S&P Global Ratings

RatingsDirect®

Summary:

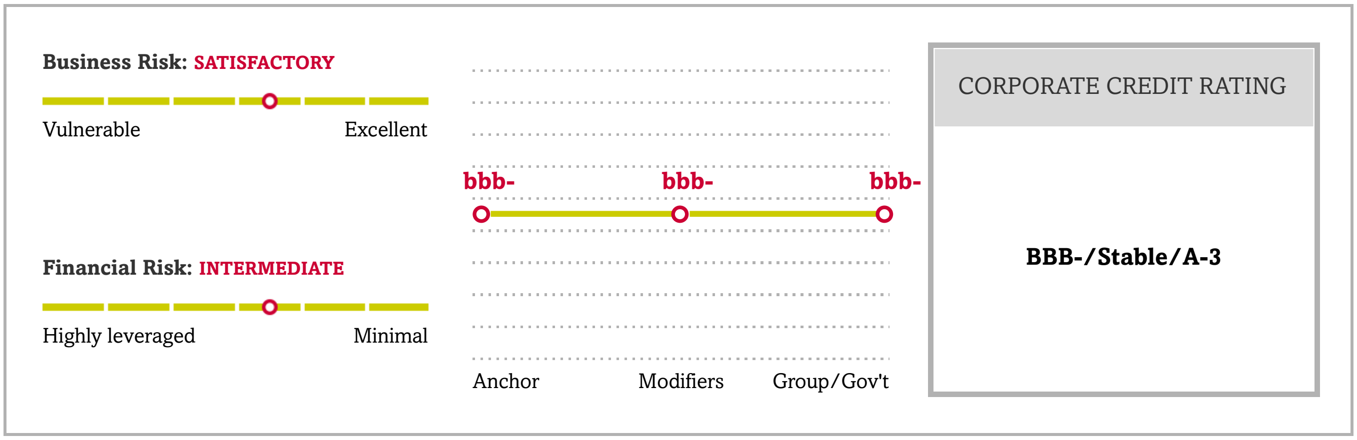
DS Smith Plc

Primary Credit Analyst:
Terence O Smiyan, London (44) 20-7176-6304; terence.smiyan@spglobal.com

Secondary Contact:
Gustav Liedgren, Stockholm (46) 8-440-5916; gustav.liedgren@spglobal.com

Table Of Contents

Summary:
DS Smith Plc



Rationale

Business Risk: Satisfactory	Financial Risk: Intermediate
• Strong market shares in Europe, which allow DS Smith to benefit from economies of scale in production, purchasing, and distribution, with proximity to customers key to the profitability of low-margin products. • Attractive end-markets, with a focus on corrugated boxes and paper packaging for the resilient fast-moving consumer goods segment. • Good ability to recover raw material cost inflation through prices, while DS Smith's own paper fiber recycling operations significantly reduce the volatility of its cost base. • Adequate geographic diversification, which is gradually improving with ongoing acquisitions, but with a narrower footprint than DS Smith's closest peers. • Lower-than-industry-average EBITDA margins.	• Prominent mergers and acquisitions (M&A) activity. • Strong cash flow generation, which helps credit ratios recover quickly after moderate debt-funded investments. • Stable and consistent financial policy. • Strong levels of liquidity and a long-dated debt maturity profile.

Outlook: Stable

The stable outlook reflects our view that U.K.-based paper packaging producer DS Smith will continue to grow its earnings through successful integration and synergies from ongoing and recent acquisitions, and generate substantial positive free operating cash flow over the next two years. While we expect the group to remain acquisitive, we believe that its credit metrics will stabilize.

Downside scenario

We could consider a downgrade if DS Smith embarked on significant debt-funded shareholder distributions or larger acquisitions than we expect, without suitable mitigants. We could also consider a negative rating action if DS Smith experienced severe margin pressure or weaker cash flows than we anticipate, leading to weaker credit metrics--for example, debt to EBITDA of more than 3x and funds from operations (FFO) to debt below 30% on a sustained basis.

Upside scenario

We consider ratings upside to be limited in the short term, due to DS Smith's growth-target policies, which we believe will limit material deleveraging. However, we could consider raising the ratings if we believed that DS Smith could sustain its credit metrics at the upper end of our intermediate financial risk profile category, specifically, FFO to debt exceeding 40% and adjusted debt to EBITDA of about 2x.

