DS Smith Plc

Full Year Results 2019/20

2 July 2020

Transcript

Miles Roberts:

Good morning. I'm Miles Roberts, the Group Chief Executive. And I'm joined here this morning by Adrian Marsh, our Group Finance Director.

Miles Roberts:

Firstly, thank you very much for spending the time to listen to our presentation, but I would also like just to acknowledge the huge effort and the commitment shown by so many people across DS Smith and in our customers and our supply chain as well, that have really enabled us to perform so well during this period. I'd just like to really acknowledge that absolutely fantastic performance.

Miles Roberts:

Looking at the results for 2019, 20, we've had a resilient performance built on our robust business model. In Europe, we've seen continued market share gains. We've now built our FMCG and resilient categories to 83% of our overall portfolio, making the business even more resilient. Europac integration has been excellent. We've upgraded the synergies and it's delivering fully on track with our expectations. And despite a difficult economic background and the impact of COVID, we've grown the profits organically. If you look in North America, we've had a good domestic performance. It has been offset by the continued negative export paper pricing, but that's being corrected with the establishment of the new Indiana Packaging Plant, it's a state of the art, it's a wonderful facility. It opened on time in budget in, in November, and we're very pleased with the customer pipeline.

Miles Roberts:

So for 2019, we've had a strong financial performance, and despite the generally difficult economic conditions, we've had very strong pricing discipline that has led to that record margin. Operating profits grew by 5% and that included the impact of about £15 million from COVID. The organic cash generation was good, combined with the successful dispose of Plastics, it's meant that the net debt to EBITA has finished the year at 2.1 times ratio, but we've also improved our liquidity as well. And our ESG performance on employees or on communities and environment, again, and we've made some really, really exciting progress there that I'm very pleased with.

Miles Roberts:

But let's just turn to COVID and summarise really what's happened and how we see the future.

Miles Roberts:

Well, firstly, we've responded very well. And this is really built on the company having a very clear purpose as to what we are, what are we trying to achieve, everybody in the company and our suppliers and our customers understand. So if you can come around that in a time of difficulty, we've got a very clear value proposition to our customers, one that they want. And they've increasingly rewarding us because of that. But most importantly, it's about our internal culture. We've talked about this many times about the values and the way that we operate and that has enabled and effective and rapid response to this situation.

Miles Roberts:

So we are, we're very proud of everybody who's worked in DS Smith. We've had fantastic support from our communities. It's been essential to keeping every plant open and our levels of customer service throughout this period have been at an all time high. We've worked with our supply chain, making sure that all of our supplies, including PPE, et cetera, have been according to our plans. And you can see on this slide, the like for like volume growth, yes, it's fallen down to sort of minus 4.5, 4.7% and the worst period, and that compares to economies that are down between 20 and 30% in that period. But of course we've had to respond. We put an extra focus on cost and cashflow, and I said in improving the liquidity of our debt facilities. But ultimately we had an impact of probably about six or seven weeks into last year, so it was relatively limited.

Miles Roberts:

Turning to the short term where we are now, we are seeing increased OCC costs directly as a result of COVID limiting the supply of OCC. It is starting to soften. We expect it really just to be an impact for the first half.

Miles Roberts:

With our volumes, whilst our FMCG has continued to do very well, we have seen this decline in the industrial sector. And along with everybody, we can all see the significant macro economic uncertainty in which we're currently operating. And on that basis decided that it will be imprudent to start the dividend payment whilst that uncertainty exists. We are absolutely aware that this is the prime return to shareholders, and we'll be looking to reinstate the dividend as soon as we can see greater clarity over the economic outlook.

Miles Roberts:

But those medium-term opportunities are there for us. There are still the structural growth drivers of our business, are still absolutely intact. In fact, a number of them we believe will be accelerated as a result of the COVID crisis, in particular e-commerce. Whilst it stepped up, we think that's a step change in their performance, similarly on sustainability in the use of our digital platforms that we've developed and our customers have, and are continuing and will continue to consolidate their supply chain and will be major beneficiaries of this.

Miles Roberts:

So, thank you. I'll now pass over to Adrian who will take you through the financial results for last year. Adrian.

Adrian Marsh:

Thank you, Miles and good morning, everyone.

I will now take you through the financial results for the year. Unless otherwise stated I'm referring to the results of the continuing operations of the business and comparisons are on a constant currency basis. This is the first year of adoption of IRFRS 16 leases for which we have not restated prior year figures, but the impact has been quantified in technical guidance in the financial review published this morning.

Adrian Marsh:

COVID-19 has quite obviously had a significant impact in the markets in which we operate and on the customers with which we serve. The effects of the global pandemic are only really reflected in the last two months of our financial year, to the 30th of April. Miles will go into more detail in a moment on volumes and current trading through this period and into the new financial year, and I will largely focused on the performance of the year 2020 as a whole.

Adrian Marsh:

I'd like though to say that I've been extremely proud of my colleagues who've kept all of our factories running and providing essential products for our customers to supply their customers during these unprecedented times, with lockdowns, having an extremely disruptive effect on their supply chains. The flexibility of our workforce and their commitment to serve our customers has been incredible. Likewise, all our office-based staff have tirelessly worked from home to ensure the businesses run as well as could possibly be expected in the circumstances and to ensure all of our regulatory obligations have been met, including the presentation of our results today. It's been an outstanding performance from everyone who works at DS Smith, and I'm exceptionally proud of being part of such an effort.

Adrian Marsh:

So turning to the numbers, here are our financial headlines. Revenue is down 2% and operating profit up 5%. I'll take you through bridges for these key line items in a moment. We've achieved a record margin, and Miles will talk more about that later.

Adrian Marsh:

Earnings per share is broadly flat. The reason that earnings per share growth is lower than profit is the rights issue that took place in July 2018 ahead of Europac acquisition completing in January 2019, with the result that the average share count this year is greater than last year.

Adrian Marsh:

Return on average capital employed is 10.6%, below our target range, but fully consistent with what was expected following the acquisitions of Interstate and Europac and the disposal of Plastics, which had relatively little capital employed. Please note that there's a 30 basis point impact from IFRS 16 and 20 basis points from the 15 million pounds identified cost impact of COVID-19, which I'll talk more about shortly.

