

## **DS Smith Q3 IMS Conference Call Transcript**

### **Speaker key**

MR Miles Roberts  
AM Adrian Marsh  
BD Barry Dickson  
AL Alexander Mees  
DOB David O'Brien  
KS Kartik Swaminathan

OP Good morning, ladies and gentlemen, and welcome to the DS Smith Interim Management Statement conference call. I'm now handing you over to Miles Roberts to begin today's conference. Thank you.

MR Good morning, everybody, and thank you for joining us this morning. I'm Miles Roberts, the CEO of DS Smith, and I'm joined by Adrian Marsh, our CFO.

This morning we are very pleased to release our Q3 interim management statement. I'd like to take a few minutes to run through the highlights of that statement, after which Adrian and I would be very happy to take any questions you have.

In summary, the business has continued to perform well, fully in line with our plans, driven by growth across the Group, and on the ongoing delivery of the synergies from the SCA Packaging acquisition.

In terms of trading our like-for-like corrugated box volume growth has remained good, and ahead of our target of GDP plus 1%. In particular Germany and Central and Eastern Europe have been particularly strong. Our volume growth reflects our market share gains from a strengthened customer proposition, driven by the innovation and removing the complexity and costs from our customers' supply chain. The pass through of input cost rises to date, with the usual short-term lag has all been as expected. Return on sales and return on average capital employed continued to improve as the benefits of synergies flow and the growth.

As regards to the outlook, the markets do remain very challenging and very difficult, but our overall outlook remains positive. Volumes are growing, and the pass through of input costs remains ongoing, so the Board expects performance in line with our medium term financial targets, and views the remainder of the financial year with confidence.

We have a full year pre close update scheduled for 30 April, with our full year results issued on 26 June.

I'd now welcome any questions anybody may have. Thank you.

OP Our first question comes from the line of Barry Dickson, from Davy

BD Yes, good morning, gentlemen. Thanks for taking the call. Two questions for me, if you wouldn't mind, one, in terms of your margin progression is impressive, given the increase in recyclable container prices in the second half of last year, and clearly the lag that you've talked about. Could you maybe give us a sense as to what happened to your underlying margins if you exclude the impact of synergies, if that's possible?

A second question then on kraft; you made a comment at the capital markets day last September that you were buying a lot of your kraftliner from the US, and we've seen US craft liner export prices decline in recent months. Maybe talk a little bit about that, particularly in the context of the fact that most of the industry now appears to be going for a €50 a tonne price increase from 1 April of this year.

MR Yes, I'll deal with the second one first. Kraft... The issue for us is around the final consumer, as the price of paper goes up or down, it's really about the final consumer and their ability to pay higher prices, our ability to pass them on, reduce them, etc.

So, if we look at things like the price of paper, we really never know where it's going to go. We were hearing kraftliner 12 months ago everybody was saying it was going to go up; it came down. Today we hear people say it's going to go up. We really don't know, and I think a lot of it is affected by the end consumer, but just because you have inflation doesn't mean that the end consumer is going to pay for it. There is some talk, as I understand it, of kraft going up, and that may well indeed be the case, but where it goes over the medium term, we don't know.

In terms of where we source it, because we treat this as a pass through, we'll buy it from the most value adding source, and that's value in terms of quality and service as well as pricing, and indeed we do bring it in from the States, but we have long-term relationships, and those relationships, and the price in those, may or may not vary in line with any short term fluctuations in the price of paper.

Our strategy remains to reduce the paper content wherever possible. Kraft is still a very expensive product. We've had one of our largest customers say recently they don't want kraft in any of their products. They just don't want it, and they've asked us to keep that confidential, as the customer, but it is a huge customer; they don't want it. And that's what we're focused on, trying to give

our customer the products that they want, to delight the end customer. But you're right, Barry, there have been some announcements of some increases, and we just have to see where they go.

On the point on our margins, I think we've set out that we've bought a business from SCA, where the margins were quite a bit lower than where DS Smith has traditionally operated, and it's a question of how we bring those SCA margins up, and a large part of that was indeed the synergies, but I think if you go back and reconcile it all, you'll see, in our last published results, they actually progressed more than these synergies in terms of our ability to add value, but again, that's not a total surprise, because we're getting the volume growth. So I think the majority of it comes from the synergies; we are seeing that slight mix improvement that's benefiting the margin, and I think if you go back to the half year, and compare it to both businesses pre acquisition, you're going to see that margin would have progressed more than the synergies, the underlying basis, but there's no doubt the major part of it does come from the synergies.

BD Thank you.