Our Base-Case Scenario

Assumptions

- Significant revenue growth of around 20% in 2017, after a meaningful favorable impact from currency exchange rates (DS Smith reports in pounds sterling, which has depreciated significantly against the euro, in which around 75% of the group's sales are denominated).
- Organic growth of 2%-4%, as we expect packaging and paper volumes to increase, although partially offset by decreasing prices.
- Acquisition spending of up to £200 million annually, which could boost pro forma annual revenue growth by about a further 5%.
- Capital expenditure (capex) of 4%-5% of revenues (£200 million-£250 million a year), as the group increases capacity and develops capabilities in e-commerce.
- A slight improvement in EBITDA margins each year as DS Smith introduces new efficiency measures and moves toward higher-margin products, with a lower share of paper and recycling sales.

Key Metrics

Year ending April 30	2016A	2017F	2018F
EBITDA margin (%)*	11.5	12.9	13.0-13.3
Debt/EBITDA (x)*	3.0	2.6	2.4-2.5
FFO/debt (%)*	24.4	31.0	32.0-33.0

A--Actual. F--Forecast. *Fully S&P Global Ratings-adjusted.

Business Risk: Satisfactory

DS Smith is the second-largest corrugated paper packaging producer in Europe, with exposure to well-diversified and consumer-oriented end-markets. The stable fast-moving consumer goods (FMCG) segment represents about 60% of the group's revenues. DS Smith distinguishes itself from its peers with its strong focus on product innovation and the value-added services it provides to its customers. This leads us to assess the group's business risk profile as satisfactory.

With its recent acquisitions, DS Smith has comprehensive pan-European coverage. That said, it lacks the access to high-margin, low-cost emerging markets of peers such as Smurfit Kappa Group and Mondi Group. With its focus on higher-volume and lower-margin customers, as well as on its lower-margin recycling segment, DS Smith's S&P Global Ratings-adjusted EBITDA margins are weaker than those of its packaging peers, although its return on capital is healthy. The recycling segment is nevertheless strategically important for supplying recycled fiber to DS Smith's mills and box plants.

DS Smith relies on client proximity with its closed-loop operating model, whereby it collects and recycles cardboard boxes from retailers. The group's relatively low absolute profitability is partly offset by the resilience of its FMCG packaging end-markets, translating into what we view as fair volatility of profitability through the economic cycle.

Although DS Smith has significant backward integration in recycling and paper production, the group remains net short in paper--a position we believe will deepen over time as its share of packaging sales increases and new paper capacity is unlikely. DS Smith's short position in paper means that the group is somewhat exposed to volatile testliner (recycled paperboard) prices. However, this exposure is partly mitigated by a proportion of sales with contractual cost pass-through mechanisms, as well as the group's strategic vertical integration in paper.

Financial Risk: Intermediate

DS Smith's intermediate financial risk profile is supported by strong cash flow generation, which we believe will help credit ratios recover quickly after moderate debt-funded investments. The group is active in M&A, targeting growth and return on capital over margins. We expect that the group's financial policy will remain unchanged, with dividend payouts, calculated as a ratio of earnings to dividends, of 2.0x-2.5x over the cycle.

Liquidity: Strong

The short-term rating on DS Smith is 'A-3'. We assess DS Smith's liquidity as strong. We expect the group's liquidity sources to exceed its 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) that we expect will have covenant headroom of over 30%. 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	Principal Liquidity Uses
• About £134 million of cash that we consider unrestricted as of Oct. 31, 2016; • Our assumption of ongoing access to an undrawn RCF of £800 million; and • Our forecast of unadjusted FFO in the range of £500 million-£550 million.	• Expected dividend distributions of approximately £120 million-£140 million; • Working capital swings of about £140 million; • Capex of about £200 million-£250 million; and • Our forecast of acquisition spending of about £200 million per year.

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 over 30% headroom.

Ratings Score Snapshot

Corporate Credit Rating

BBB-/Stable/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)
- **Financial policy:** Neutral (no impact)
- **Liquidity:** Strong (no impact)
- **Management and governance:** Satisfactory (no impact)
- **Comparable rating analysis:** Neutral (no impact)

Related Criteria And Research

Related Criteria

- Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Methodology: Industry Risk, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Key Credit Factors For The Containers And Packaging Industry, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Corporate Methodology, Nov. 19, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Business And Financial Risk Matrix

	Financial Risk Profile					
Business Risk Profile	Minimal	Modest	**Intermediate**	Significant	Aggressive	Highly leveraged
Excellent	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
Strong	aa/aa-	a+/a	a-/bbb+	bbb	bb+	bb
Satisfactory	a/a-	bbb+	**bbb/bbb-**	bbb-/bb+	bb	b+
Fair	bbb/bbb-	bbb-	bb+	bb	bb-	b
Weak	bb+	bb+	bb	bb-	b+	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-

Additional Contact:
Industrial Ratings Europe; Corporate_Admin_London@spglobal.com