Adrian Marsh:

We saw a similar ROACE effect when we bought SCA Packaging in 2012, with the ratio dipping and then building again, and we expect a similar trajectory again now.

Adrian Marsh:

Walking through the revenue, this is our continuing operations, so excludes Plastics. I've also split out North America because of the different dynamic in our US business compared to a European one. In the US we've seen good performance in the underlying packaging operation, but significant challenges in the paper business due to the substantial fall in export paper pricing since acquisition. The contribution from box volumes was £22 million with a negative balance and other volume principally from increased integration in paper and recycling and slightly lower sheet volumes. So less external paper and recycling cells and slightly less unprocessed corrugated sheets sold in the market.

Adrian Marsh:

The reduction from sales price mix is split £125 million from the forward and packaging prices as the impact of low paper prices feeds through to box prices. And the remaining £160 million is due to lower paper prices on external paper sales.

Adrian Marsh:

Turning to EBITDA, we've delivered organic growth in Europe and had a material benefit from the full contribution from Europac and the synergies we've delivered coming through in line with expectations. I've again, spit out North America to provide better transparency. In this half year, there was the impact of the Indiana site start-up costs of around £15 million, and the impact of COVID-19 in the region, which we estimated another £4-5 million.

Adrian Marsh:

Given our business is much smaller than the US we're more exposed to the COVID-19 impacts on specific customers. Profitability was down similar to half one due to low export paper prices, which whilst was beginning to reverse just before COVID-

19 struck, quickly has reverted back to the previous negative trend. Clearly, this exposure will lessen as the Indiana Packaging plant ramps up over the coming two years, increasing our packaging capacity in the US by one third, and helping to reduce the amount of paper that we sell.

Adrian Marsh:

Taking those effects into account, half two was broadly similar in profit to half one.

Adrian Marsh:

The volume contribution you see here is a net of the positive from packaging, which had a similar drop through to previous periods offset by the decrease in other volumes that I mentioned before. There is then the direct drop through from the lower packaging prices and a small mix effect of £120 million for the year, and £160 million for paper. At H1, there was a round a hundred million pounds, total price mix effect of which around £80 million related to paper and £20 million to packaging.

Adrian Marsh:

On the other side, we benefited substantially from lower paper costs and from OCC reaching historic lows in the period, and on-balance delivered one and a half percent organic growth due to our strong commercial approach and quality offering to customers. Overall, we achieved a record margin result in the middle of our target range that we set a year ago, driven by the acquisition of Europac.

Adrian Marsh:

Margins have been very strong in Southern Europe with the full integration and synergy delivery in Europac, and remain good in Eastern Europe. In Northern Europe, margins fell 80 basis points driven by paper, whilst North America effected low export paper prices along with the one-offs already described have reduced margins substantially in this year.

Adrian Marsh:

With regards to COVID-19, as I mentioned in my introduction, we performed admirably through the height of the crisis. Our priority through the crisis was to keep our staff safe and to serve our customers. We have of course, incurred additional costs related to hygiene, cleaning and logistics, but also somewhat unexpectedly from a sharp spike in the cost of OCC, which we managed to avoid most of due to our inventory position in March, but had an increasing effect through April. We have estimated that these combined cost effects were around £15 million.

Adrian Marsh:

Looking into FY 21, there will again be additional costs related to business operations. And there's also the impact of higher OCC costs. As we've seen countries exit lockdown and waste collection begin to normalize, we're now seeing OCC prices begin to revert to more normalized levels.

Adrian Marsh:

As a reminder, we consume around 330,000 tons of OCC a month. And given paper prices didn't rise to reflect this spike, it has the effect of being an unmitigated margin hit. The immediate actions we've taken during this pandemic has been, as you'd expect from us, a strict conservation of cash and laser focus on costs. By way of examples, we've reduced capex by a fifth and the difficult decision to suspend our dividend. We've cut back on all areas of discretionary expenditure and cancelled the annual management pay review. We're also working closely with our supply chain and procurement functions to address all areas of direct and indirect costs.

Adrian Marsh:

Cash flow has improved once again in the year. Working capital, whilst an outflow, is net of a further reduction in non-recourse invoice discounting in the year. We've completed our trainee or pension valuation and cash contributions remain unchanged for the next three years. capex was in line with what I guided to and our tax cost reflects higher profits.

Adrian Marsh:

Moving to cashflow, the main inflows were free cash flow and the proceeds of the plastic disposal. Dividends were the previous year's final and the impact of not paying this year's interim dividend will be a next year's cash flow. We ended the year at 2.1 times leverage, close to our target of two times. This ratio is based on our banking covenant calculations, which is on a pre IFRS 16 basis. Taking into account the full interstate put option, the ratio would have been around 2.3 times.

Adrian Marsh:

Our leverage as noted, sits at 2.1 times, and we continue to target two times as our medium-term objective. Liquidity management has always been a focus for us, and we have a good balance of public bonds with no meaningful maturities until 2023.

Adrian Marsh:

In addition to our range of public bonds and term loans, we have £1.4 billion pounds of undrawn five-year committed bank facilities. These bank facilities are a key instrument in dealing with any short-term finance needs and provide essential liquidity. The covenants attached to these facilities were put in place prior to the SCA acquisition, and we felt not appropriate for the Group in its current size and form. In discussions with our banking group, we've now permanently changed the key leverage ratio of net debt to EBITDA of 3.25 times to 3.75 times.

Adrian Marsh:

Our public debt is rated as investment grade by Standard & Poor, and we remain committed to retaining this rating. We've reviewed our asset footprint and a number of assets have been identified as a non-core and discussions have taken place with a number of buyers. Whilst these discussions have paused during the pandemic, we're now re-engaging the various processes.

Adrian Marsh:

The Board considers a dividend to be a very important component to shareholder returns. On the 8th of April 2020 in light of the unprecedented uncertainty due to the COVID-19 pandemic, the Board had decided that it'd be prudent not to pay the interim dividend due for payment on the 1st of May 2020, despite our strong liquidity profile and resilient trading at that date. The Board has since considered the overall dividend payment for this financial year and taken into consideration the interests of all stakeholders, concluded that the outlet remains too uncertain to commit to resumption of dividend payments in the short-term. Recognising the importance of dividends to all shareholders, the Board will actively consider the resumption of dividend payment when we have greater clarity over outlook.