OP The next question is from the line of Alexander Mees from JP Morgan.

AMees Thanks very much. Good morning, Miles and Adrian. A couple of questions from me, firstly, you are a pan European business, and clearly, a lot of your revenues nominated in euros. I wonder if you'll comment on the effect on your earnings with the translation of a stronger sterling here. Secondly, you commented on taking market share, which obviously has been going on for some time. Could you comment on from whom you're taking market share, please?

AM Do you want me to take the first one first? In terms of FX, Alex, you're right. In the half year we described a positive tailwind on FX, and where rates were at the half year, in spot terms, certainly in the euro, we said if that continues, and sterling doesn't weaken any further, then broadly speaking that tailwind will unwind, and that's pretty much exactly what we're expecting now, if you look at where rates are today, where they were at the half year, where they were at the year end, and if you do your own averaging, you'll see that it's pretty much exactly on line.

MR On the market share, I have to say we don't particularly look at any other competitor and say, oh, we're winning or losing; that's not how we look at it. We look at it against the whole market, but we are seeing a few trends.

Firstly, our customers are consolidating their supply chain, and they want to consolidate it, typically, across a number of regions, or, indeed, across all regions of Europe. So we're seeing a structural

shift from our customers to larger suppliers, and we clearly benefit from that, so in the first place you'll say it's coming from the smaller, more regional suppliers. That's, I think, a trend that's started, and I think it's going to continue, but beyond that I think it really is with our customers seeking to add value at every stage of their supply chain, and it does come down to the difference in companies that can add more value to our customers, through the service and the quality, throughout the whole supply cycle, and if competitors can't offer that then I think they're going to be in a weaker position, over the medium term. So we don't look at it on any one competitor; it's not of any particular interest to us. Who cares if we're going up or down relative to somebody? All that matters is how we are progressing in the market overall, but there is a structural shift on the consolidated supply chain, and certainly, the wider offering that we make continues to go down very well with our customers, and I'll say that's where it's coming from.

AMeesAs an add to that, if it is the smaller, the more regional suppliers that are losing share, do you think this hastens the consolidation of the market driven to M&A?

MR Yes, I think there's... I certainly expect, over the medium term, to see more consolidation. We're seeing bits and pieces, and I think that will continue, but if it's customer driven it's hard to resist, and we can see that with some competitors, particularly small ones, and we were talking to one; it's not a big competitor. He said the last thing I want to do is sell to a larger player when I've just lost so much business. Now, it's a very small company, but you can see that. How are you going to get it back? How are you going to get that back? Structurally they're out of the market. So I think it will drive consolidation, and certainly we know there's a lot of activity there.

AM Thank you very much.

OP The next question's from the line of David O'Brien from Goodbody.

DOB Hi, folks, just a couple from me, firstly, on the volume performance, and I suppose picking up on the strong performance in Germany, if we go back to the H1 stage, I think you pointed to some capacity additions in that market, and given that from trade articles it was suggested it's a pretty competitive environment at the moment, is there a suggestion that you yourself have to be a little bit more competitive on pricing in that market to generate such volume growth, relative to other markets, or can you give us an indication of what the pricing environment is like, and generally speaking, overall, could you quantify maybe where corrugated pricing is, year on year? Finally, on Ukraine, given your exposure, could you give us an idea of how that's performing, giving the political backdrop?

MR Yes, Germany... There is more capacity coming on stream, and I think we've touched on this briefly, and that's never welcome, because it is more capacity, and therefore it's increasing, moving

the supply curve. It is there. The capacity coming on in relation to the size of the market is not massive but it does cause some short-term issues.

Interestingly, a lot of that capacity is from some of the regional players, and what we're seeing is a lot of our growth is coming from the pan European. Having said that, it does cause some short-term issues, and we're seeing, in Germany, that pricing is competitive.

I have to say, it's competitive everywhere. Whilst there's more capacity, the German economy is not doing too badly, and the end consumer isn't doing too badly. In some other markets it doesn't matter what your cost base is, it's just extremely difficult for the end consumer to pay higher prices. So, with Germany it is a very competitive market. That's not unusual. There is more capacity. It isn't welcome, but in relation to the size of the market it's not massive. For us, recovery there is certainly not... It's coming through. We'd always want it to be faster, but it does continue to come through.

