. And that is causing some nervousness, not just in the UK but across to some of our customers across the markets in Northern Europe. Hopefully, we'll get some clarity on this over the coming few weeks. But broadly, it's remained pretty much as we described at the time of the full year.

The FMCG is more resilient than the industrial sectors, pretty much as expected. When we look at our big customers, we're seeing good, continuing growth there. It's a very strong feature of our market. And we expect then to see volumes grow – obviously, this half year, it's pretty much as we've expected – and actually see an improving trend over the remainder of this year, obviously subject to the uncertainties that I've previously described.

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In terms of the pricing, as I said, we have 40% of our businesses on index deals. These indices don't go right to the highs of paper, they don't go right to the lows, so it very much depends on average prices over a period. We are seeing quite a bit of stability in paper prices at the moment. So there, the prices on these larger customers, it can be after three, four, five months. So we are starting to see some of that coming through.

And with individual customers, you're looking at maybe there's a minus 1%, minus 2%, minus 3%, something like that. But as I say, that's really around about 40% of our business. As I said, on the other, on the 60%, we focus hugely on the value that we add to our customers, and the margin retention has been very good. There has been very limited reduction so far. So we'll see how the rest of the year plays out. But we're very pleased with that, very pleased indeed.

BD And so just one follow-on, Miles. At the time of the full year, I think the volume indication in the second half of last year was 1% to 2%. Is that still a good way to characterise the volume environment growth at the moment?

MR Yes, I think that's absolutely right. It's in that sort of range. It can bob up and down any one month to the next. But it's certainly in that range, we're seeing ongoing improvements. But we just have these macro uncertainties.

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BD Sure.

MR Our UK business has been doing very well. But we've been talking to our customers here, and they are clearly nervous. And you ask them about their outlook for their volumes, and some of them say, well, you tell me what's going to happen with Brexit, and we'll tell you what our volumes are going to be. So it's just that little bit of uncertainty. But overall, absolutely right, we're seeing in that 1% to 2% level.

BD Great. Thanks very much.

OP The next question comes from the line of Justin Jordan from Exane. Please go ahead.

JJ Thank you. Good morning everyone. Sorry, I just wondered if you can give us a little bit more colour on volume and pricing, please. In the second six months to April 2019, you reported 1.6% organic volume growth. Has it accelerated or decelerated since then? Can you just give us some more colour on that?

And secondly, just on the… you're disclosing 1% to 3% falls so far in index box price contracts for 40% of the European volumes. Is that the situation so far, and do you expect further concessions going forward in coming weeks and months? Can you just help us out on that?

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MR Sure. Well, look, on the volume, all I can say is that the overall markets remain pretty much unchanged from what we described at the full year.

JJ Sure. But Miles, at the time, you were expecting a pick-up in volumes in this year. Clearly that hasn't happened, is what you're saying now.

MR No, not at all. I think in here, we're saying that during this year, we do expect to see an improvement in the volume over this year, from the second half of last year. I think we're very clear on that. I'm saying for this first half, very much as expected, we are not seeing the markets improving from the time of the full-year results.

And as I said, I think we're very clear on that. It's very much as we expect. We are winning new business. We do see the second half being better in terms of the like-for-like improvement. Nothing has changed in our outlook from what we described at the full year. Nothing at all.

In terms of pricing, I'm saying you've got these index deals. Barry previously asked what sort of reductions that we're seeing coming through, and it's been those early few percents on that 40% of the business. Obviously, looking forward, it depends what happens with the price of paper.

We are actually seeing quite a bit of stability there. It all depends what happens in the second half of the year and there's some room for… It's just too early to call where we think things are going, where we think future paper prices will be. We just simply don't know.

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But in terms of the pricing, it's really going on those index deals exactly as we've thought, no change there. But on the non-index deals, as I've said, our service and quality and the value we're adding, the retention has been better than we thought at the time of the full year.

JJ Thank you.

OP The next question comes from the line of Lars Kjellberg from Credit Suisse. Please go ahead.

LK Thank you. I just had a question on… You just mentioned the future, the next pricing move on the container board side. But you've also been talking about your need or want to integrate or bring down integration from 80% to 60%.

MR Yes.

LK What sort of progress are you making there? Are you going to grow into that, or are you actually now considering some exit of some capacity?

MR No, absolutely. We're about just under 80% at the moment and our desire is to bring that down to 60. There are two ways of doing it. Firstly, we continue to grow our packaging business, and that obviously increases the short position. And we are looking at reshaping our paper business. It's very consistent with what we said at the time of the Europac acquisition. We're looking particularly around Central Europe where there is more capacity.