Adrian Marsh:

These are the usual line items you've come to expect. I've attempted this time to estimate the cost impact of COVID-19, but you'll appreciate that I'm not the best person to give a view on how long it will continue and what, if any additional burdens will be added to the business. My planning assumption is that it will be a H1 impact for us, and there'll be no significant second wave impacts. But I'm fully aware that this may or may not be the case.

Adrian Marsh:

Whilst a spike in OCC cost is now turning down from its peak, there is a £20 million a month impact based on 330,000 tons of consumption per month. As noted before, the current spike in OCC prices, this has not been mitigated with increases in paper prices, although this may not be the case going forward. For adjusting items, which I currently anticipate to be around £50 million, I've included the finer Europac integration costs, the normal in state put option unwind, which is non-cash, and around £20 million, which I'm anticipating for COVID related restructuring activities.

Adrian Marsh:

Stepping back from the results of the last 12 months, our margin achievement should be considered in the context of the journey that DS Smith has been on for the last decade. These are the margins DS Smith reported each of those years, and you can see that the effect of both the acquisitions and disposals synergy delivery and organic growth combined over the period, has driven us to more than double the margin. This has been due to focusing on high quality value adding packaging that customers will pay for, along with the benefits of scale of a pan European organisation once synergies delivered.

Adrian Marsh:

Clearly the level of internal paper capacity in any year can have a positive or negative impact, and it remains our objective to reduce, over time, our paper capacity, which will have the effect of reducing margin volatility. So as my wrap, it's been another year of progress in delivering against our targets. Volume continues to be ahead of the market, albeit we did see some weakness in industrial volumes before and during the COVID-19 crisis. Our main exposure in Germany was showing the positive effects of actions taken during the year, and Miles will describe our view on this once COVID has subsided and economic stimuli methods get taken in Europe.

Adrian Marsh:

I've already described our margin development, and ROACE is now reset and expected to return to a medium-term target of 12 to 15% following the two recent large acquisitions and the disposal of Plastics. Net debt to EBITDA is 2.1 times, just above our target range, and better than we anticipated at the time of announcing the Europac acquisition. I will now hand over to Miles to talk more about the business in general, and our response to the current economic environment in particular.

Miles Roberts:

Thank you Adrian. Our business is built on a clear purpose, a clear value proposition, and clear values in the way that we work with each other, with our suppliers, with our communities, and with our customers. This is what's enabled us to adapt so quickly to the changing environment. And whilst, when we come out of COVID, we will continue to thrive and develop as a company. If I look at our European performance, despite the challenging economic background and the impact of COVID, we achieved organic profit growth and a record margin. We saw our volumes really increasing throughout the period until the final six, seven weeks of the year when COVID struck. And this was built on our growth in the FMCG and e-commerce sectors. And particularly with our large customers where we've seen another high single digit, like for like growth with those customers as they've been consolidating their supply chain, And we've been a major beneficiary of that.

Miles Roberts:

But our commercial excellence last year, whilst we saw a significant decrease in the price of paper, for our packaging business, that translated into really quite a modest reduction in the end prices, with maybe more between the three and 4%, absolutely demonstrating the value that we're adding to our customers and the differentiated offering that we provide. Our paper optimisation, we currently about 80% of the paper we use in Europe is, we have the capacity, the internal capacity to supply that. And we have an ambition to reduce that to 60%. The review of those assets has been completed, but the delivery of that plan has been slightly held back because of COVID, but it remains our ambition still to get to a 60%. If I look at the US performance, the underlying position is stable, it's a good domestic performance. The export prices have remained weak in half two.

Miles Roberts:

We have seen quite an impact of COVID in April in the US, particularly with our protein-based customers. These are customers processing chicken and beef. They work in cold temperature environments. We have seen a number of those customers close their operations due to the occurrence of COVID within their workplace. However, we are now seeing that starting to improve quite significantly. On the Indiana packaging plant, we had the £15 million of start-up costs all happen on time, on budget. The main purpose of this is it's obviously to supply our customers. We haven't been able to keep up with customer demand, until we have this new capacity, that's now coming online. But it does significantly reduce our long paper position in the US. To come away from the weak export market onto the domestic markets where the prices of paper are much, much higher, and we should get a significant benefit from that. As I say, the pipeline of opportunities with our customers. And indeed, the customers we've actually secured, particularly in the last customers, have been very, very encouraging. I'm very pleased with that.

Miles Roberts:

Now given the impact of COVID, I think it's right that we give you more detail. And I show on this slide about how our volumes have been developing throughout the year, and indeed in the final months on a monthly basis. Clearly one month to the next things can move quite a quite significantly. So, if you look in H1, we grew organically at 0.7%. Again, that was ahead of the market. But during the second half, as we expected, we saw quite a noticeable increase in the rate of like for like volume growth. It was improving throughout the period. The average for the first four months of the second half was 1.5%. but then it started to fall back in March, really as the impact of COVID started to be felt in some regions, particularly in southern Europe, such as Italy, and also into Iberia. And we saw that trend continue into April. And then by May most of the regions were sort of feeling the worst effect of COVID. And in that period, we saw that our volumes declined by 4.7% on a like-for-like basis with May last year.

Miles Roberts:

We've seen June, our estimate for June. We don't have the final numbers, it's just our estimate. We're seeing an improvement in that trend, really as the lockdown starts to ease in many regions. So you see throughout the whole period, we saw the FMCG and e-commerce grow throughout. So even in May, we are seeing a like-for-like increase in FMCG e-commerce. So all of the reduction has really come from the industrial sector, particularly in automotive, particularly in heavy manufacturing.