There's not a lot more I can say there, apart from we focus on those big, pan European customers, and the big suppliers who work across a number of regions generally aren't adding capacity there, so that gives us some confidence, but the overall end market, and I think this is the important thing; this is why we focus so much on the total cost of supply for our customers, because it's the end consumer who's suffering, and you can go with whatever reason you want about pricing, you've just got to add more value to our customers, and it's not good enough just to do it on the price of the box. You've got to be working throughout their whole supply cycle, but the end consumer is hurting, and will continue to hurt. We've always planned for this. That's what our whole business model's been around, working with our customers, because the end consumer is going to stay tight for a while.

In terms of Ukraine, again, in Ukraine we've seen the Hryvnia fall another 35% against the dollar. We do have a very sizeable business there. Our balance sheet, we have an investment and we carry the 10 million sterling. That was a very, very aggressive valuation some time ago. At this stage we're comfortable with that valuation. We don't think it's going to particularly affect our earnings, because a lot of its trade is in US dollars, but clearly it's unhelpful. You've got political turmoil there. Some of the roads are closed. You can't move around. You've got Crimea, which is basically cut off now. Crimea is quite a decent place; there's a lot of activity there. So I think it will have an effect on that business, but it won't affect us significantly, because our balance sheet and our earnings etc that come from there are very limited, and a lot of their business is in US dollars anyway, but clearly it's not helpful.

DOB Yes, that's great. Thanks.

- OP We have a question from Kartik Swaminathan, from Bank of America Merrill Lynch.
- KS Hi, everyone. Kartik Swaminathan from Bank of America Merrill Lynch. Thank you for taking my questions. I apologise, but I missed the earlier part of the call, so I am sorry if I'm revisiting topics that were already asked about.
- KS My first question is on corporate activity. Could you give us a bit of an update on how your upstream paper making operations are performing across the UK and the Continent, and whether there could be any further potential to slim that footprint down on a short to medium term horizon? Secondly, on box pricing, have you fully recovered the cost of inflation from testliner, which occurred over the past year? Thanks.
- MR We'll take the second one first. We haven't recovered it in full at the moment, because the last increase was coming through in
- MR Yes, end of November, December, so certainly, for this period to the end of January, it isn't fully recovered. There is more to go. It's broadly where we expect it to be. No great surprises there. But in terms of our paper business, we've been very clear what we want to do, and we are well on with that. We're well on with our programme to realign our paper capacity with our strategy, but the paper assets, broadly, operationally, are doing pretty well. You can talk about profitability, but it's such a moving feast as to where prices go, but operationally they're doing pretty well, in terms of all the different grades we're producing, the light weighting, the kraft substitutes, etc, operationally they're doing pretty well. Obviously their profits are higher than they were a year ago; there's no doubt about that, because the price of paper has gone up, but we are absolutely clear on our medium term strategy, and we're working towards that.
- KS Thank you, sorry, just a quick follow up on box pricing, when would be the next opportunity that you have to try to hike prices? And could you also remind us of the mix of timing on your contracts? Are they still skewed towards the six months to 12 months range, or has it been brought down now?
- MR In terms of the recovery we are... It's... We're still in that four... over four months range. We're not down to the three we still want to get it to, so we are four plus months, four and a bit at the moment. It's just all due to some of the indexation, how it works, etc, And that just occurs.

In terms of this price recovery, because a lot of these costs are just pass through for us, we have to pass them through, and if paper prices go up, and I think somebody earlier mentioned about kraft liner going up, if indeed that happens, and we use it, a lot of that comes back in the indexation. But I have to say, we do have to

recover these costs, but we do everything that we can to avoid it, to lightweight, to change the performance of the box, so that we can demonstrate how to add value to our end, to our customer, simply because the end consumer is finding the cost of living pretty hard to take, pretty much wherever you are in Europe.

So, if there were another increase, it would come on the back of further increase in paper prices. I don't know when they're going to happen. If kraft goes up and stays up then there'll be some recovery there. That's just over four months, at the moment, but we're doing everything we can to avoid that, and I think if any of our customers are on the call, they would be alarmed to hear anything else but that because that final consumer continues to be in some difficulty.

KS Thank you very much.

OP At the moment we have no further questions, so I'll hand back to your hosts.

MR Thank you for your time. Just in summary, the year's continued to fall in line with our expectations, despite those tough market conditions we've talked about. We continue to grow volume, because our customers are seeking to consolidate their supply base, but it is about offering the complete service, design and production, right through the whole supply cycle. That's what our customers are looking for, and that's why they are choosing DS Smith. Our recycled corrugated packaging offers our customers the opportunity to package their products in this most cost effective material that's fully recyclable, and as such, we continue to see opportunities for growth in the market, and we're confident of the prospects of the business.

Thank you very much for taking the time to dial in, and we look forward to speaking again soon. Thank you very much.