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And the work on reshaping our paper, we're really talking about one paper mill or something like that – we're looking at about 400,000 tonnes. The work on that is progressing and it's progressing well and is actually being supported by the current stability in paper prices. So we're pleased with that. But we did say we'll be able to come back this financial year, and that's exactly what we expect to do.

LK I just sense no urgency to remove any capacity from your system today. It is what it is until you tell us different.

MR Yes, that's right. We've got our existing capacity. Strategically, we just want to have a bit less paper, particularly in and around Central Europe. We've identified how we're going to do that – organic growth and just reshaping perhaps one of our mills, etc. And the work on that reshaping is continuing well.

We've got some good assets; it's just, strategically, they aren't for us. And as I said, we'll come back this financial year on the progress on that. And we're really saying, with this announcement, that work is going exactly as we expected. Quite pleased with that, actually, how that's going, just gives us that sort of short position.

LK Okay. Thank you.

MR Thank you.

00:17:45

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

DO Hey guys. Thanks for taking the call. Two from me, please. Firstly, it's encouraging to have price stability, I guess, in the 60% of the business, and given what you're seeing on that front and stable paper prices at the moment, sequentially, should we be all expecting a material expansion in the margin in H1, given that you're going to have a significant benefit from lower cost? So leaving aside Europac and synergies, the market should expect material organic margin expansion for H1 and H2?

And secondly, how do the recycled container board inventories through your own system feel at the moment? I guess that's the big question on people's minds, heading into mid-September when there may or may not be an attempted price increase.

MR Yes. Look, we've given medium-term guidance on our margin. We raised our margin expectation. At the full year, we were 10.2, I think, and we raised the target from being between eight and ten to ten to 12. And we absolutely expect to be in that range. That is a tick-up.

That does rely on things like the Europac synergies coming through. I wouldn't say we're expecting a surge in margin in the first half because we simply haven't generated all of the synergies yet. But we do expect to be in that range. It is an enhanced range and we absolutely expect to be there for this year.

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In terms of paper inventories, you probably saw, in July I think, industry stocks fell. I think they're about 100,000 tonnes where they were the previous year. So we're seeing them come down. It really is too early to tell where it's going to end up. We'll see obviously in this month's figures. But we're seeing ongoing demand for fibre-based solutions. And obviously I don't know how everybody else is doing. We'll just have to wait to see where the numbers come out for August. But I did see that reduction in July.

In fact, we've seen a few reductions recently. There's been a bit of downtime, etc. That's on recycled stock, Kraft as well. We'll see what the current hurricane season does in terms of US supplies business. I think there's quite a bit of concern there as to some of these storms and what that could do to supply. So it's really just too early to tell. And we're certainly not… We'll just have to see what happens.

DO Thanks. If I could just have one follow-up maybe on the first question.

MR Of course.

DO I suppose a different way to ask is, I suppose you are implicitly guiding the market now that the value add that you're generating to the customer base is going to yield an expansion in the corrugated price versus the raw material cost, which is something we haven't seen for quite some time. So is that your opinion, that you're finally going to get paid for the value you're delivering to customers, and we're going to materially see that trend? What will be your range of price versus cost in H1 and H2?

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MR Yes, look, we're in our first quarter, so we have said we're expecting a medium-term expansion in our margins. And we're saying that our expectation of our financial performance this year is unchanged from the announcement at the full year.

But we have seen a growing margin in our business. If we're looking to packaging, we have seen, over many years, our ability to add more value to our customers. And those customers have been prepared to pay for that. And we see that progressing over the coming years. We see further room for growth in our margin. But in terms of our half year, in terms of our full year, all we're saying today is our expectation of that remains unchanged from what we said at the full year.

DO Great. And just one on the US. The 15 million start-up cost, how should we think about the phasing of that this year?

MR Yes. So yes, it's mainly H2. A bit in H1, but it's mainly H2.

DO Great. Thanks very much, guys.

MR No, thank you.

OP There are currently no further questions in the queue. So as another reminder, it's star one if you would like to ask a question. And we do have a few more questions in the queue. The next one comes from the line of Mikael Doepel from UBS. Please go ahead.

00:23:04

MD Thank you. Good morning everybody. Just a couple of questions from me. Maybe you could comment a bit on the cost side, what kind of a development you are seeing there, if you look at the wood costs and recycled fibre and chemicals and so on.

MR Yes, with fibre, we've seen… Generally, the environment is raw material costs, whatever they are, things are more skewed in terms of pricing. So you can look at energy, you look at transportation, you look at a number of things there, and there is a general softening in pricing. It's not dramatic, but it's just been a little bit softer.