Miles Roberts:

Looking at further detail about our FMCG and e-commerce, our customer base. I said I'm very pleased that this now represents a greater proportion of our overall box volumes. If we go back to last year it was about 80%, but it's now improved to 83%. And that is on an average for the last year. So, in the final period of last year it was actually even greater than that. We have outperformed the market as I've said previously. The opportunity with our multinational companies remain significant. We worked for all the large multinational companies across Europe. We've seen our share of their business grow steadily year on year over the last 10 years. We've seen it grow further into this year. And we believe there're more opportunity to grow a greater share of their business over the coming year and years. But as I said, the industrial sector was really heavily impacted by COVID, and we have seen reductions of between 20 and 30% on a year on year basis. Although there are some signs of improvement in June, and the outlook is for some further recovery.

Miles Roberts:

If we look it on a regional basis, again for each month, we show here that northern Europe has remained very, very resilient. Here e-commerce represents a greater proportion of goods sold than elsewhere in our business. But we have seen southern Europe suffer heavily as the lockdown has been extensive there in all countries, in Iberia, France, and Italy. We've had a lower tourist season as well, particularly in May. But we're now seeing the lockdown ease, and in southern Europe we're expecting June to show quite a good meaningful improvement on that position. And as I said previously, North America's really been hit by some large customers that we have in the food processing in chilled environments, where they've closed their operations, sometimes quite extensive periods of time due to a breakout of COVID in their employees. But again, I'm pleased to see that in June, the North American position is recovering quite strongly as well.

Miles Roberts:

So, the effect of COVID on the medium-term, we believe that COVID will accelerate a number of the structural changes we've seen in our marketplace over a number of years. The obvious element is e-commerce. We've seen an absolute boom in e-commerce business. In fact, if we just take the example of the UK, we've seen the last eight weeks of our e-commerce business has been busier than the busiest week leading up to Christmas last year. We've seen a near doubling of the volumes there. But we're also seeing, when we look at other regions across the world that have come out of COVID, they've all seen this pickup in e-commerce. But what's important is that post lockdown e-commerce has not lost the share of the market that it has gained. People have become more used to ordering online. It could be groceries or other goods, and the e-commerce hasn't lost its position.

Miles Roberts:

Very importantly, we've got a number of customers who we've been talking to about having a direct to consumer offering. And a number of those customers have really suffered during the lockdown where their outlet stores, if they've been predominantly selling just through bricks and mortar, that's obviously had a dreadful effect on their sales. So, they're now coming to us and looking to develop their own platform direct to consumer subscription models. And we think that is something that they will not let go of going forwards. When we come to our customers, this whole issue of security of supply, we've demonstrated again to our customers, even in regions where there're lockdowns, our factories have remained open. Where there've been supply issues in various regions, we can supply into that region from outside of the region with our network of plants.

Miles Roberts:

And they've rewarded us with more business as a consequence. But they're also looking to work differently. And our digital platforms that we've developed over many years of how we can communicate with customers, communicate internally, and communicate with our supply base. Lining up, improving that flexibility. Improving the efficiency of the way we work has proved invaluable during the lockdown. And we believe our customers will want to continue working along that same trend in the future. So, all of this gives us some grounds for real optimism that we can continue to grow our business, grow our share of the market, building more resilience into our business going forward.

Miles Roberts:

As we all know, sustainability has been at the heart of DS Smith's business model for many, many years. It's driven into the way we work internally with our supply base, and with our customers. We see it not only as the right thing to do, but a real driver of growth. Customers increasingly talk about circularity of products, not just how they're picked up and processed and recycled, but how recyclability is designed into the product from the start. About plastic replacement. And we're very pleased with our progress and our real leadership in this area.

Miles Roberts:

If we look at our ESG performance overall, I think it's been a year of real good further improvement. Even at one of our key meetings about CO_2 emissions, since 2015, over the last four years, we've improved our CO_2 per ton of production by 11%. And last year, we improved by 3% maintaining that trend well on track to hit our target of less than 30% reduction by 2030. Working with our employees, our performance on health and safety, we've seen significant improvements each and every year over the last 10, 12 years. And we've finished with an accident frequency rate to about two at the end of the period. Still too many accidents, but comparatively a very good and consistent improvement.

Miles Roberts:

If we look at our sites, they're all engaged in community programs. Every site with more than 50 people has a community engagement working with the communities in which they operate. Often they can be the largest employer in that region, and that's really helped us during this COVID crisis. Our plants are being classified as essential businesses. They've all remained open, and we've really enjoyed some super support from the communities in which we operate. As you know we have an excellent relationship with the Ellen MacArthur Foundation about the Circulytics, in particular using the business tool. We're very pleased with the results we've been getting from that and the classification we've received. One of the very leading companies here, all about the continued plastic replacement innovation and designing recyclability into the packaging in the first place.

Miles Roberts:

Looking at the current year, we have the current impact of COVID, and we have demonstrated how we can very effectively deal with this. By focusing on our customers, continuing to deliver for them, our service levels today are the highest they have ever been. And we're being rewarded with that with growing market share and a growing proportion of their business. We do have to deal with some of the short-term increasing costs such as the OCC impact, but we're dealing with this by continuing to drive cost efficiency throughout the organization. And of course, cash generation aided with our increased liquidity.

Miles Roberts:

In the medium-term, there are real opportunities for us to continue to develop and grow our business. That resilient FMCG e-commerce platform that we built is growing, and we believe that COVID will further enhance the attractiveness of that to the end consumer. Their fundamental growth drives of corrugated remain strong. On the sustainability agenda, the way people are living and changing their lives, all place the strength of corrugated. We will continue to optimize our paper position, our internal supply of paper, again making our business model more resilient for the future. So, with all of that we believe we're in a good position to deal with the current uncertainty that benefit from the long term opportunity. Thank you. I'll now hand over to the operator who will organise your questions.

Operator:

Thank you. Ladies and gentlemen, if you would like to ask a question, you can do so now by pressing *1 on your telephone. That's *1 if you'd like to ask a question. We will now take our first question from Alexander Mees. JP Morgan, please go ahead, the line is open.

Alexander Mees:

Thank you. Good morning Miles and good morning Adrian. Just firstly, and I suppose predictably, just on the increase in OCC prices, I wonder if you can give us some colour as to why you believe there hasn't been a response in terms of the box prices so far. Secondly, on e-commerce, so I just wonder if you can quantify the proportion of volumes or revenue that is now attributed to the e-commerce and where you think that goes in the current year. And finally, I'm just interested in your strategy around industrial packaging. I wonder if there's still a role for industrial packaging in the business as you see it now. Thank you.