In terms of recycled fibre, in the US, that has come down. That remains at low levels. In Europe, I think it has come down, up until four or five months ago. And we're seeing some stability in the price of fibre at the moment, albeit at a low level. So overall, the raw material input cost, it's fair to say, is reasonably subdued. We're not seeing any substantial increases coming through there.

MD Okay, thank you, that's helpful.

MR Yes. Sorry, it's just that [inaudible] anything there. And our other big input cost is obviously on labour. And again there, we have a very close relationship with our Works Councils, etc. and there, we're seeing some inflation coming through, but very much in line with what we expect. The increase is generally around 2% levels, something like that, generally. Yes, generally a flat environment.

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MD Okay. And then maybe if you could talk a bit about the US market. What's happening in there? Are there any dynamics that go in your favour? And also Indiana, capacity, expansion – any more guidance on the timetable there?

AM Yes, in terms of the US, domestically within the box business, we're very full. We've got a significant pipeline coming through, relying on the Indiana greenfield being up and running to plan, which is as scheduled. Starting to make boxes in November and ramping up over the six months following that. So from a box side and generating of customer interest amongst our global customers, extremely strong.

Obviously, the US is still a predominantly paper market and you've seen paper prices coming off a little bit domestically, quite a lot on the export side. Integrating our long paper position into Lebanon is an extremely important part of our strategy there. And as we said when we made the acquisition originally, we were looking to rapidly reduce the long paper position, which is very much the plan.

But in terms of the drivers of our growth in our business, there's a lot of interest around our e-commerce platform and designs in Europe, a lot of interest around our shelf ready packaging, all as you would expect. And very strong dialogue with a number of targeted customers. So we're very happy with what the prospects of that business look like.

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MD Okay, that's clear. Thank you very much.

OP The next question comes from the line of Cole Hathorn from Jeffries. Please go ahead.

CH Good morning everyone. I wonder if you can just give a little bit more colour on what you're doing to prepare for Brexit to make sure that you see limited production disruptions. And then can you just highlight some of your main concerns?

MR Brexit. Well, look, we've done a huge amount of planning for this. I'd say it's about 10% of the group, we've been through what we think the impacts are going to be and all the rest of it following the government's advice. And we are well ahead of that. We've taken some contingency stocks into our business as well. So we've really tried to prepare as much as we can. We've had a whole taskforce on this for about a year now.

The thing that we don't know is the effect on our customers. So whilst we can protect our business, it's really what's happening in our customer base. That's the bit that's uncertain. We supply a lot of, for example, food processors. A lot of these food processors are importing the food from Europe. They work really on just-in-time. A lot of them are fresh produce. We're talking to them. They have their plans. But of course, it's all very dependent on what the flow of goods is going to be. So it is a little uncertain.

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But in terms of our planning, I think we've done a lot to protect our business and how we operate, so we can deal with and continue to supply customers. But it's just uncertain as to what's going to happen. Is it going to be a hard Brexit on day one? Is it not going to happen? We really, well, I think, don't know anything more than anybody else in the country.

CH Great, thank you. And then just on Amazon, we've recently seen Amazon increase the use of some plastic packaging, with some backlash from customers in the UK.

MR Right.

CH Have you seen any impact on your box volumes from increased plastic use? And please just remind us, despite designing an e-commerce using less packaging, how are you still able to get paid more for these value-added e-commerce boxes?

MR Yes. Well, if I just talk generally with e-commerce rather than any particular customer, we continue to see a number of customers try different formats. But you're absolutely right, the use of plastic which as always been there has received quite some customer backlash, particularly for certain customers. A lot of these products aren't recyclable, and I don't think it's what customers expect to see. So when we look at our overall e-commerce volumes, they continue to do well. And that's in the UK and across Europe.

There is a lot of value that we can add to our customers in making sure of things like right-sizing or the printing, the traceability, etc. It's a really exciting area. And it continues to develop in terms of the opportunities for us to add value to our customers.

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And with all of these things, we do expect obviously to be paid for that. And we are very pleased with the value that we're able to add to our customers, and that is recognised in the margins that we make. Very good area for us. It continues to develop. They will always try different formats, but nothing beats the box, basically. Nothing beats the box.

CH Sure. Thanks so much.

OP There are no further questions in the queue, so I will hand back over to your host for any concluding remarks.

MR Well, firstly, thank you very much, everybody, for your time today to listen to us. And as we said, our business continues to progress well, despite the continued macroeconomic uncertainty, and our expectations for overall financial performance remain unchanged. Thank you very much.