Miles Roberts:

Thank you, thank you very much, Alex. You're absolutely right, the OCC costs have increased in the short-term really as a result of the limited actual recycling of the material. We see that the capacity is now coming back on stream. So, we've seen the prices fall back. I think the only reason why the paper price hasn't responded is because it is seen as a relatively short-term issue, and really coming out over the, certainly within our first half. You mentioned about e-commerce. You're right, it's been extremely, extremely busy, where e-commerce is a major proportion of that country's retail outlets. I mean for us it's now representing obviously a greater proportion. I think it's always slightly difficult to know exactly what our customers are using the packaging for, but from all our surveys it looks like it's now in the sort of the mid teens, probably about 14%, something like that of our business. And it continues to grow very, very, very nicely.

Miles Roberts:

With the industrial side. And this is now that we haven't been investing behind, we do have a business there, it's getting a smaller and smaller part of our business really as our growth in FMCG, e-commerce, other categories moves forward. Some of the facilities are shared facilities so it's difficult to sort of pop them out and say, "Right, we're just not going to do that." It does provide marginal volume. But I think you can see in our results, when the whole market is down significantly in packaging and we are outperforming that, then that is showing that we've got the right end-customer mix. I think ultimately, where do we get to? We'll probably get to about 90%, something like that on the FMCG commerce, but there'll always be some industrial in there as we seek to optimize the use of our assets.

Operator:

Thank you. We will now take our next question from Cole Hawthorne, from Jefferies. Please go ahead. The line is open.

Cole:

Hey Miles, hi Adrian. Could you just walk me through the US division in a little bit more detail? Can you walk through how the integration of that paper volumes in your US business should benefit profitability into next year? And then talk a little bit more about the weakness you saw in those protein customers and what you're seeing now on that side of the business. Then secondly, on the dividend, could you give us your initial thoughts, what you're potentially proposing to the Board when you get to your H1 results in December. Are you thinking you're going to go in line with your kind of 2 to 2.5 times coverage range?

Miles Roberts:

Just take the dividend question first, because this is a really, really tough decision. I'm quite prepared to be accused of being overcautious. It is just caution over the general economic outlook and some of the cost increases that we see in OCC. We expect them to come off and therefore, as soon as we can see some clarity, we will return to the dividend discussion. We are very clear on our policy of two to two and a half. We think that's the right policy, and we will be looking to recommence dividends with that policy in mind. I can't predict what the Board will be looking at, but as I said, I think you can probably ... We're just being cautious because of the current environment, but I said it will be fully reviewed as soon as we get more clarity as to how the markets are varying. In the US, I said we have about 200,000 tons of paper that goes for export that has been ... The prices there have been very low.

Miles Roberts:

It's good that we're actually pleased with the performance. Lebanon has about 130,000 tons of capacity, so that takes out about two thirds of that paper capacity, plus there's some other growth opportunities for us coming along as well. In terms of Lebanon, it did start up at the end of November. We started producing more when the main assets came on in January. Our expectation is that we're going to have within those first five, six months, we should have at least 15% of that capacity, all the orders we've received, et cetera, and the work we've taken on is fully in line with that. But towards the end of our financial year, if you look at Indianapolis where that was quite a hot spot for factory close, et cetera, with the coronavirus issue.

Miles Roberts:

Our factory remained open there. As we've said, all the factories have been, but a number of our clients held back production even if they're operating at a much reduced level. As I said, the pipeline is very good with our customer base. If we look at, as we're sort of coming out of the coronavirus issue, we're starting to see the volumes out of Lebanon increase towards the line that we expected. We're not quite there yet. We wouldn't expect to be there, but we're absolutely confident that they'll come back because we have the orders. It's more our customers just not being able, not operating or operating below capacity, but as I said, the pipeline and the actual ... What we've received is good. We're pleased with that. We're confident this is going to take out about two thirds of that excess paper capacity.

Miles Roberts:

Did that answer your question?

Cole:

It does. Just one follow up on the dividend. If you go back to that two to three times cover. I understand this year, you're going to be impacted by higher costs, et cetera, which is impacting profitability, but looking out into FY beyond this year, into 2022 and 2023, what are your priorities for the capital allocation going through it? How do you see DS Smith moving forward beyond 2021 into capex, potentially M&A, et cetera?

Miles Roberts:

Absolutely. Look, we have very clear dividend policy. We feel that dividend policy of two and two and a half is the right policy for us. We've had it for many years and that's enabled us to grow and develop at the same time. As I said, we just have this particular uncertainty and our priority must be to secure the company. It's until we can see that clarity. Now, moving forward, we expect to come out of this. As I said, I think actually there's some quite encouraging signs. In terms of capital allocation, we do have that dividend policy. It is a prime we return to shareholders. We're absolutely aware that. On a personal basis, I'm a large shareholder in terms of my shareholding. I can tell you, not getting a dividend, it hurts. But then in terms of future capital allocation, we do have a number of organic projects. We have a lot of demand coming in the US. We feel quite positive about that. We have further opportunities in Europe, as well, to grow particularly our packaging business.

Miles Roberts:

At the same time, we're looking at some of our non-core assets. You've seen us dispose of plastics last year, but there are some other assets particularly on the paper side. We've talked about that we'll be seeking to exit as we described previously. Would you say anything else on that, Adrian?

Adrian Marsh:

No, I think that's a fair reflection, Miles. I think if we look out in our corporate planning horizon, you can still see some significant opportunities, particularly within the business we've already got. Clearly, we're not looking at any M&A now, as you'd expect. I dare say, as we work through the next 18 to 24 months, there'll be companies that have decided that they don't want to carry on operating anymore in independent ownership. There could well be opportunities at a point in time in the future, but at the moment, the focus has to be ... The focus that you would expect, I'm sure, is absolutely on cash, conserving it, and managing our cost base until we just get that level of visibility.

Adrian Marsh:

I'm sure we'll get it. I mean, we're already seeing some positive trends, but as I said in my words, we don't know what we don't know. At the moment, you can get up on any given day and feel very positive and you can get up in any given day and hear some pretty negative news again. I guess we just have to steer through the next few months, get through the half year, and then take a good long look at what we want to allocate capital going forward.

Cole:

Thank you.

Operator:

Thank you. We will now take our next question from Mikael Doepel from UBS. Please go ahead. Your line is open.

Mikael:

Thank you. It's Mikael. I'm here with UBS. Just a couple of questions, first in terms of the volume. I appreciate you pointing out the monthly trends there. That's very helpful, so thanks for that. I just wanted to ask in terms of the visibility for July volumes, I assume you have some sort of a visibility there. What are you seeing in the market right now?

Miles Roberts:

We expect to see ... I mean, our worst period, we shown ... I've put a lot of detail there, we showed at minus 4.7. That seems to be our worst period with everywhere sort of in lockdown. We're seeing quite a good improvement in June. We don't have the final figures, but that looks pretty positive and we expect that trend to continue. It really is on the continuing growth of the FMCG, et cetera, but also the industrial, it's not coming back strongly, but it's lifting up a little bit. We are seeing know good share gains, et cetera, from our big customers on the FMCG side, so we expect on-going improvement. Did you have another question as well?

Mikael:

That's fair. Yeah. I have another one on the containerboard pricing. Just wanted to ask what you are seeing on that market right now. We do see the OCC reversing. There is some supply coming on in Europe. What are you seeing in terms of the containerboard pricing right now and what's your expectations going forward there?

Miles Roberts:

Yeah. Look, last year we saw paper prices come down, then go up. We saw a softening towards the end of last year. At the moment, it's stable. It really does depend on how, on the general recovery. To say, we're seeing our volumes improve. It just depends on the outlook. If the outlook gets worse for the general economies, then that's not going to bode well. If it continues to improve then, and hopefully the stability will continue.

Adrian Marsh:

The reality is it doesn't take much positive or negative to have an impact. We're in a reasonably fragile environment at the moment if, as Miles said it, demand becomes stronger, you can see a different set of outcomes, but if it's weaker overall for corrugated globally, then it's putting pressure on products for sure.

Miles Roberts:

Just on packaging pricing, they stayed very stable now for a while. The volatility in paper, we're still seeing quite a bit of stability in packaging as you saw last year. We're very pleased with that. Do you have another question?

Mikael:

Okay. That's fair. Thank you very much.

Operator:

Thank you. We will now take our next question from Barry Dixon from Davy. Please go ahead. The line is open.

Barry:

Yes. Good morning, Miles. Good morning, Adrian. Three questions from me. Just to follow on the pricing, Miles and Adrian. I think Miles, you mentioned on the call and maybe correct me if I'm wrong, that prices on packaging were down 3 to 4%. You might just give us a sense as to what the scale of decline in corrugated prices has been from the peak, let's say, of the start of last year.

Barry:

Secondly, on Europac, could you just help us to understand the profitability of Europac and how that's progressed over the year? I mean, on my basic math, you did a hundred, or you did £35 million of profits last year in FY19. You've done £50 underlying in, or incremental, in FY20. If I strip out the first half numbers, it looks like there was a further deterioration in profitability in Europac in the second half of your calendar 20, or your physical 2020. So you might just help us to understand that and the impact of the lower containerboard prices on that business.

Barry:

Then the last question, just going back to the US, and I suppose really trying to understand that and the deterioration of profitability. At what point do you consider impairing that business? What's the process that you have to go through, or that you went through, in terms of deciding not to impair the goodwill in that business?

Miles Roberts:

I'll get that.

Miles Roberts:

Thank you, Barry. Just on the pricing, as I said, we exited last year, the last financial year, packaging prices were between 3 and 4% below where they were at the start of the year. I think the price of paper was down, depends what grade, but sort of in a 20 to 25%. Interestingly that 3 to 4 was pretty consistent during the last few months, hence my previous comment on stability of pricing. We're very pleased with the retention? There's no doubt about that, I think. Even in this, the current environment, you're seeing customers are very, very focused on service and quality, security of that supply, and we've been able to offer them that. We're very pleased with that performance. I'm sure Adrian knows that but in Europac, I think you're missing the synergies on those numbers, Barry. I think you add in the synergies, you'll see quite a good improvement coming through there.

Adrian Marsh:

Last year was 35 plus 6 synergies. This year is 50 plus 35. I can take the impairment question as well, Barry. In terms of impairment, obviously you have to go through a process each year at your financial year end, which we've just gone through, where they look at the asset values and they look at the future revenue and the future profitability. Clearly, we have Indiana coming into play within our numbers. As you work through that, there's no indication to impair. At the half year, again, you'll look at triggers for impairment and auditors will again review the numbers that it's been through, clearly with a significant reduction in profitability which we've had this year. Then you're in a different position than you were the year before.

Adrian Marsh:

However, it's not a single year that gets looked at. You look at the business as a whole going forward for that cash generating unit that it's within and you model it on that basis, and that gets fully audited. So, no issue to impair. Your question is could there be a trigger in the future, but the trigger in the future would be significant sustained reduction in pricing or volume that has to be predicted to continue for a significant period and or us failing to manage the long paper position. At the moment, it's never one year in isolation. You look at it over the round and if your future cash flows can't support your asset valuation, you have no option but to impair.

Barry:

Okay. Thank you.

Operator:

Thank you.

Miles Roberts:

Thank you.

Operator:

We will now take our next question from David O'Brien from Goodbody. Please go ahead. The line is open.

David:

Hey guys. Thanks for taking my question. First, I'm sorry to bring you back to the dividend, but you've talked about OCC starting to turn back down and down, which will have produce cost pressures. You're seeing improvement in volume performance in Europe and you expect Indiana to improve as well. It seems like the outlook is getting a little bit better for you. I'm just struggling to reconcile that with the caution on the dividends. I wonder, could you give us some lines in the sand as external observers of the company to say when a dividend could be reinstated and if you were to colour in what underpins your caution.

David:

Also, against that backdrop, your description of the robust business model and the resilience in the model, I guess we're seeing that to an extent in the volume side of the business, but it isn't really transferring into the profit performance of the business with organic profits down by double digits in the second half, and consensus looking for north of 20% of a decline in 2021. I'm just wondering what leverage can you pull to maybe improve the resilience of earnings in the company in the near term and you've referenced cost savings in the presentation. Is there an actual cost saving number you could share with us?

Miles Roberts:

Just taking the dividend, and as I said, you can accuse us of being over prudent, and you're right in a lot of things that you say. We have had a big hit on OCC and we see the cost coming off, but it is a hit in the short-term. We can see the volume's improving and they are, but we do have a volume decline. You can see Indiana coming on as well. That's absolutely right. The US has been held back again because of those issues. There's a long discussion about this. Given that sort of just general uncertainty, we can commence paying dividends, again, at any time. We just want to see that our expectations are actually paying out. They're actually coming as well as we expect, and then we'll recommence. We fully understand this is the primary return, looking at our liquidity profile, et cetera. It's just that caution because only a few months since we made the decision to not pay the interim decision. It's three months ago and we just looking for more clarity. In terms of on the organic side, on the organic profitability ...

Adrian Marsh:

I don't remember the question. Sorry.

Miles Roberts:

Just on the organic profitability, I think when you look at that-

David:

In terms of the ... You've talked about the robust business model, and to an extent, we can see that in your volume performance, albeit it's weakened a little bit. But the earnings number for the company has come under a little bit of pressure in the second half, and it looks like consensus and our own expectations would prefer deterioration. What are the leverage you guys can pull to offset that, because it seems like there's a pretty sharp decline in organic profits.

Adrian Marsh:

Yeah. I mean, look, David, we wouldn't put out a specific target, but there are a number of, as you would expect a number of initiatives on-going at the moment, not least just in straight procurement, what we're buying, how we're operating. Whilst the environment is uncertain we do have opportunities to rationalize and manage our cost base and we will take all of those.

Adrian Marsh:

Likewise, we're looking at flexibility of labour where we're operating, how we're operating and there's some significant, COVID impacts in next year, but in terms of the absolute cost lines that we're taking, they're all being played. They're all being pulled. It's no different to be fair than we've had each and every year. I don't know if you've got anything to add on that Miles?

Miles Roberts:

No, I think if you look at the second half performance, we have had the level of start-up 15 plus COVID is 30 plus the impact of those lower volumes. If you adjust for those, recognizing that there's a lot of one off with COVID in there, I think you see the underlying performance is actually quite a bit better than that because the volumes were actually increasing and our margin retention was good as well.

Miles Roberts:

So on that adjusted basis, actually, it's quite a good basis.

David:

Great. Can I just add one extra question, just that our working capital finance has been reduced to 428 now, I think previously Adrian said just around 500 was the level you are happy with. Can you just give us a colour on what's changed and where you see the comfort level now?

Adrian Marsh:

Yeah. Look somewhere between four and 500. I mean, clearly, we've always said we look at things on an economic basis. And if we can manage to cover a reduction in factoring, if it's more economic to do it to use an alternative method, we will do that. And we have done, we have now got access to extremely cheap European commercial paper, and we've been using that to finance. I mean, everything in the end, as we said before, becomes a decision around economics and a decision around cost.

Adrian Marsh:

And I've said I'd be comfortable around the 500. I am comfortable around the 500. Have I taken a conscious effort to put it to 428 versus just under 500, not at all, but the economics of the flows of our working capital and alternative cheap financing have been compelling. And we continue to look at that.

Adrian Marsh:

I mean, it won't go above 500. Do I think it will go below four? Probably not, but it's impossible to say. I mean, we've been running for the last 18 months. I think I've talked about it at the last year end, and probably the half year. A significant program around how we manage working capital with our business, whether it's collections, whether it's ensuring we've got effective procurement with all of our suppliers or it's particularly inventory and spare part engineering, spare parts. And we continue to drive at that.

David:

Thank you.

Operator:

We will now take our next question from Justin Jordan from Exane. Please go ahead. The line is open.

Justin Jordan:

Thank you. Good morning, everyone. Thank you for the colour you've given us on COVID-19, I'm delighted to see the modest recovery you've seen in recent weeks. Can I just concentrate on more longer-term strategy, please, because I appreciate there's various issues at play today, but can we just return to, over the last decade

Miles as CEO you've completed, I think it's 20 acquisitions, and M&A has been a very important driver of the expansion of the Group over the last decade.

Justin Jordan:

But if we think specifically on Interstate, you've now owned it for almost three years and you've very publicly and repeatedly talked about a 12 to 15% return hurdle for M&A. On Interstate, including the minority, including the M&A and restructuring cost, the acquisition of CCC, the Indiana box plants, you've spent about 1.1 billion sterling to deliver 39 million of EBIT. That's a sub 4% return in capital employed on that US expansion. Can you please explain to us what's gone wrong, frankly, what you as CEO will do to improve the performance of that business going forward?

Miles Roberts:

Absolutely. But I think you've seen the returns we have been making. If you look at the US, when we bought it, I think in the first full year, we made over 13% return, 13.2 from memory, something like that. I remember discussing it with yourself. And we've always said that with the exposure this business has done very well. The returns are very good. The exposure is on the export price of paper. All the reduction comes from that export price. We identified that risk. This is certainly a sort of a medium-term asset. We have to bring that paper back on shore domestically, and then we'll get the returns. If you adjust for the change in the price of paper that we'll get from bringing this volume back on shore, then you start to get the returns much more in line with our range of 12 to 15%. That is what we set out. That is what we're doing, and we're pleased with that progress, but we have been hit by the export market.

Justin Jordan:

And to get to 12 to 15% return on the US then please Miles.

Miles Roberts:

We were 13.2% in the year before last, we said the deterioration, you've got the cost of opening Lebanon, plus you've got the export market. We bring the export market back on shore, plus you get the return from the packing side on Lebanon. You get back into that 12 to 15%, which is where we were, it's just a point in time that you're choosing.

Justin Jordan:

Okay. But if you take a step back and just look at Group return Miles, it's excluding Plastics, because clearly discontinued business you've excluded from your own historical return on capital employed. Your Group return was 14.7 in fiscal 16. It's now fallen for four straight years. In the same four-year period industry period have seen improvements to capital employed. Now, unfortunately that is an indication that your M&A is just not delivering whether it's Interstate or whether it's Europac, it's just not delivering results at 15% return hurdles.

Miles Roberts:

No, look, we're very confident about the acquisitions we've made. If you look at the history of when we bought SCA Packaging, we made a very modest return in the first year, you don't earn 14 to 15% in the first year of any acquisition. If you look at the Europac acquisition, the return on capital employed there last year with all the reduction in paper was just below 9%. And that's with all the reduction in paper. We said when we bought it, the target was to be 9% in the first full year. So we're in line with that, but you have to recognise if you sell your highest return on capital employed assets, plastics, and invest in new assets, you don't make the same return in the short-term, but we're confident of getting back into that range exactly as we have done before, you look at the forward projections and we can absolutely see that. Most certainly.

Justin Jordan:

Okay. Can you give us a timeline then, please to get group return at capital employed back to your 12 to 15% range.

Miles Roberts:

Yes, we've talked about that being in the medium-term. That's absolutely right. We can't, COVID has come at us. We didn't know about that. We're looking for recovering these markets but look at the history. Look at what's happened, that 14.7 was with all those other acquisitions in there. It shows what we can do. You can see the synergies coming through. It explained the program of improvement. I mean, look at how are we performing on the front line as well? Really these, they're all in strategy. And it's purely a consequence of old and new and the goodwill there and the time for these synergies to come through, et cetera, that's all it is.

Justin Jordan:

Okay. Well, Miles, look, we're personal friends, so I don't want to get personal things away in the way of accountability. But one suggestion I'd make to you personally is when with the interim results in December, can you give us a returns analysis of recent M&A from Interstate, from UK Paper, Europac, etc. Prove to us that you can deliver 12 to 15% returns on those acquisitions. And if you're unwilling to do that, please don't do future M&A. Clearly it is very worrying.

Miles Roberts:

Justin, we've set it all out.

Justin Jordan:

Miles, the numbers don't lie. The return is falling.

Miles Roberts:

Justin, Justin, Justin, we have set that all out. When we announced the acquisitions, it's all been there. You can't seriously expect us to make an acquisition that gives us a 15% return on capital in the first year, the acquisition, Justin, I don't understand what you're saying. You were positive on them, recognising it's a low return on capital in the first full year. So, go back to the acquisition case. That is what we stand by. That is what we've always delivered and we will in the future. It's all there already.

Operator:

Thank you, we will now take our next question. Carl from Janice Henderson Investment, please go ahead, the line is open.

Carl:

Thanks. Just a couple of questions. I'm just asking for some elaboration around comments you've made. When you talk about optimising the paper manufacturing, if you could elaborate a little bit on that, I'd be most grateful. Also when you refer to service levels being the highest they've been, what's the measure there? And finally, just a question around US as lockdown's re-establish, just if you could help me understand a bit more about your exposure to the South and West and markets in the US.

Miles Roberts:

Yeah. On the paper manufacturing I said we have roughly about 80% of the paper we need is manufactured and our target is to get that to 60%. The way of getting there, we're really looking at getting around about 10% of our paper capacity out. We've completed that review of that work. And indeed we've been discussing with a number of parties about those assets. So, prior to this whole sort of COVID, actually making quite reasonable progress.

Miles Roberts:

But the COVID situation just in terms of getting people together and transactions, et cetera, it has just slowed it, but that is still our intention, exactly what we want to do, we've got a good idea of where it's going to go to. And it's about executing on that strategy. When we talk about our customer service levels, we talk about on time in full delivery, you can see that the Group performance has been improving steadily over the years.

Miles Roberts:

And that's despite bringing in a number of acquisitions. In fact, all the acquisitions we've ever made have always had a lower customer service level than ours. It's one of the reasons that focus on that service, how we able to grow and take share consistently. That's on time in full, that's within the delivery window. So some of our biggest customers, we could have a window to deliver within half an hour. And at that measure last year, we finished at over 95%. I have to say the Europac acquisition was we started with that. It was more in sort of the early 80%, that number is in there. And today we're seeing our performance is up around about the 97%, something like that. So, it's the highest it's been. And that is an industry leader that is on time in full, that is they order everything, they get exactly what they've ordered.

Miles Roberts:

Not that the lorry turns up and it could be a little bit short. So, we are pleased that it's recognised as absolutely industry leading standard. If we look down into the US and we have had the various lockdowns. In terms of our businesses it's sort of up and down the East coast. The issues that we've had are not so much around the individual States and being a part of it, it's just been some of the customers.

Miles Roberts:

And we focus in the food and drink area, it's been very good for us, but as I said, in the transcript, a number of these customers operate in low temperature environment. And that seems to have caused a spike in the instance of COVID in their workforce. And once they get an outbreak, they're basically being forced to close. Now, we are seeing them coming back with increased hygiene standards, et cetera. We've seen quite an improvement coming back in June. So that's really been that issue rather than being exposed to any particular Southern States. In fact, in Texas, more than once we said, we don't have anything there.

Operator:

Thank you. We will now take our next question from Luigi Algisi from Wells Fargo. Please go ahead. Your line is open.

Luigi:

Good morning. Thanks for taking my question. To some extent you partially answered this in a previous reply, but I was wondering with regards to your strategy to reduce your long paper position, if it's something that we could see happening this fiscal year, or, you see that more likely later on? If you could just tell us a little bit more about the what's the ideal timeline and likely timeline for us.

Miles Roberts:

I mean, in terms of the actual paper assets, we certainly hope to get that completed as soon as possible. And certainly in this current year, we had hoped that it would be completed roundabout around about now, but it just has been that it just has been delayed. That's what we're looking for. Obviously, subject to on-going discussions.

Operator:

Thank you. There are no further questions in the queue at this time. I will turn the call back to the host.

Miles Roberts:

Well, thank you very much, everybody, for your time in today's presentation. As I said, we were pleased with the performance of last year. I think we're dealing with the COVID outbreak well, and we see some good medium-term opportunities for further growth and development of the group. Thank you very much.